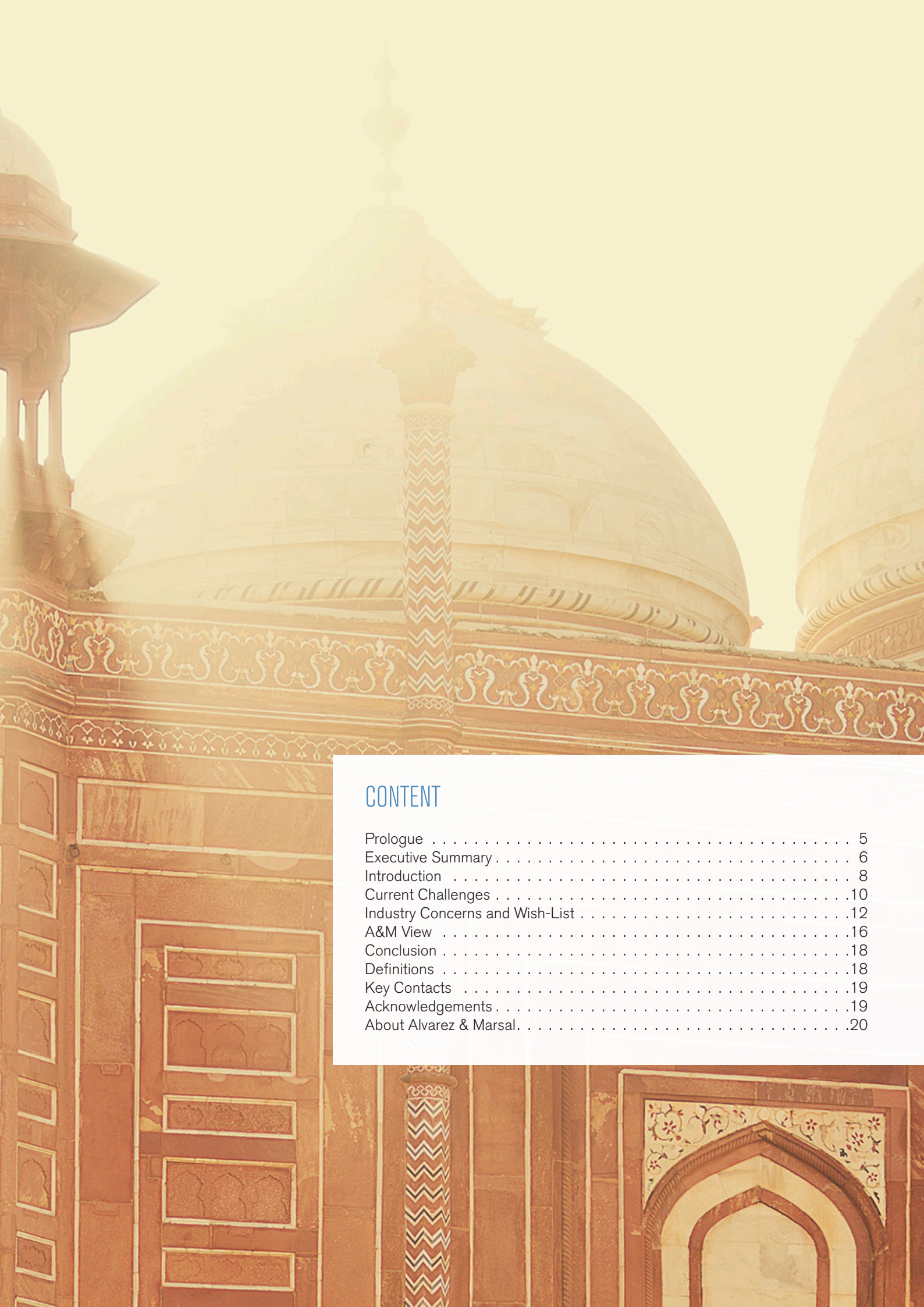


REVITALIZING STRESSED ASSETS IN INDIA:

INDUSTRY PRACTITIONERS' PERSPECTIVE







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This report is an outcome of extensive primary and secondary research on the Indian stressed asset market. During the course of the study, we interviewed 31 industry practitioners across 18 organizations including banks, special situation funds, asset reconstruction companies and law firms. We also conducted an anonymous survey to identify the practical challenges in the existing bankruptcy, insolvency and stressed asset resolution mechanisms to aggregate feedback on the proposed changes by the Bankruptcy Law Reform Committee (BLRC). We have also highlighted best practices from more efficient bankruptcy jurisdictions and suggested measures that are best suited for the Indian market.

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PROLOGUE

The market has voiced a growing need for the implementation of a unified insolvency code in India. The stressed asset scenario and the poor track record of asset revival clearly points to the need for such a framework. The World Bank uses insolvency resolution as a key parameter to establish the “Ease of Doing Business” in a particular country; India is ranked 130 out of 189 countries. Recognizing this issue, the Indian government formed the Bankruptcy Law Reform Committee (BLRC) with a view to strengthen the sections pertaining to bankruptcy and insolvency in the Companies Act, 2013 and to lay the foundation for a comprehensive Indian Insolvency Code. Through an extensively researched Interim Report released in February 2015 and a discussion forum of global and local experts, the BLRC has encouraged industry stakeholders to contribute to the process.

As a global leader in managing bankruptcy and crisis situations, Alvarez & Marsal (A&M) plays diverse roles across developed and emerging economies. Our professionals advise policy makers, borrowers and lenders on bankruptcy matters and serve in roles such as chief restructuring officer and company administrator, among others. Through this study, we offer a broader perspective from industry practitioners in India including lenders, law firms, asset reconstruction companies, investment banks and special situation investors.

The objective of this study is to cover three key areas pertaining to the bankruptcy landscape in India. The first is to identify practical challenges in the existing insolvency and stressed asset resolution mechanisms. Secondly, we endeavor to aggregate the views of industry practitioners on critical discussion areas. The final objective of this report is to highlight best practices from other jurisdictions to suggest measures that would best suit the Indian context.

We hope that this report will offer a different perspective and complement the committee's endeavors. Alvarez & Marsal remains committed to playing a proactive and constructive part in building a robust bankruptcy code and supporting the revival of stressed assets.

Sankar Krishnan
Managing Director and Co-Head
Alvarez & Marsal India



EXECUTIVE SUMMARY

Total stressed assets in the Indian banking system has multiplied by over five times since FY 2011 to \$133 billion in FY 2015. The average duration for insolvency resolution in India is at a high of 4.3 years compared to the South Asian region's average of 2.6 years. The World Bank's "Doing Business" ranking, which uses insolvency resolution as a key parameter, has placed India at 130 out of 189 countries. Recognizing these and other wide-ranging problems, the government of India constituted the Bankruptcy Law Reform Committee (BLRC) in 2014, which released an interim report in February 2015 to invite feedback from the industry. The BLRC had made comprehensive recommendations to strengthen the bankruptcy-related sections in the Companies Act, 2013. At A&M, we conducted interviews with industry practitioners with regard to challenges faced and BLRC recommendations to gain a holistic perspective of the bankruptcy and insolvency landscape currently in India.

40 percent of the industry practitioners surveyed rated execution difficulties as the biggest challenge with respect to revival of a stressed asset. Challenges in building consensus among creditors and lack of adequate legal rights / infrastructure followed closely on the list of impediments.

- 33 percent of respondents said that in practice, raising additional working capital is one of the biggest execution challenges during revival; replacing existing management and maintaining promoter cooperation are other issues.
- 40 percent of practitioners agreed that fear of vigilance action is a primary impediment in creating creditor consensus; other reasons cited were policy differences across banks and vacancies in senior leadership roles at certain banks.
- 33 percent of survey participants blamed insufficient bandwidth of the Debt Recovery Tribunal (DRT) and Debt Recovery Appellate Tribunal (DRAT) as a major legal gap. They also highlighted some of the laws that are detrimental to the revival of stressed assets.

While opinions differed between respondents on specific clauses, there was an indisputable support for the direction being set by the BLRC, both in terms of the legal provisions as well as infrastructure. In terms of initiation of rescue proceedings, nearly all respondents agreed that obtaining a decision within two months of the initial application to the National Company Law Tribunal (NCLT) is a "must have." The respondents unanimously welcomed the committee's recommendation on adopting the Company Administrator role similar to western countries and agreed that involvement of secured creditors in the appointment of the Company Administrator is of utmost importance. A significant majority of the practitioners were similarly of the view that the Company Administrator should have the power to take over management of the assets of the borrower suo moto. Most respondents also expressed the need to introduce a bench of the NCLT in every state that has a High Court.

A&M strongly believes that the recommendations made in the interim report of the BLRC would significantly strengthen the bankruptcy legislation in the country. In addition, we have also identified certain legislative provisions that would be relevant, practical and useful in the Indian context.

- *Accountability* to initiate the insolvency proceedings by filing the application with the bankruptcy court, if the company cannot meet its ongoing obligations (“wrongful trading”), should lie with the debtor company.
- *Obligation to demonstrate viability of a business* should lie with the debtor company and any related decisions must be taken in a time-bound manner to increase the utility of such information.
- *Bankruptcy Jurisdiction should be separate* within the framework of NCLT and only the bankruptcy court should have full jurisdiction over all the cases related to the debtor and should be empowered to dispose of all the matters.
- *Automatic interim moratorium* should be in place until the bankruptcy court decides on the application of the moratorium.
- The Company Administrator should be allowed to appoint an auctioneer or auction the assets by themselves to *incentivize buyers of the stressed assets*.
- The bankruptcy court should provide for *protection of rescue financing*. The debtor should have the ability to pledge unencumbered assets to raise rescue financing.
- Administration is an expensive process and there should be *clear guidelines* with respect to the priority of administrative fees.

We believe that the direction being set by the BLRC is unprecedented and a significant step in the right direction. If implemented as envisaged, the recommendations would considerably strengthen the insolvency framework in India and empower all stakeholders to pursue the course of action that preserves the most value under complex conditions.



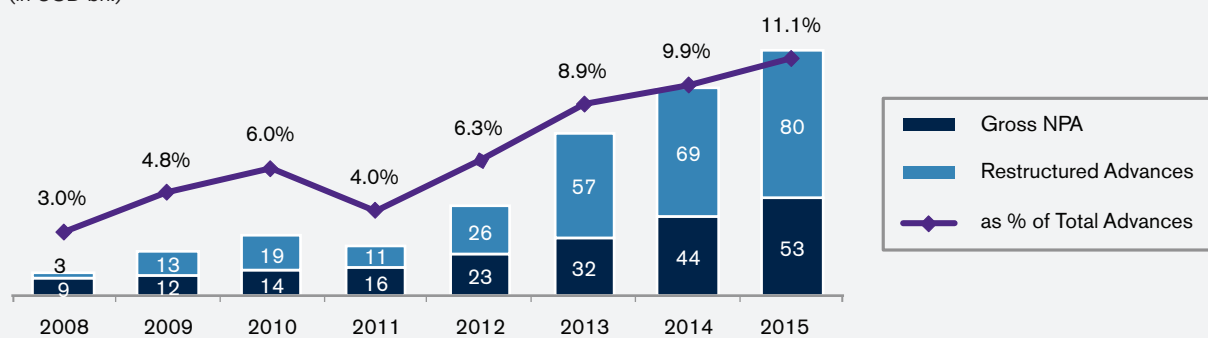
INTRODUCTION

With the Government of India's publicly stated goal of improving the country's position in the World Bank's "Doing Business" rankings, there has been a renewed focus on creating a unified Bankruptcy Code that simplifies how companies are restructured, liquidated or wound up. In order to address this urgent need, the Government of India had constituted the Bankruptcy Law Reform Committee (BLRC or the Committee) under the auspices of the Ministry of Finance in 2014. The mandate taken up by the Committee was to study the corporate bankruptcy legal framework in India, submit a report to the government for reforming the system and formulate an insolvency code for India. The Committee's task is a complex problem, given the current stressed asset and insolvency landscape in the country.

WORSENING STRESSED ASSET SITUATION

Stressed assets have been building in the Indian banking system as over half of all scheduled commercial banks (contributing to approximately 88 percent of advances) witnessed an increase in the stressed asset ratio in the first half of FY 2015. Total stressed assets grew from \$27 billion in FY 2011 to approximately \$133 billion in FY 2015, an increase of five times (Figure 1). During the same period, total advances grew by 1.8 times, pointing to significant asset quality deterioration at Indian banks.

Figure 1 - Stressed Advances of Scheduled Commercial Banks
(in USD bn.)



Source: RBI

HIGHER DURATION OF INSOLVENCY RESOLUTION

The average duration for insolvency resolution in India is 4.3 years, significantly higher than that of South Asia region (2.6 years) and that of Organisation for Economic Co-operation and Development (OECD) high-income countries (1.7 years). Indian insolvency outcomes typically result in a piecemeal sale rather than sale as a going concern, which is more common in developed economies. As per World Bank estimates, recovery rates in India (25.7 cents on the dollar) are also considerably lower than the South Asia average (36.2) and OECD average (71.9). India has been ranked 130 out of 189 in the World Bank's report "Doing Business," which puts India almost in the last quartile amongst comparable nations.

COMPLICATED INDIAN BANKRUPTCY LEGAL LANDSCAPE

There are a multitude of laws dealing with insolvency matters including the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA), the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDDBFI) and the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI). In addition, there are provisions to restructure loans through the Corporate Debt Restructuring (CDR) route or through the Joint Lenders Forum (JLF) route. The Reserve Bank of India (RBI) has taken a host of measures to improve the asset quality across the banking ecosystem and to eliminate some of the loopholes in the existing system. These measures include setting up the JLF guidelines, changing asset classification norms for restructured accounts, incentivizing greater recovery by asset reconstruction companies (ARCs) and most recently introducing the strategic debt restructuring (SDR) provisions. While these incremental improvements are important, there is a critical need to undertake a more comprehensive overhaul of the bankruptcy and insolvency laws in India.

In response to this wide-ranging problem, the BLRC had released an interim report, based on extensive research and consultation, in February 2015 to invite feedback from the industry. The BLRC made comprehensive recommendations to strengthen the bankruptcy-related sections in the Companies Act, 2013. These sections would serve as the base for the Insolvency Code that should come into effect at a later stage.

To play a constructive part in the process, A&M conducted interviews with industry practitioners to get a holistic perspective of the challenges faced by stakeholders involved in the bankruptcy and insolvency landscape in the current scenario. Insights were sought from practitioners covering a representative section of public, private and foreign banks, asset reconstruction companies, corporate law firms and special situation investors. An anonymous survey was also conducted to understand the industry's views on the interim recommendations of the BLRC and to aggregate industry feedback for the consideration of the Committee. We also identified certain legislative provisions that would be relevant and useful in the Indian context and would improve the likelihood of revival and recovery. The following sections summarize the findings of our study on building a robust bankruptcy and insolvency legislation and ecosystem based on our global bankruptcy expertise across all major jurisdictions.

CURRENT CHALLENGES

Industry practitioners named numerous execution difficulties as the biggest challenge with respect to revival of a stressed asset. Challenges in building consensus among creditors and lack of adequate legal rights / infrastructure followed closely in the list of impediments (Figure 2).

Figure 2 - Survey Response to “Select top three challenges in the current set up with respect to revival of stressed assets”

Weighted score, % of respondents

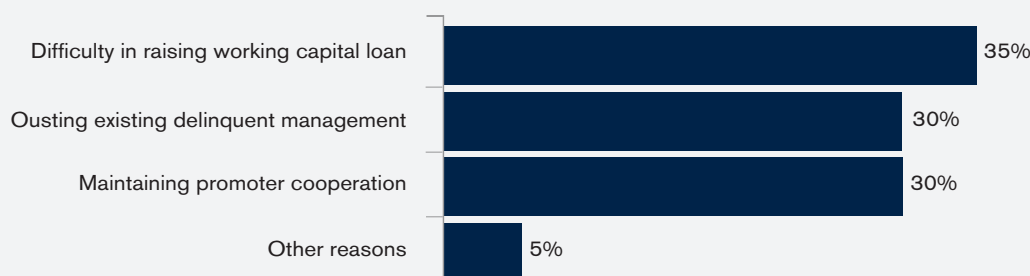


Source: A&M Survey, July 2015

There are already several avenues available to the secured lenders to pursue revival or recovery through CDR, JLF, DRT or by enforcing SARFAESI. In practice, execution challenges remain in critical areas such as raising additional working capital, replacing existing management and maintaining promoter cooperation (Figure 3). For revival, additional capital is almost always required and lenders are usually unwilling to put in additional capital at risk. Although SARFAESI gives secured lenders the legal right to replace ineffectual management, this is practically impossible to achieve (and sometimes not desired by lenders) as promoters tend to litigate and the long time taken for resolution in the current judicial system leads to severe degradation in value of the assets.

Figure 3 - 1 Execution difficulties during revival process are mainly:

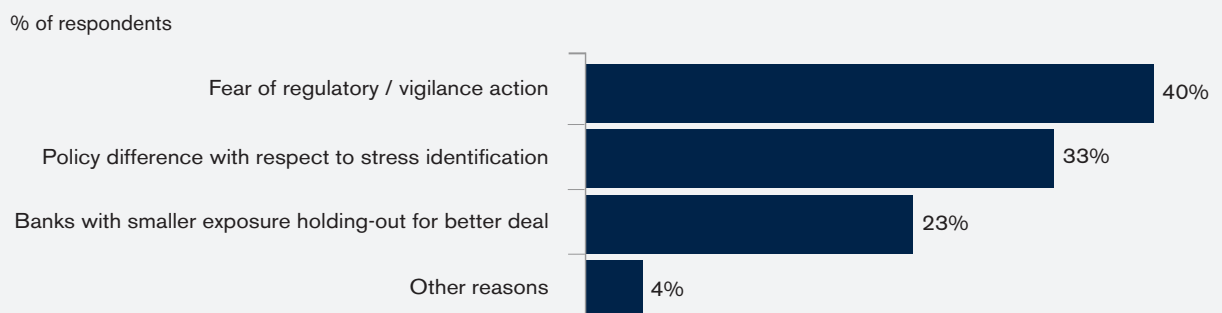
% of respondents



Source: A&M Survey, July 2015

Even when lenders follow the restructuring route through CDR or JLF, concerted action is difficult to achieve in practice. Further complicating the issue is that bilateral or consortium lenders tend to not work cohesively together to drive recoveries. Survey respondents say that bank executives are wary of such decisions as they may be construed as being soft on delinquent borrowers, thus potentially inviting regulatory or vigilance action. Banks also differ in terms of their approach and internal policies with respect to addressing stressed accounts. This is more visible when comparing public sector and private banks due to the differing set of constraints under which they operate (Figure 4). Long duration vacancies in senior leadership roles at certain banks was also a reason for delayed decision making, according to survey respondents.

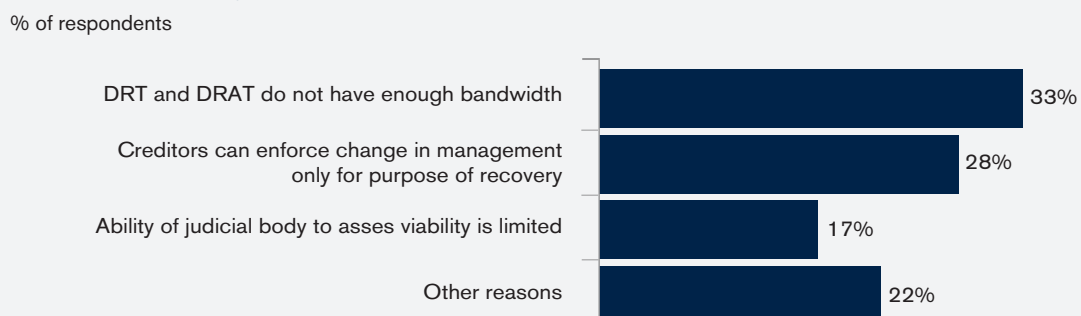
Figure 4 - 2 Difficulty in creating creditor consensus is due to:



Source: A&M Survey, July 2015

The legal challenges in revival or recovery are fairly well known. The DRT and DRAT simply do not have sufficient bandwidth to tackle the volume of applications being filed each year. Even with the six additional DRTs being set up, this problem is unlikely to be alleviated. Beyond the capacity constraint, industry respondents highlighted a capability mismatch as well. While Presiding Officers are highly qualified in the legal profession, their experience limits them from making quick and reasonable decisions on matters of insolvency and commercial viability (Figure 5). Besides the issues of the legal ecosystem, respondents also highlighted that some of the laws are detrimental to revival of stressed assets. A pertinent example is the SARFAESI provision of having to return possession of the asset post recovery.

Figure 5 - 3 Legal gaps are due to:



Source: A&M Survey, July 2015

INDUSTRY CONCERNS AND WISH-LIST

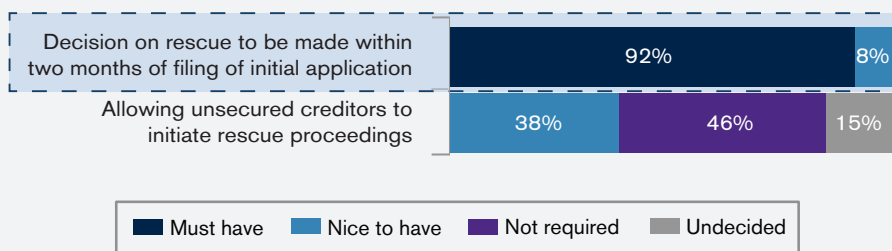
While opinions differed between respondents on specific clauses, there was an indisputable support for the direction being set by the Committee, both in terms of the legal provisions and the infrastructure. A&M's survey examined some of the key changes being proposed.

INITIATION OF REVIVAL PROCEEDINGS

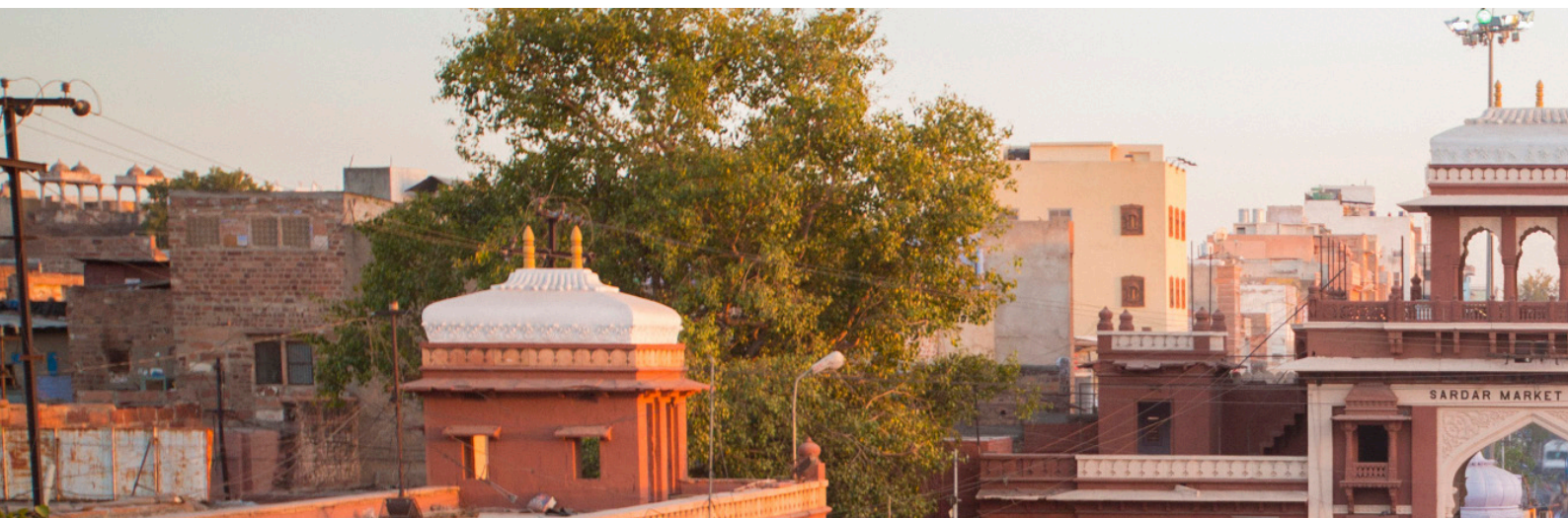
In terms of initiation of rescue proceedings, nearly all respondents agreed that obtaining a decision within two months of the initial application to the NCLT is a "Must have" (Figure 6). In the current situation, although such timelines are stipulated even for decisions by the DRT, they are not adhered to in practice. Achieving certainty and predictability around such key decision milestones would be critical to the success of any bankruptcy law.

Figure 6 - Responses to proposed BLRC changes pertaining to "initiation of revival proceedings"

% of respondents



Source: A&M Survey, July 2015

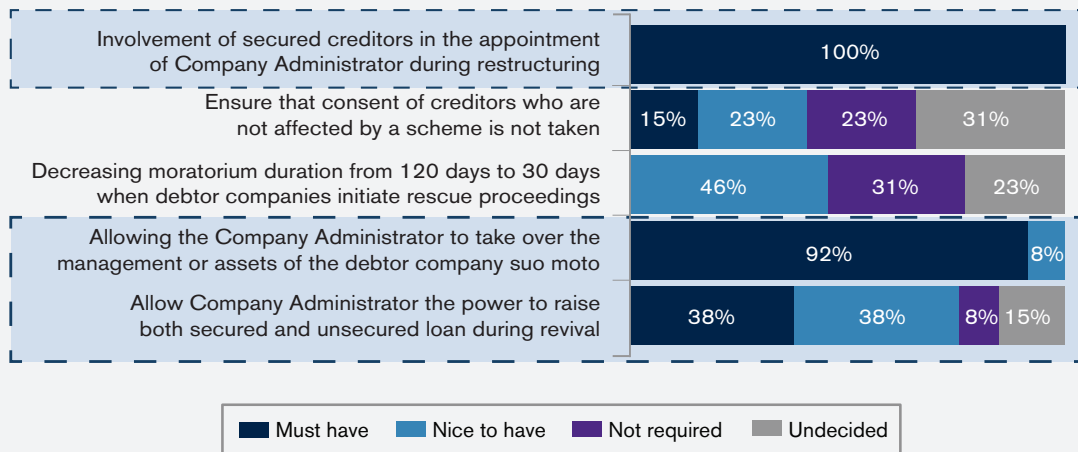


COMPANY ADMINISTRATOR

The respondents unanimously welcomed the Committee's recommendation on adopting the Company Administrator role similar to the practice of western countries. They also agreed on the importance of the role, and hence the involvement of secured creditors in the appointment of the Company Administrator was seen as a "Must have." A significant majority of the practitioners were similarly of the view that the Company Administrator should have the power to take over management of the assets of the borrower suo moto. They were however divided on giving them the right to raise secured or unsecured loans, given sensitivity around cash flow priority structures and the resultant impact on their claim on pledged assets (Figure 7).

Figure 7 - Responses to proposed BLRC changes pertaining to "Company Administrator"

% of respondents



Source: A&M Survey, July 2015

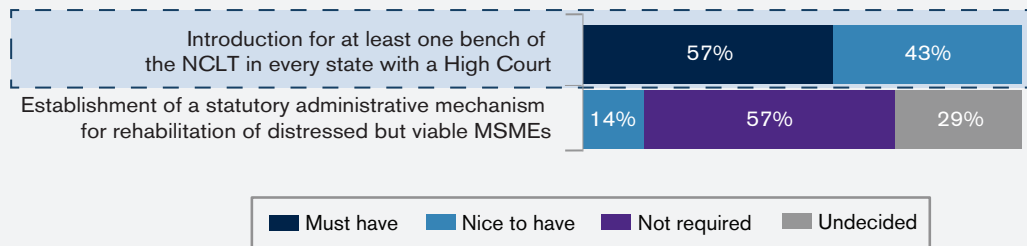


LEGAL INFRASTRUCTURE

Most respondents were of the view that it is necessary to introduce at least one bench of the NCLT in every state that has a High Court (Figure 8). It was highlighted that it was necessary to learn from the issues plaguing the DRTs and DRATs, both in terms of their bandwidth and capabilities of the competent authorities in these judicial bodies.

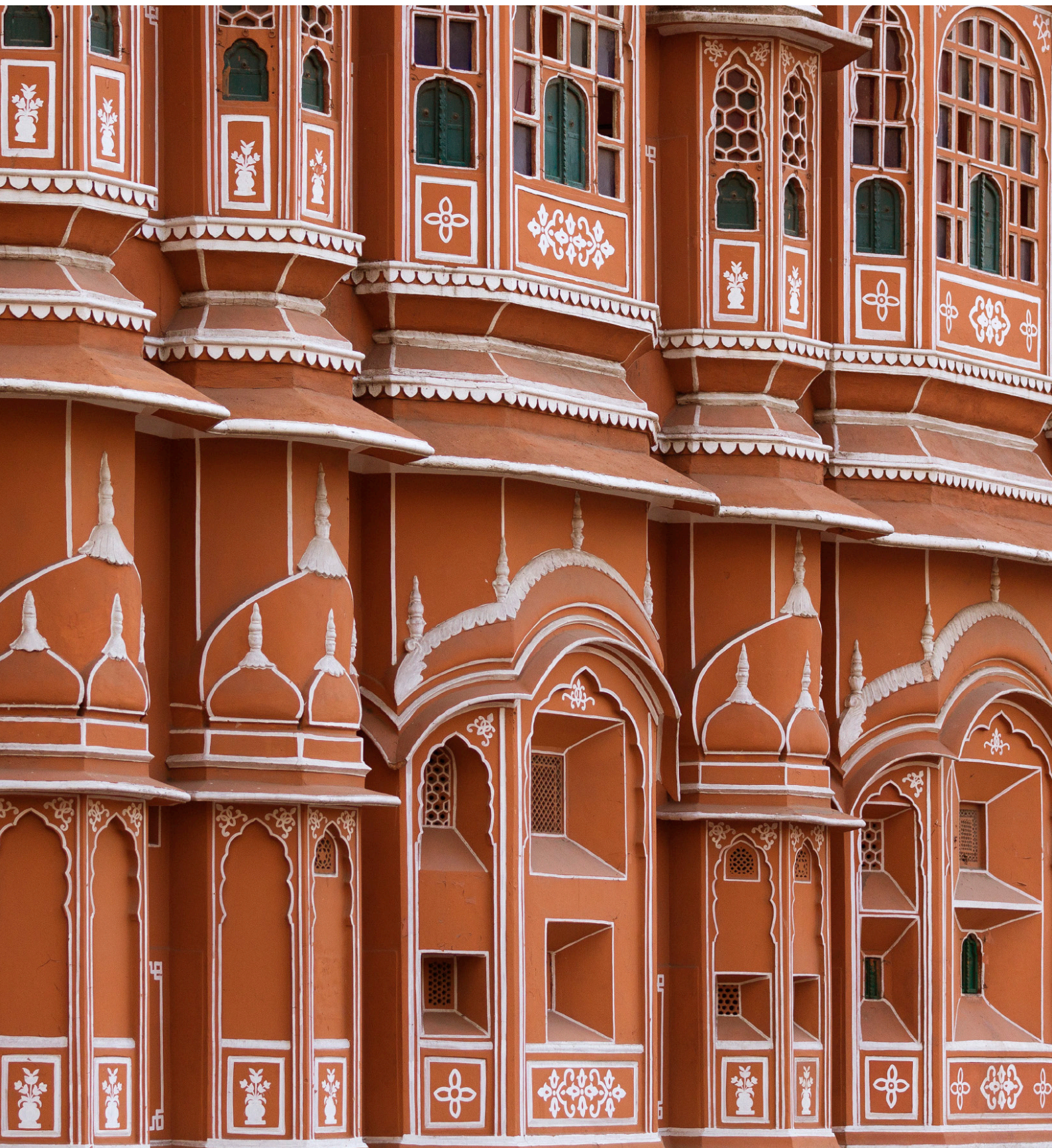
Figure 8 - Responses to proposed BLRC changes pertaining to “Legal infrastructure”

% of respondents



Source: A&M Survey, July 2015

There were a few common themes emerging from discussions with industry practitioners. First, the bankruptcy law and process need to create a reasonable fear of an unfavorable outcome for borrowers who try to “game” the system. Hence, action should be expedited against willful defaulters and perpetrators of fraud and penalties must be severe. Second, the clarity and predictability of bankruptcy proceedings need to be high, in terms of interpretation and enforcement of laws and guidelines, time taken to complete the process, jurisdiction of competent authorities and so on. Third, the success of the new process would hinge on the capability of people at various levels and significant effort would be needed to develop these skills across the spectrum. There is no scope to develop a “one size fits all” approach and authorities at every stage would need to make subjective decisions requiring assessment of alternatives while applying commercial considerations. Hence there is a critical need to create an ecosystem of qualified / certified agencies and authorities that can make commercial decisions and play the role of Company Administrator.



A&M VIEW

The recommendations made in the interim report of the BLRC would significantly strengthen the bankruptcy legislation in the country. With the right implementation and enforcement of such a law, it would enhance the position of lenders who have traditionally been in a weaker position, without being unfair to scrupulous borrowers. In addition to the recommendations already being discussed, this study also looked at practices adopted across the world that typically increase the probability of a better outcome in revival or recovery. The following sections highlight some of A&M's recommendations.

ACCOUNTABILITY

The debtor company should be required to initiate the insolvency proceedings by filing the application with the bankruptcy court, if the company cannot meet its ongoing obligations ("wrongful trading"). If the debtor fails to do so, necessary criminal / civil penalties should be applied to the debtor's directors and management, thus creating a strong incentive to act quickly when they realize a default is probable. This will force debtors to recognize the problem earlier, leading to preservation of value.

OBLIGATION TO DEMONSTRATE VIABILITY

- Within 60 days of initial application, the Company Administrator should present the viability plan which will lead to either a liquidation or a reorganization.
- The debtor should be mandated to disclose all the obligations — secured, unsecured, employee-related and statutory payments ("creditor obligations") within 30 days after initiation of the proceedings.
- The debtor should disclose monthly financial statements within 45 days from the end of the month.
- The debtor should submit a plan of reorganization within 180 days of initial application which can be extended with the consent of bankruptcy court.
- Approval of the plan should require:
 - Two-thirds majority of secured creditors by value and 50 percent by volume
 - More than 50 percent of unsecured creditors by value; in the case of non-agreement of an unsecured class of creditors, a "cram-down" provision should be available assuming the reorganization / revival plan is treating the class of creditors "fairly and equitably," following the absolute priority rule and prohibiting payment to the holders in a senior class more than the full value of their claims or interests.

BANKRUPTCY JURISDICTION

Within the framework of NCLT, there should be a separate bench for handling bankruptcy cases. Once the proceeding begins, only the bankruptcy court should have full jurisdiction over all the cases related to the debtor and should be empowered to dispose of all the matters. This provision is critical in the Indian context, given the history of multiple laws and overlapping jurisdictions. It will be necessary to subsume all existing laws into the new Insolvency Code.

MORATORIUM FOR DEBTORS

Automatic interim moratorium should be in place until the bankruptcy court decides on the application of the moratorium. A clear list of grounds should be laid down to guide the decisions of the bankruptcy court.

INCENTIVIZING BUYERS OF STRESSED ASSETS

The Company Administrator should be allowed to appoint an auctioneer or auction the assets by themselves (to be approved by bankruptcy court). Pre-bankruptcy, the debtor's assets should be transferred to the purchaser free and clear of all liens and claims. This would significantly increase interest from potential buyers and also reduce the valuation mismatch between buyers and sellers due to the reduced risk of unknown liabilities. In addition, no related party or employees of the debtor company should be allowed to participate in the auction process in order to prevent abuse of the process by deceitful borrowers.

PROTECTION OF RESCUE FINANCING

The bankruptcy court should provide for protection of rescue financing. The debtor should have the ability to pledge unencumbered assets to raise rescue financing. Any rescue financing should be approved by the bankruptcy court and may have a lien that has priority over secured creditors and a claim with superior priority to administrative expenses (including employee claims). During revival, the debtor has to meet all obligations relating to the operations of the business. Such measures would significantly incentivize new investors to fund the revival.



CONCLUSION

The direction being set by the BLRC is unprecedented and a significant step in the right direction. If implemented as envisaged, the recommendations would significantly strengthen the insolvency framework in India. It would empower all stakeholders to pursue the course of action that preserves the most value under complex conditions.

As the experiences of other countries have shown, there are no perfect laws and bankruptcy codes anywhere in the world. However, it is imperative to have a robust insolvency code and to keep improving it to suit the specific needs of the country and the existing business environment. The presence of a strong framework to deal with corporate insolvency and creditor and debtor protection is vital to unlock new avenues for funding and foster growth in credit markets. Thus the drafting of the Insolvency Code should not be seen as a one-time exercise but as a continuous work-in-progress to strengthen a critical area of the Indian economy.

DEFINITIONS

THE DIFFERENCE BETWEEN INSOLVENCY AND BANKRUPTCY

Many people mix up the terms “insolvency” and “bankruptcy,” assuming they mean the same thing. However, these two words, though similar, actually have different meanings. Simply speaking, insolvency is a financial state of being that is reached when one is unable to pay off one’s debts on time. Bankruptcy, on the other hand, is a legal process that serves the purpose of resolving the issue of insolvency.

INSOLVENCY

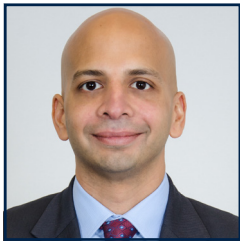
Insolvency is essentially the state of being that prompts one to file for bankruptcy. An entity – a person, family or company – becomes insolvent when it cannot pay its lenders back on time. In general, this occurs when the entity’s cash flow in falls below its cash flow out. For individual debtors, this means that their incomes are too low for them to pay off their debts. For companies, this means that the money flow into the business and its assets are less than its liabilities.

Typically, those who become insolvent will take certain steps toward a resolution. One of the most common solutions for insolvency is bankruptcy.

BANKRUPTCY

Bankruptcy is a legal declaration of one’s inability to pay off debts. When one files for bankruptcy, one agrees to pay off what is owed with help from the government. In general, there are two main forms of bankruptcy – reorganization and liquidation bankruptcy. Under reorganization bankruptcy (Chapter 11 under the U.S. Bankruptcy Code), debtors restructure their repayment plans so they are more easily met. Under liquidation bankruptcy (Chapter 7 under the U.S. Bankruptcy Code), debtors sell certain assets in order to make money they can use to pay off their creditors.

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ACKNOWLEDGEMENTS

This report was prepared by Nikhil Shah, Managing Director; Khushboo Vaish, Director; and Akshay Chandrasekhar, Manager with Alvarez & Marsal India.

The authors also thank all the participants for taking the time to complete our survey and share their perspectives in the interviews.



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