ASSET RECONSTRUCTION COMPANIES:

SMALL STEPS ON A LONG ROAD AHEAD
As a thought leader in the turnaround and restructuring sector in India, Alvarez & Marsal has been at the forefront of assisting borrowers, creditors and policy makers. This white paper is an outcome of primary and secondary study carried out on the Indian stressed asset market. Our findings are culled out from industry interviews, proprietary data, internal analysis and an anonymous survey conducted within the ARC community.

UNDER THE SCANNER

The asset reconstruction sector has garnered special attention from the Reserve Bank of India (“RBI”) in recent months. The reasons are fairly obvious. Total stressed assets in the Indian banking system have been growing at an exponential pace over the past few years. According to the latest figures available with Indian Banks’ Association (“IBA”), as of March 31, 2014, gross non-performing assets (“NPA”) in public and private banks stood at INR 2,635 billion and restructured advances pegged even higher at INR 3,906 billion. Total stressed assets grew by 297 percent between FY 2011 and 2014, whereas total advances grew only by 57 percent over the same period.

The performance of the Corporate Debt Restructuring (“CDR”) cell has not been particularly positive. As of June 30, 2014, of the 486 approved cases, only 15 percent have exited successfully, 27 percent have failed and the balance cases are still in the restructuring process. The sale of non-performing assets to Asset Reconstruction Companies (“ARCs”) has grown 3.6 times in the March quarter of FY 2013 - 14 over the previous quarter with the total outstanding security receipts (“SRs”) as of June 2014 of INR 420 billion. The outstanding SRs have been a cause of concern for the regulator apart from the deteriorating health of banks’ balance sheets.
RBI SHAPING THE INDUSTRY

On August 5, 2014, the RBI instituted certain amendments to the “Regulatory Framework for Securitization / Reconstruction Companies 2003,” with the aim of encouraging more objectivity and prudence in acquisition and treatment of stressed assets by ARCs. The regulator increased the minimum cash component of the acquisition price of a NPA by an ARC to 15 percent from the earlier 5 percent and provided more time to ARCs for due-diligence (not less than two weeks). It has reduced the planning period (period allotted to ARCs for formulating a reconstruction plan for an acquired NPA) from 12 months to 6 months and recommended a valuation of SRs be completed at the end of six months (previously twelve months). The RBI has also advised that the calculation of management fees for ARCs as percentage of the net asset value (“NAV”) must be at the lower end of the range of NAV conducted by a Credit Rating Agency (“CRA”), rather than on the gross outstanding value of SRs as was done earlier. Furthermore, the regulator has permitted membership of ARCs to Joint Lender Forum (JLF) and mandated certain disclosures for ARCs and compulsory reporting to the IBA.

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<th>KEY REGULATORY CHANGES BY RBI</th>
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| Increase in the cash component required for acquiring a NPA | 5 percent | 15 percent | • With ARCs having limited balance sheet strength, realistic pricing is likely to set in, reducing the overall acquisition price  
• Fewer “large” transactions due to cherry-picking of deals backed by ‘hard’ assets |
| Reduction in stipulated time to formulate a restructuring plan | 12 months | 6 months | • ARCs will be bound to take quicker action and formulate a restructuring plan that drives recoveries |
| Stricter basis for calculation of management fees | Outstanding value of security receipt | Lower end of net asset value as determined by a credit rating agency | • Management fee is likely to reduce for ARCs  
• ARCs will focus on driving recoveries in acquired assets |
ARC INDUSTRY OUTLOOK

A&M conducted detailed interviews with a majority of the active ARCs and also took an anonymous survey to outline trends and sentiments in the sector.

The RBI’s changes have been lauded by most of the ARCs and two-thirds of the participants believe that amendments are a step in the right direction towards reducing the stressed assets in the Indian banking system (refer figure 1). However, in the short term, over next six months, most of the ARCs feel that the sale of stressed assets would slow down and regain momentum in subsequent quarters. This was anticipated with the increased cash component of the acquisition price and additional disclosures regarding valuation of assets by ARCs. In the next six months, ARCs expect SBI and its associates and Central Bank of India to offload the maximum value of stressed assets in the market amongst the public sector banks. This will also rationalize pricing. During the past six months, the average acquisition value had been in the range of 60 to 80 percent of book value, which most of the respondents expect to decline over the next six months in the range of 40 to 60 percent of the book value (refer figure 2). The average cash component of the acquisition price by ARCs as percentage of total acquisition value has been in the range of 6 to 10 percent, which will now increase to greater than 15 percent. It is also expected that ARCs’ management fee which have been in the range of 1.5 to 2.5 percent of the gross acquisition price will now reduce with fees being tied to the performance of the ARC in terms of recoveries.

As per CRISIL, the credit rating agency, for the principal debt acquired until 2008, the recovery ratio (recovery ratio is the recovery as a percentage of principal debt acquired) as on December 2013 was 36 percent. Going forward in next 12 months, half of the participants expect the recovery ratio to lie in the range of 25 to 50 percent, whereas the other half was more optimistic, and believe that it would improve to 50 to 75 percent. However participants do not believe that the typical redemption period for security receipts would improve from the current estimate of 3 to 5 years.
In light of the new regulations, a majority of the ARCs plan to change their bidding strategy, with many stating that they, “will focus on lower vintage NPAs,” “will focus on stressed assets backed by plant, machinery and land,” “will focus on stressed assets where promoters are ‘supportive,’” “will focus on private sector banks so that they can undertake bilateral deals,” and “will focus on debt aggregation in accounts suited for restructuring.”

**Figure 1** - The RBI guidelines will decrease the stressed assets (as percentage of total assets) in the Indian banking system

**Percent of respondents**

- 16%
- 17%
- 50%
- 17%
- 16%

Source: All data is compiled as a result of A&M’s proprietary interview process within the ARC community

**Figure 2** - In the next six months, what do you expect the average acquisition value of stressed assets as percentage of book value?

**Percent of respondents**

- < 40% of BV
- 40 - 60% of BV
- 60 - 80% of BV
- 80 - 100% of BV
- >= 100% of BV

Source: All data is compiled as a result of A&M’s proprietary interview process within the ARC community
FUNDING CONTINUES TO BE THE BIGGEST CHALLENGE

As per the industry estimates, the current capitalization of all the ARCs put together adds up to around INR 30 billion. With the cash component increased to 15 percent, the net worth of ARCs would be sufficient to acquire only INR 200 billion of stressed assets. Assuming ARCs acquire the NPAs at 60 percent of book value, all the ARCs put together can garner INR 333 billion of NPAs. With Gross NPA and restructured advances totaling INR 6,541 billion, ARCs can acquire approximately only 5 percent of these assets from banks.

The ceiling on foreign investment in ARCs is now 74 percent, subject to the condition that no sponsor may hold more than 50 percent of the shareholding in ARCs either by way of FDI or through FII. Thus, although the sector is ripe for foreign investment, distressed asset funds have traditionally been wary of this market due to legal and regulatory issues. However, this scenario appears to be changing, with ARCs acknowledging the likelihood of foreign funds investing in the distressed asset market, directly or indirectly.

Recently, Asset Care and Reconstruction Enterprise (“ACRE”) sold a 49 percent stake to SSG Capital Management Pte. Ltd. (“SSG”), a Hong Kong based distressed and special situations hedge fund. The strategic investment by SSG will allow ACRE to tap its financial strength and also its expertise in the distressed asset sector. More than 90 percent of participating ARCs have either initiated talks with funds or are open to dialogue with such funds. Most ARCs agree that funds will invest in the equity of ARCs or in ARC trusts. Direct investment in equity of stressed assets is unlikely. A key challenge for ARCs is the ability to fund the working capital needs of stressed assets to enable a revival.

Distressed asset funds are increasingly seeing an opportunity here, but this option comes with a rider. To enable them to take high risk, funds require a cash flow priority, a clear first charge on assets and returns in excess of 25 percent. With a consortium of lenders who often act independently, bringing all the parties together and convincing them to agree to a plan will be a major challenge for a special situation fund.

“With the cash component increased to 15 percent, the net worth of ARCs would be sufficient to acquire only INR 200 billion of stressed assets, which is 5 percent of GNPA and restructured advances.”
Overall, the RBI’s amended guidelines have been hailed as a step in the right direction. All of the ARCs that we met during our research unanimously agreed that the move by regulators will rationalize recent trends in the industry and will benefit the various stakeholders in the stressed asset sector. Valuations will become more realistic, and ARCs will focus more on asset quality and less on AUM (asset under management) while building a portfolio. However, ARCs feel that regulatory clarity in certain areas would be beneficial.

For example, the RBI has permitted the sale of Special Mention Account 2 ("SMA-2"), where the principal and / or interest is overdue between 61 - 90 days, to ARCs and a few such deals have been concluded in the first half of 2014. However, ARCs are cautious about bidding for such accounts, due to the lack of clarity in the regulations. Since the rights under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act ("SARFAESI Act") are applicable only to NPAs and not to SMA-2 accounts, ARCs prefer to avoid ambiguity and rather bid for NPAs. Regulatory and legislative action would help resolve this issue and incentivize quicker action to tackle stressed assets before they become NPAs.

Furthermore, there is scope for better alignment of incentives to drive recoveries and redemption of SRs. This is necessary to ensure true transfer of risk from the banks’ balance sheet to that of an ARC. Our research indicates that the industry is already moving in this direction. For instance, banks are reportedly exploring compensation models with a greater weight on recoveries. Under such a model, the management fee could successively step down by around 0.25 - 0.50 percent each year. Additionally, there would be an incremental success fee component (also stepping down annually) for SRs redeemed within one to two years of the asset sale to the ARCs. Coupled with the periodic revaluation of the NAV of SRs by rating agencies, such a compensation model would greatly incentivize quicker recovery by ARCs.

Even in a scenario where assets are auctioned, banks need to take a holistic view. Thus far, our research suggests that banks have not been placing much emphasis on the credit rating or redemption history of an ARC during a transaction, but rather focusing on the bid price by the ARC. If banks seek to maximize the probability of higher recovery, they must favor ARCs which have a better credit rating and redemption track record. Overall, the sector would greatly benefit from structures and practices that reward strong recovery practices and assertive steps toward redemption. A majority of our survey respondents also agree that the RBI’s guidelines could lower competition for deals, as the capital requirements would preclude some of the ARCs having lower capital bases.
RIGHT TIME TO GEAR UP FOR RECONSTRUCTION AND REVIVAL

Recovery by ‘one-time settlement with promoter’ came out as the most preferred mode for recovery by ARCs, followed closely by ‘sale of assets’ and ‘financial restructuring only’. ‘Financial and operational restructuring’ and ‘sale to distress asset fund’ were the trailing choices for ARCs. This is understandable, as the ability of ARCs to change management under current guidelines is restricted with limited upside.

**Figure 3 - What will be your recovery strategy? (Chose multiple options)**

Percent of respondents

- Recovery by one-time settlement with promoter: 83%
- Recovery by sale of assets: 67%
- Recovery of financial restructuring only: 67%
- Recovery by financial and operational restructuring: 50%
- Recovery by sale to a stress / distress asset fund: 50%

Source: All data is compiled as a result of A&M’s proprietary interview process within the ARC community

From the RBI’s perspective, it will take a while to achieve the objective of transferring risk off the banks’ books. However, as long as the risk still partially resides with the bank, it is yet possible to improve the chance of revival and recovery. The regulator definitely has a role to play, by clarifying provisions granting ARCs the right to unilaterally enforce changes within defaulting companies, especially non-cooperative ones. Even in situations where the existing management is cooperative, quick and decisive actions are critical to enabling a revival. This will mean greater coordination among lenders in a consortium, more information sharing and the willingness to accept cash flow structures that would attract distressed asset investors. ARCs too will need to place greater emphasis on revival and strengthen capabilities around reconstruction.
CONCLUSION

While the picture regarding the Indian stressed asset market is often painted to look grim, the time is ripe to take decisive action. All the stakeholders have evolved and understand the steps needed to improve it. Revival of the stressed assets is possible if the stakeholders’ incentives are aligned, there is regulatory certainty and the system is supportive. With further clarity around regulations and collaborative action, the system can be strengthened to support revivals sooner rather than later which would benefit all stakeholders.

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