

India Financial Sector

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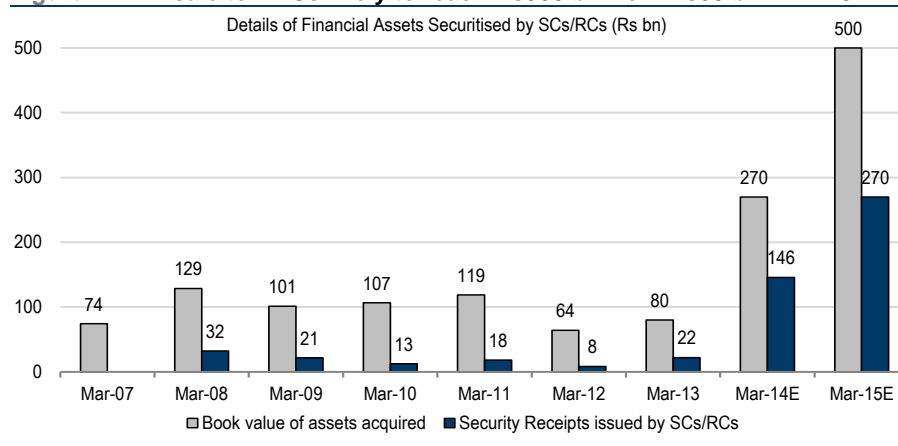
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SECTOR REVIEW

Distressed asset recovery: A reality check

Figure 1: NPL sale to ARCs likely to reach Rs500 bn from Rs80 bn in FY13



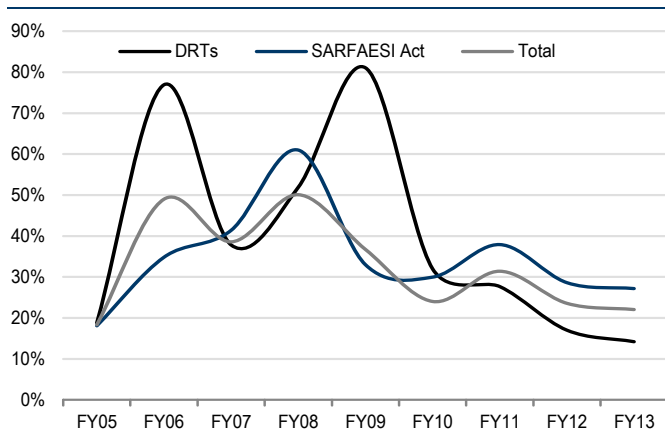
Source: RBI, Credit Suisse estimates

- Promoter-backed recovery still preferred.** The key takeaway, from our India Distress Debt trip held last week, was the continued reliance on promoter-backed resolution for stressed corporate assets by the banking system. Our interactions with banks, asset reconstruction companies, RBI and rating agencies confirmed that given the poor track records (20-30% recovery rates) of options like Lok Adalat, Debt Recovery Tribunals and SARFASEI, debt restructuring is preferred. Even for assets sales, primarily promoter-led sell-offs (US\$8-10 bn over the past year) have been successful.
- ARC's transactions are hinged on management fee.** In FY14, NPL sales to ARCs have jumped to Rs270 bn from Rs80 bn in FY13, and will likely double further in FY15. However, these are being done primarily without the transfer of risk as banks continue to hold over 90% of the security receipts (SRs). ARCs have also raised acquisition price to 60%+ of book value, compared with ~25% of book historically. With ARCs earnings 1.5-2% fee on the AUM, they have been willing to incur the 5-10% initial cash outflow on the inflated asset value.
- Reality check on true SR value 12-24 months later.** As the SRs get revalued based on ratings from the 2nd year of issuance, the true value of these holdings will reflect in bank financials with a lag. The inflated value of SRs may also result in banks giving away a large share of recovery proceeds to the ARCs in management fees. Therefore, while reported Gross NPAs may moderate for the banks in coming quarters on account of NPL sales to ARCs (many PSUs have sold 5-33% of Gross NPAs), for a true measure of impaired assets, investors will need to aggregate GNPA+restrd assets+ SRs.

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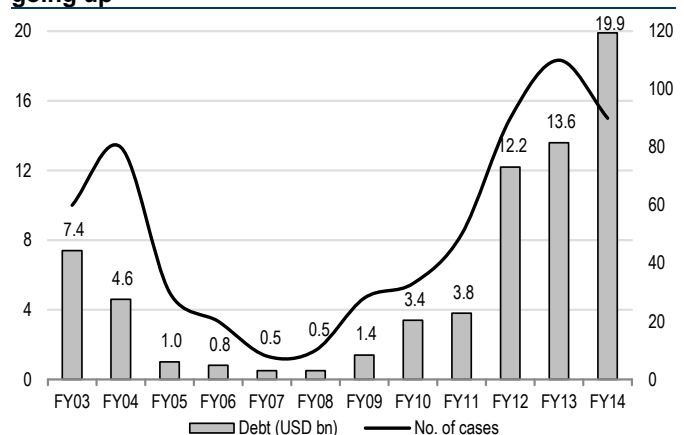
Focus charts

Figure 2: Recovery rate of traditional methods below par



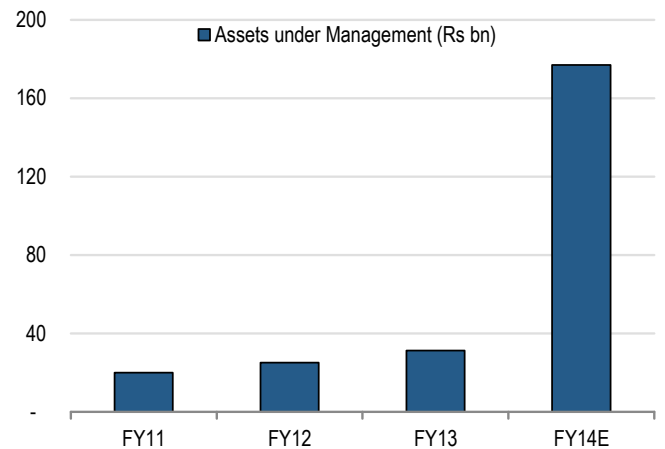
Source: RBI

Figure 3: CDR preferred though provisioning requirement going up



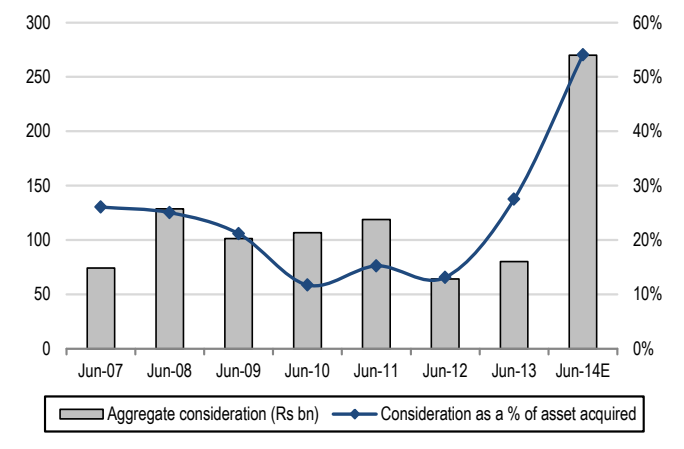
Source: CDR Cell

Figure 4: AUM of ARC have jumped on SR-based deals



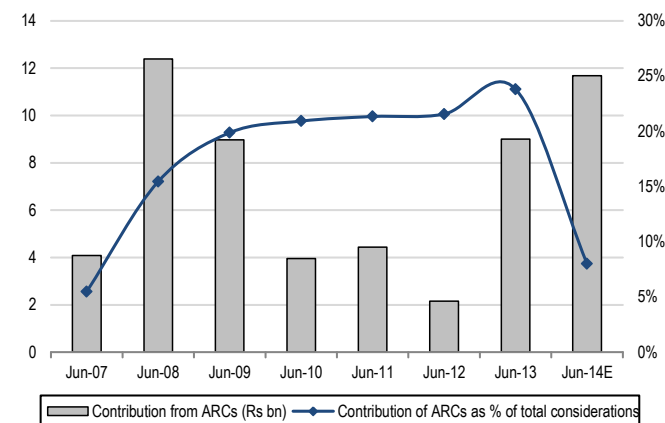
Source: Company data, Credit Suisse estimates, Edelweiss+Phoenix+JM ARC

Figure 5: Discount to book value has narrowed sharply



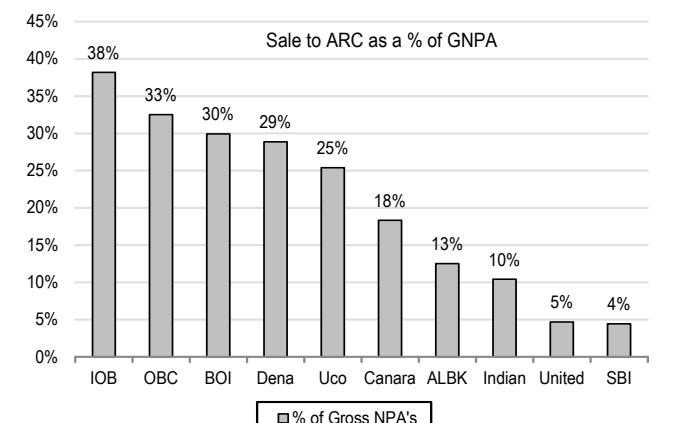
Source: RBI, Credit Suisse estimates

Figure 6: Cash component has gone down to ~8-9% on more SR-based transactions



Source: RBI, Credit Suisse estimates

Figure 7: NPA sold to ARCs at 5-40% of reported GNPA's



Source: Company data, Credit Suisse

Distressed asset recovery: A reality check

Promoter-backed recovery still preferred

The key takeaway from our India Distress Debt trip held last week was the continued reliance on promoter-backed resolution for stressed corporate assets by the banking system. Recovery track record for promoter-backed resolution has been better, and without their support, decay in asset value has been rapid. Our interactions with banks, asset reconstruction companies, RBI and rating agencies confirmed that given the poor track records (20-30% recovery rates) of options like Lok Adalat, Debt Recovery Tribunals, and SARFASEI, debt restructuring is preferred. CDR has been a preferred route with industry experts estimating referrals to remain close to record level of ~Rs1,000 bn even in FY15. Even for assets sales, primarily promoter-led sell-offs (US\$8-10 bn over the past year) have been successful.

ARC's transactions hinged on management fee

In FY14, NPL sales to ARCs have jumped to Rs270 bn from Rs80 bn in FY13 and will likely double further in FY15. However, these are being done primarily without the transfer of risk as banks continue to hold over 90% of the security receipts (SRs). ARCs have also raised acquisition price to 60%+ of book value, compared with ~25% of book historically for cash-based transactions. With ARCs earnings 1.5-2% fee on the AUM, they have been willing to incur the 5-10% initial cash outflow on the inflated asset value. The share of cash as transaction value has also come down to 8-9% vs ~25% a few years back.

Regulatory changes have also helped ARCs become more meaningful. RBI has allowed the sale of sub-standard accounts to ARCs vs earlier NPAs for more than two years. Further, one time dispensation allows amortisation of losses on the sale of NPL to ARCs by banks over a period of two years for sale done before FY15. As newer NPAs are being sold with lower provisions, banks have been keen to sell at a higher nominal value.

Reality check on true value 12-24 months hence

As the SRs get revalued based on ratings from the second year of issuance, the true value of these holdings will reflect in bank financials with a lag. Inflated value of SRs may also result in banks giving away a large share of recovery proceeds to the ARCs in management fees. Therefore, while reported Gross NPAs may moderate for the banks in coming quarters on account of NPL sales to ARCs (many PSUs have sold 20-40% of Gross NPAs), for a true measure of impaired assets, investors will need to aggregate GNPA+restrd assets+SRs.

Many PSU banks have sold NPAs equivalent to 5-33% of their gross NPA during the year during FY14, thus reporting sharp reduction in reported NPAs. However, this has not resulted in any transfer of risk or incremental provisioning on the part of the bank. Among PSU banks, BOI, ALBK and UCO have been the most aggressive in selling NPAs, while most other banks are also planning to accelerate sale to ARCs. Instead of the resolution of stress in the system upfront, deferring the required provisions would result in further risk building into the system and will continue to weigh on the valuations. Remain UNDERWEIGHT on India Financials. Top sells are SBI, BOI and Union Bank.

Valuation table

Figure 8: Valuation summary

Pvt Sector	CS Rating	Current Price (In \$ bn)	Mkt cap	BVPS (Rs)		P/B (x)		P / Adj B (x)		EPS (Rs)		EPS growth (%)		P/E (x)		ROE (%)		P/PPoP (x)	
				Rs	FY14E	FY15E	FY14E	FY15E	FY14E	FY15E	FY14E	FY15E	FY14E	FY15E	FY14E	FY15E	FY14E	FY15E	FY14E
Axis	O	1,528	11.9	803	924	1.9	1.7	2.0	1.7	131	151	13	16	11.7	10.1	17.4	17.5	7.2	6.0
HDFC Bank	O	716	28.5	184	219	3.9	3.3	3.9	3.3	36	45	26	25	19.9	15.9	21.3	22.3	12.1	9.6
ICICI	N	1,262	24.2	634	700	2.0	1.8	2.1	1.9	85	94	18	11	14.9	13.4	14.0	14.1	10.5	8.9
Kotak Mahindra	U	808	10.3	236	274	3.4	2.9	3.4	2.9	34	39	14	16	24.1	20.7	15.2	15.3	13.0	11.5
Yes Bank	U	451	2.7	197	259	2.3	1.7	2.3	1.8	45	46	23	3	10.1	9.7	24.9	21.4	7.4	6.1
J&K Bank	O	1,760	1.4	1,199	1,398	1.5	1.3	1.5	1.3	251	259	15	3	7.0	6.8	22.8	20.0	4.6	4.0
IndusInd	U	486	4.2	163	190	3.0	2.6	3.0	2.6	26	32	23	22	18.4	15.1	17.3	18.2	11.1	8.9
ING Vysya	O	549	1.7	375	414	1.5	1.3	1.5	1.3	42	48	4	14	13.1	11.5	12.4	12.1	9.3	7.2
Public Sector																			
Bank of Baroda	O	817	5.8	799	885	1.0	0.9	1.3	1.1	104	115	(3)	11	7.9	7.1	13.5	13.7	4.2	3.5
Bank of India	U	237	2.5	405	424	0.6	0.6	0.8	0.7	49	52	4	7	4.8	4.5	12.4	12.6	1.9	1.6
PNB	N	786	4.7	949	1,051	0.8	0.7	1.2	1.1	122	138	(11)	13	6.4	5.7	11.1	13.8	2.7	2.3
SBI	N	2,065	25.6	1,806	2,120	1.1	1.0	1.5	1.3	142	183	(21)	29	14.6	11.3	10.3	11.7	5.4	4.1
Union Bank	U	155	1.6	274	276	0.6	0.6	0.8	0.7	27	35	(28)	30	5.7	4.4	10.1	12.7	2.0	1.6
IOB	U	55	1.1	121	146	0.5	0.4	0.8	0.8	6	13	(8)	136	9.8	4.1	7.1	10.6	1.9	1.5
Non-bank fin																			
HDFC	O	887	23.0	177	197	5.0	4.5	5.0	4.5	35	42	10	19	25.1	21.1	20.9	22.5	18.3	15.2
IDFC	O	114	2.9	100	107	1.1	1.1	1.1	1.1	13	12	11	(11)	8.5	9.6	14.2	11.5	5.6	6.1
Shriram Transport	O	747	2.8	384	453	1.9	1.6	2.0	1.7	69	79	7	15	10.8	9.4	19.6	19.0	5.0	4.4
M&M Finance	N	249	2.3	93	108	2.7	2.3	3.0	2.5	17	21	(4)	25	15.0	12.0	3.2	3.2		
LIC Housing Finance	O	267	2.2	153	174	1.7	1.5	1.8	1.6	24	27	15	10	11.1	10.0	16.9	16.2		
L&T Finance	N	68	1.9	36	41	1.9	1.7	2.1	1.8	4.6	5.4	7	19	14.8	12.4	9.4	11.0	8.2	6.9
Core Business																			
ICICI	N	1,026	19.6	535	604	1.9	1.7	2.0	1.8	71	80	10	14	14.5	12.8	14.1	14.1	7.9	7.0
HDFC	O	505	13.1	122	141	4.1	3.6	4.1	3.6	31	36	16	16	16.4	14.1	26.6	27.1	10.5	8.7

Source: The BLOOMBERG PROFESSIONAL service TM, Credit Suisse estimates

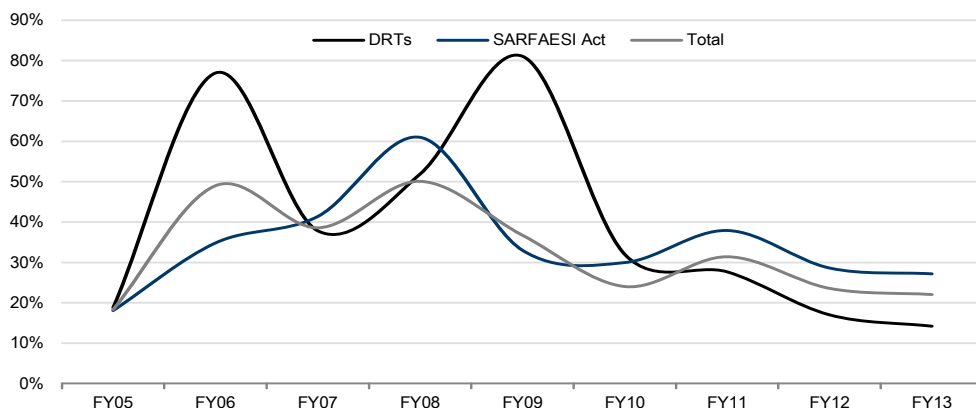
Promoter-backed recovery preferred

The key takeaway from our India Distress Debt trip held last week was the continued reliance on promoter-backed resolutions for stressed corporate assets by the banking system. Recovery track record for promoter-backed resolutions has been better, and without their support, decay in asset value has been rapid. Our interactions with banks, asset reconstruction companies, RBI and rating agencies confirmed that given the poor track records (20-30% recovery rates) of options like Lok Adalat, Debt Recovery Tribunals, and SARFASEI, debt restructuring is preferred. CDR has been a preferred route with industry experts estimating referrals to remain close to record level of ~Rs1,000 bn even in FY15. Even for assets sales, primarily promoter-led sell-offs (US\$8-10 bn over the past year) have been successful.

Recovery record for other mechanisms has not been encouraging

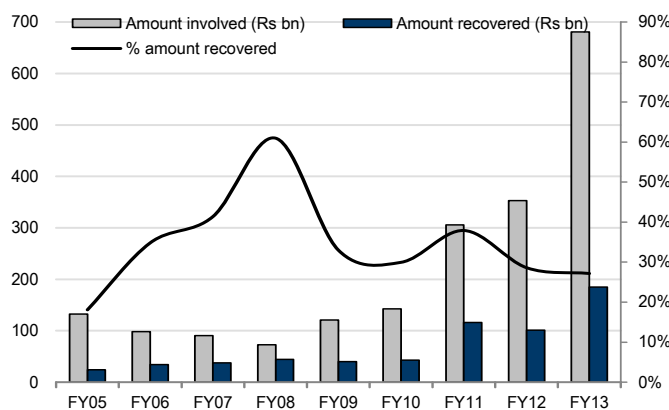
Banks have had an increased number of options to deal with problem assets, either through Lok Adalat, DRT or SARFESI, though the CDR has been the most preferred route for resolution by the banks. Recovery rates have been relatively low and falling through the SARFESI and DRT routes. While CDR referrals have picked up sharply in the past few years (US\$20 bn in FY14), new regulations have incrementally made the CDR process more stringent, and further, this route will no longer be available from April 2015.

Figure 9: Recovery rates have been low and on the decline



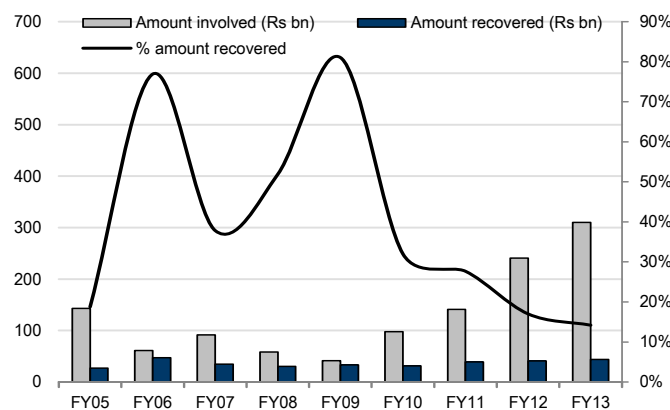
Source: RBI

Figure 10: Pick-up in SARFESI route, avg recoveries ~31%



Source: RBI

Figure 11: DRT route has seen weak recoveries at ~28%

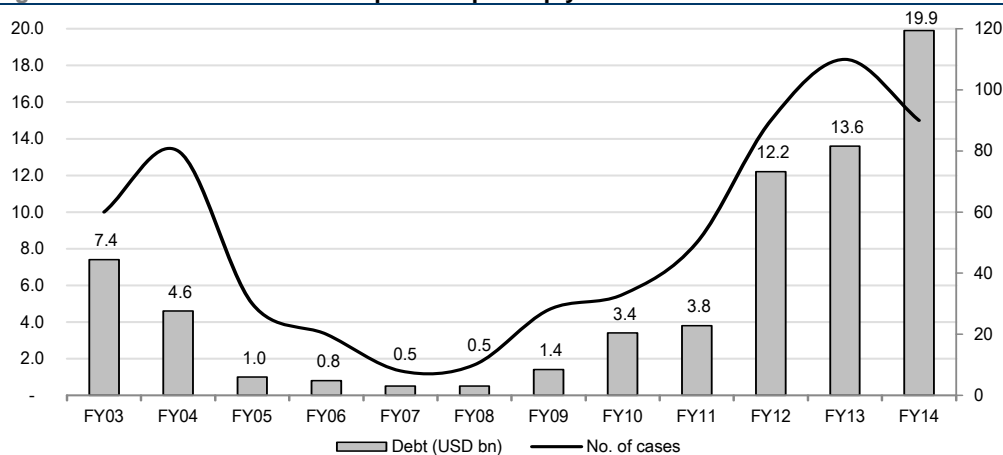


Source: RBI

CDR restructuring still the most preferred route for banks

CDR has been a preferred route with referrals of ~US\$20 bn in FY14. While the number of cases referred in FY14 dropped, the value of referrals went up on account of larger corporates being referred (Lanco Infra, ABG Shipyard, Era Infra, Gujarat NRE, etc.).

Figure 12: Referrals to CDR have picked up sharply

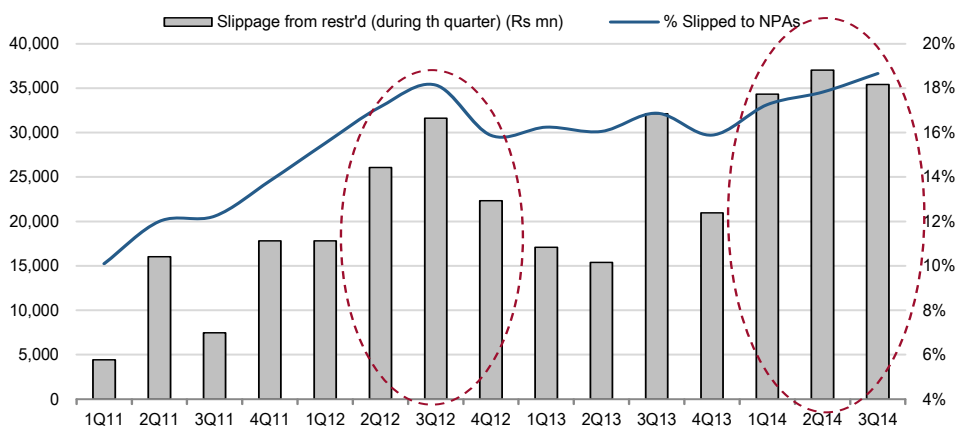


Source: CDR Cell

Slippages from restructured assets have been rising

After high level of restructuring now for the past 8-12 quarters, slippages from restructured portfolios are again picking up. Typically, slippages from restructured assets pick up with a lag of 4-8 quarters, especially as the moratorium period gets over. In recent cases of restructuring, banks have been willing to provide longer interest moratorium periods to delay problem recognition. However, as a large number of cases with payment moratorium start re-payment in the next few quarters, the likelihood of slippages picking up further remains high.

Figure 13: Slippages from restr'd loans have picked up again

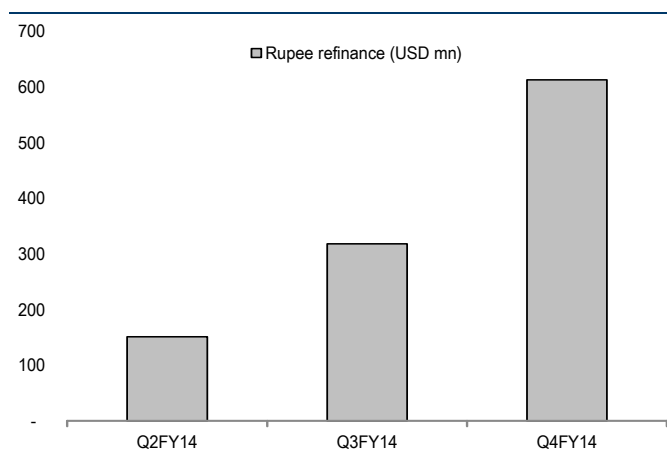


Source: Company data, Credit Suisse estimates, * for our coverage PSU banks

Banks were guaranteeing ECBs to refinance loans

Over the past year, Indian banks also increasingly used guarantees for external commercial borrowings (ECBs) of corporates for refinancing their rupee loans exposure rather than restructuring these. As per RBI data, this had picked up to US\$1.75 bn (up 87% YoY) in FY14 for borrowers with aggregate debt of over US\$30 bn. Many of these ECB refinances have been supported by Indian banks (both PSU and private), providing guarantees/standby letter of credit (SBLCs). Recent transactions include ECBs of Essar Steel, Bhushan Steel, Lanco Infra and ABG Shipyard. RBI has now clamped down on this, with it recently disallowing banks to issue such structures and move their credit exposure off balance sheet. This route will also therefore be no longer available to the banks.

Figure 14: Increasing use of ECBs to refinance rupee debt



Source: Company data, Credit Suisse

Figure 15: List of recent ECB raises to refinance rupee debt

Company Name	Date of issuance	ECB for refinance (\$ mn)
Bhushan Steel	May-13	100
DIAL (GMR Infra)	Jul-13	108
Bhushan Power & Steel	Oct-13	115
Jet Airways (India)	Jan-14	150
Uttam Galva	May-13 & Jun-13	230
Wardha Power (KSK Energy)	May-13	250
Essar Steel	Mar, Jun, Sep & Oct-13	216
Lanco Infratech	Mar-14	450
Essar Oil	Mar, Nov & Dec-13	465

Source: RBI

Asset sales have picked-up

Lenders have also been pushing the overleveraged corporates to undertake asset sales to reduce debt. Over the past 18 months, asset sales of US\$8-10 bn are estimated to have been undertaken by these overleveraged corporates and groups. CRISIL believes that these asset sales have been a key positive and expects corporate stress to bottom, aided by the success of these efforts.

Notably, all bankers on the trip indicated that even for the asset sales, they preferred the process to be driven by the promoter. In their experience, hostile /foreclosed asset sales are difficult to push through and delays in the process lead to rapid decay in the net realisable value of these assets. ARCs also indicated that for their **cash-based bids for assets, they primarily peg the valuation to just the land value of assets.**

Figure 16: Asset sales worth US\$8-10 bn important in the de-leveraging of corporates

Company	Asset	Description	Status	Newsflow date	Consideration (Rs mn)
DLF	NTC Mill	17 acres of mill land at Worli	Sold	Aug-12	27,000
	Aman Resorts	Luxury hotel chain (25 properties around the world)	Sold	Feb-14	22,500
	Wind Power	150 MW in Gujarat	Sold	Jan-13	2,823
	Wind Power	34 MW in Tamil Nadu	Sold	Apr-13	1,887
	Wind Power	33 MW in Rajasthan	Sold	Apr-13	522
Jaiprakash	Cement plant	5 MT plant in Gujarat	Sold	Sep-13	38,000
	Cement plant	74% stake in cement JV	Sold	Mar-14	6,900
	Land	300 acres of land in Noida	Sold	May-13	15,000
	Power Plant	300 MW and 1091 MW hydro electric plants	Sold	Mar-14	103,200
GMR	Energy	Sell 70% stake in GMR Energy (Singapore)	Sold	Mar-13	26,500
	Mining	Sale of 50% stake in Tshedza Mining Resource (Pty) Ltd	Sold	Mar-13	6,000
	Airport	Sold 40% stake in Istanbul Airport	Sold	Dec-13	19,000
	Road project	Sale of 74% stake in highway in Tamil Nadu	Sold	Mar-13	2,220
	Road project	Sale of 74% stake in highway in Andhra Pradesh	Sold	Mar-13	2,060
IVRCL	Road project	Salem – Kumarapalayam, road project in Tamil Nadu.	Sold	Apr-13	
	Road project	Kumarapalayam – Chengapalli, road project in Tamil Nadu.	Sold	Apr-13	22,000
	Road project	Chengapalli – Walayar, road project in Tamil Nadu.	Sold	Apr-13	
	Land	Land parcel in Noida (128 acres)	Sold	Jan-13	3,000
Lanco Infra	Power Plants	Sold its 70MW Lanco Budhil hydropower project and two plants of 5MW each in Himachal Pradesh	Sold	Feb-14	6,550
Videocon	Gas block	Sold 10% stake in a Mozambique gas block to ONGC and Oil India.	Sold	Jun-13	170,000
Adani Port & SEZ	Abbott Point	Sold its Abbott point terminal in Australia to the promoter family. (Adani group)	Sold	Jan-13	Undisclosed
Tata Power	Coal mining	Sale of PT Arutmin Indonesia to Indonesia's Bakrie Group	Sold	Feb-14	30,000
	Power	30% stake in its Indonesian sub, PT Mitratama Perkasa	Sold	Feb-14	7,200
Hotel Leelaventure	Chennai, IT Park	Sold its IT park building in Chennai to RIL	Agreement	Feb-13	1,702

Source: Company data, Credit Suisse estimates

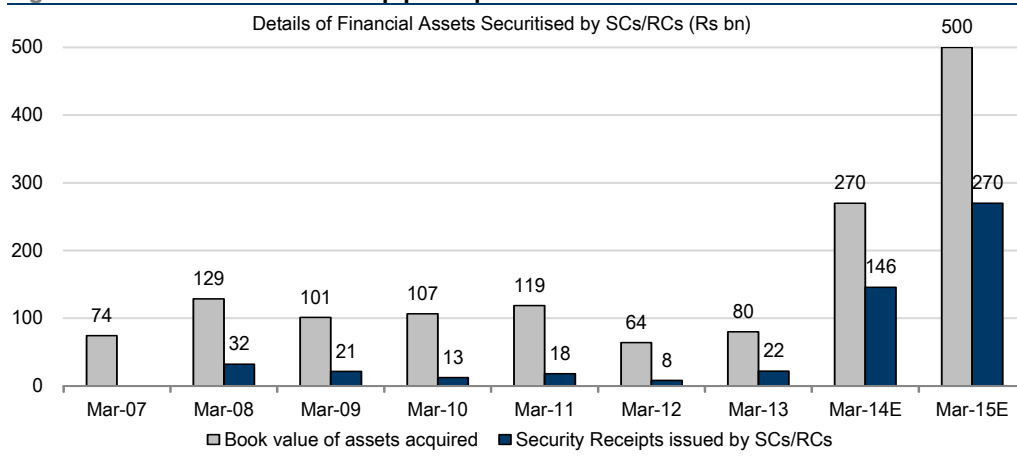
Sales to ARCs accelerating

The increasing provisioning requirement on restructured loans and constraints on capital pushing the banks to clean up their balance sheet are leading to banks increasingly selling NPLs to asset reconstruction companies.

Sales to ARCs up over 3x in FY14

In FY14, NPL sales to ARCs have jumped to Rs270 bn from Rs80 bn in FY13 and will likely double further in FY15 as the ARCs attempt to aggregate debt of the borrowers whose loans they acquired in FY14. Notably, over 90% of the NPL sales to ARCs are from the state-owned banks. For the industry, 95% of SRs issued are for corporate accounts and the rest for retail.

Figure 17: There has been a sharp pick-up in asset sales to ARC's



Source: RBI, Credit Suisse estimates

Regulatory push driving the pick-up

While, the asset reconstruction companies have been present in India for close to 15 years, their activity was relatively limited. The banks had also not actively used this route as the recovery track record from the previous cycle for the larger ARCs was not encouraging. However, the following factors have led to the pick-up in NPL sales:

- (1) the push by the finance ministry to PSU banks to reduce their reported NPA levels,
- (2) RBI also favouring banks to transfer bad debt to ARCs to facilitate earlier resolution,
- (3) Basel III migration putting pressure on banks to free capital,
- (4) increasing popularity of SR-based transactions based on the 5:95 rule and
- (5) regulations getting more stringent for the CDR mechanism.

Regulators facilitating transfer of assets to ARCs

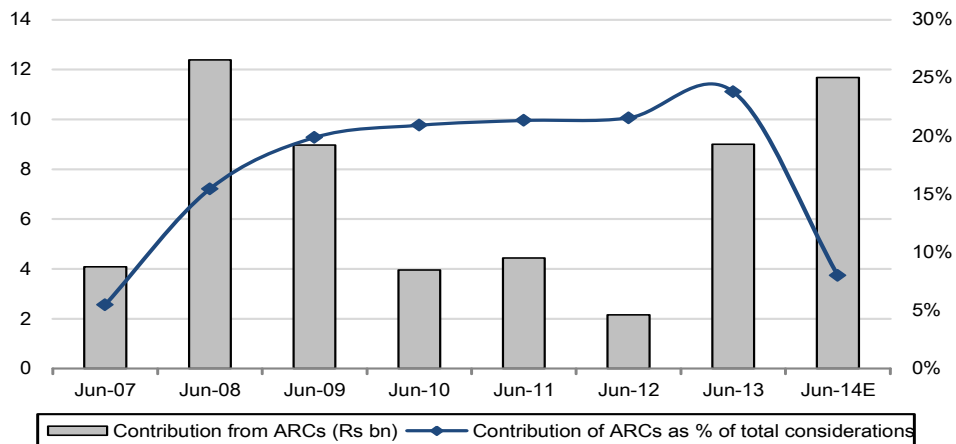
Over the past few months, regulatory changes by RBI have also helped ARCs to become more meaningful players.

- RBI allowed the banks to sell sub-standard accounts to ARCs as well, against earlier ruling of not allowing sale before two years of ageing of NPA. Further, in recent guidelines, RBI has allowed the sale of SMA2 accounts to ARCs as well.
- ARCs not to be used as a price discovery mechanism. Banks will have to disclose a reserve price, and it would be binding for banks to sell if the bid is higher than reserve price.
- One-time dispensation allowing amortisation of losses on the sale of NPL to ARCs by banks over a period of two years for sale done before FY15.
- Increase in FII/FDI limits to 74% for the sector with further increase to 100% under consideration.
- Allow 25% of money raised from the QIBs to be raised for the purpose of providing working capital/interim financing to stressed companies.
- RBI allowing gains on the sale of NPLs to ARCs to be booked through P&L. Though it is still uncertain if the banks can book gains on “recovery” on SR-based transactions or only in case of cash recovery, these could be booked as gains.

Limited transfer of risk in SR based transactions

While the sales of problem assets to ARCs have picked up sharply in the last year, the sales have primarily been on SR basis. As banks continue to hold over 90% of the security receipts (SRs), there is limited transfer of risk. As per RBI guidelines, the minimum cash component in the transaction is set at 5%. Most of the recent transactions have been on this 5:95 formula, with limited cash outflow for the ARCs.

Figure 18: Cash component has dropped to ~8% of transaction value



Source: RBI, Credit Suisse estimates

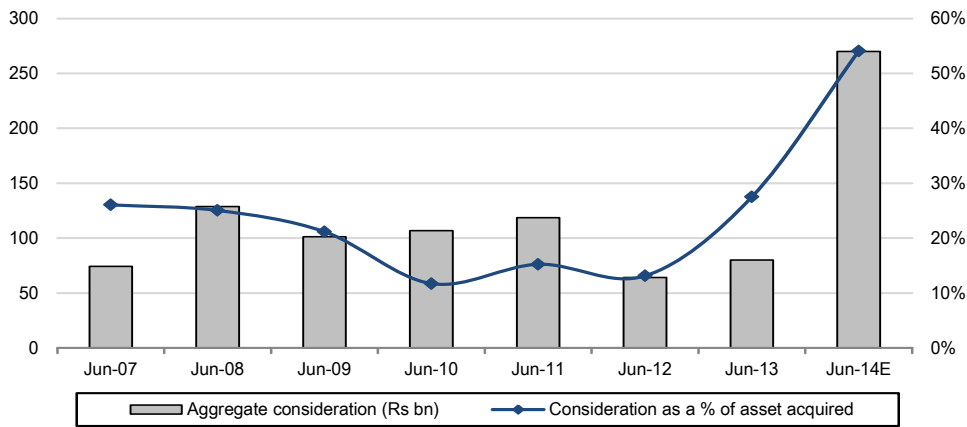
Historically, SR-based recovery has been lower than recoveries, when assets were purchased by ARCs on a cash basis.

Discount on asset values has contracted

Historically, ARCs have acquired assets at ~25% of book value; however, over past 12 months, average acquisition price has risen sharply to ~55-60% of the principal value, with most of the transactions happening on SR basis. Accordingly, the share of cash contribution by ARCs in transactions came down to ~8-9% vs historical average of ~25%.

Average recovery period has been 3-4 years, depending on the complexity of the account. Most of the NPAs being sold are from a doubtful category, with couple of years of ageing. However, with change in RBI regulations, increasingly banks are looking to sell NPAs from sub-standard category. Further, ticket size of NPLs being sold has also been moving up.

Figure 19: Consideration as a % of BV jumped on SR-based transactions

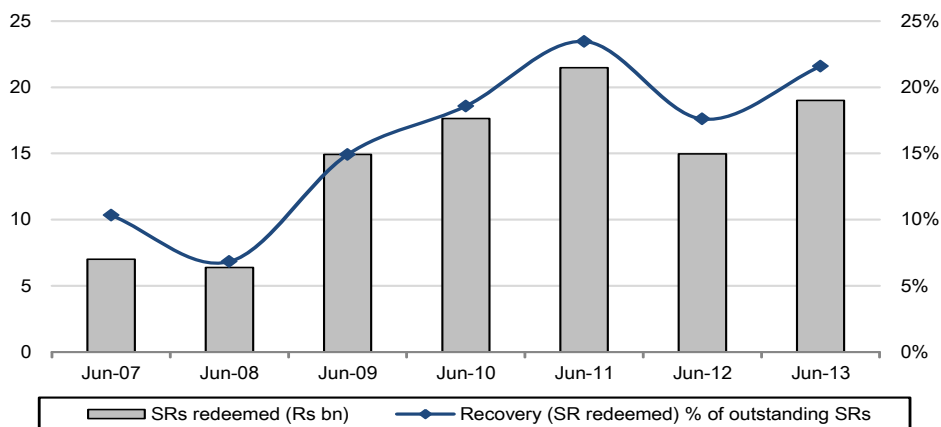


Source: RBI, Credit Suisse estimates

Recovery experience of cash-based deals is better

After initial experience with ARCs, banks started asking for higher cash component in NPL sales as reflected in an increase in cash contribution from ~5% in FY07 to ~25% in FY11. This resulted in larger discount on asset values and overall volume of transaction for the industry coming down as well. However, the recoveries trend improved as well, driven by transactions at deeper discount and increased share of cash. Both the trends have started reversing sharply from FY14 onwards, as banks are willing to accept a higher share of SRs in a transaction.

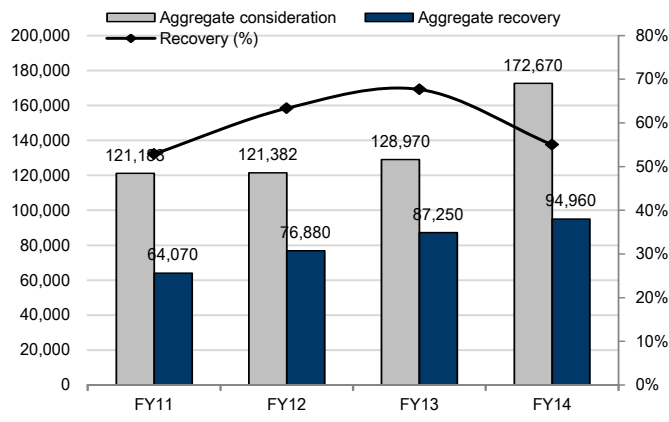
Figure 20: Trend in recoveries improved post FY08 on increase in share of cash in transactions



Source: RBI, Credit Suisse estimates

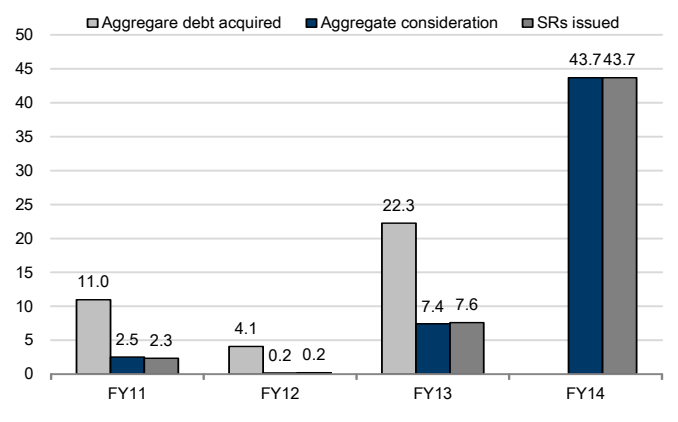
ARCIL, the largest ARC, has also been one of the most active in the auctions along with Edelweiss and JM ARC. It has witnessed a sharp jump in SRs issued in FY14 to Rs44 bn vs Rs7.8 bn in FY14.

Figure 21: Acquisitions have picked up, recovery slows



Source: Company data, Credit Suisse

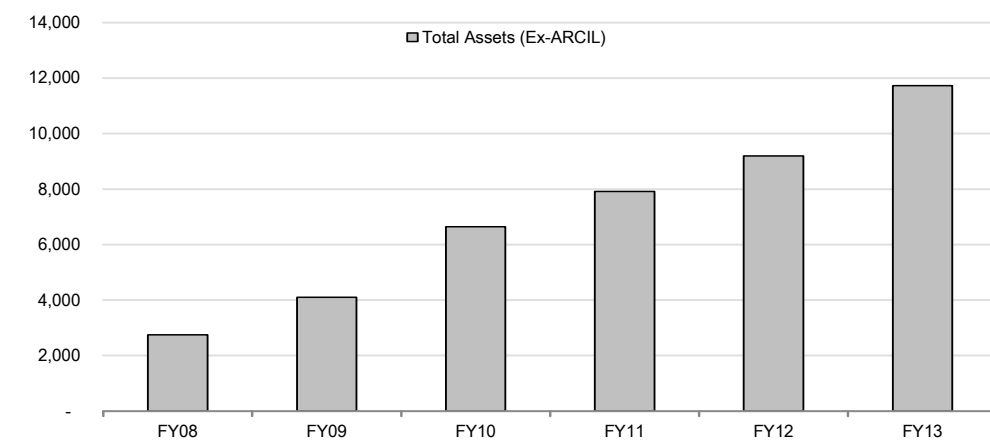
Figure 22: Sharp increase in SRs issued



Source: Company data, Credit Suisse

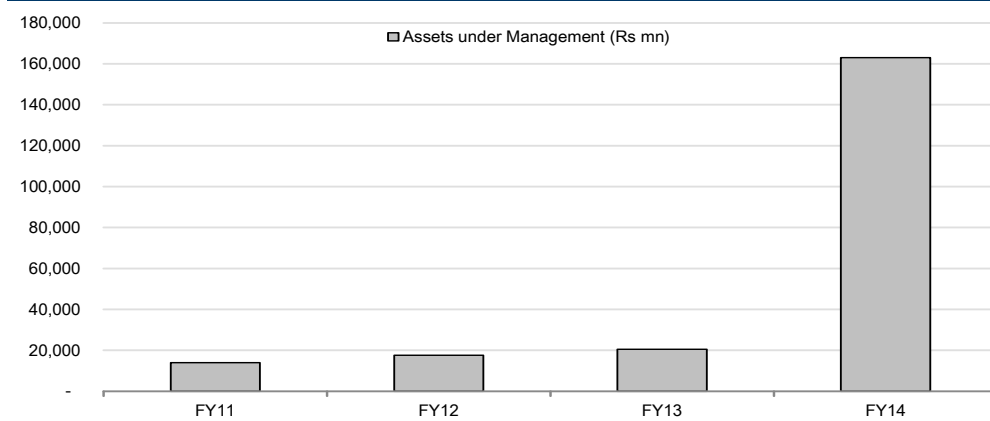
AUM for key industry players have increased manifold in FY15. Edelweiss ARC has increased its AUM from Rs5bn to Rs90bn, largely on the 5:95 to 10:90 route, with average cash payments of ~8%.

Figure 23: Total balance sheet size for ARCs has increased over 4x over last 5 years



Source: Company data, Credit Suisse

Figure 24: AUM has picked up sharply in FY14



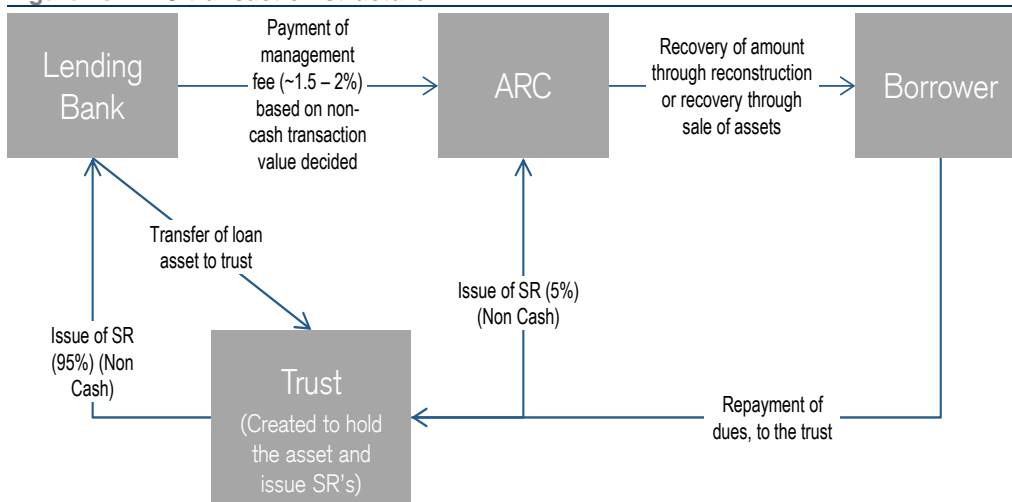
Source: Company data, Credit Suisse estimates *combined for ARCIL, Edelweiss & Phoenix

Current transactions focused on management fees

ARCs now appear to be increasingly working on a management fee model. Acquisition price has also increased to 60%+ of book value, compared with ~25% of book historically for cash-based transactions, as most of the deals are happening on a SR basis. With ARCs earning 1.5-2% fee on the AUM, they have been willing to incur the 5% initial cash outflow on the inflated asset value. Therefore, the share of cash-based transactions has dropped as ARCs are willing to purchase at the higher price on SR basis, resulting in higher AUM fees against actual cash outflow of only 5-10% of AUM.

ARCs are increasingly working on a management fee model, with limited purchases on a cash basis. ARCs, in their role as fund managers, earn a fee based on the value of the asset purchased (i.e. their AUM). Typically, the fee earned is in the range of 1.5-2%, which is sufficient to compensate for the initial investment of 5% and generates healthy returns as well.

Figure 25: ARC transaction structure



Source: Company data, Credit Suisse estimates

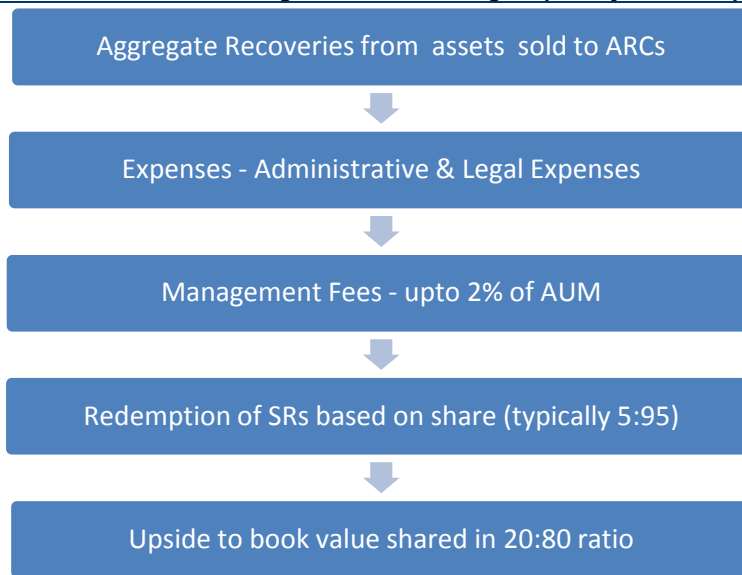
Management fees takes precedence over recoveries realisation

Distribution of recoveries from the acquired NPLs/assets follows a waterfall structure, which gives the highest precedence to admin expenses and management fees over the SR redemptions. Only after management fees are paid, recoveries can be used for redemption of SRs.

Therefore, management fee paid on the inflated value of SRs can turn out to be a very high cost solution for the banks. Let's assume a scenario where the ARC recovery rate is say 20% of the face value of SRs over the 5-year maturity period of the SR. In such a scenario, banks may end up sharing ~50% of total recoveries as management fee.

With banks increasingly focusing on selling newer NPAs with lower provisioning, banks are keen to sell on higher nominal values to avoid taking immediate provisions.

Figure 26: Waterfall structure—management fees has higher priority vs redemption of SRs



Source: Company data, Credit Suisse estimates

Large capital needs for the ARCs industry to sustain current growth rate

Balance sheet size of ARCs has gone up 4x in the last 5 years; however, ARCs would still need large amounts of capital to absorb stressed assets at current pace. Currently ARCs are not allowed leverage and the cash contribution of any transaction (currently 5-10%) is contributed by ARCs from their capital. Even assuming average 10% cash contribution by ARCs in deals done so far, the net worth of ARCs would be sufficient to fund only Rs230 bn of stressed assets. Only QIBs can invest in ARCs, and RBI has recently increased the FDI/FII holding limit to 74% with proposal to increase it to 100% under consideration, to ease the capital crunch for the sector.

Figure 27: ARC industry would require significant equity infusion, to absorb material portion of problem assets

FY13	Total Assets	Shareholders' funds
ARCIL	15,514	14,707
Pridhvi ARC	1,398	1,019
Pegasus ARC	1,857	1,238
Phoenix ARC	1,426	1,356
Reliance ARC	1,250	1,217
Edelweiss ARC	1,151	594
JM Financial ARC	4,649	2,821
	27,245	22,952

Source: Company data, Credit Suisse estimates

Key takeaways from industry meetings

We now present the key takeaways from our meeting with the ARCs, rating agencies and distressed debt funds on the direction of distressed debt resolution.

Figure 28: Key takeaways from the industry meetings**ARCIL**

- ARCIL historical acquisition cost has been roughly at ~20-25% of book value, which has gone up to ~60% of book in past six months on more SR-based transactions happening. *Share of cash in aggregate consideration in past six months has gone down to 8-9% for them.*
- Average ticket size of accounts sold are ~Rs500 mn with ARCIL not targeting accounts of more than Rs5 bn. *Average recovery period for the ARCIL has been historically 3-4 years.*
- Most of the NPLs sold currently are from doubtful category with more than 3 years of ageing, although banks have started exploring options of selling substandard accounts as well.
- Management fees is roughly 25% of their revenue (~2% of AUM) and they target to increase it to 30-40%.
- ARCIL claims to have made 25-30% IRR on their sales; however, ROEs are much lower at 7-8% on account of write-offs of SRs made during the periods.
- *Almost 90-95% of SR issued have been towards corporate loans* and retail only a small part of it.
- ARCIL cumulative performance table

Particular since inception (Rs mn)	Mar-14
Total Debt Acquired	708,610
Principal Debt Acquired	307,160
Security Receipts (SRs) Issued	172,670
Total Recovery	95,680
Recovery (%)	54%
SRs/Total Debt (%)	24%
SRs/Principal Debt (%)	56%

International Asset Reconstruction Company (IARC)

- IARC is focused on small- to mid-sized corporate accounts with total AUM of Rs12 bn. Has acquired ~570 assets with total book value of ~Rs56 bn.
- *Avg ticket size of loans being sold to ARCs has been moving up with relatively large ticket loans also being sold* by the banks. IARC ticket size have been in the range of Rs500-1,000 mn with the largest deal concluded this year of Rs6 bn.
- *Debt aggregation is the one of the key role of ARCs and has been one of the biggest challenges.* ARCs strongly prefers deals that gives it right over at least 50-60% of total NPL by value.
- IARC expects SMA accounts to also be sold by banks post RBI allowing it in its latest regulations.
- *Capital is going to be a constraining factor with ARC industry growing at a rapid pace.* Further, ARCs can only raise money from QIBs, though RBI has recently increased FII/FDI limit to 74% with proposal to increase it to 100% under consideration.

Edelweiss ARC

- *Edelweiss has been one of the most active ARC in the industry,* with its AUM increasing to Rs90 bn from Rs5 bn in one year. JM Fin and ARCIL have participated in most auctions as well.
- Edelweiss focus segment on mid to large SMEs and mid-sized corporate. It believes that incrementally focus of *ARCs would evolve to revival/ restructuring of distressed companies as well from recovery earlier.*
- New CDR regulations have made incremental restructuring difficult going forward.
- Willing to acquire assets on SR basis based on bank's price expectations. However, key is to have open communication with the bank on valuations and recovery.

Phoenix Asset Reconstruction Company

- Kotak Bank started distressed assets operations in 2004-05, acquiring the assets on its balance sheet. Summary performance of Kotak is: Asset acquired – Rs53bn, Investments – Rs17.3bn, Exited – Rs23.8bn, Value to be Realized – Rs14.2bn, IRR – 30%.
- With increase in SR based transactions and asset size being acquired, Kotak Bank set-up its own asset recons subs – Phoenix ARC. Phoenix ARC has acquired assets worth Rs2.1 bn under its Fund I and has recently launched its second fund with target corpus of Rs5bn.
- Key criteria while acquiring a distressed assets are: *(1) priority takeout, (2) going concern and (3) single point strategy for aggregation.*
- Estimate that ~Rs100 bn worth of NPLs were sold in March-14 alone.

CRISIL

- Out of the total Rs180 bn SR issued so far, Rs90 bn has been rated by CRISIL. About 53% of these SRs have been redeemed.
- *Banks get an initial period of one year to get the SRs rated. Thus, it will take at least 18-24 months for SRs to start showing decay in value.*
- For larger accounts, *ARCs prefer recover process by taking promoter's on-board.* Either OTS or restructuring/recovery backed by promoter has resulted in higher recovery rate.
- *Recovery rate from small-sized assets higher at ~60% vs larger assets,* as promoters of larger companies are more resourceful and have knowledge of legal processes to stall the recovery process.
- One of the key criteria for rating is ARCs' ability to aggregate. Value of land appreciation has been a good indication of recovery.
- *Corporate asset quality* - CRISIL believes that pace of restructuring is unlikely to come down from last year's run rate of ~Rs1,000 bn, though gross NPLs for the banking system is unlikely to increase from current 4-4.5%.
- For SME sector – sensitivity to interest rate is high. Corporate are delaying payment and there could be another 6-7 months of pain.

State Bank of India

- *SBI has sold NPAs worth Rs30 bn to ARCs and is further exploring opportunities to sell NPLs* to clean up its balance sheet.
- Ticket size is not a constraint while selling to ARCs. SBI is aggregating accounts with its associate banks as well to make it more attractive for ARCs.
- Asset quality stress is likely to continue for next two quarters before receding. Total SMA accounts for corporate portfolio at similar level to corporate NPAs (Gross NPA ~7% for corporate segment).
- Management doesn't expect any capital injection for at least next 15 months.
- *Sectoral outlook:* See risks emerging back for textile and auto ancillaries with appreciation in INR. Power - Some of the power projects need to raise equity due to cost overrun. Road - SBI has approved new road project after three years based on new bidding norms. Metals – expects that in the long run only integrated plants will survive.
- *Loan growth: SBI is targeting 25% loan growth in corporate loans for FY15.* To grow through acquisition of debt of operational projects. It doesn't expect any new project financing opportunities, though some brownfield expansion may happen.

IndusInd Bank

- IndusInd has total outstanding SRs of Rs1.4 bn of which 60% is retail and rest corporate. Recovery rate has been ~90% over the last three years.
- IndusInd enters into SR transaction only after writing down the value of the asset. It sells retail asset to ARCs primarily for sale of assets through ARCs.
- *Expect further pick-up of activity level for ARCs in next 6-8 months. May look to set-up distressed debt fund in partnership with ARCs* to leverage the opportunity. It's a relatively longer gestation investment though with high IRRs.
- The management expect current pace of restructuring to continue with CDR referral of another Rs1,000 bn in FY15E.
- Targeting 25% loan growth from corporate segment driven by 13-14% increase in volume, rest ticket size.
- Growth in mid-corporate segment last year was driven to an extent by lease rental discounting, where irrespective of the sector, the risk is relatively low according to the management.
- *Looking to build capabilities in project financing space especially distribution capabilities,* though don't expect it to be more than 5% of balance sheet at any time. Don't want to take ALM mismatch on the book.
- CV sector – utilisation level for the sector has gone up though expects CV portfolio growth to pick-up only after few quarters. Loss Given Default (LGD) on CV book though has gone up recently to ~30% in some regions.

GMR Group

- Targets to reduce groups debt from Rs450 bn to Rs320 bn in next 12-18 months.
- Focus on asset sales, to reduce leverage

Source: Company data, Credit Suisse estimates

Reality check of true value 12-24 months later

As the SRs get revalued based on ratings from the second year of issuance, the true value of these holdings will reflect in bank financials with a lag. Inflated value of SRs may also result in banks giving away a large share of recovery proceeds to the ARCs in management fees. Therefore, while reported Gross NPAs may moderate for the banks in coming quarters on account of NPL sales to ARCs (many PSUs have sold 20-40% of Gross NPAs), for a true measure of impaired assets, investors will need to aggregate GNPA+restrd assets+SRs.

Reality check will come 12-24 months later

RBI requires the SRs issued to banks to be rated within 12 months of the transaction, thus giving banks a temporary respite during which they don't need to make any incremental provisions. Once rated, banks would require to make provisions depending on the rating of the SRs. Figure 29 shows the typical rating scale for SRs based on the assessment of recovery potential by the rating agencies.

Figure 29: Provisioning required based on credit rating of SR

Rating Scale	Present value of estimated recovery as a % of face value of SR's
RR5	<25%
RR4	26% - 50%
RR3	51% - 75%
RR2	76% - 100%
RR1	101% - 150%
RR1+	>150%

Source: Company data

SRs are issued for a period of five years with an extension possible up to eight years by taking board's approval. Based on our interaction with ARCs and rating agencies, the SR rating will start to show decay 12-18 months post the rating, while in many cases, the decay in SRs only comes through after 4-5 years, once there is more clarity on the recovery possibilities.

Further, the current cycle is different from the earlier cycle due to the share of cash in the earlier transactions being much higher. As a result, deal values more accurately reflected actual recoverability of the SRs. Compared to that, we expect decay in SRs in current cycle to be faster and recovery percentage to be lower.

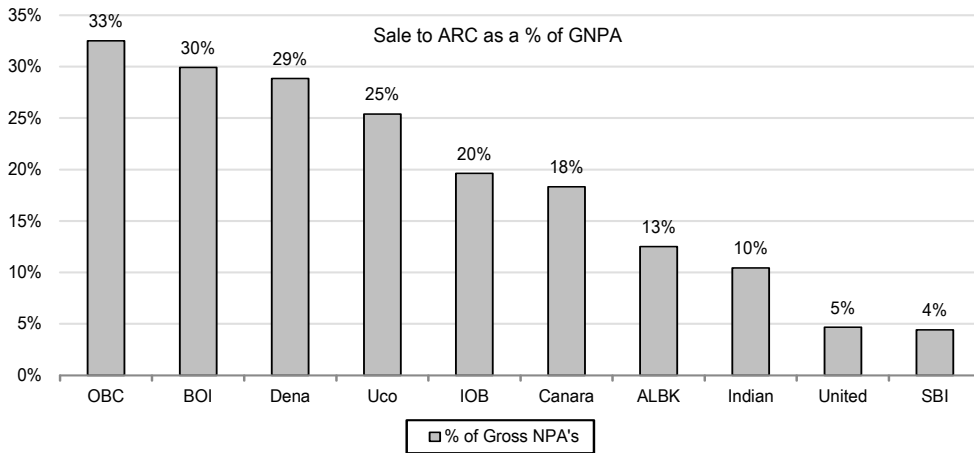
True problem loans at NPLs+restructured+SRs

Many PSU banks have sold NPAs equivalent to 5-33% of their gross NPA during the year during FY14, thus reporting sharp reduction in reported NPAs. However, this has not resulted in any transfer of risk or incremental provisioning on part of the bank, but effectively the risk moving from loan book to investment book. With our expectations of NPL sale to ARCs picking up further (~Rs500 bn in FY15 vs Rs270 bn in FY14), it is important to include SRs in reported problem assets to get the true direction of NPA levels.

Among PSU banks, IOB, BOI, OBC and UCO have been most aggressive in selling NPAs, while most other banks are also planning to accelerate sale to ARCs. Among PSUs, only PNB has no plans for an NPL sale to ARCs as of now. The aggressive NPL sale on SR basis will push the recognition of problem closer to the Basel III migration timeline, adding to the capital risk (capital needs estimates at US\$35-40 bn till FY18 for Basel III migration). Instead of resolution of stress in the system upfront, deferring the required provisions

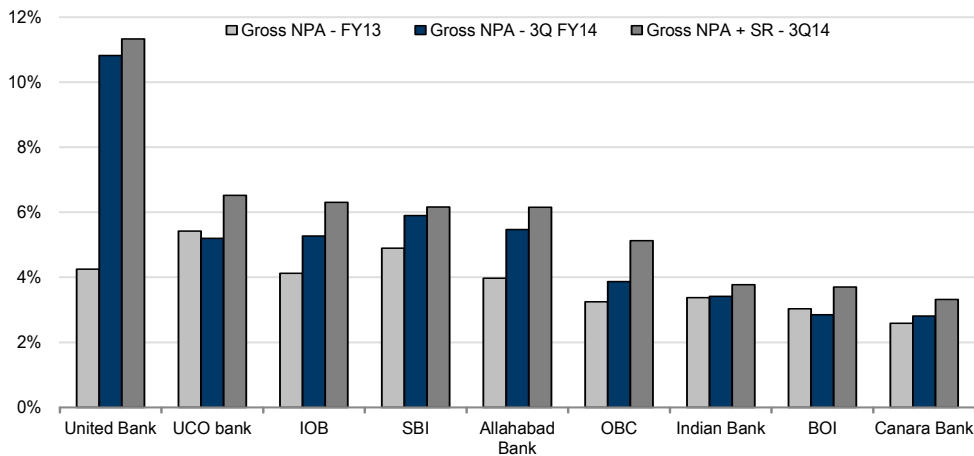
would result in further risk building into the system and will continue to weigh on the valuations over a longer period, till the underlying problem gets resolved. Remain UNDERWEIGHT on India Financials. Top sells are SBI, BOI and Union Bank.

Figure 30: NPA sold to ARCs at 5-40% of reported gross NPAs



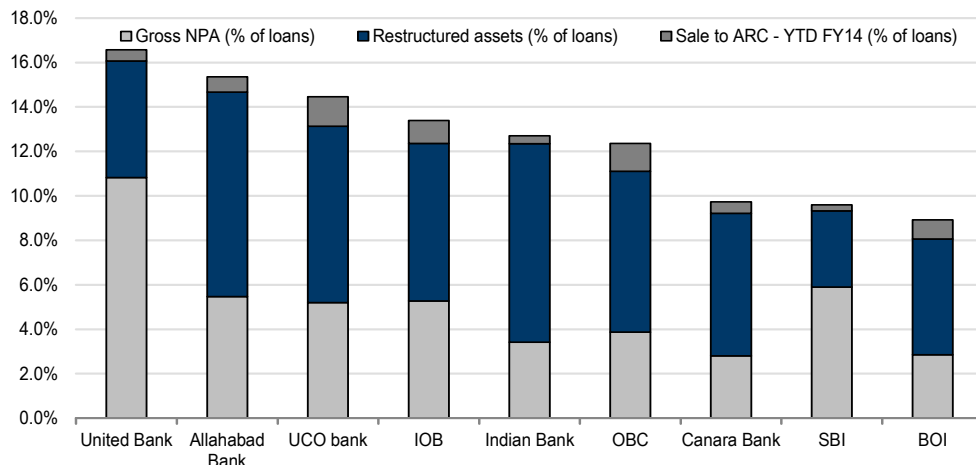
Source: Company data, Credit Suisse

Figure 31: Sale of NPAs to ARCs has resulted in reported NPAs being understated



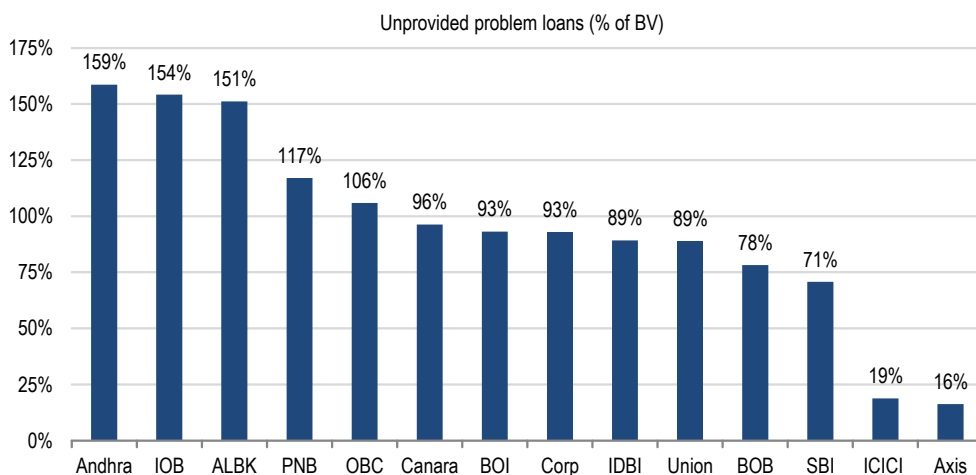
Source: Company data, Credit Suisse estimates

Figure 32: Total problem loans at 9-17%, including GNPA's+restr'd loans+SRs



Source: Company data, Credit Suisse estimates

Figure 33: Un-provided problem loans at 70-160% of book value



Source: Company data, Credit Suisse estimates

Appendix

ARC industry

ARCs are largely funded by banks, large capital needs for ARCs, to absorb the problem loans.

Figure 34: Shareholding of key players in the ARC industry

Asset Reconstruction Company	Major Shareholders	% Stake
Asset Reconstruction Company (India) Ltd	State Bank of India	20%
	IDBI Bank Ltd.	19%
	ICICI Bank Ltd.	13%
	Punjab National Bank	10%
ASREC India	Allahabad Bank	27%
	Bank Of India	26%
	Andhra Bank	26%
	Indian Bank	11%
Pridhvi ARC	Individuals	43%
	PNB	10%
Eedelweiss ARC	Edelweiss Custodial Services Limited	49%
Phoenix ARC	Kotak Mahindra Group	49%
Pegasus ARC	Bhimjyani family	50%
	DE Shaw Group	49%
	Rakesh Jhunjhunwala	1%
Reliance ARC	Reliance Capital Limited	49%
	Corporation Bank	12%
	Indian Bank	12%
India SME Asset Reconstruction	SIDBI	
	SIDBI Venture Capital Ltd.	
	United Bank of India	
	Bank of Baroda	
UV Asset Reconstruction	Central Bank of India	
International Asset Reconstruction	HDFC Bank Ltd.	
	Tata Capital Financial Services Ltd.	
	City Union Bank Limited	
JM Financial ARC	JM Financial	

Source: Company data, Credit Suisse estimates

Companies Mentioned (Price as of 29-Apr-2014)

ABG Shipyard (ABGS.BO, Rs230.2)
Adani Ports and Special Economic Zone (APSE.BO, Rs191.65)
Allahabad Bank (ALBK.BO, Rs98.7)
Andhra Bank (ADBK.BO, Rs66.25)
Axis Bank Limited (AXBK.BO, Rs1528.1)
Bank of Baroda (BOB.BO, Rs817.2)
Bank of India (BOI.BO, Rs236.5)
Bank of Mah (BMBK.BO, Rs37.9)
Bhushan Steel (BSSL.BO, Rs446.65)
Canara Bank (CNBK.BO, Rs287.1)
Central Bank IN (CBI.BO, Rs50.6)
Corporation Bank (CRBK.BO, Rs294.9)
DLF Ltd (DLF.BO, Rs153.55)
Dena Bank (DENA.BO, Rs63.1)
Era Infra (ERCI.BO, Rs17.48)
Essar Oil (ESRO.BO, Rs59.1)
GMR Infrastructure Ltd (GMRI.BO, Rs25.35)
Gujarat NRE Coke (GJNC.BO, Rs10.67)
HDFC Bank (HDBK.BO, Rs715.9)
Hotel Leela (HTLE.BO, Rs19.15)
Housing Development Finance Corp (HDFC.BO, Rs887.35)
ICICI Bank (ICBK.BO, Rs1262.05)
IDBI Bank (IDBI.BO, Rs68.0)
IDFC Ltd (IDFC.BO, Rs114.0)
ING Vysya Bank (VYSA.BO, Rs548.95)
IVRCL Ltd (IVRC.BO, Rs15.04)
Indian Overseas Bank (IOBK.BO, Rs55.05)
IndusInd Bank (INBK.BO, Rs485.55)
Jaiprakash Associates Ltd. (JAIA.BO, Rs57.35)
Jammu and Kashmir Bank (JKBK.BO, Rs1759.85)
Jet Airways (JET.BO, Rs269.7)
KSK Energy Ventures Ltd (KSKE.BO, Rs70.2)
Kotak Mahindra Bank Ltd (KTKM.BO, Rs807.7)
L&T Finance Holdings Limited (LTFH.BO, Rs67.5)
LIC Housing Finance Ltd (LICH.BO, Rs266.5)
Lanco Infratech Ltd. (LAIN.BO, Rs7.79)
Mahindra and Mahindra Financial Services Ltd (MMFS.BO, Rs248.6)
Oriental Bank (ORBC.BO, Rs249.5)
Punjab National Bank Ltd (PNBK.BO, Rs786.05)
Punjab Sind (PUNA.BO, Rs48.15)
Shriram Transport Finance Co Ltd (SRTR.BO, Rs747.2)
State Bank Of India (SBI.BO, Rs2065.3)
Syndicate Bnk (SBNK.BO, Rs103.3)
Tata Power Company Ltd (TTPW.BO, Rs80.9)
UCO Bank (UCBK.BO, Rs76.4)
Union Bank of India (UNBK.BO, Rs154.5)
United Bank of India (UBOI.BO, Rs31.0)
Uttam Galva Stee (UTTM.BO, Rs68.65)
Videocon (VEDI.BO, Rs164.65)
Vijaya Bank (VJBK.BO, Rs40.3)
Yes Bank Ltd (YESB.BO, Rs450.75)

Disclosure Appendix

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Restricted	3%	

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