

January 31, 2020

## Asset Reconstruction Company (I) Limited: Rating reaffirmed

### Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Commercial paper programme	200.00	200.00	[ICRA]A1+; Reaffirmed
<b>Total</b>	<b>200.00</b>	<b>200.00</b>	

\*Instrument details are provided in Annexure-1

### Rationale

The rating reaffirmation factors in Asset Reconstruction Company (I) Limited's (ARCIL) comfortable capitalisation profile with a sizeable net worth, a favourable net worth to assets under management (AUM) metric, its institutional shareholding, and its track record of operations in the asset reconstruction industry. ARCIL is the third largest asset reconstruction company (ARC) in the country with AUM of Rs. 11,877 crore as of September 30, 2019. The rating also takes into account the company's equity-funded acquisition strategy, which was followed in the past, and led to conservative gearing (0.12 times as of September 30, 2019).

These strengths are, however, partially offset by the inherent risk profile of the company's asset class, given its presence in the distressed assets space, the high share of corporate exposures (83% of total AUM) which are large ticket sized and involve a complex and protracted resolution process, and the uncertainty associated with the resolution of stressed assets resulting in lumpy cash flows. However, ARCIL's track record of stable fee income in the past and its regular cash churn from the small and medium-sized enterprises (SME)/retail segments, which have a faster turnaround time, provide some comfort. The rating also takes into account the moderate resolution performance till date with a recovery ratio (defined as cumulative recovery to cumulative acquisition price) of 61% as of March 31, 2019 (59% as of March 31, 2018). However, a sizeable part of the assets acquired during FY2013 to FY2015 are yet to be resolved. The write-off of unresolved assets, if any, on the completion of the eight-year period from acquisition, in line with the Reserve Bank of India's (RBI) guidelines, could adversely impact the company's profitability level over the medium term. The rating also factors in the limited seasoning of the asset reconstruction industry with continuously evolving dynamics and regulations, and a volatile earnings profile. ICRA notes that the valuation of an ARC's assets and its management fee are linked to the recovery ratings of the security receipts (SRs). Thus, any untoward movement in the recovery rating profile of the portfolio can have a bearing on the ARC's financial profile. In ICRA's view, the company's ability to judiciously acquire new assets and achieve resolution in a timely manner while maintaining a comfortable capital structure and a competitive cost of borrowings remains a key rating sensitivity.

### Key rating drivers and their description

#### Credit strengths

**Established track record in ARC business** – Incorporated in 2002, ARCIL is among the top three ARCs based on its AUM of Rs. 11,877 crore as of September 30, 2019. The company primarily operates in the corporate segment, which constituted 83% of the AUM as of September 30, 2019. However, ARCIL is increasing its business exposure to the SME (12%) and retail (5%) segments. It has a strong pan-India setup with 11 branches across the country and employee strength of

~300+. On a cumulative basis, the company had issued SRs of Rs. 22,701 crore as of September 30, 2019, of which Rs. 9,730 crore has been resolved till date while the cumulative recovery stood at Rs. 14,172 crore.

**Strong institutional shareholding and experienced management team** – Avenue India acquired an equity stake of 25.03% through the secondary market in FY2019 and became the largest shareholder of ARCIL. Avenue India is a subsidiary of Avenue Capital, a US-based \$10.4-billion fund with expertise in distressed debt, which is a strategic investor in ARCIL. ARCIL is also sponsored by leading Indian banks including State Bank of India (SBI, 19.95% stake), IDBI Bank Ltd (IDBI, 19.18%), ICICI Bank Ltd (ICICI, 13.26%) and Punjab National Bank (PNB, 10.01%), together holding 62.40% of the equity capital. The company's board of directors comprises ten members including its CEO & MD, four independent directors and five sponsor directors representing Avenue India, IDBI, SBI, ICICI and PNB. The other members of the management team are seasoned industry professionals with an average experience of over two decades in leading their respective workstreams.

**Comfortable capitalisation profile supported by sizeable net worth** – ARCIL's net worth remained sizeable at Rs. 1,945 crore as on March 31, 2019 and Rs. 2,010 crore as on September 30, 2019, which is the largest among its peers. With limited borrowings of Rs. 243.82 crore, ARCIL's capital structure remains comfortable with a gearing of 0.12 times as on September 30, 2019. The current capital remains adequate in relation to the operations with net worth to AUM of ~17% as of September 30, 2019, which is healthier than most of its peers. The company's leveraging strategy for future growth remains conservative with the gearing expected to remain capped at 0.50 times over the near-to-medium-term.

**Average track record of recovery from assets** – The company's cumulative recoveries to cumulative acquisitions improved to 61% as on March 31, 2019 from 59% as on March 31, 2018 on the back of a reasonable pickup in the resolution performance. Further, the share of higher-rated SRs (with expected recovery of more than 75%) in ARCIL's total AUM increased to 43% as on September 30, 2019 from 19% as on March 31, 2018 (50% as of March 31, 2019). However, a sizeable part of the assets acquired during FY2013 to FY2015 are yet to be resolved (~Rs. 5,796 crore at the AUM level). The write-off of unresolved assets, if any, on the completion of the eight-year period from acquisition, in line with the RBI's guidelines, could adversely impact the company's profitability level over the medium term<sup>1</sup>. However, ARCIL's share in the FY2013-2015 vintage assets remains limited (Rs. 721 crore yet to be resolved), which alleviates the impact to some extent. Furthermore, the company is actively looking at various resolution plans to address the unresolved assets. Nevertheless, its ability to maintain the pace of resolutions and recovery of dues remains important from a credit perspective.

**Adequate profitability indicators** – The company benefits from consistent fee-based income of Rs. 145.22 crore in FY2019 and Rs. 70.95 crore in H1 FY2020 against Rs. 127.86 crore in FY2018. ARCIL reported a net profit (as per IND-AS) of Rs. 149.09 crore (6.65% of average total assets or ATA) in FY2019 against Rs. 37.79 crore (1.97% of ATA) in FY2018, primarily driven by the higher fair value gain of Rs. 160.02 crore in FY2019 compared with a fair value loss of Rs. 32.32 crore in FY2018. The increase in the net profit was also somewhat supported by lower regulatory write-offs in SRs in FY2019 compared to earlier years. In the near-to-medium-term, ARCIL's regulatory write-offs are expected to remain low as its acquisitions were lower during FY2012-2013. Owing to the higher net profit, ARCIL's return on average net worth improved to 7.97% in FY2019 from 2.25% in FY2018. Further, ARCIL has continued to report adequate profitability with a net profit of Rs. 64.54 crore (5.74% of ATA) and return on average net worth of 6.78% in H1 FY2020.

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<sup>1</sup>As per RBI guidelines, an ARC needs to resolve assets within five years (extended to eight years subject to approval from the RBI) of the acquisition of the assets and any unresolved asset/SR needs to be written off completely by the end of the five/eight-year timeline

## Credit challenges

**High share of corporate exposures** – The company focuses on the corporate segment, an asset class with a high risk profile on account of its complexity, higher ticket sizes as well as levels of high degree of engagement with the promoters. Given the lumpy nature of these assets, the inability to achieve resolutions as per expectations, in terms of the amount recovered as well as timelines, can have a bearing on the company's profitability. ARCIL's cash inflows from the corporate segment remain contingent on recoveries/resolution of its SRs and can thus be lumpy and exposed to uncertainty. Also, the recoveries from the vintage book have been low and have been a drag on the company's performance. ARCIL's track record of stable fee income in the past and its regular cash churn from the SME/retail segments, which have a faster turnaround time, provide some comfort. In ICRA's view, any delay or inability in the resolution of delinquent assets could impact ARCIL's profitability and liquidity profile and will remain a key rating monitorable.

**Valuation of investments, profitability and net worth susceptible to changes in recovery ratings** – The valuation of ARCIL's investments in SRs and its management fee are governed by the recovery ratings of the SRs, which, in turn, are assigned by external credit rating agencies based on the recovery prospects of these SRs from the underlying assets. ARCIL may have to write down the value of its investments in case the recovery ratings are downgraded, which may adversely impact its net worth. If the ultimate or final recovery from the underlying stressed asset remains below its acquisition value, the loss may also become permanent. Further, the management fees for the assets acquired after August 2014 are linked to the lower end of the rating band or NAV, whichever is less. Therefore, a downgrade in the ratings would lead to a fall in the management fees.

**Limited seasoning of the industry and volatile earnings profile**– In ICRA's view, the seasoning of the ARC industry remains limited, given the higher risk profile in the distressed assets space, the evolving industry dynamics and the significant ramp-up in the industry's AUM post 2014. Given the uncertainty associated with the quantum and timelines of recovery, as inherent in the stressed assets space, the earnings profile of ARCs remains volatile.

**Ability to scale up AUM in increasing cash deal scenarios across ARC industry** – With the revised RBI guidelines for the provisioning requirement of banks in the case of selling stressed assets, the ARC industry shifted its focus more towards cash deals/purchases from the earlier SR deals/purchases. While this change is facilitating more efficient price discovery for assets, the upfront capital requirement of the ARCs has increased, as witnessed by ARCIL's cash investments of 83% in its total acquisitions in FY2019 against 36% in FY2018. However, in FY2020, ARCIL has also followed the co-investment model with Avenue Group, which has reduced the upfront requirement to some extent. Going forward, the ability of ARCs to judiciously acquire assets and scale up their AUMs, while maintaining a comfortable capital structure and competitive cost of borrowings, remains a key rating sensitivity.

## Liquidity position: Adequate

The company has been traditionally following a conservative leveraging strategy as its acquisitions have been funded largely through equity. ARCIL has sanctioned working capital credit lines of Rs. 675.00 crore from various banks with an aggregate outstanding limit of Rs. 243.82 crore as on September 30, 2019, leaving a moderate cushion in terms of unutilised limits. The company's bank balance and cash and cash equivalents remained limited at Rs. 1.11 crore as on September 30, 2019. The cash flows are expected to remain lumpy, given the inherent nature of the business. However, ARCIL generates regular cash flow from operations from its retail and SME AUM, supported by the quick turnaround and simpler resolution for this asset class though its share in the overall AUM is low. During the last six quarters, the average net cash flow from operations (excluding cash flows from redemptions), on an overall basis, was Rs. 41 crore per quarter

(ranging from Rs. 23 crore to Rs. 73 crore). As on date, the company had no outstanding amount towards the commercial paper programme.

## Rating sensitivities

**Positive triggers** – Not applicable

**Negative triggers** – Pressure on the rating could arise on any delay in the recovery or inability in the resolution of assets, leading to lower-than-expected cash flows, higher write-offs or reduced profitability indicators. Moreover, a sharp increase in the gearing level would lead to a rating downgrade.

## Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	<a href="#">ICRA's Credit Rating Methodology for Non-Banking Finance Companies</a>
Parent/Group Support	Not applicable
Consolidation/Standalone	Standalone

## About the company

Incorporated in 2002, Asset Reconstruction Company (India) Limited (ARCIL) is the first asset reconstruction company (ARC) in India. It is among the leading players in the distressed assets space with AUM of Rs. 11,877 crore and is the third largest player in terms of AUM and largest in terms of net worth. Over the years, ARCIL has transacted with over 60 banks, financial institutions and other counterparties and has acquired non-performing loans (NPLs) of more than 2,800 borrowers (in addition to retail portfolios) with total dues of ~Rs. 88,013 crore. The company has issued SRs in excess of Rs. 22,308 crore since inception. ARCIL has a pan-India setup with 11 branches across India and employee strength of ~300+.

The company was jointly promoted by several banks and financial institutions. In FY2019, Avenue Capital Group, a US-based investment firm, became the largest shareholder of the company after acquiring a ~25% stake from existing shareholders. The other shareholders of the company include State Bank of India (20%), IDBI Bank (19%), ICICI Bank (13%) and Punjab National Bank (10%).

In FY2019, ARCIL reported a profit after tax of Rs. 149.09 crore on a total income of Rs. 328.64 crore against a profit after tax of Rs. 37.79 crore on a total income of Rs. 135.17 crore in FY2018. On a provisional basis, ARCIL reported a profit after tax of Rs. 64.54 crore on a total income of Rs. 69.41 crore in H1 FY2020.

## Key financial indicators (standalone)

	FY2018 (Audited)	FY2019 (Audited)	H1 FY2020 (Provisional)
Total income	135.17	328.64	69.41
Profit after tax	37.79	149.09	64.54
Net worth	1,796.05	1,945.06	2,009.60
Assets under management	11,827	11,902	11,877
Total assets	2,125.90	2,356.77	2,370.91
Return on average total assets	1.97%	6.65%	5.74%
Return on average net worth	2.25%	7.97%	6.78%
Gearing (times)	0.09	0.14	0.12

Source: ARCIL; Amounts in Rs. crore

## Status of non-cooperation with previous CRA: Not applicable

## Any other information: None

## Rating history for past three years

Instrument	Current Rating (FY2020)			Rating History for the Past 3 Years			
	Type	Amount Rated	Amount Outstanding	Rating 31-Jan-2020	FY2019 14-Dec-2018	FY2018	FY2017
1 Commercial Paper Programme	Short Term	200.00	-	[ICRA]A1+	[ICRA]A1+	-	-

Amount in Rs. crore

## Complexity level of the rated instrument

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website [www.icra.in](http://www.icra.in)

### Annexure-1: Instrument details

ISIN	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	Commercial Paper	NA	NA	7-365 days	200.00	[ICRA]A1+

Source: ARCIL

### Annexure-2: Not applicable

## Analyst Contacts

**Karthik Srinivasan**

+91 22 6114 3444

[karthiks@icraindia.com](mailto:karthiks@icraindia.com)

**Samriddhi Chowdhary**

+91 22 6114 3462

[samriddhi.chowdhary@icraindia.com](mailto:samriddhi.chowdhary@icraindia.com)

**Sainath Chandrasekaran**

+91 22 6114 3439

[sainath.chandrasekaran@icraindia.com](mailto:sainath.chandrasekaran@icraindia.com)

**Piyush Kherdikar**

+91 22 6114 3414

[piyush.kherdikar@icraindia.com](mailto:piyush.kherdikar@icraindia.com)

## Relationship Contact

**L. Shivakumar**

+91 22 6114 3406

[shivakumar@icraindia.com](mailto:shivakumar@icraindia.com)

## MEDIA AND PUBLIC RELATIONS CONTACT

**Ms. Naznin Prodhani**

Tel: +91 124 4545 860

[communications@icraindia.com](mailto:communications@icraindia.com)

## Helpline for business queries:

+91-9354738909 (open Monday to Friday, from 9:30 am to 6 pm)

[info@icraindia.com](mailto:info@icraindia.com)

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## ICRA Limited

### Corporate Office

Building No. 8, 2nd Floor, Tower A; DLF Cyber City, Phase II; Gurgaon 122 002

Tel: +91 124 4545300

Email: [info@icraindia.com](mailto:info@icraindia.com)

Website: [www.icra.in](http://www.icra.in)

### Registered Office

1105, Kailash Building, 11th Floor; 26 Kasturba Gandhi Marg; New Delhi 110001

Tel: +91 11 23357940-50

### Branches

Mumbai + (91 22) 24331046/53/62/74/86/87

Chennai + (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294,

Kolkata + (91 33) 2287 8839 /2287 6617/ 2283 1411/ 2280 0008,

Bangalore + (91 80) 2559 7401/4049

Ahmedabad+ (91 79) 2658 4924/5049/2008

Hyderabad + (91 40) 2373 5061/7251

Pune + (91 20) 2556 0194/ 6606 9999

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