April 03, 2023

Asset Reconstruction Company (I) Limited: [ICRA]AA- (Stable) assigned

Summary of rating action

Instrument*	Current Rated Amount (Rs. crore)	Rating Action
Non-convertible debenture (NCD) programme	200.0	[ICRA]AA- (Stable); assigned
Total	**200.0**	

**Instrument details are provided in Annexure I*

Rationale

The assigned rating considers Asset Reconstruction Company (I) Limited's (ARCIL) established track record of operating in the asset reconstruction industry for almost two decades. As of December 2022, ARCIL was the second largest asset reconstruction company (ARC) in India in terms of net worth and assets under management (AUM). Moreover, it is backed by experienced sponsors with Avenue India Resurgence Pte. Ltd. holding a 60% stake in the company. ARCIL benefits from the expertise of its largest sponsor in the global distressed assets space and enjoys operational support from the sponsor, Avenue India Resurgence Pte. Ltd.

The rating is also supported by ARCIL's healthy capitalisation with a net worth of Rs. 2,137 crore as on December 31, 2022. It has demonstrated an adequate track of recoveries with the cumulative recoveries to cumulative acquisitions ratio remaining in the range of 59-65% over the last five years. Comfort is also drawn from the company's low leverage with debt to net worth of 0.1 times as on December 31, 2022, and average debt to average recoveries of less than 1.0 times for the last three years. The management intends to keep the leverage below 0.5 times over the medium term, though its ability to maintain the pace of resolutions and recovery will remain a key driver of its cash flows and debt servicing ability.

The rating is, however, constrained by the volatile nature of the cash flows in the ARC industry. Further, the valuation of an ARC's assets and its management fee are linked to the recovery ratings of the security receipts (SRs), which can result in volatile profitability. Thus, any adverse movement in the recovery rating profile of the portfolio can have a bearing on the company's financial profile. Going forward, ARCIL's ability to generate healthy cash flows through timely resolutions will remain important from a credit perspective. Also, the asset reconstruction industry's prospects have remained susceptible to regulatory changes. In this backdrop, the company's ability to judiciously acquire new assets while maintaining a comfortable leverage will remain imperative for its credit profile.

Key rating drivers and their description

Credit strengths

Established track record in ARC industry and backing of experienced sponsors – ARCIL was India's first ARC to commence the business of the resolution of stressed assets upon acquisitions from Indian banks and financial institutions. It continues to be one of the prominent players in the domestic ARC industry with an operational track record of almost two decades. As of December 2022, ARCIL was the second largest ARC in India in terms of net worth and AUM. While its net worth stood at Rs. 2,137 crore, the AUM stood at Rs. 16,009 crore as on December 31, 2022. Till date, ARCIL has issued cumulative SRs of Rs. 30,784 crore. As of December 31, 2022, gross SRs outstanding totalled Rs. 16,009 crore, of which ARCIL's share was Rs. 2,739 crore. Net of provisions, ARCIL's share in the SRs or its net asset value (NAV) stood at Rs. 1,778 crore as on December 31, 2022. The company has a pan-India setup with 15 branches across India and employee strength of ~247 (including off-roll employees), as of December 2022.

ARCIL remains sector agnostic and mainly operates in the corporate and small and medium-sized enterprise (SME) segment (~92% of AUM as on December 31, 2022), which is riskier than the retail segment on account of the comparatively larger ticket size, higher complexity involved in the transactions, and the protracted resolution process. ICRA, however, notes the growing share of retail assets in the AUM (8% as of December 31, 2022 from 5% as of March 31, 2019). Going forward, ARCIL plans to remain focused on acquiring retail assets. Nonetheless, the share of retail assets is expected to remain modest in the near to medium term, given the relatively shorter time for such resolution. As on December 31, 2022, the top 10 exposures in ARCIL's books (based on NAV) accounted for 21% of its share in SRs.

In FY2022, Avenue India Resurgence Pte. Ltd, a part of Avenue Capital Group, acquired an additional 34.4% stake from the other sponsors in ARCIL taking its total shareholding in the company to 59.7%. Avenue Capital Group is a global distressed debt management fund with an established presence in the United States (US), Europe and Asia. As of January 31, 2023, Avenue Capital Group managed assets worth $12.5 billion. ICRA believes that ARCIL will benefit from the global expertise of its largest sponsor. Further, ARCIL enjoys operational support from the sponsor, Avenue India Resurgence Pte. Ltd. ICRA notes that the partnership between the two entities remains non-exclusive. ARCIL's other key sponsors include State Bank of India (SBI; 20%) and Punjab National Bank (10%) among others. ARCIL also benefits from managerial supervision through its adequately diversified board, comprising three Sponsor Directors and four Independent Directors.

Adequate track record of recovery from assets – ARCIL's cumulative recoveries to cumulative acquisitions has remained in the range of 59-65% over the last five years. The NAV of the higher rated SRs (with expected recovery of more than 75%) formed 55% of AUM as of December 31, 2022, while ARCIL's own share in higher rated SRs was 58%. ICRA notes that a sizeable part of the assets acquired in FY2015 and FY2016 remained outstanding as of December 31, 2022 and the same are required to be written off in FY2023 and FY2024. Nevertheless, the company has fair valued these assets over the years. This, coupled with additional provisioning made by the company, is expected to prevent an impact on the near-term profitability. Although ARCIL has demonstrated its ability to maintain the pace of resolutions and recoveries (~63% in 9M FY2023) while shortening the time to recovery, the same remains a monitorable as it scales up its operations.

Healthy capitalisation and recoveries provide good coverage for debt servicing – ARCIL's capitalisation remains healthy with a net worth of Rs. 2,137 crore as on December 31, 2022. The existing capitalisation level adequately supports the current scale of operations. Comfort is also drawn from the management's stated intent of keeping the leverage below 0.5 times over the medium term (0.1 times as on December 31, 2022). Additionally, it is noted that ARCIL's average debt to average recoveries ratio has remained below 1.0 times in the last three years, providing good coverage against debt. Further, given the ambitious growth target and the intention of keeping the leverage in check, the company plans to pursue the co-investment model and cash deals, wherein its share in the issued SRs can be as low as 2.5% (thereby reducing the potential on-balance sheet borrowings for ARCIL) as per the amended regulatory framework for ARCs. The share of acquisitions with a co-investor increased to 14% in 9M FY2023 from 4% in FY2019. Historically, the accretion to reserves was supported by nil dividend distribution by the company. However, ARCIL made a dividend payout equivalent to 10% of its equity capital in FY2022. Going forward, the dividend payouts are expected to be in the range of 20-50% of the equity share capital.

Credit challenges

Volatile cash flows and earnings due to inherent nature of the business – The resolution process for stressed assets, especially corporate assets, involves a protracted recovery process with low recoveries in the initial years. ICRA notes that the cash flows and profitability of the entities operating in this segment remain volatile, given the inherent nature of the asset reconstruction business. Further, the valuation of an ARC's assets and its management fee are linked to the recovery ratings of the SRs. Thus, any adverse movement in the recovery rating profile of the portfolio can have a bearing on the company's financial profile. It is to be noted that the recovery proceeds are first used for the payment of management fees and other expenses and dues, while the balance is used for the redemption of the SRs. Thus, the SR redemption ratio trails behind the recovery ratio. ARCIL's reported return on assets (RoA) has been volatile and ranged between -3.7% and 7.4% in the last five years (FY2019 to 9M

FY2023). The profitability was impacted in FY2021 due to the write-off of SRs, resulting in net losses. Going forward, ARCIL's ability to achieve timely resolutions and healthy recoveries from its assets will remain important from a credit perspective.

Evolving nature of the industry with challenges in acquiring assets at reasonable prices – The asset reconstruction industry's prospects remain susceptible to regulatory changes. Nonetheless, the amended regulatory framework, requiring a higher capitalisation level for undertaking ARC operations besides allowing lower investment requirement for acquisitions and the option to participate as a resolution applicant under the Insolvency and Bankruptcy Code (IBC), is expected to benefit established ARCs. Nevertheless, ARCIL's ability to judiciously acquire new assets while maintaining a comfortable capital structure and a competitive borrowing cost remains imperative. Moreover, the developments related to the securitisation of stressed assets and the commencement of National Asset Reconstruction Company Limited, and their impact on the private players in the industry will remain monitorable.

Liquidity position: Adequate

As on December 31, 2022, ARCIL had on-balance sheet liquidity of Rs. 237 crore, besides enjoying sanctioned bank lines of Rs. 620 crore with minimal utilisation in the recent past. The company has remained largely debt-free except for the occasional drawdown of working capital facilities in the past few years. Further, ICRA believes that the key sponsor company, Avenue India Resurgence Pte. Ltd., will extend funding/liquidity support (in the form of intercorporate deposits (ICDs)/loans) in case of contingencies. The sponsor has demonstrated its support to ARCIL by participating as a co-investor in certain full cash deals and the trend is expected to continue.

Rating sensitivities

Positive factors – The rating may be upgraded in case of a significant increase in the scale of operations and a sustained improvement in recoveries while maintaining strong capitalisation, achieving a diversified portfolio, and delivering healthy profitability and cash flows on a sustained basis.

Negative factors – The rating may come under pressure if the company's profitability or the trajectory of its recoveries weakens significantly on a sustained basis. Moreover, a sharp increase in the leverage with a gearing of over 0.75 times may lead to a rating downgrade.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	Rating Methodology – Non-banking Finance Companies (NBFCs)
Parent/Group support	Not applicable
Consolidation/Standalone	Standalone

About the company

Incorporated in 2002, Asset Reconstruction Company (I) Limited (ARCIL) was the first ARC of India. US-based investment firm, Avenue Capital Group, is the largest shareholder of the company with a stake of 59.7%. The company is also sponsored by leading Indian banks including SBI, PNB, Karnataka Bank, The South Indian Bank and Federal Bank. These banks together hold 35.1% of the equity capital. Between 2004 and December 2023, ARCIL issued SRs totalling Rs. 30,829 crore, with Rs. 16,009 crore of SRs outstanding as on December 31, 2022. The company has a pan-India setup with 15 branches across India and employee strength of ~247 (including off-roll employees), as of December 2022.

In FY2022, ARCIL reported a profit after tax (PAT) of Rs. 143 crore on total income of Rs. 304 crore compared to a net loss of Rs. 87 crore in FY2021. In 9M FY2023, the company reported a PAT of Rs. 136 crore on total income of Rs. 259 crore.

It is to be noted that the recovery proceeds are first used for the payment of management fees and other expenses and dues, while the balance is used for the redemption of the SRs. Thus, the SR redemption ratio trails behind the recovery ratio.

Key financial indicators (audited)

ARCIL	FY2021	FY2022	9M FY2023^
Fees income	149	244	112
Interest income	22	14	26
Fair value changes - realised	73	368	126
Fair value changes - unrealised	(33)	(97)	48
SRs written off (including provision)	(235)	(227)	(55)
Other Income	2	2	2
Profit after tax	(87)	143	136
Net worth	1,890	2,034	2,137
AUM	13,833	14,036	16,009
Investment in SRs (at gross value)	1,712	1,406	1,810
Total assets*	2,334	2,344	2,456
Return on assets	-3.7%	6.1%	7.4%
Return on net worth	-	7.3%	8.7%
Gross gearing (times)	0.2	0.1	0.1

*Source: Company, ICRA Research; ^Provisional; All ratios as per ICRA's calculations; Amount in Rs. crore; *Based on net assets*

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

Instrument	Current Rating (FY2024)				Chronology of Rating History for the Past 3 Years		
	Type	Amount Rated (Rs. crore)	Amount Outstanding as of Mar 20, 2023 (Rs. crore)	Current Rating	Date & Rating in FY2023	Date & Rating in FY2022	Date & Rating in FY2021
				Apr 03, 2023	-	-	-
1 NCD programme	Long term	200.0	-	[ICRA]AA- (Stable)	-	-	-

Complexity level of the rated instruments

Instrument	Complexity Indicator
NCD programme	Simple^

^ Subject to change based on terms of issuance

The Complexity Indicator refers to the ease with which the returns associated with the rated instrument could be estimated. It does not indicate the risk related to the timely payments on the instrument, which is rather indicated by the instrument's credit rating. It also does not indicate the complexity associated with analysing an entity's financial, business, industry risks or complexity related to the structural, transactional or legal aspects. Details on the complexity levels of the instruments are available on ICRA's website: Click Here

Annexure I: Instrument details

ISIN	Instrument Name	Date of Issuance	Coupon Rate (%)	Maturity	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	**NCD programme***	-	-	-	200.0	[ICRA]AA- (Stable)

*Source: Company; *Yet to be placed*

Annexure II: List of entities considered for consolidated analysis

Not applicable

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