Asset Reconstruction Company (I) Limited

December 14, 2018

Summary of rating action

Instrument*	Current Rated Amount (Rs. crore)	Rating Action
Commercial paper programme	200.00	[ICRA]A1+; assigned
Total	**200.00**	

**Instrument details are provided in Annexure-1*

Rationale

The rating factors in Asset Reconstruction Company (I) Limited's (ARCIL) comfortable capitalisation profile with sizeable net worth and favourable equity to assets / assets under management (AUM) metrics, its strong institutional shareholding, and its track-record and position in the asset reconstruction space. ICRA notes that Avenue Capital, a US based $10 billion fund with expertise in distressed debt, is in the process of acquiring a 27% equity stake in ARCIL through the secondary market subject to the receipt of regulatory approvals. ARCIL's liquidity profile remains adequate, supported by the equity funded acquisition strategy followed in the past, thereby resulting in conservative gearing, coupled with the presence of adequate bank-lines. ARCIL's AUM consists of corporate, retail and SME segment with larger focus on corporate segment (85% of AUM) which have a higher inherent risk profile. Cash inflows from corporate segment remain contingent on recoveries / resolution of its security receipts (SRs), and given the nature of the underlying asset-class these can be lumpy and exposed to uncertainty. However, considering ARCIL's track-record of stable fee-income in the past and its regular cash churn from SME/Retail segment, which has a faster turn-around time, provide some comfort. The rating also factors in the limited seasoning of the asset reconstruction industry with continuously evolving dynamics and regulations. The Reserve Bank of India's (RBI) guideline dated September 2018 mandates a higher provisioning requirement in case a bank holds more than 10% of security receipts (SRs, threshold reduced from 50% to 10% from April 2018) backed by its sold assets and issued under that securitization. This in-turn is expected to result in a higher cash consideration (as opposed to SRs) for acquiring assets and will thus increase the upfront capital requirement for asset reconstruction company's (ARC) for scaling up the AUM. 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 competitive cost of borrowings remains a key rating sensitivity.

Key rating drivers

Credit strengths

Established track record in ARC business – Incorporated in 2002, Asset Reconstruction Company (India) Limited (ARCIL) is among the top three players in the asset reconstruction business based on its AUM of Rs. 11,716 crore as of June 2018. In terms of net worth, it is the largest ARC. The company largely operates in the corporate segment which constituted 85% of the AUM, followed by the small and medium-sized enterprises (SME, 10%) and retail (5%) segments as of June 2018. ARCIL has a strong pan India set up with 15 branches across India and employee strength of ~300+. On a cumulative basis, the company has issued SRs of Rs. 21,637 crore as of June 30, 2018 of which Rs, 9,025 crore has been resolved till date; while cumulative recovery stood at Rs. 12,831 crore.

Strong institutional shareholding – ARCIL is sponsored by leading Indian Banks including SBI (20% stake), IDBI (19%), ICICI (13%) and PNB (10%). These banks together hold 62% of the equity capital. The company's board of directors comprises eight members including its CEO& MD, three independent directors and four sponsor directors representing IDBI, SBI, ICICI and PNB bank. ICRA notes that Avenue Capital, a US based $10 billion fund with expertise in distressed debt, is in the process of acquiring a 27% equity stake through the secondary market, subject to the receipt of regulatory approvals. Following the acquisition, Avenue Capital is expected to be ARCIL's largest shareholder and would also have a representative on the board. ARCIL's CEO & MD has 25+ years of experience in the banking sector. The other members of the management team are seasoned industry professionals with average experience of over two decades in leading their respective workstreams.

Comfortable capitalisation profile and moderate gearing target for current scale of operations – The company's net worth is comfortable at Rs. 1,745 crore (IndAS) with a gearing of 0.04 times as on June 30, 2018. The current capital remains adequate in relation to the operations with net worth to AUM of 15% and net worth to company's investments of 115% as of June 30, 2018, which is healthier than that of the peers. The leveraging strategy for future growth remains conservative with the gearing expected to remain capped at 0.50-0.75 times over the near to medium-term. ARCIL plans to fund its future growth initially through long-term bank line facilities and later through market borrowings comprising a mix of non-convertible debentures (NCDs) and commercial papers.

Average track-record of recovery from assets - The company has been able to resolve 42% of the total dues acquired till June 30, 2018. Cumulative recoveries to cumulative acquisitions improved to 59% as on March 31, 2018 from 54% as on March 31, 2015 on the back of a reasonable pick-up in resolution performance. There has been a decline in the share of higher-rated SRs (with expected recovery of more than 100%) in the total AUM in the past few years. Going forward, the company's ability to maintain the pace of resolutions remains important from a credit perspective.

Adequate profitability indicators – ARCIL reported a net profit (as per IGAAP) of Rs. 122.80 crore (6.67% of average total assets or ATA) in FY2018 compared with Rs. 45.63 crore (2.78% of ATA) in FY2017 supported by improved resolutions and a controlled cost structure. The company also benefits from consistent fee income which formed 86% of its total income in FY2018 (FY2017: 87%). The increase in net profit was also supported by lower regulatory write-offs in security receipts in FY2018 compared to FY2017. In the medium term, regulatory write-offs are expected to remain low as the company's acquisitions were lower during FY2010-2013. The return on average net worth was 6.67% (as per IGAAP) in FY2018 compared with 2.78% in FY2017. ARCIL has shifted to Indian accounting standards (IndAS) from the first quarter of 2019. As per IndAS, it reported a net profit of Rs. 32.73 crore in Q1 FY2019 while the net profit for FY2018 was Rs. 24.46 crore due to adjustments of fair value changes in valuation of investments which is a non-cash item.

Credit challenges

Limited seasoning of the industry - 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 significant ramp-up in the industry AUM post 2014. The rating is constrained by the inherent risk associated with the distressed assets space and the uncertainty associated with the quantum and timelines of recovery.

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 promoters. Given the lumpy nature of these assets, the inability to achieve resolutions as per expectations, in terms of amount recovered as well as timelines, can have bearing on the company's profitability. ARCIL's cash inflows from corporate segment remain contingent on recoveries / resolution of its security receipts 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 company's performance. ARCIL's track-record of stable fee-income in the past and its regular cash churn from SME/Retail segment, which has a faster turn-around 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.

Ability to scale up AUM at competitive costs while maintaining a healthy capitalisation profile - The change in the RBI's guidelines for the sale of stressed assets can lead to an increase in the provisioning requirement for banks and can thus result in disincentivising the SR route of selling assets to ARCs. The impact on long-standing NPAs, with an existing high provisioning cover, would be lower. While this would facilitate more efficient price discovery for assets, the upfront capital requirement for the ARCs would be higher given the expected shift to cash mode form the SR mode of asset acquisition. So far, the company has funded its acquisitions through equity evidenced by the low gearing levels. However, going forward, the ability of ARCs to judiciously acquire new assets and resolve them while maintaining a comfortable capital structure and competitive cost of borrowings remain a key rating sensitivity.

Liquidity position

The company has traditionally followed a conservative leveraging strategy and acquisitions have been funded largely through equity. As per the information provided by the company, ARCIL has sanctioned credit lines of Rs. 550 crore from various banks while the outstanding short-term bank borrowings for the working capital facility stood at Rs. 39 crore as of September 30, 2018. The company's bank balance and cash and cash equivalents was Rs. 32 crore as of September 30, 2018. ARCIL generates regular cash flow from operations from its Retail & SME AUM, supported by the quick turnaround and simpler resolution for this asset class, albeit its share in the overall AUM is low. During the last six quarters the average net cash flow from operations (excluding cashflows from redemptions), on an overall basis, was Rs. 35 crore per quarter (ranging from Rs. 15 crore to Rs. 81 crore). As on date, the company had no outstanding amount towards the commercial paper programme.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	ICRA's Approach for Rating Commercial Papers ICRA's Credit Rating Methodology for Non-Banking Finance Companies
Parent/Group Support	NA
Consolidation / Standalone	Standalone

About the company

Incorporated in 2002, Asset Reconstruction Company (India) Limited (ARCIL) is the first asset reconstruction company (ARC) in India. The company is sponsored by leading Indian banks including SBI (20% stake), IDBI (19%), ICICI (13%) and PNB (10%). These banks together hold 62% of the company's equity capital. Other prominent shareholders include Lathe Investments Pte (an affiliated investment vehicle of GIC Special Investments Pte Ltd., Singapore), which holds a 10% stake, IDFC Bank (8%), FirstRand Bank Ltd, South Africa (4%), Karnataka Bank (3%), HDFC Limited (2%), ICICI Home Finance Company Limited (2%) and Karur Vysya Bank (2%). Moreover, Barclays Bank plc, Quiveo Enterprises Ltd, Cyprus (part of the Ashmore Group), The South Indian Bank, The Federal Bank and others hold a stake of 1% each. Historically, ARICL had transactions with 70+ banks, Financial Institutions and counter parties and has acquired non-performing loans (NPLs) of more than 2,800 borrowers (in addition to retail portfolios) with total dues of Rs. 84,849 crore as on March 31, 2018. The value of SRs issued exceeds Rs. 21,567 crore. The company has a pan-India setup with 15 branches across India and employee strength of ~300+.

Key financial indicators

	FY2017(IGAAP)	FY2018(IGAAP)	FY2018(IndAS)	Q1 FY2019(IndAS)
Total income	234.71	263.22	112.83	72.11
Profit after tax	45.63	122.80	24.46	32.73
Net worth	1,566.11	1,688.90	1,711.62	1,744.35
Assets under management	10,997.84	11,827.49	11,827.49	11,716.07
Total assets	1,718.18	1,962.05	1,996.79	1,881.52
Return on average total assets	2.78%	6.67%	1.31%	6.75%
Return on average net worth	2.96%	7.55%	1.49%	7.58%
Gearing (times)	0.02	0.09	0.09	0.04

Amounts in Rs. crore

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years

	Instrument	Current Rating (FY2019)				Chronology of Rating History for the Past 3 Years		
		Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	FY2019	FY2018	FY2017	FY2016
					Dec-2018			
1	Commercial Paper Programme	Short Term	200	-	[ICRA]A1+	-	-	-

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

Annexure-1: Instrument details

ISIN No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
-	Commercial Paper	NA	NA	7-365 days	200.00	[ICRA]A1+

Source: Asset Reconstruction Company (I) Limited

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About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

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