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Foreign investment in distressed assets in India: Opportunities and challenges

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Over the past decade, high growth rates, new start-ups and investment opportunities have made India a preferred choice for private equity investment.[1] However, a sluggish growth rate and the decreasing value of rupee have resulted in a bleak investment outlook towards India recently. The slow growth rate has resulted in companies not turning in expected performances, and has resulted in changing investors' mood and has given way to enhanced interest in distressed assets opportunities with good and reputed corporates coming under pressure.

Investment in distressed assets has increased substantially in the global markets and India is no different. Indians by mind-set are reluctant to dilution of equity and usually look towards debt when in need of funds. Such debt needs are traditionally met by banks with private debt forming a minor portion of such funding. In situations of economic downturn, when operating cash flows come under stress, banks, unlike private debt players, are in many cases unable to tailor the debt product to match the needs of the borrower.

While foreign investment has consistently explored opportunities for distressed asset funding in India, the regulatory environment has not been conducive to foreign investment, both in the form of equity and debt in distressed assets. Recent initiatives from a regulatory standpoint may play a larger role in encouraging investments in distressed assets. We discuss some of the drivers why distressed assets continue to grow, and then few models that are being used by foreign investors for distressed asset investments.

Drivers

Resistance to dilute

In India, a majority of companies are family run. According to a study by ASK Investment Managers, family-owned businesses comprise over 75% of the top 500 publicly listed companies.[2] These family-run businesses amount to approximately 60% of the total market capitalisation. Another study estimates the total number of companies in India that are promoter led to be around 85%.[3] These companies are led by the promoter(s), who are averse to giving up any control of the company, and hence are reluctant to dilute their equity in the company. Hence, the preference is to meet funding needs by raising debt.

Lack of funding sources

The main source of finance for companies has traditionally been bank finance. However, stringent RBI provisioning norms require banks to declare loans as non-performing assets (NPAs)[4] if the loans remain unpaid or have not been serviced for certain periods. Once a loan has been declared as an NPA, it results in immense reputational and financial loss to the company, which may choke the company of funds when needed as no other bank would fund the company.

Unlike other economies, pension funds and insurance companies in India have statutory restrictions on such investments, and hedge funds take a hands-off approach to distressed assets due to apprehensions of lack of liquidity.

Slow economic growth

The Indian economy slowed abruptly in 2010 and 2011, caused by a variety of reasons, including high inflation rate, weakening of the rupee, regulatory uncertainty along with high borrowing costs which resulted in industrial production to plummet.[5] At the beginning of 2012, the Indian private equity market had seemed to be on an upward trajectory, but by mid-year, the road ahead seemed increasingly bumpy. The economic slowdown has investors anticipating a spurt in the pool of distressed assets. These are generally due to cash flow issues faced by fundamentally strong corporates, which are generally a temporary phenomenon.

Stringent provisioning norms

On default, banks are required under law to treat 'un-serviced' loans as NPAs. In addition to having bad loans on their books, the assets of the bank are strained by the provisioning norms applicable to them, under which the banks are required to maintain capital reserves against their loans in default and provisions for restructured loans, if any.[6] A high percentage of loans under default also tend to indicate that the bank is adopting a riskier approach, leading to concerns about its growth, in addition to having a negative impact on the profitability and efficiency of the bank. The lack of assurance that these loans would become good on restructuring, provide additional incentive to dispose these loans from their books. Hence, for the above mentioned reasons, banks prefer to offload the bad loans from their books, rather than to restructure them.

Models and structures

With increasing distressed assets targets, interest in distressed assets from a foreign investment perspective has increased substantially. Foreign investment can be routed into distressed assets through one of the following models.

Asset Reconstruction Company and securitisation model

The ability of an Asset Reconstruction Company (ARC) to receive foreign investment was hitherto limited to only 49% and that too with prior approval of Foreign Investment Promotion Board (FIPB).[7] However, in December 2012, the Central Government enhanced the foreign investment limit from 49% to 74% and further in August 2013 from 74% to 100%. Out of this 49% will be permitted under the automatic route.

Further, foreign investment in security receipts (SRs) issued by a scheme of SRs issued by an ARC which was hitherto permitted only up to 10% by an individual foreign institutional investor (FII) is also now permitted up to 74% and the restriction of 10% has now been dispensed with.[8]

Even as regards the investment in SRs, the requirement of bidding for debt limits and the expensive auction process has been done away with and FIIs can now invest up to 74% of such SRs under the FII route using the US$51bn limit which is now available on-tap. Such relaxation is likely to encourage foreign investment in ARCs, which often was cash starved to purchase the NPAs from banks and financial institutions.

Key challenges:

- ARCs can only acquire NPAs and to that extent distressed loans which have not yet become NPAs may not be able to be acquired by ARCs. Hence a foreign investor willing to invest in a distressed asset which is not yet an NPA may not be able to use the ARC model.
- Even though foreign investment up to 100% has been allowed, such investment above 49% remains subject to FIPB approval, which is seen on a case to case basis. However, importantly, a single investor may not hold more than 50% of the capital of the ARC[9] and to that extent the ability to take control of the recovery and revival of the distressed assets may not be in the control of the foreign investor, which is extremely crucial for distressed assets. Even though 74% foreign investment in SR has been allowed, the trust issuing such SRs must be sponsored by an ARC which in most cases is promoted by state owned bodies and have seen little success thus far.

Private investment in public equity model

Private investments in public equity (PIPE) are popular for two reasons. First, unlike a private company, valuation of the entry and exit price of a listed company can be easily determined based on the market. Second, exits from a listed company are much easier as there is usually ready market for sale and from a regulatory perspective there are no regulatory challenges in terms of entry and/ or exit price valuation, as in case of unlisted companies.[10]

Key challenges:

- An acquisition of 25% or more shares of an Indian company or the acquisition of control of the company would trigger an open offer under the Securities Exchange Board of India (SEBI)

Figure 1: Foreign investments in ARCS

	Prior to December 2012 IRR	Prior To August 2013 (changes introduced by the circular)	Post August 2013 (changes introduced by the Press Note)
Foreign investments in ARCs			
FDI	49% Government route	74% Government route	49% - Automatic route; Beyond 49% – Government route
FII	Not permitted		
Security receipts of ARC or scheme/ trust of an ARC			
FII	49% 10%- limit for individual FII	74%	No change

Source: Nishith Desai Associates

Substantial Acquisition of Shares and Takeover Regulations, 2011 (SAST) mandating such acquirer to make an open offer of at least 26% of the shares of the company. Therefore the ability of a foreign investor to acquire control of a listed company is limited to such extent.

- The turn-around of a company with distressed assets is much easier in a closely held company compared to a listed company. To take a listed company private, delisting and squeeze out of minorities may be required, which in the current regulatory environment, has its own challenges.
- The insider trading regulations may be attracted in the case of a public company, which might impede the exit of a foreign investor.

Non-convertible debenture model

Under the non-convertible debenture (NCD) model, any foreign investor, i.e. an FII or a Qualified Foreign Investor (QFI)[11] can invest up to US$51bn on-tap to purchase or subscribe to or to-be-listed debentures under the FII or the QFI route. NCDs can be used for distressed asset funding since the NCDs can be structured in a manner that the redemption premium can be pegged to the cash flows of the company or any other variable of the company such that the investor earns an equity upside. Further, since NCDs are pure loans, security creation may be possible through an Indian security trustee and there are no regulatory limits on the amount of payouts of such NCDs, as against compulsory convertible debentures (CCDs).[12] Further, NCDs are not subjected to any pricing restriction, and hence can be freely priced, as compared to other FDI investment options, which generally have to comply with DCF valuation.

The proceeds of the loans received from the NCDs may be used to discharge the rigid and inflexible bank loans. The terms of the NCDs can be tailored to suit the needs of the borrower such as a longer term maturity, moratorium in earlier years, lower interest and higher redemption premium, etc.

Key challenges:

- Being pure lenders, an NCD holder may not exercise the same degree of control on the company as an equity shareholder.
- Payment of excessive interest or redemption premium may be disallowed by tax authorities as a deduction for the Indian company.
- In cases of security enforcement, the NCD holders have to rely on the security trustee, as against driving the enforcement process on their own.

Non-banking financial company model

Onshore funding vehicles such as non-banking financial company (NBFCs)[13] have become increasingly popular for distressed asset funding. Such NBFCs may fund either by way of loan, or investment in shares of the Indian company. Investment NBFCs[14] requires prior approval of FIPB to receive any amount of foreign investment and therefore the typical model adopted by NBFCs have been lending. The proceeds of the loan received from the NBFC is used to discharge expensive bank loans and the terms of the loans received by the NBFC can be tailored to suit the needs of the borrower such as a longer term maturity, moratorium in earlier years, lower interest and higher redemption premium, etc.

Key challenges:

- If any NBFC has more than Re100 crores of assets, then such NBFC cannot invest more than 15% of its owned fund in a single companys and more than 25% of its owned fund in a group of companies.
- Any NBFC accepting foreign investment to an extent exceeding 75% needs to be capitalised for a minimum of US$50m, which may trigger the prudential norms, as mentioned above.
- Setting up a new NBFC is a time consuming process, while acquiring an existing NBFC comes with its own risks of historic liabilities.

Buyouts/equity funding structure model

Direct investment into the company by offshore investors under the Foreign Direct Investment (FDI) route is another attractive option. Under this route, the investors enter into a shareholders agreement with the company and the promoters of the company, and have rights under the agreement.

Key challenges:

- Exit is generally an important challenge for investors in India.
  - Lack of an environment conducive to initial public offerings substantially limit its possibility as an exit option.
  - RBI has constantly been questioning put options contained in agreements stating that the same makes the investment in the nature of debt and hence, the enforceability of put options is questionable in India currently.
  - The maximum price at which investors can exit is as per the discounted cash flow method, which restricts the premium on redemption that the investors would like to receive.
  - The transfer of shares of the company, i.e. a trade sale, requires the cooperation of the promoters of the company, which may be an issue.

Conclusion

The means of achieving success of distressed asset funding by way of the turnaround of the business may typically be by way of acquiring control and changing the management of the company, sale of the non-core business of the investee entity or by hiving off the main profitable entity into a new entity and/ or salvaging the real assets of the company. Each option may have its tax and regulatory challenges in addition to the practical issues of dealing with other lenders, banks, etc.

In a market where promoters are reluctant to dilute their equity in the company, the traditional modes of distressed assets funding are unlikely to succeed. As such, innovative or alternative modes of investment are required, and the structures discussed here provide the alternative modes for investment into distressed assets.

Notes:

1. India Private Equity Report 2011, Bain & Company.
2. As per market capitalisation excluding banks and financial institutions.
3. From the Family to the Firm: A view from the Indian Prism, January 2013, Deloitte.
4. A loan is considered an NPA when the repayment of the installment of the principal amount or the interest repayment remains outstanding or overdue for over 90 days. Further, if such asset remains an NPA for a period of less than or equal to 12 months, it will classified as a 'sub-standard asset' in the books of the bank; if it remains an NPA for a period of more than 12 months, it shall become a 'doubtful asset'. Any asset where a loss has been identified by the auditors, or by the Reserve Bank of India, but the asset continues to remain in the books of the bank, it shall become a loss asset, which is considered uncollectible although there might be some recoverable or salvage value.
5. India Private Equity Report 2013, Bain and Company.
6. The provisions for restructured loans have been increased from 2.5% to 5% with effect from June 2013.
7. http://rbi.org.in/Scripts/NotificationUser.aspx?Id=2613&Mode=0
8. http://www.rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=8318
9. Ibid

[10] In India, entry and exit price valuation shall be in terms of the Discounted Cash Flow (DCF) method of valuation.

[11] Any such person, FII or QFI may invest upto US$51bn as long as such investment is not structured under the Portfolio Investment Scheme (PIS).

[12] There is a 13%-14% limit on payout of CCDs, however, such limits do not apply to NCDs.

[13] A NBFC is defined under Section 45I(c) of the RBI Act as a company engaged in granting loans/advances or in the acquisition of shares/securities, etc. in any manner provided the principal business of such a company does not constitute any non-financial activities.

[14] An investment NBFC is a financial institution carrying on as its principal business the acquisition of securities.

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