

Press Release

Edelweiss Asset Reconstruction Company Limited

November 26, 2018

Rating Assigned



Total Instruments Rated*	Rs. 300.00 Cr.
Long Term Rating	ACUITE Provisional**AA+/Stable (Assigned)

* Refer Annexure for details

**Acuité shall convert the provisional rating into final rating on receipt of the final instrument term sheet, executed trust deed, corporate guarantee and appointment of debenture trustee.

Acuité has assigned its '**ACUITE Provisional AA+**' (read as **ACUITE provisional double A plus**) rating to the Rs. 300.00 Cr. Proposed Non-Convertible Debentures of **Edelweiss Asset Reconstruction Company Limited (EARC)**. The outlook is '**Stable**'.

The rating is based on the credit risk profile of Edelweiss Financial Services Limited (EFSL), which will provide unconditional and irrevocable guarantee for the proposed NCD issue. The structured payment mechanism for the instrument will ensure timely servicing of the debt obligation including principal and interest.

Payment structure for the proposed NCD issue

Day*	Action
T-1	EARC to deposit funds to meet coupon payment/principal redemption
T	In the event EARC fails to deposit the requisite funds in the designated account on any T-1 date, EFSL shall deposit the shortfall amount in the designated account on T date to meet the coupon payment/principal redemption.

* T being coupon payment date, scheduled/early principal redemption date, or put/call option date

Analytical Approach

To arrive at its rating, Acuité has considered the standalone business and financial risk profiles of EARC and notched up the rating by factoring in support from the holding company of the Edelweiss group i.e. Edelweiss Financial Services Limited.

About the company

EARC is sponsored by Edelweiss group, one of India's leading & diversified financial services conglomerate. The company was incorporated in 2007 and is registered with Reserve Bank of India as an Asset Reconstruction Company in 2009. EARC is in the business of acquiring non-performing assets (NPAs) from banks and financial institutions and resolving them through appropriate resolution strategies. EARC has acquired financial assets from 57 Banks & Financial Institutions till date.

Edelweiss Group currently holds 74.81% stake in EARC with the balance held by high networth individuals (HNIs) and institutional investors. CDPQ (Caisse de Depot et Placement du Quebec), one of North America's largest pension fund managers, has invested Rs. 500 Cr in EARC through compulsorily convertible preference shares which shall be converted into equity shares within 4 years from the investment.

About the Edelweiss Group

Edelweiss Financial Services Limited (EFSL), the holding company of the Edelweiss group, was incorporated in 1995. Edelweiss group offers a robust platform of financial services to a diversified client base across domestic and global geographies. Its key line of businesses includes: credit (retail, corporate and distressed), franchise & advisory (wealth management, asset management and capital markets) and insurance (life and general). The Edelweiss group comprises of Edelweiss Financial Services Ltd and its 59 subsidiaries and 5 associate companies. Edelweiss group has a pan India presence with a global footprint extending across geographies with offices in New York, Mauritius, Dubai, Singapore, Hong Kong and UK.

Key Rating Drivers

Strengths

Expectation of strong support from Edelweiss Financial Services Ltd

EARC, promoted by EFSL, is strategically important to the Edelweiss group, as distressed asset business has been identified as a key focus area for the group given the strong growth potential for the segment in India. In addition to EARC, Edelweiss group has also launched distressed asset funds to manage third party investments in this segment. The recent regulatory changes such as enactment of The Insolvency and Bankruptcy Code 2016 has resulted in paradigm shift in the recovery of stressed assets which augurs well for players like EARC. This segment has attracted major foreign investments consequent to the recent regulatory changes.

As on 30th September 2018, EFSL (through its various subsidiaries) has invested Rs.281 Cr in EARC and holds 74.81% stake. The group will infuse additional capital to support its growth plans over the medium term. CDPQ, a leading North American pension fund manager, has invested Rs.500 Cr in EARC in the form of CCPS. On a fully diluted basis, the stake of Edelweiss group shall be 60% & CDPQ will hold 20% stake (post conversion into equity) in the company.

The parent continues to extend branding, strategic, management, and funding support to the company. EARC benefits from the synergies with the credit and investment banking businesses of the group. The group's senior management has representation on the company's board and plays a key role in the strategic decisions of the company. The company also benefits from the expertise and active involvement of the group's senior management in the acquisition and resolution process for large NPA acquisitions.

EARC also benefits from the strong presence of the group in the financial services market which enables the company to raise long-term funding from a diverse investor base. Additionally, EFSL has extended unconditional and irrevocable guarantees for some of the capital market borrowings of the company on a need based basis.

Acuite believes that EARC will continue to benefit from the strong support from the ultimate parent given the strategic importance to the group and the shared brand name and the synergies with the group's other businesses.

Leading market position in Asset Reconstruction business

EARC is the largest player in the distressed asset business in India with outstanding security receipts (both own and managed) of Rs. 47,310 Cr as on 30th September 2018 (Rs. 43,598 Cr as on 31st March 2018). The AUM has significantly increased over a period of 5 years (FY14 to FY18) at a compounded annual growth rate (CAGR) of 48%.

The growth has been supported by the sharp increase in the stressed assets of Indian banks and the focus on cleaning up the banks' balance sheet coupled with favorable changes in regulation enabling increased sale of stressed assets. The discount rates for recent acquisitions have been impacted by increased competitive intensity and improved recovery prospects for many of the stressed assets. EARC undertakes detailed evaluation of the NPAs and the recovery prospects and decides its pricing strategy based on the risk-reward assessment. EARC focuses on debt aggregation

which enables the company to play a critical role in the NPA resolution and recovery prospects; the company has acquired nearly 100% debt in many of the top NPAs or is among the leading lenders.

Acuité believes that EARC is expected to maintain its leadership position in the market, based on its expertise and recovery track record and presence of a fully dedicated turnaround team.

Comfortable capitalisation

EARC has a comfortable capitalisation as reflected in its large net worth of Rs.1,077 Cr as on 31 March 2018 (Rs.835 Cr a year ago). EFSL-the holding company has infused equity capital of Rs. 281 Cr till date. It has also attracted external capital – CDPQ has invested Rs. 500 Cr in the company. The parent company shall continue to support the company by way of regular capital infusion. The regular capital support has resulted in moderate gearing of 3.7 times as on March 31, 2018 (3.8 times as on March 31, 2017). As on March 31, 2018, 52% of the EARC's borrowings were from Edelweiss group companies and excluding such group company borrowings, its adjusted gearing stood at 1.8 times as on March 31, 2018 as against 2.2 times as on March 31, 2017. EARC's gearing is expected to remain below 5 times on a steady state basis over the medium term. The capital adequacy remained stable at 20.50% as on March 31, 2018. EARC also benefits from the steady accruals to networth as reflected in the return on average net worth of 18.7% in FY 2018 (19.6% in FY 2017).

Acuité believes that EARC will maintain comfortable capitalisation supported by its large net worth, steady accruals to net worth, and demonstrated ability to raise capital.

Weaknesses

Volatile earnings profile

EARC's earnings profile comprises of management fee and profits linked to the recoveries from the acquired assets. Management fees will continue to form a stable source of income for the company given EARC's scale of operations. However, the earnings profile is susceptible to the volatility inherent in the recoveries from acquired assets and fair valuation of the underlying SR investments (as per IND AS, outstanding SRs shall be booked on fair value). The stream of management fees is relatively steady as it is linked to the assets acquired and has priority over payments to the SR holders. However, the recovery income can be lumpy depending upon the recoveries during a particular period and hence overall earnings profile exhibits volatility. Also, any changes in fair value of outstanding SRs held by EARC may add to the volatility.

Out of EARC's total income of Rs.833 Cr for FY 2018, Rs.784 Cr is fee based income i.e. 94% (96% in the previous year). In H1FY19, EARC has booked a management fee income of Rs.471 Cr. and ~Rs.79 Cr was booked on account of fair value changes made.

Acuité believes that the favorable changes in the regulatory environment for recovery from NPAs coupled with the increased skin in the game for the ARCs (in terms of higher investments in the NPA acquisitions and higher provisioning requirement for banks on their SR investments) is expected to support higher recoveries from large stressed accounts over the medium term. However, any sharp decline in the recoveries or sharp increase in credit provision shall impact the profitability and shall remain key monitorable.

Inherent challenges in the industry

EARC will continue to face challenges given the inherent nature of the asset reconstruction business. The key is the assessment of the discount rates at which the distressed assets are acquired. Recent trend shows that the discount rate for recent NPA acquisitions are declining steadily in many cases because of various factors including high probability of recoveries and changes in regulations. Any significant aggression by ARCs may adversely impact the profitability and ability to mobilize attractive funding for future NPA acquisitions.

The profitability of the company depends on timely resolution of the stressed assets. Also, the management fees is now linked to the NAV instead of the face value of the SRs. Given the scale up of the operations of EARC in recent years, the sustainability of the recovery performance will be visible only over the medium term, especially as NPA resolution is a long process and is linked to level of industrial and economic activity in the country.

Furthermore, the provisioning requirement for banks' investment in SRs against the NPAs sold by them to the ARCs have been changed recently. This will result in either slowdown in the growth of the ARCs or significant increase in cash deal with banks, thus resulting in sharp increase in the funding requirements for the ARCs. The ability of the ARCs to tap third party investments in these SRs will remain the key to the growth of the industry.

Liquidity Position

EARC mainly relies on long term funding with tenure of 9-10 years, where the payments are fairly staggered. Also, EARC maintains adequate amount of unutilized bank lines. EARC has a steady inflow of management fees which provides adequate cushion for debt servicing. Also, support from Edelweiss group shall act as a liquidity support.

Outlook: Stable

Acuité believes EARC will maintain 'Stable' credit risk profile over the medium term supported by the continued support from EFSL, its leadership position in the ARC segment and comfortable capitalisation. The outlook may be revised to 'Positive' in case of a material and sustained improvement in the earnings profile or if there is improvement in the Edelweiss group's credit risk profile. Conversely, the outlook may be revised to 'Negative' if there is lower than expected support from the group or weakening in the group's credit risk profile. Deterioration in capital position or in the earnings profile will also result in a 'Negative' outlook.

About the Rated Entity - Key Financials

	Unit	FY18	FY17	FY16
Total Assets	Rs. Cr.	5276.86	4249.46	2509.08
Total Income (Net of Interest Expense)	Rs. Cr.	407.71	211.10	92.84
PAT	Rs. Cr.	178.33	101.99	44.98
Net Worth	Rs. Cr.	1077.49	834.90	205.52
Return on Average Assets (RoAA)	(%)	3.74	3.02	2.23
Return on average Net Worth (RoNW)	(%)	18.65	19.60	25.07
Total Debt/Tangible Net Worth (Gearing)	Times	3.67	3.77	10.91
Gross NPA	(%)	NA	NA	NA
Net NPA	(%)	NA	NA	NA

Status of non-cooperation with previous CRA (if applicable)

None

Any other information

None

Applicable Criteria

Default Recognition: <https://www.acuite.in/view-rating-criteria-17.htm>

Non-Banking Financing Entities: <https://www.acuite.in/view-rating-criteria-10.htm> Securitized Transactions : <https://www.acuite.in/view-rating-criteria-29.htm>

Group and parent support: <https://www.acuite.in/view-rating-criteria-24.htm>

Application of Financial Ratios and Adjustments: <https://www.acuite.in/view-rating-criteria-40.htm>

Note on complexity levels of the rated instrument

<https://www.acuite.in/criteria-complexity-levels.htm>

Rating History (Upto last three years)

Not Applicable

*Annexure – Details of instruments rated

Name of the Facilities	Date of Issuance*	Coupon Rate*	Maturity Date*	Size of the Issue (Rs. Cr.)	Rating/ Outlook
Proposed Non-Convertible Debentures	29-Nov-18	9.90	24-Nov-28	300.00	ACUITE Provisional AA+/ Stable

*tentative; yet to be finalized.

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About Acuité Ratings & Research:

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