

Press Release

Edelweiss Asset Reconstruction Company Limited

August 01, 2019



Rating Reaffirmed

Total Instruments Rated*	Rs. 300.00 Cr.
Long Term Rating	ACUITE AA+/Negative (Reaffirmed; Outlook: revised from Stable to Negative)

* Refer Annexure for details

Rating Rationale

Acuité has reaffirmed the rating of **ACUITE AA+ (read as ACUITE double A plus)** on the Rs. 300.00 Cr. Secured Guaranteed Non-Convertible Debentures of Edelweiss Asset Reconstruction Company Limited (EARCL). The outlook is revised from '**Stable**' to '**Negative**'.

Acuité has recently reaffirmed the rating on Unsecured Perpetual Non-convertible debentures of Edelweiss Group while revising the outlook to **Negative** from **Stable**. The revision in outlook is primarily driven by the significant exposures to real estate sector entities and other big ticket exposures to entities with below average financial risk profile. Acuite believes that the credit profile of EARCL will be significantly aligned to the overall credit profile of the Edelweiss Group. This is especially in view of the fact that EARCL's resource raising ability will be linked to the Edelweiss Group's Financial Flexibility.

The changes in the regulatory dispensation governing ARCs has resulted in a tilt towards acquisition of assets through cash deals. EARCL acquired Rs. 7739 Cr. of distressed assets in FY2019 as against Rs. 7008 Cr. in FY2018. Acquisition through Cash consideration comprised 53 percent of the overall acquisitions in FY2019 as against 19 percent in FY2018. The growth in cash deals has resulted in increased capital intensity of the business. These changes in the business model have translated into higher capital requirements for the ARCs and hence the financial flexibility of Edelweiss Group to infuse additional funds to support EARCL's business growth will be a key rating monitorable.

Analytical Approach:

To arrive at its rating, Acuité has considered the standalone business and financial risk profiles of EARCL and notched up the rating by factoring in support from the holding company of the Edelweiss Group i.e. Edelweiss Financial Services Limited (on a consolidated basis). EFSL has extended its unconditional and irrevocable guarantee for the NCD issue.

The terms of the NCD also have a payment structure to ensure timely servicing of the debt obligation including principal and interest, as under:

Payment structure for the proposed NCD issue

Day*	Action
T-1	EARCL to deposit funds to meet coupon payment/principal redemption
T	In the event EARCL 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 by 12 pm. In case the Guarantor fails to deposit such funds in the designated account on T date, it will be constituted as a default on part of the Guarantor.

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

About the Edelweiss Group:

Edelweiss Financial Services Limited (EFSL), the holding company of Edelweiss Group, was incorporated in 1995 and has diversified its line of operations across various fund based and non-fund based businesses. Edelweiss offers a bouquet of financial services, to a diversified client base across domestic and global geographies. Its key line of business includes; credit (retail, corporate and distressed), franchise & advisory (wealth management, asset management and capital markets) and insurance (life and general).

The Edelweiss Group comprises Edelweiss Financial Services Limited, 59 subsidiaries and 2 associate companies (As on March 31, 2019). 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.

About the company-EARCL

EARCL 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. EARCL is in the business of acquiring non-performing assets (NPAs) from banks and financial institutions and resolving them through appropriate resolution strategies. EARCL has acquired financial assets from 57 Banks & Financial Institutions till date.

EFSL holds 74.81% stake in EARCL (as on March 31, 2019) 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 EARCL through compulsorily convertible preference shares which shall be converted into equity shares within 4 years from the investment.

Key Rating Drivers

Strengths

- Expectation of strong support from Edelweiss Financial Services Limited:**

EARCL, 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 EARCL, 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 EARCL. This segment has attracted major foreign investments consequent to the recent regulatory changes.

As on March 31, 2019, EFSL (through its various subsidiaries) has invested Rs.281 Cr in EARCL and holds 74.81% stake. The group will infuse additional capital to support its growth plans over the medium term. The regular capital support has resulted in moderate gearing of 2.8 times as on March 31, 2019 (3.6 times as on March 31, 2018). EFSL has extended unconditional and irrevocable guarantees for some of the capital market borrowings of the company on a need based basis. (Rs. 1606.7 Cr. of EARCL's capital market borrowings are guaranteed by EFSL as on date). CDPQ, a leading North American pension fund manager, has invested Rs.500 Cr in EARCL 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. Acuité expects Edelweiss Group to Support EARCL's growth plans over the medium term.

Besides funding support, the Group continues to extend branding, strategic, management, and funding support to the company. EARCL 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 inputs from the group's senior management in the acquisition and resolution process especially for large NPA acquisitions.

EARCL also benefits from the strong presence of the group in financial services which enables the company to raise long-term funding from a diverse investor base.

Acuité believes that EARCL 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**

EARCL is a leading player with ~50 percent market share in the distressed asset business in India with outstanding security receipts AUM of Rs. 46,424 Cr as on March 31, 2019 (Rs. 43,598 Cr as on 31st March 2018).

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 sheets. The regulatory changes to facilitate resolution of stressed assets has resulted in a higher role for ARCs who are better equipped to resolve distressed assets on account of their expertise in these areas.

EARCL undertakes detailed evaluation of the NPAs and the recovery prospects and decides its pricing strategy based on the risk-reward assessment. EARCL 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 EARCL 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.

Weaknesses

- **Susceptibility of earnings profile to acquisition of assets and timely resolution:**

EARCL'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 EARCL'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 over overall earnings profile exhibits volatility. The quality of distressed assets (reflected in the recovery ratings) held by ARC has declined in FY2019. A larger proportion of the security receipts of the underlying distressed assets have slipped to the lower rated categories indicating lower likelihood of recoveries from these assets.

Acuité believes that the future earning profile of the EARCL will depend on its ability to successfully identify and acquire distressed assets and also to resolve these assets in a timely manner. The challenges to timely resolution of these assets (especially large ticket assets) due to factors like lack of consensus amongst lenders, changes in regulatory environment etc. will continue to impinge on its operating performance and profitability.

- **Inherent challenges in the industry:**

EARCL will continue to face challenges given the inherent nature of the asset reconstruction business. The changes in the regulatory regime pertaining to acquisition of distressed assets from banks by ARC has tilted the balance in favor of those ARCs who are able to acquire assets for direct cash conditions as against issuance of Security receipts. The current disposition does not provide any significant benefits to the banks (sellers of these distressed assets) in case the investment of the bank in these SR's exceed a threshold limit. Hence, the banks are incentivized to go for cash deals.

Against this backdrop, ARCs like EARCL have a higher dependence on its sponsors to provide funding support in order to demonstrate a consistent growth in acquisition of distressed assets. The intense competition from other ARC's will also add to the headwinds in achieving the growth in scale of operations.

Liquidity Position

EARCL mainly relies on long term funding with tenure of 9-10 years, where the payments are fairly staggered. Also, EARCL maintains adequate amount of unutilized bank lines. EARCL 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: Negative

Acuité believes that the Group's credit profile could face pressures over the near to medium term on account of its significant exposure to entities in real estate and elevated possibility of asset quality slippages in view of the below average credit profile of certain large borrowers. The outlook may be revised to Stable in case the Group is able to demonstrate a significant traction in its retail loan book while maintaining or improving its profitability, capitalization and asset quality metrics. Conversely, the rating will be downgraded in case of any increase in credit costs due to asset quality slippages or deterioration in capitalisation or profitability metrics. Any significant decline in the Group's stake in EARCL below existing levels will be key rating sensitivities.

EFSL- Key financials (Consolidated)

	Unit	FY19 (Actual)	FY18 (Actual)	FY17 (Actual)
Total Assets	Rs. Cr.	64052.9	62892.2	45063.9
Total Income*	Rs. Cr.	6159.2	5044.5	3809.1
PAT	Rs. Cr.	995.17	863.18	609.30
Net Worth	Rs. Cr.	7674.5	6906.0	4483.5
Return on Average Assets (RoAA)	(%)	1.65	1.55	1.37
Return on Average Net Worth(RoNW)	(%)	14.34	14.70	12.73
Total Debt/Tangible Net Worth (Gearing)	Times	6.06	7.09	7.76
Gross NPA	(%)	1.87	1.75	1.59
Net NPA	(%)	0.83	0.70	0.60

EARCL- Key Financials (Standalone)

	Unit	FY19 (Actual)	FY18 (Actual)	FY17 (Actual)
Total Assets	Rs. Cr.	6840.37	5476.84	4359.39
Total Income*	Rs. Cr.	774.92	345.97	211.10
PAT	Rs. Cr.	435.02	180.17	101.99
Net Worth	Rs. Cr.	1734.93	1158.52	914.05
Return on Average Assets (RoAA)	(%)	7.06	3.66	2.97
Return on Average Net Worth(RoNW)	(%)	30.07	17.39	18.22
Total Debt/Tangible Net Worth (Gearing)	Times	2.79	3.57	3.52
Gross NPA	(%)	NA	NA	NA
Net NPA	(%)	NA	NA	NA

*Total income equals to Total Income net off interest expense

Status of non-cooperation with previous CRA

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>
- 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)

Date	Name of Instrument / Facilities	Term	Amount (Rs. Cr)	Ratings/Outlook
17- Dec-18	Secured Guaranteed Non-Convertible Debentures	Long term	10.00	ACUITE AA+/Stable (Assigned)
	Proposed Secured Guaranteed Non-Convertible Debentures	Long term	290.00	ACUITE AA+/Stable (Assigned)
26-Nov -18	Proposed Non-Convertible Debentures	Long term	300.00	ACUITE Provisional AA+/Stable (Assigned)

*Annexure – Details of instruments rated

ISIN	Name of the Facilities	Date of Issuance	Coupon Rate	Maturity Date	Size of the Issue (Rs. Cr.)	Ratings/Outlook
INE015L07618	Secured Guaranteed Non-Convertible Debentures	13-Dec-18	9.9%	08-Dec-2028	10.00	ACUITE AA+/ Negative (Reaffirmed)
INE015L07618	Secured Guaranteed Non-Convertible Debentures	21-Dec-18		08-Dec-28	26.50	ACUITE AA+/ Negative (Reaffirmed)
INE015L07618	Secured Guaranteed Non-Convertible Debentures	04-Jan-19		08-Dec-28	36.00	ACUITE AA+/ Negative (Reaffirmed)
INE015L07618	Secured Guaranteed Non-Convertible Debentures	27-Mar-19		08-Dec-28	10.00	ACUITE AA+/ Negative (Reaffirmed)
INE015L07618	Secured Guaranteed Non-Convertible Debentures	15-Apr-19		08-Dec-28	6.00	ACUITE AA+/ Negative (Reaffirmed)
-	Proposed Secured Guaranteed Non-convertible Debentures	NA	NA	NA	211.50	ACUITE AA+/ Negative (Reaffirmed)

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About Acuité Ratings & Research:

Acuité Ratings & Research Limited (Erstwhile SMERA Ratings Limited) is a full-service Credit Rating Agency registered with the Securities and Exchange Board of India (SEBI). The company received RBI Accreditation as an External Credit Assessment Institution (ECAI), for Bank Loan Ratings under BASEL-II norms in the year 2012. Since then, it has assigned more than 6,000 credit ratings to various securities, debt instruments and bank facilities of entities spread across the country and across a wide cross section of industries. It has its Registered and Head Office in Mumbai.

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