

Press Release

Edelweiss Asset Reconstruction Company Limited

February 06, 2020



Rating Downgraded

Total Instruments Rated*	Rs. 300.00 Cr.
Long Term Rating	ACUITE AA (CE [^]) /Negative (Rating downgraded from ACUITE AA+/Negative)

* Refer Annexure for details

[^]Credit Enhancement in the form of corporate guarantee from EFSL

Rating Rationale

Acuité has downgraded the long term rating to '**ACUITE AA (CE)**' (**read as ACUITE double A (Credit Enhancement)**) from '**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 continues to be '**Negative**'.

The rating action in respect of EARCL is primarily driven by Acuité's recent decision to downgrade the rating on certain instruments of Edelweiss Group (EG) while continuing the outlook as Negative. Acuité further 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.

Reasons for revision in rating on instruments of EG:

The revision in rating is primarily driven by Acuité's expectation of a significant increase in credit costs due to asset quality pressures and a moderation in the profitability metrics of the Edelweiss Group during FY2020. The rating action in respect of Edelweiss Group also factors in Acuité's belief that the group may face challenges in attaining any significant improvement in its asset quality and profitability metrics over the near term, due to the tepid economic environment.

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 credit enhancement in the form of corporate guarantee extended by Edelweiss Financial Services Limited (The ultimate holding company of EG). EFSL has extended its unconditional and irrevocable guarantee for the NCD issue. The rating of Edelweiss Group is central to the rating of EARCL.

Standalone (Unsupported) Rating: ACUITE A+

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 September 30, 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 September 30, 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 2.5 times as on September 30, 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. EARCL's financial flexibility is supported by the group's demonstrated ability to mobilise resources through setting up of various funds based on investor preferences such as distressed credit fund, Real estate Credit Fund, Structured debt fund and Infrastructure Fund. The aggregate size of distressed credit fund as on September 30, 2019 is Rs. 9850 Cr. of which is Rs. 6100 Cr. has already been deployed and the remaining Rs. 3750 Cr. is available for deployment (based on Investor presentation).

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. 46,858 Cr. as on September 30, 2019 (Rs. 46,424 Cr as on 31st March 2019).

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 majority stake (i.e. above 50 percent) in many of the top NPAs as on September 30, 2019.

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 optimal acquisition and resolution strategy:**

EARCL's earnings profile comprises of management fees, recovery incentives and upside premium 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 is linked to the assets under management and has priority over payments to the SR holders. The recovery incentives and upside from acquired assets are likely to fluctuate depending on the performance of the ARC. Since EARCL may not be the sole lender in most of the cases, its ability to influence a resolution strategy will also require a concurrence of the other lenders. Generally, higher the quantum of debt aggregated by EARCL, higher would be the ability to influence the resolution strategy.

The top 10 exposures of EARCL accounted for 41 percent of the overall outstanding SRs as on September 30, 2019. Of these exposures, Essar Steel India Limited which comprised ~10 percent of the overall SRs held as on September 30, 2019 has been resolved in Q3FY2020. The Essar Steel judgment by Supreme Court is expected to serve as precedent and pave the way for quicker resolution of other such cases. Amongst the top 10 exposures of EARCL, the balance exposures are from different sectors like steel, ports, power and paper. Some of these exposures have been initiated as early as FY2014 and FY2015.

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, Edelweiss Group will have to mobilise funds through various investors which can be utilized to support the growth in acquisition of distressed assets. The continued confidence of the potential investors in the Edelweiss Group will be necessary in order to attract funds under these arrangements.

Rating Sensitivities

- Regulatory environment governing ARCs
- Deterioration in credit profile/financial flexibility of Edelweiss Group

Material Covenants

Edelweiss Group is subject to covenants stipulated by its lenders/investors in respect of various parameters like capital structure, asset quality among others. As per confirmation from edelweiss, they are compliant with covenants stipulated by lenders/investors.

Liquidity Position: Adequate

EARCL mainly relies on long term funding with tenure of 9-10 years, where the payments are fairly staggered. EARCL has a steady inflow of management fees which provides adequate cushion for debt servicing. Since a part of EARCL's cash flow will come from long term resolution of assets, the funding profile is in sync and is long tenured.

EARCL's liquidity profile is supported by the group's centralised treasury operations and adequate liquidity position. The group has demonstrated the ability to raise medium to long term funding from banks/capital markets which should support the Group's ability to plug any possible mismatches. The Group's liquidity profile is supported by funding from diversified base i.e. banks and financial institutions along with capital market instruments like CBLO borrowings, Commercial Papers and NCDs. The Group on a consolidated basis had maintained liquidity buffers of Rs. 10, 300 Cr. (includes short term loan book of Rs. 4150 Cr. as on December 31, 2019. EARCL is supported by strong parentage of Edelweiss Group and can tap the excess liquidity available with the Group in case of future exigencies. Further, the group has received fresh sanction for securitization of Rs. 2930 Cr. during the period April to December 2019.

Outlook: Negative

Acuité believes that the Group's credit profile could face pressures over the near to medium term on account of increasing asset quality and profitability pressures on the back of a tepid operating environment. The outlook may be revised to Stable in case the Edelweiss Group is able to demonstrate a significant and sustainable improvement in its Net NPA levels (less than 1 percent) and profitability indicators (ROAA goes above 1.5 percent). Conversely, the rating will be downgraded in case of a further slippages in asset quality or significant challenges in achieving an improvement in profitability parameters. 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)
Total Assets	Rs. Cr.	64052.9	62892.2
Total Income*	Rs. Cr.	6159.2	5044.5
PAT	Rs. Cr.	995.17	863.18
Net Worth	Rs. Cr.	7674.5	6906.0
Return on Average Assets (RoAA)	(%)	1.65	1.55
Return on Average Net Worth(RoNW)	(%)	14.34	14.70
Total Debt/Tangible Net Worth (Gearing)	Times	6.06	7.09
Gross NPA	(%)	1.87	1.75
Net NPA	(%)	0.83	0.70

EARCL- Key Financials (Standalone)

	Unit	FY19 (Actual)	FY18 (Actual)
Total Assets	Rs. Cr.	6840.37	5476.84
Total Income*	Rs. Cr.	774.92	345.97
PAT	Rs. Cr.	435.02	180.17
Net Worth	Rs. Cr.	1734.93	1158.52
Return on Average Assets (RoAA)	(%)	7.06	3.66
Return on Average Net Worth(RoNW)	(%)	30.07	17.39
Total Debt/Tangible Net Worth (Gearing)	Times	2.79	3.57
Gross NPA	(%)	NA	NA
Net NPA	(%)	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>
- Credit enhancement: <https://www.acuite.in/view-rating-criteria-49.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
1 August 2019	Secured Guaranteed Non-Convertible Debentures	Long term	10.00	ACUITE AA+/ Negative (Reaffirmed)
	Secured Guaranteed Non-Convertible Debentures	Long term	26.50	ACUITE AA+/ Negative (Reaffirmed)
	Secured Guaranteed Non-Convertible Debentures	Long term	36.00	ACUITE AA+/ Negative (Reaffirmed)
	Secured Guaranteed Non-Convertible Debentures	Long term	10.00	ACUITE AA+/ Negative (Reaffirmed)
	Secured Guaranteed Non-Convertible Debentures	Long term	6.00	ACUITE AA+/ Negative (Reaffirmed)
	Proposed Secured Guaranteed Non-convertible Debentures	Long term	211.50	ACUITE AA+/ Negative (Reaffirmed)
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(CE) /Negative (Downgraded from ACUITE AA+/Negative)
INE015L07618	Secured Guaranteed Non-Convertible Debentures	21-Dec-18	9.9%	08-Dec-28	26.50	ACUITE AA(CE) /Negative (Downgraded from ACUITE AA+/Negative)
INE015L07618	Secured Guaranteed Non-Convertible Debentures	04-Jan-19	9.9%	08-Dec-28	36.00	ACUITE AA(CE)/Negative (Downgraded from ACUITE AA+/Negative)
INE015L07618	Secured Guaranteed Non-Convertible Debentures	27-Mar-19	9.9%	08-Dec-28	10.00	ACUITE AA(CE)/Negative (Downgraded from ACUITE AA+/Negative)
INE015L07618	Secured Guaranteed Non-Convertible Debentures	15-Apr-19	9.9%	08-Dec-28	6.00	ACUITE AA(CE)/Negative (Downgraded from ACUITE AA+/Negative)
-	Proposed Secured Guaranteed Non-convertible Debentures	NA	NA	NA	211.50	ACUITE AA(CE) /Negative (Downgraded from ACUITE AA+/Negative)

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About Acuité Ratings & Research:

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