

Press Release

Edelweiss Asset Reconstruction Company Limited

February 05, 2021

Rating Reaffirmed



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

* Refer Annexure for details

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

Rating Rationale

Acuite has reaffirmed the long term rating to '**ACUITE AA (CE)**' (read as **ACUITE double A (Credit Enhancement)**) 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 reaffirmation takes into account strategic importance EARCL holds for the Edelweiss group including expectation of management, financial and operational support from the group, established market position with outstanding securities receipts AUM of Rs.42,072 Cr. as on September 30,2020. The rating also factors in reduction in gearing levels (1.97 times as on September 30, 2020 as against 2.15 times as on March 31, 2020) and improvement in capital adequacy ratio of 34% as on September 30,2020 as against 32.5% as on March 31,2020.

These strengths are constrained by the susceptibility of the earning profile 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), high concentration risks (top 10 exposures of EARCL accounted for ~31 percent of the overall outstanding SRs as on September 30, 2020) and uncertainty associated with the resolution of stressed assets in the current operating environment.

Analytical Approach:

To arrive at its rating, Acuite 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, 56 subsidiaries, 66 trusts and 5 associate companies (As on March 31, 2020). 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 70 Banks & Financial Institutions till date.

EFSL holds 74.8% stake in EARCL (as on March 31, 2020) 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, invested about Rs.512 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, 2020, EFSL (through its various subsidiaries) has invested Rs.281 Cr. in EARCL and holds 74.8% stake. The group will infuse additional capital to support its growth plans over the medium term. The regular capital support coupled with reduction in borrowings has resulted in moderate gearing of 1.97 times as on September 30, 2020 (2.15 times as on March 31, 2020). EFSL has extended unconditional and irrevocable guarantees for some of the capital market borrowings of the company on a need based basis. CDPQ, a leading North American pension fund manager, has invested about Rs.512 Cr. in EARCL in the form of CCPS. On a fully diluted basis, the stake of Edelweiss group shall be 59.84% & CDPQ will hold 20% stake (post conversion into equity) in the company. Acuite 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.

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.

Acuite 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 ~44 percent market share in the distressed asset business in India with outstanding security receipts AUM of Rs.42,976 Cr. as on 31st March 31,2020 as against Rs.46,386 Cr. as on March 31,2019. SR redemptions gained traction in FY2020 (Rs.8,330 Cr. in FY2020 as against Rs.4,906 Cr in FY2019)

supported by robust recoveries (Rs.11,257 Cr. in FY2020 as against Rs.7,019 Cr. in FY2019) on the back of resolution of some large accounts. The momentum remained intact with ~Rs.3,600 Cr. recoveries in nine months ended December 2020. On other hand, SR issuances stood at Rs.4,922 Cr. in FY2020 as against Rs.7,739 Cr. in FY2019.

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, 2020.

Acuite believes that EARCL is expected to maintain its leadership position in the market, based on its expertise 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. The company reported Profit after Tax (PAT) of Rs.302 Cr. on total income of Rs.1,166 Cr. in FY2020 as against on Rs.435 Cr. on total income of Rs.1,367Cr. in FY2019. In H1FY2021, the PAT stood at Rs.86 Cr. on total income of Rs.428 Cr. 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 ~31 percent of the overall outstanding SRs as on September 30, 2020. Amongst the top 10 exposures of EARCL, the exposures are from different sectors like steel, ports, real estate, power and paper. Some of these exposures have been initiated as early as FY2014 and FY2015.

Acuite 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
- Delayed resolutions impinging recovery performance, thereby impacting earning profile

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.

Assessment of Adequacy of Credit Enhancement

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 viz. Credit (retail and corporate), Wealth management including Capital Markets, Asset Management, Asset Reconstruction and insurance (life and general). Acuite believes that CE will stand adequate in all scenarios and in event of any support, EFSL will provide the necessary support.

Liquidity Position: Adequate

EARCL mainly relies on long term funding with tenure of ~4 years, where the payments are fairly staggered. EARCL reported cash and cash equivalents of Rs.670 Cr. as on September 30, 2020 and 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.6,600 Cr. (includes short term loan book of Rs.1,550 Cr.) as on September 30,2020. EARCL is supported by strong parentage of Edelweiss Group and can tap the excess liquidity available with the Group in case of future exigencies.

Outlook: Negative

Acuite believes that the Edelweiss Group's credit profile will continue to face pressures over the near to medium term on account of the deterioration of asset quality and profitability. The weakness in the operating environment and a slower than expected economic revival across the country can impinge on the near term performance. Acuite will be closely monitoring the performance of the Group and any further impairment in asset quality or reduction of profitability will impart a strong negative bias to the rating. The outlook may be revised to Stable in case Edelweiss Group is able to demonstrate significant and sustained improvement in asset quality and profitability.

EFSL- Key financials (Consolidated)

	Unit	FY20 (Actual)	FY19 (Actual)
Total Assets	Rs. Cr.	53,324	64,053
Total Income*	Rs. Cr.	4,810	6,159
PAT	Rs. Cr.	(2,044)	1,044
Net Worth	Rs. Cr.	7,233	7674
Return on Average Assets (RoAA)	(%)	(3.48)	1.65
Return on Average Net Worth (RoNW)	(%)	(27.46)	14.33
Total Debt/Tangible Net Worth (Gearing)	Times	4.91	6.06
Gross NPA	(%)	5.30	1.87
Net NPA	(%)	4.10	0.83

*Total income equals to Total Income net off interest expense

EARCL- Key Financials (Standalone)

	Unit	FY20 (Actual)	FY19 (Actual)
Total Assets	Rs. Cr.	6,546.47	6,840.37
Total Income*	Rs. Cr.	430.36	774.92
PAT	Rs. Cr.	301.55	435.02
Net Worth	Rs. Cr.	2,036.41	1,734.93
Return on Average Assets (RoAA)	(%)	4.51	7.06
Return on Average Net Worth (RoNW)	(%)	16.02	30.07
Total Debt/Tangible Net Worth (Gearing)	Times	2.15	2.79
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-52.htm>
- Non-banking Financing Entities: <https://www.acuite.in/view-rating-criteria-44.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-53.htm>

Note on complexity levels of the rated instrument:

<https://www.acuite.in/view-rating-criteria-55.htm>

Rating History (Upto last three years)

Date	Name of Instrument / Facilities	Term	Amount (Rs. Cr)	Ratings/Outlook
6 February 2020	Secured Guaranteed Non-Convertible Debentures	Long term	10.00	ACUITE AA(CE)/ Negative (Downgraded from ACUITE AA+/Negative)
	Secured Guaranteed Non-Convertible Debentures	Long term	26.50	ACUITE AA(CE)/ Negative (Downgraded from ACUITE AA+/Negative)
	Secured Guaranteed Non-Convertible Debentures	Long term	36.00	ACUITE AA(CE)/ Negative (Downgraded from ACUITE AA+/Negative)
	Secured Guaranteed Non-Convertible Debentures	Long term	10.00	ACUITE AA(CE)/ Negative (Downgraded from ACUITE AA+/Negative)
	Secured Guaranteed Non-Convertible Debentures	Long term	6.00	ACUITE AA(CE)/ Negative (Downgraded from ACUITE AA+/Negative)
	Proposed Secured Guaranteed Non-convertible Debentures	Long term	211.50	ACUITE AA(CE)/ Negative (Downgraded from ACUITE AA+/Negative)
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 Facilities	Date of Issuance	Coupon Rate	Maturity Date	Size of the Issue (Rs. Cr)	Ratings/Outlook
INE015L07618	Secured Guaranteed Redeemable NCD	13-Dec-18	9.90%	08-Dec-28	10.00	ACUITE AA(CE)/ Negative (Reaffirmed)
INE015L07618	Secured Guaranteed Redeemable NCD	21-Dec-18	9.90%	08-Dec-28	26.50	ACUITE AA(CE)/ Negative (Reaffirmed)
INE015L07618	Secured Guaranteed Redeemable NCD	04-Jan-19	9.90%	08-Dec-28	36.00	ACUITE AA(CE)/ Negative (Reaffirmed)
INE015L07618	Secured Guaranteed Redeemable NCD	27-Mar-19	9.90%	08-Dec-28	10.00	ACUITE AA(CE)/ Negative (Reaffirmed)
INE015L07618	Secured Guaranteed Redeemable NCD	15-Apr-19	9.90%	08-Dec-28	6.00	ACUITE AA(CE)/ Negative (Reaffirmed)
INE015L07618	Secured Guaranteed Redeemable NCD	26-Jun-19	Not Available	08-Dec-28	3.50	ACUITE AA(CE)/ Negative (Reaffirmed)
INE015L07618	Secured Guaranteed Redeemable NCD	24-Jan-20	Not Available	08-Dec-28	5.00	ACUITE AA(CE)/ Negative (Reaffirmed)
-	Proposed Secured Guaranteed Redeemable NCD	Not Applicable	Not Applicable	Not Applicable	203.00	ACUITE AA(CE)/ Negative (Reaffirmed)

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About Acuité Ratings & Research:

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