Asset Reconstruction Company (India) Limited (Revised)

January 20, 2022

Ratings

Instrument/Facilities	Amount (Rs. crore)	Ratings[1]	Rating Action
Long Term - Non-Convertible Debentures (NCD)	200.00 (Rs. Two hundred crore only)	CARE A+; Stable (A Plus Stable)	Assigned

Details of instruments/facilities in Annexure-1

Detailed Rationale & Key Rating Drivers

The rating assigned to the proposed long-term NCDs of Asset Reconstruction Company (India) Limited's (ARCIL) factors in the strong sponsor commitment, synergies with sponsor and experienced management, established track record in the Asset Reconstruction Company (ARC) domain, comfortable capitalization, low gearing, and comfortable liquidity profile. However, the ratings are constrained by volatility in profitability due to lumpy nature of cash flows, moderate recovery track record due to higher vintage assets, concentration risk and evolving distressed asset market and inherent risk associated with the business model. The company's ability to resolve and recover dues from assets in a timely manner shall remain a key monitorable from a credit rating perspective.

Rating Sensitivities

Positive Factors: *Factors that could lead to positive rating action/upgrade*

- Significant scale-up of asset base with demonstration of recovery performance
- Sustained improvement in the earnings profile

Negative Factors: *Factors that could lead to negative rating action/downgrade*

- Any adverse event in the assets acquired by ARCIL impacting recovery performance, in turn impacting overall profitability and solvency of the company
- Increase in gearing levels beyond 0.75x for sustained period

Detailed description of the key rating drivers

Key Rating Strengths

Strong sponsor commitment

ARCIL is mainly sponsored by Avenue India Resurgence Private Limited (Avenue India) holding a stake of 25.03% as on September 30,2021. Avenue India, which acquired a stake of around 25% in FY19 via a secondary market transaction, is a subsidiary of Avenue Capital (Avenue), a US-based US$11.8-billion fund with expertise in distressed credit strategies across U.S., Europe, and Asia. The other institutional sponsors of ARCIL comprise of leading Indian banks namely State Bank of India (SBI, 19.95%; CARE AAA; Stable), IDBI Bank Ltd (19.18%; CARE A1+; Stable), ICICI Bank Ltd (13.26%; CARE AAA; Stable) and Punjab National Bank (10.01%; CARE AA+; Stable), together holding 62.40% of the equity capital. The other shareholders include GIC-Singapore (5%), ICICI Home Finance (2.26%) while Karnataka Bank, South Indian Bank and Federal Bank jointly hold 5.2% stake in the company.

Going forward, Avenue intends to strengthen its long-term commitment towards ARCIL by acquiring entire stakes from IDBI, PNB, ICICI Bank and ICICI Home Finance aggregating around 44.7% in the company. The transaction, post regulatory approval, is expected to make Avenue India a majority shareholder with around 69.7% stake in ARCIL. CARE Ratings views this transaction as a positive which is likely to consolidate the operations along with majority control of the company with Avenue, thereby increasing the likelihood of timely financial support from the sponsor. SBI intends to continue holding its stake in ARCIL.

Synergies with sponsor and experienced management

While ARCIL has benefitted from Avenue's global expertise, ARCIL has also done several debt acquisitions along with Avenue for acquiring stressed assets from banks / NBFCs on a cash basis. The underlying synergies/arrangement between ARCIL and

[1] *Complete definitions of the ratings assigned are available at www.careedge.in and in other CARE publications*

Avenue continues to be on a non-exclusive and arm's length basis. The company is led by its MD & CEO, Mr Pallav Mohapatra with large experience having worked as MD & CEO of Central Bank of India and DMD of SBI. ARCIL's board of directors has ten members comprising of its MD & CEO, four independent directors and five sponsor directors from Avenue, IDBI, SBI, ICICI and PNB. Mr Anil Gorthy, a seasoned professional, heading Avenue's Asian credit business is currently the Chairman of the Board. ARCIL's top management comprise of seasoned industry professionals.

Established track record in ARC domain

ARCIL, incorporated in 2002 is one of the first ARCs in India and is amongst the top three ARCs in the industry with Assets under Management (AUM) of Rs.14,227 crore as on September 30,2021 (FY21: Rs.13,833 crore). With a large vintage, ARCIL has primary established itself in the corporate distressed debt segment which comprised of 86.3% of the AUM while SME (8.7%) and retail (5%) accounted for the rest as on September 30,2021. The company has a strong pan-India setup with nine branches across the country and employee strength of around 200. On a cumulative basis, the company has issued Security Receipts (SRs)[2] of Rs.26,481 crore as of September 30, 2021, of which Rs.12,254 crore have been resolved till date against which the cumulative recovery stood at Rs.16,482 crore. The company envisages an AUM growth from Rs.14,227 crore as on September 30,2021 to Rs.20,000 crore by FY24, wherein ARCIL's contribution is expected to be around Rs.3,500 crore of the outstanding AUMs.

Comfortable capitalization and low gearing

ARCIL has a net worth of Rs.1,946 crore and enjoys a low leverage of 0.17x as on September 30, 2021 (vis-à-vis 0.17x as on March 31, 2021) due to partial debt utilization of its working capital facilities. ARCIL generally invests under the 15/85 scheme in most of its acquisitions which requires it to invest a minimum of 15% as cash while the remaining investment is held as either cash by other co-investors or security receipts (SRs) issued by a respective trust to banks and NBFCs. The company has also acquired assets in 100% cash or along with co-investors. The management has also reiterated its stated policy of maximum leverage of 0.50x and keeping its debt below Rs.1,200 crore.

While the ratio of ARCIL's investment share in AUM increased to 83% for acquisitions done in FY19 greater investments in cash deals, the same had tempered down to 15% in FY21 (FY20: 31%) as most of the deals are either SR based or with co-investors. On a cumulative basis, ARCIL's investment's share in AUMs has been range bound between 20-23% since FY16 and stood at 22% as on September 30, 2021. The current capital remains comfortable with Net Asset Value (NAV) of ARCIL's on book SRs to tangible net worth at 87.8% as on September 30, 2021 (vis-à-vis 90.80% as on March 31, 2021). While ARCIL plans to tap the debt capital market in FY22, CARE Ratings expects the company to follow a conservative leverage strategy.

Key Rating Weaknesses

Volatility in profitability with FY21 affected by write-offs

ARCIL's lumpy nature of business has resulted in volatile profitability metrics with return on total assets for 1HFY22 (annualized) at 4.74% as on September 30, 2021 (FY21: negative 3.73%; FY20: 1.40%). The complex nature of recoveries makes it difficult to ascertain the certainty of both timing, and amount of fund inflows for the company. Moreover, this is further affected by the fact that ARCs are mandatorily required to write off assets which have stayed unresolved for eight years as per RBI guidelines. However, post write-off, any potential recoveries made in the recovery process are written back

The company has written off Rs.235 crore of assets in FY21 which resulted in a net loss of Rs.87.09 crore in FY21 (FY20: Rs. 32.71 crore net profit). Going forward, ARCIL's investment in acquired assets of around Rs.456 crore are completing eight years in the next two years (FY22-24), post provisioning has an NAV of Rs.211 crore. Subject to recoveries from these SRs, this limits the write off that can be expected from SRs on account of mandatory write off on completing eight years. CARE Ratings believes, the company's comfortable capitalization shall provide an adequate cushion to withstand any potential write offs for FY22-FY24. Nevertheless, out of the total write offs of Rs.813 crore on cumulative basis till September 30, 2021, Rs.188 crore is recovered by ARCIL.

[2] *Working of ARCs: The ARCs acquire NPAs from banks or financial institutions either through bilateral deals or auctions. After acquisition of the asset, they formulate schemes for inviting subscription to security receipts (SRs) by Qualified Institutional Buyers (QIBs) through one or more trusts set up exclusively for the purpose. Debt can be acquired either through cash alone or a mix of cash and SRs. To ensure that ARCs have more skin in the game of acquisition, they are required to invest a minimum of 15 per cent of the SRs under each scheme on an ongoing basis till the redemption of all SRs (Source: RBI)*

A large part of revenue comprises of consistent fee-based income derived from the management fee. The fee-based income stood at Rs.119.55 crore (64% of total income) for H1FY22 (FY21:61%, FY20:56%). However, the nature of write offs and fair value changes (NAV) due to accounting adjustments have resulted in the volatility of the profitability in the last three years.

Moderate recovery track record due to high vintage assets/SRs

ARCIL's cumulative recoveries to cumulative acquisition stood at 62.2% as on September 30, 2021 (FY21:64.5%, FY20: 69.4%) While the company saw a decline in recoveries at Rs.854 crore in FY21 (FY20: Rs.1148 crore) due to Covid-19, FY22 has seen healthy recoveries of Rs.1,142 crore till November 20, 2021. CARE Ratings notes that the seasoning of assets in ARCILs portfolio comprises of a higher percentage of assets acquired before 2016 at 60% as on September 30, 2021. Regulatory write-offs[3], on completion of eight years from acquisition, impacted profitability in FY21. In this regard, ARCIL's share of assets issued between FY14-16 is relatively lower (Rs.211 crore), which moderates the impact of regulatory write offs to some extent.

ARCIL has a focused team towards achieving resolution for both written off and higher vintage assets and expects to achieve resolution of such assets till FY24. The company's ability to resolve and recover dues from assets in a timely manner shall remain a key monitorable from a credit rating perspective. The NAV for the AUM stood at Rs.6,851 crore (which is 48% of Rs.14,227 crore) as on September 30, 2021. While ARCIL's investment in AUM stood at Rs.2,551 crore (18% of AUM), the NAV for the same stood at Rs.1,709 crore on the company's balance sheet as on September 30, 2021. CARE Ratings note that the company has made prudent provisions, post which 72% assets comprising of the of company's NAV have credit rating which imply a recovery of 75% and above.

Concentration on wholesale exposures

ARCIL is mainly focused on the corporate stressed debt segment, the resolution of which is complex making the recovery of cash flows lumpy in nature along with provisions and write offs. The corporate resolution process also comprises of legal hurdles and working closely with the promoters and lenders for each asset. The corporate segment comprises of 86.3%, SME segment contributing 8.7% of the overall AUMs as on September 30, 2021, while the remaining 5% comprises of retail book. The company is trying to increase its exposure to the retail and SME segment since they have provided a regular monthly cash churn to the company of around Rs.25 crore, thereby providing liquidity support. Given the large corporate book with a higher share of vintage assets, the cash flows from this segment shall remain dependent on the complexity and timing of the recovery process which can be uncertain and lumpy. CARE Ratings believe that the impact of any delays in the same shall be a key monitorable going forward.

Evolving distressed asset market and inherent risk associated with the business model

ARCs in India have been subject to large regulatory changes, funding challenges and write offs which can result in uncertainty in resolution of acquired assets with respect to recovery amounts and timelines. The Indian distressed assets market is in a nascent stage with limited seasoning and is gradually developing with regulatory policies taking shape steadily. To this effect, the recommendations by RBI's constituted committee include incentivizing quicker resolutions, price discovery, acquisition of distressed assets with a lower seasoning and enabling ARC participation in the Insolvency and Bankruptcy Code (IBC) process. CARE Ratings notes that RBI's recommendations and setting up of the National Asset Reconstruction Company Limited (NARCL) to acquire Rs.2 lac crore of NPA assets from public sector banks with a Government of India guarantee of Rs.30,600 crore is likely to provide a fillip to this sector in relation to resolutions and recoveries and strengthen of overall framework for ARCs in the country.

Liquidity profile: Comfortable

ARCIL stands amongst one of the lowest leverage ARCs in relation to its peers and its acquisitions in the past three years have largely been funded through equity and churning of cash from recoveries (leverage: 0.17x as on September 30, 2021). The company has a sanctioned working capital credit lines of Rs.710 crore from seven banks which had a utilization of Rs.42 crore as on November 22, 2021. (Rs.334 crore utilized as on September 30, 2021) The company's cash & bank balance stood at Rs.234 crore as on September 30, 2021. The company has a comfortable cushion in terms of liquidity and shall maintain a low leverage to fund the 15-20% upfront cash portion for future acquisitions. However, CARE Ratings believes that access to long-term debt from banks and capital markets to ARCs remains a funding constraint for the sector.

Moreover, ARCIL's retail and SME segment generate monthly cash flows to the company of around Rs.25 crore given a faster turnaround in these asset classes and lower complexity involved. The free cash flow from operations (CFO) generated by the

[3] *Following the resolution, ARCs start recovery of debt and work on the redemption of SRs. ARCs are allowed a period of five years to recover the dues. However, the period can be extended up to eight years subject to the approval of their Boards (Source: RBI)*

company which exclude the cash flow from redemptions stood at an average of Rs.54 crore (Rs.23 crore to Rs.75 crore) during the last ten quarters ending September 30, 2021. The company generated a healthy CFO in 1QFY22 of Rs.75 crore. It is expected that that the company's ability to generate CFO shall aid in future acquisition of assets and result in lower gearing levels.

***Analytical approach*:** Standalone

Applicable Criteria
Financial Ratios - Financial Sector
Rating Outlook and Credit Watch
Definition of Default
Rating Methodology- Non-Banking Finance Companies

About the Company
ARCIL, incorporated in 2002 is one of oldest ARCs in the country in the business of resolving and recovery of non-performing and distressed loans. ARCIL, mainly sponsored by Avenue India, a subsidiary of Avenue Capital, a US$11.8 billion US-based debt investment company who acquired around 25% stake in a secondary market transaction in November 2018. The other shareholders of ARCIL mainly include State Bank of India (20%), IDBI Bank (19%), ICICI Bank (13%), Punjab National Bank (10%) and GIC (5%). It is among the top three players in the distressed assets space with AUM of Rs.14,277 crore. ARCIL has a pan-India setup with nine branches across India and employee strength of around 200. ARCIL has developed an expertise in the ARC space having acquired non-performing loans of more than 2,800 borrowers (in addition to retail portfolios) with total debt of around Rs.97,403 crore. The company has issued cumulative SRs of Rs.26,668 crore since inception with a cumulative recovery of around 63% as on September 30, 2021. ARCIL's own cumulative investment has been Rs.5,830 crore (22%).

Brief Financials (Rs. crore)	FY20 (A)	FY21 (A)	1HFY22(P)
Total operating income	260.73	245.91	187.29
Profit after tax (PAT)	32.71	-87.09	56.29
Assets under Management (SRs)	12,358.50	13,833.34	14,227.22
Managed Assets on Balance Sheet	1,829.68	1,695.14	1,708.56
ROTA% (BS Assets)	1.40	-3.73	2.37
Tangible net worth	1,976.45	1,867.51	1,946.25

A: Audited P: Provisional

Status of non-cooperation with previous CRA: Not applicable

Any other information: Not applicable

Rating History for last three years: Please refer Annexure-2

Covenants of rated instrument / facility: Detailed explanation of covenants of the rated instruments/facilities is given in Annexure-3

Complexity level of various instruments rated for this company: Annexure 4

Annexure-1: Details of Instruments/Facilities

Name of the Instrument	Date of Issuance	Coupon Rate	Maturity Date	Size of the Issue (Rs. crore)	Rating assigned along with Rating Outlook
Debentures-NCDs Proposed	-	-	-	200.00	CARE A+; Stable

Annexure-2: Rating History of last three years

Sr.	Name of the	Current Ratings	Rating history

No.	Instrument/Bank Facilities	Type	Amount Outstanding (Rs. crore)	Rating	Date(s) & Rating(s) assigned in 2020-2021	Date(s) & Rating(s) assigned in 2019-2020	Date(s) & Rating(s) assigned in 2018-2019	Date(s) & Rating(s) assigned in 2017-2018
1.	Debentures-Non-Convertible Debentures	LT	200	CARE A+; Stable	-	-	-	-

Annexure 3: Detailed explanation of covenants of the rated instrument / facilities: Not Applicable

Annexure 4: Complexity level of various instruments rated for this Company

Sr. No.	Name of the Instrument	Complexity Level
1.	Debentures-Non-Convertible Debentures	Simple

Note on complexity levels of the rated instrument: *CARE has classified instruments rated by it on the basis of complexity. This classification is available at www.careedge.in. Investors/market intermediaries/regulators or others are welcome to write to care@careredge.in for any clarifications.*

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