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Evolution of Private Credit in India

November 2021

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Foreword



Dinkar Venkatasubramanian

Partner & Head,
Turnaround and Restructuring Strategy

This whitepaper, the first of its kind in India, examines how private credit emerged as a significant source of financing to businesses in the US/UK and tracks the triggers for the evolution of these markets. The paper then critically analyzes the private credit and deal environment in India and throws light on potential opportunities, growth imperatives, and key considerations for the evolution of the private credit market in India over the next 5 - 10 years.



Bharat Gupta

Partner,
Turnaround and Restructuring Strategy

Globally, investors are diversifying their portfolios and seeking better returns by moving from traditional asset classes towards alternative asset classes. Private credit now accounts for about 12%¹ of global private capital assets under management. With abundant liquidity, post the pandemic, money managers are scouring global markets for yields and a lot of these funds are hitting the shores of emerging markets, including India.

India offers a large structural opportunity for private credit investors. Post a huge spate of bad loans, traditional lenders are risk averse and NBFC players are still recovering from the crisis driven by one of the largest NBFC in India leaving a large market open for private credit players to capture, as India gallops to becoming a US\$5 Trillion economy. Introduction of creditor friendly Insolvency and Bankruptcy Code along with dedicated tribunals to resolve corporate commercial and insolvency cases have laid a strong foundation for private credit to feel confident of investing in India. A series

¹Mckinsey Global Private Markets Review 2020

²<https://www.livemint.com/news/india/indias-forex-reserves-slip-to-638-65-bn-11633092959569.html>

³RBI report on Trend and Progress of Banking in India 2019-20, Economic Survey 2020-21, EY analysis



of economic and administrative reforms viz, Goods & Services Tax, Real Estate Regulation Act, reduction of corporate direct taxes and production linked incentive schemes have created a much more business friendly environment. India's foreign currency reserves are at an all-time high at US\$ 640b+² and continue to swell. In tandem the tight fiscal policy followed until pre COVID, helps in maintaining exchange rates within a narrow stable range.

Our estimates³ of the performing credit opportunity (Expected IRR 12 - 18%) range from US\$39b (low credit growth) to US\$89b (high credit growth) over next 5 years, that would be available for incumbent NBFCs and new private credit funds. Stressed asset investment opportunities over next 5 years, emanating from existing stock of unresolved NPAs, fresh credit defaults, and special situation opportunities could be worth approximately US\$25b. These stressed asset and special situation opportunities would attract private credit funds looking for higher yields (Expected IRR 18 - 24%) and strategic investors.

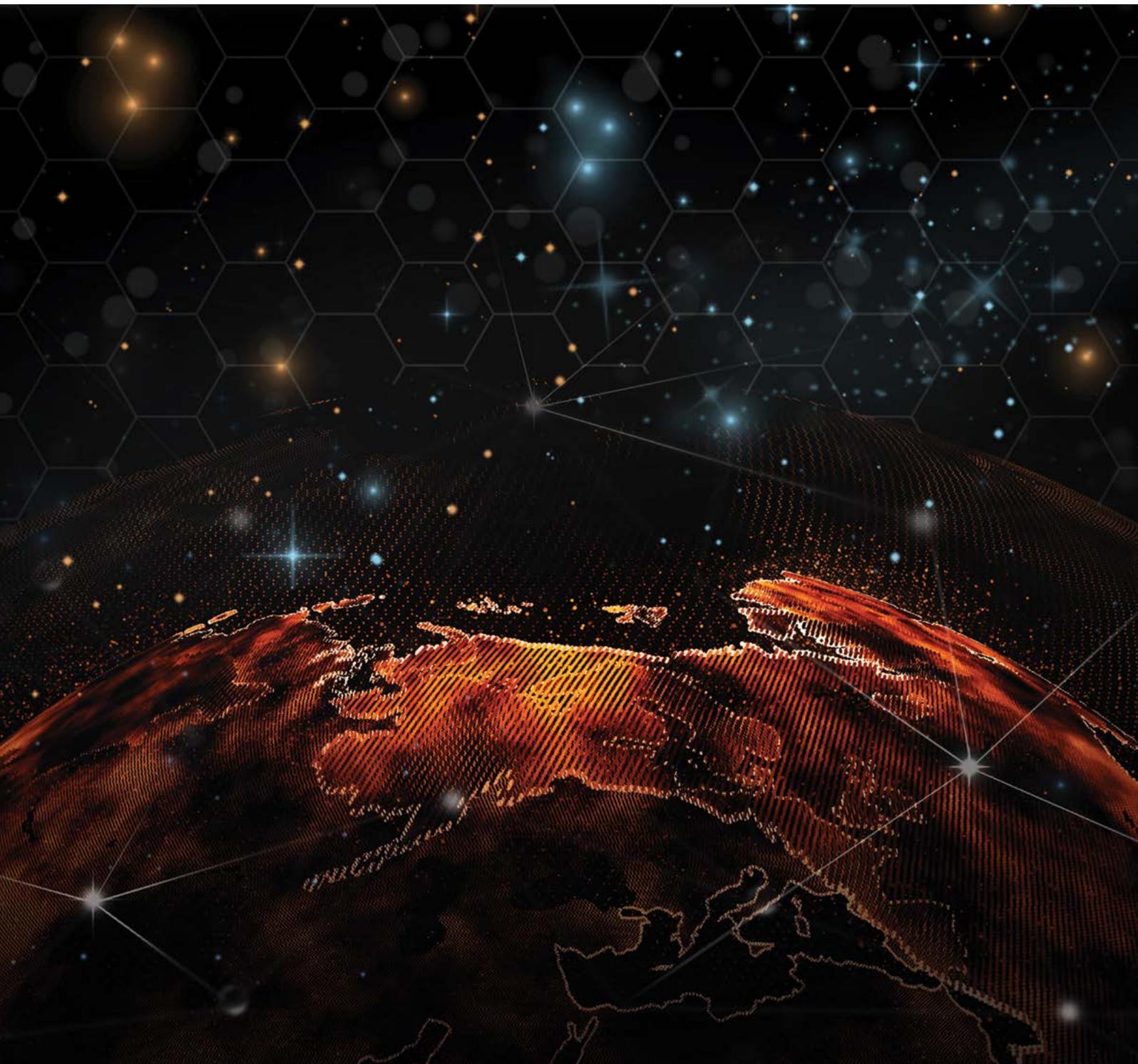
India will continue to offer opportunities across 12-24% IRR range as multiple dynamics are at play. Stable currency and high economic growth will improve investor confidence. However, bottoming of interest rate cycle, inflation fears on the back of commodity cycle picking up and recent concerns regarding delays in enforcement of creditor rights will push rates higher.

Private credit in India is in the early stages of evolution and the future looks extremely bright. However, lot more needs to be done to improve the ongoing delays being experienced in enforcement of creditor rights, delays in decision making by incumbent lenders and removing some regulatory distortions in secondary market for debt. Investors must appreciate some of the nuances of investing and operating in India, which are laid down in the last section of this white paper.



01

Private Credit: A global perspective





Growth of the Private Credit market

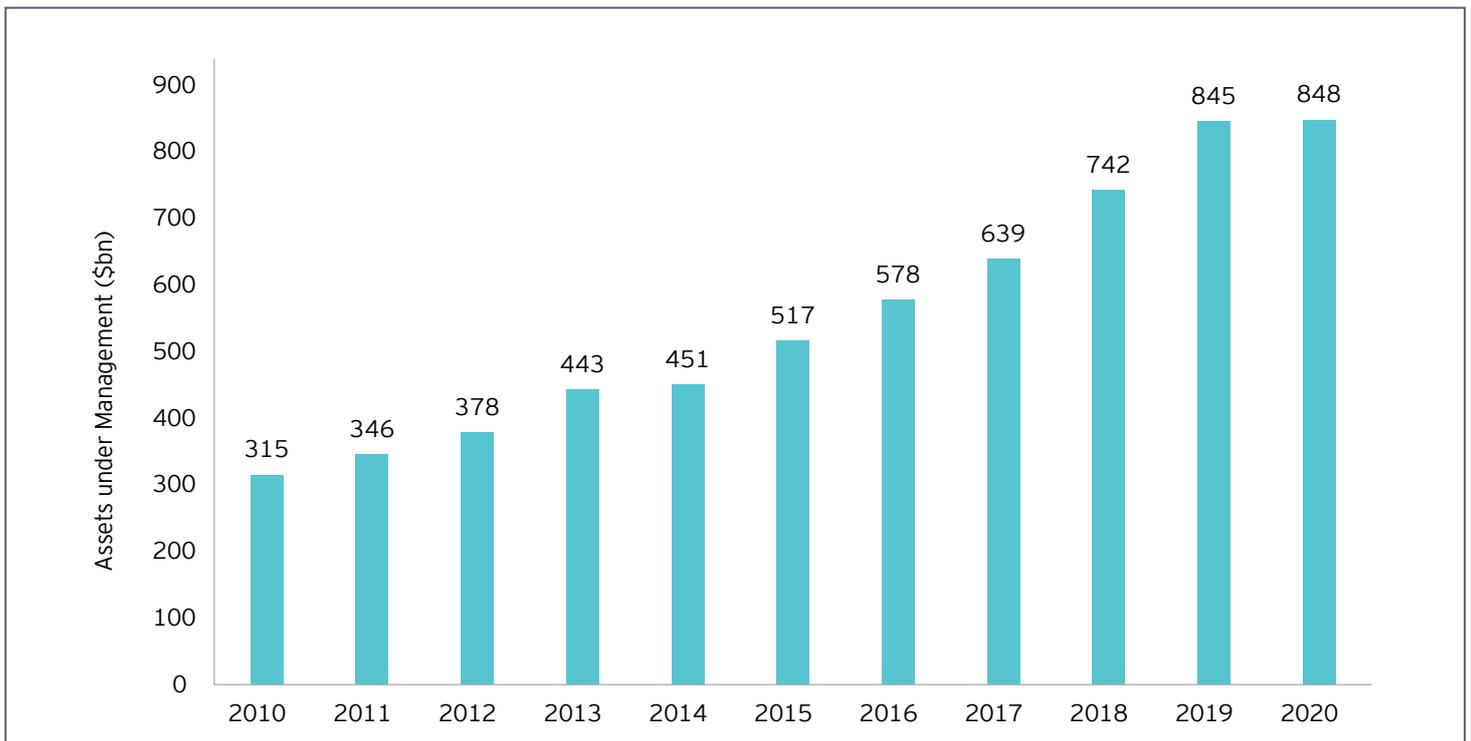
Private credit can be described as non-bank lending in high-yielding and illiquid investment opportunities in debt-like instruments. It is offered to mid-market firms, which are underserved through traditional sources of capital. Private credit investments share many features of a debt instrument such as seniority, tenor, collateral provisions, and floating/fixed coupons. They also bring the necessary flexibility to structure their returns by embedding back-ended premiums, options and warrants. Private credit comprises various strategies ranging from capital preservation to return maximizing strategies, which indicate their ability to offer flexible capital solutions based on business needs and risk assessment.

The growth in the global private credit industry received a significant growth thrust after the financial crisis in 2008. There were three factors primarily driving the growth of private credit as an asset class. Firstly, after the crisis, as banks came under stricter capital requirement norms, they moved away from lending to smaller or riskier borrowers creating a demand-supply mismatch in the mid-market segment. Secondly, from the borrower's perspective, private credit offered greater customization of structures and longer loan tenures to match the cash flow profiles of the business. Lastly, from the investor's

perspective, private credits appeal lies in the higher yields and diversification benefits the asset class offers. High yield opportunities are lucrative to investors, especially given the negative interest rate environment that persists in the global financial markets.

As a result of these factors, private credit has witnessed an annual growth in AUM of ~10% over the last 11 years (Refer Figure 1). The global private credit AUM's in 2020 aggregated to \$848 billion (as a reference point, the AUM on the Private Equity markets are approximately \$3.9 trillion⁴). According to a survey done by Preqin, private credit will continue to grow at ~11% annually till 2025 and reach an estimated AUM of ~ \$ 1.46 trillion⁵. Private credit funds have nearly \$300 billion of dry powder ready to be invested should suitable opportunities arise. While most of the investments will be concentrated in the US and the UK, as emerging markets reform their financial system, they will benefit from spillover of the residual dry powder.

Figure 1: Private Credit AUM growth since 2010⁶



⁴McKinsey-Global-Private-Markets-Review-2020

⁵<https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/private-debt-to-grow-11-annually-to-2025-prequin-survey-says-61312547>

⁶Preqin

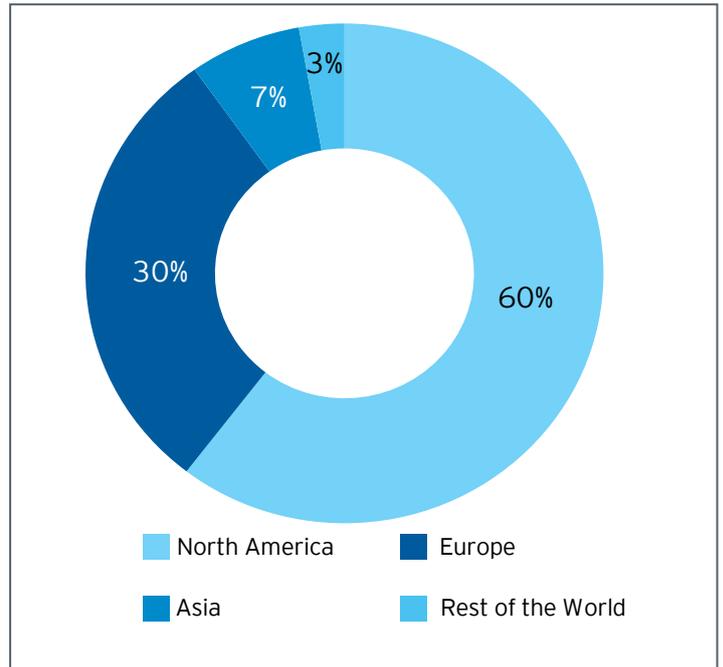


Popular investment destinations

The North American and European markets constitute 90% of the total Private Credit AUM (Refer Figure 2). Further, surveys indicate that roughly half of private credit asset managers invest predominantly in the United States, one-fourth focuses on the United Kingdom, and the remainder is spread worldwide. We will explore why these markets are so popular with Private Credit investors in a later section.

~90% of the Private Credit AUM are concentrated in North America and European Markets (H1 2019)

Figure 2: % of Total Private Credit AUM by geography (H12019)



Listed below are top global funds that have raised significant private credit capital over last 10 years.

Figure 3: Top funds by total capital raised for private credit in 10 years⁷

Rank	Firm	Total capital raised in 10 years (\$b)
1	Oaktree Capital Management	38.0
2	Goldman Sachs	37.1
3	GSO Capital Partners	34.2
4	Intermediate Capital Group	28.4
5	Ares Management	25.3
6	HPS Investment Partners	22.2
7	Centerbridge Capital Partners	18.9
8	Cerberus Capital Management	17.4
9	Apollo Global Management	16.2
10	Fortress Investment Group	13.6

⁷Prequin data as on January 2019



Private Credit strategies⁸ and expected IRRs

Private credit fund managers deploy a wide range of structured and flexible financing solutions, offering significant advantages to both their investors and borrowers. From an investor perspective, private credit offers diversification benefits while potentially earning high yields in a negative interest rate environment. These solutions cater to investors with different risk appetite. For a borrower, private credit becomes a source of capital, albeit at a higher cost, that can be tailored to the specific needs of their business.

These strategies range from collateralized lending at one end to special situations and distressed debt at the other end and can be classified as under:



⁸Cambridge Associates. 2017. "Private Credit Strategies: An Introduction."

Given the structure of the returns in Private Credit deals, the absolute return is measured by Net Internal Rate of Return, i.e., IRR net of fees and carried interest. Given that this is an emerging asset class and the market is opaque, there are very limited studies available that measure the aggregate performance of Private Credit Funds across regions. Studies done by Russel Investments and British PE/VC Association looked at the IRR of a sample of funds. They found that within the sample of Private Credit Funds studied in the US and the UK, the US\$ IRR ranged from ~ 4.5% to ~12%, with mean returns being closer to ~ 10%. The wide dispersion of IRR range is because there are many strategies (senior lending to distressed debt) within the Private Credit universe, as discussed earlier.

For an emerging market like India to attract Private Credit Capital, it would have to offer opportunities to investors to realize IRRs which are commensurate with additional risks associated with emerging markets that the investor assumes.

“

Yield is primarily driven by risk free rate, risk premium and tax. Government can help with tax rates on interest. They can continue to make enforcement process more efficient to bring down the risk premium. The fundamental of the underlying business and controlling shareholder's intent matters the most. If the underlying business is doing well and there is intent to pay, then risk goes down a lot

CEO and MD
Asia focussed investment management firm





02

Prerequisites to become an attractive Private Credit investment destination



Not all jurisdictions are equally favorable for creditors. Variations between jurisdictions can explain why certain countries such as the US and the UK rank ahead of others in attracting private credit. We have identified the major factors leading to the variations between jurisdictions and analyzed their impact on private credit markets in the developed markets of the US and the UK versus India.

Power of creditors

Lenders care about recovery rates in the event of a default. Recovery rates, the ability to repossess collateral and reorganize debtors, depend primarily on creditors' legal rights in reorganization and liquidation procedures. Bankruptcy laws define who controls the insolvency process and who has rights to the property of a bankrupt firm, and with what priority. Power of creditors can further be sub-divided into two parts -

- ▶ Creditor rights (enshrined in insolvency and bankruptcy laws)
- ▶ Effectiveness of enforcement of these rights

Creditor rights

La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997, 1998) first proposed the concept of a Creditors Rights Index to measure creditor rights across countries. This index measures the legal rights of creditors against defaulting debtors in different jurisdictions. It measures the powers of secured lenders in bankruptcy. Creditor rights across 8 sample jurisdictions have been presented below (Refer Figure 4).

Figure 4: Creditor rights - characteristics of insolvency codes in eight representative countries (2017)⁹

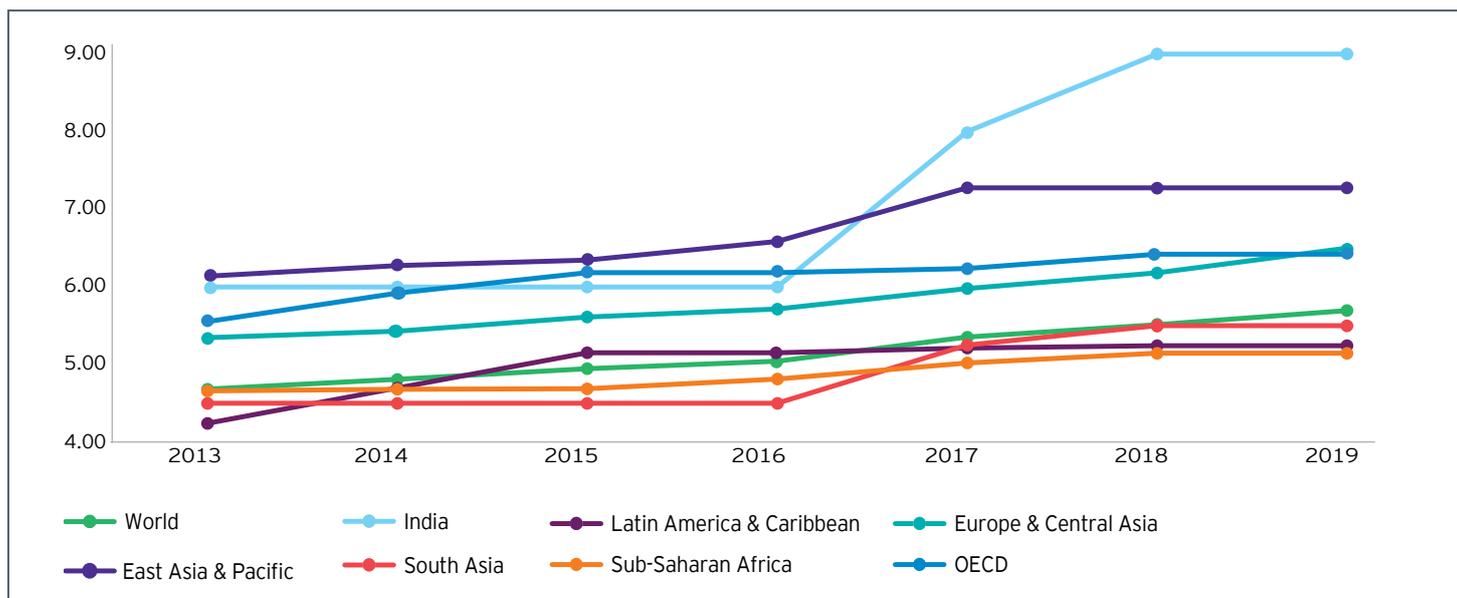
#	Country	India	The UK	The USA	China	France	Germany	Japan	Sweden
1	Creditors have unilateral rights to seek court protection or appoint parties to manage the business in default	Yes	Yes	No	Yes	Yes	Yes	No	No
2	There are restrictions (creditor consent or insolvency test) to enter court proceedings	Yes	Yes	No	Yes	No	No	No	Yes
3	Officers and directors face liability for operating the business while insolvent	No	Yes	No	Yes	Yes	Yes	Yes	Yes
4	The debtor continues to manage the firm pending the resolution of the case	Yes	Yes	No	No	No	Yes	No	Yes
5	Secured creditors can seize their collateral, i.e., there is no 'automatic stay'	No	Yes	No	No	No	Yes	No	No
6	Secured creditors rank first in priority (above other creditors such as government or workers)	Yes	Yes	Yes	Yes	No	Yes	Yes	No
7	The debtor can obtain post-filing super-priority credit	No	No	Yes	No	Yes	No	No	Yes
8	There are provisions for co-operation between domestic and foreign courts for cross border insolvency cases	No	Yes	Yes	No	EU only	EU only	Yes	No

An analysis of the Credit Right table indicates that the UK is the most creditor-friendly jurisdiction in terms of the rights enshrined in the insolvency law. Germany closely follows the UK. Additionally, we also see a clear improvement in creditor rights (See Figure 5), especially across emerging market countries. Since these indexes were constructed, various papers were published to examine the impact of creditor rights on debt contracting. Kee-Hong Bae and Vidhan K. Goyal, in their 2009 paper *Creditor Rights, Enforcement, and Bank Loans*, examined

how variations in creditor rights impact loan contracting terms i.e. loan size, maturity, and spreads. They concluded that creditor rights matter only for loan spreads. Differences in creditor rights are not systematically related to loan size and loan maturity. Even for spreads, the effects of creditor rights are weaker than differences in enforcement have on spreads. This brings us to the next and more important aspect of power of creditors i.e. the ability to enforce creditor rights.

⁹Corporate Financial Distress, Restructuring and Bankruptcy (4th Edition) by Edward I. Altman, Edith Hotchkiss and Wei Wang

Figure 5: Strength of legal rights index score¹⁰



Enforcement of creditor rights

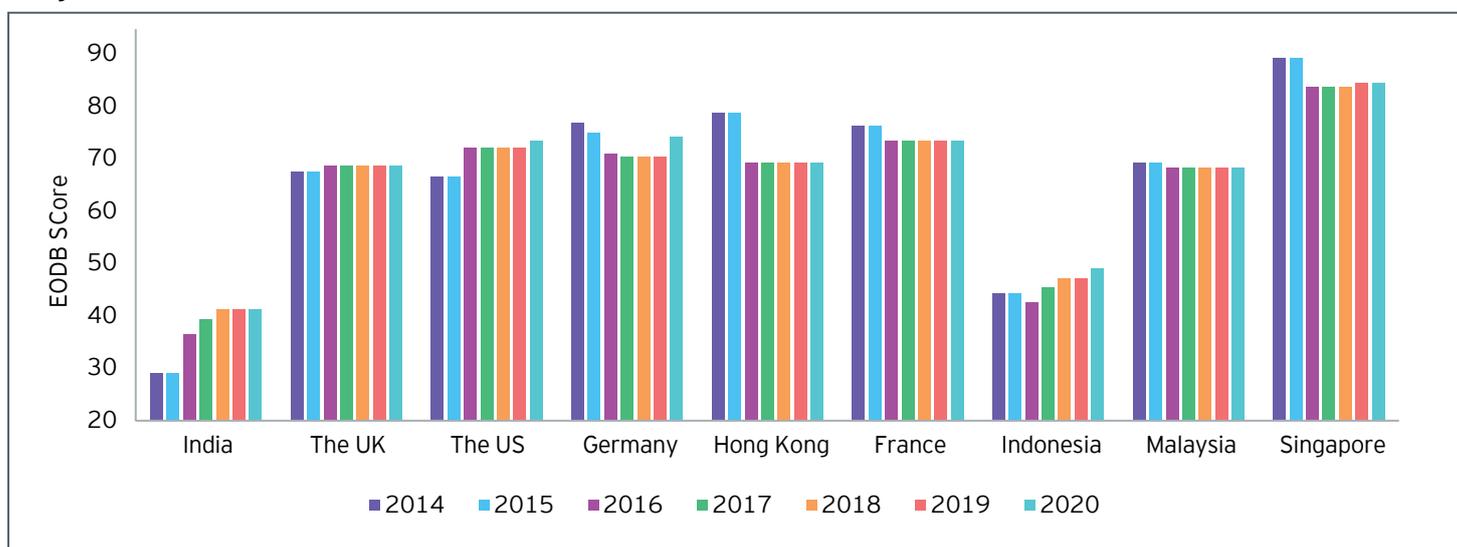
While strong creditor rights give the necessary legal blessing to attract debt investments in the country, its protection through the legal systems and institutions is what matters more to investors; as they say, the proof is in the pudding. When lenders perceive limited downside risk, they are more willing to lend. Enforcement of creditor rights can be further broken down into two elements - (1) property rights protection (2) track record on enforcement of contracts. These two elements, in turn, impact default rates, recovery rates, and time/cost spent to recover, which creditors care about.

Property rights protection: To measure the extent to which a country respects private property rights, we rely on three country risk variables that measure corruption, risk of expropriation of private property, and risk that contracts may be repudiated. In a debt market context, these manifest in the form of predictable and timely outcomes in case of litigation, bankruptcy process, possession of collaterals as opposed to being at the mercy of the borrower.

Enforcement of contracts: The other aspect which has an important bearing on outcomes for creditors is how a country fares with respect to enforcement of contracts. In the event of default, there will be multiple touchpoints between the creditor and the judicial system (such as insolvency, liquidation, dispute resolution, collateral possession etc.). Attributes of the country's judicial system, such as time to enforce contracts, cost incurred, and quality of judicial process, are important for the creditor.

The Ease of Doing Business analysis reports country-wise scores on enforcement of contracts. These scores are a function of the duration of legal procedures, associated costs and efficiency of court processes. The chart below (Refer Figure 6) reports the scores of a sample of countries from the EODB reports from 2014 until 2020. India and Indonesia, which have much lower scores than the other countries on the charts, ranked 163 and 139 respectively (190 countries in total), indicating a large room for improvement.

Figure 6: EODB Scores - enforcement of contracts (2014 to 2020)¹¹



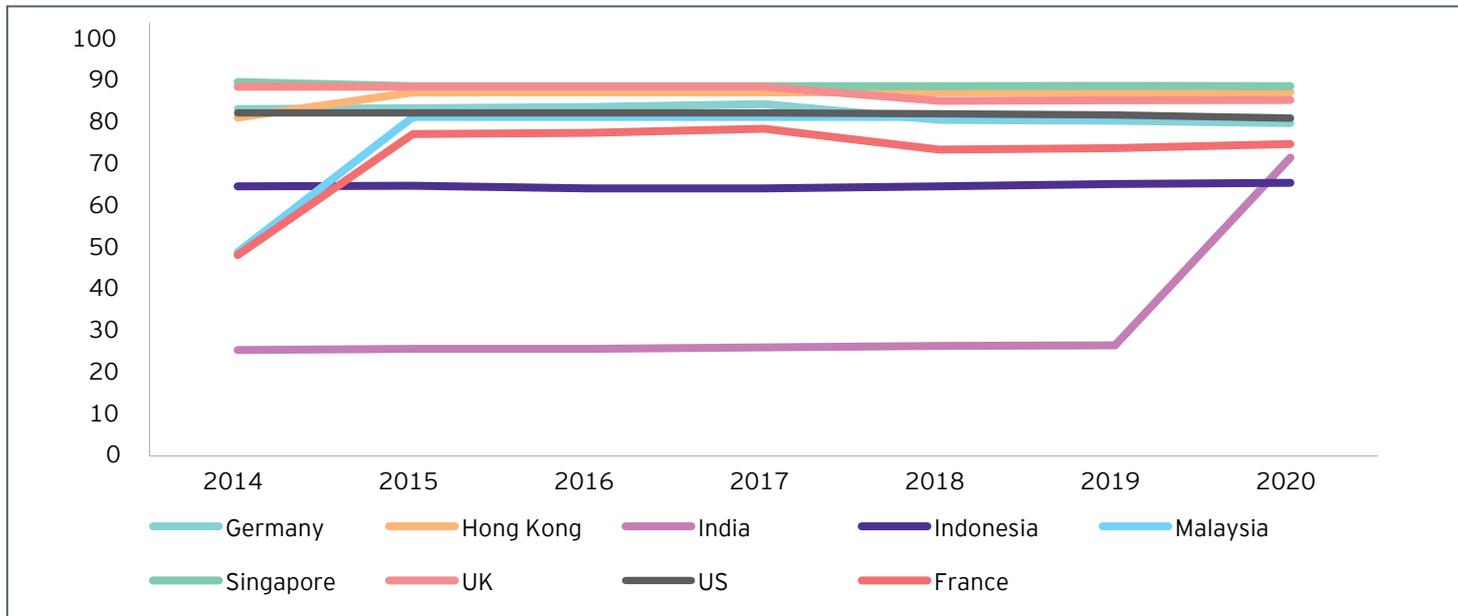
¹⁰World Bank data

¹¹Ease of Doing Business 2020 - <https://www.doingbusiness.org/en/custom-query>

Recovery rates and timelines: Fund managers need to price default risks into the pricing of their contracts, and hence they need to consider aspects such as recovery rates and timelines. This is especially important since returns on private credit lending typically tend to be capped, and hence downside protection is critical to meet the sponsor's expectation on fund IRR. We have presented the recovery rates of secured creditors through judicial reorganization, liquidation, or debt enforcement (foreclosure or receivership) (Refer Figure 7).

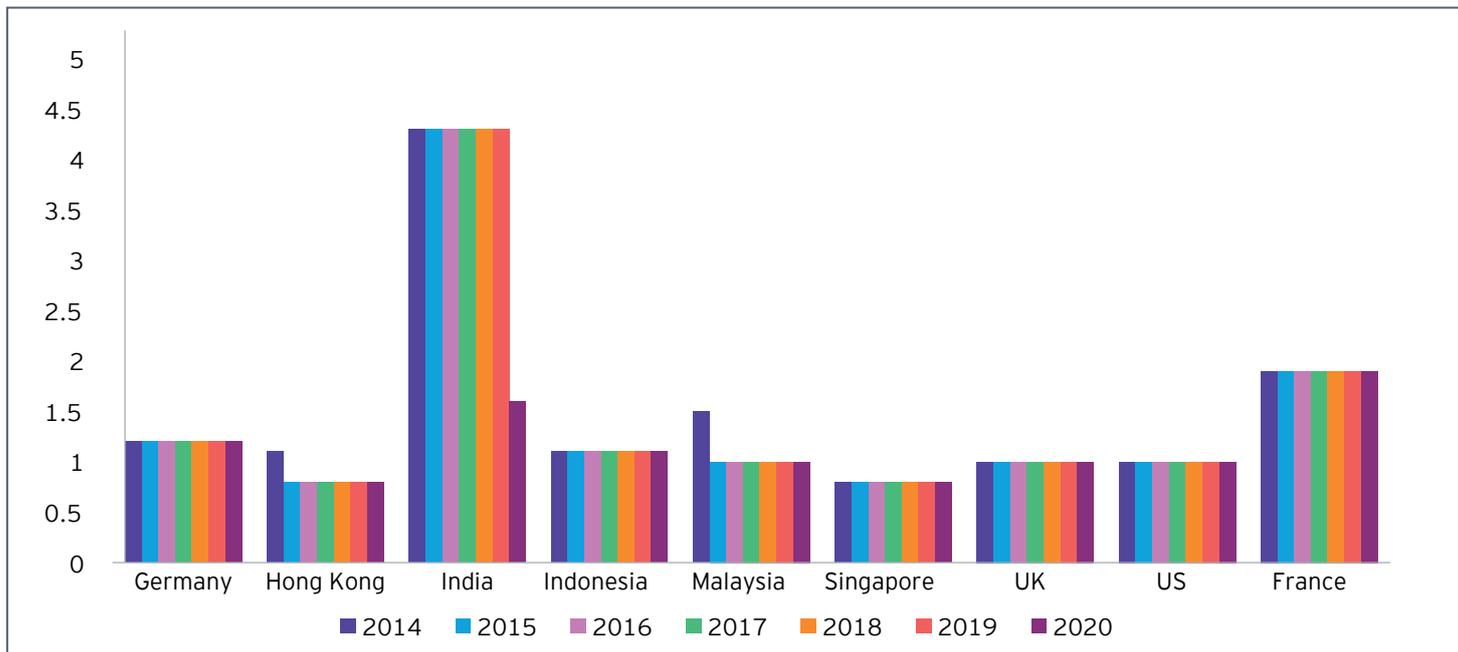
Recovery rates in the US, the UK, and Germany have consistently been 80%+ since 2004. On the other hand, India is climbing up the ladder, with its recoveries in 2020 reported at 71.6%. Some of the large steel assets drove higher recoveries in 2020, which will surely drop as we move into the long tail. It is pertinent to mention here that within Asia Pacific jurisdictions such as Hong Kong, Indonesia and Malaysia have reported a better track record than India over the last 10 years.

Figure 7: EODB scores - recovery rates % (2014 to 2020)



In terms of time to recover dues under a judicial proceeding, we can also see that the countries like India and Indonesia are making reforms that are closing the gap between them and other developed countries such as the US and the UK. Private credit strategies typically have an investment horizon of 4-7 years, and longer recovery times can impact their IRRs as cash distribution to limited partners gets delayed (Refer Figure 8).

Figure 8: EODB scores - recovery time in years (2014 to 2020)¹²



¹²World Bank Ease of Doing Business 2020 report.

Claims trading

Much before inception of private credit, the US had a large and active leveraged loans and high yield bond market that aided in the development of the private credit as an asset class. As a result, the maturity of the system, regulations, and the players have significantly evolved. Claims trading, for instance, was a significant advancement since the enactment of the US Bankruptcy Code in 1978. Some say that it has resulted in the transformation of the US Bankruptcy Process to a more market-driven form. The ability to trade claims has resulted in the entry of specialized distressed debt firms, it has enabled holders of claims to find a marketplace to offload and has led to a higher concentration of ownership among claims that represent fulcrum security.

Currency risks

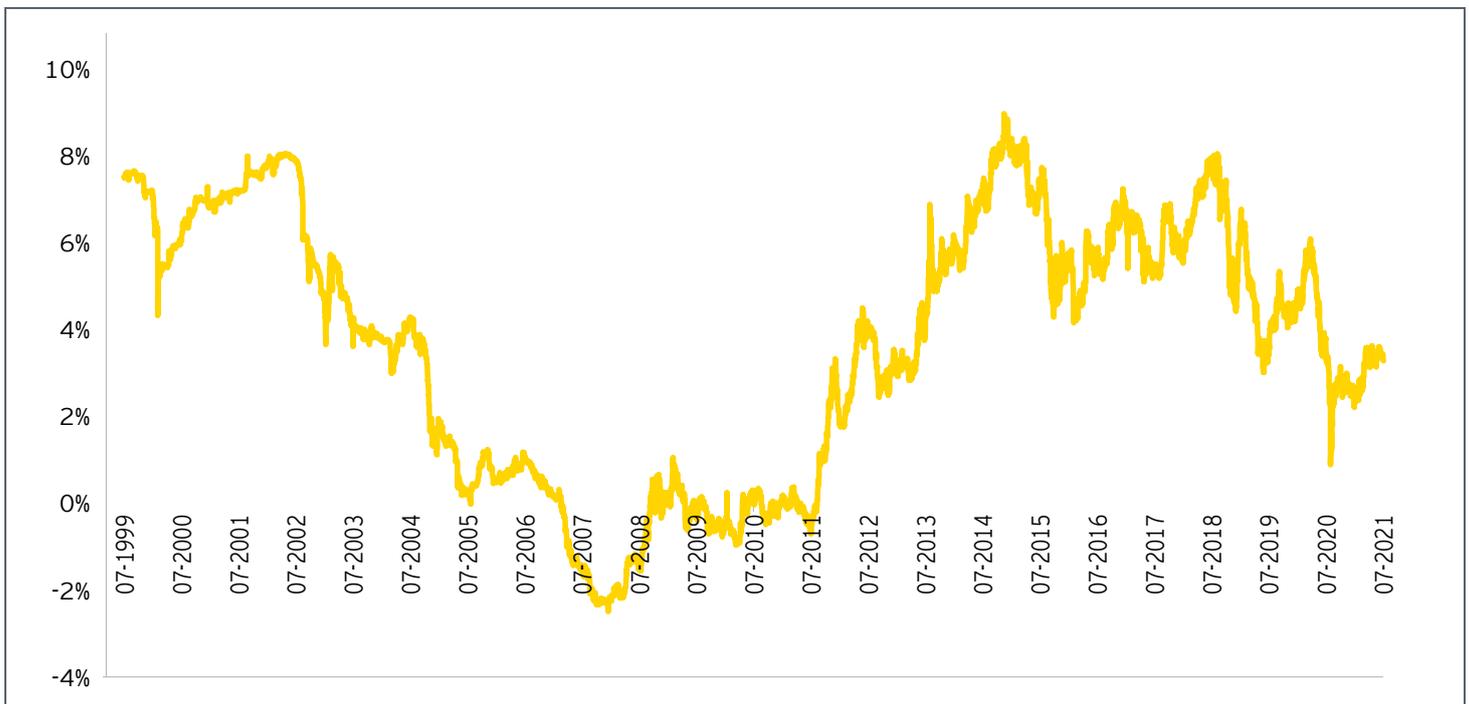
Currency risk continues to be a substantial concern for foreign investors due to two critical factors of private debt investments - stable returns and asymmetrical nature (i.e. cap on the upside) of the investment.

Depending on the currencies involved, annual currency volatility may exceed 10% per annum, and during the 2008 financial crisis, volatility in even very liquid currency pairs, such as EURUSD, exceeded 15% per year. This volatility can have severe impact on the returns of a portfolio of private debt investments and in some cases even on dry powder.

Typically, natural hedges, sound structuring, ensuring financial resilience of the borrower and a good macro strategy can help protect net returns from currency fluctuations. In addition, funds use tailored hedging solutions to mitigate downside risks. Hedging need not be on a one-to-one basis but instead should focus on protecting against tail-risk events.

The chart below (Refer Figure 9) presents the average annual depreciation on the INR versus the US\$ on seven years rolling return basis. Over the last 20 years, the average annual depreciation has been 3.7%, and LPs factor the same into their return expectations from private credit investments in India.

Figure 9: Average annual currency (appreciation) / depreciation (Rs to US\$)¹³



¹³S&P Capital IQ



Regulatory policies

Stricter capital requirements due to Basel III and Solvency II brought about a heightened de-levering among European banks. It forced high street banks to focus on simpler loan structures with lower risk and operational costs. Changes in regulation (such as bank risk capital calculations, liquidity requirements, and ring-fencing) have aggravated the issue by effectively increasing the lending cost to SMEs and mid-market companies, which has disincentivized banks from lending to this market segment. Private credit funds stepped in to close some of the gaps. Today, most private credit players have an additional criterion to make an investment decision - ESG compliance!



03

Private Credit in India: A structural opportunity





Structural opportunity

As mentioned earlier, global financial crisis (and consequently pull back by banks from lending to riskier and mid market borrowers) provided a solid thrust to the growth of Private credit market in the US, the UK and Europe. In India, from mid 2000s till early 2010s, bank credit grew at a scorching pace, aided partly by government and central bank's desire to alleviate the impact of financial crisis. By mid 2010s it was clear, that lot of that debt has turned bad, constraining the ability of Indian banks to lend further. Several resolution frameworks were put in place by the Reserve Bank to help lenders resolve the NPAs, however, these measures met with limited success.

2016 was a seminal year for the Indian economy and more so the banking and finance industry. Formation of National Company Law Tribunals and the introduction of a creditor in control Insolvency and Bankruptcy Code provided two large pieces of the foundation for the growth of private credit in India.

With unmet demand for credit, large stock of stressed assets and creditor friendly judicial framework in place, India attracted attention of several foreign investors including large pension funds and private credit players. Since then several such investors have made long term commitments by establishing strategic partnerships, setting up local offices and making direct and indirect investments.

Over last several years, the legislature has committed itself to several high impact macro reforms like Goods and Service Tax, Real Estate Regulatory Authority, Production Linked Incentive scheme, etc. that have led to a stable long term growth outlook for the country and a strong forex reserve position. We discuss some of these in greater detail below.



Private credit is seeing structural changes on two counts – (i) supply side changes – disruption of the business model of NBFCs, mutual funds and structured finance desk of private sector banks in wholesale lending/ investments; and (ii) settling in laws for enforcement and down side protection which is so important for credit – IBC, pre-packs and now bad bank. NBFCs supported the evolution of private credit for last few years and now AIFs is the future of Indian private credit

Kapil Singhal
Managing Partner, True North Credit



We believe that credit as an overarching theme will play out very well in Indian context. Our focus is to ensure that we choose the right opportunities which are significantly risk adjusted and downside protection is strong. India has this great structural change working towards its advantages as the Government and regulator are focussed on expanding the reach of the market and improving laws. We intend to play the entire credit spectrum, though we have significant leadership in both Special Situations & Distress Credit strategies. We believe that India is warming up to covenant heavy structured financing and with improvement in laws the enforcement of covenants is becoming easier. This will lead to a lot of capital getting deployed in this area

Amit Agarwal
Head - Edelweiss Stressed Assets Strategy - EISAF II



As Indian economy develops and grows, private credit should grow with it. As business environment are dynamically changing (including with lot of technology companies), private credit will become more important as some of these businesses will not be able to tap into traditional asset backed lending by banks

CEO and MD
Asia focussed investment management firm

The NPA issue and consequent risk aversion setting in scheduled commercial banks

During the global financial crisis, Reserve Bank of India introduced the policy of regulatory forbearance, which helped borrowers' tide over temporary hardship caused due to the crisis and avoid a contagion. However, the forbearance continued for too long (unfortunately for ~7 years¹⁴) after the economic recovery, resulting in unintended and detrimental consequences for banks, firms, and the economy. As per an ex-RBI Deputy Governor, excessive bank lending during 2009 to 2012 led to a build-up of stress in the economy. The period saw extension of credit to sectors such as infrastructure, power, telecom, metals (iron and steel, in particular), engineering-procurement-construction (EPC), and textiles. The undercapitalized banks engaged in lending to financially troubled companies and groups. The Dirty Dozen firms (accounting ~25% of total NPAs in 2016) continued to receive credit during the forbearance period, despite a fall in their average interest coverage from 3.66 in FY2007 to 0.89 in FY2015¹⁵.

The period of 2012-16 saw a significant rise in the stressed loans in the banking sector. The rising trend of undercapitalized projects, optimistic industry leaders focussing on debt fuelled business expansion, and delay in recognizing the true size of stressed assets exacerbated the problems. The banks permitted the restructuring of unviable entities. After that, RBI developed a mechanism for Asset Quality Review by bank.



The RBI's concerted efforts since 2014 to ensure timely and accurate asset classification, while necessary to ensure a clean-up of the books, has also led to constraints on the availability of capital for PSU banks - a declining trend of bank credit growth indicated below (Refer Figure 10). This had hastened the process to release resources blocked in unproductive/stressed assets for productive use, thereby creating opportunities for private credit funds and ARCs to step in.

¹⁴ ¹⁵Economic Survey 2020-21

Pursuant to the implementation of Basel II, the corporates with banks borrowings were required to be rated. This resulted in a rise in issuers in sub-investment/ non-investment grade categories. As of March 2021, the majority of borrowers (~70% and ~56% of CARE and CRISIL rated issuers, respectively), by number, fall under non/sub-investment grade categories - a space being closely looked at by private investors.

The NBFC boom followed by a liquidity crisis

The last decade of the 20th century witnessed a rapid growth of lending through NBFCs. This was primarily due to quicker decisions, higher risk assumption, geographic focus, customized funding, and flexible structures offered by NBFCs versus commercial banks.

Another significant development was the NBFC boom in late 2017. Post demonetization in 2016, much cash had flown in the banking system, which was lent to NBFCs. By 2018, more than 50% of outstanding loans in the real estate sector were provided by NBFCs. Direct lending of ~10-14% of banking funds were made to NBFCs on account of lower risk weights. However, the crisis in 2018 was a seismic event - significantly affecting the financial ecosystem. The overall credit deployed by non-bank lenders contributes to ~25%¹⁷ of the domestic credit in the system.

In the past, the NBFCs were the first port of call for promoters looking for more flexible non-diluting capital solutions. However, in 2018, all of this changed post the collapse of one of the largest NBFC players in India, with funds drying up for this segment and a number of NBFCs facing liquidity concerns. With these existing pools of capital going out of the market, the gap between demand and supply widened further, creating a pipeline of opportunities for rescue or refinancing capital for private credit players to target.

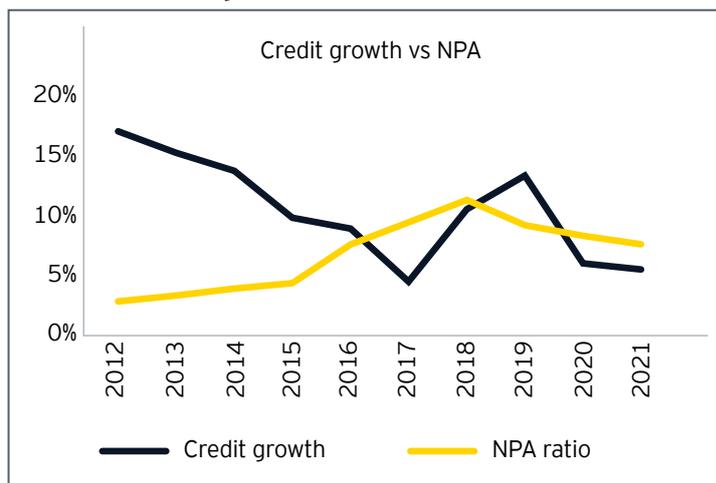
Formation of National Company Law Tribunal

Effective 1 June 2016, the government announced the set up of tribunals to deal with corporate disputes arising under the Companies Act 2013 and to act as the adjudicating authority for the insolvency resolution process under the IBC 2016. Eleven benches were initially set up (later increased to sixteen) with the objective to reduce time and cost of dispute resolution and improve ease of doing business. The idea to set up these dedicated and specialised institutions based on recommendations of Justice Eradi Committee is fundamentally sound, however much more needs to be done to achieve the original objectives.

Introduction of Insolvency and Bankruptcy Code

The introduction of the Insolvency and Bankruptcy Code has been the most significant legislative reform in the Indian stressed asset landscape. While the Code is evolving to address the challenges and concerns raised by stakeholders, it has truly driven a behavioral change among the market participants. Against 4,541 cases admitted under insolvency, the Code has resulted in 396 resolutions in a short span of five years. Recoveries have averaged ~36% to financial creditors, and the average time period is 419 days for resolution under IBC¹⁸. One of the biggest change that IBC has driven is a fear in the minds of borrowers that they can potentially lose their business.

Figure 10: Rise in NPAs and consequent decline in bank credit growth¹⁶



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Private credit is at an inflection point in India. If India is to become a \$5 trillion economy over the next 3 to 5 years, it needs to add about \$2–2.5 trillion in credit to support this growth. With banks still over cautious in lending and NBFCs facing asset liability mismatches, private credit has emerged as a preferred source of capital for hungry corporates. With traditional financiers lending selectively, there is currently a peculiar bipolarity in the Indian credit markets, with corporates that are the ‘haves’ able to raise very easy cheap financing vs the ‘have nots’ that are struggling to raise capital from traditional financiers, thereby paving the way for private credit providers

Eshwar Karra
CEO, Kotak Special Situations Fund

¹⁶RBI Website; Sector Wise Bank Credit Deployment; EY analysis

¹⁷RBI, NHB, EY analysis. Note: Bank credit to NBFCs is reduced from the computation of overall systemic credit

¹⁸IBBI report - June 2021

Formation of the national bad bank

One of the major hurdles in resolving stressed assets is time consuming decision-making by the financial creditors. In the Indian context, this is a challenge since the size of the syndicates could be as high as 30 banks! This leads to creditor hold-out problems and delayed decision making resulting in stretched resolution timelines. To overcome this challenge, a National Bad Bank - the National Asset Reconstruction Company (NARC) - was incorporated in July 2021.

Initiatives taken by RBI to resolve stress outside NCLT

The RBI has been at the forefront of handling the challenges thrown by high NPAs in the banking system and has continuously taken several initiatives to alleviate stress and improve the investment environment to attract foreign capital.

- ▶ Consolidation of public sector banks from 27 in 2017 to 12 in 2021, which should aid faster decision making
- ▶ Prudential framework for the resolution of stressed assets (RBI circular dated 7 June 2019)
- ▶ Relaxing of regulatory barriers to allow global distress debt funds to operate with relative ease in India
- ▶ Resolution framework for the COVID 19 related stress (dated 6 August 2020)
- ▶ RBI is evaluating opening-up secondary trading of debt to create liquidity in debt markets
- ▶ Formation of committee to evaluate the development of the bond market to create a robust alternate source of debt capital
- ▶ Formation of committee to review working of the ARCs

Major economic reforms by government

- ▶ **RERA:** The Real Estate (Regulation and Development) Act, 2016, (RERA), seeks to protect the interests of home buyers and also boost investments in the real estate sector. RERA aims to make real estate purchases simpler by bringing in better accountability and transparency and also better regulation in the real estate industry.
- ▶ **GST Act:** The Goods and Service Tax Act was implemented in July 2017 and is a comprehensive, multi-stage, destination-based tax that is levied on every value addition in the economy. It is an indirect tax and has replaced many indirect taxes in India such as the excise duty, VAT, services tax, etc. This has helped in formalization of the economy and improved tax compliance.
- ▶ **Repeal of retrospective tax:** In 2021, the Indian government introduced legislation to repeal the policy of impose a retrospective tax, which taxed capital gains on transactions that occurred prior to the law being framed in 2012. By repealing this policy, a major concern for foreign investors has been addressed and potentially improved India's image as an investment destination.

Flexibility in fund-setup and investing

Regulatory restrictions prohibit banks from providing structured financing solutions, and this creates an opportunity for private credit to step in to address the market needs. Today, private credit investors can invest from various onshore and offshore structures depending upon their context. We have covered this in greater detail in the section, "Fund-setup and regulatory environment".

Stable currency

A stable currency is critical to attracting overseas investors. Based on analysis of the last 20 year data of INR/US\$ exchange rates, the average currency depreciation in Indian markets on a 7-year rolling return basis has averaged at ~4%¹⁹. RBI has proactively managed the exchange rates by buying dollars from the market to keep the rupee stable despite the unprecedented huge dollar printing by the US Fed. As of July 2021, India's foreign currency reserves have reached an all time high of US\$640b, providing RBI significant firepower to manage any currency fluctuations.

¹⁹ES&P Capital IQ



Opportunity size of high yield and performing credit in India²⁰

India's high yield investment class is providing sizeable opportunities to non-traditional players to participate and create value. The next few years are likely to witness flow of private capital, specifically in the credit markets.

To better understand the size of the potential opportunity, we have analyzed the existing credit markets comprising - scheduled commercial banks (SCB) and non-banking financial companies (NBFC) players with aggregate credit outstanding of ~\$1,461b and ~\$318b, respectively. Further, certain credit exposures have been deducted to arrive at the outstanding wholesale credit to non-financial private corporates, representing the addressable opportunity for high yield credit, performing credit, special situations, etc. These calculations have been presented in Chart 1 (Scheduled Commercial Banks - credit analysis) and Chart 2 (Non-Banking Financial Companies - credit analysis)



The inflection point for Private Credit in India is already evident from the recent fund-raising activity from global marquee institutions in both performing and special situations & distress space in India private credit. We believe that mid-market companies' performing credit that yields from 14% - 17% INR is best positioned today. This is primarily as the biggest competition of mutual funds, and NBFCs have gone out of the market; at True North, we feel the biggest scalable and sustainable opportunity exists in this asset class.

Kapil Singhal

Managing Partner, True North Credit



Chart 1 - Sectoral deployment of credit by banks

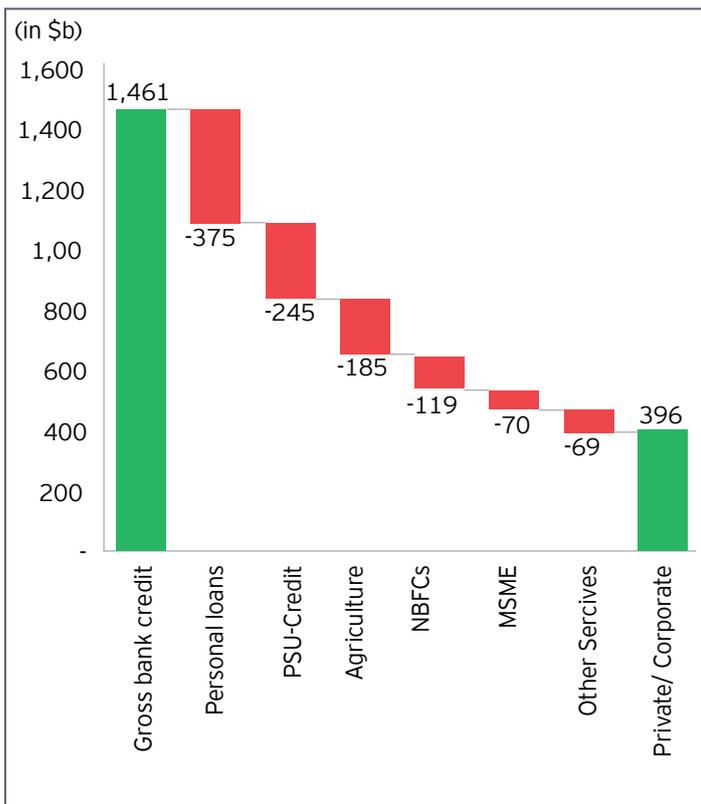
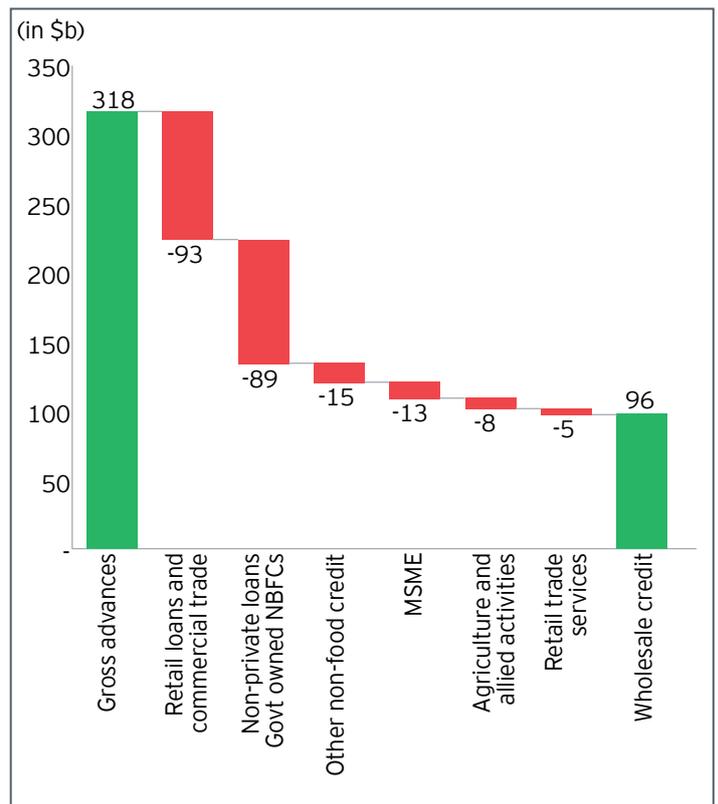


Chart 2 - Sectoral deployment of credit by NBFCs



²⁰RBI report on trend and progress of banking in India 2019-20, Economic Survey 2020-21, EY analysis; Bank credit data includes reported data of scheduled commercial banks

As depicted in the above graphs, total outstanding credit to private sector mid and large corporates aggregated to around US\$492b.

We have estimated the annual opportunity for private credit in India, for the next 10 years - segmenting the same into the following buckets:

High-yield and special situations segment (expected IRR 18-24%) - mainly comprising stressed financing opportunities arising from the non-financial private corporate debt book of scheduled commercial banks or NBFCs.

Performing credit (expected IRR 12-18%) to finance the growth needs of the business mainly from NBFC channel with some trickle-down of sub-investment grade financing opportunities which traditional banks may not finance

In addition to the above, there will be potential deals from the existing NPA stock sitting with banks and NBFCs.

Long term and patient capital from private credit funds will play a vital role in a country where credit markets have been disrupted so sharply over the last 2-3 years. We could see opportunities of over \$50 billion dollars in next 5 years in the Indian context across the credit spectrum

Amit Agarwal,
Head, Edelweiss Stressed Assets Strategy - EISAF II

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The table below summarizes the annual opportunity for high yield / performing credit financing in the near term (2022), medium-term (2026), and long-term (2030). The estimates take into account potential credit growth, loan defaults, expected recoveries, and risk-return profile. The worst and best case scenarios are based on assumptions on credit growth rates.

Figure 11: Estimated annual opportunity for Private Credit

Year	2022		2026		2030	
Case scenario (\$b)	Worst	Best	Worst	Best	Worst	Best
IRR: 18% to 24%						
High yield credit	1	1	3	4	5	10
Special situations	1	2	3	4	4	6
IRR: 12% to 18%						
Performing credit	7	15	9	23	13	47
Annual opportunity	9	18	15	31	22	63
Pre-2020 NPA	4	4	-	-	-	-
Total Addressable Market	13	22	15	31	22	63

It is pertinent to mention that this opportunity is being chased by a suite of investors such as promoters, strategic players, HNIs, NBFCs, ARCs, bank re-financing and private credit. The largest set of opportunities will be in the Performing Credit space with IRRs between 12% to 18% mainly from the growth of the NBFC wholesale book.

As the market matures, more players (specifically international institutional investors) are likely to enter this dynamic space. Further, the resolution of existing stock of non-performing loans would require an additional flow of credit. Given the size of the opportunity in the coming years and transition from solution credit to growth credit, let us look at how the key players are positioning to maximize this lucrative opportunity. The key developments and current deals in the market are briefly captured in the next section.

“Credit as a spectrum in private credit business has returns ranging all the way from Gross INR 12% to 22%+ across various strategies. The yield expectation is led by the risk that one is undertaking. We do not see any significant change in yields over the next 3–5 years on the high yield side as there are upside potentials in such deals. On fixed rate performing credit side the pressure on yields may not be more than 100–150 bps which is well withing tolerance levels as the enforcements risks come down, timeline to recover money comes down and overall credit costs are lowered. We are already at the bottom of interest rate cycle and we expect that there is no significant pressure on yields

Amit Agarwal
Head - Edelweiss Stressed Assets Strategy - EISAF II

“The Indian mid market corporate space offers a large deployment opportunity for performing credit funds and is currently highly under served. While efforts required for filtering and due diligence is high, but it offers an attractive risk-reward proposition. The key differentiator here is ability to offer flexible and bespoke solutions, especially given that the banks and NBFCs are getting more “cookie cutterised” in their approach. Key theme for True North’s performing credit fund is to build a “granular and diversified portfolio with well governed mid market companies in sectors that we understand well

Rubin Chheda
Managing Director, Investments, True North Credit

“Within private credit space, investment in distress and special situations provides an opportunity for securing high yield returns as investments are tagged with multiple risks linked to turnaround of the asset, provided the investor has the right team and infrastructure on the ground. The Government’s renewed approach to IBC with introduction pre-pack and setting up NARC will help push the resolution of distressed assets. Clearly, this is going to be the top priority of private credit investors, given the size of NPL to be resolved is expected to be over USD 150 billion plus

Shantanu Nalavadi,
Managing Director, India Resurgence
Asset Management
Business Pvt. Ltd



Private credit activity in India

There are principally two types of structures through which private credit investors can participate in the debt markets in India:



Investors/Fund houses have followed multiple strategies to enter the Indian market. Take ARCs as an example. In May 2016, to boost the capital base of ARCs, the Govt permitted 100% FDI in ARCs. Following this, several investors have taken large equity positions in ARCs (Refer Figure 12).

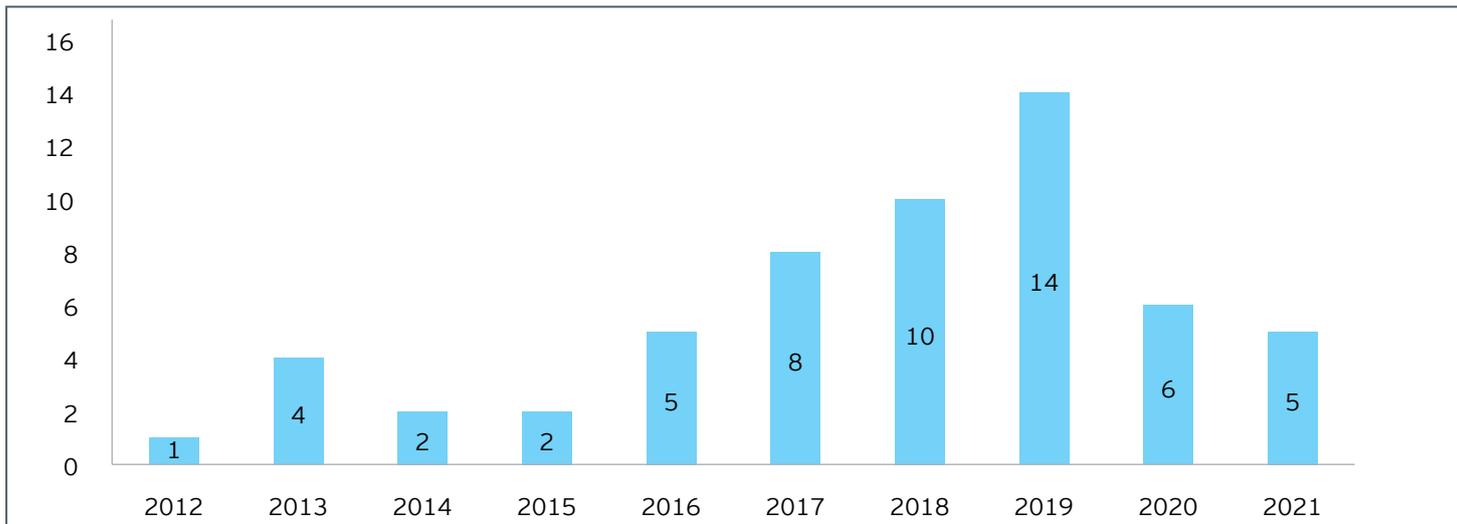
Figure 12: Foreign participation through ARC

Investor	ARC
Blackstone	International Asset Reconstruction Company
SSG Capital Management	Asset Care & Reconstruction Enterprise Limited
International Finance Corporation	Encore Assets Reconstruction
Avenue Capital Group	Asset Reconstruction Company (India) Limited
Emso Asset Management and J.C. Flowers & Co	J.C. Flowers Asset Reconstruction Private Limited
Lone Star	Lone Star India Asset Reconstruction Private Limited
Bain Capital Credit	India Resurgence Fund
Varde Partners	Aditya Birla Asset Reconstruction Company
CDPQ	Edelweiss Asset Reconstruction Company

Post the regulatory overhaul of stressed asset resolution, starting with the IBC in 2016, investing through AIF, which are privately pooled investment vehicles, has also been popular. The chart below (Refer Figure 13) shows the number of AIFs registered by fund houses as credit/debt funds over the last 8 years. There has been a noticeable increase in the registration numbers post 2015 i.e. when the IBC came into effect. Some of the popular fund houses investing through the AIF route include Kotak, Barings and Piramal to name a few.



Figure 13: Number of credit fund registrations as AIF Category 2 in India²¹



In terms of the deal volumes and sizes²² in first half of 2021, more than ten private credit transactions have been closed with an average deal size of ~\$118m aggregating an investment value of ~\$1.3b. Further, we have analyzed key deals involving varied credit strategies in the next section **“Analysis of select private credit deals.”**

We understand that the market would soon witness quasi debt deals and control transactions, based on quality of the investee company and its promoter group. As the space matures and becomes competitive, funds would be required to transform standalone strategies to hybrid models (multi-strategy or opportunistic), based on risk-return profile of the fund. Further, GPs may develop innovative structures and evaluation criteria (say ESG considerations) and diversify portfolio allocation, with a view to enhance returns and comply with regulatory requirements. The determination of timely exit strategy would be critical to manage risk and governance mechanisms. Till March 2021, majority of the funds were sector and instrument agnostic. However, a few sector-focused funds (Kotak Realty fund, real estate credit opportunities fund of Edelweiss, etc) have already emerged and this trend may continue as the market develops and opportunities are discovered.

“

Yields are driven by what do the investors expect from an investment on supply side and ability of the borrower to get alternative credit on the demand side. As Indian economy grows bigger, more corporates are expected to achieve investment grade ratings which will certainly put downward pressure on yields from private credit investments, especially those on the performing credit side. Also foreign investors are likely to see competition from home grown investors who have access to Indian balance sheet / rupee financing versus dollar financing adjusted for dollar hedge costs

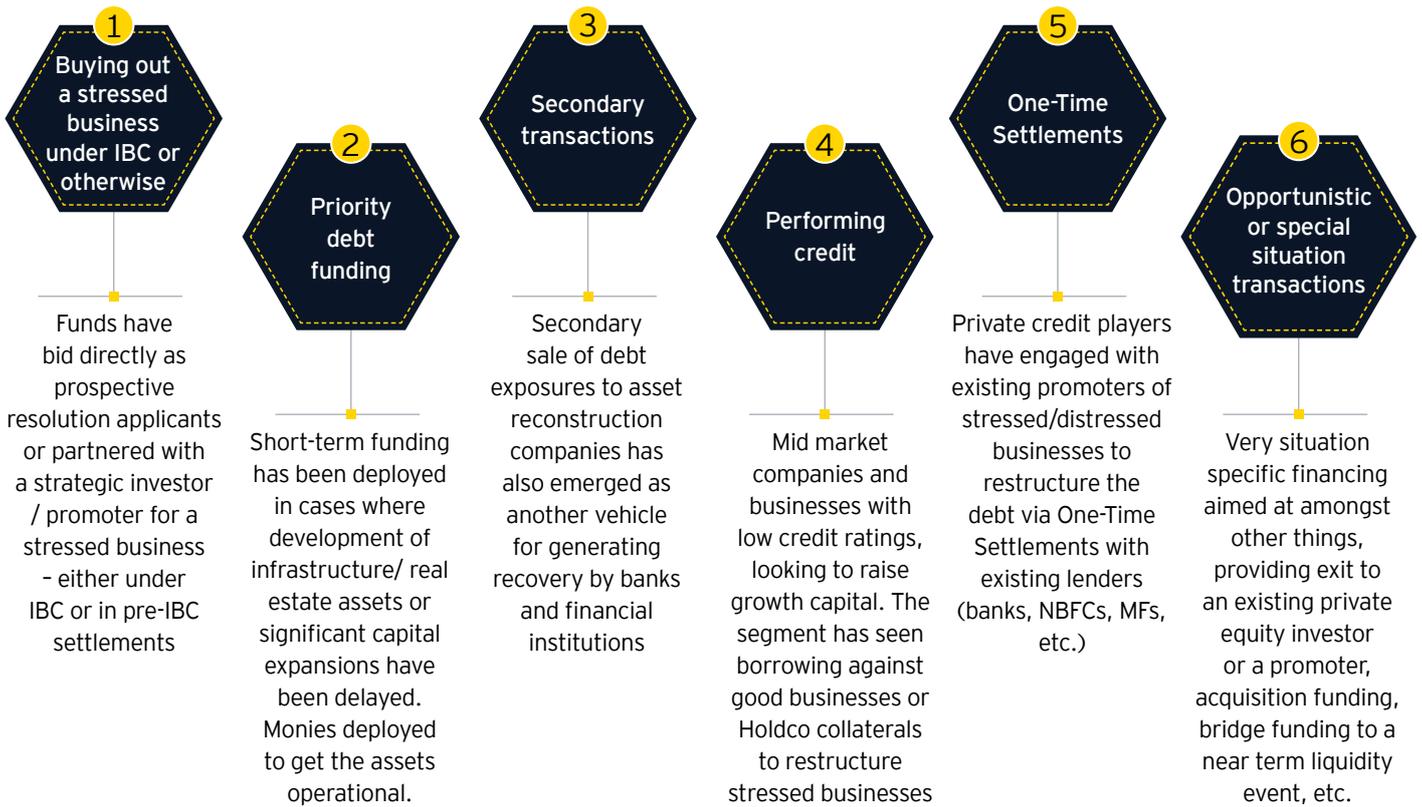
Shantanu Nalavadi
 Managing Director, India Resurgence Asset Management Business Pvt. Ltd

²¹SEBI AIF registration data and EY Analysis

²²Based on EY analysis of information available in public domain.



Multi-dimensional deals in private credit



The private credit market will favor players with a proven ability of having deployed capital towards creating bespoke financing solutions for corporates that are unable to access the traditional lending market. Over the last 18 months, at Kotak Special Situations Fund, we have invested ~\$650m across nine transactions. In each of the transactions, we have provided “solution capital” through an efficient financing structure to cater to the Promoter or the Company’s needs

Eshwar Karra
CEO, Kotak Special Situations Fund





Analysis of select private credit deals

Fund managers in India have pursued diversified/ hybrid investment strategies. The deal dynamics of select transactions are detailed below²³ :

Particulars	Deal 1	Deal 2	Deal 3	Deal 4
Investor(s)	Kotak Investment Advisors Limited	Cerberus Capital Management; Edelweiss Alternate Asset Advisors; Goldman Sachs	Kotak Investment Advisors Limited	SSG Ares Capital; Asset Care and Reconstruction Enterprise Limited
Investee company	Jindal Stainless Limited	Kesoram Industries Limited	Prius Commercial Projects Limited	Altico Capital India Limited
Sector	India's largest stainless-steel producer	Cement	Engaged in leasing out commercial space	NBFC engaged in providing loans to India's real estate sector
Transaction rationale	Recompense dues to existing lenders as part of CDR process;	Debt resolution with bankers; Ease liquidity in business	Build a portfolio of office assets; Leverage Kotak's real estate business	Exit to lenders pursuant to a resolution plan under RBI circular dated 7 June 2019
Credit strategy	Secondary transaction	One-time settlement	Acquisition under IBC	Special situations/ opportunistic
Instrument	NCDs, ~5.8%* equity stake	NCDs and OCDs	Equity and NCDs	Quasi debt and security receipts
Coupon p.a.	11%	1-18m: 9.1% 19-36m:11.3% 37m+:13.1%	NA	NA
Deal month	March 2020	March 2021	March 2021	March 2021
Maturity	February 2027	February 2026	NA	NA
Deal value	\$73m	\$275m	\$60m	\$380m
Investment period	7 years	5 years	NA	NA
Target IRR/ yield	NA	~20-22%	NA	>20%

*After stake sale in April 2021, Kotak holds 4.28% stake;

²³Private Circle, VCCircle, company filings, press release and news articles



Key challenges for private credit in India

Solid foundation has been laid for the growth of private credit in India and the opportunity size in future is significant. However, the growth of the market will not be linear and we will continue to face hurdles, some known today and some new that will emerge in future.

Basis our experience and extensive discussions with several fund managers, we have highlighted some of the key challenges impeding growth private credit in India:

Delays in formal bankruptcy process

NCLT as a dedicated platform and a creditor in control / commercially oriented IBC were meant to significantly cut down the time required for a resolution. However, vested interests have blunted the main instrument by leveraging the weaknesses in the system, namely - lack of adequate judicial capacity and infrastructure, lack of commercially oriented judiciary, corruption, an ecosystem that is "learning on the job", disproportionate focus on cost of resolution versus expertise, etc.

As a result, ~75% of ongoing cases under the IBC are delayed beyond the stipulated timelines as on 30 June 2021. The average time taken for resolving cases or initiating terminal liquidation is 419 days and 362 days respectively²⁴.

Timelines above do not include significant delays in admission of new petitions thereby making ineffective the other important use of IBC i.e. as a stick.

Delays in outside NCLT resolution

There are multiple reasons for the delays here namely, large lending consortiums (including non traditional lenders that are outside the purview of RBI regulations), fear of 3Cs (Central Bureau of Investigation, Comptroller and Auditor General and the Central Vigilance Commission) making it difficult for PSBs to take a commercial call, legacy valuation reports that act as impediment to accept new reality, promoters unwillingness to let go or dilute their holdings, fraud, poor communication and stakeholder mismanagement by promoter, etc. Delays in the admission of IBC petitions have emboldened promoters to stall negotiations and frustrate lenders.

Consolidation of debt as a result of PSB merger and creation of NARCL, will help in faster resolution in specific cases.

Barring cases of fraud and unwilling promoters, lenders and promoters should consider bringing in professional expertise to manage the crisis, develop a turnaround plan and mediate a settlement between all parties. Appointing Chief Restructuring Officers and turnaround managers, early in the crisis will help preserve enterprise value, leading to lower sacrifices from all stakeholders.



The biggest reason for past losses in India in private credit has been lending money to companies and owners with governance issues. This is the single biggest issue to watch out for. Staying focused, grounded and with the basic understanding that things will go wrong in a couple of deals, as this is a higher risk asset class, is another crucial aspect – this will allow you to take action on time. Exit is vital – but that is the result of choosing a well-governed company and managing the position well. Of course, one should get paid for providing a mezzanine, equity-like part of capital structure, a non-bank end-use or taking an event call risk to exit, but nothing can price in a fraud or governance risk

Kapil Singhal
Managing Partner, True North Credit



Corporate governance issues

Cash leakages, asymmetry of information, opaqueness created by complex ownership structures and poor accounting policies will continue to be a bane for investors. Promoter background checks, robust diligence, tight security creation and contracts that allow post transaction business and covenant monitoring and change of management can help mitigate some of the risks.

Easy monetary policy environment

Economic devastation as a result of COVID, led central banks everywhere to loosen their purse. In India, the RBI has been guarded in its response but has made ample liquidity available through banking channels and allowed one time rescheduling of loans. As a result of easy monetary policy to tide over the COVID impact, several businesses that had weak balance sheets, have got both liquidity and additional time to repair their businesses. While it has been excellent from an economy and job perspective, it has reduced opportunities for private credit in the short term.

Inability of Alternate Investment Funds (AIFs) to directly enter secondary market

Presently, bank debt can only be assigned in a secondary sale to an Asset Reconstruction Company (ARC) or another bank or NBFC. With the feature of deferred consideration existing only for ARCs who are given license by RBI after a process lasting several months, partnership with domestic ARCs has become a key prerequisite for new funds looking to invest in India. However, recent reports²⁵ suggest that government is actively looking to allow AIFs to participate in loan transfers.

²⁴IBBI newsletter, June 2021

²⁵<https://economictimes.indiatimes.com/markets/stocks/news/sebi-mulls-carving-out-separate-aif-category-to-buy-distressed-loans-from-banks/articleshow/86271926.cms?from=mdr>

Illiquid secondary trading debt market

The distress debt and high-yield market continues to be relatively illiquid which raises premiums and IRR expectations to a level which may not be matched by bank's haircut expectations. Quality of information and management teams thus become key components in identifying and concluding deals.

Unavailability of recourse to SARFAESI

Recourse to SARFAESI is not available for non-notified NBFCs, subscribers to unlisted or unsecured non-convertible debentures. Private credit deals should be structured to comply with rather than overcome these requirements. Mitigants which may be considered include cash trap arrangements or switching over to different instrument or a different platform.

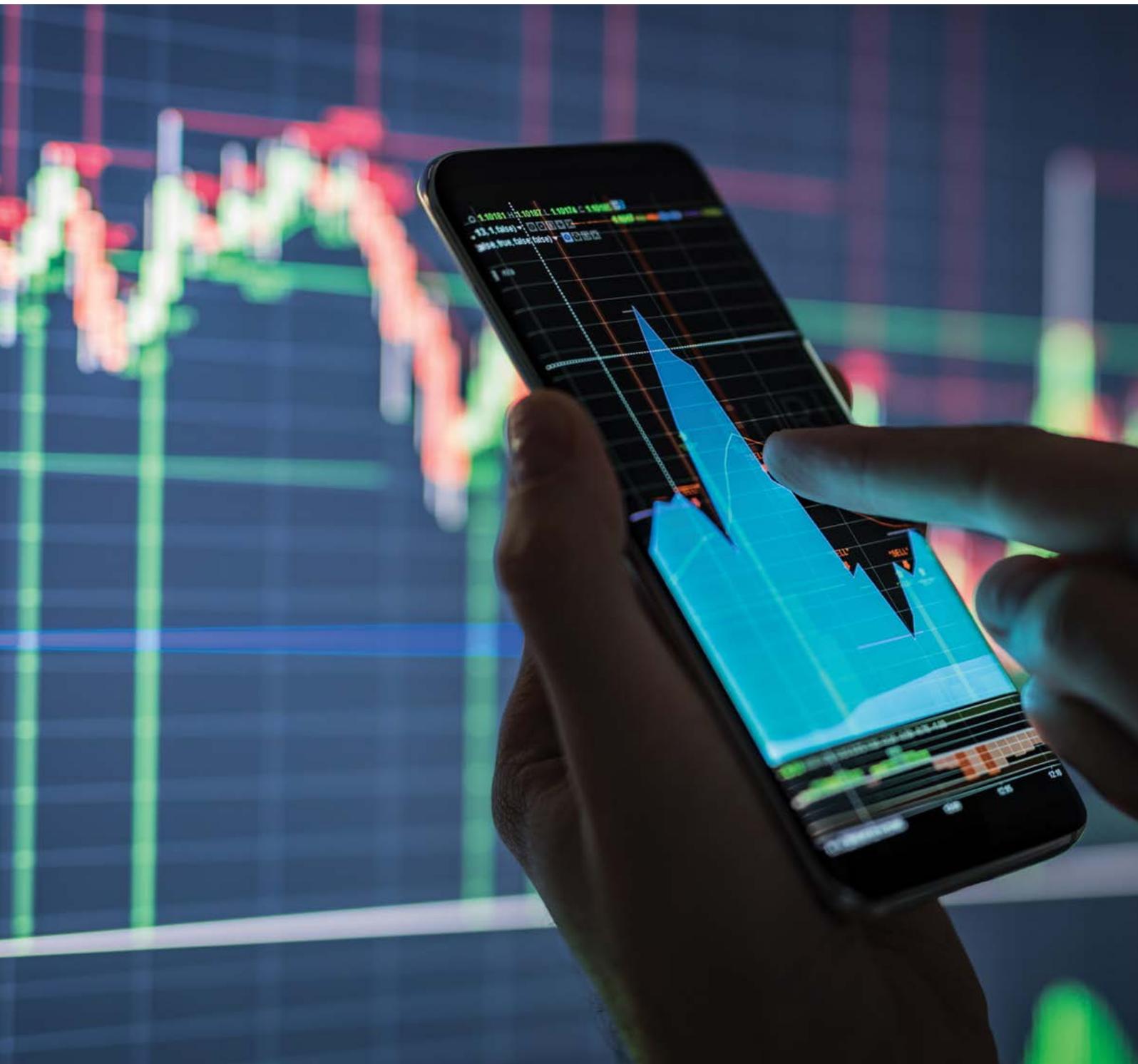
Regulatory constraints and uncertainty

Foreign debt is subject to certain regulatory constraints in the form of maturity requirements, concentration limits and restrictions on repatriation of proceeds (for instance no more than 25% of the principal amount of debt raised from FPIs through the voluntary retention route can be repatriated within the committed retention period).



04

Private Credit: Insights for operating in India





Fund setup and regulatory environment

By Tejas Desai, Partner, Private Equity & Financial Services - Tax & Regulatory services, EY

As highlighted in the previous section, India offers a structural and significant growth opportunity for private credit. Given paucity of capital required to resolve stressed assets, the regulators have actively modified existing and developed new regulations to welcome private credit. Some of the recent and significant regulatory and tax developments, that have structuring considerations have been listed below:

- ▶ Tightening of foreign debt investment rules under the FPI route by the RBI through the imposition of single borrower and minimum maturity norms
- ▶ Introduction of VRR route for FPIs by the RBI to encourage long term foreign debt
- ▶ Success of Indian AIFs as a platform to attract both domestic and offshore capital for debt investments, encouraged inter-alia by the restrictions under FPI route
- ▶ Progressive liberalization of the ECB regime for foreign debt in terms of eligible borrowers, lenders and end use requirements
- ▶ Tighter tax anti-abuse rules in the form of Indian GAAR and OECD's Multi-lateral instrument for tax treaties
- ▶ Gradual evolution of ARCs with greater emphasis on turnaround and restructuring through partnerships with global funds
- ▶ A highly favourable tax regime for funds with credit strategies set up in GIFT City, India's first offshore financial centre - similar to those available to global funds set up in Singapore/Mauritius

In this section, we take a look at some of the key considerations from a tax and regulatory standpoint for investors/GPs in setting up a credit platform. Principally, there are two types of structures:

- ▶ Offshore investment routes being FDI, FVCI, FPI, ECB
- ▶ Onshore vehicles being NBFC, AIF, ARC

Each of the foreign investment routes come with conditions as well as pros and cons which are linked to the following important criteria:

- ▶ Type of instruments permitted ie equity, debt, convertibles
- ▶ Regulatory pricing requirements
- ▶ Ceiling on interest payments by the borrower
- ▶ Minimum maturity and concentration norms
- ▶ Sectoral restrictions
- ▶ Registration/licensing requirements
- ▶ Tax arbitrages

For the investors, particularly foreign investors, they can optimize their tax outcome through the use of tax treaties. Please see Table 1 for a comparative tax outcome for the key jurisdictions from which investment has flown into India.

Table 1 - Tax considerations for investments via select jurisdictions²⁶

Country	Capital gains on equity shares	Capital gains on other securities (including debt and derivatives)	Interest
France	Exempt (if shareholding is less than 10%)	Exempt	10%
Netherlands	Exempt (subject to conditions)	Exempt	10%
The UAE	Taxable	Exempt	12.5% (5% for banks)
Mauritius	Taxable	Exempt	7.5%
Singapore	Taxable	Exempt	15% (10% for banks)
Japan	Taxable	Exempt	10%
The USA	Taxable	Taxable	15% (10% for banks and financial institutions)
Hong Kong	Taxable	Taxable	10%
Spain	Exempt (if shareholding is less than 10%)	Exempt	15%
Ireland	Taxable	Exempt	10%
Luxembourg	Taxable	Exempt	10%

²⁶Double taxation avoidance agreements entered between India and respective country

Similarly, the onshore vehicles i.e. NBFC, ARC and AIF are governed by SEBI and RBI's regulatory framework and can be deployed either standalone or in combination to achieve the desired commercial outcome. Please see Table 2 for a comparative analysis of the onshore vehicles.

Table 2 - Comparative analysis of onshore structures²⁷

Parameters	Onshore structures		
	NBFC	ARC	AIF
Intent	For providing loans and making investments	To create a platform to acquire distressed loans and restructure them	To raise a fund platform for investments in securities
Ease of Investment	RBI approval required	RBI approval required	SEBI approval required
Minimum Capital Requirement	Min. INR 20 million and 15% of assets	Min. INR 1 billion and 15% of assets	Corpus size of each scheme to be > INR 200 million
Leverage	Onshore and Offshore	Onshore and Offshore	Not Permitted for Cat II AIF (except if the AIF is in GIFT City)
Ability to acquire existing loan	Possible	Possible	Investments permitted only in securities
Protection under SARFAESI	Available to certain class of NBFCs	Available	Not Available
Tax efficient cash extraction	Structuring required; some tax leakage likely	Structuring required; some tax leakage likely	Possible

Getting a right structure/vehicle(s) is key to do deals in the Indian market. Each of these have their regulatory and tax conditions/nuances and these are dynamic. For instance, recent press reports indicate SEBI's intention to carve out a separate category of AIFs which may be permitted to purchase distressed loans from banks and NBFCs. If that happens, it will be a game changer for the private credit ecosystem. A detailed evaluation of the regulatory and tax framework in light of commercial objectives, is therefore imperative to building a successful, flexible and tax optimal platform for the Indian market.



Deal origination and transaction structuring

By Vishal Bansal, Partner, Turnaround & Restructuring Strategy, EY

High economic growth, improving laws and focus on opening of debt markets for external capital has cheered the private credit space. While the opportunities are rising, it is critical that funds/ investors are prepared to take advantage in the coming years. The investors must consider investment objectives and risk-return considerations. A holistic approach involving improved communication, quick decision making, management assessment, effective due diligence, understanding business operations/ sector, prudent business plan, strong risk management, strategic focus and vigorous implementation are key drivers for a successful deal in private credit market.

The following are some of the opportunities that private credit players should be excited about with regard to the potential deal flow in the near to medium term.

Transition / bridge financing:

Businesses rescued by distress / special situation funds may become an attractive opportunity for performing credit funds. It is extremely difficult for such businesses to access bank financing as a means for exit over the medium term (18-36 months). Private credit (more specifically performing credit financing) can play an important role in such exits as well as provide additional capital for growth (at competitive pricing). Such businesses may finally transition to bank financing over a period of 36-60 months.

Takeovers / refinancing:

Private credit providers, from time to time, look to exit certain companies / sectors (basis size, exposure level, etc) or look to generate liquidity for their asset-liability management / NPA / Risk management and often reach out to different creditors who can take over / refinance their exposures. For NPAs and 60+ dpd loans, they usually approach ARCs whereas for standard performing loans that are regular or less than 60 dpd, they usually reach out to fellow NBFC institutions or banks. Such accounts may also be an attractive asset class for private credit and could be potential take over / refinancing opportunities for them.

Alternative asset manager:

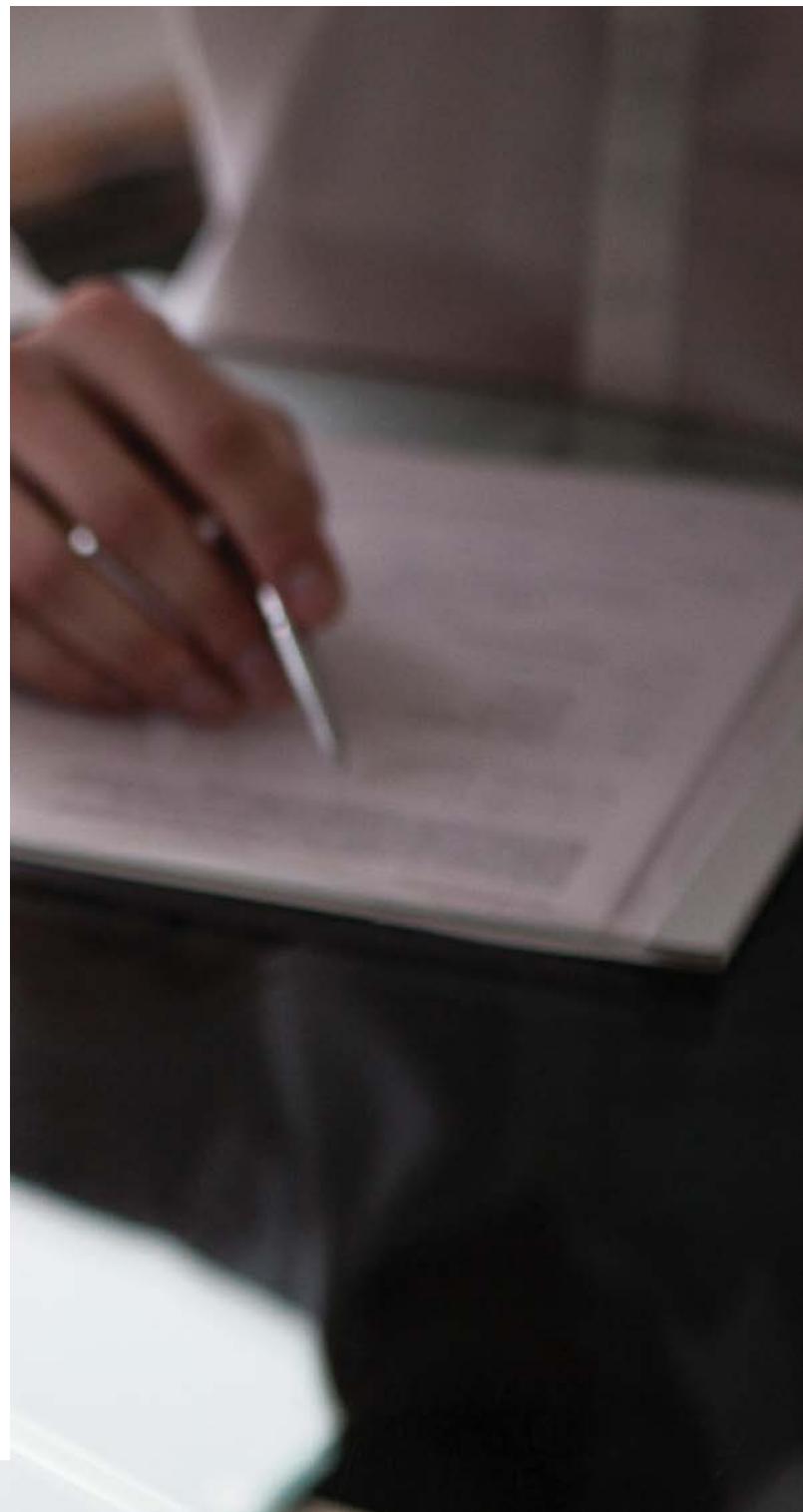
Increasing regulatory oversight / higher dependence on bank financing for large NBFCs (for their own borrowings) have currently taken away some of the flexibility which remains the hallmark of such financing. Capability of customising the credit structure completely to suit the borrower requirements across sectors has allowed private credit to also act as worthy competitors to existing NBFCs for primary origination.

Across geographies / currencies / capital structure:

With the increasing global presence of the Indian businesses, the flexibility / ability to fund transactions cross border, cross currencies and across capital structure remains a formidable strength of the private credit providers.

Duration play

Exit is an integral part of any lending thesis. Customisation of credit structure may include partial risk of refinancing towards the end of the tenor (especially if the intent is to exit anytime <24-36 months). The ability of banking system to give exit in case of a performing credit transaction may become an issue in the absence of any clear regulatory guidelines (this would result in change in repayment schedule). Longer duration instruments (5-10 years) with Put / Call option would be generally preferred for an early exit (repayment of balance outstanding) through takeover from a banking institution. Alternatively it may also avoid hardships (to be faced by the investor) on account of reset of terms in case of any exigency (resulting in a delayed exit).





Operations turnaround in India

By **Barat Gupta**, Partner, Turnaround & Restructuring Strategy, EY

Private credit operates in the higher end of the risk return spectrum. High yield (Exp IRR 18 - 24%) credit lending is still in early stages of development in India. While theoretically, private credit lending is lower risk vis-à-vis private equity, high yield investing situations have their own risk nuances that private equity players would consider high risk and not engage with. These risks stem from inter alia operational and financial distress, lack of access to traditional bank financing even in the medium term, doubtful governance standards, depleted management capability, etc. India has its own peculiarities where lending community (banks and NBFCs) have historically (and largely even today) taken a passive approach to resolving stress. This leads to operational decay in the business over months and years, with the borrower losing market share,

“

Getting to the top is optional, getting back down is mandatory. A lot of people forget about that.

Ed Viesturs

High altitude climber and only American to have climbed all 14 8000ers

”

under investing in assets (brands, distribution, people, plant and equipment and technology) and skewed working capital position. Several examples (across industries like aviation, beverages, glass, consumer electronics, plastics, etc) where repeatedly businesses with excellent franchise have lost enterprise value and even ended up in liquidation.

The quote above from Ed Viesturs can be considered analogous to lending, where lending is optional but return of capital, ideally with full returns is mandatory. It is also true that in a competitive environment and in the rush to deploy capital, important checks and balances are compromised. Newly set up private credit players will do well to remember and learn from the failed outcomes and sour experiences in several private equity investments made in India in the first decade of this century.

Following are some the key solutions to address the specific nuances of Indian stressed situations and to ensure return of capital from operations or a liquidity event:

- ▶ **Comprehensive business monitoring to reduce asymmetry of information** - Closest an investor and borrower management come to same understanding of the business is after a holistic due diligence and during discussions on investment theses. Once an investment is made, the information gap continues to grow as the investment team moves on to do another transaction and in most cases, business performance tracking is left to a junior team member to handle. Excessive reliance is placed on verbal assurances and early warning signs are often missed.

Embedding a business monitoring as a pre-requisite from day 1 should be a non-negotiable in most lending situations and contracts, including by an advisor of investor choice. A business monitoring as opposed to a cash flow monitoring would bring transparency on performance on key metrics, focus on significant drivers of margins and cash and identify early warning signs (example rising input prices, loss of key customers, reducing market share, or governance issues). Use of data analytics and visualisation tools can keep investors and management on same page regarding performance versus investment theses, and in real time.

“

Financial Discipline of the borrower is of paramount importance for the lender. Asset monitoring starts with appointment of right mix of professionals, instil internal and cash flow controls and add value through initiatives that support growth and ability to identify and mitigate market and business risks. Partnering in business operations through monitoring is a win-win situation for the both the lenders and the borrowers

Shantanu Nalavadi

Managing Director, India Resurgence Asset Management Business Pvt. Ltd

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- ▶ **Make the catch up investment upfront:** As mentioned earlier most stressed businesses in India suffer from years of neglect in investment in people, processes, brand, equipment, critical spares and technology. Capability and bandwidth of enabler functions shrinks significantly and often unable to support operations at pre stress levels or higher. A weakened sales team will not be able to achieve sales targets, an under qualified quality function will be unable to check on defects or a critical equipment with missed preventive maintenance will fail at critical juncture. These impediments can cause significant damage to business and achievability of investment theses.

It is important to factor the above while estimating the funding requirement and ensuring these are fixed right upfront. Margin of error in a turnaround situation is usually small, so its important to ensure adequate muscle is added to the business to build resilience.

- ▶ **Become a proactive partner in value creation:**
“Exceptional” returns in a high yield investment are derived not from periodic interest payments but from value to be vested in warrants and options, through improved operating performance. Similar to how private equity in India has evolved to drive value creation in their investee companies, private credit managers will have to quickly evolve to adopt this capability. Bringing the right mix of skills to the table is key as in stressed business that has just received a fund infusion or relief from near term debt commitment, a turnaround manager in the initial months would be more appropriate to make the business healthy. Once the business vitals normalize, growth focussed expertise could be brought in. Doing the latter first, could stretch the limited business resources and create further complications and bring the turnaround to a grinding halt.

“

We play an active role with the senior management towards devising the Company’s strategy. We leverage the various verticals of the Kotak platform such as investment banking, equity research, asset management, economic research, wholesale banking etc to add value to the business. We believe in having a certain degree of operational control as it builds long term discipline. In addition, we keep a close eye on the company’s performance (budgeted vs actuals) and on our exit thesis. If there is any significant deviation in either the performance or in our exit thesis, we proactively step in to work with the senior management for instant remedial action.

Eshwar Karra
CEO, Kotak Special Situations Fund

”

As in mountaineering, climbing an 8000 metre plus peak requires minimum 12-18 month tailored fitness program even for a normal fit person. In stressed business situation, the starting point is a sick often frail business that will require a phase of recovery and rebuild before it can begin a high growth journey. Keeping this in mind, will help in finding the right solution for return of capital along with the well deserved IRR.

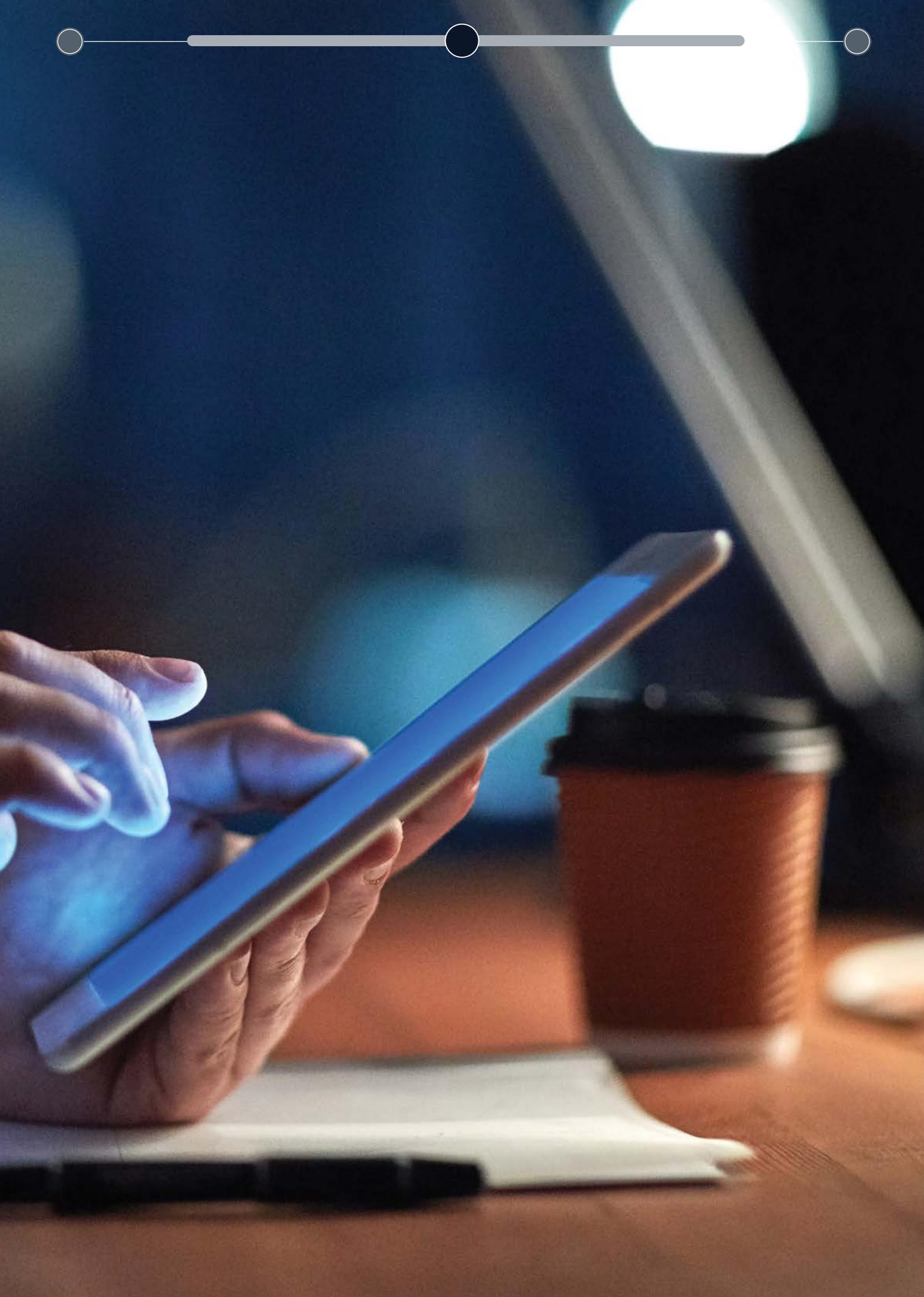


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Glossary

Term	Full form
AIF	Alternative Investment Fund
ARC	Asset Reconstruction Company
AUM	Assets Under Management
CARE	Credit Analysis & Research Limited
CRISIL	Credit Rating Information Services of India Limited
CRO	Chief Restructuring Officer
ECB	External Commercial Borrowings
EISAF II	Edelweiss India Special Assets Fund II
EODB	Ease of Doing Business
ESG	Environmental, Social and Governance
FDI	Foreign Direct Investment
FPI	Foreign portfolio investment
FVCI	Foreign Venture Capital Investor
GAAR	General anti-avoidance rule
GIFT	Gujarat International Finance Tec-City
Gol	Government of India
GP	General Partner
HNI	High Net-worth Individual
IBC	Insolvency and Bankruptcy Code, 2016

Term	Full form
IL&FS	Infrastructure Leasing & Financial Services
IRR	Internal Rate of Return
LP	Limited Partner
MF	Mutual Fund
NA	Not available/ Not applicable
NARCL	National Asset Reconstruction Company Limited
NBFC	Non-banking financial company
NCLT	National Company Law Tribunal
NPA	Non-performing assets
OECD	Organisation for Economic Co-operation and Development
PSB	Public Sector Banks
PSU	Public Sector Undertaking
RBI	Reserve Bank of India
SARFAESI	Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002
SCB	Scheduled commercial banks
SEBI	The Securities and Exchange Board of India
SME	Small Medium Enterprises
VRR	Voluntary Retention Route



Editorial team

Bharat Gupta

Partner, Turnaround and Restructuring Strategy
Ernst & Young LLP
Email: bharat1.gupta@in.ey.com

Rohit Somani

Director, Turnaround and Restructuring Strategy
Ernst & Young LLP
Email: rohit.somani@in.ey.com

Yusuf Tambawala

Vice President, Turnaround and Restructuring Strategy
Ernst & Young LLP
Email: yusuf.tambawala@in.ey.com

Yash Punwani

Senior Associate, Turnaround and Restructuring Strategy
Ernst & Young LLP
Email: yash.punwani@in.ey.com



Leadership contacts - by solution

Turnaround and Restructuring Strategy

Dinkar Venkatasubramanian

Partner & Head, Turnaround and Restructuring Strategy

EY Restructuring LLP

Email: dinkar.venkatasubramanian@in.ey.com

Abizer Diwanji

Head, Financial Services

Ernst & Young LLP

Email: abizer.diwanji@in.ey.com

Ramkumar SV

Partner,

EY Restructuring LLP

Email: ramkumar.sv@in.ey.com

Anoop Narayan

Associate Partner,

Ernst & Young LLP

Email: anoop.narayan@in.ey.com

Vishal Joishar

Associate Partner,

EY Restructuring LLP

Email: vishal.joishar@in.ey.com

Nitin Jain

Partner,

Ernst & Young LLP

Email: nitin.j@in.ey.com

Bharat Gupta

Partner,

Ernst & Young LLP

Email: bharat1.gupta@in.ey.com

Pulkit Gupta

Partner,

EY Restructuring LLP

Email: pulkit.gupta@in.ey.com

Lokesh Gupta

Partner,

Ernst & Young LLP

Email: lokesh.gupta@in.ey.com

Partha Guha

Associate Partner,

Ernst & Young LLP

Email: partha.guha@in.ey.com

Vishal Bansal

Partner,

Ernst & Young LLP

Email: vishal.bansal@in.ey.com

Shailendra Ajmera

Partner,

EY Restructuring LLP

Email: shailendra.ajmera@in.ey.com

Transaction Diligence

Kuldeep Tikkha

Partner and Head, Transaction Diligence

Ernst & Young LLP

Email: kuldeep.tikkha@in.ey.com

Ambarish Bharech

Partner,

Ernst & Young LLP

Email: ambarish.bharech@in.ey.com

Private Equity Services

Vivek Soni

Partner and National Leader,

Private Equity Services

Ernst & Young LLP

Email: vivek.soni@in.ey.com

Tejas Desai

Partner,

Ernst & Young LLP

Email: tejas.desai@in.ey.com

Ajit Krishnan

Partner,

Ernst & Young LLP

Email: ajit.krishnan@in.ey.com

Our offices

Ahmedabad

22nd Floor, B Wing, Privilon
Ambli BRT Road, Behind Iskcon
Temple, Off SG Highway
Ahmedabad - 380 059
Tel: + 91 79 6608 3800

Bengaluru

12th & 13th floor
"UB City", Canberra Block
No. 24, Vittal Mallya Road
Bengaluru - 560 001
Tel: + 91 80 6727 5000

Ground Floor, 'A' wing
Divyasree Chambers
11, O'Shaughnessy Road
Langford Gardens
Bengaluru - 560 025
Tel: + 91 80 6727 5000

Chandigarh

Elante offices, Unit No. B-613 & 614
6th Floor, Plot No- 178-178A
Industrial & Business Park, Phase-I
Chandigarh - 160 002
Tel: + 91 172 6717800

Chennai

Tidel Park, 6th & 7th Floor
A Block, No.4, Rajiv Gandhi Salai
Taramani, Chennai - 600 113
Tel: + 91 44 6654 8100

Delhi NCR

Golf View Corporate Tower B
Sector 42, Sector Road
Gurugram - 122 002
Tel: + 91 124 443 4000

3rd & 6th Floor, Worldmark-1
IGI Airport Hospitality District
Aerocity, New Delhi - 110 037
Tel: + 91 11 4731 8000

4th & 5th Floor, Plot No 2B
Tower 2, Sector 126
Gautam Budh Nagar, U.P.
Noida - 201 304
Tel: + 91 120 671 7000

Hyderabad

THE SKYVIEW 10
18th Floor, "SOUTH LOBBY"
Survey No 83/1, Raidurgam
Hyderabad - 500 032
Tel: + 91 40 6736 2000

Jamshedpur

1st Floor, Shantiniketan Building
Holding No. 1, SB Shop Area
Bistupur, Jamshedpur - 831 001
Tel: + 91 657 663 1000

Kochi

9th Floor, ABAD Nucleus
NH-49, Maradu PO
Kochi - 682 304
Tel: + 91 484 433 4000

Kolkata

22 Camac Street
3rd Floor, Block 'C'
Kolkata - 700 016
Tel: + 91 33 6615 3400

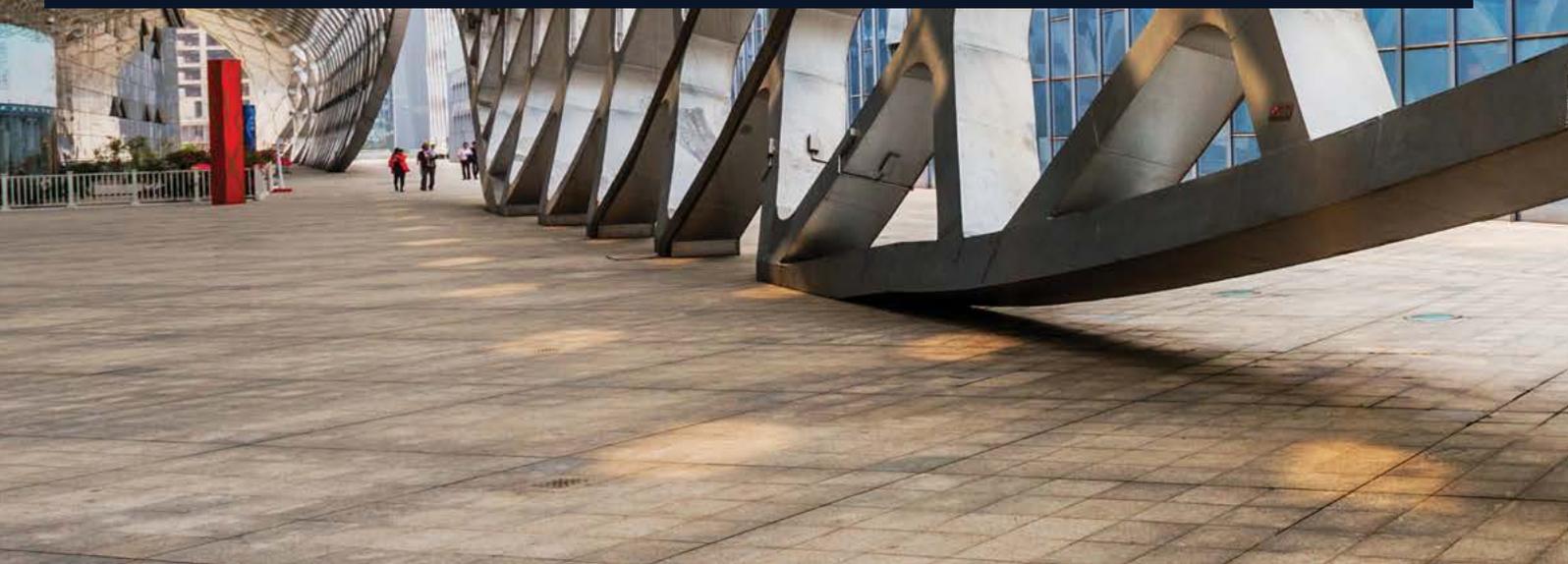
Mumbai

14th Floor, The Ruby
29 Senapati Bapat Marg
Dadar (W), Mumbai - 400 028
Tel: + 91 22 6192 0000

5th Floor, Block B-2
Nirlon Knowledge Park
Off. Western Express Highway
Goregaon (E)
Mumbai - 400 063
Tel: + 91 22 6192 0000

Pune

C-401, 4th floor
Panchshil Tech Park, Yerwada
(Near Don Bosco School)
Pune - 411 006
Tel: + 91 20 4912 6000





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