Banking Distress – The Road Ahead

Akhil Gupta
Vice Chairman
Bharti Enterprises Ltd.

Perhaps the most topical subject in India today, after GST, is Non Performing Assets (NPAs) of Indian Banks and the acute distress these are placing the Banks in.

Some very serious steps like invoking Insolvency Act and resultant restructuring of debt &/ or shareholding, revamping of management, etc. are being taken by Banks under blessings from RBI & Government. To begin with, twelve big 'defaulter' companies have been identified & named for this 'treatment'.

These indeed are commendable steps with the right message. However, we are all aware that these twelve are mere tips of the iceberg. It is common knowledge that there are thousands of NPA cases with all Banks of all sizes and in all sectors, which need resolution. Many of them remain under the radar because of size but each one of them is a ticking time bomb.

One basic feature of all discussions so far is the emphasis on 'haircut' taken by Banks by way of provisions, thereby either reducing the amount of outstanding loan or restructuring it to give more time for repayment.

This is where I feel the approach is flawed and would invariably fail for the reasons discussed hereinafter.

If we were to look at the NPA cases, there will be two categories. One which have EBITDA and EBIT but whose Net Debt:EBITDA ratio i.e. leverage is so high that under no circumstances would it ever be able to service the debt - in many cases interest itself, leave alone repayments. These cases have, to my mind, a viable & credible solution which is discussed subsequently.

The other category with negative EBITDA on a consistent basis are the ones which either need to be shut down immediately without wasting any time or effort (by invoking bankruptcy laws, etc.) or asking the administrators to look at possible mergers to attain size and synergies.

The focus of my discussion is on the first category of NPA cases where there is EBITDA but not sufficient to service the existing debt. My belief is that any attempt to try and restructure the debt in any which manner – whether by way of outright write off of some debt (which has its own huge limitations for the Bankers) or restructuring in terms of tenure of payments, is not going to work in most of these cases. This is for the simple reason that even with the reduced debt, in most cases the EBITDA would not be enough to give the company a free run to achieve its potential.

To my mind, the solution which would work in most of these cases would comprise of the following :

a) The Banks should take a bold step in converting the entire debt into equity and not take half measures. RBI has provided ample teeth to the Banks now to convert the debt into equity at favourable valuations for Banks and this step should not have any legal impediments any more. In most of the cases, the Banks with these conversions should end up owning more or less the entire equity of the company.

b) In the process, the Banks would get rid of the promoters which perhaps would be an extremely important step in rehabilitation of these companies. Fortunately, the general mood in the country today is such that there is no sympathy for defaulting promoters and thus it is extremely unlikely that any Court would intervene in favour of such promoters.

c) This of course would leave the issue of as to who should be managing those companies. For this, what is needed are professional outfits which would specifically focus on turnaround of distressed companies with industry experts and functional experts, who could assist the Banks in running such companies. The Banks and the professional entities would need to work together for this. This would be the biggest challenge which has to be taken up urgently.

d) The ideal solution of course would be that the professional entities who would undertake turnaround of such companies, should also take a significant stake in the company at pre-determined valuation from the Banks so that between the Banks and such entities there is a controlling interest. This would enable them to turn around the company efficiently and align their interests. For this, such management companies would need to tie up with financial investors looking to invest in distressed assets space.

The advantage of the above solution would be that this would give these companies the vital freedom of getting their act in order, making necessary investment in modernization of their plants and getting the working capital structure in place.

Under the circumstances, not only would the operations of such companies improve significantly, but also these companies would become net profit and free cash flow companies in no time without any tax liability for years to come as it is assumed that they would be having large unabsorbed tax losses that would be carried forward. The result would be that these companies can start getting high PE multiples, especially because of the fact that they would not be carrying any debt burden at all.

The likelihood is that in no time would the value of equity for these companies become big enough to give good returns to the Banks taking above steps. Please also note that since the company would revamp the management by putting industry experts into the operations, it is more likely that the operating efficiencies also would improve significantly with no financial stress on the operating team.

I believe that with this approach, the Banking distress in a very large number of cases can be taken care of without jeopardizing the investments that have gone into the business or endangering the jobs that are existing in such companies. Professionals who have turned around or scaled up the companies in their professional career need to be encouraged to form such management companies comprising functional experts as well as industry experts.