What 2019 has in store for financial sectors, distressed assets

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The year 2018 ended with a substantial liquidity squeeze in the financial markets due to several factors including rate hikes by the Reserve Bank of India, the crunch that non-banking financial companies faced and regulatory curbs on state-run banks saddled with bad debt. Simultaneously, in lieu of India's burgeoning consumer demand in the long term, the Indian market witnessed some marquee acquisitions like Walmart Inc.'s $16 billion acquisition of Flipkart and Hindustan Unilever's $5.25 billion acquisition of iconic health drink brands of GlaxoSmithKline Consumer Healthcare Ltd.

Also, India remains the fastest-growing major economy of the world with gross domestic product expanding at a rate of more than 7%. Business indicators are improving, too, as evident by the country's move up in the World Bank's ease of doing business index.

Indian equity markets were resilient and ended with about 6% gains. This is despite global headwinds, including action by global central banks, an escalating trade war that threatened to derail the global economy, political uncertainty arising from the change in control in the US Congress, higher energy prices and the potential of a disorderly Brexit.

A number of local factors also dampened market returns. These include the impending elections, introduction of long-term capital gains on equities, the crisis that engulfed NBFCs in general and IL&FS in particuar, the Punjab National Bank scam and the trailing impact of the Goods and Services Tax and demonetisation.

We expect liquidity pressure to ease in the second half of 2019. This will be limited to larger NBFCs, albeit with increased cost of funding.

As the financial sector continues to reel under multiple crises, we do not anticipate material increase in corporate lending by large banks and NBFCs. Capital-starved state-run banks will find it hard to allocate capital to corporate lending as they focus on resolving their balance sheet issues. The change of guard at large private-sector banks will also lead to selective corporate lending. Public and private-sector banks are likely to continue to focus on retail lending, leading to a gap in capital available for corporate lending.

With the easing of liquidity, we will see NBFCs participating more actively, albeit selectively, as some of them will face asset impairment issues similar to what the banks witnessed in the last cycle of expanded corporate lending. Recent restrictions in the policy for accessing offshore debt markets has meant the drying of an alternative source of credit and capital.

This, of course, means increased participation by other credit providers such as alternative investment funds (AIFs) for liquidity and growth, especially in distressed assets. This appears to be a medium-term trend until the banking sector and NBFCs resolve their issues.

Distressed asset resolution remained the overarching theme for the Indian economy. Overall, the Insolvency and Bankruptcy Code (IBC) witnessed several success stories in 2018 as it has become the preferred mode of breaking the logjam in the Indian financial system.

The IBC has led to the resolution of unpaid claims of nearly Rs 1,27,000 crore with most of the cases being resolved through settlements between creditors and debtors.

As per the Ministry of Corporate Affairs, of the 9,000 cases that have come to the various benches of the National Company Law Tribunals since the IBC became operational in December 2016, almost 4,400 cases have been resolved so far.

However, with reported non-performing assets (NPAs) amounting to about Rs 10 lakh crore, much work remains to be done. Despite the law being in its infancy, it appears to be stabilising and more cases should get resolved through this mechanism. The recovery of NPAs is not only a positive sign for the banking sector but also for the economy in general.

Despite the headline number on resolutions, the IBC witnessed challenges on various fronts in 2018. These includes issues relating to the parity (if any) between secured and unsecured financial creditors, between operational and financial creditors, value maximization versus process, challenges to disqualification criteria to promoters, successful bidders failing to pay up and disqualified promoters stepping in outside of the process to clear their dues.

All eyes will now be on the resolution of cases involving Essar Steel and other companies including Bhushan Power & Steel Ltd and Amtek Auto Ltd. This will hopefully provide clarity on some issues raised in those resolutions.

The government and the Insolvency and Bankruptcy Board of India have supported the incipient bankruptcy law by reacting promptly to any gaps therein. Much needs to be done to address the infrastructure requirements of the IBC, if it is to deliver on its promise. There is need for more appellate tribunals, improved training and understanding of the law, and reducing the opportunity for frivolous litigation causing delays in resolution.

We expect continued support to this major legislative reform based on the significant success stories witnessed in 2018.

While we are witnessing resolutions across many sectors through the IBC, the distress in the energy sector remains a matter of concern for the government. The power sector has assets of about 50,000 MW stuck at various stages. Of these, we have seen resolution of only one asset, the 1,980 MW Bara power plant, which was acquired by Resurgent Power Ventures.
The outcome of the Supreme Court case on the power sector being exempted from the IBC is awaited. The eventual success of the proposed 'Pariwartan' scheme will depend on visibility on the funding required for stranded assets and steps taken for asset turnaround, including forming a view on execution of long-term power purchase agreements and fuel linkage.

This sector continues to be of interest to funds focussed on distressed assets, such as India Resurgence Fund. Indeed, the distressed assets space is a perennial opportunity. These stressed asset cases can be resolved in a timely manner by addressing the root causes of distress, preserving the assets for stakeholders, protecting economic value and contributing to India's growth.

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