ILLUSTRATION BY AJAY MOHANTY

The buy side in bankruptcy process

Political leadership must create a team that will work on the bankruptcy reform to get good recovery rates in a few years

SNAKES & LADDERS

AJAY SHAH

The main focus of the Indian bankruptcy reform has been on the sell side: On creating conditions where lenders eject shareholders and put a firm up for sale. We need to also think about who will show up to buy. In the main, there are two kinds of buyers: Large firms in the same industry, and private equity funds. In the first few years, there will be three problems: Old defaults, limited pool of buyers, and scepticism about the bankruptcy reform. This will give low prices, which is good for buyers and bad for lenders.

In the past, shareholders in India liked to default on debt, and regulators helped lenders to hide the default. The new law has given power to lenders to eject shareholders once default takes place. This is a great milestone for the Indian credit market.

A big bottleneck lies in getting lenders to behave sensibly. This is about technically sound regulation of banks and insurance companies, so that assets must be marked down to zero over the one year after the first default. Lenders will then show losses immediately, before the bankruptcy process unfolds, and recoveries will show up as pure profit at future dates. This will create incentives for lenders to behave sensibly when faced with default. The Reserve Bank of India (RBI) and the Insurance Regulatory and Development Authority of India are grappling with this problem.

Once the machinery of the bankruptcy process is working and the regulation of lenders is done correctly, we will get a stream of cases coming through.

What about the buyers? The bankruptcy process is a market, with sellers and buyers. For the market to work well, we need both sides to perform. There are two kinds of buyers: Those who buy the firm as a going concern versus those who buy assets in a liquidation.

A recent default is generally by a going concern. A going concern contains organisational capital which has value over and above the physical assets. Most going concerns are able to produce some cash flow, and the net present value (NPV) of that cash flow is the price that a buyer would feel like paying. The buyer offers cash in exchange for 100 per cent equity control of the company with a clean slate, that is, all debt is wiped out.

Once time elapses after the first default, however, financial distress destroys organisational capital. Firm depreciation is accelerated because financial stress and the incentives of shareholders lead to inadequate upkeep of the firm. When there is delay after the first default, organisational capital is destroyed. The firm is often reduced to a collection of physical assets which go into liquidation. Here, the buyers offer cash in exchange for individual assets.

The perfect buyer for a going concern is a control-oriented private equity fund. The buyer would put up cash to buy a going concern at a discount, and expend resources on turning it around. The private equity fund would aim to resurrect a profitable business, and obtain a successful exit.

The top 2,000 listed companies are also potential buyers of going concerns in their own industries. Buyers would see synergies in acquiring a customer base, skilled staff and brands. If the IBC had been in place, Kingfisher might have been up for sale in 2009 (see *https://goo.gl/o2XyfM*). At the time, there was value for a buyer like Jet Airways. Such a buyer, however, sees organisational capital differently. The buyer will generally want to impose her internal processes in many areas, and would thus not attach any value (say) to an internal HR system of the target.

The second case is liquidation: Where the organisational capital has been destroyed, and what's being sold is just physical assets. Here, the perfect buyer is one of the top 2,000 listed companies. As an example, it makes sense for Britannia to buy land and machinery of a bakery at a discount, and weave it into the vast Britannia production system.

In the early years, valuations will be poor, for three reasons. The first hurdle is about the sound working of the IBC. Buyers are concerned about the fragility of the IBC machinery. Will this machinery work as envisaged? Will transactions go through correctly? Will there be legal challenges or other unpleasant surprises? These uncertainties push buyers to bid conservatively until the policy team in the bankruptcy reform achieves respect.

The second hurdle concerns capabilities of the buyers. There are few control-oriented private equity funds in India today. It takes years for these organisations to bulk up. Similarly, it will be years before the 2,000 listed companies organise themselves with teams, capital and processes through which they regularly participate as buyers in the bankruptcy process.

The third hurdle concerns the staleness of the defaulting firm. The greater the delay after default, the greater the value destruction. India has a big overhang of firms which defaulted in the past, and the bad news has been hidden so far. As an example, of the 15,000 non-financial firms in the CMIE database with recent data, 1,000 have interest payments larger than the earnings before interest. With old defaults, liquidation is often the only outcome, and the recovery rate will be poor.

The most important measure of the success of the Indian bankruptcy reform is the recovery rate. In the early years, the recovery rate will be poor for these three reasons. The political leadership must create a team that will work on the reform, so as to get good recovery rates in a few years.

The erstwhile promoters can and should be bidders in the insolvency resolution process. There will be discomfort when a promoter buys a 100 per cent stake in the defaulting company, with debt wiped out, for a low price. This is, however, a fair outcome as long as the process is open and transparent, and multiple other parties have the opportunity to look at the transaction. We should worry about the process hygiene and not be emotional about the outcome.

The writer is a professor at National Institute of Public Finance and Policy, New Delhi