ILLUSTRATION BY BINAY SINHA

The next level of credit analysis

There should be estimates for the resolvability of companies. Cheapest debt financing should go to firms that have higher chances of success

Credit risk analysis in India in the past has focused on the question: Will this company be able to pay its dues? Now we need to additionally think about the loss experienced by lenders after default. What will happen if the company gets into trouble? What recovery rates will be obtained through the Insolvency and Bankruptcy Code (IBC)? This takes us to the question of resolvability. High resolvability requires a comprehensible and transparent business, where control can be transferred easily. Such businesses will elicit buoyant bids in the IBC process, and the loss, given that there is a default, will be low. This will yield cheaper debt.

SNAKES & LADDERS

AJAY SHAH

Level 1 in the credit market is a lender who knows nothing about the borrower, and only thinks about the collateral. The failure probability is not important; the focus is only on the collateral. This requires the least capabilities at the lender. This works well when doing loans against securities, where collateral can be valued every day, and liquidated at will. When dealing with complex firms, however, the collateral available is limited. The liquidation value of a lot of plant and machinery is poor.

Level 2 in the credit market involves thinking about the probability of default. In banks like SBI and HDFC Bank, and the better bond investors, there is growing rigour in the process of utilising accounting data about the firm, about its peers, and about its industry, in arriving at a sense of the risk that is faced. Over the years, the better lenders have started slowly developing the institutionalised application of mind for judging the failure probability.

However, the probability of default is only one part of the story. What happens when default does happen? In the past, default was followed by hand wringing. Banks and the RBI were organised to hide bad news. There was also Level 1 thinking, the liquidation of collateral based on the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (Sarfeisi), but this does not provide safety in lending to large corporations.

Things have changed quite a bit with the IBC. The Indian bankruptcy reform should be viewed as two very different stories: One playing out on the stock of old distressed debt and another playing out for new debt that is now being contracted. For new debt, a new world is shaping up. The old ways, of banks and the RBI hiding the bad news, are behind us. This is because any one aggrieved person can approach the National Company Law Tribunal (NCLT). This can be one bank or one bondholder or one aggrieved canteen contractor or one aggrieved employee. This has significantly disrupted the secretive clubby ways through which bad news was hidden and ever-greening was done.

For new lending that is taking place now, the credit market needs to think about two questions. First, what is the failure probability? And second, what will happen when someone invokes the IBC? Once the Insolvency Resolution Process (IRP) starts, what kinds of bids will be obtained?

In an ideal world, when the IRP starts, many bidders will arise. These could comprise some strategic players in the same industry (e.g. a large listed cement company bidding for a small cement company) or they could be private equity funds partnering a new management team. When there are many bidders, the bidding war will drive up the price paid through the IRP.

Under what conditions will bidders pay more in the IRP? The key thing that bidders worry about is booby traps in the business. A comprehensible and transparent business can be readily transferred from an old shareholding/management structure to a new one.

What impedes transferability or “resolvability”? The booby traps that frighten bidders are the bad ways of old Indian businesses. These include oral contracts, incomplete contracts, methods through which money is stolen from the business by managers, dubious land titles, pending litigation, violations of laws or regulations, and intricate business relationships with family members of promoters. Under these conditions, it is not easy for a new ownership/management arrangement to step into the shoes of promoters. If it is felt that a firm is a mess inside, that it contains too many troublesome and opaque features, that it is not easy to replace the current promoter, then bidders will bid lower values.

The best teams in the Indian credit market are learning Level 2: How to use firm and industry data to estimate the failure probability of the firm. They will now need to up their game to Level 3: To set up procedures for estimating the extent of resolvability of the company. The cheapest debt financing will go to businesses that have a low failure probability and high resolvability. A new set of debt covenants should arise, limiting the behaviour of promoters in ways that increase resolvability. Developing Level 2 and 3 expertise is even more important for arm’s length investors, i.e. the bond market.

Resolvable firms will obtain a competitive advantage against non-resolvable firms through a reduced cost of debt. The clean, transparent, transferable firms will of course command a higher price when a control transaction for equity is contemplated also. Whether a board of directors envisages a possible exit in the future through a control transaction, a possible equity raise, or a possible debt raise, in all cases, there are gains from building a clean business.

The term “resolvability” was invented in the global financial regulation discourse in the context of the resolution corporation. The resolution corporation must look at the landscape and slot financial firms into two buckets: Those that it has the institutional capability to resolve (in the event of default) and those that it can't resolve. Micro prudential regulation and the resolution corporation have to work together to limit the damage that is impending, from the low resolvability part of the financial system. That kind of analysis will take place in India once the Financial Regulation and Deposit Insurance Bill is enacted, and the resolution corporation is in place. It is intriguing to see this concept show up in thinking about the failure of non-financial firms in India.

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