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Spotlight Asia

Kroll M&A Newsletter

October 2018

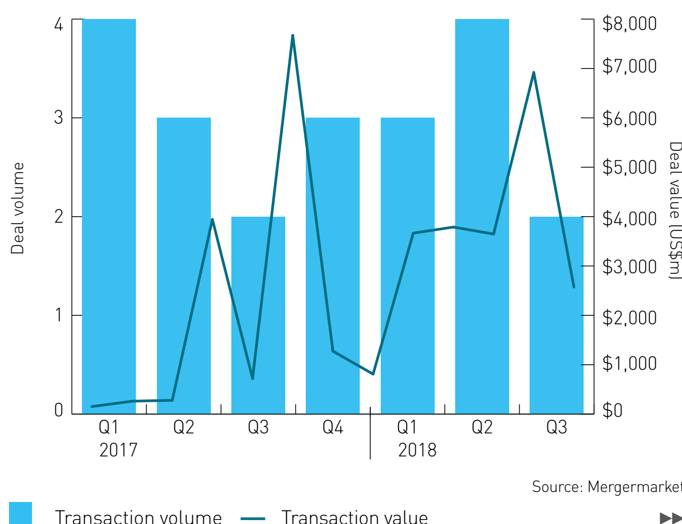
Distressed M&A in India: A risk worth taking?

More than two years since its inception, India's Insolvency and Bankruptcy Code (IBC) is proving to be more than just another acronym in a series of past failures by Indian regulators to create a viable restructuring mechanism in the country. Since May 2016, some 900 companies have been referred to the National Company Law Tribunal (NCLT) and the list of companies going through the IBC restructuring and insolvency process – starting with the so-called "dirty dozen[+]" – continues to grow. Opportunities for investors and acquirers have also grown as quality assets at attractive valuations come to market, providing further impetus to an already hot market for M&A in India.

Since 2017, distressed M&A* values in India have totalled US$14.3bn, a noticeable 12% of total M&A value, led by deals involving Bhushan Steel (US$7.4bn), Reliance Communications (US$3.7bn) and Fortis Healthcare (US$1.2bn). Close to US$10bn of those deals have been closed in 2018 alone.

In terms of actual deals, distressed M&A has accounted for a nominal 3% of total M&A volume in the Indian market at only 21 out of a total 623 deals completed since 2017.

India distressed M&A (2017-YTD 2018)



Source: Mergermarket

Transaction volume — Transaction value

We are pleased to present the latest edition of Spotlight Asia, Kroll's M&A newsletter, produced in association with Mergermarket.

Contents include:

- An overview of distressed M&A and asset sales in India since 2017
- Sector analysis of distressed deal volumes and values
- Observations on foreign interest and expected participation in 2018 and beyond
- An interview with Tarun Bhatia, Managing Director, Head of South Asia, Kroll and Varun Gupta, Managing Director and India Country Leader at Duff & Phelps

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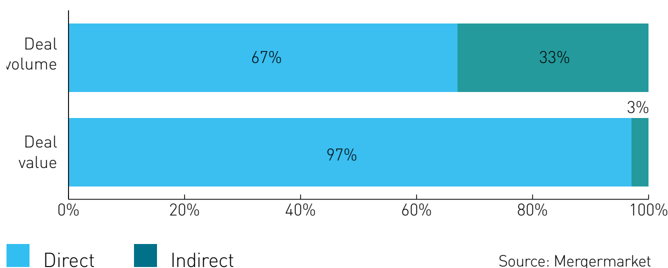
[+] https://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=40743

*For the purposes of this analysis, "distressed M&A" is defined as any transaction involving sale of a company directly in distress or where the transaction was carried out where the parent group/company was in distress.

Distressed M&A in India: A risk worth taking?

India distressed M&A: Direct v indirect (2017-YTD 2018)



► In that vein, 67% of distressed transactions were classified as "direct" where the asset itself was distressed, while the remaining 33% "indirect" transactions resulted in a sale because the parent organization was in distress. Expectations are strong that distressed M&A will be an ongoing theme for acquisitions in the country and will increase as more companies are admitted under the IBC and make their way through the NCLT process.

M&A market overview

Overall, Indian M&A has had an impressive year, with deal values launching to a five-year high at US$72.2bn. This was led by Walmart's US$16bn acquisition of Indian e-retailer Flipkart, as the US retail giant looks to expand operations in India and tap the country's burgeoning consumer class. The US$10bn acquisition of Indus Towers by Bharti Airtel has also contributed to this dealflow, with the previously mentioned Indian distressed deals adding to the total.

Foreign interest has helped propel M&A in India in recent years, with foreign investment M&A in India doubling from US$15.3bn in 2015 to US$32bn so far in 2018. Foreign investment in India accounted for almost half of deal volume so far in 2018 and 45% of M&A value, drawn by India's growing economy and government efforts to remove regulatory barriers for foreign investment.

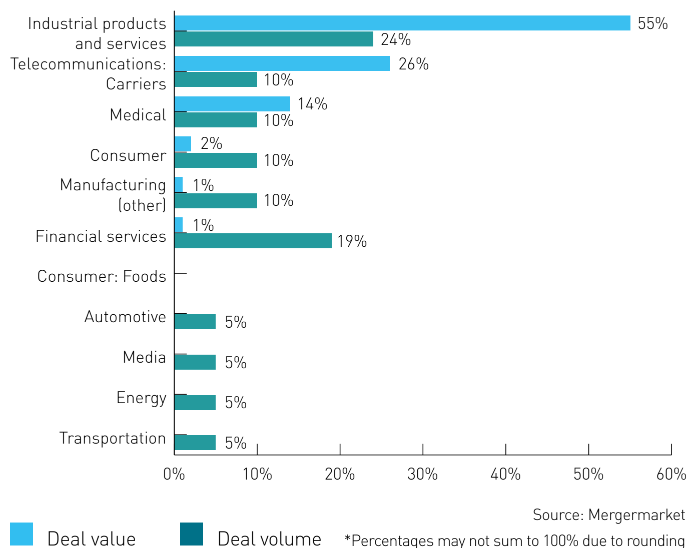
This momentum could continue through the remainder of 2018 and into 2019, especially in sectors directly linked to the consumer market, as dealmakers regain confidence in the market. It remains to be seen, however, whether this confidence is yet strong enough for foreign investors to venture into the country's distressed investment space, although some international groups are making inroads.

Sectors in distress

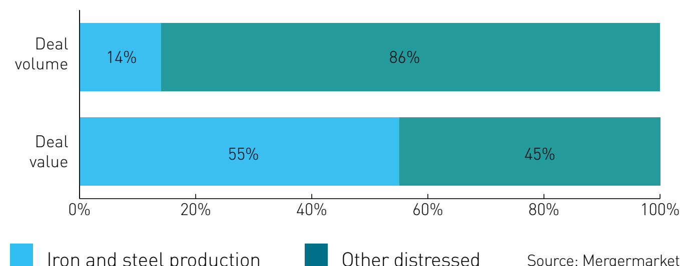
New companies are entering the NCLT process almost daily, and certain sectors stand out as particularly vulnerable. According to Mergermarket intelligence, sources say that steel, power, real estate and infrastructure companies are prime candidates for referral to the NCLT. Many companies in sectors such as manufacturing, textiles, consumer and metals are also over-leveraged and likely to face the chopping block.

Since 2017, distressed deals have focused predominantly (by value terms) on the industrial products and services (55% by

India distressed M&A: Sector analysis (2017-YTD 2018)*



India distressed M&A: Steel sector (2017-YTD 2018)



value), telecommunications (26%) and medical (14%) industries. Significant deal volume, however, was seen in the industrials (24%) and financial services (19%).

Stressed steel assets have accounted for significant deal value. Through three acquisitions, US$7.8bn in assets have changed hands since 2017, accounting for 55% of distressed asset values and 14% of distressed asset volumes. In addition to the Bhushan Steel deal, the largest to be resolved so far, asset sales have included the acquisition of Electrosteel Steels by Vedanta (valued at US$274m) and Jindal Stainless by its creditors for US$132m. Likewise, ArcelorMittal is set to acquire debt-ridden Essar Steel after India's Competition Commission gave its blessing of the deal in late September 2018. Such deals could be the tip of the iceberg as the Indian steel sector undergoes consolidation, with domestic and international steel majors vying for these assets.

Investor groups

Who are the participants in the unfolding story of India's insolvency regime? In terms of buyers, the narrative so far has been led mostly, and somewhat unsurprisingly, by domestic dealmakers: Indian investors accounted for 90% of distressed deal value and 81% of deal volume. Foreign buyers have played a more silent role ►►

Distressed deals in India: Weighing the risks and opportunities

Tarun Bhatia, Managing Director, Head of South Asia, Kroll and Varun Gupta, Managing Director and India Country Leader at Duff & Phelps, discuss the evolving investment landscape for distressed M&A in India and explain best practices to securing returns and mitigating risks.

How has the bankruptcy code evolved in the past two years?
Initially, there was concern that the Indian Insolvency and Bankruptcy Code (IBC) would lack firepower; however, while there have been some hits and misses, on the whole, the IBC has been very much a positive for the Indian market and is opening the door to a new investment class: distressed assets.

The success so far stems from a few key factors. Firstly, the IBC has had the support from various high-level stakeholders such as the government, the regulators and the judiciary. Secondly, some of the initial restructuring and insolvency proceedings show the IBC's efficacy and efficiency. Resolutions have been focused on the large corporate names to generate good global and domestic interest from investors and to illustrate the government's commitment to the process itself as well as the timeliness of the process.

So far, the results have largely been positive and could ultimately bring significant change to the culture between borrowers and banks in India. It's a step in the right direction although most people realize the IBC still has a long way to go.

Are Indian distressed M&A opportunities a risk worth taking for foreign investors? How can these investors mitigate risks?
The risks for investing in these distressed assets are not much different than those in any other M&A deal. As long as you have an effective strategy and the right people and resources in place, distressed opportunities can prove to be very valuable pursuits.

When considering investing in distressed assets, a good place to start is by analyzing the genesis of the distress. In some cases, this may simply be business risks playing out. For example, the company or asset may have been over-leveraged, anticipating a demand-supply cycle that didn't materialize. It is not that the asset itself is necessarily "bad" but rather that certain unfortunate circumstances led the asset into turbulent waters. In such cases, the right investor with the right resources may be able to buy the asset and turn around operations.

That being said, winning bids for these assets is not just a matter of putting the most money on the table. Courts are deciding many of these deals based on the best resolution plans: developing a believable blueprint to turn around the business. These strategies need to be developed on an asset-by-asset and company-by-company basis – and for foreign investors this means having the right team on the ground in the form of advisors and local partners to guide them through the process.

What are the key risks in these deals? What are the unseen risks that often get overlooked?
One of the main risks foreign investors must be aware of is the nature of the market. India is still a promoter-led economy, that is, key individuals perform very wide-reaching management roles not just within the business or organization, but also across the supply chain and within formal and informal business networks. When investigating an asset, it's crucial to understand how the business functions, who the owner/operator is and what ties connect various parts of the business with the local community, suppliers and politics. While the IBC says promoters are barred from the process, they are still very much involved with the success of the business assets themselves.

For this reason, it's important to bring in the right people and industry experts who know the sector and know the business and political terrain. Sometimes, this means starting from zero: buying the asset and then bringing in a new management team to manage the business. This is especially true for financial investors. Capital is just one piece of the puzzle. Expertise and best minds to build and scale the company is another, as well as performing due diligence to root out any other risks.

How should investors prioritize due diligence tasks during the often hectic and fast-paced bidding process?
A good approach to prioritizing and conducting due diligence is to break the process into pre-investment and post-acquisition tasks.

Pre-investment: Investors may get caught up with focusing on the simple question of "Why is the asset distressed?" but it's important to develop a full picture of both the asset and the ecosystem in which the asset operates. What are the operating issues? What are the environmental issues? Were there instances of fraud among the former management?

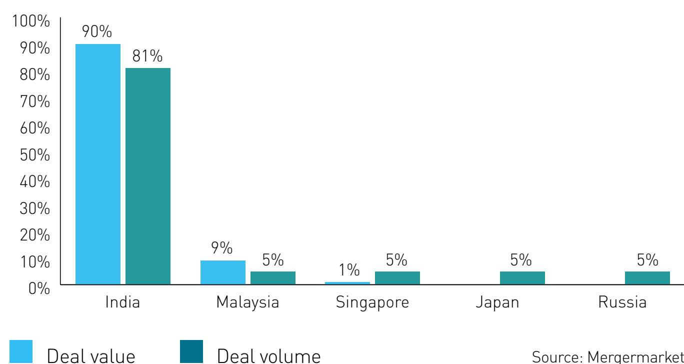
We mentioned promoter issues previously. That's going to be important to investigate and reveal the links between former owners and current suppliers and customers.

Post-acquisition: Ultimately, you have to realize that, as part of the restructuring process under the IBC, there is going to be limited access to certain data about the operations, employees and general business of the subject company. And the information one does access should be questioned. How much is reliable and how much is just part of a poorly managed information system? Hence once the buyer takes control of the distressed company, the initial 60-90 days become very important to do a 360 degree check on the key functions and operations to understand if there are gaping holes or inappropriate business practices to be addressed.

These are just a few of the main areas potential investors must consider. And while it may seem like a daunting task, it should not be a full deterrent. There is potential for significant opportunity in India, especially now. Pre-transaction due diligence and post-acquisition fraud checks are likely to become an integral part of the distressed asset acquisition process, and the value of third-party assessments should not be discounted as unnecessary, even for investors familiar with the market.

Distressed M&A in India: A risk worth taking?

India distressed M&A: Buyer/investor geography profiles



Source: Mergermarket

Companies admitted to NCLT via IBC

Source: NCLT

thus far, with Malaysia-based IHH Healthcare Berhad leading this charge with its lone deal worth US$1.2bn. Singaporean Wilmar International was another foreign buyer with its deal to acquire Shree Renuka Sugars for US$122m. However, the stage is being set for a change in this cast, and the next scene could see a very different set of investors begin to participate.

According to Mergermarket intelligence, PE majors such as KKR, Blackstone and other international firms have indicated interest, although watching from the sidelines at present. Other firms are forming partnerships with Indian players.

However, this has yet to translate into deals, and overall, foreign PE buyouts in India have declined steadily. In 2016, foreign buyers completed 78 buyouts worth US$11.3bn. So far in 2018, only 60 such deals have been completed at a total value of US$7bn. However, these figures make up a considerable portion of total PE activity, with foreign buyouts accounting for 85% of total buyout deals and 78% of those values.

Activity from overseas corporate buyers has been equally muted. According to Mergermarket intelligence, participation from foreign strategic buyers is only likely for those with existing operations or knowledge of the regulatory environment in India. Bidding for distressed assets is unlikely to come from those without a substantial business presence.

Outlook: 2018 and beyond

In addition to the +900 companies admitted into the NCLT, an additional 600-1,000 are expected to join the list over the next 12-18 months, creating a large pipeline of acquisition opportunities in the months and year ahead. While high-profile deals like Bhushan and Essar have dominated headlines and brought attention to the process in the past, according to Mergermarket intelligence, the playing field could get particularly crowded for NCLT targets in the sub-INR 20bn (US$281m) segment, with smaller suitors in search of more affordable and digestible targets. Equally, further supply could be created in the power sector as financial distress could see US$40bn-$60bn in assets among thermal power producers eventually come on the chopping block, according to news reports.

Another question that could be answered is what role (and in what quantity) foreign participants will have in this activity and if and/or when they will start entering the market in any noticeable numbers. Discounted assets are unlikely to be enough to attract this capital. Without a substantial rationale and the confidence in their ability to carry out effective due diligence of targets in a market already notorious for being shrouded – as well as lack of working knowledge of the regulatory system – these players may remain on the sidelines, at least in the near term.

Long term, the question may revolve around whether these changes will have a sustainable and transformative impact not just on the insolvency process (which seems to be taking shape), but to the overall local business culture. Will the IBC engender change in the dynamics between borrowers and creditors? Will it be enough – and will it last? While this remains to be seen, precedent is being set and examples made of promoters who have failed to keep their businesses out of overwhelming and unsustainable debt. With various cases to learn from, promoters could get serious about the possibility of defaults, otherwise they run the risk of losing their businesses.

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