Business Standard

A second balance sheet deleveraging

This time round, it is the promoters who are grappling with intense liquidity shock

Akash Prakash **May 20, 2019** Last Updated at 23:30 IST

In India, over the past few years, we have seen an intense balance sheet deleveraging among large corporate houses. The infamous Credit Suisse "House of Debt" reports had chronicled how several large Indian companies had unsustainable capital structures, with no free cash flow, and a desperate need to deleverage. Their debt burden had to come down. This deleveraging has taken place over the past six to seven years, through asset sales, bank write-offs and in certain cases change in control. Both the banking system (with the non-performing assets peaking at near 15 per cent) and the economy have borne the pain of this debt workout. Just when we thought we were coming near the end of this deleveraging cycle, and could look forward to a pickup in private sector investment, we are now faced once again with excess leverage.

This excess leverage and balance sheet deleveraging will now be at the promoter level, at their personal balance sheet. This is where there is intense stress today, stress which can damage the credit markets and once again short circuit any potential recovery in private sector investments. All balance sheet deleveraging cycles involve debt pay-downs, which reduce investments and inevitably slow down the economy. If you are scrambling to deliver free cash flow, you will cut investments to the bone.

Illustration: Ajay Mohanty

Post the IL&FS default in September, we have seen intense pressure on all except a handful of Non-banking Financial Companies (NBFCs). They have had their access to long-term funds constrained and costs of funding have risen 100-200 basis points. Many NBFCs have had simply no choice but to sell down assets to meet debt maturities. Most have limited ability to lend as they are unable to raise fresh funding. These same NBFCs were major players in promoter funding and structured credit. With their inability to lend, they are no longer willing to role over maturing promoter funding structures, forcing promoters to scramble to raise the cash needed to pay off their liabilities. This has come as a shock to promoters used to rolling over their liabilities.

A second source of promoter funding has been the debt mutual funds. Through various structures, we have seen funds subscribe to the debt of many promoter holding company entities, collaterised against listed company shares of the promoter. Market scuttlebutt has it that such funding is more Rs 1 trillion. This is spooking the markets, as we do not know exactly where this promoter funding is sitting. We also do not know whether it is being marked-to-market accurately. Debt funds have had to take a markdown for their exposure to IL&FS paper, and it seems possible that more such markdowns may happen as more promoter funding structures come to light.

Most investors did not seem to realise the risks being taken by some funds on their behalf. Consequent to this realisation many debt funds are now facing redemption pressures. The regulator also seems to be taking a dim view of this type of lending. It is fair to say that going forward, debt funds will pull back their exposure to such promoter funding structures. There is no question of these structures being rolled over. Once again the promoters are being asked to repay maturing structures, there is no rollover.

The third source of funding for promoters was the structured credit book of private corporate banks. These banks are under intense pressure from investors to curtail such types of risk exposures. It is unlikely that this source of funding will continue to be extended. The biggest player in this space has serious capital and management challenges. It also seems determined to undergo a business model change, and de-risk its lending book.

There is therefore a severe liquidity shock for promoter balance sheets. Most business families are scrambling to cut their promoter funding exposures given the lack of alternative funding sources.

This promoter balance sheet deleveraging has many unintended consequences.

First of all, in certain cases, markets have hammered the stocks of the companies whose shares have been pledged. In many cases, wherever we see large pledged share exposures, the stocks have been hammered so as to trigger a default event, and create forced selling of the shares pledged as security for the loan. Companies which have no underlying operating issues, have seen their shares fall by 50-60 per cent because of these pledges.

Secondly, we have seen attempts by promoter families to sell large blocks of stocks to raise the cash to reduce their personal debt. These block sales will be much more common and may put pressure on stocks.

Thirdly, this scramble to reduce personal leverage has also driven most promoters to attempt to sell assets. In most cases all this leverage was taken to build infrastructure businesses or assets in their personal capacity. Once again, we have a buyer's market for assets, as numerous infrastructure and real estate assets are put up for sale by various promoter families. Given the amount of wealth destruction seen in infrastructure, it is amazing to me that anyone actually expects the private sector to invest again in greenfield assets in this space.

With this new balance sheet deleveraging cycle, just like the one we have just gone through, it will take time to repair balance sheets, and rebuild risk appetite. It will take time for the financial intermediaries to get comfortable. For the majority of Indian promoters, there is no chance they will invest in a hurry.

We are unfortunately back to where we were seven years ago. The government will have to drive and front-load investments in the economy, and the financial intermediaries in the system will take time to regain confidence. One can only hope that this workout gets completed faster. We cannot afford another seven years of single digit earnings growth. The private sector has to rebound faster than the first balance sheet deleveraging cycle.

The writer is with Amansa Capital