



OCTOBER
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THE BOTTOM LINE

Impending Threat of Bankruptcies



FOREWORD

Dear Readers

Greetings from the editorial team!

We were overwhelmed by your response for the first edition of 'The Bottom Line', a joint initiative of the Finance Clubs at IIM Ahmedabad, Bangalore, Calcutta and Lucknow. We present to you the second edition collated jointly by professors, students and industry leaders. For this edition, we put specific focus on Bankruptcy, a topic that gained fuel after the Indian Government launched the Insolvency and Bankruptcy Code in 2016. A lot has happened since then and while the debate on whether the code is effective or not is still on, several articles of this edition aim to provide you with a fair understanding of the code, the hits and the misses and the remedies. Recently there have been concerns over the \$6bn telecom bankruptcies left in lingo and the Ministry of Corporate Affairs is contemplating extending the halt on new bankruptcy cases for another six months. In such times of highly volatile news, we hope to not let such structural legal issues take a backseat.

Meanwhile, investors across the world are closely monitoring the health of U.S. President Donald Trump, the Big Hit Entertainment, the management label for K-pop sensation BTS has come out with an IPO; oil firms have started evacuating offshore platforms as Tropical Storm Delta approaches, Microsoft announced its plans to build cloud services hub in Greece and London has yet again denied renewal licence, but this time, to Ola. Closer at home, RBI did not slash the repo rates citing signs of economic recovery and has projected positive GDP growth in Q4 leading to -9.5% growth in FY21. With India Rating Research revealing the sharp rise in fiscal and revenue deficits in state budgets seen in Q1

FY21, India's industrial production shrinking 10.4% in July and Gold imports at four month low in September, we are still guessing if the worst is over.

Meanwhile, governments world over are grappling with increased unemployment rates, Cambodia is looking at dynasty rule with the Prime Minister Hun Sen passing on the baton to his son after 35 years of rule, US has reached debt level of 106% of GDP leaving economists question its sustainability and the East Turkistan National Awakening movement's report has re-opened the issue of Uighur's oppression in China. Closer at home, analysts are still forecasting which direction the India-China war will go in while India strengthens its relations with Vietnam over a common enemy. On the other hand, there are speculations on weakening relations between India and Bangladesh and COVID has put the significance of BRICS in question as the member states (except China) fail to contain the virus. Our aim is not to deride any decisions but to collaborate, share knowledge and accelerate healthy debates on how such events that affect the world we live in. Our unique collaborative initiative aims to bring together not just the best minds and writers to create a resource worth reading, but also expand the reach of the above writers to students and readers interested in the world of business.

We hope that leaders of the world watch and take notice. If not the current leaders, but you the reader, the future leaders of the world.

P.S. – Any feedback from our readers, be it topics addressed, quality of content, potential topics, etc. would be welcome. We hope that every subsequent issue is better than the last.

Happy Reading!!

GLOBAL MACRO TRENDS

September started off with a massive sell off in NASDAQ stocks effectively reducing steam in its dream run. Later, it was revealed that Softbank, the Japanese giant, had taken colossal positions in options and hence part of the Bull Run in tech stocks was due to option sellers buying up the underlying shares to hedge their position. Ironically, Softbank, in its quest to earn some extra return with options trading, eventually lost more because of a decline in their share price as investors punished the company for indulging itself in such speculative activities. Markets across the world remained volatile with the overhang of virus, mixed economic signals and uncertainty over recovery.

Central Bank commentaries: ECB's president Christine Lagarde's remarks on Euro's appreciation and emphasis that policy makers are ready to adjust all of their instruments showed a strong sentiment to contain Euro's more than 10% jump since March while inflation remained below zero. Federal Reserve policymakers signalled near-zero interest rates will last through 2023 to aid US economy in its rebound from the pandemic. 13 out of 17 officials expected rates to remain near zero through 2023. Further east, the Bank of England gave a clear signal that it may consider cutting interest rates below zero for the first time in history leading to sharp drop in pound. Far east, the Bank of Japan signalled its readiness to ramp up stimulus if job losses from coronavirus heighten the risk of deflation. The central bank's governor emphasized on working closely with the new PM to shield the economy from pandemic's pain by loosening policy further.

WTO Rules against USA: In a stunning blow to the US, the WTO ruled that President Trump's decision to levy tariffs on China in 2018 violated international trade rules. Trump had imposed tariffs on \$360

billion worth of Chinese goods during the trade war. Of course, the USA showed no signs of containing their anger towards WTO. If the US files an appeal, which they will most likely, the case is expected to end up in a legal limbo, with no resolution in sight.

Too early for recovery yet? World Bank's chief economist Carmen Reinhart said that global economic recovery from the coronavirus pandemic might take as long as five years. There'd probably be a quick rebound as lockdown measures are lifted but a full-fledged recovery will take about 5 years. Following the crisis, global poverty rates would rise for the first time in twenty years, she said.

Closer Home: Output from eight core industries declined 8.5 percent in August, registering a sixth consecutive monthly contraction. Except for coal and fertilizers, all sectors recorded negative growth in August. Contraction for the April-August period stood at 17.5 percent. After GDP numbers came in, several rating agencies and financial institutions tracking the Indian economy revised their GDP growth projections expecting a greater contraction for the fiscal. However, signs of positivity were seen at the end of the month with Mint's macro tracker showing 6 of 16 high frequency economic indicators above their 5-year average trend.



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BANKRUPTCY IN INDIA: CONCEPTUAL ISSUES AND STRUCTURAL FRAMEWORK

In its most recent Financial Stability Report (FSR), the Reserve Bank of India predicts that in a “very severe stressed scenario”, the gross non-performing assets (NPA) of the banking sector could rise to as high as 14.7% of total loans by March 2021. Under the baseline scenario, the gross NPA ratio could rise to 12.5%. The Reserve Bank of India (RBI) stress test covered 53 scheduled commercial banks. Are the banks adequately capitalized to withstand such high volumes of unexpected losses is a question that will be answered once the COVID crisis blows away. The FSR, though, states that the capital adequacy ratio can fall by 133 bps to 13.3% by March 2021, which is fairly adequate.

Bankruptcy is a problem of capital structure and management. Managing a problem company, taking adequate action on early warning signals, the process of resolution and turnaround is like flying a plane. Balance is the key. On one hand, it is important to protect the sanctity of debt contracts and reinforce a sound credit culture, but it is equally important to make sure that clauses don't become so onerous that the spirit of entrepreneurship starts getting affected.

In India, the Government, RBI, and Insolvency and Bankruptcy Board (IBBI) have defined the pillars for efficient resolution or liquidation of stressed assets so that balance sheets may be de-clogged.

The first issue is to reinforce credit culture and debtholders senior claim on assets. For this, the *legal framework* has been strengthened through the Insolvency and Bankruptcy Code 2016 (IBC) and its later amendments, including the 2019 and 2020 ones. IBC brings to an end a complex maze of multiple laws that we had in India for stressed asset

resolution. The very fact that promoters may fear losing the firm to the highest bidder should incentivize the firm to protect credit culture and not over-borrow. Ideally, bankruptcy regulations should bring down the time needed for resolution so that the firm/asset starts producing cash flows again and /or the recovery rate improves for firm/ assets that can't be turned around. IBC fixes a timeline for resolution in 330 days.

Data suggest that till now, the average time for completion of 250 cases ending in approved resolution plans was 423 days, which came down to 380 days, excluding the time excluded from the Corporate Insolvency Resolution Process (CIRP) by the adjudicating authority. The time taken for the 955 cases yielding liquidation orders was 312 days. The recovery rate increased from 26.5% in 2018 to 71.6% in 2019, and the time taken in recovery improved from 4.3 years in 2018 to 1.6 years in 2019.

The second issue is **reducing agency problems**. This needs strengthening the **regulatory framework** so that depositors and small saving are protected from big scale defaults. Weak credit discipline in banks particularly with regard to follow-up and monitoring (I will not get into appraisal/sanction stage issues) often leads to build up of stressed assets. RBI needs to strengthen the risk-based supervision, so that divergence between provisions and NPAs reported and inspected is reduced. In this regard creation of and Enforcement Department is welcome for deterrence. Also, as now SEBI makes it mandatory for listed entities to disclose defaults within one working day will perhaps also lead to rating agencies timely revising their grades with attendant implications for risk weights and capital requirements for banks.

The third issue is information asymmetry, and in order to reduce it **institutional framework** has been strengthened with the establishment of Central Repository of Information on Large Credit (CRILC), Joint Lenders Forum (JLF) mechanism, and overseeing committee.

The final issue is the **fiscal dimension often driven by political will**. Resolutions need haircuts and higher provisioning. Capital raising from markets/Government, mergers based on strategic fit, sale of non-core assets, etc. needs to be pushed, and tough decisions will have to be taken.

In conclusion, the process of bankruptcy resolution will evolve as history of NCLT/NCLAT judgements

build up. There will be pains and costs, especially after the pandemic ends, but if we keep resolving it structurally and asking the right questions conceptually, this will lead the way for sustained growth.



By **Dr. Vikas Srivastava**
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BEHAVIOURAL BIASES, COVID-19 PANDEMIC, AND MARKET VALUATION

Around the world, the pandemic stricken financial markets have recovered from the lows recorded by the fourth week of March 2020 quite quickly in a matter of weeks. The quick market recovery is viewed as a 'worst-is-over' sign for health and economy around the world.

For such a view to unquestioningly hold true in the market valuation, financial markets should be able to deploy clear-headed thinking on several interlinked, daunting, and hitherto unfamiliar questions. How successful and quick would the world be in protecting a large fraction of the world population through vaccination? Would communities and nations be able to protect its vulnerable population from the virus through personal hygiene and social distancing until a vaccine arrives? How successful would be the governmental response in combating the pandemic driven loss in demand, through fiscal stimulus and liquidity support? How efficiently can the firms and communities replace face-to-face interactions with remote interactions and workflow arrangements?

In this context, it is important to assess whether investors are prone to erroneous judgments in these questions while estimating the likely impact of the pandemic. Behavioural finance has documented many deviations in our forecasts which could deflect decision-making away from arriving at the most likely future outcome. Furthermore, even when our forecasts are close to the most likely state of the world, we may still make decisions inconsistent with the forecast future. Some of such key departures, entwined into investor decision making, which may not allow the market recovery levels to reflect the true impact of the pandemic are discussed below.

Anchoring: Investors are known to apply several short-cuts in an attempt to achieve simplification of

the demanding cognitive task of forecasting the unknowable future. Among the widely adopted short-cuts is the widespread use of past price averages such as a 52-day moving average, in order to judge whether a stock is cheap relative to the current prices. While in a state of the world, where revenue growth, profitability, and investment requirements of firms are expected to remain stable, such a short-cut may provide an easy approach to the challenging forecasting problem. However, COVID-19 is deeply altering the economics around firms. For many firms, their future may only have a remote connection to their past. Then, short-cuts based on past price averages are likely to be horribly wrong in judging the attractiveness of investment opportunities. Therefore, it is likely that as the stock market valuation corrected in late March 2020, a large number of investors, anchored on such short-cuts, saw a rare opportunity to buy 'quality' stocks at 'cheap' prices.

Overextrapolation: Investors are known to generate forecasts based on their own experience of the market, rather than taking into account the entire range of probable market outcomes. It is likely that the experience of investors covers only a small range of the likely outcomes and therefore, may not unbiasedly forecast future outcomes. In the context of the pandemic, a large fraction of investors likely have no experience of a protracted financial crisis driven by an elusive pathogen. Instead, most investors have the experience of a rapid V-shaped recovery of the economy from the 2008 global financial crisis. There is a certain chance that social distancing may not work for long in many countries in countering COVID-19 infections, and effective vaccine development may take a long time. The likelihood of a delayed economic recovery is unlikely to be digested into the forecasts of investors who

the forecasts of investors who overly extrapolate their own experience of the swift economic recovery during the 2008 crisis.

Loss aversion: Investors are known to be loss-averse in their decisions to invest in risky assets, such as stocks. A particular manifestation of the loss-averse behaviour is the selling preferences of investors, known as disposition bias. Disposition biased investors are much more likely to sell their investments with capital gains than those with capital losses. Such an asymmetric selling behaviour is driven by our instinct to protect the self-image as a skilled stock picker. What is the implication of such behaviour during the COVID-19 pandemic? Let us imagine an investor holds the share of a hotel firm. Given the likely contraction in future business travel, hotels are likely to face de-growth or no growth in their revenues for the foreseeable future. Reflective of the poor future revenue growth dynamics, driven by the shift in travel preferences, hotel stocks are expected to steeply correct. However, if a large

fraction of the disposition-biased investors stay away from selling their holdings in hotel stocks, it could lead to an underreaction to the negative outlook of such stocks. As an outcome, hotel stocks are likely to remain overpriced relative to their true value. There are several such sectors, transportation, urban real-estate, and airlines are some such examples.

The various investor biases in forecasting and trading discussed above point out that the rapid market recovery, which we have seen around the world may reflect an underreaction to the adverse impact of COVID-19.



By Prof. Joshy Jacob
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‘NOT ALL CASH BURN INCURRED IS EQUAL’ – ‘GOOD CASH BURN’ VERSUS ‘BAD CASH BURN’

In this period of over-supply of cash for technology startups globally, the fact remains that justifying high cash burn has become a lot easier. I fundamentally believe that we are lucky to be living in times wherein access to capital for innovation is plenty, having said that, over capitalization is having its side effects ranging from entrepreneurs losing focus (as they suddenly believe that capital is a strong enough moat), lowering the bar with regards to capital allocation decisions to the more recent echo of justifying cash burn through loosely held assertions like ‘Leading consumer internet companies are also losing cash’ – this last statement got me thinking. While the statement is absolutely correct, it misses two key points which I hope to detail using this blog (1) Not all cash burn incurred is equal – ‘Good Cash Burn’ helps the company drive rapid growth which is sustainable at scale and there is a solid path to profitability which is then justifiably accompanied by high valuations. While ‘Bad Cash Burn’ drives top line growth and more often than not, at high revenue scale, pushes the company to a point of no return with entrepreneurs fighting the five key battles of

growing, controlling burn, proving unit profitability, fighting competition and raising capital TOGETHER! (read ‘Herculean task’) (2) At the cost of stating the obvious Companies with ‘Bad Cash Burn’ can only sustain high valuations for a short period of time

The Good Cash Burn

Consider the following scenario – your startup spends a \$1 to acquire a customer, you recover this acquisition cost, from contribution profits (revenue less all direct variable costs), in 6 months. Customer lifetime value is large and the company continues to grow at a healthy clip. Your marketing team has cracked at least one acquisition channel which is working well (consumer acquisition cost is stable as you spend more acquisition dollars on the channel). I am inclined to add one more layer to this situation which is more probable in B2B or software startups rather than B2C startups – let’s say with the above-mentioned metrics the company is fast approaching profitability and hence, the company is in no real hurry to raise capital. Let’s examine the following two possible scenarios –

Months	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
Unit Model	-1	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17

Scenario I – entrepreneur remains conservative in increasing acquisition spend as the lure of profitability and/or the pain of dilution and fundraise holds her back. She increases customer acquisition spend conservatively by 2x.

Months	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
1	(2.0)	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
2		(2.0)	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
3			(2.0)	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Overall Cash flow (1+2+3)	(2.0)	(1.7)	(1.3)	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Cumulative Cash flow	(2.0)	(3.7)	(5.0)	(4.0)	(3.0)	(2.0)	(1.0)	-	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0

Peak Cash Burn = \$5

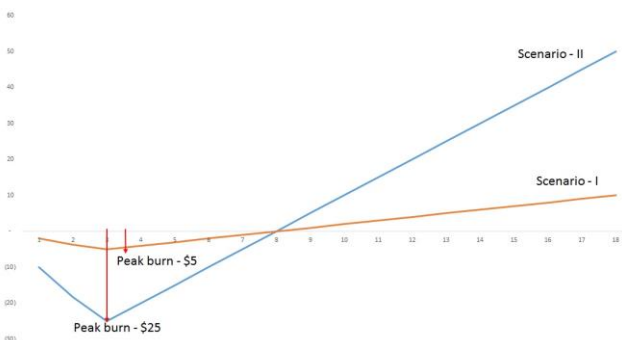
Scenario II – entrepreneur raises a large round of capital and pumps money into customer acquisition. She increases the customer acquisition spend by 10x.

Months	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
1	(10.0)	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
2		(10.0)	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
3			(10.0)	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Overall Cash flow (1+2+3)	(10.0)	(8.3)	(6.7)	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Cumulative Cash flow	(10.0)	(18.3)	(25.0)	(20.0)	(15.0)	(10.0)	(5.0)	-	5.0	10.0	15.0	20.0	25.0	30.0	35.0	40.0	45.0	50.0

Peak Cash burn = \$25

The following graph does justice to the point I am trying to make –

CUMULATIVE CASH FLOW COMPARISON – Scenario I & II



Following are some of the key highlights from the graphs above –

1. While total cash burn in Scenario II (\$25) is way higher than in Scenario I (\$5) but the scale and hence, eventual profitability is much higher for the aggressive entrepreneur. And hence, this burn is absolutely justified given the long term return on this invested capital.

2. If you end up in Scenario I, the opportunity loss (and heartburn) of a missed opportunity can be quite crazy. I have been in a real situation wherein the board decided to be conservative in a situation like this which resulted in an outcome which was well below potential!
3. This is a case of 'Good Burn' – if your company is experiencing 'Good Burn' please reach out to me (and mention the same in the subject line and I will come back as fast as I can)

The Bad Cash Burn

'Bad Cash Burn' can have multiple situations. I capture some of them below –

1. Situation I – characterized by long customer acquisition cost payback period and short customer lifetime values – let's say a business with 36 months payback but 9 months of customer lifetime values – let's say a business with 36 months payback but 9 months of customer lifetime value (read 'high churn'). The business never recoups invested capital

forget making a return. At this point, the company needs to re-think it's 'product-market fit'

2. Situation II – Customer retention is high (customer loves the service) but the company fails to make contribution profits at the transaction level (and hence, there is no payback in sight) and the company scales losses with more transactions! I believe there are two reasons why companies don't make contribution profits (1) Heavy competition (2) Rapidly scaling behind a flawed 'product-market fit' or loss of 'product-market' fit. I believe the first reason is a relatively better position to be (vis a vis the flawed 'product-market fit' situation) in as competitive madness can hope to settle sooner than later for the pursuit of real profits (topic for a separate blog). Having said that, you need to strictly guard against scaling up if you are in the second bucket – my strong suggestion is that you need to go back to the drawing table to prove strong product-market fit and prove a line of sight of unit economics before putting more capital to scale.

3. If you push for scale in a 'Bad Cash Burn' scenario, there will be a point in the evolution of the company wherein you will be fighting the five key battles of growing, controlling burn, proving unit profitability, fighting competition and raising capital TOGETHER! (read 'Herculean task').

4. Solve to avoid a 'Bad Cash Burn' scenario under any circumstances. More on how a public company lost 90% of its value due to 'Bad Cash Burn' scenario

To Summarize –

1. The statement that 'Leading consumer internet companies are losing money' and hence, a high burn is justified is an irresponsible statement to make. The burn needs qualification between 'Good' and 'Bad'. If there is one thing that is true it is that companies

with 'Bad Cash Burn' scenarios can only sustain high valuations only in the short term.

2. If you are experiencing 'Good Burn' and you DO NOT accelerate investing behind the same – you run the risk of losing a big opportunity. Essentially, doing a disservice to yourself, your team and existing investors.

3. If you are experiencing 'Bad Burn' and you DO accelerate investing behind the same – there will be a point in the evolution of the company wherein you will be fighting the five key battles of growing, controlling burn, proving unit profitability, fighting competition and raising capital TOGETHER! (read 'Herculean task'). You run the risk of putting the company to a point of no return as your existing investors might help for some time but will sooner than later want outside investors to price the round and invest – essentially, doing a disservice to yourself, your team and existing investors.

4. At the cost of repetition, solving for unit economics is far easier at a small scale than that at a large revenue scale

5. Everything starts from Nothing!!



The above article has been taken from blog "**The Networth Effect**" written by **Mr. Raghav Bahl**. The author is the Head of Investments, India at Alibaba Group. The views expressed here are personal & do not necessarily reflect the views of any organization. For more articles authored by Mr. Raghav, please visit <https://thenetwortheffect.com/>

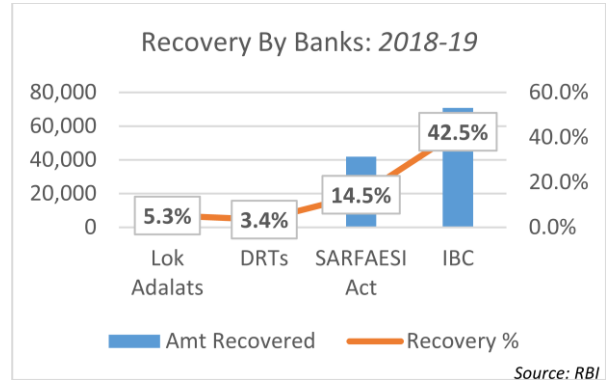
BETTER LATE THAN NEVER

A famous literary work of Ernest Hemingway has the following dialogue: "How did you go bankrupt?" Bill asked. "Two ways," Mike said. "Gradually and then suddenly."

This snippet accurately describes the transition of an insolvent company to a bankrupt company. Rising costs, competitive pressure, lack of demand are some of the reasons a well-functioning company can end up defaulting on its obligations and eventually filing bankruptcy. The Indian economy has been struggling with the resolution of Non-Performing Assets (NPAs) that has brought the entire banking sector to a grinding halt.

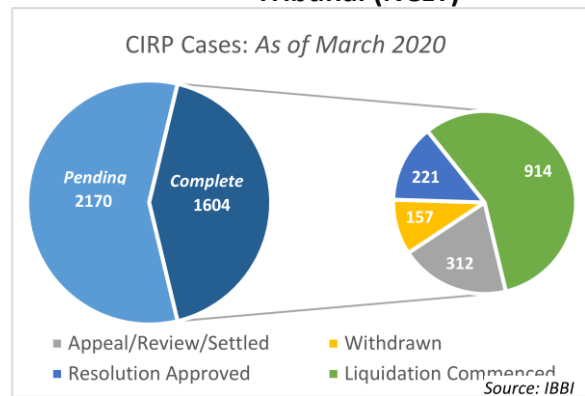
To arrest this ever-increasing NPA ratio and nip the problem of stressed asset resolution in its bud, the government introduced Insolvency and Bankruptcy Code (IBC), 2016. The preamble of the act states, "An Act to consolidate and amend the law relating to reorganization and insolvency resolution of corporate persons...in a time-bound manner for maximization of value of assets... to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders...".

It's been almost three years since the first corporate insolvency resolution process (CIRP) was initiated under this code, and over this time, it has produced less hits than misses.

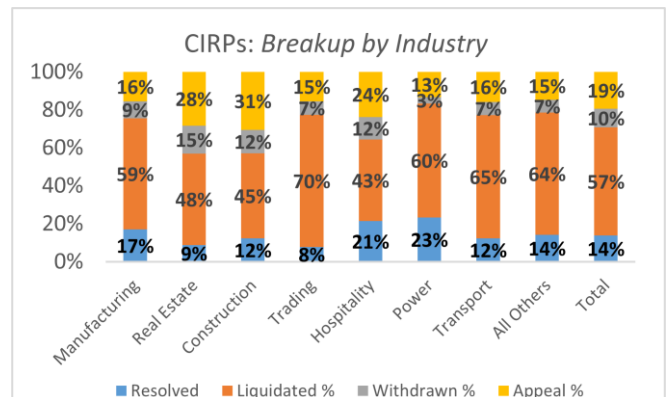
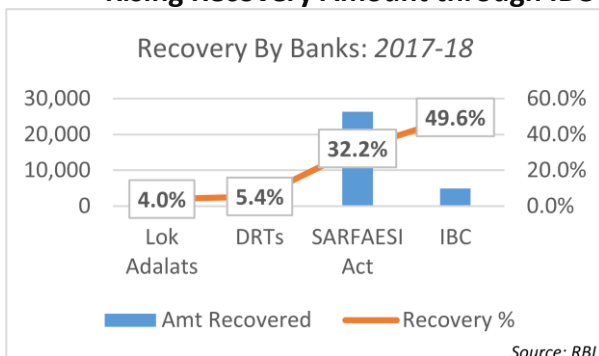


A total of 3774 insolvency applications have been admitted under the code so far, and only 1604 have reached a decisive conclusion. Though this completion rate exceeds that of past legislation, it's still a far cry from the prompt time-bound resolution it aims to achieve.

Status of Cases filed before National Company Law Tribunal (NCLT)



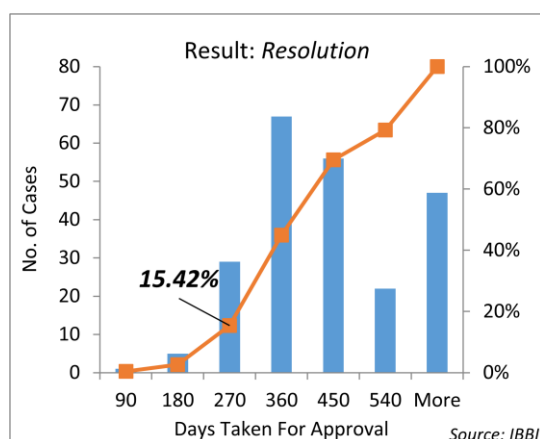
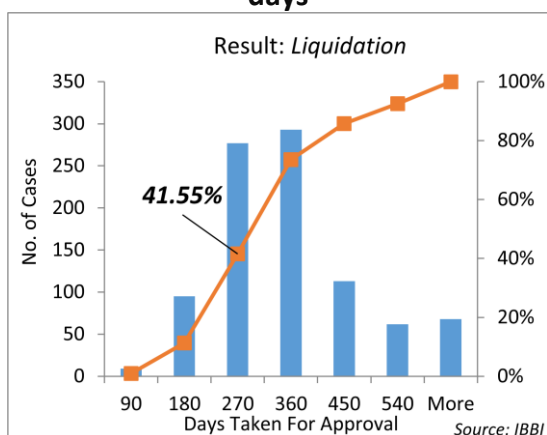
Rising Recovery Amount through IBC



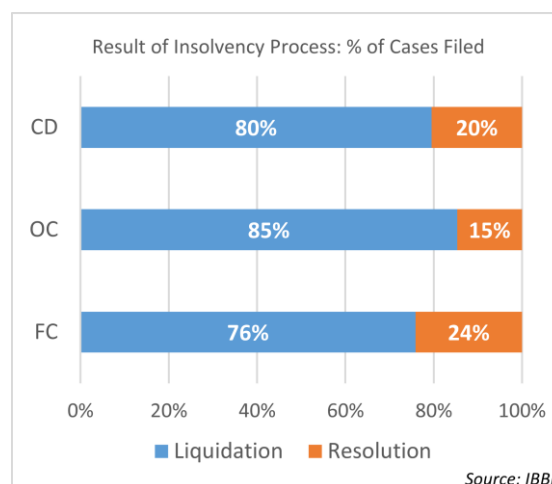
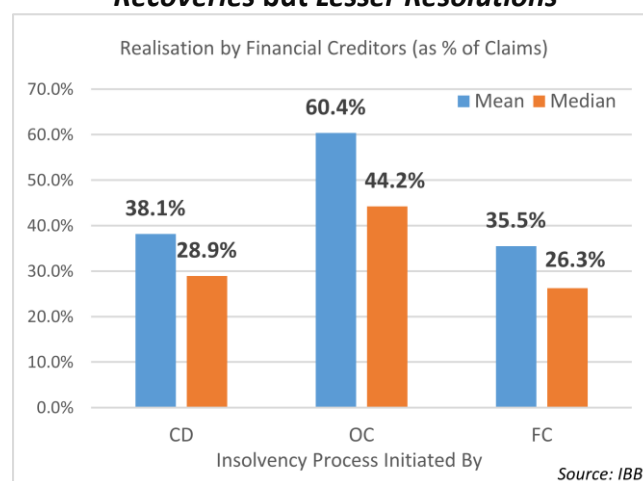
With more than half of the companies ending in liquidation, the overall resolution rate remains subdued at 14%. The real Estate, Trading, and Transportation sector have seen the least turnaround of insolvent companies with less than 10% cases ending in resolution. This is mainly due to the huge quantum of debt involved and pending legal cases against companies in these sectors. Around a third of the cases involving construction companies have been appealed by the corporate debtor adding to the backlog.

The code provides that an insolvency proceeding can be initiated either by operational creditors (OC) or financial creditors (FC) on the occasion of a default by the corporate debtor (CD). It also provides for the debtor to file an application itself in case of non-payment of obligations. However, the data shows that results vary starkly depending upon the type of applicant who initiated the proceedings.

Very Few Cases solved within the mandated 270 days



Operational Creditors Filing IRPs lead to Higher Recoveries but Lesser Resolutions

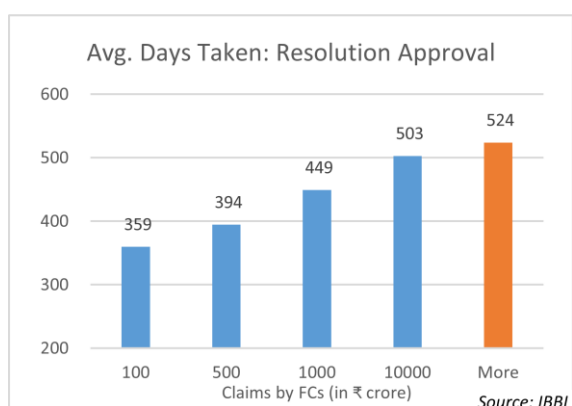
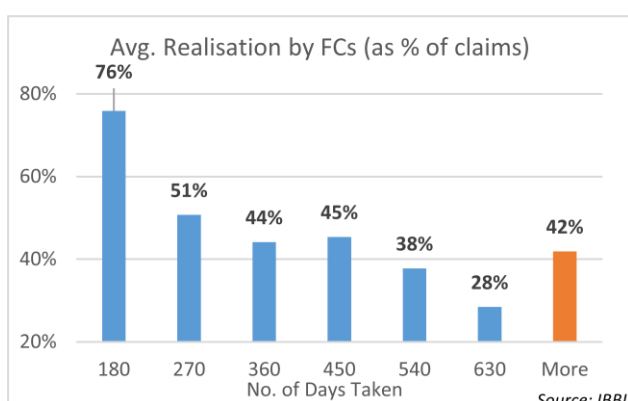


The code's objective of time-bound resolution has failed to materialize as more than three-fourths of the cases couldn't be resolved within the limit of 270 days, with a good proportion of them stretching even over two years.

The main reason behind this big difference could be that operational creditors are likely the first stakeholders to witness stress in their relations with the debtor. Thus, it could be that they file an application in the initial stages of insolvency, thus

helping creditors recover more through resolution. At the same time, however, a lot many cases filed by operational creditors end up in liquidation vis-à-vis those filed by others. This is could be because operational creditors cover a wide ambit of stakeholders: suppliers, employees as well as government bodies that are owed money by the debtor. Most of them are resolution-averse as they have little interest in the long-term survival of the firm in contrast to financial creditors who have lent against consideration of the time value of money. This observation also supports the argument offered by the Supreme Court to only include financial creditors in the Committee of Creditors (CoC) and vest them with authority to decide the plan of action.

Recovery rates reduce with time, large claims take more time for approval

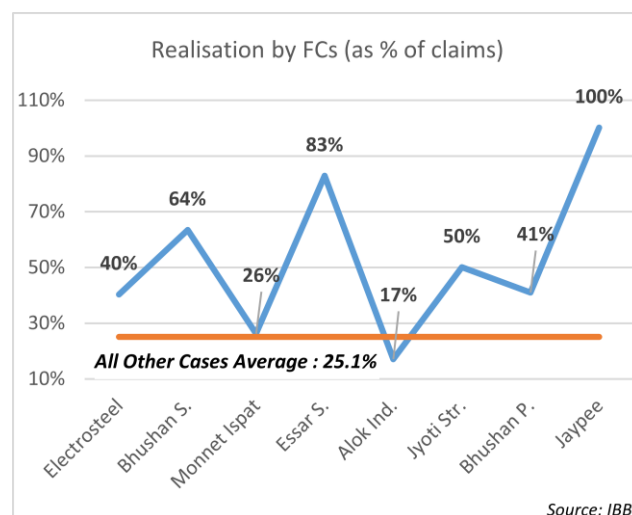


The realization rate consistently decreases for creditors up to 2 years, thereby validating that insolvent corporates lose value over time. However,

if the case extends beyond 630 days, the recovery rate surprisingly shoots up. This could be due to the fact that cases with claims exceeding ₹10,000 crore take more time to resolve, and consequently generate better returns for stakeholders.

Top 8 Debtors Account for 75% of total recovery, all other cases lag behind

Debtor	Claims (₹ crore)	Realisation (₹ crore)	% of Claims
Electrosteel Steels Ltd.	13175	5320	40.4%
Bhushan Steel Ltd.	56022	35571	63.5%
Monnet Ispat & Energy Ltd.	11015	2892	26.3%
Essar Steel India Ltd.	49473	41018	82.9%
Alok Industries Ltd.	29523	5052	17.1%
Jyoti Structures Ltd.	7365	3691	50.1%
Bhushan Power & Steel Ltd.	47158	19350	41.0%
Jaypee Infratech Ltd.	23176	23223	100.2%



The code has been successful in helping creditors recover money from large insolvent enterprises. However, these 8 companies alone account for 75% of total amount recovered through IBC. The average realization rate of these companies far exceeds that of all others combined, thus raising questions on the efficiency of IBC to resolve the majority of insolvencies.

The code also provides a provision to withdraw an application subject to the approval of 90% of creditors in the Committee of Creditors (CoC). The code encourages out-of-court settlements that are mutually beneficial to all stakeholders, as creditors save on insolvency costs, and the debtor retains control over the enterprise. However, there have only been 137 withdrawals, with 101 of them settled so far. This has further increased the regulatory burden on NCLTs and the judiciary.

Very Few Withdrawals (Settlements), Non-BIFR Cases Take Longer to Resolve (422 Days)

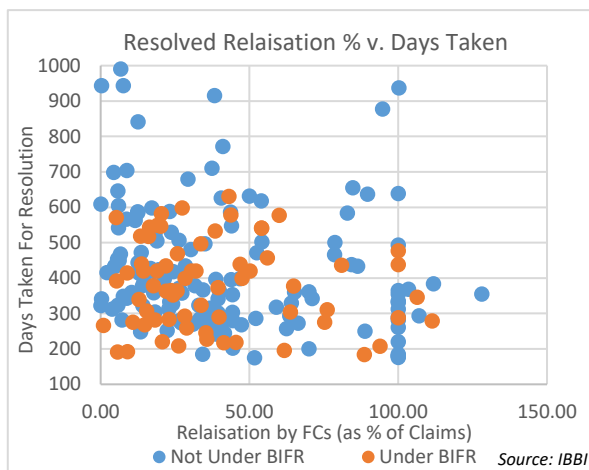


Table 5: Claim Distribution and Reasons for Withdrawal

Amount of Claims Admitted* (₹ crore)	No. of CIRPs
≤ 01	64
> 01 ≤ 10	36
> 10 ≤ 50	21
> 50 ≤ 100	08
> 100 ≤ 1000	06
> 1000	02
Reason for Withdrawal*	
Full settlement with the applicant	38
Full settlement with other creditors	08
Agreement to settle in future	10
Other settlements with creditors	45
Corporate debtors not traceable	02
Corporate debtor struck off the Register	01
Applicant not pursuing CIRP due to high cost	02
Others	31

* Data awaited in 20 CIRPs

Source: IBBI

A total of 69 companies resolved under IBC were defunct or under the Board for Industrial & Financial Reconstruction (BIFR). On segregating these companies, it can be seen that going-concern

insolvent companies take about 422 days on average to reach a resolution as compared to defunct/under BIFR companies that only take 380 days on average.

Way Forward: Introduction of Pre-Packs

The term “*pre-pack sale*” has been defined by the Association of Business Recovery Professionals as “an arrangement under which the sale of all or part of a company’s business or assets is negotiated with a purchaser prior to the appointment of an administrator, and the administrator effects the sale immediately on, or shortly after, his appointment.” Pre-packs promote corporate resolution in the least time possible. By minimizing the need for legislation, they can reduce the burden on NCLTs and accelerate the whole process. They do not disrupt business operations and help maintain customer and employee confidence, a valuable resource to maximize the amount of recovery.

The IBC has its fair share of shortcomings, but it is a step in the right direction. It has been modelled after similar international standards and has the potential to evolve into a foolproof insolvency resolution mechanism, provided certain processes can be further streamlined. The IBC needs to act much sooner and faster at the same time to make headway into cases, lest it’s too late.

As renowned macroeconomist Rudiger Dornbusch said, “The crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought.”



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PRE-PACKS: WILL THIS ALTERNATIVE MECHANISM RESCUE THE SLOWDOWN FACED BY INSOLVENCY AND BANKRUPTCY CODE ('IBC')

Background:

Through the Ministry of Corporate Affairs, the Government of India has set up a sub-committee to propose a detailed scheme for implementation of pre-pack and pre-arranged insolvency resolution process via its order dated June 24, 2020. With the increasing level of complexity and litigation, every Corporate Insolvency Resolution Process (CIRP) is facing. The investor interest is getting dried out due to the delays in the process. A pre-pack resolution is possibly the only ray of hope in this situation. As outlined below, out of the total number of 2108 ongoing CIRP cases, more than 50% of the cases are in the bracket of more than 270 days. The law provides a total duration of 330 days, including approval by the National Company Law Tribunal. Below is the synopsis:

Status of Corporate Insolvency Resolution Process for the quarter ended June 30, 2020	No of CIRPs
Admitted	3911
Less: Closed on appeal/review / settled	380
Less: Closed by withdrawal	218
Less: Closed by Resolution	250
Less: Closed by Liquidation	955
Ongoing CIRP	2108
Break up of current stage of the timeline for above ongoing CIRP cases	Days
Greater than 270 days	1094
>180 days <=270 days	539
>90 days <= 180 days	402
<= 90 days	73

What is a Pre-packaged Insolvency resolution?

Pre-pack is an alternative to the current scheme, which provides a mechanism for the bidding process after the insolvency professional has taken control of the assets. A pre-packaged insolvency resolution, commonly referred to as "pre-packs," is a resolution mechanism whereby an arrangement is prepared for the sale of all or part of a company's business or assets is negotiated and agreed with a purchaser before filing for protection under the insolvency laws or appointment of an administrator and the sale is effected parallelly or shortly after the company enters formal insolvency process.

Analysis of the US and UK market:

It is a matured and evolved restructuring tool in the United States and the United Kingdom and has been increasingly used in these jurisdictions for resolving stressed businesses.

Pre-packs under US laws are typically undertaken under Chapter 11 of The US Bankruptcy Code, which provides for a Debtor-In-Possession concept. It permits the debtor company's management or its promoters to directly negotiate terms of restructuring while remaining in possession of assets. Once a pre-pack restructuring plan is agreed upon and receives requisite acceptances and approvals from the creditors, the debtor company files for Chapter 11 bankruptcy protection petition, along with its agreed-upon reorganization plan. The debtor company, however, remains subject to the oversight of the creditors' committee and the court, and any of the company's creditors will have a right to object to the plan/proposed sale in bankruptcy court.

In contrast to this, while in the UK, no statute regulates pre-packs, the mechanism acts as a

supporting tool to insolvency. It is effectively run by an insolvency practitioner who is required to follow prescribed guidelines that include conducting adequate due diligence, marketing the asset up for sale, and making relevant disclosures. The practitioner could be held liable for any issues relating to the sale process. Under the UK laws, an administrator is appointed to undertake the finalization of a pre-pack transaction and ensuring fair treatment to all.

Pros and cons of pre-packs:

Pre packs minimize value destruction, maintain going concern ability of the corporate debtor, can offer better visibility and pre-agreed returns to creditors, preserves large scale employment, more cost-effective than other alternatives of the resolution, and are more time-efficient.

While pre-packs have their benefits, they have their share of criticism and risk. It may perceive to be benefitting the secured creditors and other sets of

creditors (operational, statutory, etc.) being left out in the negotiations. It may not lead to better price discovery due to insufficient market making.

Conclusion:

While IBC is currently facing its own set of challenges with delays, litigations, and now temporary suspension of law in the interim period, it will be critical to watch the committee's recommendations and how quickly the provisions pertaining to pre-packs are rolled out.



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ACQUISITION STRUCTURES UNDER NCLT

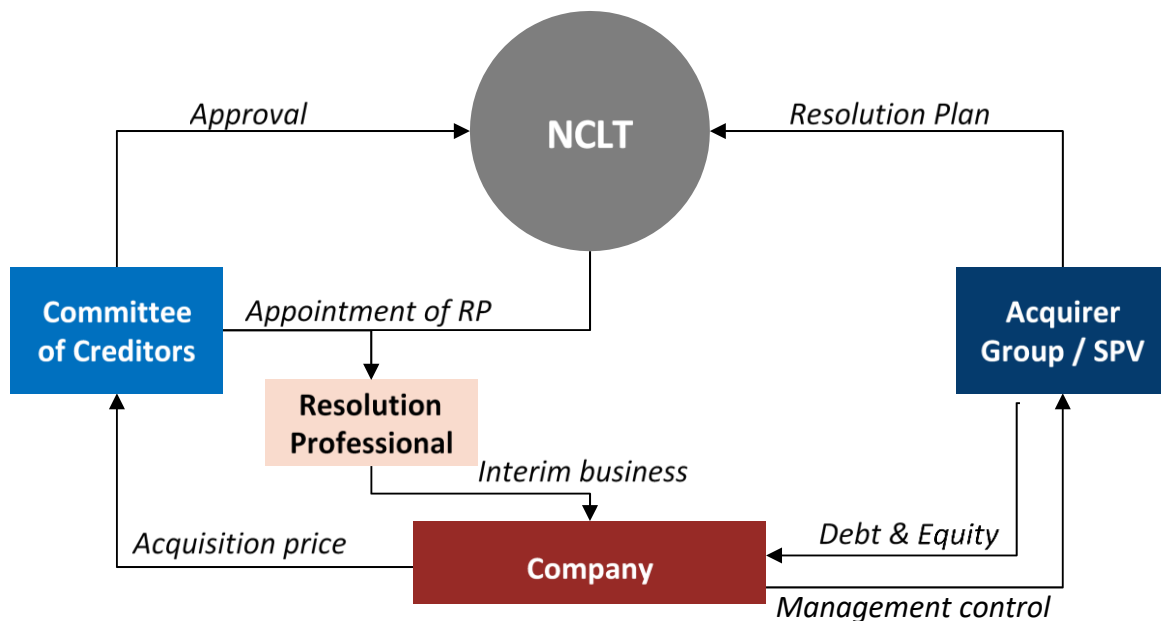
The Indian economy, by its characteristics, is classified as a growing economy and has been growing at a steady rate. With the growth in mind, the government has started taking steps to unlock the value stuck in stressed assets. Over the years, India has witnessed multiple laws and regulations for dealing with financial failures which have failed to aid lenders for effective and timely recovery or restructuring of defaulted assets, causing an undue strain on the Indian credit system.

Introduction of Insolvency and Bankruptcy Code, 2016 ('IBC'), and National Company Law Tribunals

('NCLT') have been instrumental towards timely resolution of insolvency proceedings. Current reforms (IBC, RBI circular, etc.) show commitment by the government towards resolution of stress in the Indian banking sector.

Companies defaulting on financial dues are referred to NCLT by financial and /or operational creditors. Corporate Insolvency Resolution process ('CIRP') aims to settle outstanding dues, replace existing management, and acquisition of company through approval of resolution plan.

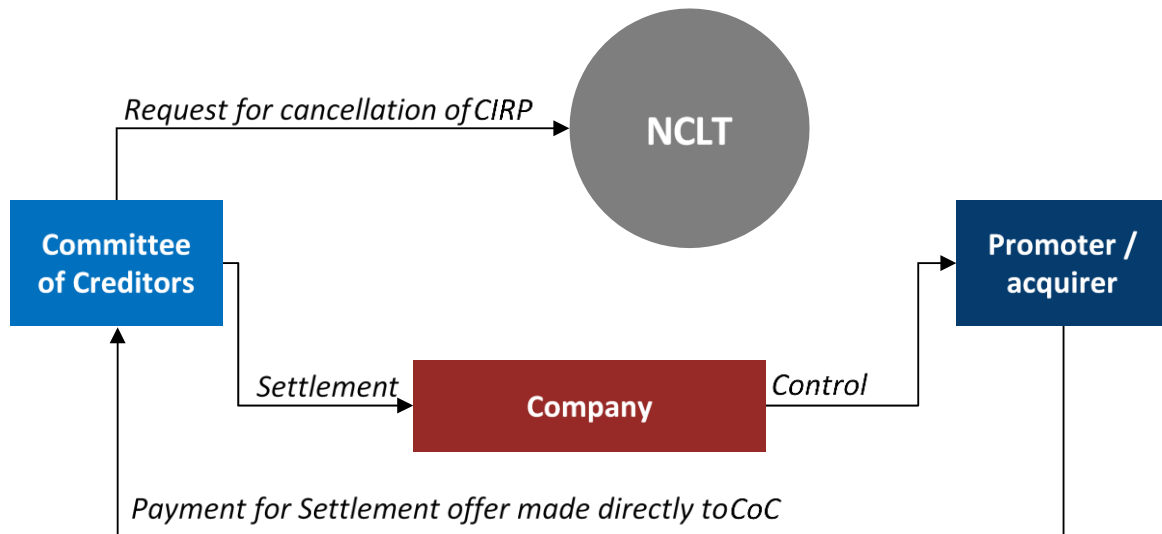
Structure 1 – Acquisition through group company /Special Purpose Vehicle ('SPV')



Brief steps considered during the CIRP process –

1. Default on financial dues by company
2. Filing before NCLT and invitation of claims from financial and operational creditors
3. Formation of CoC, appointment of resolution professional and admission
4. Invitation and evaluation of resolution plans
5. Approval of resolution plan by CoC and passing of NCLT order
6. Infusion of funds through debt /equity for payment of acquisition price
7. Execution of the resolution plan and transfer of ownership

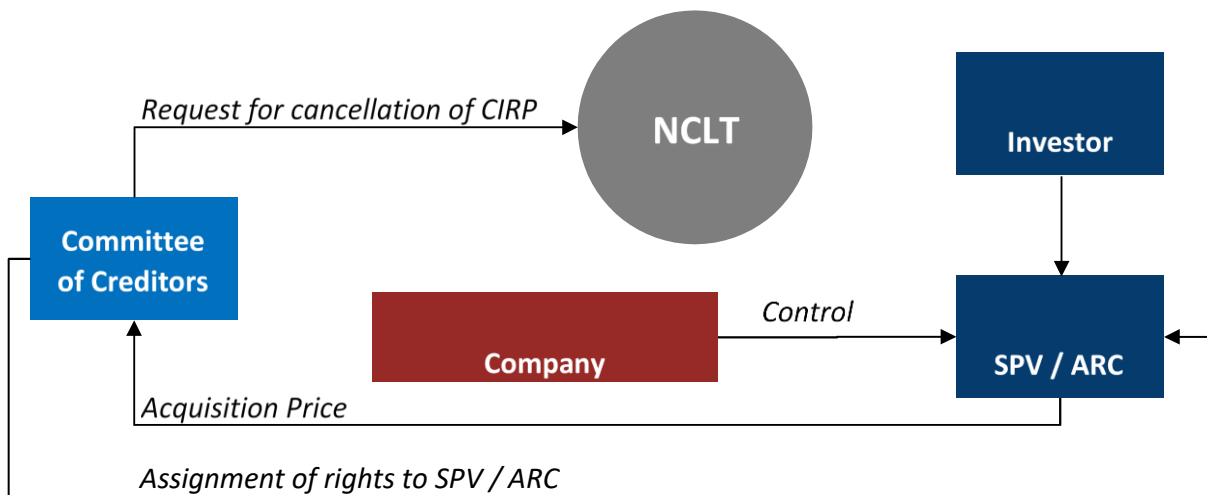
Structure 2 – Settlement outside NCLT by Promoter /acquirer



IBC has a provision which restrains a wilful defaulter from participating in the acquisition process through NCLT. However, amendments to IBC are under consideration to enable a company to exit the insolvency process for independent resolution. Once admitted into NCLT, this structure may enable to overcome the restriction.

1. Promoter / Acquirer can approach the CoC, independent of the CIRP Process
2. CoC may evaluate the proposal
3. Lenders with voting share of 90%+ are required to accept the plan
4. CoC can remove company outside NCLT and settle the acquisition

Structure 3 – Assignment of debt route



Financial institutions also evaluate the option of assignment of debt through a trust managed by an asset reconstruction company to purchase debt from

lenders, reconstitute CoC and accordingly facilitate acquisition during the CIRP

Majority of acquisition through the NCLT process follow Structure 1. Eg. Acquisition of Essar Steel by ArcelorMittal. Whereas resolution of Binani Cement by UltraTech Cement witnessed a direct settlement offer to the CoC lenders during the NCLT process, which was accepted. This may be considered as an example of Structure 2. Reliance Industries Limited, along with JM Financial Asset Reconstruction Company Limited, had implemented a structure similar to Structure 3 for the acquisition of Alok Industries.

Current times have witnessed temporary suspension of the CIRP process. With the stress building up in the Indian Credit sector, it is expected that on lifting of

the suspension, it will witness referrals of stressed businesses into NCLT. Further, due to its inherent dynamic nature it will witness newer structures, strategies, legal judgements, and amendments in the coming years.



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IS ALTMAN'S Z-SCORE A RELIABLE INDICATOR FOR INVESTIGATING BANK INSOLVENCY?

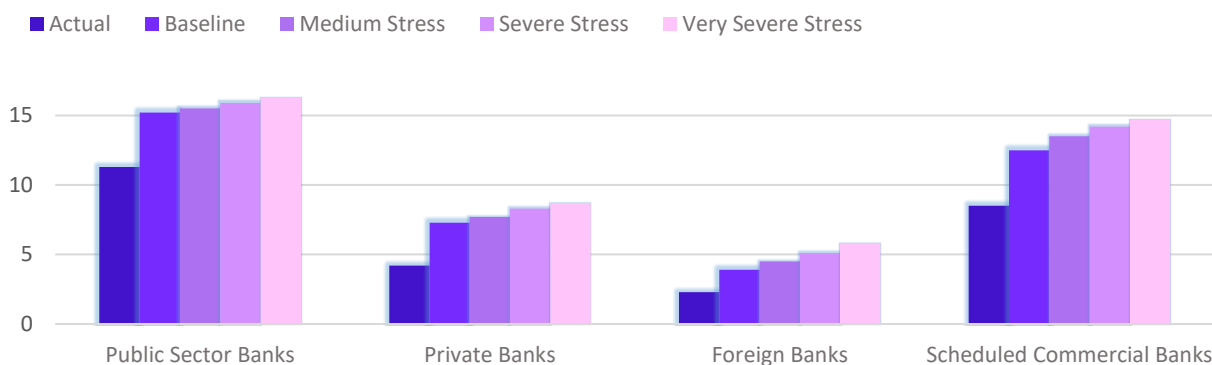
Introduction

Mountains of NPAs. Rigorous PCA framework. Low credit growth. NBFC crisis and default from the major companies... Indian banks have probably seen it all, but analysts were hopeful that 2020 would have been a game-changer, had it not been for the pandemic. A study by KPMG predicted that the Indian banking sector was headed towards becoming the fifth-largest banking industry in the world by 2020. However, as with all other industries, the Indian banks were no exception to a skewed growth. Worse, the economic fallout of the pandemic pushed up RBI's expected estimates of non-performing assets of the banking sector to a jaw-dropping 12.5% by March 2021, and this, by the way, is a baseline scenario! The central bank's Financial Stability Report noted the NPA ratio could jump to as high a

level as 14.7% in the event of severe stress. As of March 2020, the ratio stood at 8.5% of total advances. Sounding alarm bells for the economy, the Reserve Bank of India said the problem of bad loans plaguing the Indian banking sector could worsen towards the end of the ongoing fiscal year.

Consequently, the earnings of banks would be impacted due to lower net interest margins, elevated asset quality concerns, and a possible increase in provisioning requirements. A combination of these factors leaves one wondering how prone will banks be to the aftermath of the pandemic once the temporary shield provided by RBI in the name of a moratorium, runs its course. In this article, we investigate the veracity of one much-celebrated indicator used by analysts to understand bankruptcy probability in firms – Altman's Z-Score.

Gross NPA Ratio (%)



The Z-Score

Altman's Z-Score model is a numerical measurement that is used to predict the chances of a business going bankrupt. The model was developed by American finance professor Edward Altman in 1968 as a measure of the financial stability of companies. The formula has predicted past bankruptcies with a high success rate. However, this does not mean that the same will hold in the future as well.

Calculating the Z-Score of a firm involves estimating 4 accounting ratios.

X1: The ratio of Working Capital to Total Assets. It estimates the company's ability to cover financial obligations.

X2: The proportion of Retained Earnings to Total Assets. It measures cumulative profitability over time as a proportion of total assets.

X3: The ratio of Operating Profit to Total Assets. It depicts the managerial efficiency in terms of the profitability of the business.

X4: The ratio of Book Value of equity to Total Liabilities of the corporate house. It helps gauge the extent to which a firm is levered.

Once the given ratios are evaluated, the Z-Score of the firm is arrived by plugging the values in the following equation,

$$Z = 6.56 X_1 + 3.2 X_2 + 6.72 X_3 + 1.05 X_4$$

Depending on the value of the score, the firm is branded as one of the following,

- $Z > 2.6$ Safe Zone
- $1.1 < Z < 2.6$ Grey Zone
- $Z < 1.1$ Distress Zone

Results

We evaluated the respective X_i 's for each of the 12 banks that made up the Bank Nifty Index as on September 27th, 2020, using published data on Q-1, FY-21 results.

Bank	Z-Score
<i>IDFC First</i>	2.74
<i>Kotak Mahindra</i>	3.69
<i>Bandhan</i>	4.12
<i>Indusind</i>	4.21
<i>RBL</i>	4.21
<i>ICICI</i>	4.27
<i>Axis</i>	4.87
<i>SBI</i>	5.01
<i>Bank of Baroda</i>	5.17
<i>Punjab National Bank</i>	5.47
<i>Federal</i>	5.49
<i>HDFC</i>	6.03

As per the respective Z-scores, all the banks in the Bank Nifty Index have an extremely low probability of filing for bankruptcy, except IDFC First Bank.

Conclusion

Now, the real deal is if the z-score is at all indicative of the true risk of bankruptcy. We want to argue against this statement. Under normal circumstances,

the score would have been an unbiased indicator of the risk borne by banks of going bankrupt. However, skewed accounting standards and frequent variations of RBI's regulatory policies have done more harm than good. The six-month moratorium period has led to a lowered cashflow to the banks and has bought time distressed firms to generate cash in the meantime. But as the economy is continuously facing downward pressure, it is still unclear as to what extent will the firms go to service their already incurred debt. This uncertainty creates what is called a *systemic risk*, which acts as a domino effect in aggravating the aggregate default rate. This, in turn, will directly hit the books of the banks that had shelled out any penny as loan money to such firms. Hence, the potential defaults in the overall economy will significantly add to an already existing pile of NPAs, hampering banking institutions' earnings. Therefore, it is in this regard that we claim that the backward-looking z-score will not be useful at predicting the risk of bankruptcy in this sector. Hence, the sector's real z-scores would be much less than indicated through the calculations just presented in the previous section. As the end of the moratorium period is approaching, we are yet to see what awaits this sector on the other side of the realm.



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IBC – A BOON FOR RESOLUTION OR A PANDORA’S BOX OF LITIGATIONS?

The Insolvency and Bankruptcy Code, 2016 (IBC) was supposed to be the one-stop solution for revival and restructuring of stressed assets and relief to creditors. Earlier, creditors could only have recourse to the SICA, SARFAESI, or provisions under Section 391 of the Companies Act. These provisions were strenuous, time-consuming, and confusing. It was the aim that the IBC would streamline the Corporate Insolvency Resolution Process (CIRP), promote the revival of business while also protect the interests of stakeholders. Till June 2020, financial creditors had realised a total of more than ₹1.88 lakh crores from 250 (of which 81 companies were defunct) resolution plans. This sum was 1.8x the amount of the liquidation value of those 250 companies (Insolvency and Bankruptcy Board of India, 2020). The amount will be greater if we account for cases of settlements before the initiation of CIRP. However, this recovery represents only 44.70% of the claims admitted in the CIRP (Insolvency and Bankruptcy Board of India, 2020). Further, high recoveries in a few high-quality assets have skewed this amount. More than 60% of the total amount has come from just 5 cases (Insolvency and Bankruptcy Board of India, 2020). In the majority of the cases, recoveries are <20% of the claims admitted.

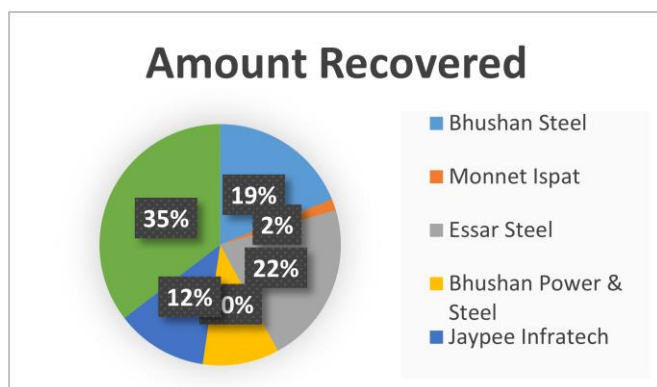


Figure 1: Distribution of Amounts recovered

There are procedural issues that are preventing the full benefits of the CIRP to be realised. The statute lays down a timeline of 180 days to complete the CIRP, extendable by 90 days. However, the vast array of compliances and litigations has ensured that the average time for approval of the resolution plan is 380 days (Insolvency and Bankruptcy Board of India, 2020). More than half of the ongoing CIRPs as of 30th June 2020, had crossed the 270-day mark.

During the CIRP, the Resolution Professional (RP) has to run the company as a going concern, focusing on finding an applicant capable of reviving operations. In most cases, operational activity has ceased, and the CoC is reluctant to invest further. Bound by the law to proceed with the CIRP and squeezed for cash-flow, the RP has to bring funds from his pocket and wait for the CoC to reimburse. Beyond a certain extent, operations and compliances cannot be done in a way that “maximizes value” for the creditors.

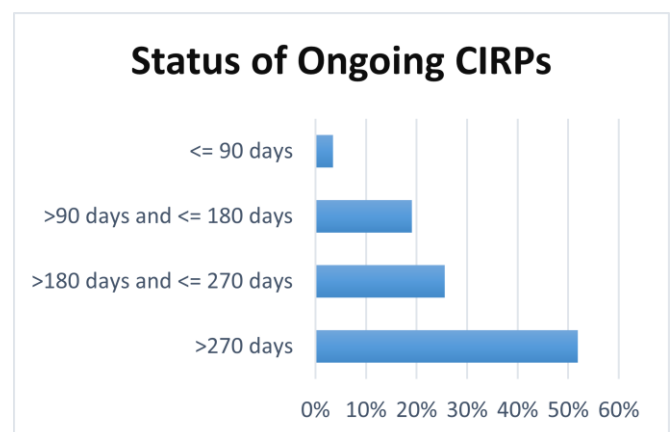


Figure 2: Status of ongoing CIRPs as on 30th June 2020

What the law has failed to anticipate is that small companies are plagued with PUFÉ transactions. Financial creditors fail to initiate CIRP early on. The companies are taken to CIRP, late, and more with the intention of liquidation than resolution

Flogging the dead horse shifts the focus on preferential transactions and fraudulent transactions. The RP stops receiving cooperation from the directors suspended. Faced with strict timelines and compliances, he is left with no alternative but to focus on saving himself from allegations of negligence, rather than finding a successful resolution. All tricks are employed by the suspended directors and the financial creditors to hide their past, and out comes a plethora of litigations.

The IBBI and the government has been very proactive about amendments. Recently, the minimum default amount has been increased from ₹5 lakhs to ₹1 crore, and new applications (after 25th March 2020) for initiating CIRP have been suspended. The argument is that this would provide protection to small businesses and prevent sale at “COVID valuations” (Dutt, 2020). But how will it affect the ever-distressed banking sector? Would this lead to complacency among the small businesses, for whose benefit such amendment was passed? Would operational creditors having debts less than ₹1 crore be at the mercy of their debtors? Can pre-pack resolutions be a game-changer? These questions have no black and white answer. The IBC must focus

on resolution, rather than digging dirt and punishing past acts of offenders. This was not in the preamble of the IBC and is best left to other government departments.

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THE FLIP SIDE OF THE INSOLVENCY AND BANKRUPTCY CODE (AMENDMENT) ORDINANCE, 2020

On 05.06.2020, the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2020 was promulgated by the President of India, which made the following amendments to the IBC, 2016:

1. No corporate insolvency proceedings can be initiated against corporate debtors for defaults arising on or after 25.03.2020 for a minimum period of 6 months (i.e. ending 25.09.2020). This period could be extended by notification to a maximum period of 1 year (ending 25.03.2021).
2. No corporate insolvency proceedings can be initiated any time in the future in respect of the

defaults mentioned in (1).

3. The directors/partners of the corporate debtor cannot be made liable to contribute, in their personal capacity, to the assets of the corporate debtor in respect of defaults which take place during this period, even if prior to the insolvency commencement date, they were aware that such proceedings were imminent, and they failed to take steps to mitigate the losses to the creditors.

The following table should be able to give us a clear picture of the situation post-implementation of the ordinance:

Date of Default	Pre-Relief Period	Proposed Relief Period	Post Relief Period
Pre-Relief Period	Y	Y	Y
Proposed Relief Period	-	N	N
Post Relief Period	-	-	Y

*Pre-Relief Period: Prior to 25.03.2020

**Proposed Relief Period: 25.03.2020 - 25.09.2020 (or other notified date)

***Post-Relief Period: Post 25.09.2020 (or other notified date)

The purpose behind the ordinance is to help businesses combat the disruption caused on account of Covid-19. In these arduous times finding adequate resolution applicants (persons willing to take over the distressed businesses) to rescue corporate debtors in default of their debts is an uphill task, and by this ordinance, the government hopes to prevent such persons from being pushed into insolvency proceedings under the Code.

A deeper reading of the ordinance highlights two main issues:

1. Is the brunt of default arising due to Covid-19 being passed onto the creditors?

Providing corporate debtors a relief period of (maximum) one year before insolvency proceedings can be initiated against them in respect of defaults arising during this period is justified under the present circumstances. However, prohibiting creditors from proceeding against them on account of these defaults in the future seems to be counterproductive.

Ex: A default on payments due to B during the relief period. Once the relief period is over, if A recovers and still refuses to clear its debt, the amendment will put B in a disadvantageous situation by prohibiting B from proceeding against A.

2. Is providing protection to directors/partners of the corporate debtor who knowingly did not take loss mitigating actions to protect the creditors justified?

Ex: A was a distressed company against whom no resolution proceedings had been initiated prior to 25.03.2020. The directors of A knew that insolvency proceedings were imminent irrespective of Covid-19, and they chose to misappropriate funds from A and default on payment to creditors during the relief period. The protection offered to the directors/partners of the defaulting companies via this ordinance will ensure that the directors cannot

be made liable to contribute to the assets of A to the disadvantage of the creditors.

How these issues will be dealt with is yet to be seen. Taking adequate measures to protect the interests of the creditors, concurrently, will be necessary for the amendment to have the desired effect.

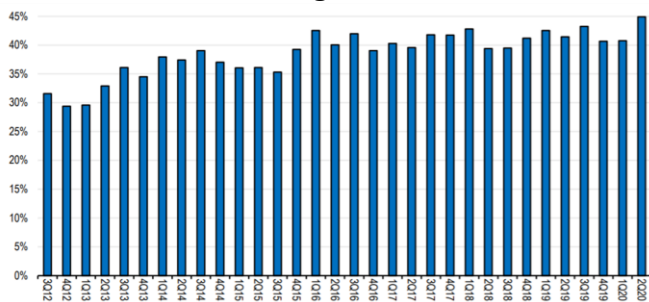


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THE COMPLEXITY OF THE POWER SECTOR

We are into the seventh-month post announcement of the lockdown. The Dark Knight of the Banking sector- Reserve Bank of India- have tried most of its conventional and unconventional weapons in the arsenal. However, it is certain that the NPAs will be on the rise in the next financial years. The things weren't bright even before the COVID scare. The share of companies who found it difficult to service their debts was increasing. The companies with an interest coverage ratio of lesser than 1 forming the part of debt share have steadily risen over time, as illustrated in the graph.

Share of Debt Owned by Companies with an Interest Coverage Ratio less than 1

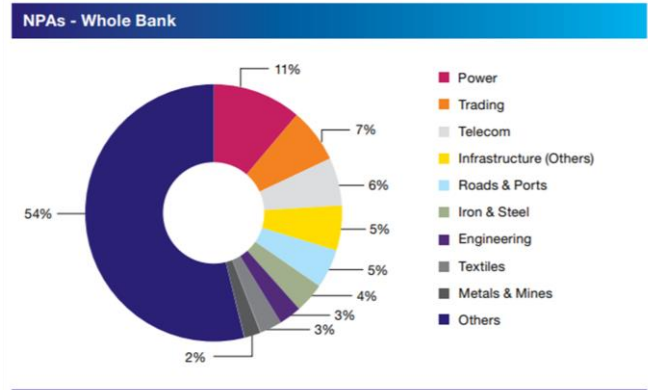


Source: Credit Suisse. Share of corporate debt. Interest cover is based on aggregate earnings before interest and taxes (EBIT)

This has created a serious structural problem, a twin balance sheet crisis where corporates find it difficult to take on new investments due to the accumulated debt, and those who are in a better financial position are unable to take loans from banks since their books were already stressed with bad loans. I'll be focusing on one such sector, which forms a huge part of the stressed assets.

Status of Power Sector: If we look at the books of the country's biggest lender, the power sector is the biggest contributor.

Industry wise distribution of the NPA portfolio (as on 31st March, 2020) is represented as under:



Source: Annual Report 19-20 of State Bank of India

As per the Bank of America-Merrill Lynch report (April 2018), the power sector has a debt of ~ INR 11.7 trillion (USD 178 bn), out of which **INR 3.5 trillion (USD 53 bn)** is already under stress. There are close to 60 GW of thermal plants that are a part of the stressed power assets (**nearly one-fifth of the total capacity**) that are undergoing the insolvency proceedings.

The power sector value chain can be segmented into the generation, transmission, and distribution sectors. While the generation is responsible for producing electricity, the grids fall into the transmission sector, passing on the responsibility to **Distribution companies (DISCOMS)** to provide electricity to the end-user. Most of the DISCOMS are state-owned, and the State Electricity Boards (SEB) are a good example of it. The final piece of the network is where **most of the problems** lie. The DISCOMS collect payments from consumers against their energy supplies (purchased from generators) to provide necessary cash flows to the generation and transmission sectors to operate.

However, **16% of the units are not billed** due to technical losses, faulty meters, wrong billings &

pilferage forming the part of the **Aggregate Technical & Commercial Losses (AT&C)**.

Moreover, the consumers end up delaying payments, and the government interventions to reduce or waive the bills creates more problems to collect the required revenue. Although the state promises to pay for the shortfall, but their payments are deferred. The **state governments** owed about Rs. **41,700 crores** in December 2019. Due to the perennial cash collection shortfall, DISCOMS are unable to make timely payments for their energy purchases from the generators. The latest data suggests that payables by DISCOMS have increased substantially from Rs. 90,000 crores as of March 2020 to more than Rs. 1.30 Lakh Crores as of June 2020.

The **Purchase Power Agreements (PPAs)** or the contracts between the Power Producers and DISCOMS defining the terms of commencement, schedule of power production, and payment terms have also been a bone of contention between the two. The existing tariffs might be much higher than the new tariffs after the additional capacity availability. This **difference in the current and future available prices** leads to the reduction in commitment from the DISCOMS to service the agreements. The regulations ensure that the tussle continuous for a longer period, although the generators have to **bear fixed costs** in that duration.

Methods for Resolutions: The sector is the backbone of the economy, and hence it gets the capital infusion from the government finances. However, it is not sustainable in the long run since the fiscal deficit is already expected to rise after the COVID crisis. The much-touted IBC may seem an obvious choice for the resolution, but as we can see, the complexities of the

power sector aren't internal in nature like the cement or steel sector. It involves a large number of stakeholders and affects the **whole value chain** on a larger level, including **power generators, coal suppliers**, etc. The IBC focuses on resolution based on the recovery of the amount it can provide to debtors. However, the recovery might take longer than usual since the payables are due from various entities **reducing the time value of money**. In addition to that, the sector has many regulations and interactions with the state, which introduces many external factors for the investors reducing their control, making the sector unattractive.

However, Public Asset Reconstruction Companies can help in the restructuring of the sector. The stressed assets can be taken of the books of the banks so that they can focus on the diligent lending in their core areas. The ARC can then further manage the structural deficiencies in the system, including the unavailability of the fuel, lack of working capital, resolution of purchase power agreements, tariff-related disputes, and the payment by the state electricity boards. The ARC should be instituted with a time horizon (between 5 to 10 years) to turn the operations profitable and make it attractive to the investors. The regulations should also be put forward to make the equity route of the ARC exits attractive as well.



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SEBI'S SURGICAL STRIKE ON MULTI-CAP FUNDS

Background

Since the last few years, SEBI has been making considerable efforts to ensure mutual fund schemes are transparent and appropriate decisions are taken in the interest of the investors. In 2017, SEBI introduced asset categorization circular where:

- the top 100 stocks in terms of market cap have been classified as large-caps, 101-250 stocks as mid-caps, and below 250 all stocks are classified as small-caps
- all schemes need to be clearly distinct and classified in select categories

Before 11th September, equity MF schemes were required to invest >65% of their AUM in equities with no specific requirement for category wise limits.

What the circular says

As per the SEBI circular, all multi-cap funds need to allocate at least 25% of AUM in large-caps, mid-caps, and small-caps each. The rationale behind this move is to ensure these funds are true to their label, and their performance is benchmarked against the appropriate index. Currently, most multi-cap funds have > ~60% allocation in large-cap stocks, as we can see below, thus, not fulfilling the risk-return expectations of a multi-cap fund.

Fund name	AUM (Rs Cr)	% of category	% of assets in			
			Largecap	Midcap	Smallcap	Others/Cash
Kotak Standard Multicap Fund	29714.07	21.75	66.47	22.5	1.53	6.98
HDFC Equity Fund	19797.98	14.49	83.16	8.38	3.93	3.67
Motilal Oswal Multicap 35 Fund	11239.87	8.23	71.95	10.07	4.66	11.72
Aditya Birla Sun Life Equity Fund	11023.35	8.07	55.91	23.95	6.49	11.56
UTI Equity Fund	10982.95	8.04	47.49	32.17	8.16	10.51

For instance, Kotak Multicap fund, which enjoys the largest AUM in the industry, benchmarks its returns against the NIFTY 200 index. Thus, the allocation of funds and benchmarking of returns, both are skewed towards large-cap stocks.

One cannot blame the fund managers for not investing in small-caps. As we know, these firms enjoy very limited analyst coverage, low transparency, and liquidity. Therefore, this results in flight to quality leading to expensive valuations in a few scripts.

You might remember that DSP Blackrock stopped accepting fresh inflows in 2017 for the 3rd time in their micro-cap funds only because they did not find many attractive small-cap stocks & the overall valuations were high. ([ET article](#))

The impact

Multicap schemes of mutual funds enjoy total AUM of INR 1.47 lakh crore as of August 2020, with 74% invested in large-caps, 16% in mid-caps, and only 6% in small-caps. The fund managers will need to rejig their portfolio, which will naturally lead to selling in large-caps and the proceeds going to mid-cap and small-cap stocks -

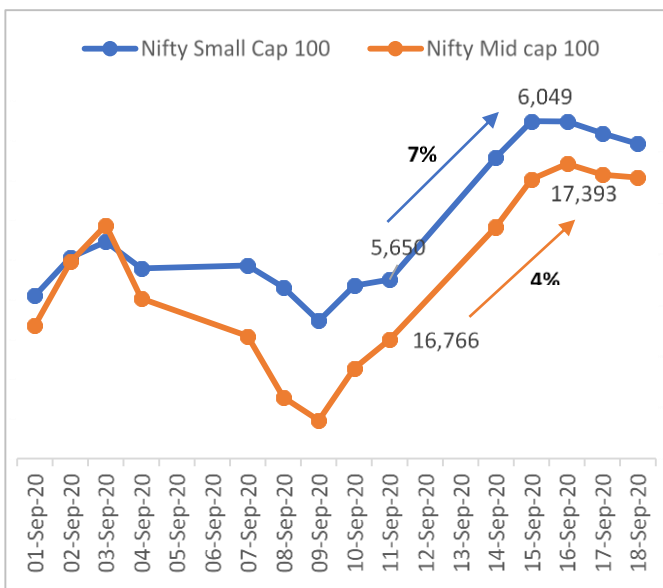
- Outflow in large-caps – INR 35,500 cr
- Inflow in mid-caps – INR 12,700 cr
- Inflow in small-caps – INR 27,000 cr

Therefore, investors have the following options with them -

- a) Return the money to unitholders
- b) Unitholders can be allowed to switch to other schemes

- c) Merging the multi-cap funds with other funds
- d) Convert the multi-cap scheme into others scheme

As expected, investors in anticipation of these inflows rushed to buy small-caps and mid-caps. As we can see from the below chart, both indices rose by 4-7%



If fund managers decide to invest in small-cap stocks, it will take **~65 consecutive days** to comply with the circular.

	INR cr.
Total traded volumes on NSE in top 100 small-cap stocks*	3,469
% Delivery*	40%
Deliverable volumes	1,388
MF's share in daily volumes*	30%
Value of stocks that can be bought	416
Total inflows as per new guidelines	27,000
# of days required to comply	65

Source: NSE; *assumptions based on market data

Pros and Cons

The obvious positives are higher liquidity and market depth in the small-caps. Another benefit would be easier capital access.

Considering the small cohort of the well-researched small-cap universe, the rationale behind this move may be ill-founded. It is highly likely that the fund managers would double down on their existing portfolio since they have comfort with these firms' business models and management. The end result will be bloated valuations of a few small-cap stocks. The asset categories mentioned above are subject to change every 6 months; thus, a small-cap can move to the midcap category in the next 6 months. Hence, there will be higher portfolio turnover and higher costs for the unitholders because of changes in the portfolio constitution.

Conclusion

The deadline to comply with the circular is 31st January. The two likely scenarios seem to be either SEBI relaxing the allocation thresholds or fund managers closing their multi-cap schemes.

Source: https://www.sebi.gov.in/legal/circulars/sep-2020/circular-on-asset-allocation-of-multi-cap-funds_47542.html



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GENE IN THE GREEN

Have you ever wondered why the same medicine prescribed by the doctor has different effects on different patients? Too easy a question, right? Different individuals have different body compositions and so naturally would have different responses. Absolutely. As you would also know, your genes play a major part in this individuality. Now, these very endowments from one's ancestors find themselves at the nucleus of a multi-billion-dollar industry.

So, what is the opportunity all about?

The genomics industry concerns itself with the exploration (testing & mapping) and study (research) of a variety of genes of an organism to find applications to solve complex diseases, conditions, etc. caused by underlying genetic disorders. As compared to genetics, genomics deals with the whole gamut of the building blocks, instead of focusing on a particular strand. Genomics as a branch opens doors to a healthcare system based on 'personalized' or 'customized' medicine instead of the current blanket approach. Precision medicine would define the future.

In other words, genomics involves the study of an organism's genes as a whole to detect patterns, anomalies, etc. and derive inferences to enable the creation of applications to fight seemingly incurable or difficult to cure diseases with a view to achieve personalized solutions that could cater to individuals and groups with specific genetic codes.

OK. Looks like a large-scale public undertaking. Shouldn't it be the Government's prerogative?

Definitely. That's what is happening. Let's take a brief look at some of these Government programs:

- USA – The All of Us Research Program was created in 2013 to gather data from over 1 Mn people living in the USA with a view to support precision medicine

- England – The Genome England project was instituted to sequence 100,000 genomes from patients with rare diseases and cancers and their families. Now the project is focused on genomic research and healthcare
- Japan – The Japan Genomic Medicine Program has been set up to promote research in genomic medicine and create next-generation precision medicine
- China – Though official data does not seem to be publicly available; the China Precision Medicine Initiative is expected to be one of the largest drives in this area

Other countries such as Australia, Brazil, Switzerland, France, Netherlands, etc. also have their own government-driven programs to promote genomic studies and research in precision medicine.

An interesting observation across these programs is that they have been institutionalized as a joint effort between the concerned government department(s) and leading research institutes concerned with the subject field.

What about India?

India, too has its own set of programs under the Department of Biotechnology (DBT) with the help of the Council of Scientific and Industrial Research (CSIR). One such program is the IndiGen project, led by the Institute of Genomics and Integrative Biology (IGIB), which has envisioned a plan to conduct Whole Genome Sequencing of around 20,000 Indians over the coming few years. The IGIB also heads the Genomics for Understanding Rare Diseases India Alliance Network (GUARDIAN) and the Genomics and other Omics Tools for Enabling Medical Decision (GOMED) programs. This ensures that the data collected from genome sequencing is

used to develop diagnostic tools and tests for other medical institutions. In fact, the Government recently launched the IndiGenome Card, which captures the genetic information stored in the database. The DBT also has specific programs to use genomics for gene mutation disorders.

So, where is the investment opportunity you were to talk about?

Dr. Lal PathLabs has started offering its own set of genetics IGIB certified genetics screening tests for diagnostics related to ailments such as Hepatitis B & C, Leukemia, etc. Also, as recently as in the month of March 2020, the Indian startup – MedGenome Labs made news for raising around USD 55 Mn from leading Venture Capital investors such as Sequoia Capital, Leapfrog & Sofina. As per VCC Edge. MedGenome has raised more than USD 100 Mn in capital since 2013 and counts biggies such as Zodiuss Capital and HDFC as some of the investors in addition to the names mentioned above.

If international markets are anything to go by as an indicator, a quick look at the charts for genomics stocks (on maybe Yahoo Finance) such as Illumina, Inc (ILMN), an American biotechnology company manufacturing genetic screening instruments, would tell you that the stock price has risen by a whopping 169% since 2017, over a span of just 3 years. This could be a proxy for understanding the increasing demand for genomics related products and services. On a closer front, using the similar method as above, we can make out that for NeoGenomics, Inc (NEO), an American laboratory which specializes in genomics testing catering to the field of oncology, the share price has risen by over 350% since 2017. ARK Invest – one of the world's largest investment houses, has created its own Exchange Traded Fund (ETF) and has recorded a 3 year annualized increase of 35.50% in the Net Asset Value (NAV). You can find

more about the ETF here - <https://ark-funds.com/arkg>.

While viewing the above data in light of startups, one should keep in mind that startups would have a higher potential to provide multifold returns to early investors with a high-risk appetite. The uncertainty is what throws the risk-reward ratio a bit off, but what is venture investing without this excitement. One of the major success factors here becomes the expertise of the promoter team, as well as the experience of the investing/ advising team. While using the data in terms of Indian companies, it should be noted that as compared to the USA, India is at a much nascent stage in terms of genomics as an industry and thus provides even growth capital and later-stage investors with a greater portion of the pie left to be enjoyed.

A few concluding remarks

In the coming years, India could see a slew of startups focused on genomics – maybe offering specialized, diagnostics area-based expertise instead of a blanket cover. Even fairly mature companies would love to get into the genomics screening and research field with the possibility of seeing such risky businesses being hived off from the main entity and thus opening investment opportunities. The onus would fall on the analysts covering the space to sift, find and back the right businesses to earn higher market-beating portfolio alphas.



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