"Companies with large debt face risk of default"

The preliminary challenge in investing in companies already under insolvency proceedings is – reversal of the order by appellate authority viz. NCLAT or the Supreme Court, explains **Ashish Parwani, Partner, Rajani Associates**.

What has been the interest for companies to invest in competitors that are moving towards insolvency or bankruptcy?

It is always a fortune for a profit making company to acquire stressed assets of a loss making company, which may be available at distress value/throw away prices. With the advent of the Insolvency and Bankruptcy Code, 2016 ("IBC"), a lot many lenders have been dragging their borrowers towards the process of insolvency where there has been failure of payment of the debts. The first and foremost interest of the competitor companies is – they are getting assets having capacity to generate revenue at distress value/ throw away prices. Secondly, the acquisition of such stressed assets will add huge value and enhance production resulting into additional capacity generation of such competitor companies at a low cost.

The competitor companies acquiring the stressed assets may also take benefits of taxation. In some instances, the competitor companies may even take the entire control of the company under liquidation to increase the asset base and production levels.

As per news articles, stressed assets in the steel sector have gone beyond 25 per cent of the entire gross NPAs of the country. Some of the top steel companies have already been directed to undergo insolvency resolution process. Example - some of the cash rich competitor companies of the steel sector such as JSW Steel and TATA Steel are already eyeing on the insolvency resolution process of the steel companies including Monnet Ispat, Bhushan Steel, Essar Steel etc., and ready to buy their stressed assets subject to certain terms and conditions.

What opportunities does the present environment present for competitors?

There are enormous opportunities available to the competitors for acquisition of stressed assets of their competitor companies. As aforesaid, the competitor companies can acquire such assets at throw away prices and increase their production levels or asset base to a new high. The present environment seems to be beneficial for companies having liquidity. With the available liquidity, these cash rich companies can pay off the creditors of debt laden companies and exploit the potential of revenue generating assets of such debt ridden companies to their optimum level.

"AN INVESTOR HAS TO BEAR IN MIND CASH FLOW/LIQUIDITY POSITION OF THE INVESTEE COMPANY BEFORE MAKING ANY INVESTMENT."

What are the challenges in investing in companies with large debt or which might be put up for NCLT proceedings?

The biggest challenge in investing in the companies having large debt is the risk of default. Any default exceeding Rs 100,000 may result into an insolvency action before NCLT and such company might have to go through the insolvency resolution process and if it fails, then liquidation process shall be triggered. An investor has to bear in mind cash flow/liquidity position of the investee company before making any investment. A lot will also depend upon the manner/structure of investment, viz. debt/ quasi-debt/equity/quasi-equity.

Every investor has different risk appetite.

Often, investors do not invest in companies having large debts except when the revenue generation capacity and cash flow position of the investee company is good and the rate of return to the investor is quite high. Thus, the challenges before the investor inter alia may include risk of default by investee company towards its financial creditors and/or operational creditors, fluctuating position of cash flow of the investee company, low risk appetite of the investee company in the event of stress, reduction in the profit component due to increased amount of interest payment on debt resultantly risk of return/ repayment to such investor etc.

▲ There are enormous opportunities for acquisition of stressed assets by competitor companies.

What are the challenges in investing in companies already under insolvency proceedings and admitted cases?

The preliminary challenge in investing in the companies already under insolvency proceedings is – reversal of the order by appellate authority viz. NCLAT or the Supreme Court. During the insolvency resolution process, if the appellate authority overturns the decision of the NCLT, the same may be detrimental to the interest of the investor and will make all the efforts futile. Also, IBC per se does not contemplate about settlement between the parties post admission of the insolvency petition. However, the Supreme Court in exercise of its power under Article 142 of the Constitution of India, has recently allowed settlement between the parties, after admission of the insolvency petition. Such settlement between the parties may also act contrary to the interest of the investor.

Recently, certain other challenges have also cropped up. First being the payment of Minimum Alternate Tax ("MAT"). Any acquisition of distressed assets triggers writing down the P&L account, resulting into book profits. Since MAT is required to be paid over book profits, there is no clarity as to who will make the payment of MAT. Secondly, other unsecured creditors not finding a place on the committee of creditors may challenge/object to a sanctioned resolution plan. Thirdly, any other affected party may also challenge the insolvency proceedings of the corporate debtor as done by home buyers in the case of Jaypee Infratech, wherein the Supreme Court has stayed the insolvency proceedings of Jaypee Infratech. Fourthly, even after sanction of the resolution plan by the committee of creditors, the shareholders/ promoters still hold a sword to thwart the implementation of the resolution plan by not passing a special resolution as required for preferential issue (as envisaged under the resolution plan) and they can hinder the acquisition of assets/transfer of control. Lastly, there is no clarity under the IBC with respect to compliances of the Companies Act, 2013 required to be made for proposed actions forming part of the resolution plan.

Which sectors can expect consolidation due to large NPAs?

Amongst the top 12 defaulters declared by RBI, five defaulters belong to the steel industry and insolvency petitions have been admitted against such five defaulter's viz. Bhushan Power, Bhushan Steel, Electrosteel Steel, Essar Steel and Monnet Ispat. It is evident that the steel sector has been facing crisis due to number of reasons. As per news articles, certain cash rich steel companies being competitors have also expressed their interest in acquisition of the stressed assets of their rival steel companies. Further, as per the figures available in general domain, the quantum of stressed assets in infrastructure, utilities, metals, power and telecom sector is also mounting and thus, it can be said that the these sectors may expect consolidation in near future due to large NPAs.

- RAHUL KAMAT