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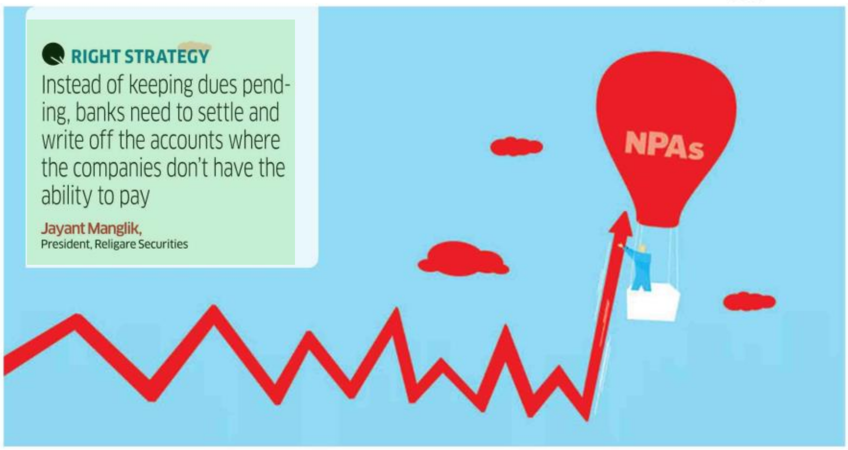
CLEAN-UP ACT RBI's steps to rein in NPAs is good news for banking sector & for fundamentally strong cos from some other sectors

Investors, It's Wise to Keep off Firms with Heavy Debt

Narendra Nathan

Banks, which were earlier reluctant to even acknowledge bad loans, in the aftermath of the RBI's stricter non-performing asset (NPA) recognition norms, have started provisioning for them. However, there has been little clarity on the recovery or resolution of the NPAs. To speed up the recovery, the government recently introduced the Insolvency and Bankruptcy Code (IBC), providing the RBI sweeping powers to deal with the situation. Within a month of the IBC's introduction, the RBI has decided to crack the whip on 12 big defaulters. These defaulters account for around 25% of the banking sector's NPAs. The RBI has also asked banks to come up with a resolution process for their remaining NPAs within six months.

Unlike the earlier, half-hearted efforts, the current structure offers a credible frame work to settle the NPA issues, say experts. This is why the banking sector is moving from NPA recognition to NPA resolution. "While prima facie it may appear as yet another process, we believe it provides a credible roadmap for the entire (NPA) resolution framework," says a recent Edelweiss Finance report. This is because the IBC has set clear timelines and the resolution plan has to be implemented within 180 days. Various methods have been allowed for NPA resolutions: Restructuring with promoter bringing in more capital, management change, merger with other companies, asset sale. However, if the banks and the companies do not agree on any resolution plan within the stipulated 180 days, the defaulting company will have go for liquidation.



RIGHT STRATEGY

Instead of keeping dues pending, banks need to settle and write off the accounts where the companies don't have the ability to pay

Jayant Manglik,
President, Religare Securities

IMPACT ON BANKING SECTOR

The NPA resolution efforts, say experts, will help the banking sector and the economy in the long term. Wholesale banks like SBI and ICICI Bank will be its biggest beneficiaries. "If things works out as expected, wholesale banks like ICICI may outperform retail banks in the next 3-4 years," says Amar Ambani, head, research, IIFL.

However, in the short term, there might be a few problems because a large number of defaulters have serious balance-sheet issues and don't have the ability to pay. "Instead of keeping dues pending, banks need to settle and write off the accounts where the companies don't have the ability to pay," says Jayant Manglik, president, Religare Securities. Most banks have provided only partially for their NPAs and write-offs mean more capital requirement for these banks. But the short-term impact of NPA resolution may not be as severe. "Most large banks are likely to have provided 40-50%, thus limiting any material incremental impact as anticipated by the Street," says the Edelweiss Finance report. To reduce the immediate impact on the profit and loss accounts and balance sheets of banks, the RBI could tweak provisioning norms for cases referred under IBC.

The primary gains for banks will come from accounts where the companies or promoters have the ability to pay. The threat of immediate liquidation could force these companies and their promoters to pay the dues. In such cases, banks could write back some of the provisions made earlier. However, the IBC is fairly new and experts have some concern about its implementation.

Though it talks about resolution within 180 days and banks can go for liquidation after that, there is no clarity on what happens if some of these companies go to court. "The wilful defaulters (defaulters who have the ability but are not paying) may use the legal loophole and try to delay things," says Manglik.

IMPACT ON OTHER SECTORS

Most of the 12 companies that have been referred to the IBC are from the steel sector. They have serious balance-sheet issues due to the fall in steel prices, problems on account of cancellation of coal and iron ore blocks. Power companies facing problems with power purchase agreements or fuel linkages also make the list. The poor balance sheets of these companies make a case for their liquidation instead of another restructuring. This may involve selling off assets immediately—within one year. A large number of such assets coming to the market in such a short time may depress their prices, benefitting relatively strong companies from the steel—Tata Steel, JSW Steel—and the power sector—NTPC, Tata Power—who will be able to buy these assets at lower valuations.

OTHER DEBT-RIDDLED COMPANIES

With speedier action on defaulters, investors are beginning to get worried about other companies that with heavy debt—their stock prices have started falling. Investors can get a clear idea on a company's debt issues by looking at their debt-equity ratio. Debt-equity ratio helps identify highly indebted companies—but not for companies whose net worth has already become negative. So, we have used net debt (debt minus cash and investments) and market capitalisation ratio for sorting the heavily indebted companies. It is advisable that you do not invest in them. "Investing in companies with heavy debt is not a good idea and it is best if retail investors stay away from companies with a high debt-equity ratio," says Manglik.

Investors should not take unnecessarily high risk by looking at trading opportunities among these companies. Even for savvy investors this segment comes at a very high risk. "Investors who enter into heavily indebted companies should understand that while some may become multi baggers, others will go into oblivion," says Ambani.

Companies You Should Stay Away from

The risk that these debt-riddled companies come with far outweighs any reward

Company	Net debt (₹ crore)	Market cap (₹ crore)	Net debt-M-cap ratio
Bhushan Steel	41,577	1,334	31.16
Videocon Industries	8,713	706	12.35
Tata Tele. Mah.	13,567	1,212	11.19
MTNL	14,692	1,361	10.80
Monnet Ispat	5,431	604	8.99
Electrosteel St.	7,371	973	7.57
Punj Lloyd	3,970	617	6.44
Ruchi Soya Industries.	4,384	713	6.15
Usha Martin	3,391	590	5.75
Gitanjali Gems	4,091	782	5.23

It is best if retail investors stay away from heavily indebted companies

SOURCE: ETIG Database. Sorted on the base of net debt-market-cap ratio. Only companies with ₹1,000 cror net debt and ₹500 crore market cap were considered.

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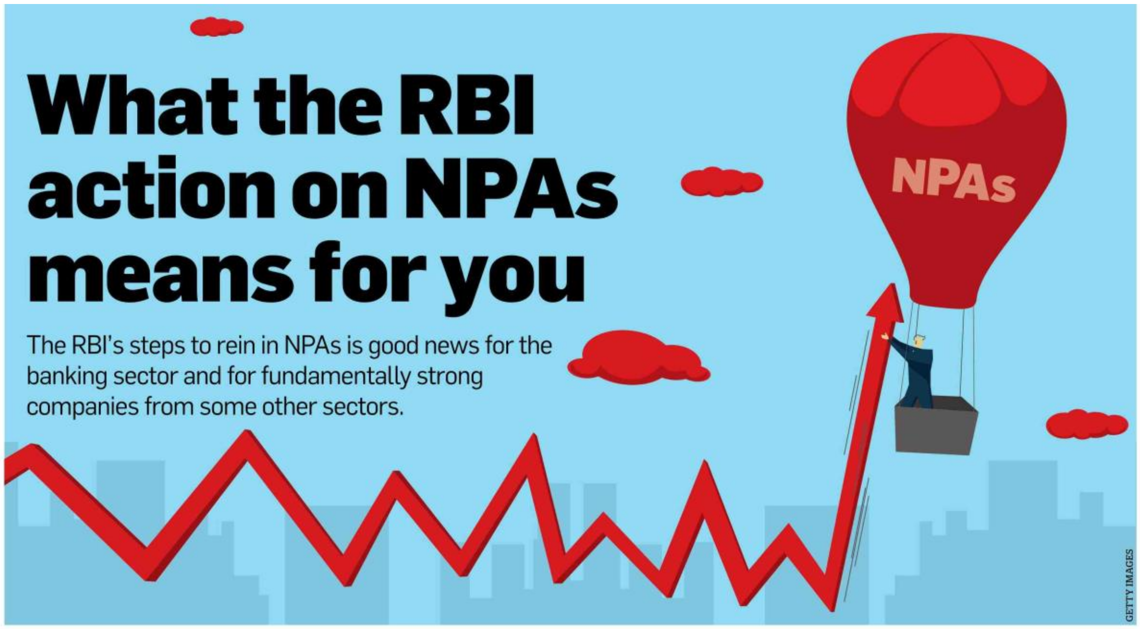
What the RBI action on NPAs means for you

The RBI's steps to rein in NPAs is good news for the banking sector and for fundamentally strong companies from some other sectors.



NARENDRA NATHAN

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