Enforcing in India. Is it easy? Not really, but the Insolvency and Bankruptcy Code has been a game-changer leading to creditors recovering US$23Bn+ from stressed loans in recent years

In this short read, we lay down the IBC journey so far and practical implications of the Code for real estate investors

Background

In May 2016, The Insolvency and Bankruptcy Code (IBC or the Code) was notified with an objective to consolidate and amend laws relating to re-organization and insolvency of corporates. This is turning out to be a game-changer for creditors and is facilitating much higher recovery in a time bound manner. While there had been several attempts at a legal framework for bankruptcy resolution prior to the IBC, these failed to meet expectations. Prior to IBC, the average time for resolution of a bankruptcy was 4+ years with recovery rate of only 26%[1].

IBC is achieving a higher success rate compared to the pre-2016 regulations. Creditors have recovered INR1.8trillion/US$23Bn+, which is 183% of the liquidation value of assets of 221 companies rescued till March 2020. These 221 companies owed INR3.8trillion/US$51Bn to creditors (recovery rate of ~46%). Approximately 3,774 companies have so far been admitted for resolution under the IBC, of which 221 have been resolved through resolution plans and 914 went for liquidation[2].

The Code has re-balanced the creditor-debtor relationship. It has brought about better compliance with / enforcement of debt contracts and discipline among borrowers

Since its introduction, IBC has undergone several amendments further strengthening the underlying regime. These amendments emerged from the implementation experience and various cases that challenged the premise of the original IBC. Examples include (1) Essar Steel case, which clarified the distribution waterfall of proceeds to be in the favor of secured financial creditors over operational creditors (2) JSW Steel - Bhushan Power deal where the code adjusted to provide for immunity to a corporate debtor (and hence the new buyer / investors) against offences committed before the initiation of the insolvency or while the process is ongoing. This evolution process continues.

Overall, the Code has re-balanced the creditor-debtor relationship to bring about better compliance with / enforcement of debt contracts and borrowing discipline among promoters / corporates. The fear of losing control over assets has also led to Promoters pro-actively seeking remedies prior to IBC proceedings. This is creating several attractive investing opportunities both a) through the IBC resolution process, and b) prior to IBC proceedings.

The Real Estate Context

On the back of several disruptions (RERA, demonetization, GST, credit crisis and now Covid-19), the real estate sector (especially residential) has been under severe stress and has seen

1. World Bank: Doing Business, 2015
2. Insolvency & Bankruptcy newsletter, Mar 2020

significant project delays. This has led to about a third of cases admitted under IBC from real estate, construction & hospitality sectors.

Within the real estate sector, in addition to lenders (banks, non-bank financial institutions and bondholders) and operational creditors, there is another major class of creditors – home buyers. In residential development projects (~70%+ of the real estate sector in India) advances from home buyers, depending on pre-sales level and stage of construction can be significant and sometimes more than the exposure of secured lenders. Under the Code, home buyers have been classified as unsecured financial creditors and have a say in approval of any resolution plan. This status and the relative size of the class make them an important stakeholder and decision maker in the overall resolution process.

Fear of losing control over assets has led to promoters pro-actively seeking solutions prior to IBC proceedings. This is creating several attractive investing opportunities

Implication for Real Estate / Opportunistic Credit Investors

The stress within the real estate sector has created several opportunities, offering an attractive risk-reward profile:

1. Acquisition of loan portfolios from stressed lenders (potentially with credit enhancements). Examples:
   - Oaktree's US$195MM acquisition of two loans from DHFL[3]
   - SSG is in documentation for closing a US$362MM acquisition of Altico Capital[4]
2. Last mile, super senior financing at equity type returns
3. Acquisition of completed assets through the IBC resolution process. Example:
   - Blackstone's acquired Trident hotel in Hyderabad for INR5,850MM / US$77MM[5]

Structuring Considerations for Real Estate transactions

While the faster and time-bound resolution process and the consequent credit discipline is a positive, it has also led to several practical implications for transaction underwriting and structuring. Below, we examine few key implications and share our thoughts on the same:

1. **Lending to real estate entities executing multiple projects with different lenders needs additional diligence, beyond the scope of loan/project under consideration**

   Issue: Under IBC, all assets of a company under resolution are pooled and proceeds from the resolution are distributed basis the waterfall. Within a class of creditors, the distributions are made pari-passu, irrespective of the specific security held by a lender.

   Example: If a lender to a delinquent project initiate proceedings against the borrower under IBC, all the assets of the borrower (including other projects) will form part of the resolution process though those other projects may be doing fine. The secured lenders to other projects are then forced into the resolution process and stand pari-passu with secured lenders of the troubled project (ignoring their project specific securities).

3. https://certuscapital.in/jan-2019-Certus-originated-and-structured-one-of-India's-first-securitization-of-wholesale-RE-loans.php
4. https://www.financialexpress.com/industry/ssg-capital-declared-highest-bidder-for-altico-final-voting-on-march-16/1896411/
5. https://www.constructionweekonline.in/business/12392-blackstone-group-obtains-nod-to-acquire-trident-hotel

The Code operates at the corporate level and makes no distinction for specific security held by a lender or cashflow / security waterfalls. It treats all secured creditors pari-passu for distribution of proceeds from a resolution

Thoughts: It is ideal to invest in / lend to project specific SPVs. Where that's not feasible, additional diligence needs to be done to get comfortable with other projects being executed by the borrower and the lenders against these projects or as an alternate, it may be prudent to transfer the investee project into a separate SPV.

2. **No distinction between senior & junior secured lenders in a resolution under IBC**

   Issue: The Code, itself makes no distinction between rights of different lenders within the same class. First charge holders and second charge holders are both considered secured creditors and the code doesn't legislate for repayment of first charge holders above junior lenders.

   Example: Borrower is executing a project which has two secured lenders. The commercial understanding between two secured creditors to a project provides for a waterfall of distribution of proceeds from the underlying project. If IBC proceedings are successfully initiated (by any of the secured lenders or others), both the secured lenders will be treated pari-passu for distribution of proceeds from the resolution and not in-line with their commercially agreed distribution waterfall. This leads to a perverse incentive for the junior lenders to take the Borrower to IBC in case their economics / rights are compromised.

   Thoughts: Senior-junior structures can be executed through multiple ways (eg: using a Trust or an ARC route, inter-creditor agreements, etc.). However, solutions may require significant case specific deliberations and should be tackled early on in a transaction.

3. **Provision of appropriate cost / compensation for other stakeholders in the 'going-in' business plan**

   Various stakeholders can also take the borrower to IBC proceedings. Therefore, it is important for investors to conduct appropriate diligence and make required provisions for liabilities related to

   - Home buyer grievances, especially if the project is significantly delayed
   - RERA compliance
   - Operational creditor dues

Conclusion:

IBC is perhaps one of the most significant reforms in recent years leveling the playing field between lenders and investors. It's not yet perfect, but within just ~3+ years of its implementation, it has instilled fear among borrowers of losing their companies / assets and is fixing the moral hazard issue that has historically plagued credit investing in India.

And it could not have come at a more opportune moment. The confluence of credit crises (underway since late 2018) and poor asset level underwriting over last several years have created a massive opportunity in RE NPLs / super-senior high yield credit, estimated at US$10Bn+. IBC is a potent tool to have by your side in capitalizing this opportunity.

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