

Covering the pledge

The case for assessing promoter pledge transactions based on entire promoter debt than a specific deal



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Executive summary

Recent market events have put the practice of lending against shares pledged by promoters under the scanner and sent market participants on a frantic search for ways to gauge the risks in such deals.

“What are the risks in these transactions?”

“What should be the cover commensurate with the risks?”

Such are the questions flying thick and fast.

To be sure, borrowing based on the value of the underlying listed shares is an easy way of monetising a promoter’s ownership without ceding control. According to Bombay Stock Exchange data, the total value of shares pledged by promoters is more than Rs 2 lakh crore, involving 800 companies¹ and Rs 1-1.3 lakh crore of pledge debt.

This has implications for the lending community, for such debt is backed by collateral of equity shares, which are inherently volatile, rather than by cash flows. Hence, pledge debt is exposed to high levels of equity risk, and the cover through pledged shares is usually small to absorb these risks.

The typical transaction cover for ~Rs 38,000 crore of rated debt in the market analysed by CRISIL² – accounting for 30-40% of the total pledge debt of promoters – is less than 2 times.

In case of a breach of covenants, lenders usually have less than a month to liquidate the shares. However, the domestic equity markets may not have the depth and liquidity to absorb the flood of promoter shares dumped by multiple lenders. Therefore, ensuring an orderly exit without a drastic impact on share prices is easier said than done.

Besides, enforceability of pledge has been called into question in the past because of legal and practical challenges.

CRISIL believes debt raised through pledge of promoter shares should be assessed based *on the overall cover available through promoter holdings* – both pledged and unencumbered – *on the overall debt that the promoter has raised in various holding/ investment companies*, and not on the pledge and structure of a specific transaction alone.

The overall cover acts as the first line of defence, determines refinancing ability, and provides the flexibility to pledge additional unencumbered shares to maintain the minimum pledge cover requirements and prevent a breach of covenants in any specific transaction.

CRISIL’s overall cover requirement for assessing debt of a promoter’s holding companies depends on the rating category, an auto-correcting factor that adjusts based on the state of the market and sensitivity of the specific stock to overall market movement. CRISIL also factors centrally the credit profile of the company whose shares are pledged and the management quality.

¹ As on February 27, 2019

² Data related to rated ‘pledge’ debt as of January 15, 2019. CRISIL has not rated any of these transactions.

Quantifying pledge-based rated debt in India

- An estimated Rs 38,000 crore of rated debt (accounting for 30-40% of total pledge debt of promoters), backed by pledge of shares, has been raised from the market to date. More than 60% of this is rated in the 'AA' category or above, and almost 90% is in the 'A' category or above
- ~90% of the rated pledge debt has transaction cover of less than 2 times. This is in sharp contrast to the Reserve Bank of India's (RBI's) prescription of a minimum collateral cover of 2 times for lending against shares by banks and non-banking financial companies (NBFCs)
- ~10% has transaction cover of 1.3 times or lower, and provides for additional illiquid collateral (unlisted shares, real estate mortgage) to compensate for the lower cover
- For ~30% of the rated pledge debt, the pledged shares have to be liquidated within 10 days in order to recover debt and avoid a payment default following invocation
- The rated pledge debt transactions are backed by shares of 32 listed companies, of which, 13 are rated in the 'A' category or below, or are unrated

Pledge-based debt is exposed to equity risk as underlying cash flows do not support promoter debt

Pledge-based debt is usually issued by promoter holding/investment companies that have limited operations of their own. Their cash flows are limited to dividend payments from the underlying companies in which they hold stakes. Such dividend payments (dividend yield at less than ~2%) are typically insufficient to ensure repayment of the pledge-based debt (interest cost at ~10%).

Also, promoters would be reluctant to dilute their stake in the listed group companies to generate funds for debt repayment. The debt is, therefore, expected to be refinanced, backed by the strength of the market value of promoter holdings in listed companies. Any significant fall in value of the shares during the tenure may lead to high refinancing risk and eventual default.

The equity market has seen sharp corrections

In order to understand the kind of share price drops in the Indian market, CRISIL analysed companies in the Nifty 500 index. The price drop in a one-month horizon was chosen considering the typical time period prescribed in most transactions for liquidating shares following a pledge invocation. The periods chosen included 2005-18 and 2009-18. The period 2005-18 was considered as it included the Lehman crisis, a black swan event.

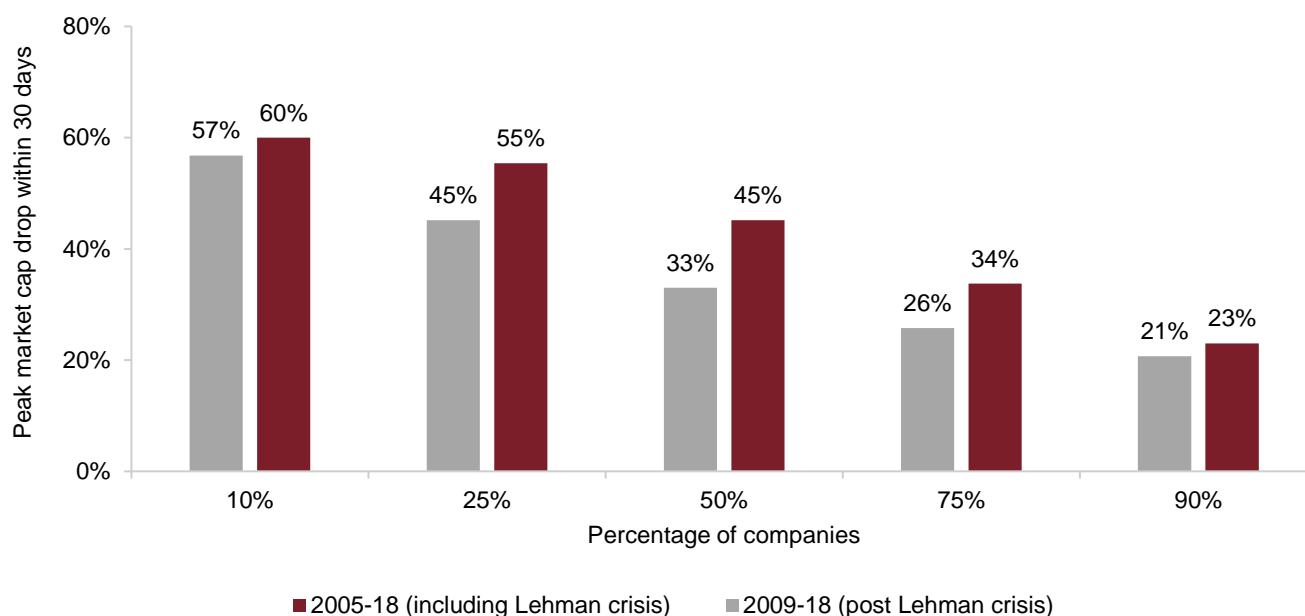
As the following chart shows, during 2005-18, 90% of companies analysed witnessed market cap declines of more than 23% within a month. A 23% price drop implies that if a shares-backed transaction had an overall cover³ (includes both pledge and unencumbered shares) of 1.3 times⁴ to start with, in 9 out of 10 cases, the market value of the shares

³ Overall cover indicates both pledged and unencumbered shares on the overall promoter debt raised through holding or investment companies

⁴ 1.3 times = $1/(1-23\%)=1/77\%$

could have dropped below the debt contracted within a month, leading to losses for debt holders. During the same period, half of companies having such transactions witnessed market capitalisation fall of more than 45%, i.e., even a cover of 1.8 times could have been fully depleted within a month in the case of 50% of companies.

Chart 1: During 2005-18, 90% of companies analysed witnessed peak market cap drops of more than 23% within a month (translating to a cover of 1.3 times)

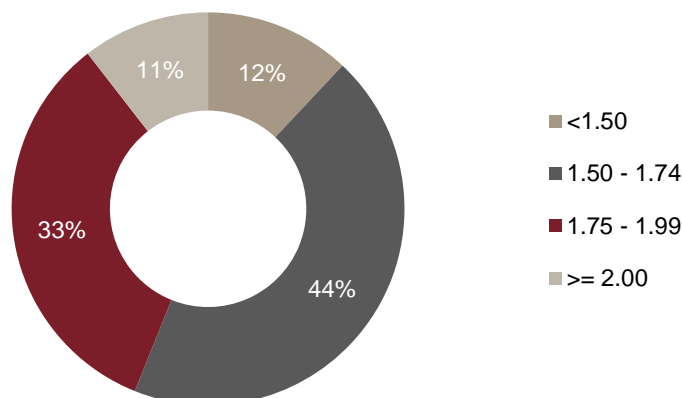


Typical transaction cover levels do not provide sufficient cushion to absorb equity risk

For loan exposures backed by pledge of shares, RBI regulations require NBFCs and banks to maintain a minimum cover of 2 times (or a loan-to-value ratio of less than 50%)⁵. This is a bare minimum and lenders are free to seek higher cover depending on the quality of the collateral.

However, certain pledge-backed debt, especially capital market instruments, may be raised at transaction covers lower than 2 times as well. Indeed, around 90% of the rated pledge debt of ~Rs 38,000 crore had cover less than 2 times – even as low as 1.2 or 1.3 times. Considering high equity volatilities as shown in *Chart 1*, low covers of 1.2 or 1.3 times may not be able to provide adequate cushion and avert a default on the debt. While NBFCs and banks have capital cushion to absorb risks as per regulatory capital adequacy norms, others do not have any such leeway.

⁵For RBI guidelines on NBFCs, please refer to RBI notification titled 'NBFCs – Lending against Shares' dated August 21, 2014 at <https://rbi.org.in/scripts/NotificationUser.aspx?Id=9180&Mode=0>; For RBI guidelines on banks, please refer to 'Master Circular- Loans and Advances – Statutory and Other Restrictions' dated July 01, 2015, at https://m.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9902#231

Chart 2: Approximately 90% of rated pledge debt had a cover of less than 2 times⁶


Given that the transaction cover requirements may not suffice to cover the equity risks, lenders create “structures” to protect against the market-related risks.

The structure requires promoters to top up the cover in case it falls below the minimum levels. For this, a promoter needs to have sufficient headroom with a reserve of unpledged shares. However, ~25% of over Rs 2 lakh crore worth of listed shares pledged by promoters in the market belong to companies whose promoters have pledged 60% or more of their holdings, which limits their ability to pledge additional shares.

Market does not have the depth to ensure orderly exit by lenders in case of liquidation of shares

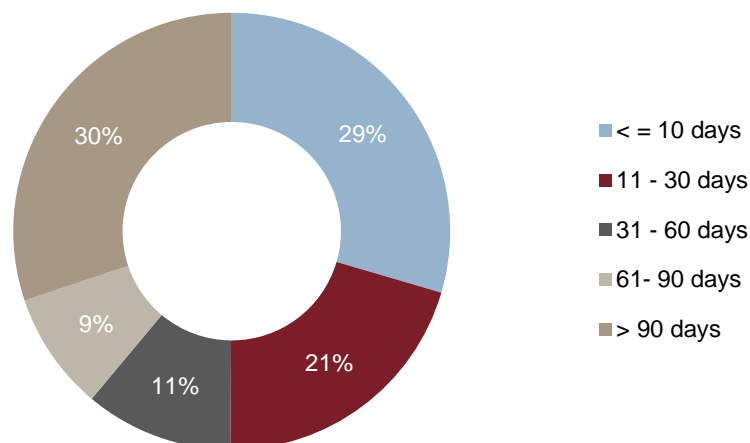
In case the promoters do not have the ability to top up, the structures envisage certain timelines to avoid a payment default through sale of shares in the market. The typical timelines are less than 30 days. Around 90% of the rated pledge debt analysed provided less than 30 days to liquidate the shares, with ~30% envisaging less than 10 days. The timelines envisaged in the structure should be a function of the liquidity in the market to ensure orderly exit without any steep impact cost. However, the liquidity in the Indian market is insufficient to provide an orderly exit in less than 30 days.

As shown in *Chart 3* below, it would take more than 30 days to sell Rs 500 crore worth of shares of 50% of companies in the Nifty 500 index and more than 90 days for 30% of companies in the index, if shares worth the average daily turnover of the respective shares in 2018 were liquidated every day.

The chart only highlights the timelines for liquidation of Rs 500 crore worth of shares. The actual quantum of pledged shares that can come up for liquidation may be much higher. This is because pledge transactions of a promoter group are not restricted to just one lender. While it is possible that lenders can dump these shares and exit in a shorter time span, such a hasty act may lead to a dramatic fall in share prices, due to which they may not be able to cover the value of debt.

⁶ Pertains to Rs 36,679 crore of rated debt, for which, information on cover was available; minimum cover below which promoters have to top up the pledge considered

Chart 3: Orderly liquidation of Rs 500 crore of shares would take more than 30 days for 50% of companies in the Nifty 500 index



Legal and practical risks may impede the effectiveness of pledge-based transactions⁷

The enforceability of the pledge of shares has been called into question in the past due to both legal and practical challenges. A case in point is Unitech Ltd, where the promoters stalled the move by the debenture trustee to sell pledged shares by securing an injunction from the court on the ground that the company would suffer irreparable loss if the stay was not granted. Such actions raise doubts about the ability of the trustee to liquidate the collateral when triggers are breached.

Promoters typically indulge in multiple pledge transactions with several lenders to raise the desired quantum of debt. For example, in one promoter group, 12 promoter holding companies had issued rated pledge debt worth more than Rs 6,000 crore. The huge supply of pledged shares following invocation by multiple lenders can potentially lead to dramatic share price declines, further accentuating the risks.

There have also been instances of promoters losing control of their operating company due to invocation of pledge of shares, as was the case in Great Offshore Ltd. In many other cases, the promoters are on the brink of losing control.

To steer clear of such episodes, lenders may, in consultation with the promoters, arrange for a standstill agreement and stay the share sale on the breach of covenants. If the practical enforceability of the structure is ambiguous, and only limited protection can be provided by the cover, then how should the credit profile of promoter debt be assessed? The following section provides the answers.

⁷ The RBI notes in its Financial Stability Report issue no. 10: "In some instances, the shares pledged by unscrupulous promoters could go down in value and the promoters may not mind losing control of the company as there is a possibility of diversion of funds before the share prices collapse."

Credit profiles of such debt instruments should be assessed based on the overall cover available – whether it is enough to withstand market stress

The overall cover available through promoter holdings (both pledged and unencumbered) on the overall debt that the promoter has raised in various companies should be the determinant of the credit profile of the promoter debt, rather than the pledged shares and the structure of a specific transaction alone.

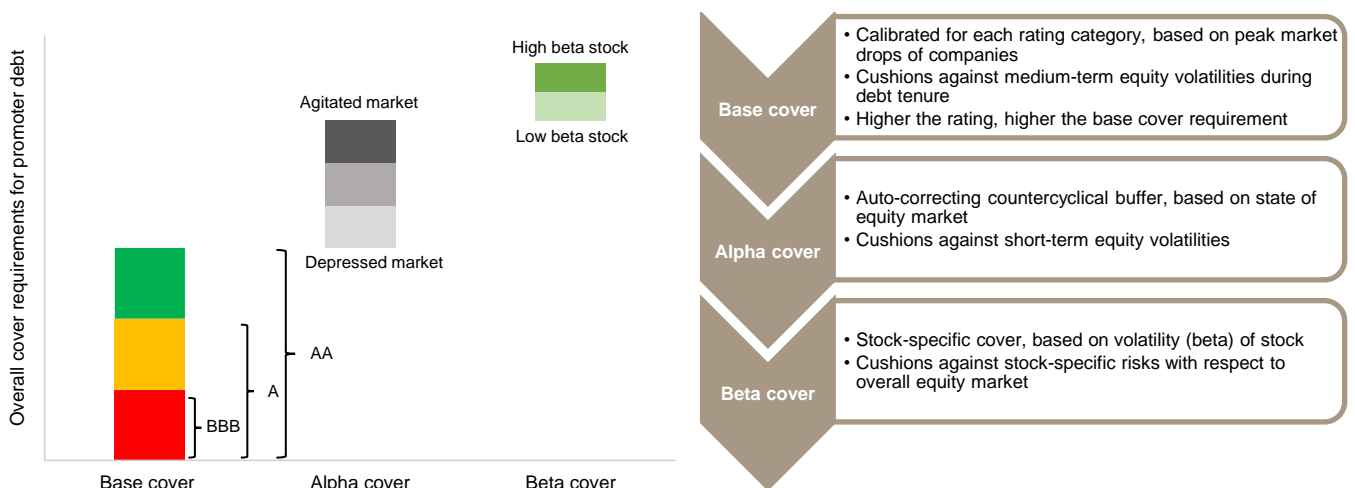
The overall cover acts as the first line of defence, determines refinancing ability, and provides the flexibility to pledge additional unencumbered shares to maintain the minimum pledge cover requirements and prevent a breach of covenants in any specific transaction. The higher the overall cover, the higher the availability of shares that can be used for topping up the pledge, enabling the transaction to withstand higher share price drops before covenants are breached and pledge is invoked by the lenders.

The overall cover should be high enough ab initio to ensure that the transaction is able to withstand medium-term share price drops during its tenure.

CRISIL takes into account not only the cover on the debt being raised as on the date of the rating, but also the future debt-raising plan. CRISIL typically considers a base cover of 4 times for a promoter holding company to be rated in the 'A' category. The exact cover requirements would depend on the rating category, the state of the equity market, and stock-specific volatility.

As the following chart shows, CRISIL's cover requirements are built from a base cover, alpha cover and beta cover. This helps segregate the risks and address the cover requirements for each risk bucket.

Chart 4: Cover requirement compartmentalised based on rating category, market conditions and stock type



Strength of underlying company and management profile should be centrally factored in

The strength of the underlying company whose shares are pledged, in terms of its business and financial profile, cash flow stability, and market capitalisation, influences its share-price volatility and liquidity. Any stress in the operating company can lead to a drop in its share price, thereby affecting the cover available.

Credit stress in the underlying company can further amplify the stress on pledge debt if the pledge debt at the promoter level was used to infuse funds into the underlying company, leading to double leverage. This is a sign of serious stress both at the company and promoter level.

The management quality of the promoter group factors their adherence to prudent debt levels and ability to preserve the value of the operating company.

Conclusion

Clearly, for pledged shares-based transactions of promoters, risks are commensurate only at appropriate cover levels – a cover that is adequate enough to withstand the equity market risks should be maintained.

The cover should be assessed on the basis of the overall cover available through promoter holdings – both pledged and unencumbered – *on all of the debt that the promoter has raised in various holding/ investment companies*, and not just on the basis of pledge and structure of a specific transaction alone.

Other factors such as strength of the underlying company and management profile should also be considered.

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