

Corporate Failures

# IL&FS, DHFL.... Who's Next?

After every major crisis, regulators tighten the screws that reduce the intensity of future crisis. In general, banks and non-banks regulations are far more advanced today than they were some two decades before. However, regulators have to always do a catch up act more than preempting crisis. Also, they tend to over-react and over-regulate that imposes huge costs and kills market growth.



**M R Raghu**, CFA, FRM, FCMA  
Head of Research  
Kuwait Financial Centre

The idea of this article is not to speculate a name that is likely to fail next. That can at best be a speculation. Corporate failures suck and financial corporate failures suck big time. Remember the case of Global Financial Crisis (GFC) and the role financial firms played to create that crisis. Even after a decade, we are still seeing books being published with titles like “Lessons learnt from GFC” or “What led to GFC”. Financial crisis leaves a grim footmark that is hard to

erase easily. Countries rocked by failures of financial firms should worry more as they have many connecting dots and impact points.

IL&FS is a company engaged in infrastructure financing and whose structure is hard to understand with more than 250 subsidiaries and not so clear ownership structures. Though the company was initially started by the Central Bank of India, HDFC and UTI, over time the ownership changed in favor of LIC, Orix and Abu Dhabi Investment

Authority (ADIA). Such a presence of globally reputed institutional investors among owners should actually give more comfort and pave way for better corporate governance. Instead, on the contrary, the executive management of IL&FS used its complicated structure to bestow themselves with generous compensations and misplaced incentives leading to the saga of default that had a humble start in June 2018. At that time it started off as a delay in repayment of ₹450 cr of inter corporate deposits from SIDBI. Though credit rating agencies downgraded the rating as a consequence, the market barely noticed. Unable to conceal the problem, over subsequent months, IL&FS defaulted on several crores of loans prompting SEBI to fire the board and institute a new board under the chairmanship of Uday Kotak. In short, it is a story of poor corporate governance unnoticed by

some of the most sophisticated global investors!

Dewan Housing Finance Corporation Ltd. (DHFL) has a different background but with the same storyline. DHFL is a deposit taking housing finance company whose business model is predicated on enabling affordable housing to middle income people and is spearheaded by Kapil Wadhwan. The trouble started in September 2018 when DSP Mutual Fund sold ₹300 cr of DHFL papers at 11% in the secondary market, way higher than the traded rates sparking speculation of liquidity crunch. However, the real problem started when Cobrapost alleged in January 2019 that DHFL promoters lent money worth ₹31,500 cr to shell companies which was used to buy assets abroad. As expected, DHFL refuted the claim through a clarification provided to Bombay Stock Exchange and

rating agencies were quick to reaffirm high safety rating to DHFL. It is only in May 2019 that CARE (rating agency) downgraded the Fixed Deposit Program worth ₹20,000 cr from 'A' to 'BBB' post which stopped DHFL from accepting and renewing fixed deposits and premature withdrawals. DHFL then delayed interest payment on its bonds and bond repayments worth ₹960 cr and is now busy selling assets to meet the promised repayments. This is yet again another story of corporate governance failure though of a different flavor.

These failures as well as bank episodes (thanks to NPA saga) have negatively impacted both stock markets and bond markets. The accompanying Table shows banks and non-banks with poor performance and good performance. The downfall is quite significant to note since such negative performances are observed only in a deep bear market.

However, the impact these had on the bond market is really significant which is summarized in Table 2. Out of approximately 1,900 fund universe, nearly 105 mutual funds got affected through their exposure to DHFL paper accounting for about 2.5% of total assets.

### Capitalizing on the chaos!

From an asset value perspective, I will not panic at this number but it warrants caution among mutual fund managers. India has been experiencing strong inflows both into equity and debt funds by foreign institutional investors during the past few years. This has increased competition among funds to outperform the benchmark which warrants them to take risk to pick up the additional yield. That is when they venture into papers like DHFL and IL&FS, especially corporate bond funds. Bond funds have significant exposure to other low-rated papers by finance companies (in search of yield) and hence I believe they may now reduce their exposure to high-risk papers which will bring down the yield of these funds going forward.

From a portfolio investment perspective, a key question is: Which is riskier banks or non-banks? While banks borrow money from retail and

#### Financial Sector Performance

Sector	Stocks Near 52-Week Low	Stocks Near 52-Week High
Banks	Yes Bank (-66.5%)	Axis Bank (+50%)
	IndusInd Bank (-26.8%)	ICICI Bank (+44.8%)
	J&K Bank (-34.1%)	HDFC Bank (+19.5%)
	Karur Vysya Bank (-20.7%)	Kotak Bank (+12.2%)
	South Indian Bank (-42.2%)	City Union Bank (+27.7%)
	Punjab National Bank (-13.1%)	DCB Bank (+29%)
HFCs	DHFL (-89.4%)	HDFC (+19%)
	IndiaBulls (-45.6%)	Aavas (+93.7%)
	PNB Housing (-28.2%)	CanFin Homes (-0.5%)
	Reliance Home (-82.2%)	
NBFCs	Piramal Enterprises (-25.8%)	Bajaj Finance (+54.8%)
	Edelweiss (-43.6%)	Muthoot Finance (+63.9%)
	IIFL (-55.6%)	Manappuram Finance (+42.8%)
	Aditya Birla Capital (-34.5%)	Cholamandalam (-10.2%)
	L&T Finance (-27.7%)	Sundaram Finance (-11.7%)
	M&M Finance (-15.4%)	Credit Access (+31.6%)
	SREI (-71.9%)	
	Shriram Transport Finance (-27.7%)	
	Shriram City Union (-36.6%)	

**Note:** 52-week total return has been provided for the stocks.

Source: Reuters; Data as of June 19, 2019

## Costly Bet: AMC's with Exposure to DHFL

Asset Management Company	AuM (US\$ mn)	DHFL Exposure Size (US\$ mn)	Size of DHFL Exposure by Overall AuM (%)
JM Financial Asset Management Ltd.	1,258	81.3	6.5
DHFL Pramerica Asset Managers Private Limited	749	17.3	2.3
Principal Asset Management Pvt Ltd.	1,070	11.3	1.1
HSBC Asset Management (India) Private Limited	1,773	17.1	1.0
Baroda Asset Management India Ltd.	1,556	13.5	0.9
UTI Asset Management Company Limited	20,382	143.7	0.7
Union Asset Management Company Private Ltd.	609	3.7	0.6
IDBI Asset Management Limited	918	5.4	0.6
BNP Paribas Asset Management India Pvt. Ltd.	1,133	5.0	0.4
Sundaram Asset Management Company Limited	4,501	17.1	0.4
Reliance Nippon Life Asset Management Limited	27,422	93.3	0.3
LIC Mutual Fund Asset Management Limited	1,920	6.4	0.3
Edelweiss Asset Management Limited	1,668	5.5	0.3
Axis Asset Management Company Limited	15,105	27.0	0.2
Tata Asset Management Limited	7,967	9.0	0.1
DSP Investment Managers Pvt Ltd.	11,094	9.3	0.1
Aditya Birla Sun Life Amc Ltd.	37,138	4.1	0.01

Source: Reuters

lend to wholesale (businesses), non-banks borrow money from wholesale and lend to retail. So when banks go bust, the losses will be significant, while non-banks may be slightly better off given their exposure to retail. However, the broader premise is one of cor-

porate governance both in banks and non-banks. Well-governed banks and non-banks do perform well in the stock market even in these testing times. Hence, research should focus on unravelling this qualitative element rather than laboring on quarterly state-

ments that can easily be doctored. In the case of IL&FS, major lapses on the part of Deloitte (auditors) were noticed.

With each major crisis, regulators tighten the screws that reduce the intensity of future crisis. In general, I would say that banks and non-banks regulations are far more advanced today than they were some two decades before. However, regulators have to always do a catch up act more than preempting crisis. Also, they tend to over-react and over-regulate that imposes huge costs and kills market growth. Calibration is the key word in terms of structuring regulations to minimize failures and where it happens, containing the contagion effect.

The beauty of such financial company failures is that it can make available well-governed companies at attractive valuations. Use every such opportunity to build on quality franchise.

Happy investing! ■

Reference # 20M-2019-09-12-01

## THE ANATOMY OF A CRISIS

## WHAT'S GONE WRONG?

The IL&FS group has a massive debt of ₹91,000 crore. The group has failed to service its dues and has defaulted on several dues since July.



## WHAT'S NEXT FOR IL&amp;FS?

The newly appointed board will try to revive the firm. The centre is planning to arrange fresh funds from the financial system, so that further defaults don't take place and the infrastructure projects are implemented smoothly.



## WHAT'S LIKELY TO HAPPEN?

The Serious Fraud Investigation Office has initiated a probe and will look into financial mismanagement. The Registrar of Companies is further probing the firm to ascertain its liabilities.



## Big backers

Major shareholders of the beleaguered IL&FS (in %)

Life Insurance Corporation of India	25.3
Orix Corp., Japan	23.5
Abu Dhabi Investment Authority	12.6
IL&FS Employee Welfare Trust	12
Housing Development Finance Corp.	9
Central Bank of India	7.7
State Bank of India	6.4

Image: Mint

Source: Annual report 2018, Bloomberg

