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Book builder

While PE investors have been keen to capitalize on India's financial services industry, Everstone Capital took a unique approach to the sector – building an independent non-banking financial company

EVERSTONE CAPITAL FIRST NOTICED A gap in India's $750 billion credit market in 2010. Over the previous decade, global investment banks had set up their own non-banking financial companies (NBFCs) to serve large and mid-cap corporate but the global financial crisis forced a sharp reassessment of this and other strategies. Most banks retreated to focus on their home markets, scaling back the NBFCs or shuttering them entirely.

"There was a vacuum for a player to come in and create that type of business," says Dhanpal Jhaveri, partner and CEO at Everstone.

With the Indian economy growing at over 8% at the time, many companies were involved in big-ticket projects, especially infrastructure. Individual projects required investment of INR80 billion ($1.2 billion), which was beyond local banks' capacity for rupee debt financing, so NBFCs were coming in with long-dated credit.

Private equity firms were drawn to the space by the consistent returns it provided. While banks usually lend to real estate firms at interest rates of 13-14%, NBFCs charge 16-20%.

Once Everstone decided it wanted exposure, the question was how to get it. Jhaveri says there was little opportunity to buy into an existing NBFC without paying a significant premium to book value. Relying on the partners' experience in financial services - co-founders Sameer Sain and Atul Kapur both worked for Goldman Sachs - they decided to create an institution from scratch.

"We decided that instead of paying that premium we could build our own business and given our experience, fund the right talent to build what would be one of the largest independent wholesale credit institutions in the country," Jhaveri explains.

Valuable partners

The start-up - named IndoStar Capital Finance (ICF) - aimed to work with corporates with net profit of INR2.5-5 billion that required funding for project and capital expenditure, long -term working capital, special situations and acquisition financing. It meant the loans had to be of a certain size - at least $20-30 million. Bigger transactions were expected to help negotiate better structured deals.

Since the Reserve Bank of India (RBI) has set the single party exposure limit for NBFCs at 15% of owned funds and group exposure is capped at 25%, extending loans of that size required at least $200 million (INR9 billion then) in capital. Everstone's Capital Partners II put around $50 million into the venture, while LP co-investors contributed another $50 million. But that that still left $100 million unaccounted for.

Unlike traditional banks, there are no caps on foreign ownership of NBFCs so Everstone brought in Ashmore Group, a specialist emerging markets investor, and Goldman Sachs, with Baer Capital Partners in a smaller role.

> "You cannot grow any meaningful credit financing business in India unless you have a degree of anchor lending coming in from the bankers" – Vimal Bhandari

"What's important for us is that the investors have a long duration of capital, at least 5-7 years, and an understanding of the business. We wanted to make sure the partners appreciated the risk as well as the potential returns it could offer, and had the balance sheet to write large checks to participate in this investment," Jhaveri says.

The role of the stakeholders extends beyond providing capital or introductions to other capital providers. As part of the company board, their representatives sit on the credit committee that has final authority in approving transactions. Management can only make recommendations.

The joint venture took almost a year to close and ICF's first capitalization was completed in March 2011. The following month Vimal Bhandari, country head of Aegon, joined as CEO and managing director. He had previously spent 17 years with IL&FS, building its various businesses in financial services.

While the investors provided strategic oversight and direction, it was Bhandari and the two others on the management team - Sandeep Baid, then head of credit, and Sanjay Hinduja , head of origination and syndication - who built the company. One of Everstone's managing directors, Pankaj Thapar, was appointed CFO.

They charged headlong into developing the liability strategy, working to build relationships to raise money from the banking system, wholesale debt markets and money markets to supplement ICF's equity capital in lending activities. It is one of the biggest challenges building an NBFC in India, since the RBI does not allow these institutions to take retail deposits.

"You cannot grow any meaningful credit financing business in India unless you have a degree of anchor lending coming in from the bankers," explains Bhandari. "To raise money from the capital or money markets is a lot more dependent on the empirical track record of the sponsors, the management team and also how the market perceives the company. Stronger qualitative issues need to be complemented by quantitative issues relating to the fundamental business model."

The process started with defining the asset composition - owing to the uncertain economic environment, a majority of ICF's loans would be senior secured credit, chiefly loans to operating companies, asset-backed loans, term loans and short-term facilities.

It would also offer loans against shares and other tangible collateral. For example, last year ICF extended a six-year loan of INR1 billion to payment service provider Prizm Payment Services, which required capital to expand its automated teller machine (ATM) network. The structured financing involved an operating lease model for the ATM assets.

"We lend to those companies where we can grow with the company and do repeat transactions. It's one of the parameters we are very conscious of," says Bhandari.

ICF lends at a project level for commercial and residential real estate properties, often in the form of late-stage financing for the completion of developments that are already underway, which reduces execution and construction risks. The team felt the demand for housing and commercial office space will continue to rise and chose to work with developers in designated micro-markets. It requires a high level of collateralization and a self-liquidity mechanism where loans can be repaid out of the sale of the underlying property.

Broadly 60-65% of the asset book is from infrastructure and operating company loans, 30% is set aside for real estate and the balance of 10% is for acquisition financing or promoter funding. "We have only three components so it is a much more predictable model from a risk and growth perspective for a lender to evaluate," Bhandari explains.

Getting rated

Next came the ratings process, where the agencies gave ICF the highest rating for its short-term paper and AA- for long-term loans. Abhinav Sharma, assistant general manager of CARE Ratings' financial sector team, says the rating is driven by leading global financial institutions that have promoted ICF, its experienced management, good risk management processes, comfortable capital adequacy and liquidity position.

These factors were part of the pitch Bhandari and his team made to the multiple bankers they chased during the long, tedious process of evaluation, cross-examination and discussion that followed to establish bank credit lines.

The conservative financial risk management practices adopted include setting leverage at a maximum of 25% of capital, even though NBFCs are allowed to operate at a 12% capital adequacy. Of ICF's net worth, 15% will always be maintained in liquid form, invested in bank deposits and near cash investments. It is also part of the company charter that there will not be any asset-liability mismatch on its book.

Furthermore, the ICF business model also seeks co-participation in some deals from other lenders - foreign institutional investors, mutual funds, other NBFCs or banks so that a part of the transaction can be sold through syndication. It increases the firm's ability to do larger deals, provide fees and benefit from yield differential, and Bhandari says, it helps "our credit standards be accepted by other people, which over a period of time makes the institutional positioning that much more robust."

Through this strategy ICF has established relationships with 12 banks, including ICICI, Axis, HDFC and numerous entities within the State Bank of India Group. The team was able to persuade bankers to start their relationship not with the easy current credit (CC) limit, but the more difficult one of giving a term loan of 54 months.

Within 12 months of formation ICF issued its first commercial paper in the money market and it has also started placing non-convertible debentures with mutual funds in the capital market. The company has cumulatively completed money market issuances of INR7.65 billion and long-term debenture issuances of INR2.65 billion.

Although the high interest rates for borrowing from banks have affected fund availability for NBFCs, within two years of operations ICF has originated and transacted 53 deals cumulatively worth more than INR43 billion. It now has an asset base of over INR22 billion, of which ICF has a net worth of INR10.2 billion and borrowings of INR11 billion. Income reached INR2.4 billion for the 2013 financial year, more than double the 2012 total, while net profit rose 69.3% to INR900.9 million.

"IndoStar had a return on total assets of 5.54% during the 2013 financial year, which indicates good profitability at its current low leverage. It is gradually building leverage and the return on net worth is expected to reach industry comparables over a period of time," says CARE's Sharma.

Meeting a need: The NBFC opportunity

In 2011, the year Everstone Capital launched IndoStar Capital Finance, KKR and Baring Private Equity Partners were among the private equity firms that together invested $200 million in six Indian non-banking financial companies (NBFCs).While investment in banks is capped at 5%, there is no such limit on NBFC ownership.

NBFCs broaden access to financial services and enhance diversification of the financial sector through credit solutions that are not offered by banks. They are engaged in everything from mortgages to vehicle and infrastructure financing and microfinance. Unlike banks, NBFCs are flexible in accepting collateral, and able to lend against shares pledged by promoters or against plots of land.

Most practitioners have niche expertise in retail or wholesale lending which gives them a competitive edge.

"For retail lending, flexible branch operations, origination and collection strengths in specific asset classes, geographies or borrower segments are an advantage," says Abhinav Sharma, an analyst at CARE Ratings agency. "For wholesale lending NBFCs, structuring and faster origination are strengths."

As of March 2012, the total number of NBFCs registered with Reserve Bank of India stood at 12,385 compared with 12,409 in 2011. While net owned funds of these institutions grew 25% to INR225 billion over the course of the 2012 financial year, the total size of all NBFCs assets in India is still only 10-12% that of the banking sector.

In the pipeline

Once ICF's asset base exceeds INR30 billion, which is expected to happen next year, the plan is to expand into new credit services. Bhandari says there is there is a significant opportunity for domestic and foreign investors who are interested in investing in the credit markets but do not have enough access to products that offer a secured return and better yields than bank deposits.

Asset management for this increasing number of wealthy families and institutions who are looking to invest in credit by buying debentures is one business expansion option. ICF intends to set up an alternate investment fund for multi-sectoral investments in senior secured debt adjacent to the credit products on its balance sheet. The company already creates a large number of debentures which it sells down to co-participants and could give credit fund investors first refusal on this paper.

"We are trying to lever up our capability in the credit space and then at the same time get into non-funded income that can be grown into a fairly large asset management business. We will look at other opportunities in the credit market and may at some point want to see what we can do in small and medium enterprise financing. That segment has big potential," Bhandari adds.

The proposed new business would enable ICF to have a more predictable fee income and access to pools of capital. It could do larger deals in participation with the fund. Needless to say, a larger and diversified business makes for a much more attractive proposition when the investors come to exit. While an IPO would present ICF with a greater ability to tap the public markets for money, Jhaveri says Everstone is keeping its options open.

"It could be a combination of doing an IPO, selling to institutional investors or to combine with a large strategic local player or another foreign player who wants to enter India," he elaborates.