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Aditya Birla Financial Services – will it benefit from being a Grasim subsidiary?

The Aditya Birla group contends that housing the Aditya Birla group's financial services business within Grasim will help it leverage a stronger balance sheet. But, without any explicit support from Grasim, it is unlikely to benefit from Grasim's stronger credit quality. The financial services business has the size to raise capital from the market on its own. Additionally, the Aditya Birla group has been increasing its debt without commensurate increases in revenues and profits – as a result, the group's overall credit quality may be under pressure over the medium to long term.

In August 2016, the Aditya Birla group (AB Group) announced a restructuring plan, in which, as the first step, Aditya Birla Nuvo Limited (ABNL) would be merged into Grasim Limited (Grasim). In the next step, the financial services business, carved into Aditya Birla Financial Services Limited (ABFSL), would be demerged and listed separately. The company stated that one of the key reasons for this two-stage restructuring was to unlock value in ABFSL, and provide Grasim's stronger balance sheet as credit support to ABFSL's growing capital needs.

IiAS will engage with stakeholders and wait for the shareholder notice of the restructuring before articulating a voting recommendation.

In the interim, we examine whether there is merit in the transaction rationale of ABFSL benefitting from Grasim as a holding company, any more than being part of the Aditya Birla group – and whether it needs any support at all. We also examine increasing debt levels of the Aditya Birla group's listed companies – Grasim (consolidated, including UltraTech Cement Limited), Hindalco Limited, Idea Cellular Limited (Idea), and ABNL (ex-Idea Cellular) – and question whether the AB group's credit quality is likely to remain unchanged given the current fund requirements of the group.

Will ABFSL be able to lower its cost of borrowing once it becomes a Grasim subsidiary?

There is a one notch difference between ABNL's CRISIL AA+ rating and Grasim's CRISIL[1] AAA rating[2]. ABNL's ratings are supported by the fact that it belongs to the Aditya Birla group – that it benefits from the financial flexibility of the group. In holding the argument that carving out ABFSL from ABNL and housing it directly in Grasim will make a material difference, the AB group suggests that ABFSL will benefit from Grasim's AAA rating.

[1] *For the purpose of this discussion, IiAS has used CRISIL ratings to discuss credit quality because it is the only rating agency to have outstanding ratings on all five listed companies – Grasim, UltraTech, Idea, Hindalco, and ABNL.*
[2] *On 13 August 2016, a day after the announcement of the restructuring, CRISIL placed Grasim's AAA rating on Rating Watch with Developing Implications (Watch Developing) – the rating agency says that the ratings have been placed on Watch Developing since its future credit profile will depend on the management's future business strategy and funding requirements in various businesses, including telecom and financial services.*

Table 1: AB Group companies' average cost of borrowings

	31-Mar-14	31-Mar-15	31-Mar-16
Grasim (consolidated)	7.2%	7.9%	7.1%
Idea	4.7%	6.2%	5.8%
Hindalco	8.3%	7.7%	7.6%
ABNL (ex-Idea)	8.9%	7.9%	7.8%
Aditya Birla Finance Limited (NBFC)	*9.3%*	*9.1%*	*8.5%*
AB Group	**7.7%**	**7.5%**	**7.1%**

Source: Annual reports, IiAS estimates *Average cost of borrowing = finance cost / average debt*
Aditya Birla Finance Limited is currently a subsidiary of ABNL, and will form part of the proposed ABFSL that will be listed separately under the scheme of restructuring.

IiAS believes that AB group's rationale for the financial services business benefitting from a stronger parent is tenuous. For a subsidiary's rating to be equated to the parent's, there must very strong strategic and financial linkages between the parent and the subsidiary. In the case of ABFSL and Grasim, the strategic and financial linkages are neither strong (between a financial services business, and a textiles and chemicals manufacturer) nor materially different from those that exist between ABFSL and the Aditya Birla group as a whole. Therefore, it may be simplistic to assume that because ABFSL is housed under Grasim's 'AAA balance sheet', it will get access to AAA-priced debt.

ABNL's ratings embed the AB group's support for the capital raising and debt repayment requirements of all its group companies, especially the listed ones. Therefore, is it is unlikely that having a direct holding company will make any material difference to ABFSL – its credit quality will remain bolstered just on account of being part of the AB group. Moreover, although Grasim's credit quality is stronger than the group's, the AB group's ability to raise funds is superior than that of Grasim's alone (even if Grasim's debt-equity is the lowest amongst all listed companies).

If ABFSL were to benefit from Grasim's stronger rating, there must be history of credit support (provided in the past) or an explicit intention to support from Grasim. If Grasim supports ABFSL, it will either raise debt or reduce its on-balance-sheet liquidity: in both cases, it will impact Grasim's credit protection measures. If it relies on other companies of the group supporting ABFSL's capital requirements, then there is really no benefit of being housed directly under Grasim.

Will Grasim support ABFSL?

Grasim suggests that the listed businesses are able to raise capital on their own and therefore do not need Grasim's support. Between 2007 and 2016, UltraTech increased its capital employed by almost 9x to Rs. 343 bn on 31 March 2016 (from Rs. 39 bn on 31 March 2007) and Idea raised Rs.156 bn[3]. If Grasim has not had the need to support the listed businesses in the past, will it make an exception for ABFSL?

[3] *Source: Grasim's investor presentation regarding the restructuring*

ABFSL's capital employed on 31 March 2016 is estimated at Rs. 299 bn, which is just a shade lower than that of Ultratech's – given that UltraTech raised capital on its own balance sheet strength, surely ABFSL can do the same.

The AB group recently listed Aditya Birla Fashion and Retail Limited (ABFRL): ABFRL's market capitalization on 30 September 2016 was Rs. 106.06 bn. The AB group, across several companies, owns 59.46% of ABFRL – it is not housed under a single parent company. ABFSL's capital employed estimated at Rs.299bn, is 3x that of ABFRL. If the AB group believes ABFRL does not need a strong parent to support its growth, why does ABFSL need one? Parentage is more critical for a financial services business than for a fashion and retail business – but both these companies benefit from being part of the Aditya Birla group, and will continue to do so independent of any internal changes to the promoter shareholding.

The AB Group has been increasing leverage over the past three years and its overall credit quality could deteriorate over the medium term

While rating agencies and the markets will decide if ABFSL will get the benefit of Grasim's AAA rating, IiAS believes the larger worry across the group is the increasing debt levels. If the group continues to increase its debt levels, it may result in downward pressure on the ratings that are supported by AB group's financial flexibility. This could affect the group's cost of debt across companies.

The aggregate debt of the four main listed companies – Grasim (including UltraTech), Idea, ABNL, and Hindalco - was Rs.1.49 trillion on 31 March 2016, which is larger than several listed banks' balance sheets. To put this in market terms, the AB group's outstanding debt is almost equal to ICICI Bank's entire market capitalization (about Rs.1.60 trillion).

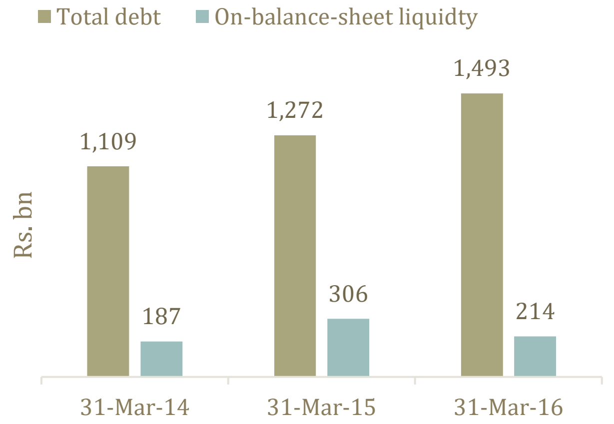
Hindalco is the largest contributor to the group's debt. The recent increases in debt have been on account of Idea's spectrum liabilities, and expansion of the financial services business. Most importantly, the increase in debt is not matched by a commensurate increase in revenues and profits: the AB Group's revenues and profits have remained flat over the past three years.

Table 2: Total outstanding debt of AB group companies **(Rs. Bn)**

	31-Mar-13	31-Mar-14	31-Mar-15	31-Mar-16
Grasim (consolidated)	96	97	120	129
Idea (without spectrum liabilities)	127	119	175	104
Idea's spectrum liabilities	13	87	94	311
Hindalco	569	647	684	675
ABNL (ex-Idea)	154	158	200	275
Total	**960**	**1,109**	**1,272**	**1,493**

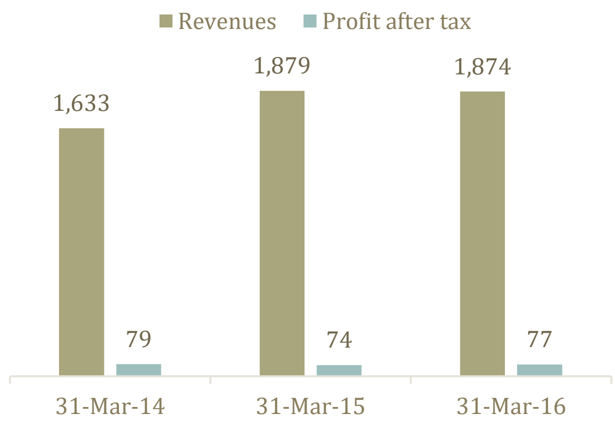
Source: Annual reports, IiAS estimates

Chart 1: AB Group's increasing debt and reducing on-balance-sheet liquidity



Source: Annual reports, IiAS estimates
On-balance-sheet liquidity refers to cash and bank balances, and current investments on the balance sheet date.
Total debt includes Idea's deferred payment liabilities towards spectrum.

Chart 2: AB Group's revenues and profits over the past three years



Source: Annual reports

Going forward, we expect Idea and ABFSL to remain cash drainers on a steady-state basis.

The telecom wars will compel Idea to invest if it wants to hold its market share. Idea is already trailing Vodafone and Airtel. Vodafone's Rs.470 bn capital support from the parent will strengthen its balance sheet and enable it to further invest in the business. The recent entry of Reliance Jio has intensified the already competitive sector. Idea's outstanding debt aggregated Rs.415 bn on 31 March 2016, which is likely to increase as it invests another Rs.128 bn in spectrum acquisitions alone. Idea and ABNL may also have to invest another Rs.7 bn (Rs.1 bn as investment in technology and another Rs.6 bn to fund expected losses) in the payments bank[4].

AB group's financial services business (ABFSL – largely the NBFC), will need capital to grow: it will need to raise both capital and debt. On 31 March 2016, its NBFC's capital adequacy ratio was 16.14% (16.94% on 31 March 2015), which is marginally higher than the regulatory minimum of 15%. Outstanding debt on 31 March 2016 aggregated Rs.229bn, which will increase as it grows.

The group's credit profile could be further strained if it continues to follow an acquisition-led growth. UltraTech's recent acquisitions of 21.2 mtpa cement plants from the Jaiprakash group will likely increase its debt burden by another Rs.115bn, as it assumes the cement plants' liabilities[5].

[4] *The AB group also needs to invest in developing a payments bank. Idea and ABNL jointly own (Idea - 49%; ABNL - 51%) the recently established Aditya Birla Idea Payment Bank Limited (Idea Payment Bank), which has received a payments bank license.*
[5] *Ultratech's (Grasim's subsidiary) CRISIL AAA ratings were also placed on Rating Watch with Developing Implications, in March 2016 following the announcement of its acquisitions of Jaiprakash group's cement plants. CRISIL will remove Ultratech's ratings from Watch and*

Sure, the valuation of the cement plants was attractive[6]. But, if the group follows an acquisition-led growth strategy in other businesses, it will create incremental pressure on the group's overall credit profile.

Don't miss the big picture

Grasim and ABNL's shareholders must question the transaction rationale (that the financial services business will benefit from being housed under Grasim). Not only is the argument weak, but it is also a point-in-time view.

Annexure 1: Outstanding ratings on AB Group's four listed companies and their subsidiaries

Sr. No.	Company Name	Outstanding rating on 10-Oct-2016	Rating rationale date
1a	Grasim Industries Limited	CRISIL AAA/Watch Developing/CRISIL A1+	13-Aug-16
		CARE AAA/CARE A1+	19-Aug-16
1b	UltraTech Cement Limited	CRISIL AAA/Watch Developing/CRISIL A1+	10-Oct-16
		CARE AAA/Credit Watch /CARE A1+	18-Mar-16
		IND AAA/Stable	17-Aug-16
2	Idea Cellular Limited	CRISIL A1+	8-Apr-15
		CARE AA+/CARE A1+	15-Jul-16
3a	Aditya Birla Nuvo Limited	CRISIL AA+/Watch Developing	13-Aug-16
		ICRA AA+/Watch Developing	16-Aug-16
3b	Aditya Birla Finance Limited	ICRA AA+/Stable/A1+	29-Sep-16
		CARE AA+	18-Jan-16
		IND AA+/Stable/A1+	27-Sep-16
3c	Aditya Birla Housing Finance Limited	ICRA AA+(Stable)/A1+	14-Jun-16
		IND AA+/Stable/A1+	15-Sep-16
3d	Aditya Birla Solar Limited	CRISIL A-/Watch Developing	13-Aug-16
3e	Aditya Birla Money Limited	CRISIL A1+	19-Aug-16
4	Hindalco Industries Limited	CRISIL AA-/Stable/CRISIL A1+	5-Oct-16
		CARE AA/CARE A1+	7-Oct-15

Source: Rating agencies' websites

take a final rating action once it has more clarity on the transaction, including the final cash outflow, operating performance of the acquired assets, and potential synergies.

[6] *IiAS recommended voting FOR the resolution to acquire the cement assets.*

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