The Startup Space requires a Distressed Funds Market in India

Dr. Amartya Kumar Bhattacharya
BCE (Hons.) (Jadavpur), MTech (Civil) (IIT Kharagpur), PhD (Civil) (IIT Kharagpur), Cert.MTERM (AIT Bangkok), CEng(I), FIE, FACCE(I), FISH, FIWRS, FIPHE, FIAH, FAE, MIGS, MIGS – Kolkata Chapter, MIGS – Chennai Chapter, MISTE, MAHI, MISCA, MIAHS, MISTAM, MNSFMFP, MIIBE, MICI, MIEES, MCITP, MISRS, MISRMTT, MAGGS, MCSI, MIAENG, MMBSI, MBMSM
Chairman and Managing Director,
MultiSpectra Consultants,
23, Biplabi Ambika Chakraborty Sarani,
Kolkata – 700029, West Bengal, INDIA.
E-mail: dramartyakumar@gmail.com
Website: https://multispectraconsultants.com

The startup scene in India is no longer at a nascent stage and, with a high frequency of booming companies and smooth exits, it has become more competitive. There is increased possibility now of more investments ending up as sunk costs. What the Indian economy needs now is the availability of a distressed funds market. The name of this asset class is self-explanatory; it is the practice of investing in distressed debt or in startups which are debt-ridden or in a state of distress due to things like inability to pay back loans.

At first sight, it seems like a bad idea to to invest funds in an organisation that has already indicated incompetence. Here is how a demand for investing in such a product, the supply of which is increasing gradually, can be created:

Investment	Current price (INR)	Value (INR) if turnaround succeeds	Value (INR) if turnaround fails	Expected value (INR)
Debt	100	200 (100% gain)	80 (20% loss)	140 (40% gain)
Equity	400	1000 (150% gain)	0 (100% loss)	500 (25% gain)

Assuming that there is a 50% chance of success after investment into the distressed asset, the expected rate of return gives a greater return in the case of investment into distressed debt of the company. The reason for investors opting in for this is that, if a company fails, debt is recovered prior to the recovery of equity, as conventionally lenders are prioritised. This opportunity, then, is more attractive to debt investors.

Across the world, markets for distressed funds do not function merely by passively investing in these companies but investors also often contribute to the decision-making processes of these entities. Sometimes, investors even get involved in lend-to-own situations wherein they can buy the company's debt (for a reduced value, if the company is over-leveraged) and

acquire enough of it so that the investors end up having to make space for you to own the company instead of paying you amounts for debt repayment.

Distressed Funds are attractive for additional reasons like:
Regular cash flow is paid to investors in the form of interest payments, which is compulsory unlike the payment of dividends, especially in the case of startups.
Corporate restructuring power can be concentrated in the lender. The structure can be such that debt repayment is prioritised over long term sustenance.
With legal hurdles out of the way with policies like the bankruptcy code in place, startup failures can be cushioned with the existence of distressed asset purchase possibility. Perhaps, means such as crowdfunding can be used to cushion distressed firms. This can be done in the form of a private equity fund which can be transformed into a publicly tradable asset. A mechanism as follows can be set-up.

Allow ARCs like Edelweiss' Asset Management Department or DSP Blackrock's Distressed Debt Funds to be opened to the public for attracting more funds, while necessarily categorising these investments to be of greater risk for protection of public interest. Pooling of funds from the crowd will have a two-fold benefit:
a. Incentivise fund managers to advertise strongly (as they can have a new product to reap benefits from, as well as have access to more capital) to potential retail investors, thereby increasing awareness.
b. Reduce the risk on the large investment firm who cannot afford to reduce its liquidity by placing funds in a distressed asset.

Create mechanism within these ARCs to function like Private Equity Players wherein they can charge a management fee for investing in these entities and taking charge of the management of these organisations. Active participation in the management of distressed entities will increase the chances of gain via investment in debt situations, creating more situations like that of the 100% gain as illustrated above, while still being a safe bet for these organisations. In the worst case scenarios for the investors, they lose the ability to recover their debt (which too, they acquired for a fraction of its value) but gain the control of the entity. They can then infuse further capital into these corporations for CapEx/OpEx purposes and aim at maximising returns thereby.

Markets come at a cost of likely inefficiencies and loopholes in the laws that regulate them. With a set-up like this, the interests of venture capitalists is boosted and a greater demand for direct investments in innovative problem-solving startups is created. This makes it all the more likely for large investors to be interested in lend-to-own situations in order for them to be able to access the entrepreneur's product while eliminating the entrepreneur with the possibility of placing himself in "lend-to-own" situations.

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