

RETAIL BOND STREET

Speed Bump or Dead End?

When top-rated firms sold bonds at high yields to retail investors, it was an opportunity to beat low bank rates. But with the spectre of defaults, inability to assess risk and regulatory gaps emerges. If unaddressed, evolution of bond market will remain a mirage, write Saikat Das and Joel Rebello

Three years ago, thousands of retail investors queued up to buy the bonds of a three-decade-old home financier braving Mumbai's monsoon rains, setting a record of sorts in India's corporate bond market history. Now, those disillusioned investors are queuing up to figure out whether they would receive interest payments on the same set of bonds, leave alone the principal due for repayment last August.

Bonds of Dewan Housing Finance Corp, a triple A-rated mortgage lender, were in such demand that the company that wanted to raise just about ₹4,000 crore ended up with a demand nearly five times that from retail investors. All of that happened in just about six hours since the bids opened, making the DHFL sale a record subscription collection by an Indian private issuer on the first day of a public bond sale.

Now, the company is mired in legal battles, and an orderly resolution of the outstanding debt seems a tough ask in the absence of dedicated bankruptcy laws for financing companies.

In hindsight, it might be termed irrational exuberance. But the fallout may give a serious blow to the nascent bond market, which the industry needs and the regulator is finding difficult to groom.

TRUTH BYTES

"People went for higher yields and they thought that if it's rated AAA it will remain AAA for life," says Ravneet Gill, chief executive at Yes Bank. "Economic cycles have become shorter, business cycles have been truncated, businesses have become more competitive."

As the NBFC industry undergoes a tumultuous period of adjustment to new realities after the blow-up of Infrastructure Leasing & Financial Services (IL&FS) last year, a key component of funding for industry, especially the financial services that tapped savings, remains squeezed and investors are turning their backs on them.

Risk aversion is gripping the financial services industry with even mature investors such as mutual funds and banks slamming their doors on many NBFCs. While institutions could open up sooner, retail participation in the bond market may still take longer to revive.

"Whatever has happened in retail bonds is also a lesson for investors not to be lured by high interest rates offered by these companies and put a large proportion of their savings," said Sandeep Bagla, associate director at Trust Capital, an investment bank specialising in bond sales. "Fixed income investment is about safety and beating inflation and not earning superb returns. This education has to reach retail investors."

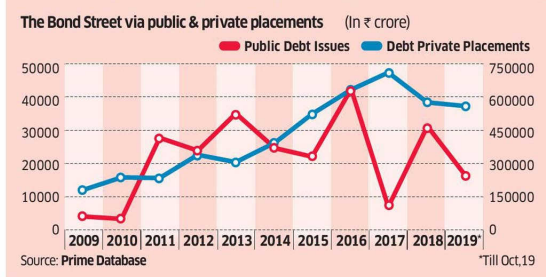
THE COOKIE CRUMBLER

Investor perceptions and companies' hesitation to tap them are already reflecting in the amount of money that was raised from the market.

Fundraising from retail bond issues this year has already halved,



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making it difficult to keep the economy well oiled. About ₹15,688 crore has been raised through 31 issuances this calendar year, down from ₹30,701 crore through 20 issues a year earlier, data from Prime Database showed.

Srei Equipment Finance withdrew its retail bond sale in September after it was downgraded by a notch. IIFL Finance raised ₹244 crore in August against its planned size of up to ₹1,000 crore.

Tata Capital Financial Services raised over ₹2,234 crore in five days in August this year exhausting more than half of its total target size. ECL Finance, a subsidiary of Edelweiss Group, has so far raised about ₹200 crore since the issue opened last week. The targeted total issue size is ₹500 crore. It would remain open up to November 22.

SAFETY FIRST, GLORY IF POSSIBLE

"Retail investors are clearly looking for more of safety rather than chasing yields, especially after the latest series of bond defaults," said Ajay Manglunia, managing director and head of institutional fixed income at JM Financial. "Return expectations have taken a back seat, with bank deposits

regaining some popularity."

In this backdrop, investors may begin to distinguish between the sovereign and the rest.

Power Finance Corporation and its subsidiary Rural Electrification Corporation (REC) are likely to raise up to ₹10,000 crore each via public sale of bonds in the next few weeks, issuances that traders believe might inject a fresh lease of life into the comatose corporate bond market.

THE SECRET GUILD

For an individual, to invest in bonds is riskier than investing in initial public offering of shares by companies because of issues such as availability of information, liquidity, and the opacity of the issuers' borrowings with various lenders with different covenants.

To begin with, unlike the equity market, not much analysis is available to investors on bonds since most brokerages do not track the bond market with as much granularity as they do for equities.

Fixed income markets are extremely illiquid with hardly any corporate bond getting traded on stock exchanges. That makes it impossible for an individual to sell

without sacrificing value.

During times of stress, yields jump even for a minor price sensitive development. Bond yields and prices move in opposite direction. In the recent past, it was evident when yields on the bonds of DHFL, Indiabulls Housing, and ECL Finance rose sharply.

Bonds of Dewan carrying a coupon of 9.25% now quote at 67% yields.

THE MISSING ZEROES

The value of ₹1,000 invested in DHFL is now ₹198.75, BSE data showed. The same gauge for ECL Finance, which sold bonds in May through public issuances, is now at ₹925 apiece indicating massive value erosion.

Reliance Home Finance bonds offered 9.15% at the time of issuance, but there are no takers in the secondary market after a downgrade to default. The value of ₹1,000 invested in such bonds is now ₹270.

Yet another challenge the retail investor faces is his inability to realise that he need not be on par with many other creditors who would have lent to the same company that he also did.

"Nobody is infallible," said Joydeep Sen, debt market consultant at Phillips Capital.

"There is an expectation among investors that once a company is rated AAA, it should never default."

According to a senior financial advisor, who sold DHFL bonds to his clients, retail investors do not have the clout or energy to follow up in case of defaults.

Lenders sew up deals with different covenants that give them rights over the assets of the company when it defaults. Secured creditors get the first right and then the unsecured creditors. Individual investors in most cases don't even realise where they stand in the waterfall.

YIELD AND SALE

Retail bond issuances keep catching investor fancy whenever administered interest rates fall due to the Reserve Bank of India's (RBI) easing cycle when banks cut rates they offer.

It also coincides with the financial markets' squeeze when borrowers are charged a premium by institutional investors and they look to diversify their liability profile.

As companies borrow from individuals, the selling point becomes the higher yield that they offer vis-à-vis the bank deposits, the benchmark for an average saver.

When bonds of companies such as DHFL, IIFL, ECL Finance were sold in the past, the yield differential with State Bank of India's fixed deposit rate was in the range of 180-220 basis points. A basis point is one hundredth of a percentage point.

MISPRICING RISKS

While even professional investors at mutual funds could occasionally get caught on risk assessment as they were in the post IL&FS default, individuals hardly have the specialisation to assess risk.

"Recent events where some entities have defaulted leading to

potential loss to retail depositors highlight the risk associated with retail deposits and that safety should precede the lure of higher deposit rates," said Kaushal Shah, executive director and head financial services at Kotak Investment Bank. "It is imperative for retail investors to analyse and have a better understanding of the financials and standing of such entities."

Apart from yields, distribution by agencies has had its share in promoting bonds to retail investors. As is the practice in the sale of many financial products, there have been false promises from salesmen or not making the risks clear to investors.

RATINGS AND RULES

Other than sales pitches, investors anchor their decisions to invest on the credit rating of the companies. But ratings have become as unreliable as the meteorological department's weather predictions.

"The basic issue is, the dichotomy of interest: the rating agency is paid by the issuer, but the rating is referred to by investors," said Sen from Phillips Capital.

Two of the biggest financial failures in recent memory were IL&FS and DHFL. Both institutions carried triple A ratings until they got into trouble.

Since then, markets regulator Securities and Exchange Board of India (Sebi) has tightened disclosures standards for rating agencies.

In June, Sebi prescribed guidelines, including probability of default (PD) benchmarks in a bid to strengthen the disclosures made by credit ratings companies to enhance rating standards.

More than a month ago, the market regulator came out with new norms that make it mandatory for companies to provide details on delayed loan repayments and possible defaults to credit rating agencies amid concerns over banks citing 'client confidentiality' to resist sharing of such information by borrowers.

Regulators could come up with a set of rules in the form of first right over the assets when a company defaults, which could comfort bond investors. But that would need amendments to the Insolvency and Bankruptcy Code (IBC).

"A stricter covenant, better ratings, lower leverage and strong backings should help, coupled with bond trustees taking a lead in monitoring and being quick in implementing these," Manglunia said.

As regulators and issuers ponder over how to claw back the credibility of the bond market, retail investors may believe they are better off with conventional bank deposits, even if that means being missing out on higher returns. Return of capital trumps the return on capital—at least for now.

"The overall economy has become disruptive to that extent you will see a flight to safety," says Gill of Yes Bank. "Which means customers will put money into banks, put money in government bonds, to that extent I feel raising money through corporate bonds will become that much more challenging."