Emerging Trends in Debt Placements

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Public Offer vs. Private Placement
The Indian debt markets play an important role in the capital formation process and complement the equity markets. There are 2 broad methods by which an Indian corporate can raise term debt from the capital market. The first is the Private Placement market where the Issuer invites a select group of qualified institutional investors to subscribe to bonds / debentures issued. The second method is a Public offer where securities are offered to the Public at large including retail investors. Under Section 117C of the Companies Act, any issue where the number of investors is greater than 49 is deemed to be a public issue. A public issue is governed by the regulations laid out by the Securities & Exchange Board of India (SEBI) where the prospectus has to be vetted by SEBI before circulation to potential investors. Private placements on the other hand are currently outside the ambit of SEBI. In the year 2002-03, there have been only 14 public issues aggregating Rs 5731 crores. In comparision, the Private Placement market saw 485 issues aggregating Rs 48423 crores (for tenor greater than 1 year) and is clearly the preferred mode of raising funds because of its simplicity and speed.

Development of the Private Placement market
In the last 5 years the trend has been for Issuers to move from the bilateral Bank loan market to the capital markets. The aggregate amounts raised (across all tenors) in the last few years is shown in the table below:

Years	Amount (Rs.crore)
1998	30983
1999	38747
2000	55073
2001	62449
2002	59133
2003	70153

Regulatory framework
The Private Placement process itself is outside the purview of any of the regulators. However the market participants have several regulators overlooking their operations. For example Issuers are governed by guidelines of the DCA and the listing guidelines of stock exchanges. Banks are subject to RBI guidelines; Insurance companies to IRDA guidelines; Mutual Funds to SEBI guidelines. Viewed from this perspective, the market is not as unregulated as it seems in the first instance.

Growth prospects
The growth of the capital market has been fuelled by several factors

(a) New investors: The Indian capital market has seen the growth of Private sector mutual funds who are active investors in corporate debt. In addition, the growth of the insurance sector has increased the available corpus of large players like LIC & GIC. With the greater integration of financial markets, we expect that it is a matter of time before FIIs become as active in debt as they are in Equity. One also expects that specialized funds which focus on distressed debt and lower credit rated paper will emerge once investors derive comfort from a stronger legal framework (like the SARFESI act)

(b) Increased role of Banks: Traditionally, Banks have played the role of providing short term (< 1 year) working capital financing to industry while Financial institutions like IDBI / ICICI / IFCI provided term financing. However over the last 5 years, the boundaries between Banks and term lending Financial Institutions have blurred with the adoption of the concept of " Universal Banking ". Banks have therefore increased their appetite for term lending and term investments and are active investors in the Private placement market. The RBI guidelines on private placements (discussed below in greater detail) have enabled banks to derive greater comfort on the adequacy of disclosures. Bank participation in the private placement market will only increase over time.

(c) Increased use of credit rating: An important reason for the growth of the bond market is the role played by credit rating agencies. CRISIL, ICRA, CARE and Fitch are the four credit rating agencies operating in India. Ratings provide a uniform benchmark acceptable to all investors in the process of credit appraisal. In the absence of a credit rating, the process of credit appraisal by several investors would be both laborious and time consuming. Most large Indian issuers have got themselves rated by one or more of the rating agencies. This has enabled the development of the Private placement market. With the renewed emphasis on transparency we expect that rated issuances will become the norm and unrated issuances will become extremely expensive.

(d) Cost effectiveness: The interest rate accessed by AAA rated corporates in the capital market has been significantly lower than the interest rates in the loan markets. Bonds are priced at a spread over the risk free Government of India security for the same tenor. Most Banks provide term financing at a margin over the Prime Lending Rate ("PLR"). The PLRs of Banks have typically been higher than the corporate bond rates thus making the Private placement bond market cost effective. In addition, the favourable tax treatment for investments made by Mutual funds in bonds has helped in making the bond market cheaper than the loan market. We believe that this will continue in the immediate future leading to greater number of issuers tapping the private placement market.

Improved disclosure

In June 2001, the Reserve Bank of India (RBI) issued a circular which specified guidelines for what commercial banks should do in terms of minimum due diligence prior to investing in corporate bonds. The guideline clearly encourages Banks to prefer rated paper over unrated paper. At the same time RBI has clearly stated that rating should not be the only basis for making an investment decision and each bank should convince itself of the commercial viability of every investment proposal. Towards this end, the memorandum of private placement should contain detailed financial projections of profits and cash flows when the final maturity of the bonds issued is greater than 5 years. This circular has caused some amount of uniformity in disclosures made by Issuers.

Impact of proposed SEBI changes

There have been some discussions on how the Private placement process can be improved without compromising on the significant benefits afforded by the same. Towards this end, the secondary market advisory committee of SEBI has laid out a discussion paper on the SEBI website and sought market feedback. One of the key changes is to make the disclosure for private placements to be on par with the DIP guidelines prescribed by SEBI for public issues. I believe that increased and improved disclosures are good for the healthy development of the market. At the same time, if disclosures are made as onerous as that specified in the DIP guidelines, it will have adverse consequences for the market including a steep fall in issuances. Various market participants have provided SEBI with their views and it is expected that SEBI will come out with final guidelines that will help in the orderly growth of the markets.

2002-2003 trends

The aggregate amount raised by Issuers in the period April 2002 to March 2003 was Rs 48423 crores, out of which the Private Sector accounted for 21 %; PSUs 26 %; Financial Institutions 36 %; State Level undertakings 17 %; [Source: PRIME]. State government issuances are on decline. AAA issuers accounted for over 60 %; AA+ 10 % while AA and below accounted for 30 %. This clearly shows a polarisation of investor preference towards the higher rated issuers. Most of the issuances have been in the 3-5 year bucket. Issuers raising greater than 5 year money have been few and far between.

Dematerialisation

The year also saw the RBI making dematerialisation mandatory for all corporate bonds. The SEBI secondary market committee has also recommended that dematerialisation be made mandatory. A concerted effort by NSDL to move from paper based instruments to an electronic form found favour with all market participants. This has made the settlement process easier. In addition it is also more cost effective since secondary transfers of instruments in demat form do not attract stamp duty. One of the basic building blocks for increased secondary trading is therefore in place.

Post disbursement monitoring

One of the irritants which has been plaguing the market is the inordinate time that some Issuers take in creating security over fixed assets. The RBI has also instructed banks to closely track the security creation process post disbursement. Should security not be created in the time frame laid out in the Information Memorandum, Issuers are liable to pay penal interest @ 2% over the coupon rate. In addition, the Board of Directors of the Issuer are also liable should the Issuer not comply with the terms of the issue. This has made the role of a debenture trustee extremely important. This is a step in the right direction, which will ensure that the Private placement grows in an orderly, disciplined fashion.

Innovative instruments

A notable feature this year has been the growth of the Securitisation market. There have been Mortgage backed securitisations by Issuers like LIC Housing Finance, HDFC etc through the NHB Trust and issuers like Citibank through a special purpose company. There have also been securitisation of commercial hire purchase receivables by Issuers like Citicorp Finance, Ashok Leyland Finance and TELCO among others. This market is expected to grow over the next few years.

Credit enhancement through partial credit guarantees has been another area of growth. In the last year, IFC (a multilateral institution) and FMO (Dutch development financial institution) have partially credit enhanced issuers like Bharti Televentures and Ballarpur Industries. This has enabled lower rated issuers to derive the benefits of a capital market issuance namely extension of tenor and lower interest costs. The increasing interest of multilateral agencies and international development institutions in developing the Indian capital markets augurs well for Indian corporates in terms of an alternate funding source.

A common thread in all structured products is packaging of risk to ensure that different market participants can assume risks that they are comfortable with. In earlier years, if a Company wanted to avail credit from a multilateral institution, it had to be denominated in foreign currency. The issuance of rupee guarantees by IFC and FMO is a recognition that Rupee denominated borrowings are a better mechanism compared to dollar denominated debt for companies whose revenues are largely in rupees. In other words the nationality of the institution assuming the credit risk and the currency of the borrowing need not necessarily be inextricably interlinked.

New Issuers

The ample liquidity in the Indian financial system will provide a fillip for international issuers to tap the rupee markets. It is believed that some of these international issuers like IBRD and ADB have the necessary regulatory approvals in place for an issuance of a rupee bond and are waiting for an opportune timing for raising money. As and when these issuances happen, it will help in deepening the private placement market.

Secondary market

While the Primary market has grown by leaps and bounds, the same cannot be said for the Secondary market in corporate bonds. Trading volumes are limited to Rs 50-100 crores per day and is largely in the AAA rating category. There are 2 reasons for the limited participation in the secondary market (a) Many investors particularly Banks, Provident funds and Insurance companies are Hold to maturity investors (b) Investors who would like to trade prefer to trade in GoI securities rather than corporate bonds since the GoI security market is a deeper and more liquid market

Way forward

The Indian private placement market has come a long way since the early nineties. However it has a long way to go before it can reach the size and depth of international markets. One of the bug bears of the corporate bond market is the relative lack of liquidity compared to GoI securities. This is in a sense a self fulfilling problem – when every investor believes that the market is illiquid, the market does indeed become illiquid. A liquid market is the only true method of price discovery. I do look forward to a day where repos are permitted in corporate debt; as also to a day where there is active market making in corporate bonds. Both are key to ensure that liquidity in corporate bonds is enhanced from prevailing levels. This is also an imperative to reduce the cost of entry and exit (Bid / Offer spread). In my view there are several ingredients to ensure sustainable growth of the Indian debt markets (a) larger number of participants (professional fund managers for PFs, private insurance companies) (b) wider variety of permissible instruments including derivatives (c) dynamic investors who are constantly reviewing the portfolio performance (d) Issuers who believe in being investor friendly by ensuring adequate disclosures and being transparent both pre and post disbursement. Lastly while regulation by a market regulator is important, each market participant should embrace the principles of self regulation, fairness and transparency to ensure the long term vibrancy of the Indian debt capital markets.