Domestic & Overseas Debt Raising By Indian Corporates – New Challenges

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As India prepares to integrate with global markets, it is necessary to have strong and efficient financial markets manifested by liquid debt and equity markets. The market should facilitate and represent trading in corporate securities (instrument) across a wide range of maturities and credit rating. Enacting market friendly laws that give direction to the market, pragmatic regulation to put enabling systems in place for healthy development of the markets, transparent dealing and settlement systems, robust infrastructure, efficient movement of funds and research, sales and distribution capabilities enable development of vibrant capital markets. This in turn helps in developing confidence among the various market participants, viz., issuers (borrowers), investors, traders, intermediaries, etc. and their active participation provides depth to the market. Besides transparency and liquidity, the systems should provide for intrinsic controls and balances to mitigate systemic risks and, thus, prevent system failures. While India has taken steps in right direction to reform the financial sector a lot still needs to be done in the area of capital markets, particularly opening them further and ultimately integrate them with global financial markets. In the following paragraphs it is proposed to take a look at some of the challenges before Indian corporate in raising the debt, domestically and overseas.

Internationally, bond markets are much larger with turnover being many times that in the equity markets. However, in India, traded volumes in the debt market are not only low as compared to the equity markets, it is also predominantly contributed by the trading in government securities. An efficient bond market can help the corporates optimize their cost of borrowing with access to large investor base.

Trading in corporate bonds market in India comprises mainly the privately placed bonds of Financial Institutions and highly rated Public Sector undertakings. Trades in corporate Bonds rated below 'AAA' or 'AA+' are few and far between and they do not really have a market. Efficient bonds market provides a transparent mechanism of pricing a corporate credit irrespective of credit rating, even for a junk paper and also depth of investors with wide options for the corporates to raise money. Moreover, apart from financial sector viz. Banks, Insurance Companies, PFs, Mutual Funds, etc. ideally the retail sector should also be persuaded to look at corporate bonds as savings instruments, a pre-requisite for which is easy liquidity.

In the wake of some of the leading Development Financial Institutions (DFIs) transforming into commercial Banks, the long term domestic debt for projects is being financed by the Banks who have limited long term funds and work on the principles of minimizing the asset liability mismatch. Moreover, with the proposed implementation of Basle-II, the banks will have to provide more aggressively for market risk and valuation issues become crucial tempting them to manage the portfolios with lower duration. In such a scenario, the long term bonds so necessary for funding infrastructure projects would have a limited basket of investors, ie; Insurance Companies and pension funds. This may show up in an inherent liquidity issue in the secondary market for such papers.

During FY2002 to FY2004, the Indian debt market witnessed unidirectional downward movement in yields. However, ever since the yields started rising, the corporate bonds market has become dormant mainly due to valuation concerns due to which the bond pricing does not reflect the liquidity in the market and term loans of similar maturity are available at even lower coupon. This is clearly an anomalous condition and needs to be corrected. Perhaps it would be desirable to look at the need for valuation of loan book also so that interest risk perception is the same for loans and bonds.

While a number of Mergers and Acquisition (M&A) transactions are being witnessed in India, Leveraged Buy-Outs (LBOs) are yet not common and the restriction on the banks to fund M&A transactions in private sector continues to be a point of debate.

During the year 2004 and year 2005 (till date), large amount of debt has been raised by the Indian corporates from overseas markets. While a large proportion has been in the form of Foreign Currency Convertible Bonds (FCCBs), the same has been supported by the buoyancy in the domestic equity markets. Going ahead, the appetite for the same would depend not only on the fundamentals of the corporates, but also on the overall performance of the Indian economy and the equity markets.

ECB is an attractive option for highly rated large corporates. However, raising ECB is not easy for other medium / small sized corporates. This can also be attributed to the legal and regulatory framework including the bankruptcy laws and recovery procedure in India which have been a concern for the overseas lenders.

ECBs have been mostly available for an average maturity of 5 years with the maximum tenor of 7 years as 5 years segment is the most liquid in the market with widest investor acceptance. This may lead to a refinancing risk for the projects requiring long tenor loans.

Offshore Borrowings in the form of ECBs usually carry floating interest rate linked to LIBOR. This brings interest rate and foreign currency risks on the Balance Sheets of the borrowers. It has been witnessed that the derivatives market in India do not have much depth and the options available to corporates (other than some of the biggest business houses) are not very transparent in terms of pricing. Recently, the RBI has also stipulated restrictions on the use of MIFOR which was one of the most commonly used tool for hedging the interest rate as well as foreign currency risks by corporates in liability management.

Most of the Indian corporates have been passively managing their currency exposures. As India moves towards full capital account convertibility and the economy integrates more and more with the global markets, various economic developments in the large globalised economies, such as USA, UK, Euro zone, etc., may have significant impact on the inflows and outflows and value of Indian Rupee. This would require the corporates to have more comprehensive risk management policies and an active management of their balance sheet with respect to the interest rate and currency exposures.

As we have been witnessing over last more than a year, a number of Indian manufacturing companies have been acquiring companies or units abroad. It is expected that more Indian corporates (not only in the software services but also in manufacturing and other services) may become truly global players with significant market presence in their product area. However, the success may be a result of not only managing product portfolio, but efficient management of risks, particularly those related to financing and liability management.