Debt Private Placements

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There has been an exponential growth in the amount of debt raised through the Indian capital markets in recent years and private placements have been the preferred route of most issuers. Today, private placements account for nearly 95% of the debt mobilisation in the capital markets with the volume of raising increasing by 180% in the past three years.

The expansion has been aided by key structural changes and reforms in the past few years such as:

- banks being permitted to invest without any limits in debentures issued by private sector corporates as compared to a limit of 5% (of net incremental deposits) applicable earlier. This has significantly increased the volume of debt raised by private sector corporates through the debt private placement route.
- Provident Funds being allowed to invest a large portion of their accretions, hitherto invested only in government securities and bank deposits, into bonds issued by Public Sector Undertakings and Development Financial Institutions.
- RBI gradually reducing the cash credit component and substituting it with a loan component in bank financing, thus encouraging corporates to look to the debt markets for raising funds.
- Debt mutual funds offering a number of tax advantages leading to their growing popularity.
- Foreign Institutional Investors being permitted to set up dedicated 100% debt funds for investment in Government and Corporate Debt.

Advantages of a Private Placement

Private placements have become the preferred route of fund raising as they offer a number of distinct advantages over a public issue:

- The entire resource raising exercise can be completed in a much shorter time span as compared to a public issue.
- The funds are also utilised more efficiently as they are available to the issuer earlier and the investor starts earning interest almost immediately.
- Pricing is more accurate as it is done at the time of the launch of the issue. Also, due to the issues being limited to institutions or large investors, book building can be effectively employed in private placements, giving both the investors and the issuer the benefit of a true price.
- Private placements also offer the issuer the flexibility to alter issue terms in the light of dynamic market conditions. This is of greater importance now since the debt market after the deregulation of interest rates is naturally witnessing greater volatility.
- A private placement can cater to specific investor needs and issuer preferences. This encourages the development of new products like floating rate instruments, Tier-II or subordinated debt for banks and institutions, securitised products etc.
- In the absence of advertising, the costs of a private placement are also much lower. Since the placements are limited to semi-wholesale and wholesale investors the expense for printing and registrars are also limited.

The high costs involved in a public issue make it cost ineffective to use this route for meeting short-term funding requirements. Private placement on the other hand will offer issuers a market for their short term requirements and investors an alternative to bank deposits.

Emergence of Bookbuilding as the Favoured Mechanism for Price Discovery

Bookbuilding has emerged as a strong vehicle for price discovery, giving both the issuer and the investor

> **IPCL Bookbuilding: A Case Study**
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> *The IPCL Bond issue was the first "true" book-building in the Indian debt market with a "price discovery" where investors got an opportunity to determine the final pricing on these bonds. Investors were initially required to submit their interest levels at various coupon rates. The cut-off coupon level was determined after aggregation of investor demand at different levels.*
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> *The spread of response across investor segments demonstrated investor receptivity to the Bookbuilding concept. IPCL had the option to retain the issue size of Rs. 300 crore at 14.15% or retain Rs. 450 crore at 14.20%. IPCL weighed the option of retaining the oversubscription of Rs. 150 crore at an incremental cost of only 0.05%. In IPCL's considered view, the benefit of retaining the oversubscription out-weighed the marginal cost.*
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> *Response in this issue demonstrated investor sensitivity towards even a 0.05% difference in coupon rate. As the bookbuilding process is the only way to gauge such fine differences in sensitivity of demand, issuers would stand to benefit from adopting this process*

a "true" price. Private placements involve placement with institutional, wholesale and semi-wholesale investors as against a public issue which involves placement with widespread retail investors. Bookbuilding has become an established process for efficient pricing and allocation.

NEED FOR FURTHER REFORMS

Even though there has been significant growth and development in the debt market over the past few years, there is need for further reforms which would add to the depth and vibrancy of the markets. In order to sustain high levels of industrial growth, there is an urgent need for large investments in various sectors, particularly the infrastructure sector. A large quantum of this funding would be in the form of debt raised from the capital markets, especially the private placement market.

For the private placement debt market to serve its purpose effectively, there is a requirement to streamline the process of fund raising further and bring down the costs of borrowing. Presently, the debt market is segmented and illiquid resulting in high cost of public and private sector borrowing.

Lack of Liquidity

The following table illustrates the difference in liquidity in the US and Indian Government Securities markets:

Country	Percentage of total outstanding Government Securities traded daily
US[1]	6.2
India	0.25

1 Public Securities Association (PSA) estimates

Liquidity of a market is not a measure of trading volumes and number of market participants. Liquidity is evidenced by the way markets react to news and change in fundamentals, the spreads quoted over a long period of time and the maximum trading size possible without moving the price. In fact, liquidity is essential to market confidence, volumes and ensures the most cost effective borrowing terms for issuers. Liquidity also contributes to the development of the market to accept longer maturities and new derivative structures which provides issuers with improved financing flexibility.

Some suggestions for improving liquidity in the markets are:

- Currently each State imposes a stamp duty on transfer of debentures. The rates of stamp duty differ from State-to-State and rates are as high as 5% in some states. This hinders active trading and market-making in debentures. Stamp-duties on transfer of debentures should be removed and these instruments should be dematerialised.
- There is a need for the introduction of market makers. To do this, market intermediaries should also be allowed to access credit at cheaper rates. In India, access to credit by intermediaries is limited and costs are high. There are also limits on the volume of business an intermediary can do with a bank/mutual fund. These artificial limits should be removed as this would increase competition and service standards in the industry
- There is also a need for allowing repo transactions in a larger number of securities and allowing more participants in the repo market
- Existing participants like nationalised banks should be encouraged to actively trade in securities. Banks should be required to mark their entire portfolio to market prices. They should also be encouraged to establish efficient trading operations and develop internal accounting and risk control systems
- Market players should be allowed to go short. There is also a need for the development of an active interest rate futures and derivatives market. These markets will allow market participants to hedge their interest rate exposures. They will also allow traders to create positions tailored to their forecasts and allow market makers to hedge the interest rate risks on their inventories, thereby allowing them to hold larger positions.

Segmentation of the Market

The debt market is currently highly segmented with investments by market players subject to differing regulations. A typical private placement issue by a private sector corporate would be placed with commercial banks, corporates, regional rural banks, institutions, mutual funds and insurance companies. On the other hand in addition to these segments a public sector undertaking can access funds from provident funds, trusts, co-operative banks etc. Further, there is a stamp duty on transfer of debentures issued by private sector corporates which is not there in the case of public sector undertakings affecting liquidity of the instruments.

These factors lead to distortions in pricing as spreads are not truly based on credit risk of the instrument but are influenced by other factors. Some suggestions for reducing such distortions are:

- Provident Funds and co-operative institutions should be required to invest in debt securities meeting a minimum rating threshold instead of differentiating based on ownership. They should also be allowed to invest in mutual funds investing in securities meeting this criteria.
- Blanket permission needs to be given to Public Trusts to invest in highly rated paper. Presently they need to take approvals on a case-to-case basis.
- Stamp duty on instruments should be rationalised.

Future Trends

Going forward, the private placement route is expected to continue to be the preferred mode of fund raising for issuers. There is likely to be an overall expansion of the market and new classes of issuers are expected to emerge; state governments and municipal corporations will directly access this market for funds. At the same time, securitisation will also bring banks, housing finance and consumer credit companies and other issuers into the market for their refinancing needs.

The large demand for funds from the infrastructure sectors are also expected to be partly met through fund raising in this market.

There is also likely to be greater issuance of floating rate debentures. Debentures linked to the Bank Rate, Treasury Bill auction rates, Bank PLRs, Bank fixed deposit rates etc. have already been issued. There was also a recent issue of bonds linked to the Mumbai inter-bank overnight average rate reported by Reuters. The development of a benchmark on the lines of LIBOR should be encouraged to assist the issuance of floating rate debentures.

Currently, in the Indian markets there is appetite only for investment grade paper and most of the investors insist on a formal rating before investing. With the increase in the number and type of investors, it is expected that in future issues of lower credit quality like greenfield projects may find a niche with investors.

The market's growth has also been supported by greater degree of reliable information about issues, investors and market conditions. On-line news service agencies like Reuters provide information on market rates reported by participants. Listing of private placement issues on stock exchanges like the National Stock Exchange and reporting of trades allow market participants to get information on secondary market rates. Information service agencies like PRIME Database has extensive coverage of issues in the private placement market providing information and insights on the trends. As information in the private placement market has generally not been available to all participants, such agencies are serving a useful purpose. They are expected to perform an important role in the further growth and sophistication of the market.