Can high yield bond markets fund growth capital?

Rakesh Singh
Group Head-Investment Banking, Capital & Commodity Markets
HDFC Bank Ltd.

Last few years have witnessed rapid growth in investment in tax free bonds and fixed maturity plans of Mutual funds particularly when Indian equity markets were range bound. As per estimates as of 31st March 2014, cumulative AUM under equity schemes was just over Rs. 186000 crores whereas investment in FMPs was around Rs. 136000 crores. The shift from equity investments in favour for tax free bonds and FMPs indicates that investors opted for greater certainty of returns. Further, it is generally assumed that investors allocate their wealth across debt, equity, real estate and gold and this allocation is usually a function of their risk appetite and return expectations. If this assumption were to be true, investors should have continued their allocation to equity schemes in the last couple of years too and made handsome returns in the current markets. However, this is indeed not the case as many investors opted out of equity markets and preferred to increase their allocation to FMPs and tax free bonds. I understand that most investors sold their existing holdings in the recent market rally and are now making a re-entry into equity markets. We can therefore conclude that investment decisions are driven by certainty of returns and investors do adopt a dynamic asset allocation strategy.

On the other hand, companies raise capital either by way of debt or equity to fund their business plans. Companies raising debt financing from banks are required to provide security of fixed assets, current assets or alternate collateral and the end use of the funds has to meet stipulated regulatory requirements. Generally in most cases, the initial stage of capital intensive business is mired with losses and in such cases promoters raise equity to fund these losses. Nevertheless, after a couple of rounds of equity has been raised ie Series A, B and even C, the overall business begins to take shape. At this stage, it has a certain value represented by its EV (Enterprise Value). Subsequent rounds of equity financing are raised at EV estimated by equity investors who generally bid for financing these business. If the said business has value, why cannot the company raise debt collateralized by shares that represent this value comprising the underlying business. If the answer is yes then it obviously represents a higher risk than the usual corporate bonds and falls in the category of high yield bonds. These high yield bonds as and when issued by corporates can be used to fund growth, particularly corporates in the asset light sectors like Media where asset financing is not possible.

A high yield bond is thus collateralized by shares of the company and may be listed on stock exchanges. Investors will most likely expect higher yield on these bonds ranging from mid to high teens depending on the stage of the business and the risks involved. There bonds may be issued in the nature of deep discount bonds so that they do not pose cash flow challenges to business in the growth phase. The preferred tenor of such bonds may be 3 to 5 years with an option to the investor and/ or the issuing company to convert these bonds in equity. Conversion of bonds into equity can be made optional such that the party seeking conversion pays a suitable premium in expectation of higher future returns. In effect, if the company were to seek conversion into equity, then the conversion may be at a discount to Equity Value of the business at the time of issue of these bonds and vice versa. High yield bonds generally stipulate covenants based on the business plan and failure to meet these covenants may lead to an Event of Default (EOD). In such circumstances investors may opt for enforcing security to take control of the business in order to salvage value and recover their monies. Ability of swiftly enforce security, sell the business and recover monies will hold key to maximizing value. It may also be worthwhile to consider whether a high yield bond investor enjoys that same security enforcement rights that are available to banks under SARFESI so that timeliness of action can help maximize value for investors.

As investments of this nature require deeper understanding of business and involve higher degree of risk appetite, it may be worthwhile to open the high yield bond market to QIBs and HNIs. Similar instruments are already in vogue in the real estate markets where investors are putting money in high yielding instruments backed by mortgage of construction properties. Further, listing of these instruments does help in periodic dissemination of company information to investors. On the lines of FMPs, investors can participate in dedicated schemes meant to fund a single asset through dedicated schemes launched by fund managers as investors may not be keen to partake in multiple assets. If we can establish an initial market for such bonds, then the promise or expectation of earning mid to high teen returns will get due allocation from investors as the market grows. A thriving high yield bond market will help investors to accept a wider spectrum of risks in anticipation of higher returns. Investors who shy away from equity markets may also opt for higher yielding bonds in anticipation of making returns lower than equity but more than high grade bonds. Listing also assures liquidity in addition to regular dissemination of information. Further, failure to adhere to listing guidelines imposes penalties on the company and its key managerial personnel as per the listing guidelines and is a strong disincentive as it erodes value for the promoters and the management team. An ecosystem that enables issuance of high yield bonds with will thus pave way possibly to fund successful asset light companies in the media and consumer internet domain like Flipkart, Myntra etc. and introduce another asset class. In this era of thinking out of the box, can the regulators look at this favourably?