'Role of Mutual Funds in Corporate Bonds market'

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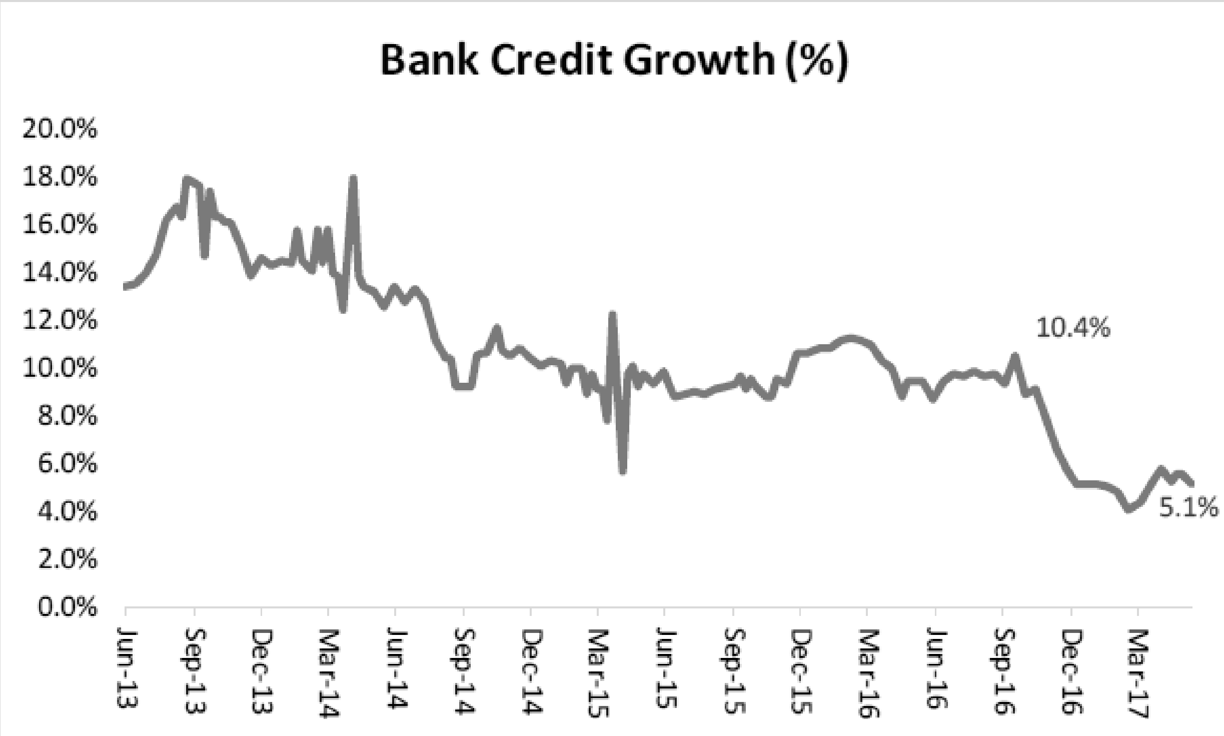
Bond market plays a vital role in mobilisation of the latent resources of the nation towards capital creation, asset building and wealth generation. For this reason, the need for a well-developed corporate bond market is vital in nation building and economic growth. The equilibrium of profit-motive of the borrower at the one end; and that of obtaining the best interest rate possible for the lender at the other; results in an efficient price; and a more effective allocation of resource. This in turn fuels entrepreneurship on ground, job creation and the whole economic cycle takes off. Thus, an efficient, deep and well developed corporate bond market serves an important function.

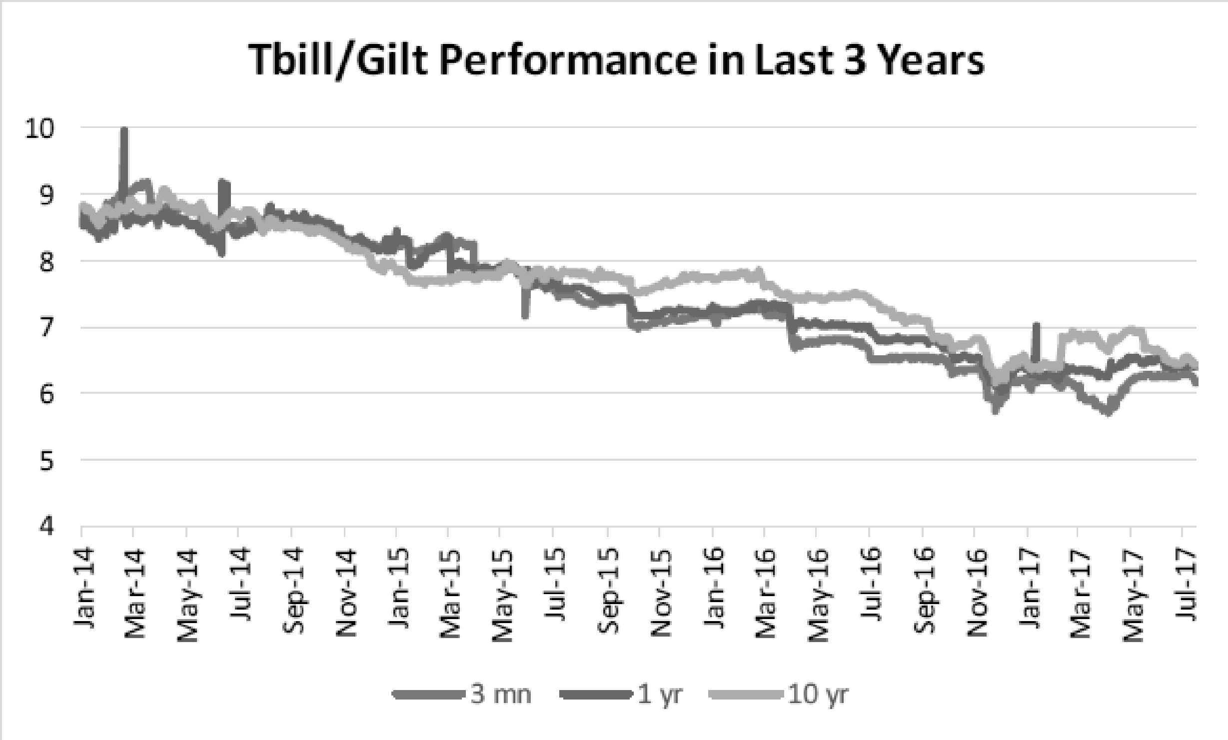
In India, while the growth of the corporate bond market has been impressive, it still remains overshadowed by the larger gilt market in size, activity, liquidity and participation. However, the situation may have begun to change slowly. The declining fiscal deficit as percentage of GDP is increasingly allowing for substantial savings to be channelled towards commercial activity; and a portion of which is also moving into the corporate bond market.

Moreover, the high NPA levels in the Indian banking sector have led to risk aversion. At some PSU banks the NPA exposure is in double digits of total asset. This has led to near halt in the lending activity as many banks have become apprehensive.

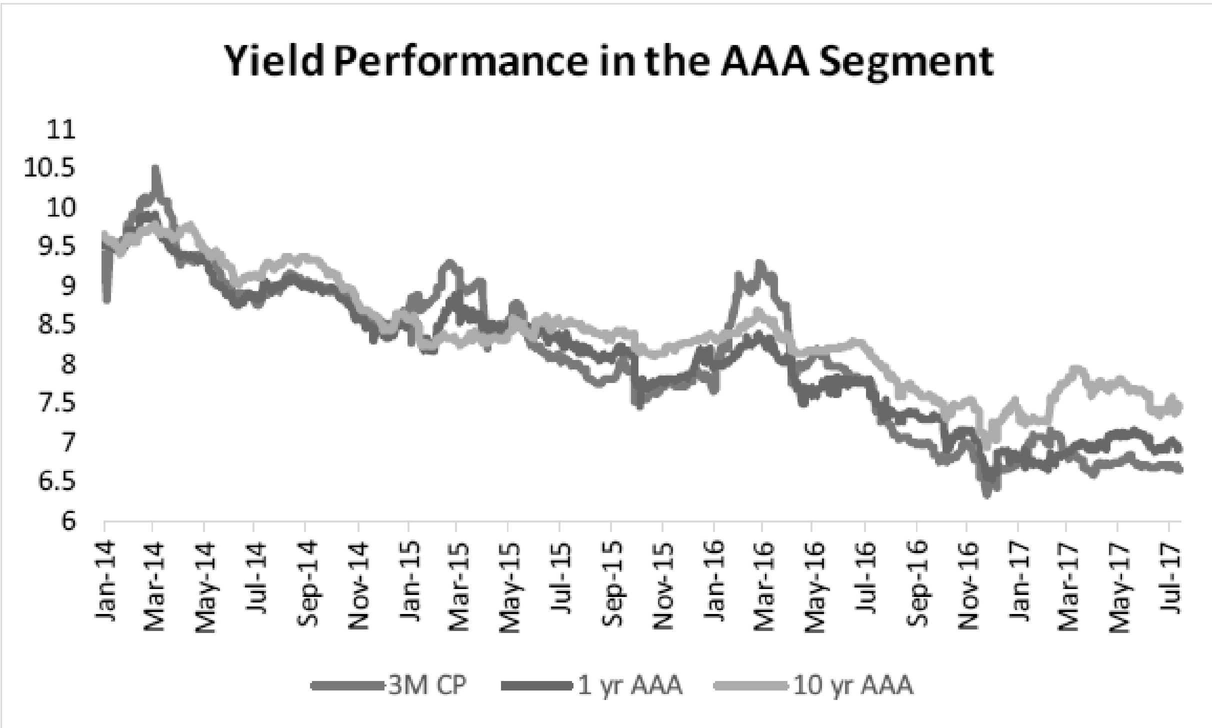


The NPAs as reported by PSU banks till Dec-16 stood at around Rs 6 lakh crore. The consequent slowdown in the lending on one hand and continued deposit inflow at another has led to one of the lowest credit growth. In fact, the credit growth of 5.08% yoy is the lowest in six decades.

But the interesting fact is that this decline in credit growth rate is also partially attributable to the rise of corporate bond market as the alternative source of funding. Corporates are increasingly tapping the bond market for their working capital requirement as well as for their intermediate requirements. The risk aversion in the banking sector and the declining cost of capital in the general economy has incentivised this borrowing for the corporates.



For a perspective, the 10 year gilt has declined from 8.8% in Jan-14 to around 6.4% in July-17. This 240 bps compression in three years on back of sharp deceleration in CPI inflation has brought down the cost of borrowing and has also raised the real interest rates. Similarly, the yields in the AAA bond segment too have declined, albeit not all too rapidly as in comparison to gilt. Yet the compression in 10 yr AAA is by around 200 bps while that in the 3 month Commercial Paper (CP) segment is at around 257 bps. The 3 month CP is currently trading at around 6.6% while the 10 year AAA is at around 7.45%. This compression reflects the quantum of reduction in the cost of capital for the companies; making debt market an attractive avenue for corporates to raise capital.

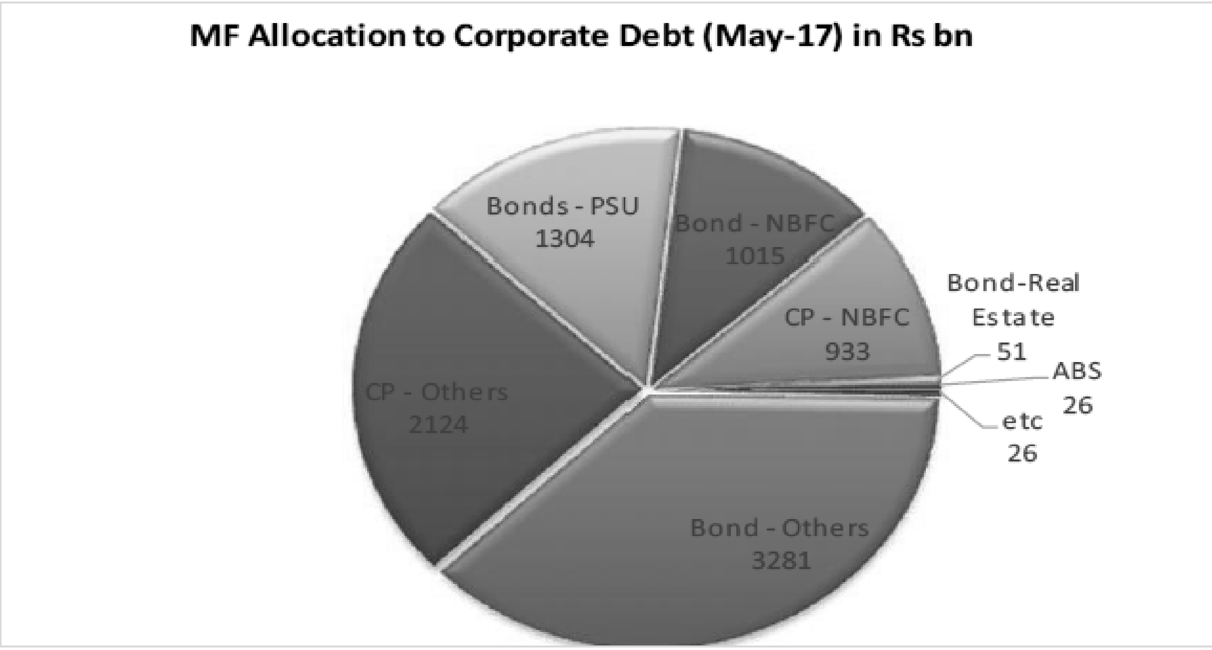


As a consequence, we are seeing financialisation of savings; with much of physical savings now flowing into Bank, mutual fund, and direct equity products. The process is likely to pick more pace; what with the cumulative impact of demonetisation, GST implementation and digital economy providing a simultaneous push for a more formal economy.

As is visible, in the last 1 year (June16 – June17), the corporates have issued NCDs of around Rs 6 lakh crore. There were around 8600 fresh issuances while the total corporate debt outstanding was at around Rs 24.81 lakh crs. On the basis of outstanding debt, the corporate debt segment has grown by around 18% cagr over the last three years. This is indicative of the spurt in activity in this segment.

On the other hand, the Mutual funds have emerged as one of the major sources of funding for the corporate debt. Over the past 1 year, mutual funds have allocated around Rs 2.54 lakh (May-16) to corporate debt. That is over 40% increase in allocation from same period in May-16.

Mutual funds have allocated significantly over the last one year into both bonds and CPs. Over the last 1 year (data as on May-17), the allocation by mutual funds into the CPs has increased by around Rs 59000 cr. Likewise, in the corporate bond segment, the incremental allocation is of around Rs 194,000 cr during the last 12 month period.



The point is: while the credit growth in the banking sector is limpid, the credit growth through surrogate means is taking place. And mutual funds seem to have emerged as the leading fund provider. We believe that this role of the mutual funds is only likely to grow.

The mutual funds industry presently (end June-17) stands at around Rs 19 lakh crore. A year ago the average aum was at around Rs 14 lakh crore. In percentage basis, the mutual funds as an industry has grown by 35% yoy. This kind of growth only highlights the rising interest amongst the larger Indian investor towards mutual funds. We believe that this shift towards mutual funds would continue to rise in the coming period. As a consequence, mutual funds may emerge as one of the key lenders for Indian corporates.

Already, the resources that the mutual funds are pouring in into their credit analysis and research desk is noteworthy. As the corporate assets with mutual funds rise, the analytical and allocation-making component of the mutual funds would become increasingly important for all the stakeholders.

Having said that, despite the size of the exposure to corporate debt, Indian mutual funds have managed to maintain credit quality. This awareness for asset quality and serviceability while also pursing performance; will increasingly attract more and more retail investors towards credit-oriented (STP/accrual/bond) mutual funds.

In a way, the mutual funds are providing a proxy route for the retail investor to invest in the corporate debt; which otherwise has high entry barrier and is quite complex for an average investor to configure individually. We believe that this intermediation of the mutual fund industry would bring in fresh skill and perspective (along with the money) to the corporate bond market and would help in more effective and responsible capital allocation over the long term.