Corporate Bonds – The Changing Landscape & Potential Game Changers

Ajay Manglunia
Co-Head-Fixed Income Advisory
Edelweiss Securities Ltd.

In terms of absolute size, the Indian corporate bond market rivals the huge government bond market at 50% of the latter's size. However it is dwarfed in comparison to the bank credit market. Moreover, the distribution of outstanding bonds is still skewed towards public sector entities and companies from the financial sector. These anomalies are slowly but steadily being rectified as both corporate India and institutional investors are converging onto the corporate bond landscape as never seen before. FY17 was a watershed year for corporate bonds as both primary and secondary market activity took off from the dormant growth patterns of the previous few years. The ball was set rolling on the much awaited corporate bond reforms as well in this year by the RBI. However, FY18 was witness to a loss of this momentum as concerns emerged on the macro front and the yield trajectory underwent a sharp reversal. When we look back on this period at some point in the future, it will appear merely as a blip on the Indian corporate bond success story. While there is no doubt that we are on the path to this success, the journey can be accelerated by focusing on a few key game changers, particularly in the form of reforms and evolution of investment approaches. Some of these big themes are already playing out and will gain greater impetus over the next few years if monitored appropriately and facilitated by the various stakeholders.

SUPPLY SIDE

- Migration from bank credit to bond market to continue
  The corporate bond market has grown at a 5Y CAGR of over 16% compared to bank credit growth of 10% and the YoY growth rate has been even higher for corporate bonds in recent years. However, in absolute terms, the corporate bond outstanding is at about INR 28 tn which is merely 1/3rd the outstanding bank credit of INR 86 tn. This skew is undergoing a slow but gradual correction and the transition will gain further momentum as the large borrower framework kicks in. Issuers from non-financial sectors will have to play a crucial role here as they tap the more efficient bond markets for their incremental financing needs as well as switch part of their existing borrowing from banks. Another key benefit of this migration will be the more uniform distribution of credit risk, thereby easing the pressure from stressed bank balance sheets.

- Public issue of bonds to gain prominence
  Bulk of the bond market capital raising is still heavily skewed towards the private placement route although the public issue market has seen a handful of big ticket marquee issuances over the last couple of years. Issuers are gaining increased awareness about the benefits of public issuance (investor diversification, secondary market liquidity, etc.) and hence showing preference for this avenue. FY17 was a blockbuster year for public issues but it was followed by a dry spell in FY18. The segment has bounced back strongly in FY19 with NBFCs able to raise almost INR 190 bn in the first quarter and a strong issuance pipeline waiting in the wings to tap the market through the year.

DEMAND SIDE & LIQUIDITY

- Corporate Bond Repo
  The Reserve Bank of India has taken several measures to develop and deepen the corporate bond market. One of the big measures introduced is Corporate bond Repo, whereby an entity can pledge corporate bonds with another entity to raise funds. The entity, who makes pledges, will also agree to repurchase the bonds at a specified price. Repo platforms have been recently launched by the leading exchanges for tripartite repurchase of corporate bonds. The repo mechanism should improve liquidity and appetite on the lines of the G-Sec market as large borrowers will be pushed to corporate bonds. The measures will give a boost to both demand and supply for Corporate Bonds. While the exchange platform has been launched, the regulators need to monitor the activity regularly and ensure sufficient momentum right at the outset. The market feedback needs to be incorporated swiftly and the platform should be rolled out to other major investor categories like NBFCs, corporate treasuries and even to FPIs at some point. Once the repo market is established, the enhanced liquidity scenario can set the platform for the development of the dormant CDS product as well as aid the introduction of hedging tools for corporate bonds on the lines of the bond futures market for government bonds.

- Relaxation of Rating Restrictions
  The Union Budget 2018-19 proposed a relaxation of the Investment threshold of the rating framework from "AA" to "A". This measure, once implemented, will firstly remove entry barriers for lower-rated corporate

credit. Small and lower rated borrowers were so far majorly accessing the loan route through banks to raise funds. With lower credit getting acceptability, such borrowers can also access the more efficient bond market which will help issuers to get better pricing. From the investors' perspective too, the relaxation provides avenues to assess credit independently and thereby diversify their holdings & enhance portfolio yields. Pension funds and insurance which are amongst the biggest buyers of corporate bonds will have access to a much wider universe post this relaxation. The second-round effect of this move will be enhancement of the overall market liquidity as new players enter the market.

- Diversification of Investor Base to Retail & Foreign Portfolio Investors (FPIs)
  The above mentioned demand and supply side evolution will eventually be accompanied by much higher involvement of retail and offshore investors, akin to the participation in the equity markets. FPIs in particular hold less than 7.5% of all corporate bonds outstanding, despite the size of the market in comparison to other Emerging Markets where their holdings are much more sizable. As the regulations are streamlined and underlying market liquidity improves across the credit curve, the comfort levels of FPIs will go up and coupled with the sound macro story, sizable, consistent flows are inevitable. At some point in time, India will be added to the key global bond indices and this will drive up the flows exponentially. Coming to retail participation, the level of awareness and appetite is evident from the response to public issues so far. As the government's efforts towards financial inclusion and digital India gain further thrust, the retail investors will look beyond the traditional investment options like fixed deposits, small savings schemes and gravitate towards the more attractive yields in retail segment of corporate bonds.

Role of technology as a disruptor & facilitator

As with a host of other sectors, the bond markets will also undergo a dynamic shift once technology is embedded into regular trading, execution, issuance and research. The secondary corporate bond market is largely voice driven due to its OTC nature, but with the emergence of data and analytics driven tools, the markets will be much more different as compared to what we see today. Data will be a powerful tool in the hands of investors and will facilitate informed, sophisticated decision making. It will facilitate the transition to a transparent, efficient market which will accelerate the achievement of the above mentioned objectives of liquidity and diversification. The quick adoption of technology is contingent on the development of robust underlying architecture and infrastructure under the able guidance of the regulators and with the full-fledged participation of the major market participants & stakeholders.