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Real Returns

Five things to check out before buying NCDs

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Non-convertible debentures come with high returns, but carry high risks too

It is not just equity IPOs (initial public offers) that are seeing boom times lately; public offers of non-convertible debentures (a fancy name for bonds) are seeing a scramble from retail investors too. An NCD offer by Indiabulls Housing in mid-September was subscribed two times over. A ₹4,000-crore NCD issue from Dewan Housing Finance in August raked in applications worth ₹18,000 crore. In the last six months, Indian companies are said to have raised ₹24,000 crore via public NCDs against ₹1,500 crore at the same time last year.

With interest rates on bank fixed deposits tumbling to 7 per cent levels, investors seem to be chasing NCDs for their higher interest rates of 8.5 to 10 per cent. But these returns, they must note, come with higher risk to their capital. Here are five things you must check before bidding for an NCD.

Is it genuine?

Yes, debentures are today a popular mode for mainstream NBFCs to borrow from the market. But they're also a favourite with Ponzi scheme operators. It was through the issue of illegal 'Optionally Fully Convertible Debentures' that two Sahara group companies mopped up big money, without complying with SEBI's rules.

Therefore, the first check you must run on an issuer of retail bonds is if the company is authorised to issue such bonds in the first place. NCD issues are regulated by multiple regulators —– RBI, SEBI and Ministry of Corporate Affairs. You can check the RBI and SEBI sites for lists of NBFCs and entities specifically *prohibited* from accepting public deposits or collecting money. The new RBI site *www.sachet.rbi.org.in* offers useful FAQs on the subject too. Unless the NBFC is registered with the RBI, it isn't permitted to issue any NCD.

Is it a public issue?

NBFCs can raise money both through public issues and private placements of NCDs.

When companies raise money through a public issue, they are subject to SEBI's tighter 2008 regulations on debt securities, which are quite similar to those for IPOs of shares. So the issuer has to file a draft prospectus with SEBI with a full disclosure of its financials, use of proceeds and risk factors, ensure secondary market listing for the bonds and secure a credit rating. These SEBI rules require firms to refund sums raised through NCDs, if they don't achieve a minimum subscription of 75 per cent.

The new Companies Act has a separate set of rules for NCD public issues too. Companies issuing them are required to appoint a debenture trustee to oversee the servicing of the bonds. They are also required to set aside a 'debenture redemption reserve' out of profits each year, to meet redemption demands at maturity.

When NBFCs raise NCDs from investors on a private placement basis, the issue is subject to guidelines laid down by the RBI. The central bank classifies privately-placed NCDs as 'retail' if the issues collect a minimum investment of anything from ₹20,000 to ₹1 crore per applicant. Such NCDs have to be compulsorily secured by an asset. Importantly such bonds cannot be sold to more than 200 investors. So if you find a private placement of NCDs that is widely circulated, it is probably in violation of these rules.

The rating can change

Most people make a straight comparison of NCD interest rates with bank FDs and find them very attractive. But while bank FDs are quite safe (the RBI has a host of buffers including deposit insurance to protect against defaults by banks), NCDs are only as safe as the financial position of the issuer.

The first thing you must check out to assess safety in an NCD is its credit rating. The credit rating will help you assess the probability of default and also make relative comparisons between NCD issuers.

Among the recent crop, the AA+ by Brickworks for SREI Infrastructure Finance makes the firm riskier than the Brickworks AAA rated Dewan Housing and Finance.

But don't take even triple A ratings as a guarantee. This is because the credit rating is a moving target. It represents the firm's credit-worthiness at the time of the issue. But when you buy long-term NCDs, it can well change over the one, three or five-year holding period of your bond.

Rating agencies can downgrade issuers quite sharply and suddenly in the event of headwinds to the business. For instance, Jindal Steel and Power which had issued NCDs to institutional investors such as mutual funds and pension funds recently defaulted on its interest payments on September 30, which it attributed to 'temporary cash flow mismatches'. The sharp fall in steel prices has hit the firm's ability to repay debt and cut its credit rating from BB+ to D in the last six months.

If an NCD is offering interest rates that are a 1.5 or 2 per cent above prevailing bank deposit rates, consider that as a clear premium for risk. Mouth-watering interest rates on NCDs usually go hand in hand with higher risk to both your interest and principal.

Other tests to run

Putting the NCD prospectus through a fine tooth comb is as useful as doing it with an IPO. As the prospectus (uploaded in the issuer's website) usually lays down the business, financial position, break-up of loan book and risk factors in black and white, this is a good way to assess the issuer's credit worthiness too.

Specifically run the following checks:

- Where are the NBFC's lending activities concentrated? Infra loans, for instance, are riskier than home loans

- Are the loans backed by security?

- Do the firm's assets over the term of the NCD cover future liabilities (Asset Liability Mismatch)

Also check if the NCD has provisions for put or call options before maturity.

The put option gives you a right to ask for early repayment, and the call option allows the issuer to redeem the bonds early.

NCD interest is taxable

Many investors flock to NCDs because, unlike bank FDs, NCDs held in demat form do not suffer any TDS (Tax Deduction on Source) on their interest payouts. But this no-TDS provision does not actually exempt you from paying tax.

You still have to declare the interest in your IT return and pay tax at your slab rate. If NCDs are held in physical form, TDS is applicable on all interest payouts of over ₹5,000 a year.

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