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The NCD Rush Tread with Caution

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Cover Story

FDs held with any scheduled commercial or cooperative bank are covered under the Deposit Insurance and Credit Guarantee Corporation's scheme (for up to Rs.1 lakh in a single bank). But there is no such guarantee for NCDs. Also, FDs are more liquid than NCDs—you can withdraw money any time and, these days, most banks charge no penalty on premature withdrawals. But as the tax treatment of both these instruments is the same, NCDs score over FDs when it comes to post-tax interest rates. With current NCD rates at 11.5-12.5 per cent and FD rates at about 8.5 per cent, the post-tax returns for the two would be 7.9-8.6 per cent and 5.9 per cent, respectively (for those in the highest tax bracket).

THE LIQUIDITY DOWNSIDE

Even though NCDs are listed on stock exchanges, volumes are quite low for even the popular ones. The Shriram Transport Finance (STF) NCD issued in 2010 had an average volume of 2,000 per day in September 2012. It could be worse than this. Take the case of PTC India Financial Services (PFS). As of 17 September 2012, there was no trading on its NCDs for six months. ICRA recently downgraded its rating on PFS's 700-crore NCD programme to A from A . Now, if investors want to exit this NCD, they might find no buyers. They might have to wait till maturity and even bear the risk of further downgrades. Even if they find buyers, they might have to sell the NCD at a big discount.

DON'T DISCOUNT THE RISK

The main risks that might affect NCDs, especially those issued by NBFCs, are business risk and credit risk. Business risk might increase as the economy slows down further and funding gets hard to come by. Says Suman Chowdhury, director, Crisil: "There may be a moderation in the portfolio growth of NBFCs in the near term due to the continuing slowdown." As revenues get affected, interest payment might

SENIOR CITIZENS: THINGS TO BE MINDFUL OF

Senior citizens usually have a low risk appetite. So, while buying an NCD, they should look for a credit rating of AAA or, at the very least, AA+. While investing a lump sum for regular income, they should opt for direct credit of interest to the bank account so that receiving funds is smooth and easy. Senior citizens should never invest more than 10 per cent of their portfolio in NCDs, and always diversify across companies and sectors to mitigate risks.

get hit. This could lead to greater credit risk and chances of further downgrades by rating agencies. Here are the factors that one should look at to analyse a company offering NCDs.

- **Capital adequacy ratio (CAR).** It is used to measure a company's capital as a percentage of its risk-weighted assets. CAR indicates whether the company has a cushion for future losses. A CAR of more than 15 per cent is desirable.
- **Non-performing assets (NPAs).** Check the company's asset quality before you invest in it. NBFCs are especially vulnerable to NPAs as they extend a lot of unsecured loans. Avoid firms that have unsecured lending of over 50 per cent. Look for adequate NPA provisioning (minimum 60 per cent).
- **Interest coverage ratio.** It is the ratio of earnings before interest and taxes to interest and indicates whether the company can comfortably pay off the interest on its debt. A ratio of 2.5 times (and more) indicates that the company is in a well-positioned to deal with any possible defaults.
- **Credit rating.** It is crucial that you check the credit rating of the NCD issue before you invest in it. Look at only those NCDs that have a rating of at least AA. We spoke to credit rating firms to understand how ratings are arrived at. Says Anjan Deb Ghosh, head - corporate sector ratings, ICRA: "The process involves estimating the issuer's capacity to generate cash from operations and assessing this vis-a-vis the issuer's debt servicing obligations over the instrument's tenure." What this means is that the credit rating agency rates the ability of the firm to repay your principal with interest in the time promised. For this, the firm needs to have healthy cash flows. Says Rajesh Mokashi, deputy managing director, CARE Ratings: "We place emphasis on assessment of adequacy of cash flows towards debt servicing."

So, what are the most important factors used to arrive at the rating? Says Mokashi, "The degree of financial risk exposure...together with the evaluation of the management, forms the basis for arriving at the rating." The process begins with a review of the economy and industry, followed by an assessment of the company's financial risks and management quality. But it is a bit different for long-term and short-term ratings, with liquidity considerations gaining more significance in case of the latter." This is why credit ratings for different instruments from the same firm might differ.

And, finally, here are a few things to keep in mind to make the most of your NCD investment. **Check the purpose.** Understand the company's reason for raising money through an NCD. Says Arvind Rao, founder and chief planner, Dreamz Infinite Financial Planners: "If the money raised is not being used for the company's core business, it's not a good sign."

Look for security. Prefer secured NCD issues over unsecured ones. Says Vinit Iyer, team leader, BNY Mellon, an investment management firm: 'A good credit rating isn't enough: one should look for secured NCDs that give preference to debtholders in the event of the company's liquidation." **Consider your risk appetite.** If you are risk-averse, NCDs are not for you. Says Kishor Kumar Balpalli, founder & principal financial planner, Rajashree Capital: "Investors not willing to