Benefits of investing in 'mid-rated' corporate bonds

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Executive summary

India's corporate bond market outstanding increased by more than 50% in the past five years to Rs 44 lakh crore outstanding as on September 30, 2023. This growth has been on the back of heathy economic growth.

On the face of it, the growth appears to be good news. But a deeper look reveals it may be too early to cheer.

Data suggests 94% of the bond issuances are rated in the highest safety ('AAA') and high safety ('AA') rating categories.

Issuances below 'AA' rated category are generally avoided by bond investors, as they club mid-rated issuances (which includes 'BBB' and 'A' category ratings) with issuances rated in the 'non-investment grade', i.e. 'BB' or below categories. This could be attributed to investors' perception that debt protection metrics of these mid-rated issuers are more volatile and carry materially higher default risk.

CRISIL Ratings has carried out an in-depth objective study of 'mid rated' corporates, with this article focusing on the steadiness of debt protection metrics in 'A' rating category and the attractive risk-adjusted return opportunities that investments in this category offers. CRISIL Ratings will focus on performance of 'BBB' rated category issuers in a subsequent article.

Let us try to understand why the Indian bond market needs 'mid-rated' corporate issuances.

First, bond issuances by mid-rated companies will enable better portfolio diversification for investors and will help deepen the financial markets for long-term development. Mid-rated companies are also on the lookout to develop alternative sources of finance beyond bank loans, given the government's focus on infrastructure buildout and rapid economic expansion. Therefore, there exists a 'win-win' opportunity for both investors and companies.

Second, an analysis of the CRISIL Ratings portfolio shows that performance of 'A' rated category corporates have been strong and resilient, with low default rates over the past decade. Their debt protection metrics have also improved significantly over the past five years. For instance, mid-rated 'A' category rated corporates today showcase leverage metrics that are similar or better than 'AA' category rated corporates a few years ago. This indicates prudence in capital allocation/capital expenditure (capex) decisions by mid-rated issuers.

Third, there has been a positive shift in Loss Given Default (LGD) trends in the Indian context over the past decade. LGD is a measure of loss that lenders or investors incur post default on debt instruments. India is transitioning in terms of LGD, aided by a stronger insolvency and bankruptcy regime. The insolvency process also serves as a deterrent for issuers resorting to wilful default, thereby improving credit discipline among corporates. Although there is still room for improvement in the insolvency process, the improved LGD will boost investor confidence in mid-rated corporate bonds.

Last, Securities and Exchange Board of India (SEBI) has initiated confidence building measures by launching the Corporate Debt Market Development Fund (CDMDF) to tackle the issue of liquidity, especially in times of market dislocation. This underlines the government intent to add depth to bond markets with an eye on the collective benefit to the economy, companies and investors.

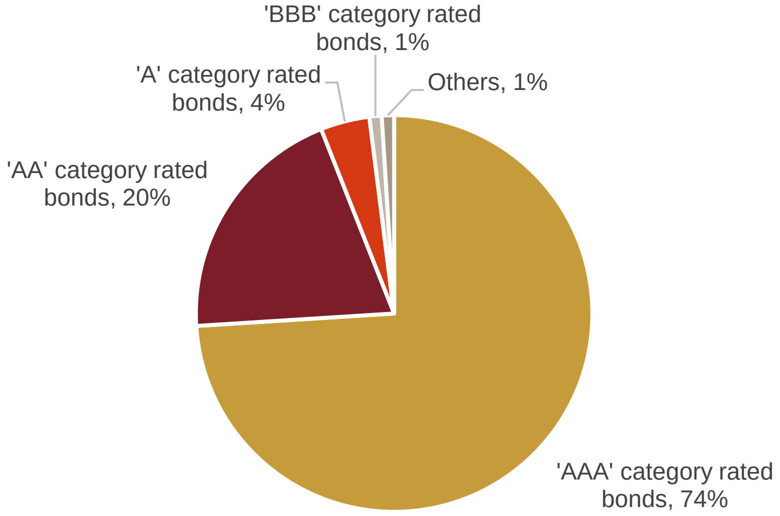
Therefore, investment in 'A' rated category issues makes a case for intelligent investment, especially in the current market scenario, where mid-rated bonds offer higher risk-adjusted returns compared with the 'AA' rated category. For the record, mid-rated 'A' category bonds offered 2-3 times higher risk-adjusted returns compared with 'AA' category rated bonds over the past three years. These returns are resilient in the backdrop of mid-rated corporates strengthening their balance sheets even as interest rates increased, supporting their case for an investment.

Historical pattern of rating skew in the bond market

India's corporate bond market has traditionally been dominated by issuances in the higher credit rating categories of 'AAA' and 'AA'. As much as 94% of the total corporate bond issuances in fiscal 2023 are from these categories, while mid-rated bonds (which includes 'BBB' and 'A' category ratings) make up only around 5% *(Chart 1)*.

This lopsided demand for bond issuances with high credit ratings, while rational on the surface, underlines concerns regarding bond issuances in the 'mid rating' category (which includes 'A' category ratings). If this concern is addressed, investors can enhance diversity and risk-adjusted returns by investing in these bonds.

Chart 1: Corporate bond issuances by rating categories in fiscal 2023



Source: Prime Database

Benefits of deepening the mid-rated market

Due to low penetration of the 'A' rated category in the bond market, corporates[1] rated in this category depend on loans from banks and non-banking financial companies (NBFCs) for majority of their funding requirement. For corporates rated in the 'AAA' and 'AA' categories, this dependence of borrowing from banks and NBFCs is much more limited.

Increase in investor awareness towards untapped mid-rated bonds will deepen the bond market, providing an opportunity for corporates rated in 'A' category to diversify their sources of finance and improve their borrowing rates.

Investors, on their part, will benefit from higher risk-adjusted returns by investing in mid-rated issuances, and will also benefit from better portfolio diversification as companies in the 'A' rated category are spread across higher number of industries, as compared with the 'AA' and 'AAA' category rated corporates.

[1] Does not include NBFCs

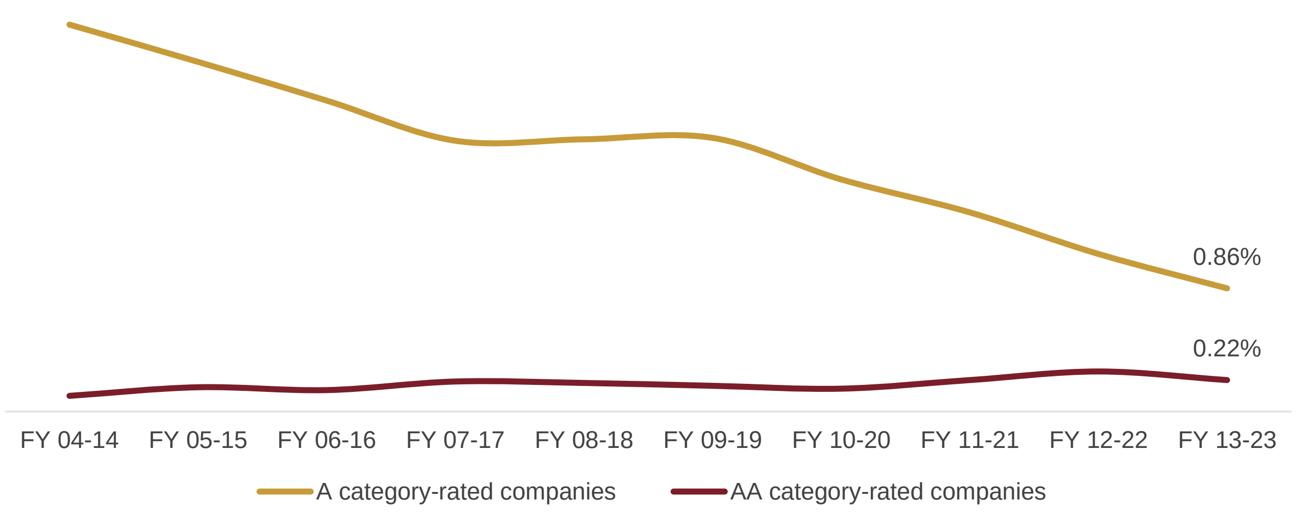
Lastly, given the government's focus on building infrastructure assets, the bond market is a solid source of long-term funds for infrastructure players. This could also help spread the funding risk across lenders, instead of being borne entirely by the banking system.

Investment in 'A' rated category issuers has become safer over the years

Decline in default rates of CRISIL mid-rated corporates

As credit ratings are ordinal, the default rates of 'A' rated category are bound to be higher than that of the 'AA' rated category. Having said that, we have seen an improvement in the default rates of 'A' rated category with the 3-year cumulative default rate declining to 0.9% for the latest 10-year period (fiscal 2013-2023) from 1.9% during fiscal 2007-2017 (Chart 2). This decline has been driven by continuous improvement in the debt protection metrics of 'A' category rated corporates[2], making them safer and less prone to default (*for detailed reasons, refer the next section*). Plus, the introduction of the Insolvency and Bankruptcy Code has played a role in enhancing credit discipline among corporates, while the increased regulatory disclosures for listed companies required by the Securities and Exchange Board of India (SEBI) has facilitated enhanced surveillance by investors and credit rating agencies.

Chart 2: Average 3-year cumulative default rates for long-term ratings across 'AA' and 'A' categories



Source: CRISIL Ratings

The low default rates in the mid-rated category can be corroborated by the episode of a large asset management company, wherein almost entire assets under management (AUM) of a few wound-up debt mutual funds schemes (having 35-40% exposure to 'A' category rated issuers at the time of winding down) was eventually returned to the investors. This substantiated that the incident was more of a liquidity issue caused due to large redemption pressure precipitated by the unprecedented Covid-19 pandemic, even though it was initially perceived purely as a credit issue.

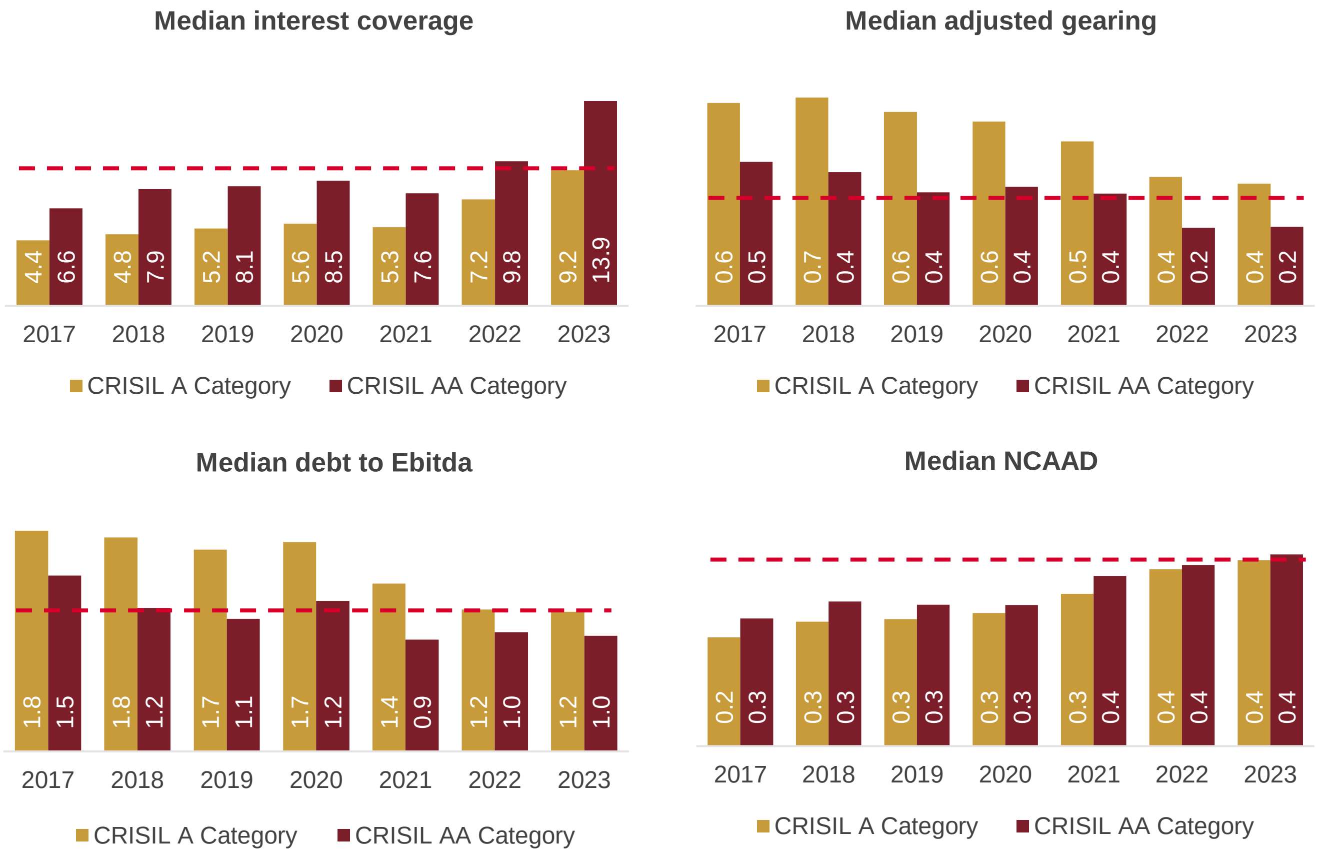
[2] The default study is applicable to 'A' rated corporates who have raised bank loan debt and/or capital market debt. Therefore, as the market for 'A' rated bonds becomes deeper, similar statics are expected to be reflected in the bond universe.

Improvement in debt protection metrics of CRISIL 'A' category rated corporates

As previously stated, a key reason for falling default rates for 'A' category rated corporates is the improvement in their credit profiles over the years. A CRISIL Ratings analysis of its rated portfolio shows as much. Companies rated in 'A' category have displayed strong credit quality over the years with current debt metrics similar to or better than that of 'AA' category rated players six years back. 'A' category rated companies have demonstrated healthy revenue growth and profitability, favourable capital structure, and robust debt servicing ability *(Chart 3)* over the years. While corporates in the 'AA' rated category have superior debt metrics vis-a-vis 'A' category rated companies at present, over the past six years, metrics for issuers in the 'A' rated category have become stronger, too, with interest coverage[3] and gearing[4] of over 9 times and ~0.4 time, respectively, for fiscal 2023, better than levels demonstrated by 'AA' category rated players in 2017 *(Chart 3)*.

Similarly, median debt to earnings before interest, tax, depreciation and amortisation (Ebitda) ratio for 'A' category rated players improved from 1.8 times in fiscal 2017 to 1.2 times in fiscal 2023. Median net cash accrual to adjusted debt (NCAAD) ratio also improved from 0.2 time in fiscal 2017 to 0.4 time in fiscal 2023. These ratios for 'A' category rated players are healthier than the metrics of 'AA' category rated players demonstrated six years back.

Chart 3: Median metrics



Source: CRISIL Ratings

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[3] Interest coverage: Ebitda divided by total interest and finance cost
[4] Gearing: Total debt/tangible networth

The strengthening debt protection metrics of ‘A’ category rated corporates have been due to improvement in the overall performance of Indian corporates over the past decade.

With growth and digital advancement of the Indian economy, the debt protection metrics of corporates have also improved with increase in scale, while improving operating leverage has aided profitability. This can be seen with median operating margins of ‘A’ category rated players improving in the past six years by 200 basis points (bps) to 13% in fiscal 2023, only 100 bps lower than the median margins of ‘AA’ category rated players in fiscal 2017.

Additionally, over the past few years, majority of the capex in the Indian economy was by the government, while private capex remained tepid. As a result, ‘A’ category rated corporates had a unique opportunity to deleverage amid a buoyant domestic economy, which helped enhance balance-sheet resilience.

Introduction of the Goods and Services Tax in 2017 widened the tax net, playing a critical role in industry consolidation towards the organised sector. Apart from large players, mid-sized players also benefited by gaining market share from their smaller, unorganised counterparts. This helped strengthen their business risk profiles and increase accruals, leading to further deleveraging in the absence of major debt-funded capex.

Lastly, financial prudence gained prominence among corporates in the aftermath of Covid-19, metamorphosing into a mindset that prioritises liquidity and manageable debt over excessively debt-funded expansion.

These factors have led to ‘A’ category rated players showcasing better debt protection metrics than ‘AA’ category rated players six years back.

The capex cycle imminent in the private sector may, to some extent, increase the leverage of these companies over the medium term, despite some of the capex being modular. Nevertheless, the deleveraged balance sheets of ‘A’ category rated players will provide a cushion to fund this capex. Additionally, the improvement in business profile of mid-rated corporates on account of improved scale and profitability, industry wide consolidation, and reduced volatility in operating parameters, will aid in keeping debt protection metrics of ‘A’ category rated companies better than 2017 levels. Therefore, the strengthened credit quality of ‘A’ category rated corporates is here to stay, given the sustained transformation of their business and finance profiles.

Regulatory steps taken to safeguard investor interest

Despite the improvement in debt protection metrics observed among ‘A’ category rated corporates, investors are still concerned about the illiquidity issues that prevail in the bond market. To tackle these issues, which were witnessed during the severe redemption pressure faced by some debt mutual fund schemes during onset of pandemic, SEBI launched the CDMDF on July 27, 2023. This alternative investment fund will act as a backstop facility for specified debt mutual funds during periods of stress or market dislocation[5], thereby tackling redemption pressure and improving liquidity of investment-grade bonds.

Additionally, the government has focused on the fair and timely resolution of stressed assets with the introduction of the Insolvency and Bankruptcy Code, 2016. So far[6], debt of around Rs 9 lakh crore from over 800 cases has been resolved under this regime. Furthermore, debt resolution platforms of the Reserve Bank of India (RBI) have been instrumental in facilitating prompt interventions, leading to improved LGD outcomes. Sectors such as

[5] The initial corpus of CDMDF is proposed to be Rs 3,000 crore, which will be contributed by specified mutual funds, and it can raise debt guaranteed by the National Credit Guarantee Trust Company (with sovereign rating) up to Rs 30,000 crore from banks. The specified debt mutual fund schemes will be able to sell bonds during market dislocation in proportion to the contribution made to the fund at the mutual fund level.

[6] As of September 2023

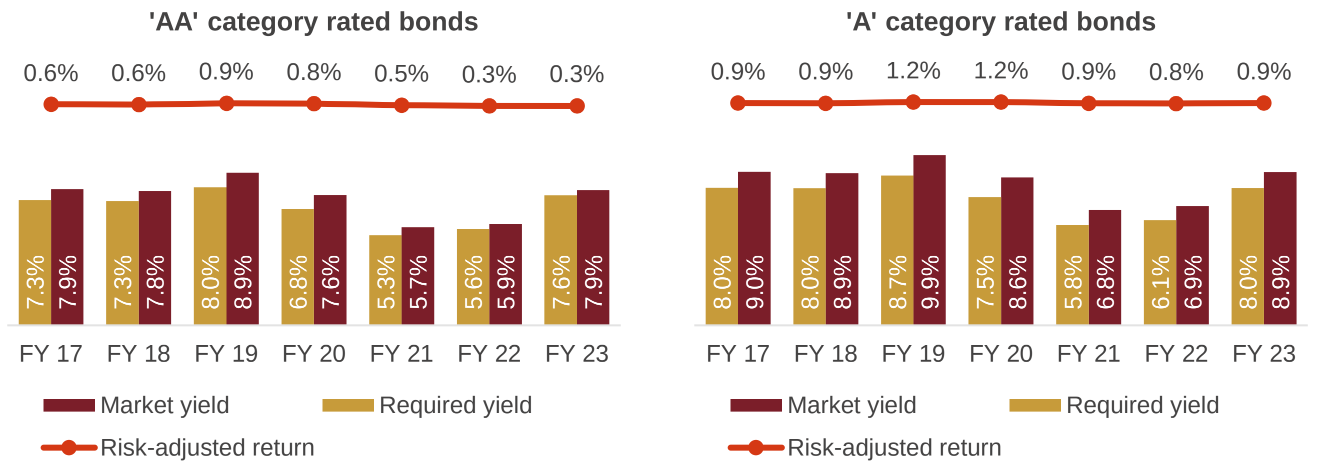
infrastructure have also seen major structural reforms, which have strengthened recovery prospects in infrastructure assets, as can be seen in CRISIL Ratings' recent publication on LGD[7]

Therefore, expected loss, which is measured by the probability of default and LGD, has come down over the years – a positive indicator to boost investor confidence.

Risk adjusted return higher for 'A' category rated bonds

While the strong debt protection metrics and creditworthiness of corporates in the 'A' rated category will be the main safeguards for investors, the strong investment attraction will stem from higher risk-adjusted returns compared with the 'AA' rated category. In fact, returns outweigh risks, with a higher differential between market yield and required yield for issuers rated in 'A' category compared with those rated in 'AA' category *(Chart 4)*. This is in the backdrop of reducing default rates *(Chart 2)* due to healthy growth and lower leverage amid moderate capex. Currently, risk-adjusted returns on bonds issued by 'A' rated category players are 50-60 bps higher compared with the 'AA' rated category

Chart 4: Risk-adjusted returns for 'A' and 'AA' rating categories bonds



Source: CRISIL Ratings

Terminologies

Risk-adjusted return is the difference between market yield and required yield.

Market yield represents the 12-month average of the daily quoted yield on bonds outstanding with modified duration of 2-3, as per CRISIL bond matrix.

Required yield refers to the yield required to cover expected and unexpected losses, including default risk.

Risk-free yield for computing required yield assumed to be the 12-month average of the daily quoted yield of G-Sec outstanding with modified duration of 2-3.

[7] https://www.crisilratings.com/en/home/our-analysis/reports/2023/09/a-structural-lift-for-infra-lgd.html

In conclusion, conditions favour mid-rated issuances

Given the reducing default rates and strong debt protection metrics of ‘A’ category rated corporates, proactive government and regulatory measures, quicker and structured insolvency processes and favourable risk-adjusted returns, the current milieu augurs well for mid-rated bonds.

We believe that it is an opportune time to add debt instruments of ‘A’ category issuers to the portfolio as it provides diversification benefit through exposure to larger set of industries compared to ‘AA’ and ‘AAA’ category rated issuers. Further, given the lower debt size of ‘A’ category rated companies, investors can improve granularity in portfolio with reduced risk of a single large default. Additionally, higher returns on ‘A’ category rated corporate bonds can compensate for their moderately higher risks.

With all the favourable changes over the past few years, the development of the mid-rated corporate bond segment is a win-win situation for all. Additionally, with the rise in yields on bonds across rating categories, after a slew of repo rate hikes by the Monetary Policy Committee of the RBI starting May 2022, there is a strong case for investment in issuances of ‘A’ category rated corporates.

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