Business Standard

Linkages between debt and equity markets

As debt markets evolve, equity investors will need to spend some time understanding the debt markets' perspective on companies

Akash Prakash February 05, 2019 Last Updated at 00:17 IST

Till recently, most equity market investors hardly paid any attention to local debt markets. Indian debt markets were quite undeveloped, with limited issuance and trading beyond government securities. Most corporate borrowings were either through banks or raised overseas. Retail participation in corporate bond issues was almost non-existent.

All the above has gradually changed over the last five to seven years. With the increasing financialisation of savings, flows into debt, both directly and indirectly through mutual funds and insurance companies, have skyrocketed. With the gradual liberalisation of foreign investment limits, even Foreign Portfolio Investments (FPIs) have become significant players in our debt markets. Companies, largely the Non-Banking Financial Companies (NBFCs), have been able to issue bonds directly to retail investors, of varying tenure, with issue sizes in the thousands of crores being quite common. There is a sea change in our debt markets, in terms of size, liquidity and sophistication. These markets will only get deeper and bigger, as domestic investors continue to shun real estate and gold, in favour of equities and debt for their own asset allocation. This is a long-term secular trend, bolstered by the rising level of absolute savings, which despite the current challenges will only get stronger.

Having established a functioning and sizeable debt market, we are now beginning to see the interlinkages between the debt and equity markets, and the influence one has on the other.

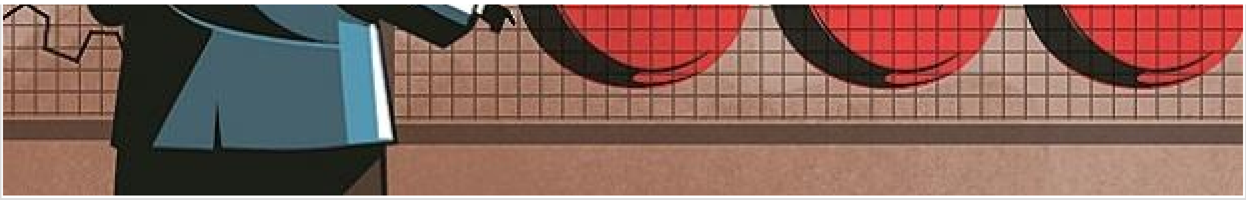

Illustration by Ajay Mohanty

We have just gone through a mini crisis for the NBFC sector, as due to the IL&FS default, institutional debt investors, froze their exposure to NBFC paper. Caught with too much NBFC exposure, many funds refused to roll over maturing paper, or at a minimum shortened the tenure. Those NBFCs that were able to access debt funds had to pay higher rates. NBFCs were forced to go back to banks for credit lines or sell assets to tide over the risk aversion of the debt market.

The debt market risk aversion towards NBFCs reduced the growth and profitability outlook for most of these financial institutions. Equity markets had to react to the reduced profitability outlook by taking down the multiples of most NBFCs. As an equity investor, one had to endure multiple compression, almost irrespective of which specific NBFC stock you owned. The macro of debt market risk aversion trumped stock specific micro developments. Debt markets drove the fundamentals, if you were not able to understand the risk aversion, you would have lost money, irrespective of which specific NBFC equity you owned or how good your stock specific analysis was.

A second case is the Essel group. Because of significant promoter group and holdco leverage, secured by pledge of shares, the equity prices of the underlying shares have been severely damaged. Zee stock has fallen by 35 per cent, despite the company reporting earnings in line or better than consensus. The company has actually performed well, gaining share in both audience and advertising, as well as having a successful OTT(over the top) launch. The stock is not falling because of business fundamentals, but purely because of fear around shares pledged getting unwound and sold in a disorderly fashion. As an equity investor, you may have been right about the fundamentals, but still be heavily underwater because debt markets are worried about default. In this case again, the equity market is being driven by the debt market, if the debt markets calm down, the equity will go up. A lack of understanding of debt markets and their concerns would have cost you money in both the above examples, no matter how good a stock picker you may be.

The development of the debt markets and their increasing scale and sophistication are good things and need to be encouraged. The fragmentation of credit risk, which is enabled by well-functioning debt markets, is a positive, and should make our financial system stronger. The decentralisation of credit decisions also reduces the scope for directed lending. We cannot afford another credit cycle of the type we have just experienced, where individual banks have had non-performing assets of up to 30 per cent of their corporate book.

However, there are some issues to ponder. My perception is that debt flows are not as retail as the SIP flows we see in equity funds. At least 10 to 15 large corporate treasuries have disproportionate power over debt funds, especially those run by mid-sized AMCs. If these large corporate treasuries decide that they do not want exposure to a certain issuer, most funds will have to fall into line, and exit that paper. This can have macro economic consequences, as just observed in the NBFC funding crisis. Many funds were forced to reduce their NBFC exposure, or risk mass redemptions. Given the impact this risk aversion has had on access and cost of funding for most NBFCs and the consequent real economy impact, one wonders as to how healthy this market structure is.

Another issue is the rating agencies. They have hardly covered themselves with glory. We have too many rating agencies and of mixed quality. How can IL&FS go from “AA” to default in less than one month? What is the rating methodology? Rating agencies are perceived to be slow and behind the market in adjusting ratings to the current reality. The rating agencies seem to take no account of equity market views. There are certain companies rated “AAA”, which equity markets have limited confidence in, as shown in their valuations. This disconnect between the equity market and ratings agency view on a specific issuer can create market dislocations. If markets lose faith in ratings, that is a very dangerous and slippery slope. Markets could totally seize up, willing to trade only the absolutely best names. Once ratings lose relevance, markets will narrow. Nobody will want to take any risk.

There also remain some doubts as to whether the debt funds are marking their paper at the correct prices. Securities and Exchange Board of India has guidelines here, but there exist some nagging doubts, as to whether the NAV of some funds fully reflect market realities. This could be just perception, but this feeling does persist. We have seen consolidation among the debt funds partly for this reason. Money has flowed into the top five houses, in a perceived flight to quality.

The emergence of our debt markets is a good thing. We need these markets to be as robust, liquid and sophisticated as possible. As an equity investor, one will need to spend some time understanding the debt markets’ perspective on the companies we are studying. Not something we have done historically. It is important because, as we have seen, the debt markets can easily blow a hole in your fundamental thesis.

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