

SEBI

Investor guide for corporate bonds market



Issued in the interest of investors by
Securities and Exchange Board of India
(SEBI)

What are corporate bonds?

Corporate bonds are nothing but debt instruments issued by a corporation, the holder of which receives interest from the corporation periodically for a fixed period of time and gets back the principal along with the interest due at the end of the maturity period.

E.g. Considering that you hold a 10% 5-year corporate bond issued by XYZ Co. with Face Value Rs. 100 and interest is paid annually:

XYZ Co. will

- *Pay you Rs. 10 every year for 5 years*
- *Redeem face value of the bond i.e. Rs.100 + Rs. 10 accrued interest at the end of 5 years.*



Seems similar to a bank fixed deposit??? You may find a corporate bond similar to a fixed deposit in a bank or a post office scheme or any such fixed-return instrument. However, every type of investment is different in its own way and has its own features, advantages and disadvantages.

Isn't it same as a debenture?? In India, the terms 'corporate bonds' and 'debentures' are interchangeably used. Though different countries have different interpretations of both the terms 'corporate bonds' and 'debentures', our Companies Act (Section 2(12)) identifies both as same.

Who can issue corporate bonds in India?

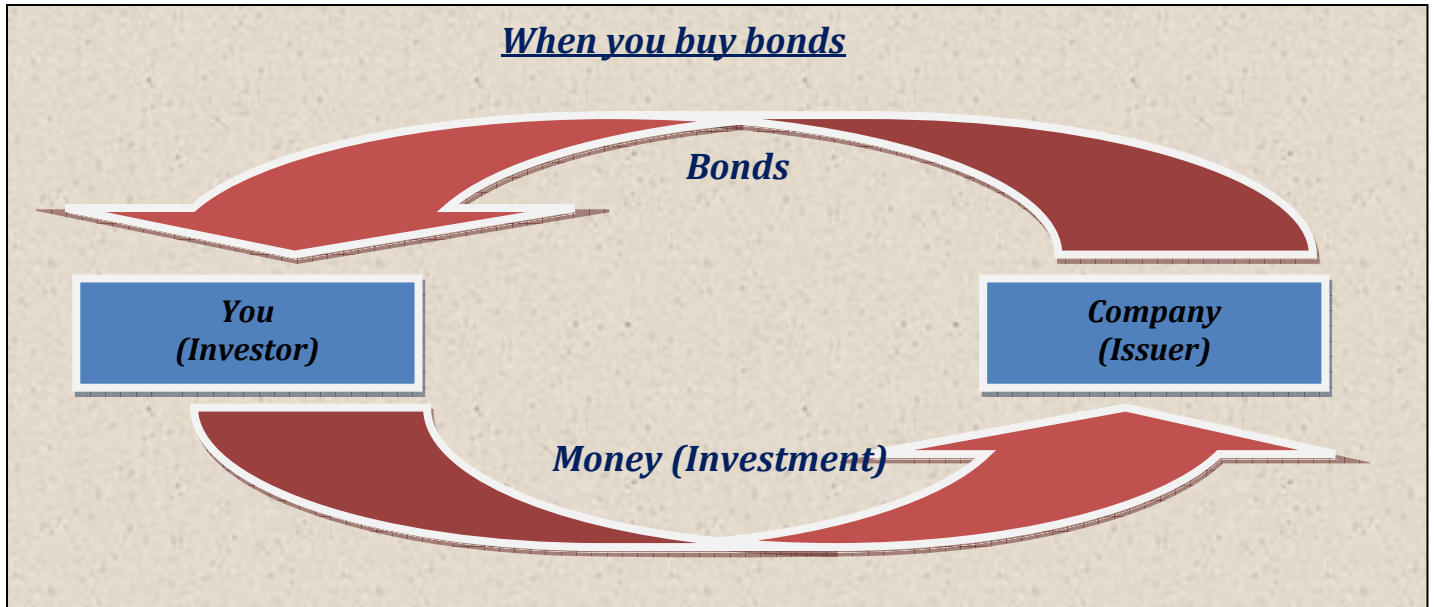
In India, both public and private companies can issue corporate bonds. A company incorporated in India, but part of a multinational group, can also issue corporate bonds. However, a company incorporated outside India cannot issue corporate bonds in India. A statutory corporation like LIC can also issue corporate bonds.

Benefits of investing in corporate bonds

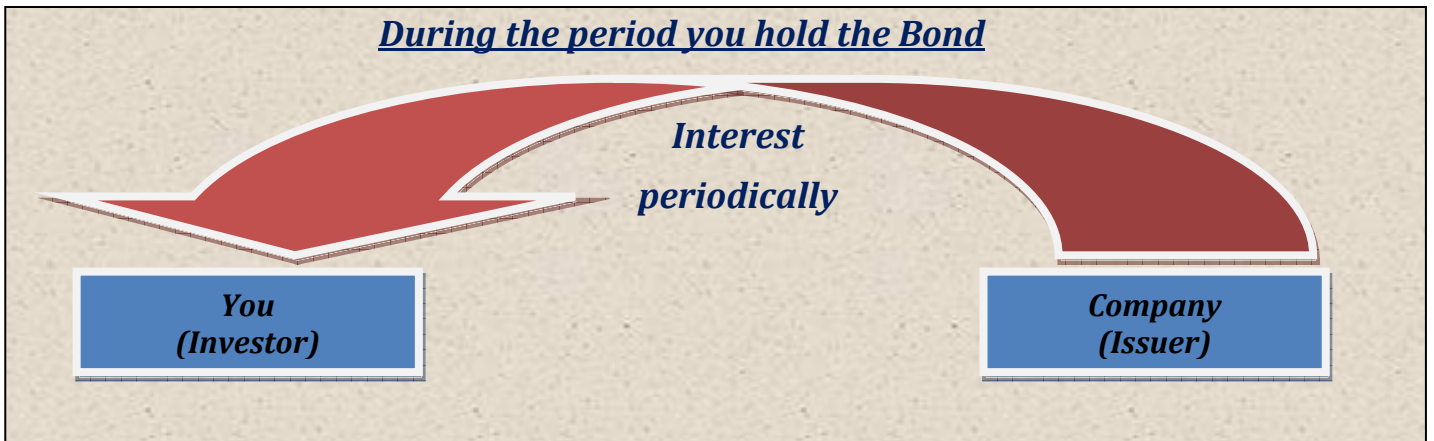
Why should you invest in corporate bonds??? If you are looking for an investment that generates fixed income periodically, corporate bonds may be an ideal investment for you. It normally offers you a higher rate of interest as compared to fixed deposits or postal savings or similar investments. If your bonds are listed, you can also sell it in the secondary market before its maturity. While a bond is usually not designed for capital appreciation; a listed bond may also earn you capital appreciation i.e. you can sell your bond at a price higher than your cost price in the market.

Model of Cash flow

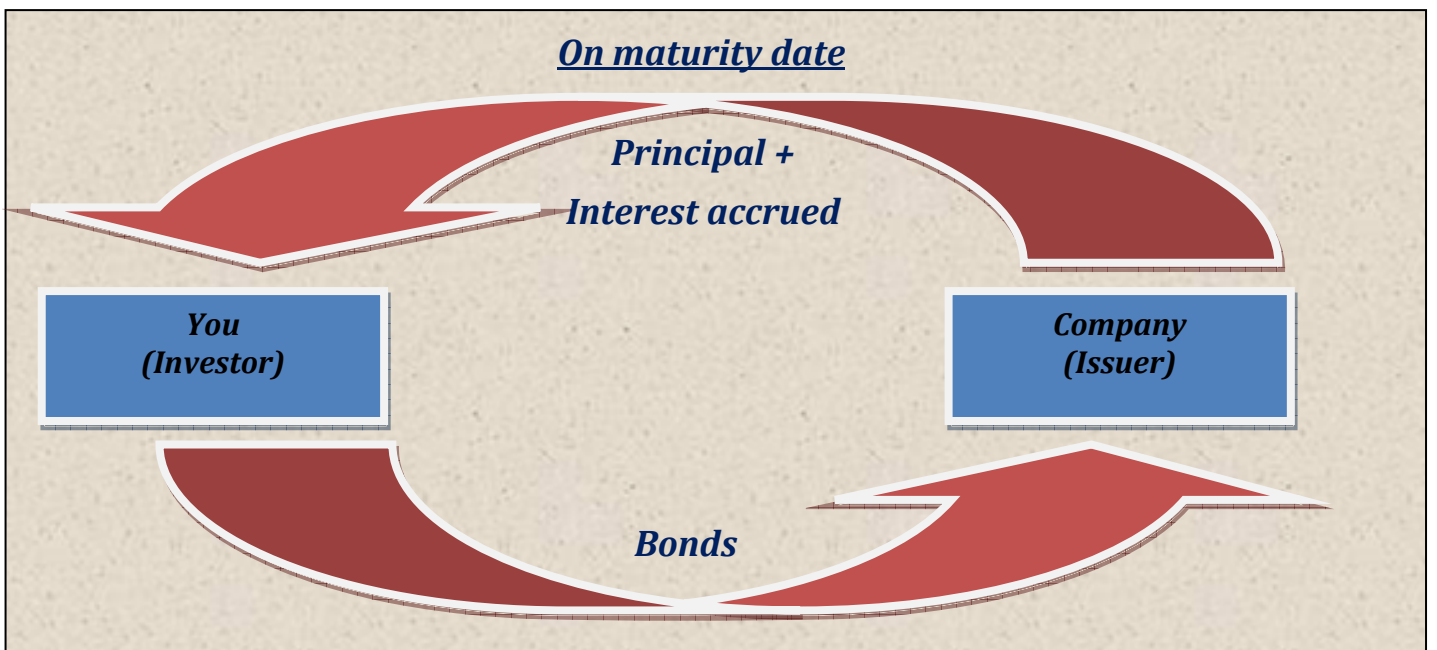
When you buy bonds



During the period you hold the Bond



On maturity date





Corporate bonds v/s other forms of investment

Corporate bonds v/s equity shares

	<i>If you hold an equity share of XYZ Co.</i>	<i>If you hold a corporate bond of XYZ Co.</i>
What is your relation to the company?	<ol style="list-style-type: none"> 1. You are part owner of the company 2. You may enjoy voting rights. 	<ol style="list-style-type: none"> 1. You are a lender to XYZ Co. 2. You do not enjoy voting rights.
What will you earn from your investment?	<p>Your returns would be in the form of</p> <ol style="list-style-type: none"> 1. Dividend paid by XYZ Co. 2. Capital appreciation (increase in price of your share) 	<p>Your returns would be in the form of</p> <ol style="list-style-type: none"> 1. Interest paid by XYZ Co. 2. You may earn capital appreciation if your corporate bonds are listed.
How risky is your investment?	<p>As a thumb rule, equity shares are considered to be the riskiest form of investment.</p>	<p>As a thumb rule, corporate bonds are less risky than equity shares.</p> <p>However, corporate bonds also have their own set of risks.</p> <p>All the risks that you may face are detailed later in this document.</p>
How liquid is your investment? <i>(If you want to sell your share/bond at any point of time, how easily can it be done?)</i>	<p>In case of equity shares listed on a stock exchange, most are easily tradable and hence you can easily sell your share.</p> <p>In case of unlisted shares / illiquid shares, you may find some difficulty and cost involved in selling your share.</p>	<p>If your corporate bond is listed, you will find it easier to sell your bond before maturity date. However, in India, corporate bonds are not as liquid as shares.</p> <p>However, if your corporate bond is not listed, you will find it difficult to sell your bonds before maturity date.</p>
What will happen to your investment if the	You will get face value of your investment back only after all other	You will get preference over the share holders of the company in

<i>company closes down?</i>	stakeholders are paid back their money.	getting back face value of your investment. However, your dues will be paid only after statutory dues (like tax unpaid, etc.) are cleared.
------------------------------------	---	---

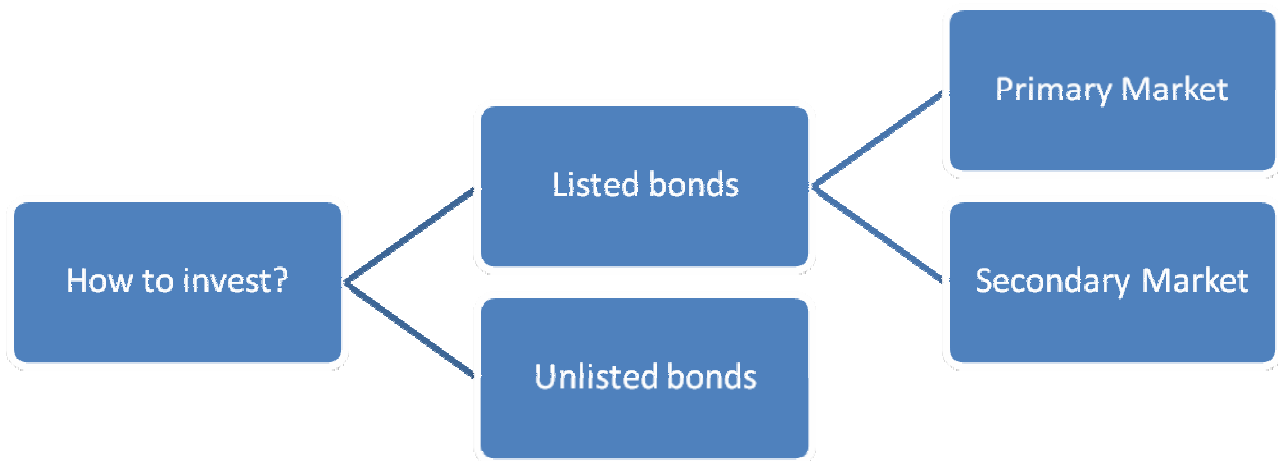
Corporate bonds v/s fixed deposit in a bank

	<i>If you hold a fixed deposit in a Bank</i>	<i>If you hold a corporate bond of XYZ Co.</i>
<i>What will you earn from your investment?</i>	A fixed amount of interest periodically from the bank	Fixed or varying amount depending on whether interest rate is fixed or floating. (Refer to fixed/floating rate of interest later in this document)
<i>Is your investment guaranteed?</i>	Your deposit is guaranteed upto a maximum of Rs. 1 lakh by Deposit Insurance and Credit Guarantee Corporation of India (DICGC) for both principal and interest amount earned by you.	Your investment is not guaranteed by Government of India or RBI or any Government sponsored agencies.

How to invest in corporate bonds?

How can you invest in such bonds??? The company which is planning to raise funds through corporate bonds will offer a public issue or a private placement. A private placement is usually made to institutional investors and not to retail investors.

A public issue means an offer will be made to the public in general to subscribe to the bonds. In a public issue, the company has to issue a prospectus before issuing the bonds. A prospectus is nothing but a document containing details about the company and the bonds to be issued. After the public issue, these bonds are listed on a recognized stock exchange in India. Hence such types of bonds are called listed bonds.



What are primary / secondary markets??

In case of listed bonds, an investor can buy the bonds through 2 avenues:

- Through the public offering by the company
- Through the exchange

The public offering by the company is referred to as **primary market** and the trading of the shares subsequently through the exchange is called **secondary market**. You can buy bonds through either of these markets. If you buy the bonds through the public offering, you will be buying the bonds directly from the company and if you buy the bonds through the secondary market, you will be buying the bonds not from the company, but from sellers who wish to sell the bonds held by them.

When you buy the bonds through a public offering, you usually buy it at the face value of the bond. However, the issuer may also issue the bond at a premium or a discount. When you buy the bonds from the exchange, you have to pay the market price, which may be higher or lower than the face value.

Technical Terms simplified

How do I understand the all the technicalities involved??? An issue of Corporate Bonds often involves various technical terms which any investor needs to understand before investing in the corporate bonds market. This document offers explanation for common terms used in any issue of corporate bonds along with examples to simplify the concepts involved.

Note: For simplification, face value of the corporate bond in all examples henceforth will be taken as Rs. 100.

List of Technical terms which are explained in the next few pages

**T
e
c
h
n
i
c
a
l

T
e
r
m
s

S
i
m
p
l
i
f
i
e
d**

Fixed/Floating interest rates

Periodicity of Interest Payments

Maturity date

Secured/Unsecured Bonds

Capacity of the firm to repay

Convertible/ Non- convertible bonds

Put/Call options



Fixed/ Floating Interest rate:

What does it mean?

A corporate bond may offer a fixed or floating rate of interest and accordingly you may earn a fixed or varying amount of interest periodically.

A **fixed rate bond** will pay you a fixed amount periodically as per the interest rate set out when the bonds were issued. This interest is determined as a % of the Face Value of the bond. Such fixed interest payments are sometimes also called coupon payments.

A **floating rate bond** has its interest rate pegged to a benchmark rate ie. (Benchmark rate) +/- (some %). The benchmark rate may be Government bond /MIBOR. As the benchmark rate changes, the interest rate on the bond will vary accordingly. Hence, a floating rate bond is considered to be relatively risky since your return is dependent on the movement of the benchmark rate.

Example

Fixed rate of interest:

A 10% 5-year corporate bond with interest paid semiannually

- ➔ will earn you a fixed amount of Rs. 5 at the end of every six months for 5 years.

Floating rate of interest

A Corporate bond offering 10 yr government bond/MIBOR + 2% with interest paid semiannually

- ➔ will earn you varying amount of interest depending upon the prevailing MIBOR rate. If prevailing MIBOR rate is say 8% then interest rate on your bond will be $8+2 = 10\%$

Why is it important for you?

- ➔ If you wish to receive a fixed amount periodically, a fixed rate bond is advisable.
- ➔ However, a fixed interest rate bond may earn you less than a floating rate bond due to lesser risk involved.
- ➔ If you plan to invest in a floating rate a bond, remember that your return will depend on the movement of your benchmark rate which may move in either direction substantially.



Periodicity of interest payments

What does it mean?

An investor in corporate bonds receives his interest payments periodically. The interest may be received **yearly or half-yearly or quarterly or even monthly** depending upon the period set at the time of issue. The interest payment dates are usually specified in the prospectus.

On the maturity date, the issuer pays back the investor face value of the bonds held by him along with the interest accrued on the same.

Interest payments are sometimes classified as **cumulative or non-cumulative**.

In case of cumulative interest repayments, if the issuer is unable to pay the investor the interest on the due date, the interest gets accumulated and can be paid on the next scheduled payment date. This clause is beneficial to the issuer since he can adjust his cash flows accordingly. However it is not beneficial to the investor since he loses the time value of money.

However, a cumulative interest repayment is always a better option for the investor as compared a non-cumulative bond since in case of non-cumulative bonds; the interest gets forfeited, if not paid by the issuer on the due date.

Example

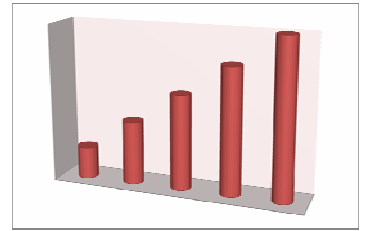
A 12% 10-year cumulative corporate bond with interest paid semiannually.

- will earn you a fixed amount of Rs. 6 at the end of every six months for 10 years.
- In case the issuer is not able to pay the interest on the scheduled date, he can pay Rs. 12 (Rs.6 of the earlier half-year + Rs.6 of current half year) on the next scheduled payment date.

Why is it important for you?

- Before investing, ensure that the payment periodicity suits your investment requirements.
- Also check whether the interest payments are cumulative or non-cumulative since it can impact your cash flows in future.

Maturity date



What does it mean?

Maturity date is the date on which the bond matures i.e. issuer repays the face value of the bond along with the accrued interest to the investor and dissolves himself of all the obligations attached to the bond. The issuer is bound to buy back the bond on the maturity date.

The maturity date determines whether the bond is long term, short term or medium term. The maturity date is usually mentioned explicitly in the prospectus.

However, some bonds have certain options (call or put options) which may allow the issuer to buyback the bonds before the due date or the holder to sell the bonds back to the issuer before the due date. This may reduce the term of the bond and hence it is essential that you analyse the effect of exercising of such options on your cash flows before buying such bonds.

Example

A 12% 10 year corporate bond with interest paid quarterly issued on 2nd January, 2010

- Has a maturity of 10 years and will mature on 1st January 2020.
- On 1st January, 2020, the investor will receive face value of his investment along with accrued interest.

Why is it important for you?

- The maturity date will help you ascertain which type of bond is suitable to your investment horizon.
- In case of unlisted bonds, you would not be able to trade them in the market and hence your funds would be locked up till maturity date.
- You should look out for call options or put options in the prospectus since it will impact your cash flows if such bonds are exercised in future.
- The option will also impact the price of the bond at the time of issue and during the trading period of the bond. (For details refer to call/put options later in this document)



Secured/Unsecured bonds

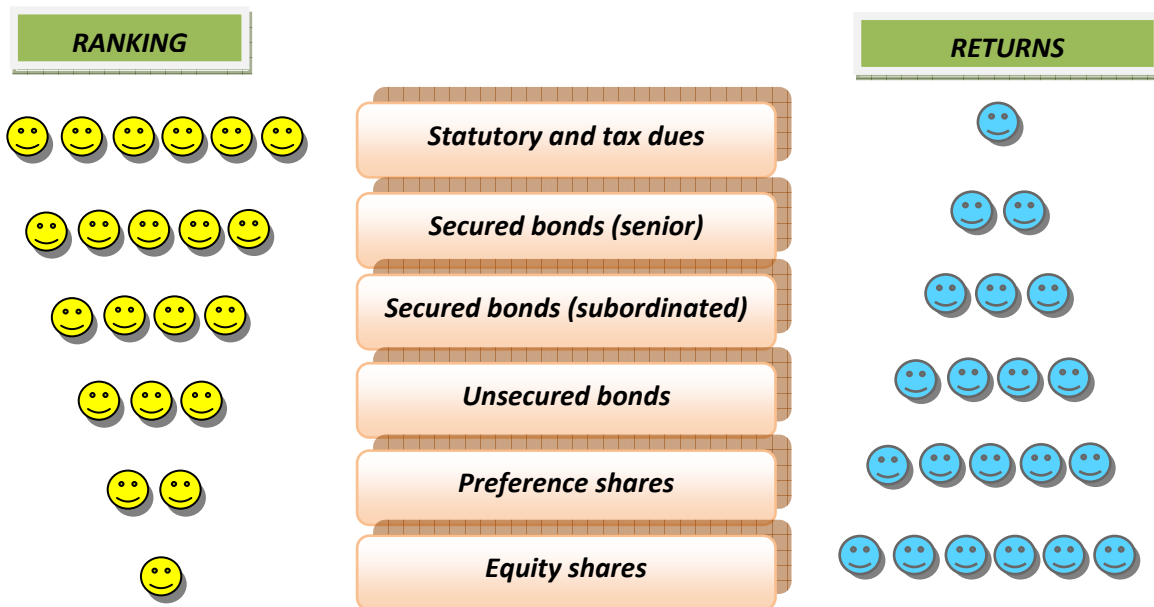
What does it mean?

If the company in whose bonds you have invested is wound up (closes down), it's important for you to know where you stand when the company repays its debts. The order in which the Company repays its debts depends upon the ranking of the bonds based on the security

Bonds are either secured against assets or unsecured. If the bonds are secured, in the event of winding up of the company, it would sell off the assets against which the bonds were secured and repay the investor. However, all secured assets do not have the same ranking.

When the company repays its assets, it has to follow the following order in repayment of its dues:

1. Statutory and tax dues
2. Secured bonds (senior)
3. Secured bonds (subordinated)
4. Unsecured bonds
5. Preference shares
6. Equity shares



Note: One cannot invest in statutory/tax dues. The diagram is only for representative purpose

You, as a bond holder, will be repaid your principal amount before the shareholders but after payment of pending statutory dues. If you hold senior secured bonds, you will be ranked higher than the holders of subordinated secured bonds and unsecured bonds in repayment of dues in case of closure of the company.

Example

If you hold subordinated bonds of a company XYZ and the company becomes insolvent:

- You will be repaid the principal and interest amount due only after the statutory and senior secured bondholders are repaid. Hence, you may even get back only part of your money if the amount left over is less than what is due to you.
- You will be repaid to the extent of amount realized of the assets against which the bond was secured.
- If the amount realized on sale of assets is less than the value of the dues against the bonds, you will only get pro-rata repayment and not the full value of the dues against your name.

Why is it important for you?

Before you purchase a bond, please read the prospectus carefully to understand

- Are the bonds secured or unsecured?
- If secured, what is the ranking with respect to other stakeholders?

The returns of the bond will depend on the security and its ranking among other stakeholders. An unsecured bond will pay you more interest than a secured bond to compensate for the higher risk involved. Similarly, as a rule of thumb, higher the ranking of the bond, lower will be its return.

Before investing in any bond, assess both the risks and the returns associated with the bond and invest accordingly.



Capacity of the firm to repay

What does it mean?

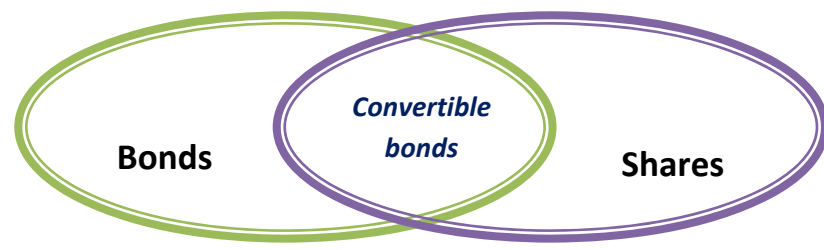
When you invest in corporate bonds, you need to ensure the company is in a position to repay your principal and the interest due to you. Hence, you need to analyze the company well before investing in its bonds.

How can the financial capacity be checked?? You can analyze the health of the company by checking its business model, its financials, by employing ratios, by meeting its management and in several other ways. The most common way of analyzing the ability of a company to pay its debts is by analyzing its financial statements. You need not be bogged down by the huge data that is provided in the annual reports. Some ratios which are given below can be used to do the analysis. These ratios are simple to understand and sufficient to have a fair idea of the capacity of the company to repay your dues.

However, along with the ratios, check the maturity pattern of the existing loans of the company and verify whether there is a significant amount of debt maturing soon and which may have to be rolled over. In addition, verify whether the company has been a defaulter in the past or has rolled over its debt or has breached its loan agreement or whether there are/were any lawsuits against the company.

Ratios	Formula	What does it signify?	Example
1 Interest Coverage Ratio	$\frac{\text{EBIDTA/Net Interest Expenses}}{\text{OR}} \\ \frac{\text{EBIT/Net Interest Expenses}}{\text{Interest Expenses}}$	<p>This ratio is used to verify whether the company's operations generate enough earnings to sustain its interest payments.</p> <p>Hence, If interest coverage ratio is high, it means the company is in a good position to make your interest payments.</p> <p>While investing in any company, go through the company's profit and loss statement and by calculating its interest coverage ratio, make sure that its earnings are comfortably higher than its interest payments.</p>	<p>E.g.: If a company's :</p> <ol style="list-style-type: none"> 1. EBIDTA = Rs. 300 crore and 2. Net interest expenses = Rs. 30 crore, <p>Then the interest rate coverage ratio is 10 i.e. the company has earnings 5 times larger than its interest payments.</p>
2. Debt-to-	Total debt/Total	It represents how leveraged the	E.g. If a company's:

<p>Equity Ratio</p>	<p>Equity</p> <p>Where</p> <p>Total equity= Shareholder's capital+ Reserves and Surplus</p> <p>For total debt, you can either use total liabilities or only long-term debt.</p>	<p>company is i.e. how much has the company borrowed vis-à-vis its own money.</p> <p>There is no ideal debt-to-equity ratio against which a company can be measured. A high debt-to-equity ratio generally means that a company has been aggressive in financing its growth with debt. Before investing in such company bonds make sure the company's financial position is such that it can sustain such high amount of debt.</p>	<p>Total debt= Rs. 100 crore</p> <p>Total equity= Rs.150 crore</p> <p>It debt-to-equity ratio is 1.5</p>
<p>3 Other ratios</p>	<p>Ratios/ Parameters like Profitability, cash flow, change in market share, increase in revenue, assets employed, etc. over the last few years</p>	<p>All these ratios give a fair clue about the general financial performance of the company and will help you analyze whether the company is strong enough to meet its financial obligations</p>	<p>E.g. If a Company's net profit ratio (Net profit/Sales) has increased from 15% to 18% , its market share has increased, its sales/assets ratio has increased from 2 to 2.5, etc. ;</p> <p>It means overall the company is performing well and hence will be in a better position to fulfill its financial obligations than a company whose performance is dismal.</p>



Convertible/Non-convertible bonds

What does it mean?

Bonds which can be converted into equity shares at a later date are called convertible bonds. Such conversion can occur at a price predetermined at the time of issue of bond or at the prevailing market price. On the same lines, bonds which cannot be converted into equity shares are called non-convertible bonds.

Is it an equity share or a bond?? Convertible bonds are in fact hybrid securities i.e. they carry the features of both equity and debt. Till the investor holds the bond, he receives interest periodically. However, once it is converted into equity shares, the investor enjoys benefits as an equity shareholder. This gives the bondholder both a fixed-income investment with coupon payments as well as the potential to benefit from an increase in the company's share price.

Since convertible bonds carry the additional option of conversion into equity share, the interest rate is usually less as compared to a non-convertible bond.

Some bonds are compulsorily convertible into equity shares after a particular period or on a particular date. Such bonds are called compulsorily convertible bonds.

Example

If you hold a 6% bond, interest payable annually, of XYZ Co. convertible into 10 shares of XYZ Co anytime after 3 years then:

- You will get Rs. 6 every year for the first 3 years
- You can convert it into 10 equity shares at any point of time after 3 years at the prevailing market price
- Once you convert the bond into equity shares, you will lose the fixed interest of 6%, but enjoy benefits of equity shares.

Why is it important for you?

- If you buy convertible bonds, ensure that you understand the conditions attached with it relating to the price of conversion, number of shares, the time period after which conversion can be made, etc.
- In addition, check whether the bonds are compulsorily convertible & the conditions attached to it.
- Before investing in such bonds, analyze the returns that you would be earning from such bonds & ensure that they match with your return requirements.

Put & Call Options

What does it mean?

Some bonds have embedded options which either allow the issuer to buyback the bonds before the maturity or the holder of the bonds to sell the bonds to the issuer before the maturity. Such options are explicitly stated in the offer document at the time of the issue of the bonds.

What are callable bonds?? Bonds which give the issuer right to buy back the bonds before its maturity are called callable bonds. Callable bonds usually come with an initial lock-in period. Since investing in such bonds exposes the investor to the additional risk of buyback they usually offer a higher rate of interest as compared to bonds without such options.

What are puttable bonds?? Bonds which give the investor the right to sell the bonds back to the issuer before the maturity of the bond are called puttable bonds. Since such bonds give the investor a right to sell before maturity, they usually offer a lower rate of interest as compared to bonds without such options.

Example

If you hold a 8% bond, interest payable annually, of XYZ Co. with a put option to the investor to sell the bonds at par to the issuer anytime after 3 years from the date of issue, then:

- Till end of the 3rd year from the date of issue, you cannot sell the bond back to the issuer (However, if it is a listed bond, you can sell it in the market even during the 1st 3 years)
- After 3 years from the date of issue, you can sell back the bond to the issuer at Rs. 100 per bond anytime till the maturity.

Why is it important for you?

- Call or put options on your bonds may alter your cash flows significantly in future.
- Before buying callable bonds, ensure that you understand the prepayment risk associated with the bond.
- Remember that a puttable bond may cost you more than a normal bond due to the option attached to it. Hence, weigh the benefit you derive from the option with the cost associated with it and buy it only if you feel it's worth the investment.

Risks involved in investing in corporate bonds

Though corporate bonds are less risky as compared to investments such as shares, they have their own risks. Some of the risks that you will be faced with if you invest in a corporate bond are listed below:

Credit risk

- **What does it mean?**
- Credit risk means the risk that the company in which you invest defaults on your interest payment or does not pay you back your principal.
- **How to mitigate the risk?**
- Analyze the capacity of the company to meet its financial obligations . If the company is in a good position to fulfill its obligations, chances of it defaulting on your dues is also less.

Prepayment risk

- **What does it mean?**
- In case your bonds contain clauses that allow the issuer to redeem the bonds before the due date, you will be faced with the pre payment risk. In this case, the company may redeem the bonds when the interest rates go down and the price of the bonds go up. i.e. you will get the face value of the bond when the market value of the bond is higher than the face value and you stand to lose the difference
- **How to mitigate the risk?**
- While this risk cannot be mitigated by you, you can always refer to the prospectus before investing to verify whether such an option is attached to your bond. If such an option exists, you can invest only if you are ready to deal with the prepayment risk that may arise in future.

Interest rate risk

- **What does it mean?**
- When you invest in a listed bond, you have to face the risk of interest rates going up and down and the resultant change in the market price of your bond. In case the interest rates go up, the market price of your bond will go down and if you plan to sell your bonds at that time, you may end up with less money than what you paid when you bought it.
- **How to mitigate the risk?**
- You may hedge your risk by investing in derivative instruments such as interest rate futures or swaps

Liquidity risk

- **What does it mean?**
- In case you wish to sell your bonds before its maturity date, you may face the risk of not finding a buyer easily for your bonds. Hence, you may not get the price you expected to receive. This is called liquidity risk.
- **How to mitigate the risk?**
- Before investing in listed corporate bonds, check whether there are enough volumes in the market to reduce the liquidity risk. Higher the volume less is the liquidity risk faced by you