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Market linked debentures in favour again; should you invest?

Much of the debt market is still reeling under the after-effects of the Infrastructure & Leasing Finance Services Company's (IL&FS) debacle. But there's one financial instrument that appears to have benefitted from the devastation. This instrument is market linked debentures (MLD), also known as structured notes.

According to report titled 'Market Linked Debentures: Issuances at its all-time high' by CARE Ratings, the net outstanding MLDs grew to Rs 21,191 crore as on December 31, 2018 as against Rs 11,356 crore as on September 30, 2017 and Rs 32,165 crore as on June 30, 2017 (when they hit a peak).

Financial year that begun on April 1, 2018 has so far seen issuances worth Rs 12,910 crore.

Experts attribute the strong uptick in the issuances of MLDs to two factors - the necessity of corporates to raise funds in a tight market and investors looking for some extra returns on post-tax basis.

That sounds like a win-win situation. But is it so simple and should you even go near it?

Why MLDs have made a comeback?

Ashish Shankar, head-product advisory, Motilal Oswal Private Wealth Management says, "The supply of money from both banks and mutual funds to NBFCs has dried up after the IL&FS issue. But NBFCs have to raise money to fund their growth and to pay for existing bonds' maturities. So they have taken the MLD route."

Issuances of MLD works in favour of NBFC in multiple ways. It lets an NBFC issue additional 5 ISINs apart from limit of 12 for NCD in a year as per SEBI mandate. Put simply, an NBFC can raise money more number of times.

Each ISIN stands for each issue of debt instrument issued by borrower. It also helps them raise 25% of their borrowings from capital market, as it is a guideline by regulators on large borrowings. MLDs help service debt with one payment at the time of maturity, whereas most NCDs expect issuers pay interest at regular interval in the form of pre-determined coupon.

Going forward, more issuances of these products are expected as more NBFCs line up for raising more capital. CARE Ratings expects issuances to increase to Rs 14,000 crore by the end of this financial year.

What does an MLD offer?

For the beginners, MLD are of two types – principle protected and non-principle protected. They are issued for the period of 13 months to 60 months and generally require minimum investment of Rs 25 lakh and more. Unlike a bond that pays a fixed interest either monthly, quarterly, half yearly or annually, MLDs do not pay any regular income. Your income from an MLD comes only at maturity.

This is how it works: An MLD is linked to some underlying financial security like a stock market index such as Nifty or a 10-year government security paper. As there is no income to be had during its tenure, the gain from an MLD is ascertained at the time of maturity, depending on how its underlying asset has moved.

For example, if an investor has bought an MLD which is linked to movement in Nifty with a promise to pay 70% movement (participation, as it is termed) in Nifty, then at the time of maturity if the Nifty has moved 50% (point to point), then the investor takes home his principle plus 35% (70% of 50%) return.

Here, at the maturity, the investor would see a payoff equal to 135% of principal invested. Note that Nifty may have actually moved up or down in the interim, but it's final position at the time of MLD's maturity is accounted for to ascertain how much money it pays you- the investor- at maturity.

An MLD being a debt instrument- even though it could be linked to an equity instrument like Nifty- may come with a credit rating. The participation rate can be higher to entice investors, if the MLD come with a lower rating. In the past, MLDs have come with a variety of credit ratings ranging from 'AAA' (connotes the highest level of creditworthiness) to 'AA' or even an 'A' rating; the latter of which denotes low credit worthiness of the borrower (the firm that issues the MLD).

This may sound too attractive. But in case of non-principle protected MLD one may see losses also, if the underlying security goes down. Of course, they offer higher participation in the movement of underlying index or security.

Each issuer is free to choose the underlying index or security with which the payoff for investor is linked. This underling index or security could be nifty, bank nifty, 10 year government bond yield, gold. The idea is to choose a security which is widely traded and not easy to manipulate.

As per CARE Ratings, principle protected MLDs account for approximately 95% of the issuances in nine months ended December 31 2018. “Investors prefer to invest in the principle protected MLD because they are sure that there downside is protected. And they have to risk only on the upside and credit risk,” says Prateek Pant, head of products and solutions, Sanctum Wealth Management.

Though the MLDs come with tenures ranging between 13 months to 60 months, the average maturity of MLDs issued has been 2.85 years in nine months ended December 31, 2018 as compared to 2.92 years in financial year ended March 31, 2018.

“Investors are seen opting for principle protected MLD with AAA rating that mature between 24 months to 36 months,” said Nishant Agarwal, managing partner and head- family office, ASK Wealth Advisors. The fall in average tenure of MLD is partly attributed to reduced investor appetite arising out of increased uncertainty in the market.

Tax efficient…

Though the investors are worried about the increasing risks in fixed income market, there is a tendency to pick these MLDs in high networth individuals given the tax treatment they attract.

Like all other listed bonds, long term capital gains earned on listed MLDs are taxed at 10%, if MLDs are sold after a year. Bond funds impose a long – term capital gains tax 20% (after indexation) on gains on investments, if held for 36 months. Interest income earned on traditional fixed deposits and debentures is taxed at marginal rate of tax.

After the payoff is ascertained just before the maturity of the MLD, the investor sells the MLD on the exchange close to fair value. This ensures that his gains so realised are taxed as long term capital gains at 10%. And the remaining amount of money is taxed as interest. This can best be understood with an example.

An investor buys an MLD at Rs 100 and the expected payoff at the time of maturity is Rs 135. Just before the maturity, the MLD is sold on the exchange at say Rs 134. Here, Rs 34 is taxed as long term capital gain.

If Investor A sells his MLD to investor B and investor B sells his MLD to investor A, then both of them will book large part of their gain as long term capital gain. Remaining return, if any (Re 1 in this case) will be taxed as interest earned at marginal rate of tax.

If the investor does not sell the units and receives the payoff as maturity proceeds, then the same will be taxed as interest at marginal rate of tax. A point to note is, capital gains on unlisted MLDs are taxed at 20% rate of tax post indexation if held for 36 months. And if held till maturity, proceeds are taxed as interest. All short term capital gains are taxed at marginal rate of tax.

Ashish Shanker says, “The favourable tax treatment of listed MLDs helps the high networth individuals pocket substantially more returns than they would otherwise earn on other comparable fixed income options.”

Stable issuers such L&T Finance, Tata Capital Financial Services, Mahindra & Mahindra Financial Services are an added attraction to high networth individuals.

“Investors across the risk spectrum are opting for MLDs since this allows them to create pay out in line with their risk profile and investment preferences. For example, an aggressive investor will be looking at outperforming the markets using MLD’s by investing in a product with higher participation. The conservative investor may be willing to accept lower participation and higher certainty of returns,” says Gaurav Awasthi, Senior Partner, IIFL Wealth Management.

…but highly complex

While MLDs appear to be juicy, these are highly complex products. It is not a plain vanilla bond offering and the outcomes may vary based on the movement of underlying securities. Two MLDs issued by the same issuer may have diagonally opposite payoffs and investors should not be blindly signing above the dotted line.

The money raised through MLD is used partly in the business activities of the NBFC and partly to buy derivative instruments to be able to pay you back your money. Like any other bond, MLD too come with credit risk. Whether MLD pays off investors at maturity, depends partly on how the underlying instruments have moved (linked to the participation rate) and how the company itself performs, that is recovers money from its businesses.

If the underlying security moves in the opposite direction, investors just get their principal, and nothing else, back. Lower ratings connote higher risk. “AA rated MLDs offer more participation than their AAA rated counterparts,” says Agarwal while explaining that high returns come with high risk. Return of capital is an important parameter and one should ignore it while chasing return on capital. Prateek Pant says, “We stick to good quality names while advising our clients on MLD and do not go below AA rated papers.”

The ability to manage the derivatives book is a tricky area. “Investors look at nifty linked debentures as they can generate extra returns than Nifty. However one must understand that the issuer should be continuously managing his options positions right. Investors should not ignore this risk while buying MLDs,” says Feroze Azeez, deputy CEO, Anand Rathi Private Wealth Management.

Some issuers prefer to enter into forward agreements to buy and sell options to mimic the agreed payoffs on their MLDs outstanding. This ensures low costs but they come with high counter-party risk. Some issuers prefer to trade long term options on the stock exchange which nullifies counter-party risk.

Though principle protected MLDs are listed on stock exchanges, they are rarely traded. You should be prepared to hold on to your investments till maturity.

“Investors should also understand that they have to get the quantum of move in the chosen direction and time taken for that move right to make money in products where promised returns are high. Getting both right is a difficult call,” says Vishal Dhawan, founder and chief financial planner, Plan Ahead Wealth Advisor.

This is not just an ordinary assured return instrument. Market linked debentures are complex instruments that are best avoided by lay investors or even those who understand markets well but don’t still get the complexities. Look at MLDs only if you fully understand them.