Debt market crisis spreads to hybrid fund investors

Three hybrid schemes of Reliance AMC have high exposure to downgraded papers

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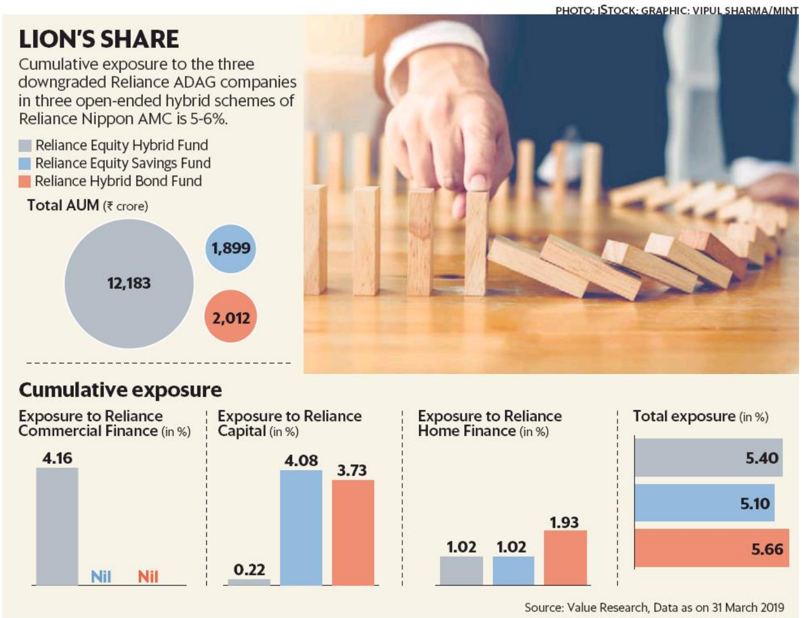

With the downgrades of three key Reliance ADAG group companies, the debt problems that were till now centred on debt funds and fixed maturity plans are now spreading to hybrid funds as well, in turn affecting retail investors more. Hybrid funds, known as balanced funds earlier, invest in a combination of equity and debt assets. Open-ended hybrid funds, in particular, are popular among retail investors. According to data from the Association of Mutual Funds in India (Amfi), as of March 2019, individual investors accounted for 88% of the assets of equity-oriented schemes, a category that includes hybrid funds.

Among the funds exposed to the downgraded companies—Reliance Capital Ltd, Reliance Home Finance Ltd and Reliance Commercial Finance Ltd—three hybrid schemes of Reliance Nippon Asset Management Ltd feature prominently on account of their category, size and exposure level. These are Reliance Equity Hybrid Fund, Reliance Equity Savings Fund and Reliance Hybrid Bond Fund.

Hybrid funds have been exposed to other troubled groups in the past such as Essel group, but in this case, the size of the funds affected and the exposure level is significant. According to portfolio data as of 31 March 2019, the three schemes have cumulative exposures to the three companies—of 5-6% of the scheme assets or roughly ₹900 crore. The net asset values (NAVs) of the three schemes were down 1-3.5% when trading resumed after the downgrade on 30 April 2019.

However, given that these are hybrid schemes, the drop cannot be solely attributed to the downgrades since they invest in equity as well. In a media statement, Reliance Nippon AMC stated that there will be a mark-to-market valuation impact on the exposure to Reliance Home Finance and Reliance Commercial Finance on the basis of "revised valuation provided by independent valuation agencies". Mark-to-market is the change in the value of a portfolio in response to a change in the market prices of its holdings. A lower valuation by an independent valuation agency would cause the NAV of the scheme to dip.

On 18 April, CARE Ratings downgraded Reliance Capital debt worth ₹21,000 crore from CARE A+ to CARE A. A day later, Brickwork Ratings followed suit; it downgraded Reliance Capital debt worth ₹14,100 crore from BWR AA to BWR A+. Brickwork Ratings also downgraded debt issued by two other ADAG Group companies, Reliance Home Finance and Reliance Commercial Finance.

Just eight days after these downgrades, on 26 April, CARE Ratings downgraded long-term bank facilities worth ₹12,500 crore of Reliance Commercial Finance to D and non-convertible debentures worth assigned to companies in default or extremely close to default. CARE Ratings also downgraded long-term debt worth ₹4,980 crore of Reliance Home Finance from CARE BBB+ to CARE D and debt worth ₹12,320 crore, earlier falling under either the CARE BBB+ or CARE BBB category, to CARE C.

Separately, on 26 April, ICRA downgraded commercial papers from Reliance Capital, Reliance Commercial Finance and Reliance Home Finance from ICRA A2 to ICRA A4. All three downgraded companies released press statements, on 27 April, with regard to the downgrade, where Reliance Capital alleged that the ratings action by ICRA was "unjustified and unwarranted".

Mint reached out to the downgraded companies. A spokesperson, representing all three companies, highlighted the measures being taken by the company to raise liquidity through asset sales. Talking about the sale of Reliance Nippon AMC, the spokesperson clarified that the due diligence for Reliance Capital's stake sale in the company is now complete and an announcement is now "imminent".

If you are invested in a hybrid scheme, financial advisers recommend a cautious approach

Reliance Nippon AMC also released a statement to distributors on its exposure to Reliance Commercial Finance and Reliance Home Finance. In it, the AMC emphasized that its investments in the company were made from January 2017 to April 2018 when the companies were rated AA+ and that there were steep ratings downgrades from September 2018. The statement further noted that Reliance Commercial Finance and Reliance Home Finance have raised significant resources through retail asset sales and securitization in excess of ₹7,000 crore.

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A media statement released by Reliance Nippon AMC also disclosed an exposure worth ₹205 crore to Reliance Capital. However, the AMC stated that this paper continues to be rated A by CARE and A+ by Brickworks and there would be no impact from the same as "there is no change in rating".

"Reliance will most probably write off investments in the downgraded companies or take a haircut. The financial health of the ADAG Group has been precarious for a long time. In a hybrid fund, the debt component is there for stability, not returns. Fund managers should not be taking risky bets with the debt portion of hybrid funds," said Suresh Sadagopan, founder, Ladder7 Financial Advisories, a financial planning firm.

A key question is whether the AMC would go for side-pocketing. This is a procedure laid down by the Securities and Exchange Board of India (Sebi) under which fund houses can segregate bad papers in case of their downgrade below investment grade from the rest of the securities in the scheme. Investors are free to withdraw their money from the rest of the scheme, except the side-pocketed units, which are also closed to fresh investments. These side-pocketed units can be redeemed once the money owed against them is recovered.

An expert with knowledge of the matter indicated, on condition of anonymity, that Reliance Nippon AMC would not resort to side-pocketing since it was confident of recovering its money in the debt of the downgraded companies. "Side-pocketing would be an acknowledgement that the initial investment decision was incorrect and AMCs are unwilling to accept that," said Shyam Sekhar, founder, should be recognized and dealt with," he added.

WHAT YOU SHOULD DO

Before investing in a hybrid fund, investors should take into account the risk factor of the debt component in the fund. According to Vishal Dhawan, founder and CEO, Plan Ahead Investment Advisors, a financial planning firm, "Investors buying hybrid funds tend to focus on the equity component to evaluate the fund but ignore the debt component. This can cause them to ignore important risks."

If you are invested in a hybrid scheme, financial advisers recommend a cautious approach, taking into account the exit load and tax implications of leaving the fund.

According to Vijai Mantri, co-promoter and chief mentor, Buckfast Financial Advisory Services, "Investors need to figure out how much of these troubled companies' securities are owned by MF schemes in which he/she has invested. If it is less than the exit load, then no issues, but if it's more than the exit load, then immediate action may be needed."

Note that hybrid schemes with more than 65% equity exposure are considered as equity schemes for tax purposes. A 15% short-term capital gains tax applies if they are sold within a year of purchase. If they are sold after a year, a 10% long-term capital gains tax applies on gains above ₹1 lakh per annum. Reliance Equity Hybrid Fund and Reliance Equity Savings Fund are mandated by Sebi rules governing their categories to hold more than 65% of their gross assets in equity.

Investors in the affected schemes should speak to their financial advisers about the best course of action to follow. Those without exposure should review the debt holdings of their hybrid schemes, and not wait for things to go wrong.

Reliance Group companies have sued HT Media Ltd, Mint's publisher, and nine others in the Bombay high

₹200 crore to D. It also downgraded another ₹5,000 crore worth of debt to C. A rating of D is

balance sheet" fund-raising and near-term liabilities have put stress on balance sheet liquidity, said the

iThought, an investment advisory firm. "Waiting for a default is not the answer. If there is a problem, it

court over a 2 October 2014 front-page story that they have disputed. HT Media is contesting the case.