

# Masala Bonds as a Source of Fund for Indian Corporates



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## 1. Introduction

A bond is a debt instrument requiring the issuer (also called the debtor or borrower) to repay to the lender/ investor the amount borrowed plus the interest over a specified period of time (Horne, 2002).

A bond is normally an interest rate-only loan, meaning that the borrower will pay the interest every period, but none of the principal will be repaid until the end of the loan (Ross, Westerfield, & Jordan, 2003).

(Fabozzi, 2000) A fundamental property of bond is that its price changes in the opposite direction from the change in the required yield. The reason is that the price of the bond is the present value of the cash flows. As the required yield increases, the present value of the cash flow decreases; hence the price decreases. The opposite is true when the required yield decreases: the present value of the cash flows increases, and therefore the price of bond increases. The expected cash flows are determined from bond characteristics or bond contract (Brealey, 2006).

Bonds are loans lasting from 12 months to over 30 years that normally pay interest at regular intervals and with repayment of their principal on the maturity date. Bonds are also known as debt, credit and fixed-income market (Mobius, 2012).

Bond as a debt instruments requires from the issuer (debtor or borrower) to repay to the lender/ investor the amount borrowed (principal) plus interest over a specified period of time. A key feature of a bond is the nature of the issuer, which is usually divided in three groups: government, municipalities and corporations (domestic and foreign) (Ivanovskia, Stojanovskib, & Ivanovskac, 2013).

There are four main types of bond (Romzi, 2013):

1. Treasury bonds: These bonds are issued by the government. Some kinds of treasury bonds issued in Indonesia are Surat Utang Negara (SUN), State Sharia securities (Sukuk), Fixed-rate bond, the State variable bonds. This bond is risk-free rate means no default risk.
2. Corporate bonds: Corporate bonds are bond which is issued by corporate. These bonds have higher risk rather than Treasury bond. The higher risk of corporate bonds caused these bonds have higher coupon payment compared to treasury bonds. Corporate bonds are debt obligating of a corporation to pay periodic interest with full repayment at maturity. Corporate bonds are classified by the type of issuer.

The four general classifications are

- (1) Public utilities, (2) transportation, (3) banks/finance, and (4) industrial.

The essential features of a corporate bond are relatively simple. The corporate issuer promises to pay a specified percentage of par values on designated dates (the coupon payments) and to repay par or principal value of the bond at maturity. In order to estimate the ability of the issuer to live up to its future contractual obligations, professional money managers use various techniques to analyse information on companies and bond issues one of them is by using three rating systems. The commercial rating companies are (1) Moody's investors Service, (2) Standard and Poor's Corporation, and (3) Fitch Ratings.

3. Municipal bonds: These bonds are issued by local government (province). Municipal bonds have default risk as corporate bonds. Usually if the bondholders are local resident, it is free of tax for the coupon rates.
4. Foreign bonds: Foreign bonds are issued by foreign governments or foreign corporations. Additional risk exists if the bonds are denominated in foreign currency.

### Masala Bonds

Masala bonds are debt instruments issued by Indian companies and the Government of India to raise funds from the international market in Indian currency. The name 'Masala' represents cuisine of India which had gained popularity worldwide. Since these bonds are pegged to Indian rupee instead of US dollar, country risk arising due to fluctuating rupee falls on investor rather than issuer. This is a new financial instrument in the Indian market that will help the Indian companies to raise capital oversee in the Indian currency. Masala bonds are intended for the foreign investors who want to participate in the Indian assets. Issuance of masala bonds is the step initiated by the Reserve Bank of India towards the internationalisation of the Indian currency. If the Indian currency becomes highly acceptable then it helps in making the currency more attractive. Masala bonds are the first Indian bonds to be listed on the London Stock Exchange.

## 2. Review of Literature

Agrawal & Jain (2018) explained how masala bonds has impacted the company's debt, cost of capital. Masala bonds has been categorised as External Commercial Borrowing (ECB). Not only masala bonds have a short- term effect but also has a long term effect on th e issuing company. The objective of the article was to determine the impact of masala bonds on the company's debt. Also, to compare the Working Average Cost of Capital and Debt Equity Ratio of listed companies in

different sectors. And it has been seen that earlier companies depended on equity more than debt. Because of which the Working Average Cost of Capital was high. But later they started issuing debt which decreased the WACC. Debt to equity ratio was constant in 2009-10 to 2011-12, because of no change in the capital structure but it increased in the year 2012-13 because the company issued long term bond. The conclusion was that the masala bonds have impacted the company's debt, Cost of Capital and performance as company's debt equity went up and the WACC came down. Hence, masala bonds have had a direct impact on the issuing companies but the impact may vary from company to company depending on their capital structure and requirements.

Challa & Kanakdurga (2016) discussed about the history of masala bonds; In November 2014 International Finance Corporation (IFC) issued the first masala bond in London in order to increase the foreign investment in India. IFC is the largest global development institution, established in 1956, owned by 184 member countries. It is mainly focused on financial companies and private sector companies in developing countries. Masala bonds were the first rupee denominated bonds listed on the London Stock Exchange (LSE). IFC named masala bonds as 'Masala' to reflect the spiciness and culture of India. The idea was similar to Chinese Dim-Sum Bonds, which are Chinese renminbi-denominated bonds and named after a popular dish in Hong Kong. Another one is Japanese Samurai bond, which is Yen-denominated bond and named after its country's warrior. Then it further explained the benefits for issuer and investors. For Issuer, it helps in diversifying the portfolio. Indian entity does not have to bear the risk of currency. For investor, one can earn better returns through masala bonds compared to the investment returns from one's home country.

Sreevas (2016) compared Masala Bonds with other currency denominated bond and shows that the RBI guide line on the issue of Masala bonds. It analysed the amount of international borrowing in Indian Rupee out of total international borrowing. Further, it explained how Masala Bond strengthened UK- India Financial partnership, and how Investors are getting better interest rates but less net return because of depreciation of value of Indian rupee.

Anshika (2016) focused on understanding the features, strengths, advantages and disadvantages of Masala Bond it further mentions the date of issue, percentage and interest rate of Masala bonds. And finally, concludes by saying Masala Bond is one of the cheapest ways to raise funds because it has low interest rates as compare to other source of borrowings. Investors are getting better interest rates but may decrease net return due to depreciation of Indian Rupee.

Verma (2016) explained how Masala Bond got its positive response, what is the benefit to borrower and investors it further discusses that Masala Bond is one of the cheapest ways to raise funds because it has low interest rates as compare to other source of borrowings. It also gives a caution that there are also possibilities that off shore investors may hedge their investment in rupee bonds in non-deliverable forward market overseas and in that situation RBI will have no control over that. There can also be a distinct possibility of adverse impact on the growth of Indian Corporate Bond Market and also on Indian Banks. And concludes by saying, Rupee bond is definitely going to be a new beginning to raise money from abroad where there is plenty of liquidity but very limited investment options and comparatively lower interest rates. It can bring in more foreign funds to the country for the development of infrastructure which is the pressing need of time, whereas interest rate burden on borrowers can reduce. Considering that fact that Chinese economy is slowing down, India is considered to be on growth trajectory and performance of rupee is much better than other emerging markets. It sets the right momentum for the rupee bonds. Until now, only reputed firms have issued Masala Bond. Investors are getting better yield and they are looking for a stable currency.

The paper aims to: Analyse the returns of masala bonds after adjusting country risk and to study investors' perception towards Masala bonds. This study helps in identifying the goodness of masala bonds after adjusting country risk. So, the investors can decide whether to keep these bonds for short term or long term. The study deals with calculating yield to maturity of the masala bond issued. Yield to maturity is the total return anticipated on a bond if it is held till maturity. Through yield to maturity we will get the total return on masala bonds. This yield to maturity is then compared with the spread. For calculating spread, we have to check the rating of the bond selected, after rating is known, then corresponding value for the rating is taken. It is then adjusted with country risk i.e. 2.64% for India. The obtained value is thus compared with yield to maturity. The higher the difference between yield to maturity of the bond and the required risk adjusted return, the better the bond.

Secondary data is used for the purpose of this study. The data is collected from different sources such as Annual Report of various companies used in the study, various financial websites, and incorporated data from various government repositories, Aswath Damodaran's Investment Coverage Ratios and Ratings: High Market cap Firms and different stock exchanges. Yield to Maturity is calculated for each masala bond issued and then it is compared with the Prof. Aswath Damodaran's Investment Coverage Ratios and Ratings (Table 1) adjusted with country risk (Table 2). Then, comparison is made with each bond to see whether the bond proves to be a better investment vehicle for the investors or fails.

### Formula for calculating Yield to Maturity

Yield to Maturity =

$$\frac{\text{Annual Interest} + \frac{\text{Par Value} - \text{Market Price}}{\text{Number of Years to Maturity}}}{\frac{\text{Par Value} + \text{Market Price}}{2}}$$

**Table 1** Investment Coverage Ratios and Rating

Interest Coverage Ratio	Rating	Spread
>8.5	AAA	0.75%
6.5-8.5	AA	1.00%
5.5-6.5	A+	1.50%
4.25-5.5	A	1.80%
3-4.25	A-	2.00%
2.5-3	BBB	2.25%
2-2.5	BB	3.50%
1.75-2	B+	4.75%
1.5-1.75	B	6.50%
1.25-1.5	B-	8.00%
0.8-1.25	CCC	10.00%
0.65-0.8	CC	11.50%
0.2-0.65	C	12.70%
<0.2	D	14.00%

**Table 2** Country default Spreads and Risk Premiums

	Country Risk Premium
India	2.64%

Now, we have to check the rating of the bond and then we have to take the corresponding spread value and add it to the country risk premium which will give the required risk adjusted return

Then, the obtained value will be compared with yield to maturity of the issuer.

The higher the difference between Yield to Maturity and required risk adjusted return the better is the bond.

**Table 3** Indiabulls Housing Finance Ltd

Issuer	Indiabulls Housing Finance Ltd
Issuer Rating	AAA
Issue Date	15-09-2016
Amount Issued	13,30,00,00,000
Maturity Date	15-10-2019
Currency	INR
Coupon Rate	8.57%
Yield to Maturity	14.18%
Market Price	99.003

(As on 14<sup>th</sup> July 2019)

From Table 1, the bond is AAA rated, the spread is 0.75%.

By adding, the country risk premium i.e. 2.64% to this spread will give the required risk adjusted return.

$$=0.75\%+2.64\%$$

$$=3.39\%$$

So, an investor must expect a return of 3.39% after adjusting the country risk. But, here the investor is getting a return of 14.18% if the bond is held till maturity.

$$=14.18\%-3.39\%$$

$$=10.79\%$$

As difference between yield to maturity of this company and required risk adjusted return is high.

We can expect good returns from the bond.

**Table 4** Province of British Columbia

Issuer	Province of British Columbia
Issuer Rating	AAA
Issue Date	09-09-2016
Amount Issued	5,00,00,00,000
Maturity Date	09-01-2020
Currency	INR
Coupon Rate	6.60%
Yield to Maturity	6.84%
Market Price	100.023

(As on 14<sup>th</sup> July 2019)

From Table 1, the bond is AAA rated. Thus, the spread is 0.75%.

By adding, the country risk premium i.e. 2.64% to this spread will give the required risk adjusted return. =3.39%  
 The investor expects a return of 3.39% after adjusting country risk.  
 $=6.84\% - 3.39\%$   
 $=3.45\%$

As difference between yield to maturity of this company and required risk adjusted return is high.  
 We can expect good returns from the bond.

**Table 5** Kerala Infrastructure Investment Fund Board

Issuer	KIIFB
Issuer Rating	BB
Issue Date	29-03-2019
Amount Issued	21,50,00,00,000
Maturity Date	29-03-2024
Currency	INR
Coupon Rate	9.72%
Yield to Maturity	7.20%
Market Price	110.034

(As on 14<sup>th</sup> July 2019)

From Table 1, the bond is BB rated. Thus, the spread is 3.50%.

By adding, the country risk premium i.e. 2.64% to this spread will give the required risk adjusted return.  
 $=3.50\% + 2.64\%$   
 $=6.14\%$

So, an investor expects a return of 6.14%.

But here the investor is getting a return of 7.20%, if the bond is held till maturity.  
 $=7.20\% - 6.14\%$   
 $=1.06\%$

As difference between yield to maturity of this company and required risk adjusted return is high.  
 One can expect good returns from the bond.

**Table 6** National Highway Authority of India

Issuer	NHAI
Issuer Rating	AAA
Issue Date	18-05-2017
Amount Issued	30,00,00,00,000
Maturity Date	18-05-2022
Currency	INR
Coupon Rate	7.30%
Yield to Maturity	7.66%
Market Price	99.345

(As on 14<sup>th</sup> July 2019)

From Table 1, the bond is AAA rated. Thus, the spread is 0.75%.

By adding, the country risk premium i.e. 2.64% to this spread will give the required risk adjusted return.  
 $=3.39\%$

The investor expects a return of 3.39%.

But here the investor is getting the return of 7.66%, if the bond is held till maturity.  
 $=7.66\% - 3.39\%$   
 $=4.27\%$

As difference between yield to maturity of this company and required risk adjusted return is high.  
 One can expect good returns from the bond.

**Table 7** National Thermal Power Corporation

Issuer	NTPC
Issuer Rating	BBB
Issue Date	03-05-2017
Amount Issued	20,00,00,00,000
Maturity Date	03-05-2022
Currency	INR
Coupon Rate	7.25%
Yield to Maturity	7.53%
Market Price	99.201

(As on 14<sup>th</sup> July 2019)

From Table 1, the bond is BBB rated. Thus, the spread is 2.25%.

By adding, the country risk premium i.e. 2.64% to this spread will give the required risk adjusted return.  
 $=2.25\%+2.64\%$   
 $=4.89\%$

The investor expects a return of 4.89%.

But here the investor is getting the return of 7.53%, if the bond is held till maturity.  
 $=7.53\%-4.89\%$   
 $=2.64\%$

As difference between yield to maturity of this company and required risk adjusted return is high.  
 One can expect good returns from the bond.

**Table 8** Housing Development Finance Corporation

Issuer	HDFC
Issuer Rating	AAA
Issue Date	22-03-2018
Amount Issued	23,00,00,00,000
Maturity Date	22-03-2025
Currency	INR
Coupon Rate	8.10%
Yield to Maturity	8.10%
Market Price	99.311

(As on 14<sup>th</sup> July 2019)

From Table 1, the bond is AAA rated. Thus, the spread is 0.75%.

By adding, the country risk premium i.e. 2.64% to this spread will give the required risk adjusted return.  
 $=3.39\%$

The investor expects a return of 3.39%.

But here the investor is getting the return of 8.10%, if the bond is held till maturity.  
 $=8.10\%-3.39\%$   
 $=4.71\%$

As difference between yield to maturity of this company and required risk adjusted return is high.  
 One can expect good returns from the bond.

**Table 9** International Finance Corporation

Issuer	IFC
Issuer Rating	AAA
Issue Date	21-03-2016
Amount Issued	2,00,00,00,000
Maturity Date	21-03-2031
Currency	INR
Coupon Rate	7.10%
Yield to Maturity	6.67%
Market Price	103.889

(As on 14<sup>th</sup> July 2019)

From Table 1, the bond is AAA rated. Thus, the spread is 0.75%.

By adding, the country risk premium i.e. 2.64% to this spread will give the required risk adjusted return.  
 $=3.39\%$

The investor expects a return of 3.39%.

But here the investor is getting the return of 6.67%, if the bond is held till maturity.  
 $=6.67\%-3.39\%$   
 $=3.28\%$

As difference between yield to maturity of this company and required risk adjusted return is high.  
 One can expect good returns from the bond.

**Table 10 Indian Renewable Energy Development Agency**

Issuer	IREDA
Issuer Rating	AA
Issue Date	10-10-2017
Amount Issued	19,50,00,00,000
Maturity Date	10-10-2022
Currency	INR
Coupon Rate	7.13%
Yield to Maturity	7.88%
Market Price	97.726

(As on 14<sup>th</sup> July 2019)

From Table 1, the bond is AA rated. Thus, the spread is 1.00%.

By adding, the country risk premium i.e. 2.64% to this spread will give the required risk adjusted return.

$$=1.00\% + 2.64\%$$

$$=3.64\%$$

The investor expects a return of 3.64%.

But here the investor is getting the return of 7.88%, if the bond is held till maturity.

$$=7.88\% - 3.64\%$$

$$=4.24\%$$

As difference between yield to maturity of this company and required risk adjusted return is high.

One can expect good returns from the bond.

### 3. Findings and Conclusion

#### Observations and Findings / Learnings

As the purpose of introduction of Masala Bond was the appreciation in the value of Indian rupee. It is very much beneficial for the country as well the companies issuing it. But when a bond is considered it has to give handsome returns to attract investors. Same thing applies here, and it has been found that the Masala Bonds perform well in the market. And in fact, perform better than other similar bonds and provide better returns. They have succeeded to meet the expectations of the investors.

It has also been seen that investors buy these bonds for short term because of the country risk. But, through this study it has been found that these bonds perform well enough even if the country risk is included.

### 4. Suggestions and Conclusion

#### Suggestions

Although, country risk is a major factor while considering Masala Bonds but investors should not just consider country risk alone. They should also consider other factors like the liquidity of the bond and risk/ return etc.

### 5. Conclusion

From the analysis done it can be said that Masala Bond proves to be good investment vehicle for investors as it provides handsome returns even after the country risk is adjusted, when compared to similar USD bond then also Masala Bond performed better.

### 6. Limitations of Study

- Only bonds issued on London stock exchange are considered for the study.
- Only 8 of the masala bonds issued in the London stock exchange are considered.
- Out of the issuing companies only few are listed on the stock market which restrains the availability of Data
- Use of secondary data does not always give accurate figures.