

# India Fixed Income Investing for Foreign Investors

*April 2017*

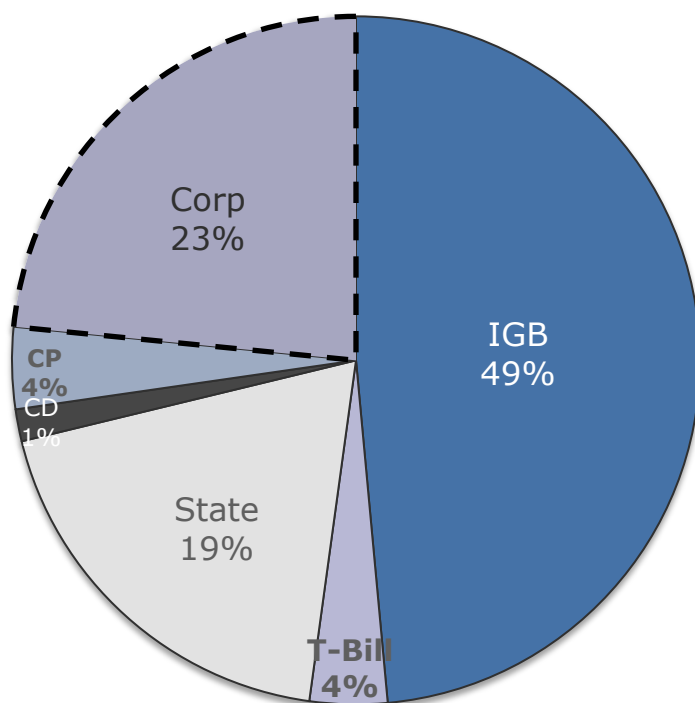


# **INR Debt Product Landscape**

# Indian Fixed Income Market Overview



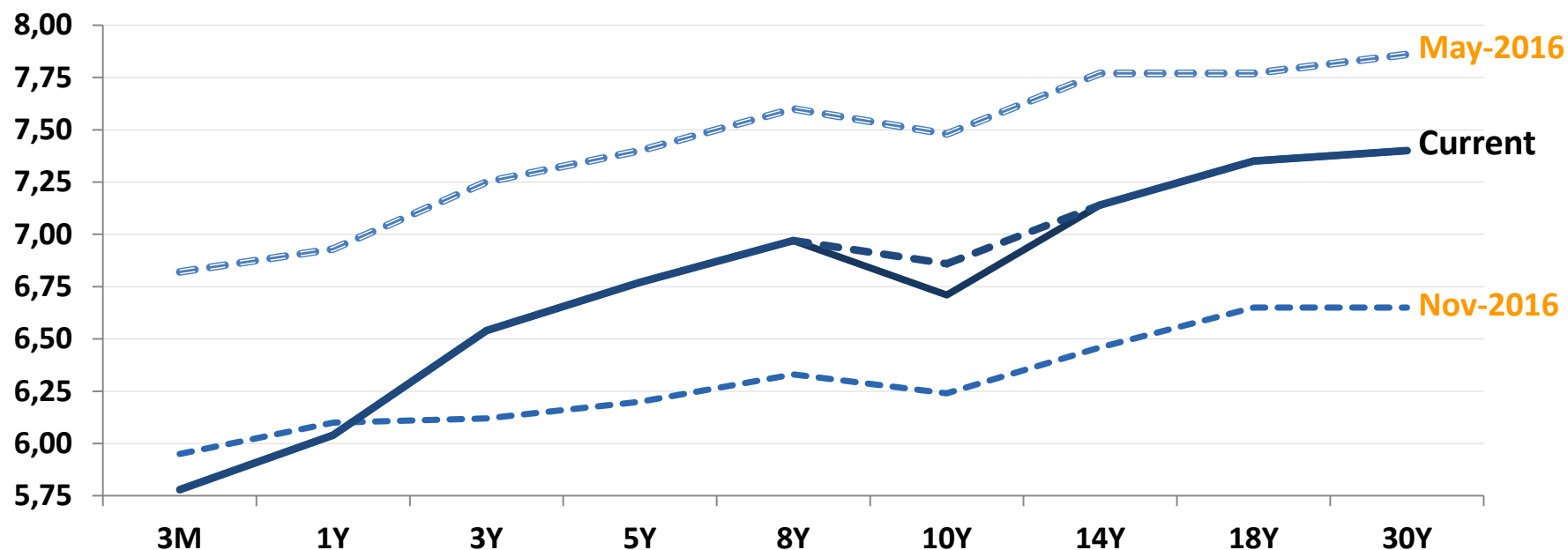
Total INR Denominated Bonds – USD 1.5 tn



Outstanding (USD bn)	
G-Sec	725
T-Bill	55
State*	285
CD	22
CP	57
Corp Bonds	350
Total	1500

- IGBs & T-Bills make up 53% of local currency bonds
- As yields continue to drop, corporate bonds will receive greater attention in the quest for higher spread
- **Expect corporate bond outstanding to grow to at least USD 500 bn by 2020**

# Sovereign Debt Yield Curve



- Curve has steepened after policy review
- FPI preference has also moved to the 5-10Y segment
- Spread of liquid off-the-run options had widened initially, now contracted due to buying momentum

# Corporate Debt Yield Curve – Quasi-Sovereign



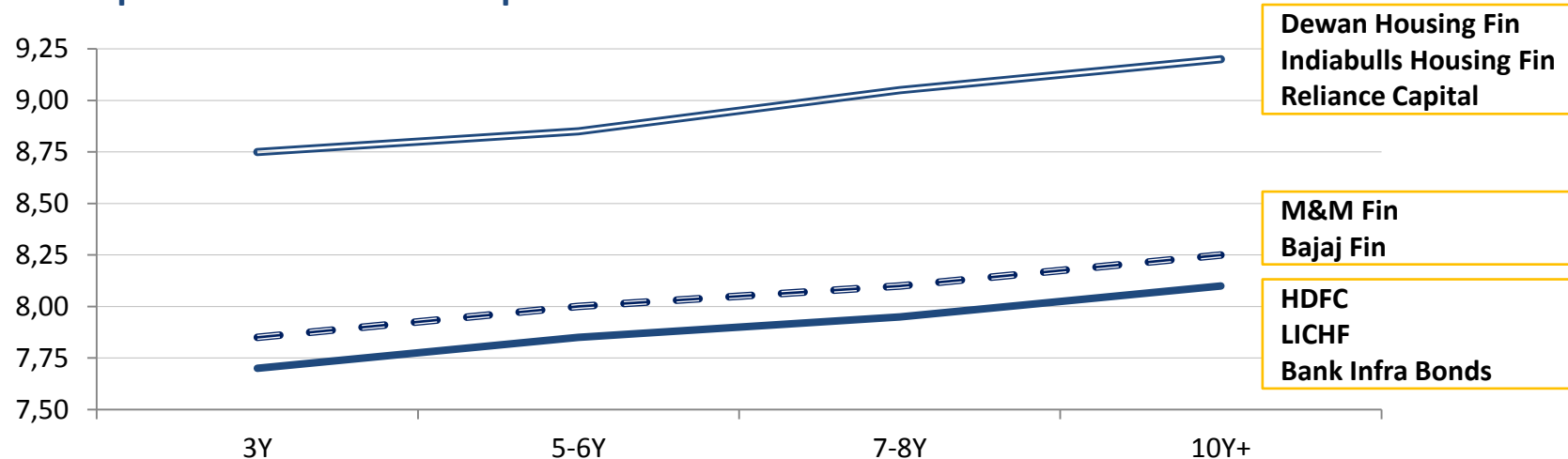
Issuer	3Y	5Y	10Y	10Y+
EXIM Bank	7.15	7.40	7.62	7.65
Nuclear Power Corp	7.15	7.44	7.64	7.70
Power Grid Corp	7.17	7.44	7.64	7.67
Rural Elec Corp	7.20	7.50	7.72	7.75
Power Finance Corp	7.25	7.54	7.75	7.77
Indian Railway Fin Corp	7.14	7.38	7.62	7.65
National Thermal Power Corp	7.17	7.42	7.65	7.70
Steel Auth of India	7.85	8.10	8.15	-

- Domestic appetite in 3-5Y segment
- Curve steepens in 5Y to 10Y portion

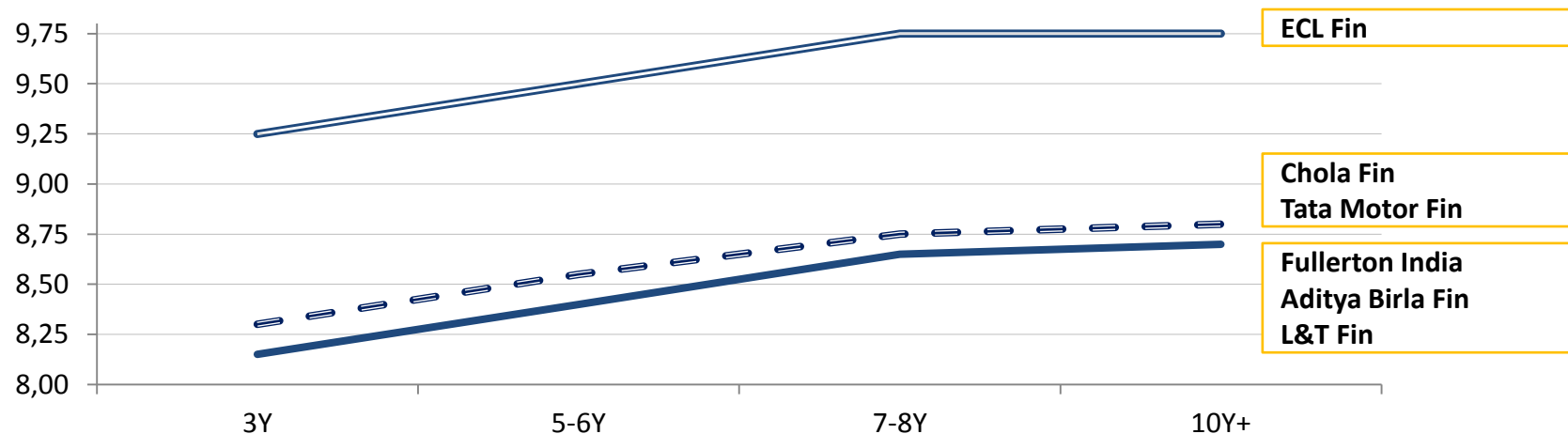
# Corporate Debt Yield Curve – Private Sector



## Sizable Spread within the AAA space



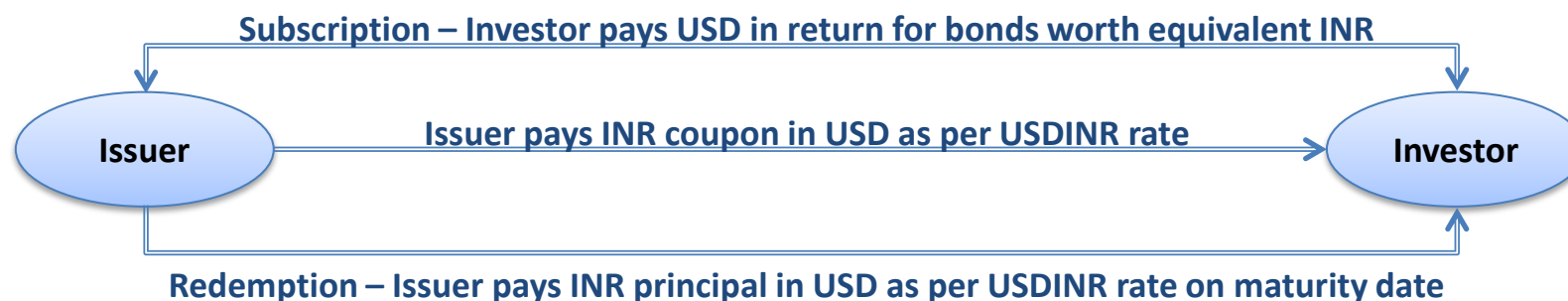
## AA+, AA Yields



# Offshore Rupee Bonds [*Masala Bonds*]



Parameter	Criteria
<b>Denomination</b>	INR denominated – offers local currency exposure for investors
<b>Settlement Currency</b>	Subscription, coupon payments & redemption may be foreign currency settled
<b>Instrument</b>	Plain vanilla bonds
<b>Borrowers</b>	All Indian corporates (public & private sector) permitted to issue such bonds
<b>Investors</b>	Any investor from a FATF compliant jurisdiction
<b>Maturity</b>	Minimum of 3 years (put / call not permitted within 3 years)
<b>All-in-Cost</b>	Commensurate with prevailing market conditions
<b>Issue Size</b>	INR 50 bn per year under automatic route. RBI approval required beyond this limit
<b>Withholding Tax</b>	5% – On par with onshore bonds and other ECB borrowing



# Masala Bonds [contd.]



- After a slow start, investor appetite picking up for offshore rupee bonds
- Issuers lining up with non-deal roadshows to tap this market
- Completed deals:

Issuer	Size	Tenor
<b>HDFC – Tranche I</b>	INR 30 bn	3Y 1m
<b>NTPC</b>	INR 20 bn	5Y
<b>Adani Transmission</b>	INR 5 bn	5Y
<b>HDFC – Tranche II</b>	INR 20 bn	4Y
<b>Indiabulls Housing Finance</b>	INR 13.3 bn	3Y 1m
<b>Fullerton India</b>	INR 5 bn	3Y 1m
<b>ECL Finance</b>	INR 5 bn	3Y 2m
<b>Shriram Transport Finance</b>	INR 11.5 bn	3Y 1m
<b>HDFC – Tranche III</b>	INR 33 bn	3Y 1m

# Cash Settled Interest Rate Futures [Bond Futures]



Parameter	Specification
<b>Contract</b>	Futures contracts based on <ul style="list-style-type: none"><li>• IGB 6.84, 2022</li><li>• IGB 7.68, 2023</li><li>• IGB 7.59, 2026</li><li>• <b>IGB 6.97, 2026</b></li><li>• IGB 7.88, 2030</li></ul>
<b>Trading Hours</b>	Monday to Friday 9:00 A.M. to 05:00 P.M. IST
<b>Expiry Day</b>	Last Thursday of the month
<b>Contract Cycle</b>	Monthly - 3 serial months, Current, Mid & Far months Quarterly – 3 serial quarters
<b>Contract Size</b>	Face Value per contract = INR 200,000 equivalent to 2000 bonds with face value of INR 100 each
<b>Price Quotation</b>	Similar to the quoted price of underlying GOI security
<b>Contract Value</b>	Quoted price * 2000

## Salient Features

- Cash settled, exchange traded
- Single traded liquid bond is the benchmark as against a notional basket in the earlier avatar
- Underlying is the most liquid instrument – hence no pricing uncertainty
- Low margin requirement (< 4%)

## Strategies

- View based
- Arbitrage
- Portfolio Hedging

## Trading Statistics

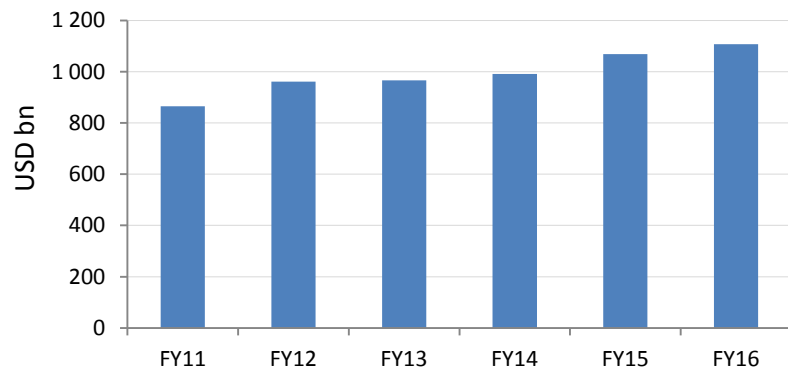
- Average Daily Trading Volume: INR 15 bn
- Current Open Interest: INR 45 bn

# Market Outstanding



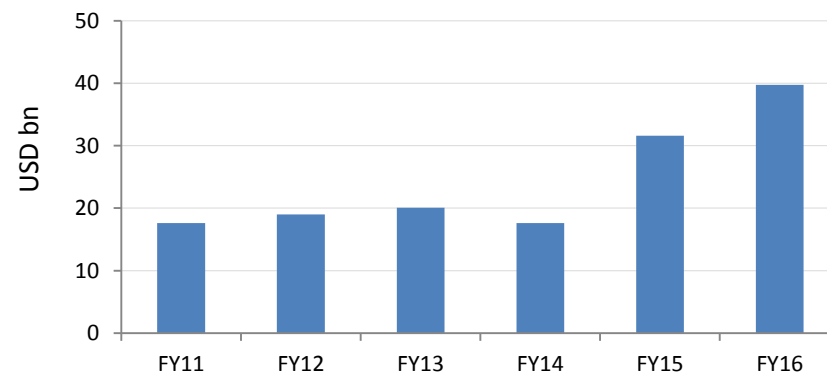
## Bank Credit - Outstanding

Source: RBI



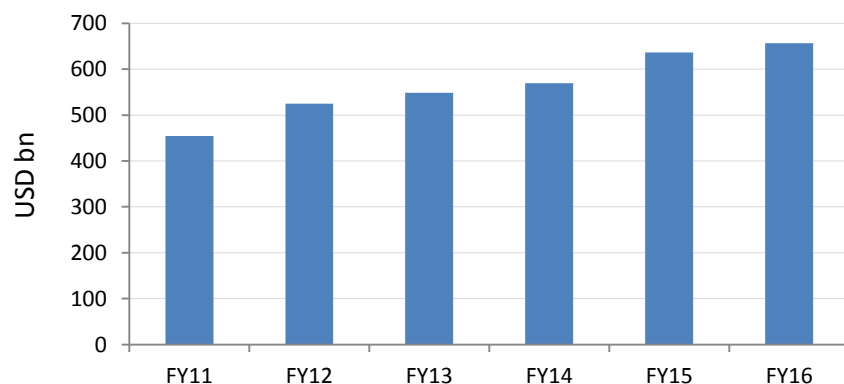
## Commercial Paper - Outstanding

Source: RBI



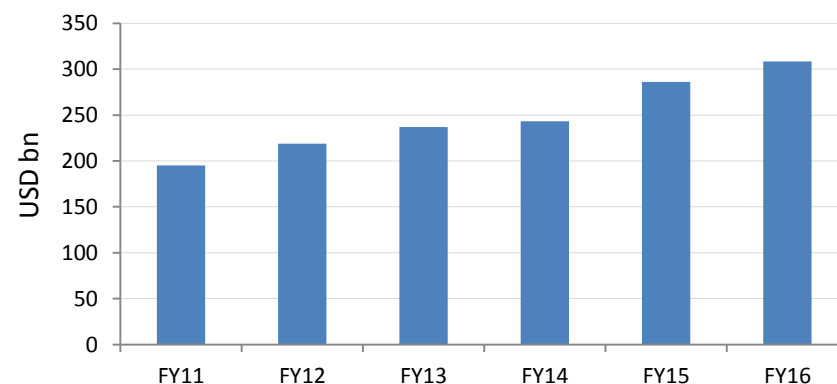
## Government Securities – Outstanding

Source: RBI



## Corporate Debt – Outstanding

Source: SEBI

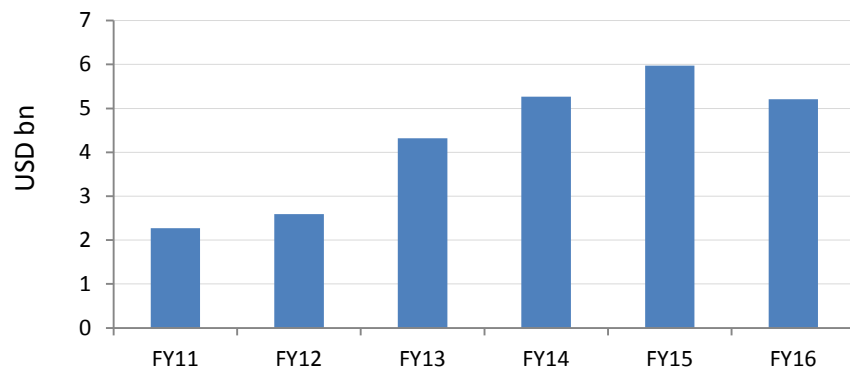


# Market Activity



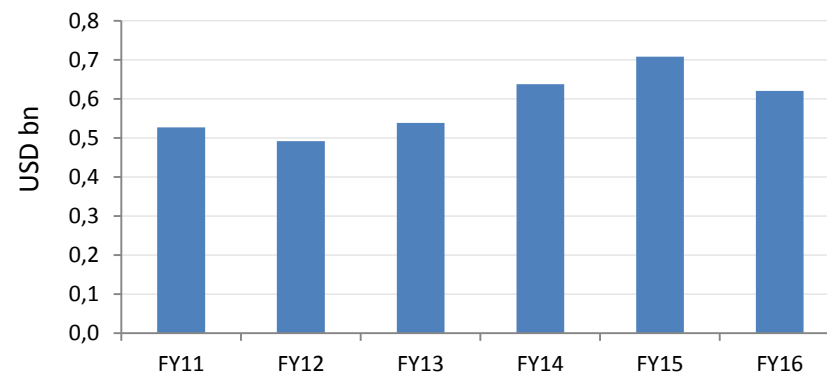
## Government Securities – Secondary Market Transactions

Average daily traded volume in G-Secs, Source: RBI



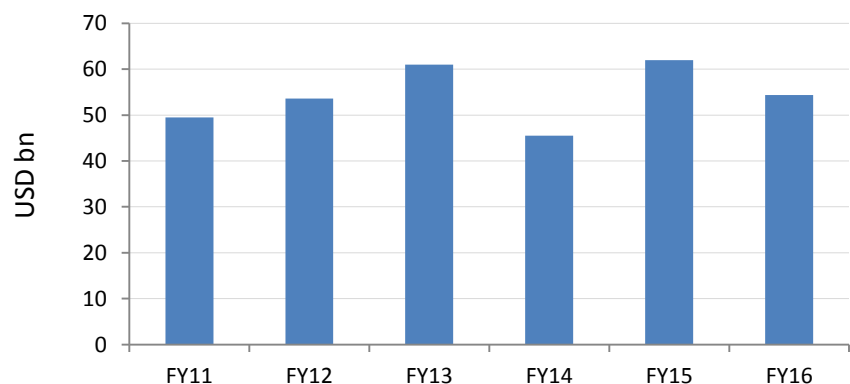
## Corporate Debt – Secondary Market Transactions

Average daily traded volume in Corp Debt, reported on NSE & BSE



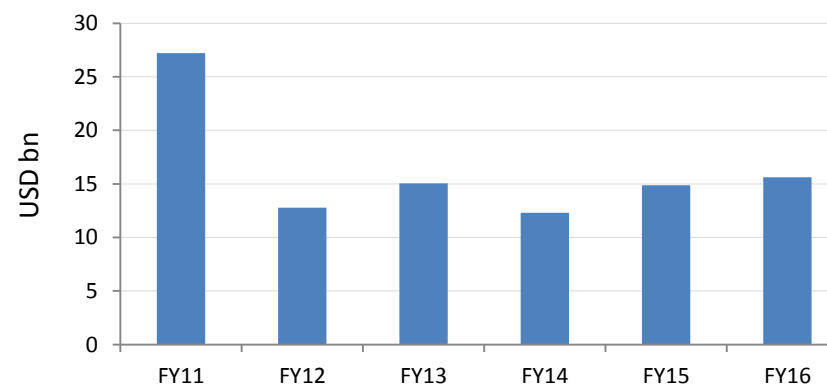
## Corporate Debt – Primary Market Issuance

Private Placement + Public Issue, Source: Prime Database



## Equity – Primary Market Issuance

Source: CMIE





# **Regulations, Limits & Trends in FPI Debt Investments**

# Overview



## Who can invest?

- Any investor registered with SEBI as Foreign Portfolio Investor (FPI) can invest in the Indian Fixed Income space

## How can they invest?

- FPIs can invest “on-tap” in Government & Corporate bonds (when limit utilization below 90%)
- Appoint a local custodian bank to settle the trade
- **Settlement Cycles: IGB – T+2, Corp Bonds – T+0, T+1 or T+2**

## Eligible Instruments

- Government Securities (dated securities with residual maturity > 3 years)
- Listed Non Convertible Debentures & bonds issued by Indian Companies (residual maturity > 3 years)
- Units of Debt-oriented mutual funds – except Money Market MFs

## Taxation

- Interest and Capital Gains are subject to taxation
- Base tax rates are as follows:
  - Coupon: **5% withholding tax**, for interest accruing between Jun 2013 and Jun 2020 (eligible only if coupon less than SBI base rate + 500 bps)
  - Short term capital gains: 30%
  - Long term capital gains: 10%
- Favorable tax rates will override the above rate in case of applicable tax treaty with the country of domicile

# Investment Limits for FPIs



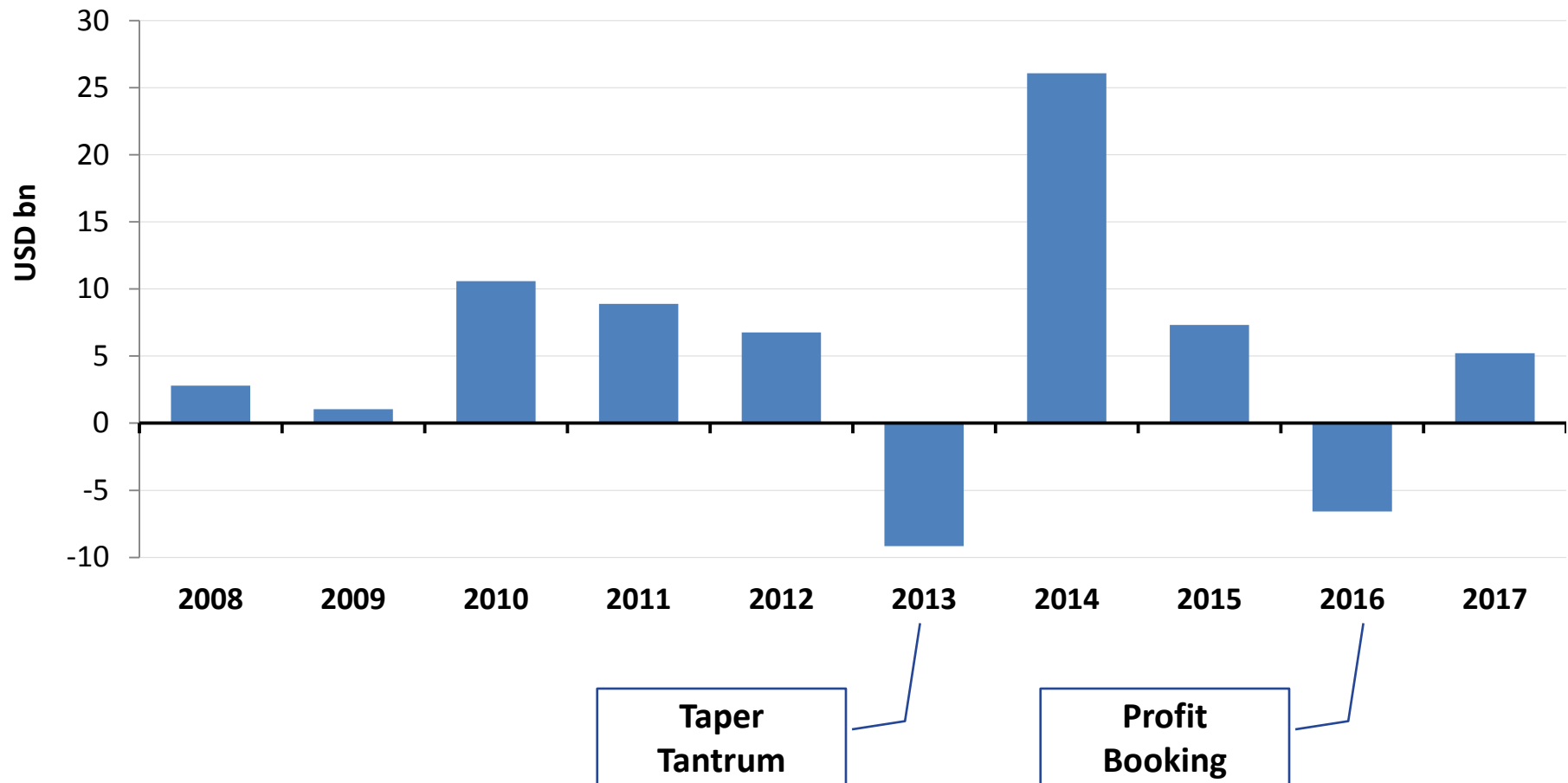
Category	IGB [All FPIs]
<b>Current Limit</b> (INR bn)	<b>1,520</b>
<b>Current Investment</b> (INR bn)	<b>1,230</b>
<b>% Free Limit</b>	<b>16%</b>

- **Residual maturity to be 3 years or higher at the time of investment in all categories**
- Limits to be announced / fixed in rupee terms
- Limits will be increased to 5% of outstanding IGB stock by Mar-2018 in phases
- Increase in limits will be announced half yearly in March & Sept and released every quarter
- **Limits available on-tap till 90% of limit is utilized; Auction mechanism to be followed post 90% utilization**
- **Unutilized limits under long-term FPI category to be transferred to generic FPI category at end of Mar-2017**

# Foreign Investor Inflows into INR Bonds



Net Debt Flows into India (Source: SEBI)



# Key Trends to Look Forward To



- Majority of foreign investor corporate bond investment is in quasi-sovereign names and HDFC / LICHF
- Incremental inquiries on top rated NBFCs / mortgage finance companies – Inflow is picking up
- As US Fed rate hikes gain momentum and EM yield spreads narrow, shift along the credit curve is likely
- Due diligence & credit analysis will be crucial
- Appetite in form of Masala bonds (offshore rupee bonds) also anticipated despite liquidity concerns
- Access to a wider pool of foreign capital → Diversified investor base
- **If Indian macro remains stable, financial services companies will be leading issuers and drivers of liquidity in both onshore and offshore markets**

# FPI Checklist



**FII registration with SEBI (Securities and Exchange Board of India)**



**Appointment of custodian (for trade settlement)**



**Investor registration with clearing houses of exchanges (for Corp Bonds) & CSGL (for IGBs)**



**Appointment of intermediaries / counterparties for trade execution**



**KYC formalities with counterparties**



# Edelweiss Financial Services – An Overview



## CREDIT BUSINESSES

Present across the spectrum of

### Wholesale

- Structured Collateralized Credit
- Real Estate
- Distressed Assets Credit

### Retail

- Mortgages
- SME & Agri-Financing
- LAS & others

## NON CREDIT BUSINESSES

Strong product franchise serving diverse client needs

- Capital Markets
- Wealth Management
- Asset Management
- Balance Sheet Management Unit
- Agri Services & Others

## INSURANCE

One of the fastest growing Life Insurance companies

## One of the top 5 Diversified Financial Services Firms

On Balance Sheet Assets	~ 321 bn
Assets under Management	~ 321 bn
Assets under Advice	~ 295 bn
# of clients	~887,000
# of employees	~6,227
# of offices	237
# of client touch points	4,500

Data as of Mar 31, 2016

## Key Institutional Investors



BIH SA

SAIF Advisors



جهاز أبوظبي للاستثمار  
Abu Dhabi Investment Authority

# Comprehensive Research Support



## Periodic Updates

- \* Daily report, briefly covering day's activity along with key data points
- \* Monetary Policy Preview and Review
- \* IRF Weekly Tracker

## Analytic Update

- \* Weekly Statistical Supplement (WSS) to understand changing deposit, lending and investment pattern of the banking system

## Special Reports

- \* Liquidity Jigsaw - Analysis of the systemic liquidity deficit drivers
- \* State Development Loans – A trend analysis
- \* Tax-free Bonds – Landscape & Outlook
- \* US Fed Rate Hike – Timing, Implications, Hangover
- \* FI Debt Flow Monitor
- \* G-Sec Auctions: Key Influencers

## Macroeconomic Research

- \* Macro data analysis - Inflation, IIP, GDP, Budget

### BOND VECTOR

Fixed Income Daily

India Fixed Income Research

Short covering, value buying help stem the free-fall of Gilts; LAF plunges

- Markets did not lose further ground at the open as yields were more or less at yesterday's level. In the absence of any major cues and ahead of an extended trading break, short-covering led to thinning of positions and yields headed south.
- In addition, there were instances of value buying as yields are at attractive levels after the recent fall and as the markets begin to factor in rate cuts at RBI's upcoming policy meet.
- The 10-Y benchmark rallied 5 bps from yesterday's level to end the session at 8.65%. Overall G-Sec volumes also picked up after a series of active pre activity sessions.
- The OS market which was relatively insulated amidst yesterday's panic had a strong session today as swap rates came off by more than 5 bps across tenors. This is a likely fallout of the easing liquidity together with anticipation of RBI rate action. The 1Y OS closed at 7.98-0.04% vs 8.02-0.03% and the 5Y swap traded at 7.54-7.60% against 7.60-7.65%.

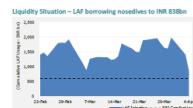
#### Non-SLR Market

ABFI placed April-End maturity CP worth INR 500mn @ 9.90%. Shriram Equipment Finance Limited placed June maturity CP worth INR 250mn @ 10.40%. Sundaram Finance placed 1 month CP worth INR 500mn @ 9.50%.

#### Money Market

The liquidity situation has finally shown signs of moderating with the LAF borrowing coming off to INR 830bn (across 2 windows combined) – this is largely on expected lines with year-end strains easing away. The call rates also softened in tandem, with the 5-day borrowing WARR settling at 9.26% vs 9.35%.

#### India Yield Curve – G-Sec & OS



Source: Edelweiss Research, Bloomberg, CDS

### MONETARY POLICY PREVIEW

Hawkishness might translate into another repo rate hike

India Fixed Income Research

The latest round of inflation data points leaves little doubt as to the tone of the RBI at the upcoming policy review. The uptick in both wholesale and retail gauges is likely to form the cornerstone of the review and might even translate into a 25bps repo rate hike. The RBI has been clear in its guidance that anchoring inflation and inflationary expectations is top priority and there is no reason to waver from this stance. As with the last review, the actions are likely to be dual aimed with the rate hike being accompanied by further easing of the liquidity measures. One of the most probable actions on this front is a 25 bps reduction in MRP borrowing rate to 8.75%, thereby normalizing the spread between LAF and MRP rates to 100bps. The recovery in the rates in September and stability therein has enabled the RBI to reverse part of the extraordinary measures and it is expected to continue with reversal over the next couple of months in the absence of any shocks. Relaxation of the LAF borrowing limit of 0.75% of NDI is one of these steps but it has a lower probability of being undertaken at this review.

The RBI did not have to resort to incremental interest rate defense to tackle the currency volatility as the initial set of measures combined with import curbs have proved successful. However, the monetary easing trajectory that was set rolling in the first half of 2013 has been abruptly halted and we are facing a possible extended tightening regime. Elevated retail inflation despite a good monsoon will be the primary concern and hence the RBI might be prompted to tackle the issue with a second successive rate cut. Even if the rate is kept on hold at this review, we expect rate hikes totaling 25-50 bps through the rest of this fiscal and resumption of monetary easing might have to wait till the beginning of the next fiscal, at the earliest.

No respite from rising food prices; Trade deficit trend continuing

Although growth has been in an extended slowdown and monetary policy recognized the need for action earlier in the year, persistently high inflation will continue to garner most of the policy focus in the near term. On the other hand, the positive trend to have emerged of late in the sharp dip in imports (particularly gold) which will result in a highly improved current account deficit as compared to earlier fears. The currency might also be supported around current levels due to this as well as the possibility of US Fed tapering being delayed to March next year. Hence the RBI might make use of its interest to tackle inflationary pressures via its monetary policy guidelines.

Money market tightness eases significantly; Mid to long term yields in narrow range

The yield curve has flattened in tune with the RBI action as the short end of the curve saw a sharp correction in response to the liquidity measures. The overnight rates have responded to the MRP borrowing rate reduction while overall liquidity tightness has been assuaged by OMO buyback and the offering of 774-day term repo. Conversely, the repo rate hike and apprehension of further hikes has kept the mid to long end of the curve under pressure. However trading has been largely range bound as a stable repo, lifting of the US budget impasse and delayed tapering helped improve some of the inflation related weak sentiment. The market is expecting a healthy guidance by the RBI and if a repo rate hike is announced, it can impact further hawkishness, pushing yields by 10-15 bps.

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Ideas create, values protect

Yield Curve	4-Apr	3-Apr	Change
1Y	8.02%	8.75%	-4
2Y	8.08%	8.75%	-5
3Y	8.08%	8.75%	-5
4Y	8.08%	8.75%	-5
5Y	8.08%	8.75%	-5
10Y	8.65%	8.75%	-7

One Bond	4-Apr	3-Apr	Change
1Y	9.25%	9.35%	0
5Y	9.26%	9.35%	0

One Bond (Non-SLR)	4-Apr	3-Apr	Change
1Y	9.90%	9.90%	0
5Y	9.90%	9.90%	0

CD	4-Apr	3-Apr	Change
3 mth	10.05%	10.05%	30
6 mth	10.05%	10.05%	30
1 yr	10.05%	10.05%	30

CF	4-Apr	3-Apr	Change
3 mth	10.50%	10.50%	35
6 mth	10.40%	10.50%	-5
1 yr	10.40%	10.50%	-5

Swap	4-Apr	3-Apr	Change
1Y	8.02%	8.08%	-4
2Y	7.98%	7.98%	-4
5Y	7.54%	7.60%	-6

Other Indicators	4-Apr	3-Apr	Change
Crude (USD/bbl)	124.2	124.3	-0.1%
Gold (USD/oz)	1623	1646	-1.4%
US Dollar	51.1	50.72	-0.8%
INR/USD Price	64.82%	67.7%	-4.12%
India Index	79.80	79.44	0.4%
Nifty	5833	5859	-2.7%
Nifty Midcap	9.24%	9.45%	-2.12%
US 10Y Treasury	3.24%	3.25%	-0.01%

\* Figures are as of 04:00 PM IST  
Source: Edelweiss Research, Bloomberg, CDS

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### STATE DEVELOPMENT LOANS

A Trend Analysis

India Fixed Income Research | December 2013



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### INFLATION

Manufacturing & core inflation below 6%; Food inflation higher as base effect recedes

India Fixed Income Research

With inflation for the month of February was 6.50% year, slightly ahead of the consensus estimate of 6.75% and higher than previous month's 6.50%, however, the breakdown of the data makes for pleasant reading as core and manufacturing inflation softened further to below 6%, now almost 1.5% below RBI's comfort level of 7%. This would provide the required buffer in case inflation is expected to bounce as a result of the imported component from higher crude prices as well as any near-term fuel price hike.

Given that the growth indicators are displaying fluctuating trends of late, stable inflation will be the key guide for the RBI in timing monetary policy action. Brent crude has stayed over USD 120/bbl since mid-Feb (average level of USD 125 in March), and if the March inflation number also stays soft in spite of elevated crude, RBI might get the conviction to begin rate cuts in the April review.

#### Headline inflation shows first uptick in 5 months

Inflation which had steadily declined from 10% in Sep to 6.55% in Jan inched up in February primarily on account of reading base effect in food inflation. As expected, primary articles and food inflation have moved back above 6% (6.3% and 6% respectively) and should now stabilize in the 6-7% range. Fuel inflation has come down from 14.2% last month to 12.0%. The headline number is expected to stay around the 7% mark in the near term with upward pressure likely to come in from the rising import bill and if the government decides to hike fuel prices.

#### Core & manufacturing inflation dip to more comfortable levels

The lagged effect of monetary tightening and the reprieve appearing in Jan & Feb have helped in controlling the closely watched components of core inflation. Core inflation (non-food manufacturing) has come off to 5.7% year vs 6.7% in Dec and manufacturing inflation is at 5.75% vs 6.3%. Higher crude prices and any hike in domestic fuel prices can push up these numbers, however the fact that the current reading is quite in control means that only a significant shock can fail the near term inflation trajectory. The central bank should gain assurance from the February data and a reading on similar lines for March can provide the trigger to begin rate action as early as the April policy review.

#### Policy implications and near term yield impact

The bond markets have been in a cautious to nervous mood of late and reacted quite negatively to the recent positive surprise in GDP data. Funding rate cuts might be delayed. The inflation release on the other hand has been cheered by the market and yields have almost spontaneously rallied by "30bps. We believe this is a one-off reaction as attention should soon shift back to the RBI's commentary in the policy review tomorrow (no rate action is expected) and a realistic fiscal consolidation effort in the Union Budget on Friday. If these are not yet off current market expectations, gifts should be foreseen and pave the issue of fast couple of weeks, backed by the underlying inflation trend and the investment slowdown.

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