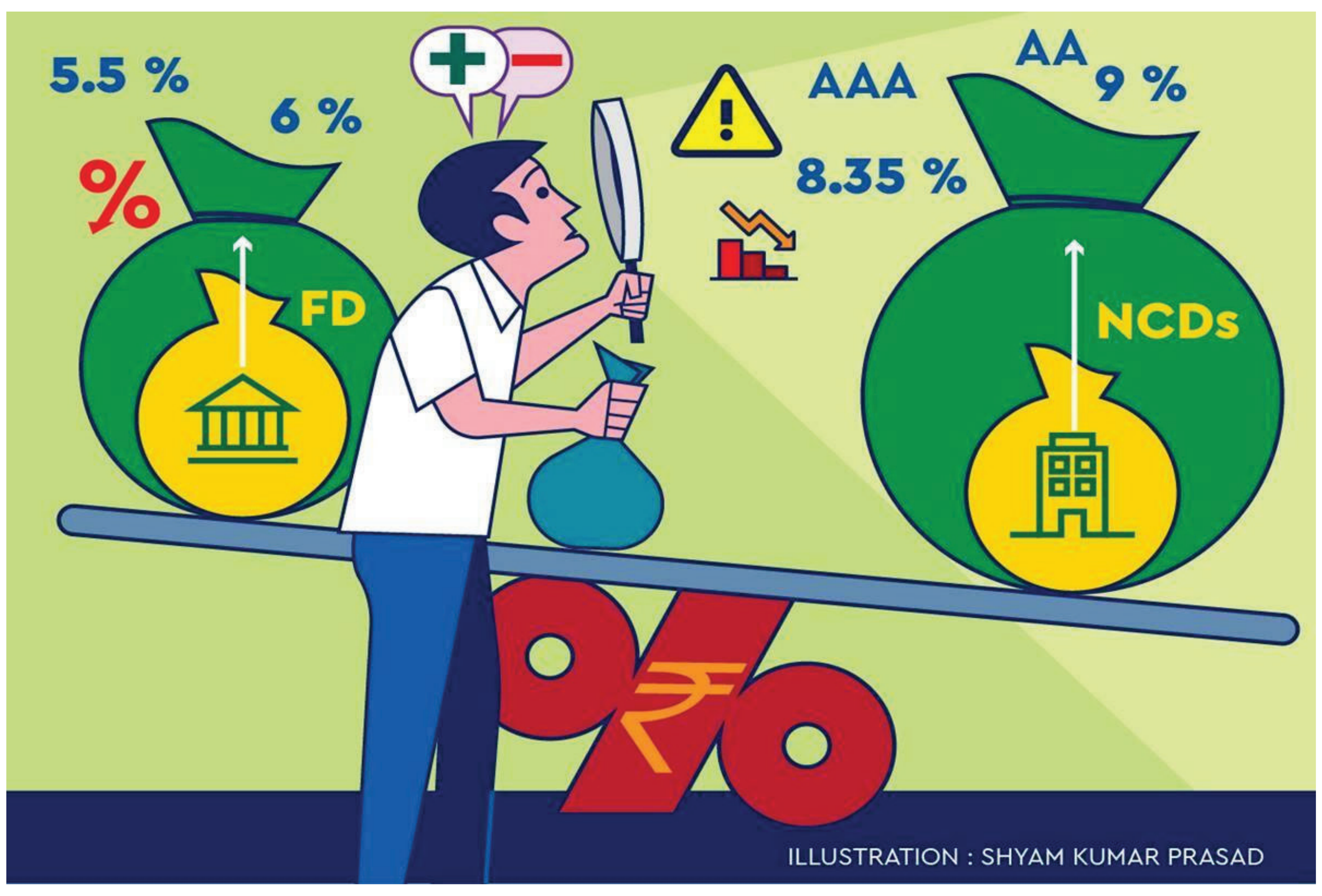
Non-Convertible Debentures: Invest in NCDs only if you can handle some risk

By: Saikat Neogi | July 14, 2021 1:15 AM

Go for secured NCDs to reduce default risk significantly. Limit your allocation to 10% of your fixed income portfolio



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Individual investors with moderate-to-high risk appetite can look at investing in non-convertible debentures (NCD). Two non-banking financial companies—Piramal Capital and Housing Finance (PCHFL) and IIFL Home Finance — have come out with their NCD issues. PCHFL is offering interest rates of 8.35-9% depending on the tenure (26-120 months), while IIFL Home Finance is offering a coupon rate of 9.6% for monthly interest payout and 10% for annual payout for a fixed tenure of 87 months.Fixed deposits rates offered by banks are 5.5-6% for 1-5 years tenure.

However, investors must be cautious while investing in an NCD and look at the credit rating of the company. PCHFL's issue has been rated as AA by CARE Ratings and AA (outlook: Negative) by ICRA, while IIFL Home Finance's instrument is rated AA with a stable outlook by Crisil Ratings and **AA+ with a negative outlook by Brickwork Ratings.**

NCDs have higher risks
Cash-strapped companies often resort to NCDs with higher interest rates to raise money from the public. Secured NCDs are backed by assets, where if the company is unable to fulfil its obligations, the assets are liquidated to repay the investors. Companies offering secured debentures pay lower coupons than non-secured ones. In unsecured NCDs, if the company defaults or faces liquidation, investors will simply lose the money invested.

As NCDs are not liquid, it is not easy to sell the bonds even in the secondary market as trading remains very thin. Investors must keep a tab on the ratings as long as they stay invested. For instance, IL&FS was downgraded to D rating, from the highest AAA in less than two months. Typically, those with AAA ratings have the highest degree of safety, those below AA should be avoided.

PCHFL's NCDs
PCHFL, a wholly-owned subsidiary of Piramal Enterprise, is offering secured NCDs with issue size of Rs 200 crore with an option to retain oversubscription of up to Rs 800 crore. The issue offers four tenures – 26, 36, 60 and 120 months with the coupon ranging between 8.35 to 9% (see chart). The face value of each NCD is Rs 1,000 and the minimum amount of investment is Rs 10,000 (10 NCDs). There are two interest payment options – annual and cumulative – in the 26-month tenure.

The company has reserved up to 40% of the issue for retail investors to be allotted on 'first come, first served' basis. The offer for the first tranche will close on July 23, 2021.

IIFL Home Finance's NCDs
The IIFL Home Loan Bonds are unsecured subordinate redeemable NCDs offering fixed rate of 10% per annum for an annual interest payout option and 9.6% for monthly interest payout option. The tenure is fixed for 87 months. The face value is Rs 1,000 per NCD and the minimum application amount is Rs 10,000 (10 NCDs). The issue size is for `1,000 crore (base issue of Rs 100 crore with an option to retain over subscription up to Rs 900 crore). Subscription for the Trance 1 issue will close on July 28, 2021.

Taxation of NCDs
There will be no tax deduction at source as the holdings will be in demat form. Interest earned on NCDs are taxed at the marginal rate. Also, if they are sold within a year, short-term capital gains at marginal rate will be applicable. If sold after a year, long-term capital gains at 10% without indexation plus education and higher education cess of 4% will be applicable.

What should investors do?
Investors must remember NCDs carry a higher credit and liquidity risk than bank deposits. Experts suggest going for secured NCDs to reduce the risk significantly in case of a complete default. Also, allocation should not be over 10% of one's fixed income portfolio.