How to tap into double digit yields on Indian credit

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Indian credit deals can yield up to 18%, but what is the best strategy to limit downside risk?

We all know India has a powerful demographic story which will ensure it owns the 21st century, says Vik Mehrotra, chief executive and chief investment officer of hedge fund specialist Venus Capital.

Its young population is eager to share the trappings of an affluent consumer society, so investment opportunities are ripe.

Indian expats often look homeward in search of high returns. But what is the best strategy to offer downside protection when the country goes through tumultuous economic periods?

India officially has the world's fastest growing economy, at 7.7%, according to the latest data. The country's equity markets enjoy strong growth but they are extremely volatile, which can damage investor portfolios.

Meanwhile the strong dollar and rising rates in USA have started reversing fund flows to emerging markets, while inflation has caused the Indian central bank to raise its benchmark interest rate for the first time since 2013.

This was a necessary action, but the rate rise will crimp growth just as Narendra Modi, the reforming prime minister who has staked everything on economic performance, faces re-election in 2019.

Strategies for equity-like returns

Investors therefore need strategies which generate equity-like returns but come without the downside risk.

An opportunity is presented by the dire state of India's banking sector. Almost all of the country's public sector banks have non-performing assets of 20-22%, thanks to historic bad loans, and their credit officers are deeply reluctant to lend more money.

The government is taking steps to recapitalise the banks, which will help. But the current situation leaves small and medium-sized businesses – which should be the drivers of India's success – starved of growth capital.

Much of the headline GDP figure is the result of public expenditure rather than private sector innovation.

Those SMEs therefore present a compelling investment case. Firms in sectors like real estate, manufacturing, financial services and IT are turning to alternative sources of lending so they can grow and provide much-desired goods and services to the swelling ranks of middle class Indians.

Non-bank finance companies have low capital cost

High on their list of sources are non-bank finance companies (NBFCs), which form an integral part of the Indian financial system. There are currently 11,469 NBFCs registered in India and 220 have assets in excess of $77m (£59.2m, €66.5m).

The structures are regulated relatively lightly by the Reserve Bank of India, allowing them to offer a wide range of lending products in comparison to the banks. And when backed by foreign investors, they can have a lower cost of capital compared to domestic NBFCs.

Other benefits include faster turnaround time on loan disbursals, product innovation, operating efficiency and strong market penetration.

Add to that recent reforms to India's insolvency and bankruptcy rules, which have given greater protection to lenders, and Indian credit begins to look like a very attractive asset class.

Deals typically last between six months and four years and produce a yield in the range of 14% -18% in rupees. Lending is backed by real estate assets, securities, corporate guarantees and restrictive covenants of 2-3 times the loan amount on deals worth US $1.5-4.5m.

And targets include acquisition financing, bridge project financing, structured construction finance and disputes or family settlements.

SMEs play vital role

SMEs account for over 80% of industrial enterprises in India and employ around 117 million people.

In the coming years they will play a vital role in raising incomes and lifting millions of workers out of poverty while driving a consumption boom.

For expats seeking high returns, to invest in their success is to invest in India's success.

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