Vodafone Idea Fiasco: Debt MF Investors Should Not Press the Panic Button Just Yet

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Highlights:

- Downside is factored in the net asset value
- Side pocketing not done so far
- Final verdict is on January 23, 2020
- Investors can choose shorter duration funds

Vodafone Idea's adjusted gross revenue (AGR) dues that amount to approximately Rs 53,000 crore and are payable to the government, have been a cause of contention in recent times. On Thursday, January 16, 2020, the Supreme Court rejected the review petition of the telecom major, casting a shadow over its future. In our annual recommended mutual fund (MF) report in 2019, three debt funds stand exposed to this risk.

Scheme	Scheme Size* (Rs crore)	% holding in Vodafone Idea Ltd	Market value of holding (Rs crore)
Franklin India Credit Risk Fund (G)	5,899.5	4.68	275.7
UTI-Bond Fund (G)	500.6	8.32	41.6
Aditya Birla SL Short Term Fund (G)	3,140.7	1.08	33.8

** Scheme size is as on December 31, 2019*

Source: iFAST Research

We spoke to Franklin India, UTI and Aditya Birla AMCs to understand their views and gauge what lies ahead. Here are the key takeaways:

The investment rationale was convincing

In the past, debt MFs invested in Vodafone Idea since its credit instruments were AAA rated. This, coupled with Indian telecom's promising prospects and a strong management team (a combination of two renowned conglomerates), made Vodafone Idea a suitable investment proposition. In comparison to Government bonds, the potential to generate alpha (incremental returns) was better.

Side pocketing not done

Side pocketing is an accounting methodology that distinguishes illiquid/low-quality investments from the relatively more liquid/high-quality investments in a debt portfolio. Consequently, the debt fund's NAV will reflect the value of liquid assets, with a separate NAV assigned to the side pocket assets (based on the estimated realisable value).

In case of Vodafone Idea, MFs have not applied this concept so far because the exposure continues to remain in investment grade, as per credit rating agencies. Side pocketing will be initiated when the exposure is downgraded to a non-investment grade.

Downside factored in

Negatives pertaining to the announcement have already been discounted in the NAVs. While Franklin India has written off its NAV to the tune of Vodafone Idea in entirety, the likes of UTI and Aditya Birla have made the necessary downward adjustments as well.

Final decision awaited

It is expected that the government is likely to reconsider its decision, after duly considering the magnitude of the impact on different stakeholders. On January 23, 2020, the final verdict will be out.

If the Supreme Court judgment against Vodafone Idea is upheld, it will undoubtedly overshadow developments in relation to the Union Budget, which is scheduled barely about a week later. Additionally, at a time when India is gradually moving up the ranks in terms of ease of doing business and attracting foreign inflows, an adverse scenario of this nature will not set a good precedent for prospective foreign investments.

For instance, if Vodafone Idea chooses to shut shop, several private and public sector banks would have to book extremely high non-performing assets, which, in turn, could curtail credit growth and liquidity further. Large-scale unemployment, concentration of pricing power in the hands of two players (Jio and Airtel), disruptions of cellular services and delayed rollout of 5G are some of the other ripple effects.

While entities in the telecom infrastructure space are expected to face similar losses, debt-heavy public sector enterprises that make use of spectrum bands will also be subject to AGR provisions on similar lines as Vodafone Idea, taxing their stressed balance sheets significantly.

From a cumulative perspective, the investment sentiment across India will be dampened, consequently hurting the gross domestic product (GDP) even more.

Perhaps, Vodafone Idea may get more time for repayment. Alternatively, a part of its AGR dues (interest and/or penalty) can be waived. Owing to heavy capital investments in this space, the promoters of Vodafone Idea would not want to let go of things easily either, unless there is no option left.

So, what should investors do?

As mentioned above, NAVs have declined in response to the newsbreak. At present, booking losses would not be advisable since any form of respite to Vodafone Idea would cause NAVs to move back up again. That said, it remains to be seen if the quantum of such rebound will be adequate to cover the extent of reduction that has taken place.

Going forward, investors should choose liquid, short-term or medium-term debt MFs. In spite of high yields, long-duration funds will be risky in the midst of the subdued and uncertainty-laden credit environment.