

ZERO COUPON BONDS: ECONOMY

NEWS: PFC withdraws zero-coupon bonds issuance due to weak investor demand

WHAT'S IN THE NEWS?

Power Finance Corporation (PFC) withdrew its ₹2,000 crore zero-coupon bond issue due to investor demands for higher yields, reflecting concerns over interest rate risks and past losses from similar bonds. Zero-coupon bonds, which do not offer regular interest, are highly sensitive to market interest rate expectations.

About Zero-Coupon Bonds (ZCBs)

- **Definition:**
Zero-coupon bonds are debt securities that do not offer periodic interest payments (unlike regular bonds which pay annual or semi-annual coupons). Instead, they are issued at a discount and redeemed at full face value upon maturity.
- **Earnings Mechanism:**
Investors earn by buying the bond at a lower price and receiving the full face value at maturity. The difference between the issue price and the maturity value is the investor's return.
- **Example:**
Suppose a bond with a face value of ₹10,000 is sold at ₹6,000. Upon maturity, the investor gets ₹10,000, thus earning ₹4,000 profit without receiving any periodic interest payments.

Advantages for the Issuer (Like PFC)

- **No Regular Interest Payments:**
Since zero-coupon bonds do not require interest payouts during their tenure, they help companies manage cash flow more efficiently, particularly useful for long-gestation infrastructure projects.
- **Fixed Borrowing Cost:**
The cost of borrowing is determined upfront at the time of issuance. This helps issuers avoid interest rate volatility and plan finances more predictably.

Disadvantages for the Investor

- **Interest Rate Risk:**
ZCBs are highly sensitive to interest rate fluctuations. If interest rates in the market rise after the bond is purchased, the bond's value in the secondary market may fall significantly. If the investor sells the bond before maturity, they may incur a loss.
- **Phantom Income Tax:**
Although no actual cash interest is received annually, tax laws in some jurisdictions (including India) may require investors to pay tax on the notional or "imputed" interest accrued each year.

Understanding Bond Yield

- **Yield-Price Relationship:**
Bond yields and prices move inversely. When bond prices fall due to market conditions (e.g., rising interest rates), the effective yield or return increases, and vice versa.
- **Yield Expectations & Market Sentiment:**
Investors anticipating rising future interest rates tend to demand higher yields upfront when subscribing to long-term bonds, to compensate for potential opportunity losses.

PFC's Withdrawn Zero-Coupon Bond Issue

- **Fundraising Target:**
PFC (Power Finance Corporation) had planned to raise ₹2,000 crore via zero-coupon bonds.
- **Market Response:**
Investors demanded higher yields ranging between 6.20% and 7.02%, reflecting their caution and expectation of rising interest rates.
- **Decision to Withdraw:**
These yields were higher than what PFC was comfortable with, leading it to cancel the bond issuance altogether to avoid higher-than-desired borrowing costs.
- **Market Sentiment Impact:**
Recent investor losses in similar zero-coupon bonds issued by REC (Rural Electrification Corporation) made the market more cautious. This legacy impact influenced investor behavior during the PFC offering.

About Power Finance Corporation (PFC)

- **Status:**
It is a Maharatna CPSE under the Ministry of Power and serves as a key institution for financing India's power infrastructure.
- **Core Function:**
Provides funding across the entire power value chain—generation, transmission, and distribution.
- **Nodal Role:**
PFC is the nodal agency for important central government schemes such as the **Revamped Distribution Sector Scheme (RDSS)** and financing of **Ultra Mega Power Projects (UMPPs)**, which are large-scale power generation projects.

This structured explanation offers clarity on why zero-coupon bonds are both attractive and risky, and how macroeconomic trends and past investor experiences shaped PFC's decision.

Source: https://www.business-standard.com/companies/news/pfc-shelves-zero-coupon-bond-issue-again-amid-weak-investor-demand-125060900849_1.html