Domestic & Overseas Debt Raising by Indian Corporates - New Challenges

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The more markets change, the more they remain the same. Corporate treasurers continue to face challenges related to volatilities of market factors like currencies, interest rates, commodity prices and equity valuations. Going into the future, we will in addition need to contend with short business cycles and shorter financial market cycles. The other significant difference is the enhanced integration of Debt, Equity and Convertible bond markets. A quick summary of Indian markets over the last 18 months will provide the background for the challenges ahead.

Business confidence: With continued stability of economic reforms notwithstanding the coalition government, business confidence continues to be high. The increased global recognition of India's technical capabilities and economic potential has meant that Indian industry is willing to invest in large, global scale projects to enhance infrastructure as well as to promote exports. With capacity utilizations in a range of industries in the 80-90% range, Indian entrepreneurs are now willing to invest capital to grow capacities. We can expect increased competition for financial resources as companies look to expand.

Foreign currency flows: India's external reserves have increased $ 118bn in May 2004 to $140bn in May 2005. This has been fuelled by remittances from NRIs, export flows, Foreign direct investment as well as portfolio capital flows. The RBI has steadily purchased dollars from these flows and injected rupee liquidity into the system.

Rupee liquidity: The high savings rate (24% of GDP) coupled with low capital formation in 1998-2003 has resulted in surplus liquidity in the Indian banking system. This liquidity has increased even further due to the RBI's purchase of $ flows. This led to interest rates reaching historic lows of 5.1% (10 year GoI) in May 2004. Subsequently however, rupee interest rates have increased by 2% to touch 7% in May 2005 on the back of higher crude oil prices, global interest rate tightening as well as increased credit demand from industry.

ECB policy: The high level of rupee liquidity and the appreciating rupee has forced the RBI to reevaluate the ECB policy. This resulted in end use restrictions being imposed in January 2004. The present policy permits corporates to raise ECBs for funding capital expenditure; but does not permit ECBs for refinancing rupee loans or working capital. The regulatory intent is clearly to use the rupee liquidity to the extent possible without restricting capital access for funding large scale projects.

Acquisitions: The last few months have seen many Indian corporates like Tata Motors, Reliance Industries and TISCO effect overseas acquisitions as part of their vision of global growth. The overseas subsidiaries of these companies have accessed the Foreign currency euroloan market to fund these acquisitions. The ECB guidelines were liberalized in 2004 enabling corporates to access the foreign currency loan market to fund overseas acquisitions. This will enable greater flexibility in funding cross border acquisitions. RBI restrictions on bank lending for acquisition of shares however is a constraint for local acquisitions.

Quasi equity instruments: We also saw the reemergence of the foreign currency convertible bond as a preferred instrument. The BSE sensex has increase from 5695 in Jan 2004 to 6800 in June 2005. In this period, companies took advantage of improved equity valuations and the improved sentiment for India paper to issue convertibles at very attractive terms. The terms included both low Yield to maturity on the bonds as well as high conversion premiums (20-50%) . FCCB issuers in this period include Indian Hotels ($150MM), Tata Motors ($400MM) , L&T ($150MM), Ashok Leyland ($100MM), Zee Telefilms ($100MM) , Tata Chemicals ($150MM), Bharat Forge ($120MM), Bajaj Hindustan ($50MM). This has meant a reduced dependence on the rupee debt markets for some of the top tier issuers.

Challenges

1. **Volatility**

   Volatility is here to stay. India's financial markets have gradually got integrated with global markets. Therefore India is no longer insulated from either global interest rate volatility or global capital flows. Reallocation of funds from OECD markets to emerging markets or vice versa causes capital flows with the concomitant effect on currencies, stock markets and interest rates. New players like lenders from Middle east , Europe and South Asia have added to liquidity in the foreign currency loan markets. New FIIs and hedge funds have added to the liquidity in the equity capital makets. The flip side however is that Indian

markets are affected when one or more of these international players change their outlook either on emerging markets in general or India in particular.

2 Reduced flows into income funds

A healthy debt market is required with an equally strong bank loan market. In recent times however, increasing interest rates have reduced the attractiveness of income funds. We see from the table below that while Liquid & money market funds have grown 53%, the AUMs of income funds has shown a sharp decline falling by 30%. Should this trend of declining income funds continue, it does not augur well for long term growth of the debt capital markets. This could be mitigated if issuers issue more floating rate paper. This also underlines the need for a vigorous interest rate swap market. We also see from the table a spike in growth funds on account of the perceived attractiveness of the equity market reflecting a change in the investor preferences.

	AUM January 2004 (Rs crores)	AUM April 2005 (Rs crores)	Growth %
Income	69320	48579	-30%
Growth	23143	37309	61%
Balanced	4404	4864	10%
Liquid / Money market	40112	61616	53%
GILT	6617	4391	-33%
ELSS	1776	1663	-6%
Total	**145373**	**158422**	**9%**

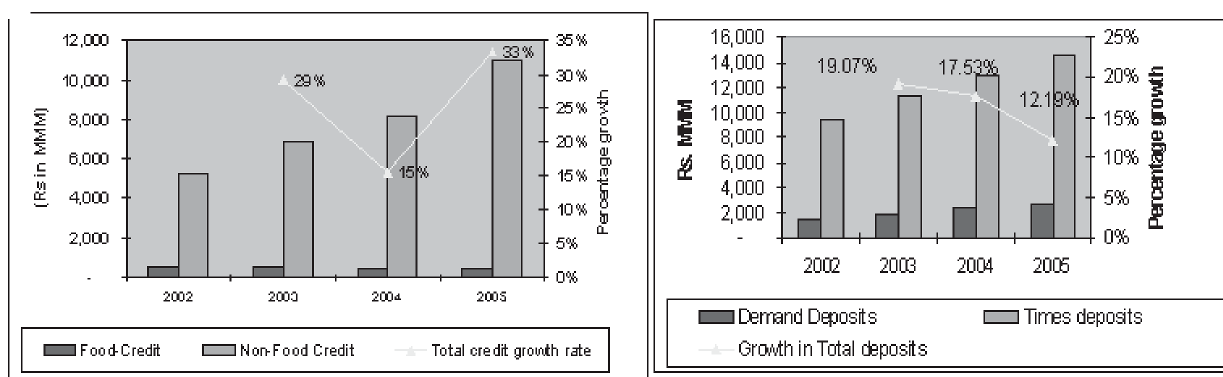
Source: AMFI monthly report

3 Tenor

Large project sizes, lower margins caused by competitive pressures imply the need for long term funds. India's financial system is still largely dominated by the banking system. Banks normally have 3-5 year customer deposits. A borrower who requires long term funds (15-20 years) is still dependant on a few providers like LIC. Infrastructure projects like power, telecom, ports, airports, urban infrastructure, roads etc require long term funds. Corporates like NTPC, NHPC, PFC, NHAI, ONGC Reliance, Hindalco etc have ambitious capex plans. Consequently we need a significant growth in the insurance, pension and providend fund sectors since they are the logical providers of long term money. In the absence of such growth, Indian corporates with large expansion plans would expose themselves to significant refinancing risks.

4 Demand supply mismatch

Bank deposit growth rates have not kept pace with growth in credit over the last 2 years. We note that credit growth has increased from 15% to 33% . At the same time deposit growth has declined from 17.53% to 12.19%. Should this trend continue, the overhang of liquidity, which we have seen in recent times, could gradually disappear. This could lead to pressure on rates. More importantly, this is a reason for large issuers to diversify their funding base by looking at alternate sources of liquidity like dollar bonds.



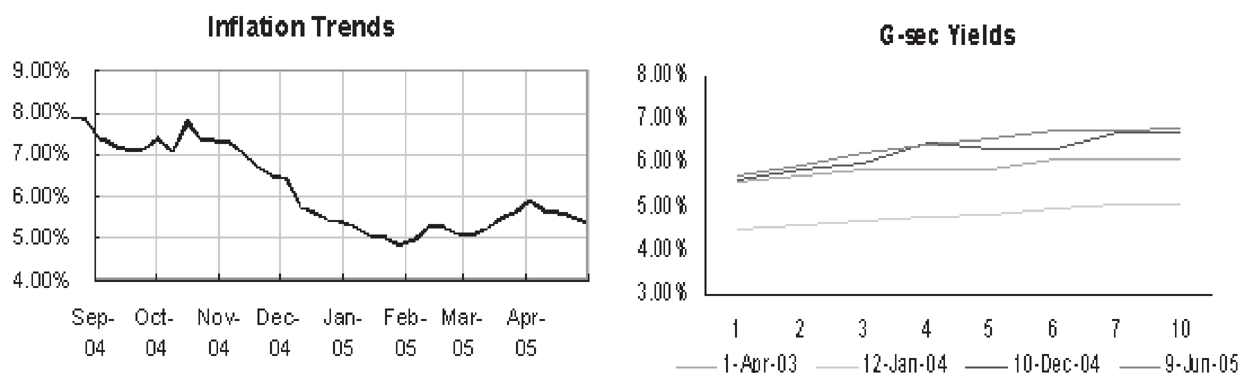
Source: RBI fortnightly statistics, 1st April 2005

5 **Threat of global liquidity cycle reversing**

Lower short term interest rates in the United States of America opened the flood gates of leveraged capital that sought high risk returns else where in the world. This led to huge inflows into emerging markets like India. The FII inflows into the country have been $12.4 bn in the last 18 months fuelling an unprecedented rise in stock market levels to all time highs. Similarly there was a resurgent demand for emerging market debt that allowed domestic corporates to raise low cost foreign borrowings. However, the Federal Reserve has hiked the Fed fund rate by 200 bps in the last one year. This coupled with a strengthening dollar has led to unwinding of this leveraged capital thereby posing the threat of a shrinking global liquidity. Such a decrease in liquidity may cause a rise in in emerging market corporate spreads.

6 **Rising Interest Rates**

The last 18 months have witnessed a sharp rise in commodity prices especially oil. While the government has chosen to follow a measured policy on oil price increases, it would be difficult to sustain such a policy if oil prices remain high for an extended period of time. Delays in price hikes have caused the petro majors to bleed in the first 2 quarters of 2005. There is an impending oil price hike given that the domestic prices have not been increased since February '05. This can have cascading effects on prices leading to increasing inflation as witnessed during the same period last year. The recent hike in reverse repo rates as well as EPF rates are pointers to the fact that interest rates demanded could be higher given the increasing inflation scenario. Inflation is expected to average 5.5% while the GDP growth is pegged at 6.5%. Increasing credit off take from banks coupled with higher inflation is expected to keep an upward bias on interest rates over the next 12 months.



A pointed out by a recent CRISIL study on default rates, the overall default rates have dropped to 2.27% in 2000~2004 compared to a 13 year average of 2.95% (1992~2004) while investment grade stability rates have increased dramatically. Empirically, the credit characteristics of AA+ issuers today compare with qualities of AAA issuers a few years ago. This coupled with abundant liquidity has caused credit spreads to compress significantly. Today AAA 5yr credit spreads are at 40 bps compared to 70 bps eighteen months ago.

Source: Citigroup

Credit spreads could increase due to
* Increased demand for money from the corporate sector
* Increased return on capital required by the banking sector

A common theme that CFO's will need to address is one of issuance strategy. This implies that companies may need to borrow when interest rates and credit spreads are low even if the utilization may be a few months down the line. In other words matching timing of issuance with utilization may not necessarily be the best way of optimizing funding costs

7 Disclosures

SEBI continues to focus on improved disclosure norms. While this is welcome from the point of view of transparency, CFOs will need to be cognizant of the impact of such changes on issuance strategy. Specifically this implies that the corporate organization must be structured to provide the information sought in the Private placement information memorandum. The corporate should also be in a position to update such information at short notice. This underscores the need to have accurate and efficient management information systems in the absence of which issuances could get delayed.

8 Risk Management

The number of instruments available today for raising capital are immense. At the same time, this has increased the need for identifying and mitigating the risks associated with such instruments. It is fair to say that with the increased complexity of decisions to be made together with the need for rapid responses to market movements, corporate boards would need to devote time and attention to develop risk management systems. This will also create human resource challenges in developing a cadre of risk management professionals who understand financial markets as well as the core business of the company.