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**What will happen to corporate performance and
economic growth if interest rates increase by 300 basis
points in the next 2 years?**

Dissertation by

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Executive Summary

This paper discusses the impact of rise in interest rates by 300 basis points on corporate performance and economic growth. Companies were selected from S&P CNX Nifty in order to determine the impact of rise in interest rates on corporate performance. These are large companies which are part of the leading index on the National Stock Exchange of India. These companies represent 24 sectors of the economy. Two companies from each sector were considered for this purpose. Analysis of these companies was done on the basis of their interest expenditure, Interest Cover Ratio, funds raised through FCCBs and their debt to equity ratio. Companies apart from the ones which were selected for the study were not considered because of their unsatisfactory financial performance in terms of profitability ratios, interest cover ratio, etc. Banks and financial institutions will lend them less because of the above factors. Hence these companies will not have any adverse impact if the interest rates rise. Therefore they were not included in the study. Investments, exports, demographics and per capita income are the four distinct growth drivers which have been considered while determining the impact of rise in interest rates on the economic growth.

Introduction

In the past Indian companies were dependent either on the equity markets or on bank and institutional lending for funds required for capital expenditure. Apart from the difficulties faced by Indian companies in raising equity during those times, their debt to equity ratios was also aggravated because of increase in debt. This situation was further worsened by increase in interest rates. However, the scenario is different now. India Inc. has become more resilient to increase in interest rates because of a number of structural changes like

decrease in debt to equity ratio, new sources of raising funds and improvement in their operational and financial efficiency.

India has also shown considerable resilience during the recent years and avoided adverse contagion impact of several shocks. Thus, rise in interest rate will not have an adverse impact on the Indian Economy but it can be beneficial.

IMPACT ON CORPORATE PERFORMANCE

Methodology

Companies were selected on the basis of their performance on S&P CNX Nifty. Two companies from each sector were considered for the purpose of analysis.

Criteria for selecting these companies:

- Past financial performance
- Ability to raise funds
- Debt to Equity Ratio
- Interest Coverage Ratio

Descriptive Analysis of the parameters considered:

1. Interest Rate Expenditure and Interest Cover Ratio:

Ratios for the last 3 years of 34 companies were analyzed out of which 14 companies' data is as follows:

Company Name	Interest Paid (Rs.Crore)			% Change over previous years		Interest Cover Ratio		
	2005-06	2004-05	2003-04	2005-06	2004-03	2005-06	2004-05	2003-04
Siemens Ltd.	Sept,05 3.95	Sept,04 1.58	Sept,03 1.48	150.00	6.76	92.92	146.5	133.96
Hero Honda Motors Ltd	2.92	1.93	1.72	51.30	12.21	484.64	631.7	558.33

Videsh Sanchar Nigam Ltd	1.8	0.08	0.44	2150.00	-81.82	382.51	7,882.63	1,235.68
Bharat Petroleum Corporation Ltd	Mar,05 140.11	Mar,04 105.35	Mar,03 247.37	32.99	-57.41	10.68	26.01	9.06
Hindustan Petroleum Corporation Ltd	158.74	81.64	55.65	94.44	46.70	2.8	21.1	54.56
Cipla Ltd	16.07	11.66	13.47	37.82	-13.44	45.17	39.73	30.28
Dr Reddys Laboratories Ltd	24.62	12.74	4.23	93.25	201.18	10.39	3.82	72.71
Dabur India Ltd	5.73	4.66	7.58	22.96	-38.52	38.5	36.41	15.97
Infosys Technologies Ltd	1	1	0.75	0.00	33.33	2,737.00	2,230.00	1,961.63
HCL Technologies Ltd	June,05 5.62	June,04 5.48	June,03 1.06	2.55	416.98	61.3	51.24	252.27
Larsen & Toubro Ltd	172.37	120.82	125.85	42.67	-4.00	7.85	8.4	7.1
Oil & Natural Gas Corporation Ltd	46.96	37.5	46.06	25.23	-18.58	465.95	525.37	296.43
Reliance Energy Ltd	191.88	134.82	69.93	42.32	92.79	5.07	4.8	6.97
Reliance Industries Ltd	877.04	1,468.66	1,434.72	-40.28	2.37	13.2	7.17	5.39

(Source: Capitaline)

- Even though the interest expenditure has increased for few companies like Bharat Petroleum Corporation Ltd, Cipla Ltd, Dabur India Ltd, Larsen & Toubro Ltd and Oil & Natural Gas Corporation Ltd during the last two financial years, they have maintained their Interest Cover Ratio. This shows that profits are also increasing with the increase in interest expenditure because of which the company is able to meet its interest obligations comfortably. Also, the Interest Cover Ratio of these companies is good enough to meet any possible increase in interest expenditure due to increase in interest rates.
- Few companies like Siemens Ltd, Hero Honda Motors Ltd, Videsh Sanchar Nigam Ltd, Hindustan Petroleum Corporation Ltd, Dr Reddys Laboratories Ltd, HCL Technologies Ltd and Reliance Energy Ltd have their Interest Cover Ratio decreased over the years with the increase in interest expenditure. However, Interest Cover Ratio still is good enough to take care of the increase in interest rates.

2. Alternative Sources of raising funds

- If the interest rates rise by 300 basis points, the companies may resort to other sources of raising funds. This is possible because of the financial flexibility of the corporate sector, which has increased due to the positive view of global investors with respect to the Indian economy. New sources of raising funds are Foreign Currency Convertible Bonds (FCCBs), American Depository Receipts (ADRs), Global Depository Receipts (GDRs) and international private equity players. For instance, during the six-month period ended June 2006 investment by private equity and venture capital funds was \$3.4 billion as against \$2.2 billion in 2005.

Out of 14 companies analyzed who have raised funds through FCCBs in the past 3 years, details of 8 companies is given below:

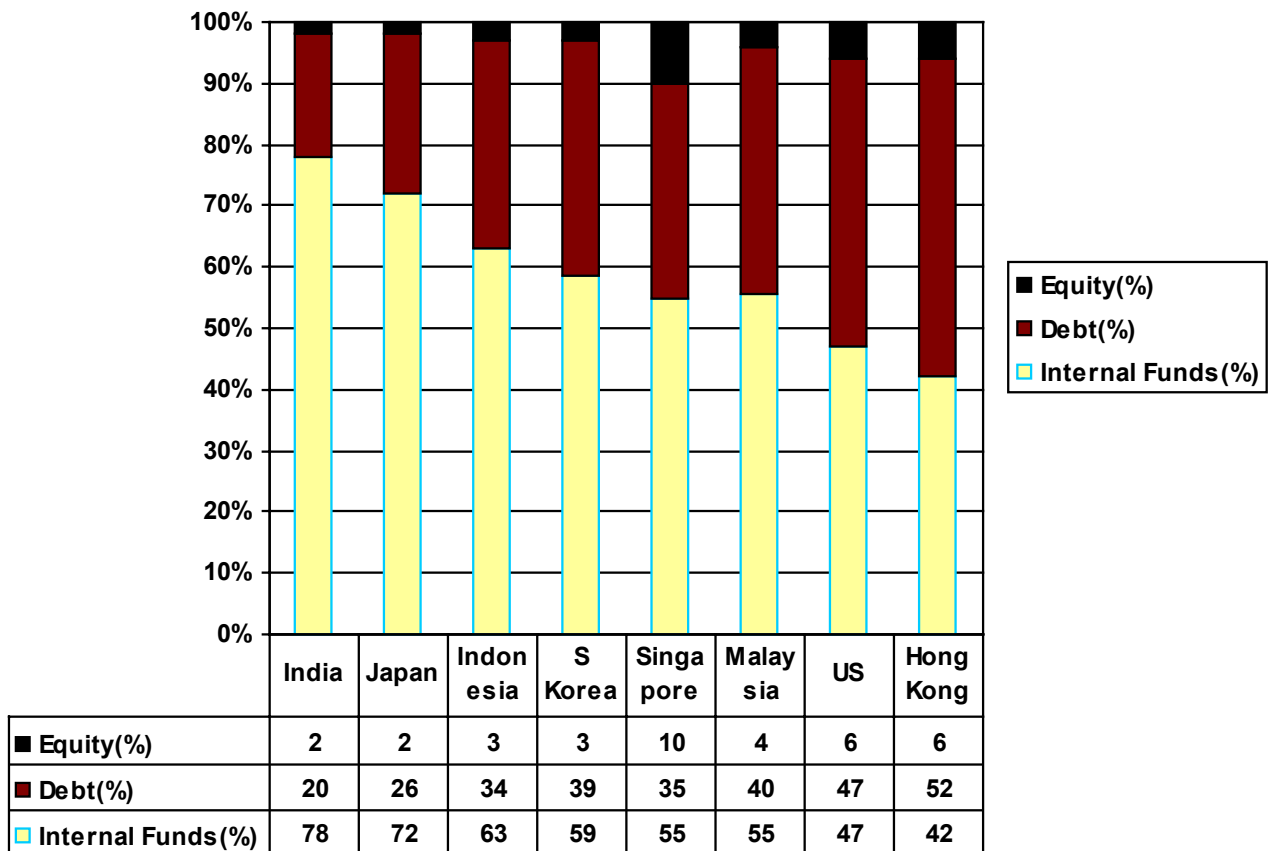
Company Name	Funds Raised(USD)	Year	Purpose
Gujarat Ambuja Cements Ltd	78,803,307	2005	Refinancing of Old Loans
	19,700,822	2005	Modernization
	25,000,000	2004	Rupee Expenditure, LOC for Modernization
Bharat Petroleum Corporation Ltd	107,500,000	2005	Refinancing of old loans
	107,500,000	2004	Modernization
Mahindra & Mahindra Ltd	40,000,000	2005	Rupee Expenditure, LOC for Modernization
	15,000,000		Rupee Expenditure, LOC for Modernization
	115,000,000		Modernization
Indian Petrochemicals Corporation Ltd	100,000,000	2005	Refinancing of old loans
ACC Ltd	60,000,000	2004	Modernization
	30,000,000		Working Capital, Rupee Expenditure
Reliance Industries Ltd	151,522,467	2006	Modernization, Import of Capital Goods
	151,522,467	2006	Modernization, Import of Capital Goods
	90,000,000	2005	Refinancing of old loans

	120,248,515	2005	Refinancing of old loans
	18,593,404	2005	Refinancing of old loans
	25,000,000		
	93,500,000		
	49,024,158		
	348,000,000		
	350,000,000		
	350,000,000		Modernization Modernization
	90,000,000	2004	Refinancing of old loans
	62,030,652		
	60,000,000		
	51,000,000		
	62,500,000		
	30,000,000		
	250,000,000		
			Rupee Expenditure LOC for Modernization
Housing Development Finance Corporation Ltd	108,553,961	2005	Refinancing of old loans Sub Lending
	500,000,000(Approval Route)		
Hindalco Industries Ltd	21,861,439	2005	Refinancing of old loans
	52,162,747		
	50,000,000	2004	Modernization

- Few companies like Gujarat Ambuja Cements Ltd, Bharat Petroleum Corporation Ltd, Indian Petrochemicals Corporation Ltd, Reliance Industries Ltd, Housing Development Finance Corporation Ltd and Hindalco Industries Ltd have raised funds through FCCBs to refinance their old loans. Besides refinancing old loans,

companies are also raising funds for modernization, import of capital goods, rupee expenditure, etc. This shows that companies are using FCCBs as a preferred option to raise funds. This is mainly because this is a cheaper source of raising funds. Thus, increase in interest rate by 300 basis points in the next 2 years will not have any adverse impact on India Inc.

- From the bar graph given below it is clear that companies are now focusing on their cash flows, accumulated surpluses from their operations to finance part of the project, rather than depending purely on new equity or debt. Thus, this is another reason why increase in interest rates will not affect India Inc's performance.



(Source: McKinsey Quarterly)

- In addition, structural changes in the corporate sector have resulted in enhanced productivity and financial flexibility. There has been an increase in the level of internal accruals. An analysis of a sample of about 1,650 companies revealed that during March 1994 to 2005, the inventory levels reduced from 2.5 months to 1.6 months, debt equity ratio decreased from 1.44 times to 0.99 times, and fixed asset turnover ratio improved from 2.1 times to 3.1 times. Thus, the corporate sector has become financial and operational efficient and diversification of the sources of capital has given it resilience in the face of short-term volatility in the equity markets and increase in interest rates.

3. Debt to Equity Ratio

- Also India Inc. debt-equity ratio has come down over the years. It continued to fall in FY06. This has fallen in every single year in the past six years. In FY06, the debt-equity ratio was down to 0.57 from around 0.8 in FY02. This was partly due to raising of fresh equity, this suggest that Indian companies are much better shielded against rising interest rates than ever in the past. Out of 22 companies whose debt to equity ratio was analyzed, details of 10 companies is given below:

Name of the Company	Reduction in Debt-Equity Ratio over a 5 year period	
	From	To
Siemens Ltd	0.08	0.00
ACC Ltd	1.52	0.72
Gujarat Ambuja Cements Ltd	0.94	0.57
Bharat Petroleum Corporation Ltd	0.89	0.54

Hindustan Petroleum Corporation Ltd	0.54	0.52
Mahindra & Mahindra Ltd	0.71	0.40
Indian Petrochemicals Corporation Ltd	1.46	0.56
Larsen & Toubro Ltd	1.06	0.42
Reliance Industries Ltd	0.78	0.49
Tata Steel Ltd	1.13	0.31

(Source: Capitaline)

IMPACT ON INDIAN ECONOMY

Indian Economy has four distinct growth drivers - investments, exports, demographics and rising per capita incomes.

Investments:

- Since the capex pipeline is usually 18 to 24 months long, the current rise in rates will not affect the ongoing expansion plans. Most industries are experiencing high capacity utilization, making expansion in capacity mandatory. These decisions are unrelated to rising interest rates.
- Flow of funds through Foreign Direct Investments in India will increase with the increase in the interest rate. This is mainly because they will earn more returns as compared to other countries. Even if the Fed Rates increase, it will not have a significant impact on Foreign Direct Investments in India because the interest rate in India is usually higher than the Fed rate.
- Multinationals like Coke use India as a manufacturing hub. This is because they can save on the transportation cost as India has a location advantage. Thus, this benefit will off set the increase in interest rates.

- Foreign investors can benefit by arbitraging when interest rates increase in India. They can borrow funds from a country with a low interest rate and lend funds in India at a higher interest rate. This will also result in higher inflow of funds in India from foreign countries.

Exports: In the past three years, our exports have grown at 21.4 per cent, 24.1 per cent and 24.7 per cent, respectively. This year the trade deficit is the widest, and yet the previous quarter showed a current account surplus. Which means services exports and capital inflows remain strong. Those inflows are a vote of confidence in the underlying economy.

Demographics: Following are few factors which are insulated by interest rates:

- In the next decade or two, the labor force will expand faster than the population. More youngsters becoming income earners mean positive implications for demand for goods as well as tax collections.
- There is a readymade market in India because of the huge population. This attracts multinational companies to invest in India because of the huge customer base.
- Any change in the interest rates in US has a direct and almost immediate impact on employment and prices. This is not the case for developing countries like India which are faced with a burgeoning labor force but are struggling to find enough jobs to engage it.

Rising per capita income: This is both a consequence and driver of GDP growth. However, as per capita incomes approach \$1,000, we see an upward inflection in economic activity. This translates into demand for durables, autos, lifestyle products,

healthcare and so on. Thus, the basic growth dynamics is not threatened by rising rates. These higher rates will surely dent demand for retail loans and, hence, all EMI-related purchases, from housing to autos to other consumer durables.

Conclusion

Companies have maintained their Interest Cover Ratio despite increase in their interest expenditure. Interest Cover Ratio for few companies has reduced over the years. However it is good enough to take care of any rise in interest rates. Companies are also resorting to alternative sources of raising funds – FCCBs. They are becoming financially and operationally efficient which is improving their accumulated surpluses. Debt to Equity Ratio of India Inc. has also declined over the years. All these factors imply that increase in interest rate by 300 basis points in the next two years will not have a significant impact on corporate performance. This is also in the case of Indian Economy. In fact it may be beneficial as there will be more inflow of funds through foreign sources.

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