EMERGING TRENDS OF INVESTING AND FINANCING ACTIVITIES IN INDIAN COMPANIES

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ABSTRACT

This paper analyzes the trends in financing and investing activities of companies in India in the recent past. While looking at the available trends, we have also tried to give a broad outlook for these in the near future. The first part deals with the financing options available to Indian companies. We believe that loans from banks and related financial institutions will continue to be used by companies to raise capital. Therefore we have focused on other emerging alternatives for companies to finance their investment needs. Some of these are private equity, ECBs and alternative investment markets. Private Equity in India has been growing at a rapid pace mainly due to the booming Indian economy and the bull run. Indian companies are also utilizing ECBs because of lower interest rates in US and European markets. Companies utilize this for overseas acquisitions, for import of capital Goods etc. ECBS will remain attractive for companies because interest rates are expected to remain low owing to financial crisis brought about by the housing sector in the US.

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1.0 FINANCING ACTIVITIES AND EMERGING TRENDS

In the last few years Indian companies have found new ways of raising capital apart from existing options like debt from banks and financial institutions. These new sources include Private Equity (PE), External Commercial Borrowings (ECBs), Alternative Investment Market (AIM) etc. Whereas bank loans will always continue to play an important role in financing needs for companies, newer trends need to be looked in greater detail. We will look at some of these newer sources and examine their future prospects.

1.1 Private Equity (PE)

Private equity refers to a type of investment aimed at gaining significant, or even complete, control of a company in the hopes of earning a high return. As the name implies, private equity funds invest in assets that either are not owned publicly or that are publicly owned but the private equity buyer plans to take private

Private Equity in India has been growing at a phenomenal pace for the last 2-3 years. The total value of PE deals announced this year grew more than 100% to cross $17.14 billion. The PE commitments are expected to reach around $48 billion by 2010 as per a study by ASSOCHAM. The reason for this phenomenal rise has been the India growth story, high corporate profitability and the strong bull-run in the Indian stock markets. Temasek has emerged as the largest PE investor this year, followed by the Blackstone group. Some big deals last year included Temasek Holdings' $1,906 million investment in Bharti Airtel, Deutsche Bank & Citigroup's $1000 million investment in GMR Infrastructure and ICICI Venture Fund's $800 million investment in Jaypee Infratech. This year has also seen the announcement of many big India based funds like 3i Group ($1 bn), IL&FS Investment ($1 bn) and ChrysCapital ($1.25 bn).

Interestingly, the last few years have also seen an exit by PE players through IPOs. An example is Suzlon Energy which was backed by ChrysCapital and Citicorp. Other top PE-backed IPOs included Punj Lloyd, HT Media, YES Bank, Shoppers' Stop and PVR Cinemas2. Going forward we also see many PE backed companies going public like ICICI–Ventures backed Subhiksha which is planning an IPO this year.

Looking at the amount of funds raised we feel that PE will emerge as an important source of capital for Indian companies. The Realty & Infrastructure sector is bound to remain a favorite followed by Banking and Financial services. But with so much money being raised there are fears that valuations are getting stretched which could slow down deal making.

Overview of current conditions is mentioned below:

- India saw the largest increase in deal activity among the big Asia-Pacific markets in 2010. Although still far below the 2007 peak of US$17 billion, last year's total deal value more than doubled from that of 2009 to US$9.5 billion, including venture capital, infrastructure PE investments and real estate investments.
- The fundamentals look auspicious for PE in India to continue to grow and evolve in 2011 and beyond. Short-term nervousness in the capital markets in 2011 and high priced corporate debt are expected to keep valuations down. That is likely to help open up interesting deal-making opportunities for PE investors. Healthy macroeconomic conditions continue to support India's status as a preferred destination for investors.
- India's fundamentals will continue to attract eager PE investors and bolster the confidence of limited partners. The pace and strength of the industry's future growth would be accelerated if valuations in India become more attractive and exits continue to build on the momentum established in 2010.
- Indian promoters are gradually coming to recognise PE as a patient source of active capital that can help build their businesses. The PE industry will need to work closely with their investee companies and invest in further educating other Indian promoters about the PE and VC value proposition.

1.2 External Commercial Borrowings (ECB)

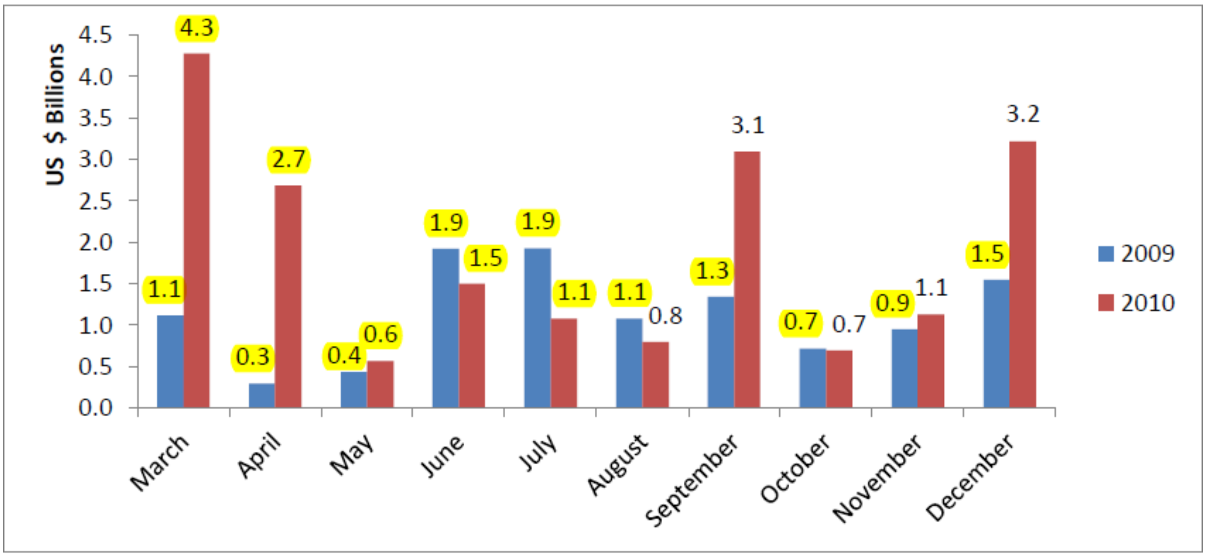
Foreign currency borrowings raised by the Indian companies from sources outside India are called External Commercial Borrowings (ECBs). These are commercial loans with minimum average maturity of 3 years. The ECBs include:-

- Bank Loans
- Buyer's Credit
- Supplier's Credit
- Securitized instruments (e.g. floating rate notes and fixed rate bonds)
- Credit from official export credit agencies
- Commercial borrowings from the private sector window of multilateral financial institutions
- Investment by Foreign Institutional Investors (FIIs) in dedicated debt funds

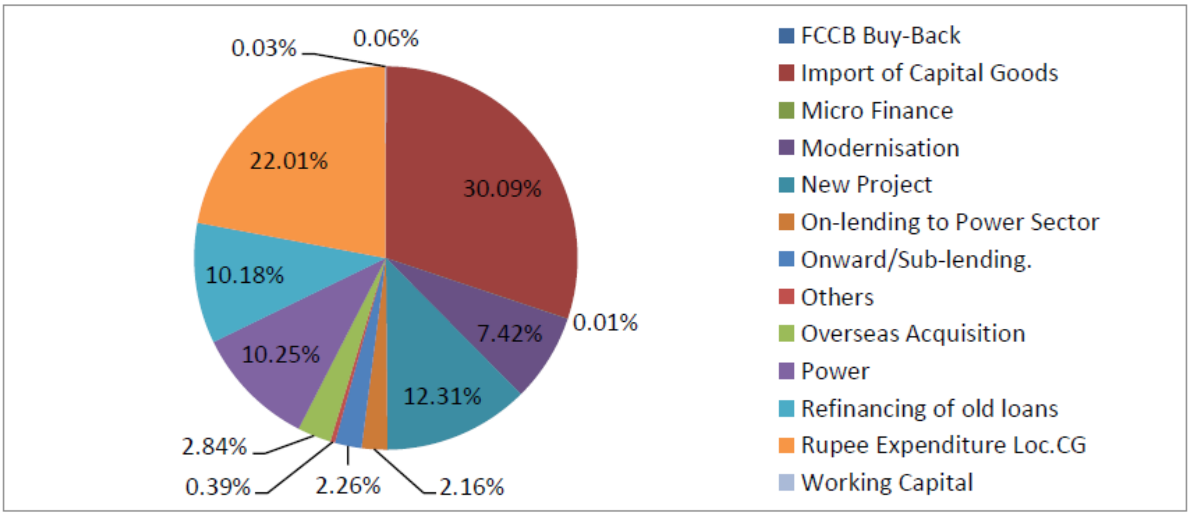
Indian companies mobilized a record $24 billion through External Commercial Borrowings (ECB) in the fiscal 2006-07. One of the reasons for the popularity of ECBs is the lower interest rates in the US & European markets compared to India. The recent major ECB deals include:

- Usha Martin raised USD 125 million for a tenure of 7 years to part finance its expansion plans with State Bank of India as the lead arranger (January '11)
- Power Finance Corporation raised USD 260 million for a tenure of 6 years for lending purposes to power sector (February '11)
- HPCL Mittal Energy Ltd. mopped up USD 100 million for a tenure of 5 years for new project (February '11)

Amount of ECB raised over the previous year on a monthly basis



Purpose wise distribution of ECBS raised during March'10- February'11



As per month wise data on FCCB and ECBs given on the RBI website, some of the common stated purposes for ECBs are Overseas Acquisitions, Import of Capital Goods, Refinancing of old loans etc. For example Tata Steel issued FCCBs worth $500 million for overseas acquisition with a maturity of 5 years and 1 month in Sept 2007. Similarly Reliance Petroleum raised $275 million via ECB for Project requirements with a maturity of 11 years in the same month.

The RBI has kept a ceiling on ECB at $22 billion as the increased dollar inflows are causing rupee appreciation. If the RBI continues sterilizing dollars, it risks increasing money supply thereby stoking domestic inflation.

BENEFITS OF ECBS OVER OTHER SOURCES OF FUNDS

- Cost of raising ECBs is much lower than that of domestic borrowings (Current Spread is around 300 bps without considering cost of hedging).
- Global financial market is a much bigger source of credit.
- Foreign lenders provide far more flexibility in terms of providing security for ECBs.

Going forward we feel that the gap between domestic and international interest rates will remain quite large. Owing to the financial crisis in the U.S. and a possible U.S. recession, the interest rates are likely to remain low. Also India is sitting on a large pile of forex reserves to the tune of $280 bn. This reduces the chances of a sudden rupee depreciation which could cause corporate debt to balloon like during the South East Asian Crisis.

Given both these facts we feel that ECBs would remain attractive means of raising funds for Indian companies especially when it comes to overseas acquisitions

1.3 Initial Public Offering (IPO)

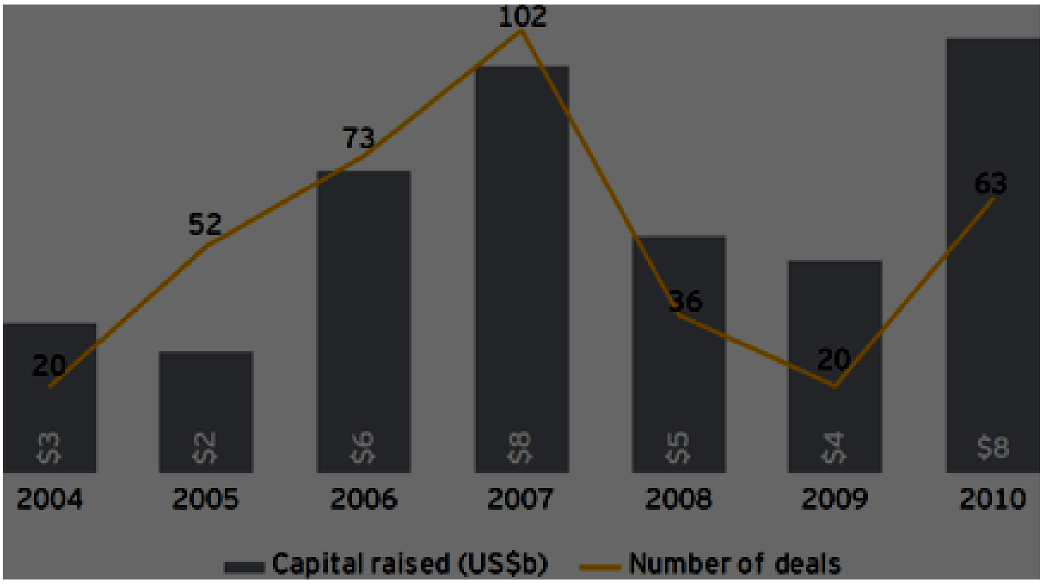
An IPO (initial public offering) is referred to a flotation, which an issuer or a company proposes to the public in the form of ordinary stock or shares. They are generally offered by new and medium sized firms looking for funds to grow. However, it can be done by big privately-owned firms seeking to transform themselves into an openly traded firm.

Some of the reasons for raising capital via IPO (from Red Herring Prospectus) are given as:

- Spice Communications – To repay long-term debt and pay for NLD and ILD licence fees.
- OnMobile Global – To meet working capital requirements, for repayment of loans, and for acquisition of companies.
- Purvankara Projects - To acquire land in Tamil Nadu and repay debt.

The amount of capital raised by Indian companies in recent years is shown below:

India IPO activity by year



Source: Dealogic, Thomson Financial, Ernst & Young

Key Trends in IPO

1. In 2011, India's IPO markets will be strong driven by an 8% GDP growth rate, healthy corporate earnings and steady growth in corporate profits. More than 100 Indian companies are expected to raise resources via IPOs and follow-on offerings.
2. India saw a dramatic recovery in its IPO markets in 2010. This revival has been a domestic consumption led–growth story, driven by an influx of capital from Western economies and a booming local stock market. India saw a growth of 215% in the number of IPOs compared to 2009.
3. 2010 saw a string of IPOs and follow-on offerings from many previously state-owned enterprises in the materials sector such as steel, oil and gas — all of which helped the Indian Government raise funds to build roads, ports and power plants. This materials sector activity stems from India's US$10 billion divestment program that spawned the largest IPO in India ever, the listing of the world's largest coal producer, US$3.4 billion Coal India, a former state-owned enterprise.
4. Driving industrial IPO activity is India's investment plan to modernize its infrastructure worth US$1 trillion. This program has led to many new listings in the energy and power, natural resources, building and construction sectors, in particular.

We can clearly see that the amount of money raised in the last 2-3 years has increased phenomenally. One reason for this would be the bull run in the Indian stock markets and the increased risk appetite of investors. In spite of the recent stock market slump, the disappointing listing of Reliance Power and the cancellation of the IPOs of Wockhardt and Emaar MGF, we feel that companies will continue to raise money via IPOs, given the strong domestic growth and investor confidence. Also PE backed companies will tap the capital markets to provide an exit route to their investors. Some IPOs to look forward this year are MT Educare, NBCC etc

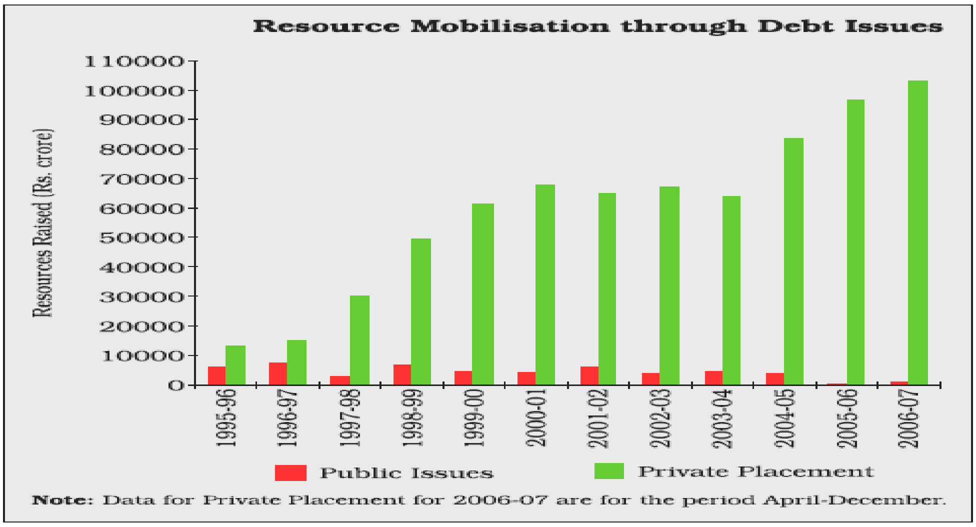
1.4 Alternative Investments Markets (AIM)

AIM is the London Stock Exchange's International market for smaller growing companies. In recent times Hiranandani Group raised a £200m fund while Unitech raised £360m. The AIM is fast becoming popular due to less disclosure and regulatory norms.

In 2007, as many as nine India centric companies were listed on AIM in 2007 raising a total of $846 million4. Some of the companies are UTV Motion Pictures, Dev Property Development, Evolvence India and Promethean India. Due to their low restriction barriers, and RBI restrictions on ECB for Real estate sector, many Indian Realty companies are considering the AIM route as a clear and viable alternative to private equity. Going forward the AIM will continue to attract companies given the ease of listing and less disclosure norms.

1.5 Corporate Debt Market

A corporate debt market can supplement banks by providing funds to companies for long term capital investment. It also provides a stable source of funds when the equity market becomes volatile. Unfortunately India has a very weak corporate debt market. Companies still relies on borrowings from banks and financial institutions. In 2004-05,the ratio of bank loans to GDP was around 36% while the corporate debt to GDP was somewhere around 4%. The government securities market is almost 10 times bigger than the corporate debt market.



To improve and popularize the corporate debt market, the weaknesses will have to be addressed. Some barriers in the primary debt market include a lack of large investors and lack of intermediaries. An emerging trend in the corporate debt market has been private placement. About 90% of the private corporate sector debt is raised through this route.

One of the major reasons for the popularity of private placement is the less number of disclosures that companies have to undergo. For example, only when the number of subscribers is more than 50, companies are required to make full disclosure like that made during public issues of equity capital. Therefore companies take advantage of this by making multiple issues while ensuring that the subscriber base is less than 50. A recommendation towards this would be to ensure that all companies would have to undergo mandatory disclosures irrespective of the size of the issue.

Some major weaknesses in the secondary market are poor quality of paper. In an emerging market, defaults by companies are relatively high. This reduces the confidence of investors in the corporate paper and thus reduces its quality. One of the recommendations given is an introduction of a debt manager in the corporate debt market. A debt manager would be able to subscribe to and trade in debt. All public issues and private placements should be made through the debt manager. Till the debt market attains critical mass, they will not be able to operate in other markets. This is expected to ensure the supply of good quality paper and increase the confidence of investors in the corporate debt market. Another measure which can improve the liquidity of the market is the ability to short sell. SEBI has recently taken some measures in this regard by allowing institutional investors to short sell in the equity market. Ensuring the same in the tradable bond market will ensure an improvement in the liquidity here as well.

2.0 INVESTMENT PRACTICES AND EMERGING TRENDS

2.1 Mergers and Acquisitions

Mergers and Acquisitions aim towards Business Restructuring and increasing competitiveness via increased efficiency. In recent years India Inc. has seen a surge in M&As. The fast growing domestic economy, a climate conducive to investment and easy financing have caused an increase in the mergers and acquisitions.

During the period January-May 2007 there have been 287 deals with a value of US$ 47.37 billion. Of these, the total outbound cross border deals were 102 with a value of US$ 28.19 billion, accounting for 59.5 per cent of the total M&A activity in India.

In 2010-11, India Inc. is back making multibillion dollar deals like never before. The total deal value this year has surpassed 2007 which was the big ticket year for mergers and acquisitions. The recession and economic slowdown had caused a lot of heartburn, disappointment and distress among the corporate honchos in the country. But with deals crossing US $55 billion this year, the smiles are back on the faces of the big guns.

Along with hunting for organizations at bargains, the deals also involve going for loss making companies in developed countries to turn them around. Value buys became the order of the day. Though a number of acquisitions were in the developed world like Singapore, Australia, Europe etc, many of them happened in the developing world as well.

In-bound M&A activities in India have been dominated by sectors like Telecommunications and Software. The out-bound M&A activities on the other hand have been dominated by the manufacturing sector companies which are now realizing the cost advantages and competitiveness that such acquisitions will provide.

Major Inbound & Outbound Deals during the year 2010 were:

- Tata Chemicals bought British Salt; a UK based white salt producing company for about US $ 13 billion.
- Reliance Power and Reliance Natural Resources merger valued at US $11 billion
- Airtel's acquisition of Zain in Africa at about US $ 10.7 billion to become the third biggest telecom major in the world.
- Abbott's acquisition of Piramal healthcare solutions at US $ 3.72 billion which was 9 times its sales.
- GTL Infrastructure acquisition of Aircel towers at about US $ 1.8 billion
- Mahindra goes international after acquiring a 70% controlling stake in troubled South Korea auto major Ssang Yong at US $ 463 million.

Major Inbound & Outbound Deals during the year 2011 were:

- GVK Power acquires Hancock Coal, one of the biggest overseas acquisitions for about 1.26 billion dollars.
- Aditya Birla Group to acquire Columbian Chemicals at an estimated 875 million dollars.
- The Vedanta–Cairn acquisition in December 2011 finally saw the completion of the much talked about Vedanta – Cairn deal.

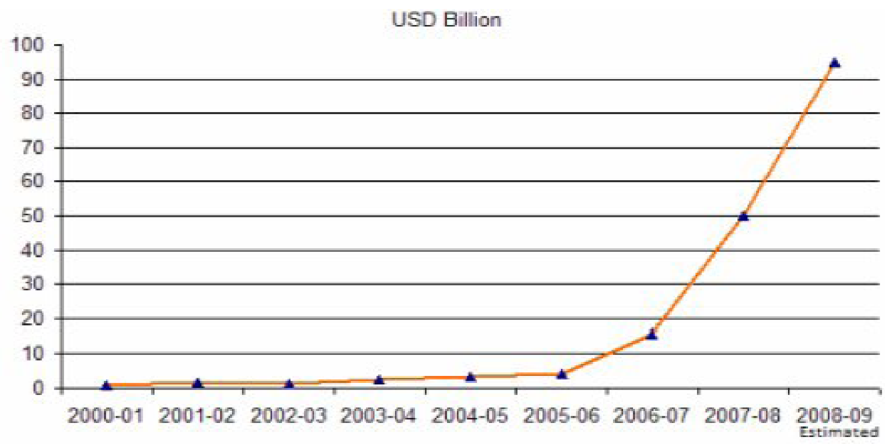


Fig: Graphical representation of Outbound deals since 2000

There are several reasons why mergers and acquisitions happen in the first place. The motives differ for companies in different sectors. Take the example of the Indian pharma sector. Through M&A activities, Indian pharma companies are getting easy access to new markets, ready manufacturing facilities, R&D base and a ready product pipeline. For example Wockhardt acquired Negma Rerads in Apr 07 for $265 million and gained access to 172 patents. The last few years have seen many acquisitions especially in the European market with Ranbaxy snapping up companies like Terapia and Ethimed and Dr Reddy’s Labs acquiring Betapharm.

We expect consolidation in sectors like domestic IT companies and Aviation where profit margins for several players are under pressure. Even in sectors like Oil & Gas, state owned ONGC is expected to continue its foray in international markets with a view achieving energy security. The oil exploration and rig manufacturers have also been able to get a better return on assets in these high yield markets. We expect the overall M&A trend to moderate going ahead. Some of the reasons would be a slowdown in corporate earnings compared to last couple of years, increased valuations thanks to a soaring stock market and lack of cheap financing

2.3 The Capex Boom

Capital expenditures (CAPEX or capex) are expenditures creating future benefits. A capital expenditure is incurred when a business spends money either to buy fixed assets or to add to the value of an existing fixed asset with a useful life extending beyond the taxable year.

India Inc seems to be fuelling what is the biggest investment boom ever. Corporate investments have been shooting up in the past two years. CMIE's CAPEX database suggests a revival in capex in 2011-12. Nearly Rs.8 lakh crore worth of projects are expected to be comissioned during the year. Most of the projects are in the power and steel sectors. The other big beneficiary of the expected capex boom will be the construction sector, which is likely to grow by 10.5 per cent in 2011-12, from 8.1 per cent in 2010-11.

Capital formation is thus expected to grow by a handsome 14.6 per cent in 2011-12, compared to the 8.6 per cent growth recorded in 2010-11.

Sectors like Steel, Cement, Power etc have aggressive expansion plans chalked out. All the major Steel companies like Tata Steel, SAIL and JSW steel are planning to boost production capacity. Steel companies are backward integrating to acquire captive ore and power to bring down production costs.

Going forward we expect continued investments in sectors like Power, Ports, Airport infrastructure and Telecommunication. The pace of investments is likely to slow down once a lot of planned capacity starts to come into production. But as of now India Inc still seems to be in expansion mode.

3.0 CONCLUSION

Having seen these trends, we feel that barring a few hiccups owing to global pressures, Indian companies will have the confidence of global investors and will have prioritized if not easy access to finance. The Indian growth story is strong and likely to continue unhindered at least in the next two decades.

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