IIFL Institutional Equities

Corporate indebtedness: 2008 redux?

Lessons of the recent past seem to have been forgotten, and the market is again staring at a repeat of 2008. Promoters' share pledges in many stocks has crossed 70–80% of their holdings, and this, coupled with rollover requirements of many FCCBs due for redemption this year, will make balance-sheet stress a key issue for companies this year.

2008 redux? The bloodbath in 2008 was made even more severe by high debt levels of companies and personal borrowings of their promoters compounded by rising interest rates. The situation was so dire that many such companies faced impending bankruptcy. Most have spent all of 2009 in improving their balance sheets; many real-estate companies, in particular, have significantly pruned their debt-equity ratios. But history has a nasty habit of repeating itself, and we are now looking at more of the same.

Promoter share pledges make a comeback: Over the past two quarters, shares pledged by promoters have been rising . While real-estate companies have the biggest promoter share pledges, many companies in other sectors too have over 50% of promoter holdings pledged. In some companies, promoters' share pledges have risen from zero a year ago to over 50% now (for instance, Orbit and Bajaj Hindustan). With markets correcting another 15-20% since December (the most recent month for which data is available), promoter share pledges have likely increased further. SEBI's requirement of disclosure of promoters' share pledges is bringing more transparency to promoters' indebtedness. However, stakes in unlisted and holding companies are not known, and hence not included in this exercise.

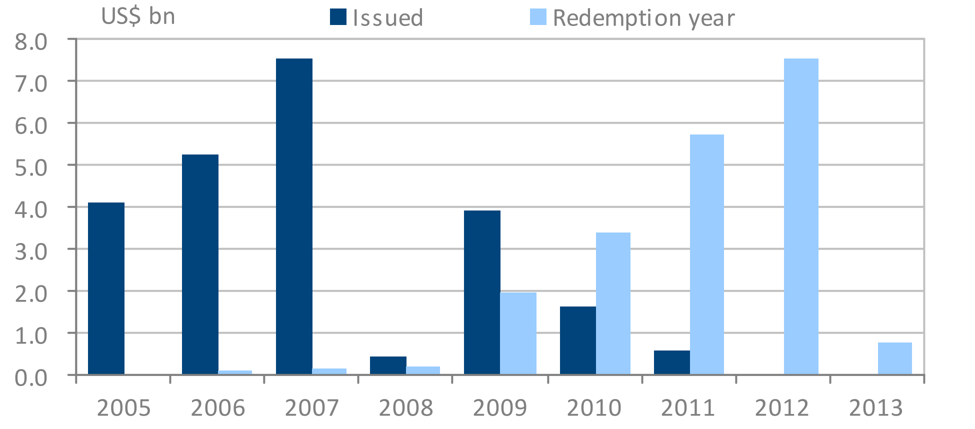
Large FCCB redemptions in 2011: Indian companies had issued US$22bn of FCCBs between 2005 and 2010. Over US$5bn of these are due for redemption in 2011 and US$7bn in 2012. While many companies have used the fall in prices during 2008 and 2009 to buy back FCCBs and some have been redeemed in January, almost US$3bn are due for redemption through the rest of the year. With stock prices in most cases below conversion prices, conversion is not likely.

Companies with over 60% promoter holding pledged

As of December 2010	Promoter holding (%)	% promoter holding pledged	% total equity pledged	Fall from 52-wk high
Ackruti City	82.5	63.3	52.2	-64.3
Cranes Software	6	61.7	3.7	-80.7
Essar Oil	16	86.3	13.8	-35.5
Ganesh Housing Corp	56.3	84.9	47.8	-51.5
JK Cement	65.3	69.2	45.2	-44.4
Orbit Corp	47	73.5	34.5	-70.9
Parsvnath Developers	67.9	83.7	56.9	-56.2
S Kumars Nationwide	44.4	76.3	33.9	-38.6
Shiv-Vani Oil & Gas	54.1	70.3	38	-48
Suzlon Energy	57.1	60.2	34.3	-45.9
Unitech	48.6	68.4	33.2	-62.7
Videocon Industries	66.7	60.7	40.5	-34.1

Source: NSE, CMIE, IIFL Research. Note: The above list is illustrative and not exhaustive

Annual FCCB issuances and redemptions



Source: Bloomberg, IIFL Research. Note: Actual redemptions in any year might differ due to buyback/conversion etc

Aniruddha Dange | dange@iiflcap.com
91 22 4646 4640

Ashutosh Datar | ashutosh.datar@iiflcap.com
91 22 4646 4642

2008 redux?

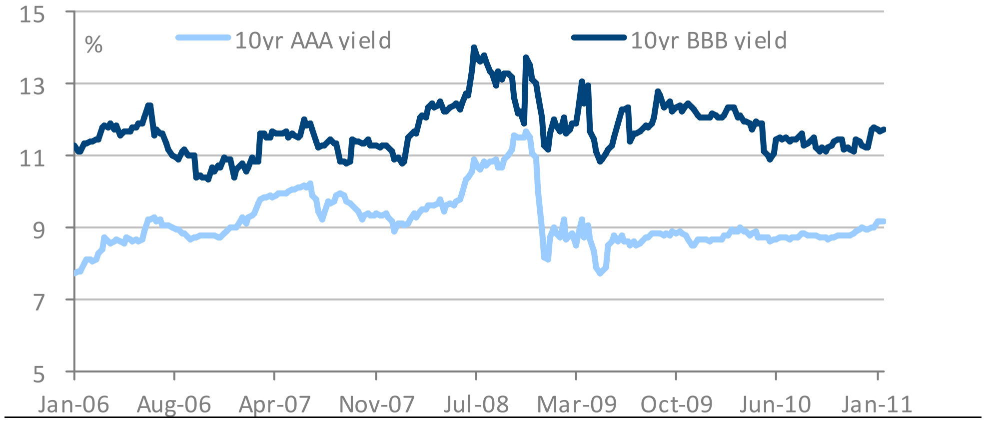
Then vs now: Like in 2008, corporate debt levels are rising; in a few cases, they have already crossed 2008 levels. Long bond yields have still not risen as sharply as short-term yields and the yield curve has flattened. But long bond yields will likely rise higher, with further monetary tightening expected during the course of the year. Consequently, interest expense will rise disproportionately for many companies and rollover risk will be an overhang for companies with already-high debt-equity ratios.

Figure 1: IIFL coverage companies with debt-equity ratio above FY08 levels

Debt-equity ratio	FY08	FY11ii
GMR Infrastructure	1.2	3.0
GVK Power & Infra	0.5	1.9
Havells India	1.6	1.8
Hindustan Construction	1.6	1.8
Jain Irrigation	1.5	1.6
Jaiprakash Associates	1.4	1.7
Kesoram Industries	1.2	1.7
KSK Energy Ventures	1.2	2.5

Source: Company, IIFL Research

Figure 2: Long bond yields have not risen, but will rise with further monetary tightening given that yield curve has already flattened significantly



Source: Bloomberg, IIFL Research

Promoter share pledges make a comeback: Large pledges of promoter shareholding had been one of the major overhangs on stocks during 2008 and early 2009. However, with the sharp recovery in stock prices as well as the business environment, pledges had declined significantly and even completely eliminated in some cases. However, the last couple of quarters have seen an increase in promoter pledges, driven by a general tightening of lending standards. The decline in share prices post December would have only increased promoter pledges further, in our view. In many cases, promoter pledges are possibly due to guarantees given for business debt, but large promoter pledges will remain an overhang on stock prices of these companies in an environment of declining stock prices and deteriorating business environment, especially in certain sectors such as Real Estate.

Figure 3: Companies with over 60% promoter holding pledged

As of December 2010	Promoter holding (%)	% of promoter holding pledged	% total equity pledged	Correction from 52-wk high
Ispat Inds	38.7	95.0	36.7	(19.7)
Essar Oil	16.0	86.3	13.8	(35.5)
Ganesh Housing Corp	56.3	84.9	47.8	(51.5)
Parsvnath Developers	67.9	83.7	56.9	(56.2)
S Kumars Nationwide	44.4	76.3	33.9	(38.6)
Gujarat NRE Coke	47.5	74.2	35.3	(41.0)
India Cements	25.2	73.7	18.6	(39.2)
Orbit Corp	47.0	73.5	34.5	(70.9)
Shiv-Vani Oil & Gas	54.1	70.3	38.0	(48.0)
JK Cement	65.3	69.2	45.2	(44.4)
Unitech	48.6	68.4	33.2	(62.7)
Ackruti City	82.5	63.3	52.2	(61.9)
Cranes Software	6.0	61.7	3.7	(80.7)
Videocon Industries	66.7	60.7	40.5	(34.1)
Suzlon Energy	57.1	60.2	34.3	(45.9)

Source: NSE, CMIE, IIFL Research. Note: The above list is illustrative and not exhaustive

Figure 4: Companies with large increase in promoter pledges over the last few quarters

	September 2009		December 2010		
	Promoter holding (%)	% Promoter holding pledged	Promoter holding (%)	% Promoter holding pledged	Fall from 52-wk high (%)
Ganesh Housing	57.5	52.2	56.3	84.9	51.5
Orbit Corp	42.0	-	47.0	73.5	70.9
Shiv-Vani Oil & Gas	54.0	39.4	54.1	70.3	48.0
Ackruti City	82.5	50.7	82.5	63.3	64.3
Suzlon Energy	53.1	43.3	57.1	60.2	45.9
Bajaj Hindusthan	37.1	-	41.8	54.1	60.8
Network 18	49.1	35.2	59.2	49.0	23.2
Indiabulls Real Estate	16.7	-	23.0	38.6	51.2
Sintex Inds	30.1	25.1	34.6	38.5	37.6
Ashok Leyland	38.6	14.1	51.0	35.0	40.2
IRB Infrastructure	73.8	4.3	74.9	25.0	49.9
Jyoti Structures	26.9	-	27.6	22.6	52.5

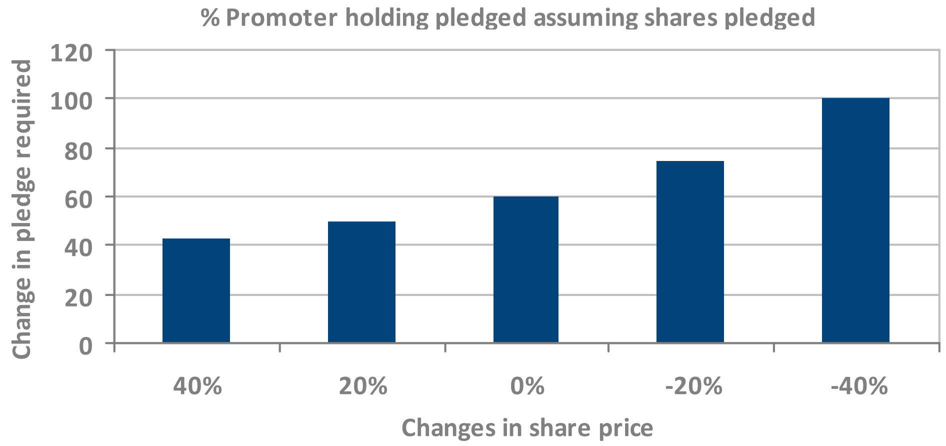
Source: NSE, CMIE, IIFL Research. Note: The above list is illustrative and not exhaustive

Figure 5: Companies with decrease in promoter pledges over past few quarters

	Sep-09		Dec-10		
	Promoter holding (%)	% Promoter holding pledged	Promoter holding (%)	% Promoter holding pledged	Correction from 52wk high
Cranes Software	36.7	91.1	6.0	61.7	(80.7)
Tata Teleservices (Maha)	77.7	63.9	77.7	33.5	(44.2)
Aurobindo Pharma	59.0	32.0	54.4	18.8	(20.2)
JSW Steel	45.0	41.5	37.7	18.0	(44.1)
Zee Entertainment	41.5	34.1	42.8	17.9	(28.8)
Kalpataru Power	63.7	32.9	55.0	13.8	(46.4)
SRF	47.3	34.0	47.4	3.5	(37.8)
Adani Ent	74.7	25.8	78.3	0.9	(25.9)

Source: NSE, CMIE, IIFL Research. Note: The above list is illustrative and not exhaustive

Figure 6: Sensitivity of promoter holdings pledged to change in stock price assuming 60% holding pledged to start with

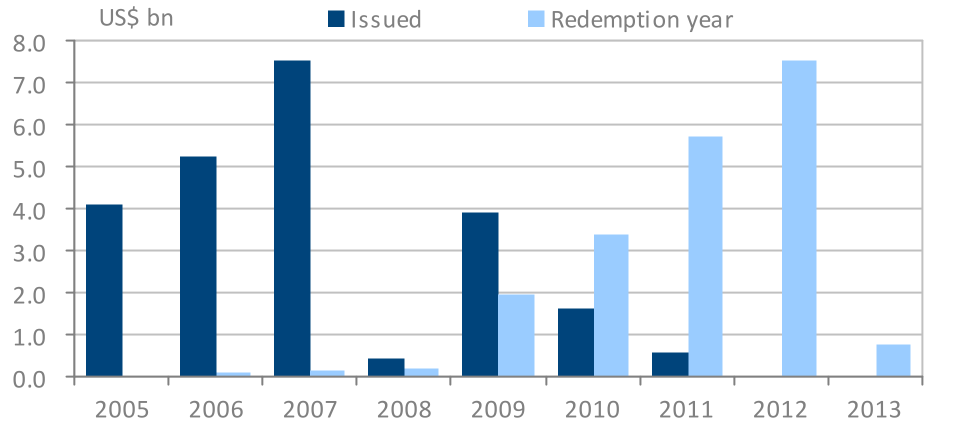


Source: IIFL Research

Large FCCB redemptions in 2011: Indian companies have issued US$22.8bn of FCCBs between 2005 and 2010. Out of these, FCCBs with face value of US$5.7bn are due for redemption in 2011 and another US$7.5bn in 2012. While many companies have used the sharp fall in FCCB prices during 2008 and 2009 to buy back their outstanding FCCBs (in some cases fully) and some would have been already redeemed in January, still almost US$3bn worth of FCCBs are due for redemption through the rest of the year. With stock prices in many cases significantly below conversion prices, conversion is not an option in many cases. Given rising domestic interest rates, re-financing the FCCBs (which would have carried very low coupon, if at all) with domestic debt will not be a cheap option. Balance-sheet stress, which was an issue in 2008 and early 2009, will likely emerge again in 2011 in some cases, in our view.

Accounting for FCCBs: Under current Indian accounting standards, FCCBs are treated as debt instruments, and any coupon on an FCCB is charged to the income statement. Most companies charge the redemption premium to the securities premium account on maturity of the FCCB. Under IFRS, however, an FCCB would be split into a debt instrument that will accrue a fair interest charge annually; the conversion option is valued separately and marked to market. Under IFRS, reported profits will thus be lower and more volatile.

Figure 7: Annual FCCB issuances and redemptions



Source: Bloomberg, IIFL Research. Note: Actual redemptions in any year might differ due to buybacks/prepayments, etc

Figure 8: Key FCCBs due for redemption in 2011

Issuer	Year of issue	Issue size (US$ m)	Outstanding (US$ m)	Conversion price (Rs/share)	Current stock price (Rs/share)
Ranbaxy Laboratories	2006	440.0	440.0	546.0	488.2
Reliance Communication	2006	500.0	296.9	480.7	94.7
Hindustan Construction	2006	100.0	100.0	123.0	32.4
Aurobindo Pharma	2006	150.0	106.2	1014.1	1,099.2
Jubilant Organosys	2006	200.0	142.1	379.0	194.6
Financial Technologies	2006	100.0	90.5	2362.7	726.4
Prajay Engineers	2006	60.0	60.0	208.0	12.6
Jindal Saw	2006	80.2	52.0	135.0	188.3
India Cements	2006	75.0	75.0	305.6	87.2
Cranes Software	2006	50.0	50.0	115.0	4.6
Vardhman Textiles	2006	60.0	60.0	423.3	260.6
Punj Lloyd	2006	125.0	49.7	272.6	68.5

Source: Bloomberg, IIFL Research

FCCB Case study 1: HCC (HCC IN; Mkt cap US$0.4 bn; CMP Rs.32; REDUCE)

Figure 9: HCC's profits would have been 12-24% lower if FCCB cost had been charged to P&L

Rs m	FY07	FY08	FY09	FY10
Reported PAT (recurring)	793	1,088	1,253	814
FCCB Debt at 0% coupon	4,462	4,375	4,067	5,000
YTM on the FCCB	6.5%	6.5%	6.5%	6.5%
Additional interest outgo on FCCB (average)	145	287	274	295
PAT post interest on FCC (post tax)	695	887	1,044	617
Change	**-12.3%**	**-18.4%**	**-16.7%**	**-24.2%**

Source: Company, IIFL Research

HCC had issued US$100m FCCBs in FY06. These were zero-coupon bonds with YTM of 6.50% and a conversion price is Rs123. The bonds are due on 30 March 2011. As per the company, these would be refinanced through current cash and domestic debt lines available. The company's end-2QFY11 D:E stood at 2.2x. If the company were to charge a fair interest on that debt to the income statement, its profits would have been 10-25% lower over the last four years.

FCCB case study 2: Punj Lloyd (PUNJ IN; Mkt cap US$0.5bn; CMP Rs68; SELL)

Figure 10: Punj Lloyd's profits would have been 2-5% lower if FCCB cost had been charged to P&L

Rs m	FY07	FY08	FY09	FY10
Reported PAT (recurring)	1,969	3,210	(2,407)	(4,308)
FCCB Debt at 0% coupon	5,423	1,989	2,520	2,246
YTM on the FCCB	4.7%	4.7%	4.7%	4.7%
Additional interest outgo on FCCB (average)	131	187	106	119
PAT post interest on FCC (post tax)	1,873	3,075	(2,484)	(4,395)
Change	**-4.9%**	**-4.2%**	**-3.2%**	**-2.0%**

Source: Company, IIFL Research

Punj had an FCCB issue of US$125m, convertible between July 2006 and 24 March 2011, at a price of Rs273 and redemption premium of 126%. Currently, FCCBs totalling US$49.7m are outstanding and its end-2QFY11 D:E stood at 1.44x. If the company were to charge a fair interest on that debt to the income statement, its profits would have been 2-5% lower (or loss would have been higher) over the last four years.

FCCB case study 3: Ranbaxy (RBXY IN; Mkt cap US$4.5bn; CMP Rs.488; SELL)

Figure 11: Ranbaxy's profits would have been 20-30% lower if it had charged the FCCB cost to P&L

Rs m	FY07	FY08	FY09	FY10
Reported PAT (recurring)	3,965	2,328	501	(852)
FCCB Debt at 0% coupon	19,888	17,732	20,240	20,856
Interest rate	4.9%	4.9%	4.9%	4.9%
Additional interest outgo on FCCB	975	869	992	1,022
PAT post interest on FCC (post tax)	3,215	1,642	(273)	(1,618)
Change	-18.9%	-29.5%	NM	NM

Source: Company, IIFL Research

Ranbaxy had issued US$440m zero-coupon FCCBs in FY06 with an YTM of 4.9%. The original conversion price of the bonds was Rs746, but it was changed to Rs540 after the Daiichi deal. The FCCBs are due on 9 March 2011, and according to the company, these would be refinanced through current cash and domestic debt lines available. If the company were to expense the interest cost at the YTM of the bonds, its profits would have been 20-30% lower than the actual reported recurring profits.

FCCB Case study 4: India Cements (ICEM IN; Mkt cap US$0.6 bn; CMP Rs.87; BUY)

Figure 12: India Cement's profits would have been 3-5% lower if the FCCB expense had been charged to P&L

Rs m	FY07	FY08	FY09	FY10
Reported PAT (recurring)	4,788	6,857	4,322	3,542
FCCB debt at 0% coupon	3,375	3,375	3,375	3,375
YTM on the FCCB	8.1%	8.1%	8.1%	8.1%
Additional interest outgo on FCCB	273	273	273	273
PAT post interest on FCCB (post tax)	4,522	6,647	4,140	3,360
Change	-5.6%	-3.1%	-4.2%	-5.1%

Source: Company, IIFL Research

India Cements issued zero-coupon convertible bonds for US$75m at a conversion price of Rs306 in May 2006. If the bonds are not converted, they will be redeemed at 147.7% of its principal amount on maturity in May 2011 (YTM 8.1%). If the company were to expense the interest cost at the YTM of bonds, its profits could have been 3-6% lower than the actual reported profits.

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.
