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India Strategy

Corporate Activity: The Silver Lining

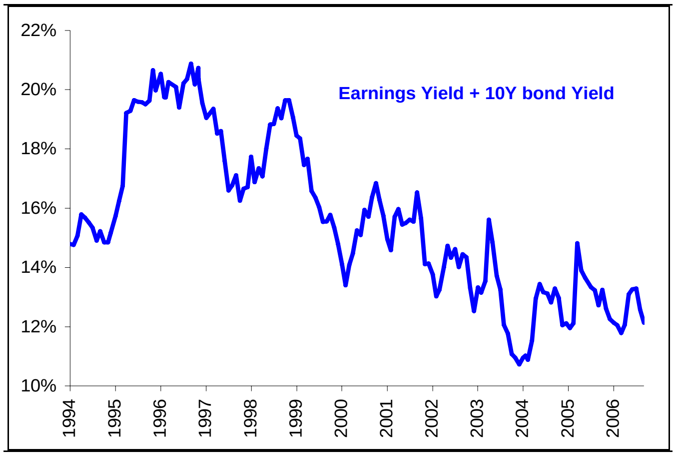
Conclusion: After years of relative inactivity, corporate balance sheet activity on both the asset and liability side has picked up pace in recent months. The favorable setting of a low cost of capital, high capacity utilization, robust growth, strong cash flows and low balance sheet gearing are now feeding into a level of activity not witnessed in over a decade.

What's New: The asset side is clearly witnessing more action. Corporate capex adjusted for depreciation has reached a five-year high and the absolute capex for the companies under our coverage will reach a new level in the current financial year. Our analysts expect the capex for our coverage universe to rise 40% in F2007 after a 50% rise in F2006 although the capex to depreciation in F2007 will likely remain below the 10-year trailing average. Corporates are preferring to add capacity to their individual balance though acquisitions (both home and abroad) and open offers, which keeps capacity growth for the country at large under check. Our numbers reveal a 56% growth in acquisitions and open offers over the past 12 months. Liabilities are transitioning less slowly even though debt issuances are up 44% year-on-year. The rapid rise in book is causing debt/equity to slip further. Corporates have curtailed share buybacks and FCCB issuances in recent months.

Implications: Overall, corporates seem to be handling their balance sheets well. There do not seem to be reckless equity issuances while rising debt issuances can be tolerated by under-geared balance sheets. The accretion to the asset side is not out of bounds and augurs well for mid-term earnings growth. In our view, a bit more capital spending will not hurt at all. Corporate balance sheets remain a positive aspect in what otherwise seems to be a cyclically stretched story in India.

Exhibit 1

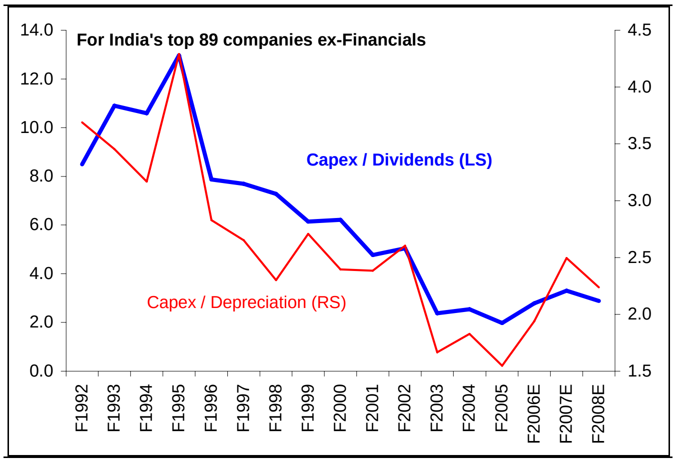
Cost of Capital is Still Relatively Low



Source: Bloomberg, Morgan Stanley Research

Exhibit 2

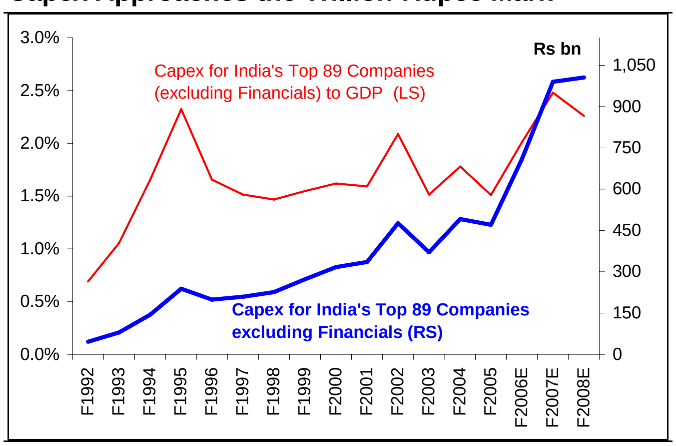
Capex Rises After Falling For A Decade



Source: Company data, Morgan Stanley Research Estimates

Exhibit 3

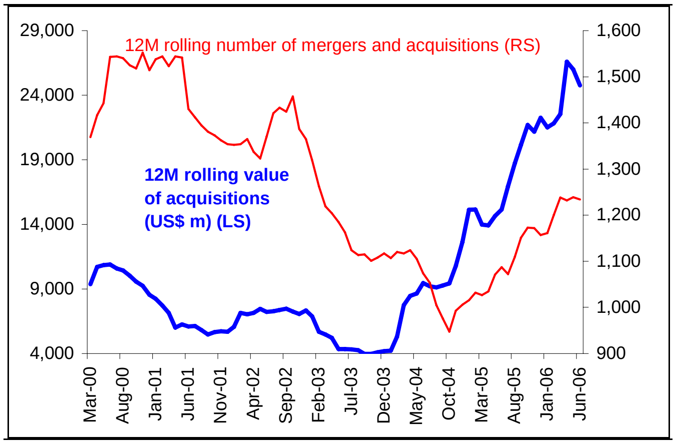
Capex Approaches the Trillion-Rupee Mark



Source: CMIE, Morgan Stanley Research

Exhibit 4

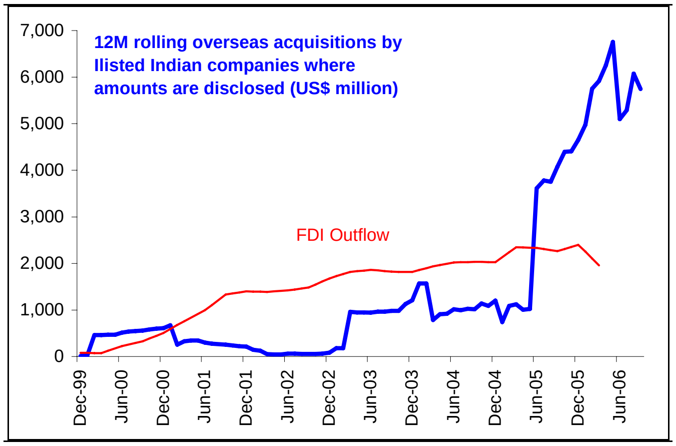
M & A Booming



Source: CMIE, Morgan Stanley Research

Exhibit 5

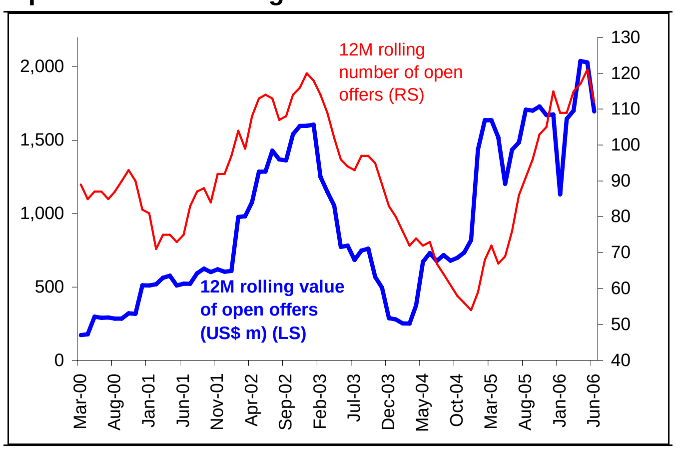
Overseas Acquisitions Riding a Crest



Source: Bloomberg, RBI, Morgan Stanley Research

Exhibit 6

Open Offers Booming But Just Off Peak



Source: CMIE, Morgan Stanley Research

Corporate Activity Up

Corporates seem to be back to investing in their own businesses quite aggressively. Cash flows are still booming and corporate balance sheet leverage ratios have been at all-time lows and thus, corporate balance sheets seem to be in great shape. While the cost of debt has moved up in recent months, the overall cost of capital is still quite low compared with history (Exhibit 1). Capacity utilization is at high levels and demand conditions are the best they have been in India's history. This setting of strong cash flows, low capital costs and high demand and capacity utilization has been in place for some time now and is an ideal backdrop for buoyant corporate activity. However, 12 months ago, the corporate sector appeared quite tentative with respect to its balance sheet on both liabilities and assets. Over the past 12 months, the corporate world's perspective has changed. Corporate activity has picked up pace and in most cases is now close to record levels.

Asset Side of the Balance Sheet Undergoing Urgent Change

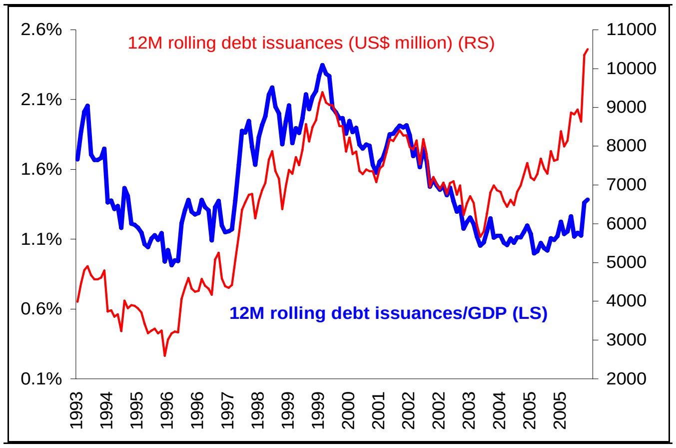
Let us first see the asset side of the balance sheet. Companies seem to be investing with urgency. Expectedly, capex is up. Capital spending relative to depreciation for the companies we cover (excluding the financials) was up in F2006 after hitting an all-time low in F2005 (Exhibit 2). Our analysts are forecasting this to rise into F2007 but then fall in F2008. The absolute capex for the companies we cover is forecast to cross Rs1 trillion in F2008 and is likely to breach its previous high relative to GDP in F2007 (Exhibit 3). The capex to depreciation ratio for these companies will likely be 2.5 in F2007 still below its trailing 10-year average of 2.6 suggesting that companies may not have spent enough to compensate for the depleted capital stock on their balance sheets.

Another reason why capex to depreciation is not rising as much as it should is that corporate India seems to have shifted focus to acquisitions as a means to add to capacity (Exhibit 4). While domestic M&A does not accrete capacity to the system as a whole, it does help cash-rich companies to overcome capacity constraints and avoid gross block addition. Domestic M&A is also being supplemented by record levels of cross-border acquisitions (Exhibit 5). Open offers are also rising, indicating a growing interest among companies and controlling stakeholders to hold larger shares in businesses, another way of adding capacity on the individual company's balance sheet (Exhibit 6).

Domestic M&A is up about 63% for the past 12 months over the preceding 12-month period. We estimate the value at

Exhibit 7

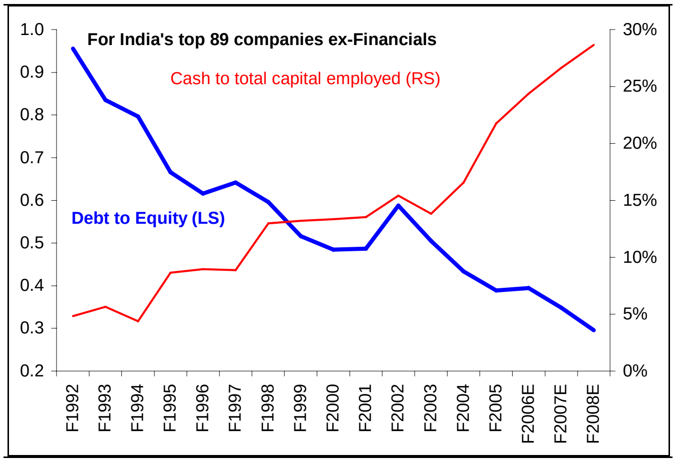
Debt Issuances Have Soared



Source: CMIE, Morgan Stanley Research

Exhibit 8

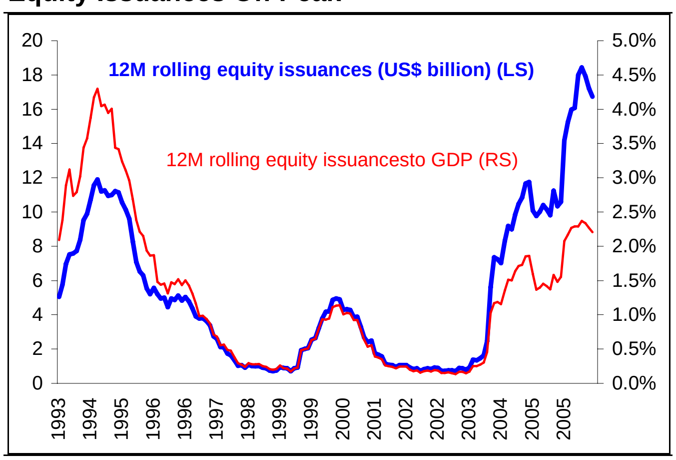
High Earnings Retention Driving Down Debt/Equity



Source: Company data, Morgan Stanley Research Estimates

Exhibit 9

Equity Issuances Off Peak



Source: CMIE, Morgan Stanley Research

US$25 billion, which compares very favorably with an estimated private corporate capex of US$65 billion in F2006. If we add domestic and overseas acquisitions to the open offers made by companies, the 12-month trailing number at US$32 billion is up 56% over the previous 12-month period. Incidentally, the companies under our coverage spent US$15 billion in F2006 on capital, a growth of 50% over F2005. Our analysts expect capital spending for these companies to rise to another 40% in F2007. The asset side of corporate India's balance sheet is clearly undergoing rapid change after years of inactivity.

Liabilities Transitioning Less Slowly

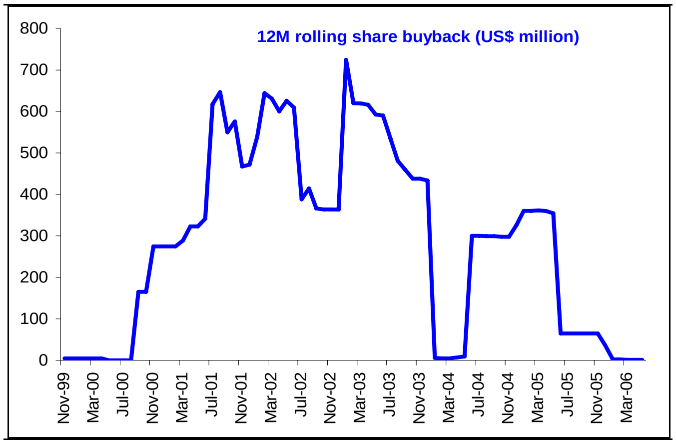
On the liability or capital structure side of the balance sheet, the changes seem less fervent than the asset side. Companies are attempting to lever up their balance sheets. Debt issuances are up 44% on a 12-month trailing basis (Exhibit 7). Absolute debt issuances on a 12-month rolling basis for the corporate sector have exceeded its high from 1990s whilst debt to GDP has crept to a three-year high albeit still lower than the high point of the 1990s. That said, our analysts are forecasting a decline in debt to equity for the companies we cover and the ratio will likely dip to new low going into the next two years (Exhibit 8).

This is largely due to the rapid growth in book driven by high earnings retention following strong growth in earnings and cash flow. To the extent that companies continue to raise equity capital, the debt-equity ratio does not seem to enjoy support on the downside. 12-month rolling equity issuances reached an all-time high of US$18 billion in June this year. However, issuances have slipped a tad since then (Exhibit 9) and, adjusted for GDP, they continue to stay below the mid-90s peak. Two other pertinent trends are the drop in share buyback (Exhibit 10) and the sharp drop in FCCBs (Exhibit 11). The former suggests that companies no longer want to use cash balances to reduce outstanding equity capital – a signal for higher capital spending and/or the rich state of equity valuations. The fall in FCCB issuance is probably a correction from the irrational level we saw earlier this year.

Overall, corporates seem to be handling their balance sheets well. There do not seem to be excessive equity issuances while rising debt issuances can be tolerated by under-geared balance sheets. The accretion to the asset side still seems short of exuberance and augurs well for mid-term earnings growth. In our view, a bit more capex will not hurt at all. Corporate balance sheets remain a positive aspect in what otherwise seems to be a cyclically stretched story in India.

Exhibit 10

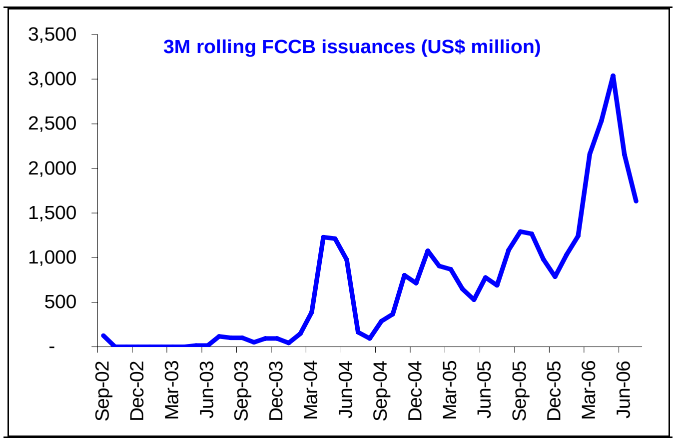
Corporates Have Stopped Extinguishing Equity Capital



Source: Capitaline, Morgan Stanley Research

Exhibit 11

The FCCB Craze is Behind Us, At Least for Now



Source: Prime Database, Morgan Stanley Research

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Total	**2,004**		**665**		

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