

THE MANAGEMENT OUTLOOK

VOLUME 1,
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MANAGEMENT
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INSIDE
THIS
ISSUE:

FII's TURNED TO BONDS

The bond market (also known as the debt, credit, or fixed income market) is a financial market where participants buy and sell debt securities, usually in the form of bonds. It usually refers to the government bond market, because of its size, liquidity, lack of credit risk and, therefore, sensitivity to interest rates. Because of the inverse relationship between bond valuation and interest rates, the interest rates are often used to indicate changes in bond prices.

As the interest rate decreases the price of bond increases. This is due to the fact that decrease in interest rate discourages the investors to put their money in bank deposits. Hence the demand

for bond rises up which leads to increase in bond price.

The Reserve Bank of India used its monetary stimulus tools and decreased CRR, SLR, Repo rate and reverse repo rate to revive the economy. The RBI is likely to take further initiatives to stimulate the economy by making a down move in interest rates. There is a clear possibility of lending and deposit rates to come down. Therefore, there would be more investments in debt instruments as investors would try to capture the capital gain out of falling interest rates. The combination of safety of capital coupled with a decent re-



turn is whetting the appetite of even the FIIs (Foreign institutional investors). With the RBI pro-actively cutting rates, there has been a surge in interest by FIIs in debt, particularly in corporate bonds.

If the investment pattern of the first 11 trading sessions in the new calendar year is anything to go by, FIIs appear to be laying much store by investments in debt as compared to investment in equity.

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"BOND PRICES AND INTEREST RATES ARE INVERSELY RELATED"



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CURRENT RATES

CRR 5%
SLR 25%
REPO RATE 5.5%
REVERSE REPO RATE 4%

"INTEREST RATES LIKELY TO FALL AND BOND PRICES LIKELY TO INCREASE"

EXPECTED RATES

CRR 3%
SLR 21-22%
REPO RATE 3.5%
REVERSE REPO RATE 2%

In 11 trading sessions of the current year, the lure of earning a decent coupon coupled with capital appreciation in a falling interest rate regime has prompted FIIs to channelize investments amounting to Rs 2,155 crore in debt instruments ('safe-haven' government securities, commercial papers, and corporate bonds).

There is a 99.99 per cent probability that interest rates will come down. We expect the central bank to cut signal rates and ratios in a couple of tranches. We see the LAF (Liquidity Adjustment Facility) corridor in the 2 per cent (reverse repo rate) to 3.5 per cent (repo rate) band, cash

reserve ratio at 3 per cent and statutory liquidity ratio at 21-22 per cent. This expectation is prompting FIIs to invest in the corporate bond market.

So what if the equity market is in bad state, boxed in the 9,000-10,000 points Sensex band? FIIs have not written off India when it comes to investing in debt. Consider the basic investment math: The cost incurred by an FII investing in India will be the one-year London Inter-Bank Offered Rate (Libor) i.e. around 2 per cent, plus the one year forward cover i.e. about 2 per cent. If the FII invests in a one-year 'AAA' rated debt instrument with the highest degree of safety, it will fetch a return of 10.25-10.50 per cent p.a. So, the

actual return on investment works out to 6.25-6.50 per cent p.a. With a one-year 'AAA' rated corporate bond currently being dealt at almost 600 basis points or 6% over the government security of one-year residual maturity, offshore investors have latched on to the attractive returns in the corporate bond market.

Thus, the combination of the possibility of declining interest rates and increase in limits for FII investment in corporate bonds from \$6 billion to \$15 billion, announced by the government last month, would encourage more and more FII inflows into the Indian bond market.

WHY DO PSUs FARE BETTER IN TURBULENT TIMES?

PSUs
Bharat Electronics Ltd.
Bharat Petroleum Ltd.
Steel Authority of India
Power Finance Corporation
Mahanagar Telephone Nigam

PSUs
OUTPERFORMED
PRIVATE FIRMS

- **LOW DEBT EQUITY RATIO**
- **HIGH CASH RATIO**
- **HIGH DIVIDEND PAYOUT RATIO**

Although the market meltdown has spared no particular set of companies, PSU firms have taken a relatively smaller hit. The stocks of several public sector companies have shown a better resilience to the vagaries of market. But why, there should be strong reasons behind it. If the expression 'cash is king' holds true, then public sector undertakings (PSUs) are definitely better prepared for tough times than private players.

PSUs are in a much better position than their private peers to borrow in the present time of liquidity crisis as they have a **healthier Debt-to-Equity Ratio**, which indicates the capability of a company to take loans. Debt-equity ratio is a measure of a company's financial leverage calculated by dividing its total liabilities by stockholders' equity. It indicates what proportion of equity and debt the company is using to

finance its assets. A high debt/equity ratio generally means that a company has been aggressive in financing its growth with debt. This can result in volatile earnings as a result of the additional interest expense. Cost of debt financing may outweigh the return that the company generates on the debt through investment and business activities and become too much for the company to handle. This can lead to bankruptcy, which would leave shareholders with nothing. An optimum level of debt in the capital structure is good, but beyond that, implies higher the debt, higher the risk. A company with lesser debt is in better position than a company with higher debt in terms of withstanding shocks, interest rate risk & payment obligations. **A survey by US-based researcher Dun and Bradstreet (DandB) suggests**

that the debt-equity ratio of Indian PSUs was below 50% as at the end of 2007-08, whereas private companies have a leverage level of around 70%.

Secondly, what further adds to PSUs' strength vis-a-vis private firms is the **high Cash and Bank balance**. The cash ratio, an indicator of the extent to which a company can pay current liabilities with cash in hand without relying on the sale of inventory and receipt of accounts receivables. The cash ratio of public sector undertakings rose sharply from 24% to approximately 42% in 2008. On the other hand, the cash ratio of private firms initially improved from 19.18% in 2004 to 30% levels during 2005, 2006, and 2007, but later fell steeply to 21% in 2008.

COMPETITIVE SECTION

“THE ARTICLE HIGHLIGHTS SOME OF THE STRENGTHS OF PSUs WHICH ALLOW THEM TO FARE WELL IN TURBULENT TIMES. WHAT CAN BE THE OTHER PARAMETERS- QUANTITATIVE AS WELL AS QUALITATIVE WHICH MAKE PSUs STRONGER THAN PRIVATE FIRMS IN HARD TIMES?”

YOUR ANSWER SHOULD NOT EXCEED 100 WORDS !!!

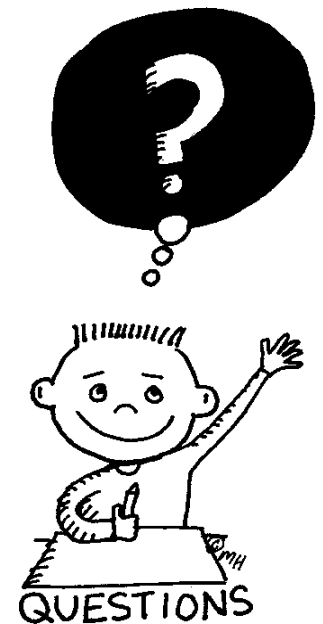
Even though raising money in the present market conditions is becoming a difficult task, the PSUs are enjoying a low debt and huge cash reserve position. PSUs used their strong earnings to strengthen their balance sheets and make calculated expansions. Against the common belief that PSUs are inefficient and should be sold to private entities, the 31 PSUs earned revenues similar to those of 216 private firms. Sales growth of PSUs has remained robust throughout the last five years in spite of a huge base in terms of turnover.

Other than the two parametric financial strengths of the PSUs - low debt-equity ratio and high cash ratio, we have

Dividend Payout Ratio as the third parameter. Dividend payout ratio is the percentage of earnings paid to shareholders in dividends. The payout ratio provides an idea of how well earnings support the dividend payments. Companies with healthy earnings and optimum dividend policy distribute good amount of dividends to their shareholders i.e. they tend to have a higher dividend payout ratio. **Over the last five years, the dividend payout ratio has consistently declined for the private sector companies, whereas the PSUs make a much higher contribution to**

the exchequer through both taxes and dividends.

All these quantitative financial parameters show how PSUs sit pretty when India Inc falls on hard times and how PSUs can fare better in times of trouble. PSUs outperformed private companies in terms of revenue, profits and growth. They are better prepared for tough times because of factors like optimum leverage, high cash reserves and good dividend policy.



Send your answers to
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**Best answers will be
duly Complimented.**