



GLOBAL STRATEGY & INVESTMENT CONSULTING



COMMERCIAL PAPERS CORPORATES' HARBOR AGAINST RISING BORROWING COSTS

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Preface

To battle rising interest rates, India Inc. are routing funds from commercial papers to flush its mega investment projects with managing capital or inventory purchasing capability and mutual funds are readily grabbing the same. As per the Reserve Bank of India, the outstanding amount of commercial papers issued by corporates as at end of March 2008 was INR 32,592 Crores, while this figure rose 44% by June 2008 to a record INR 46,000 Crore. Commercial Papers have gained immense popularity in the Indian Industry for efficiently sourcing short-term funds in the money market what with the Central Bank of India posing cumbersome provisions for external commercial borrowings.

Commercial Papers have numerous advantages for the corporate India. Firstly, it does not need to be registered with the SEC (Securities and Exchange Commission) if the period for which it is issued is less than 270 days. Second, funds raised via commercial papers do not represent any fresh borrowings. Third, they are issued only when the CPs rates are lower than borrowed money from banks thus saving on interest costs.

The Economics of Commercial Papers

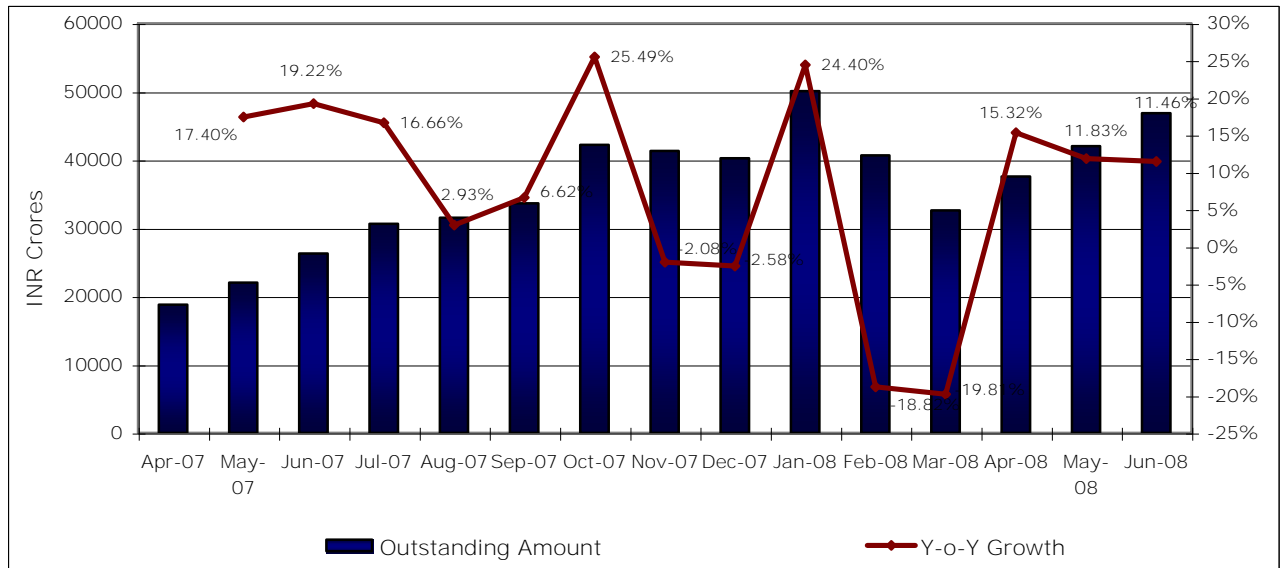
A Commercial Paper (CP) is an unsecured, negotiable short-term debt instrument issued by a corporation which confirms the liability of the issuer to pay the holder of the instrument a fixed amount on the stipulated date. CPs has fixed maturities and are sold at a discount reflecting market interest rates prevailing at that time. They are typically issued for financing short-term working capital needs, purchasing inventory, accounts receivable etc. and can be directly issued to investors or through banks/merchant banks/dealers.

Commercial Papers are generally issued in multiples of INR 5 Lakhs for a period ranging from a minimum of 15 days to a maximum of 1 year. The discount rates on CPs are determined by the demand and supply factors in the money market and the interest rates on the other hand by the competing money market instruments such as certificate of deposits (CDs), commercial bills and treasury bills.

Commercial Papers are not issued at the back of any collateral as such but on the basis of the high-quality debt rating of the firm. Thus it follows, CPs have to entail a compulsory rating by recognized credit rating agency such as Credit Rating Information Services of India Ltd. (CRISIL) or the Investment Information and Credit Rating Agency of India Ltd. (ICRA) or the Credit Analysis and Research Ltd. (CARE) or the FITCH Ratings India Pvt. Ltd. or such other credit rating agency (CRA) as may be specified by the Reserve Bank of India from time to time.

Figuratively Speaking!

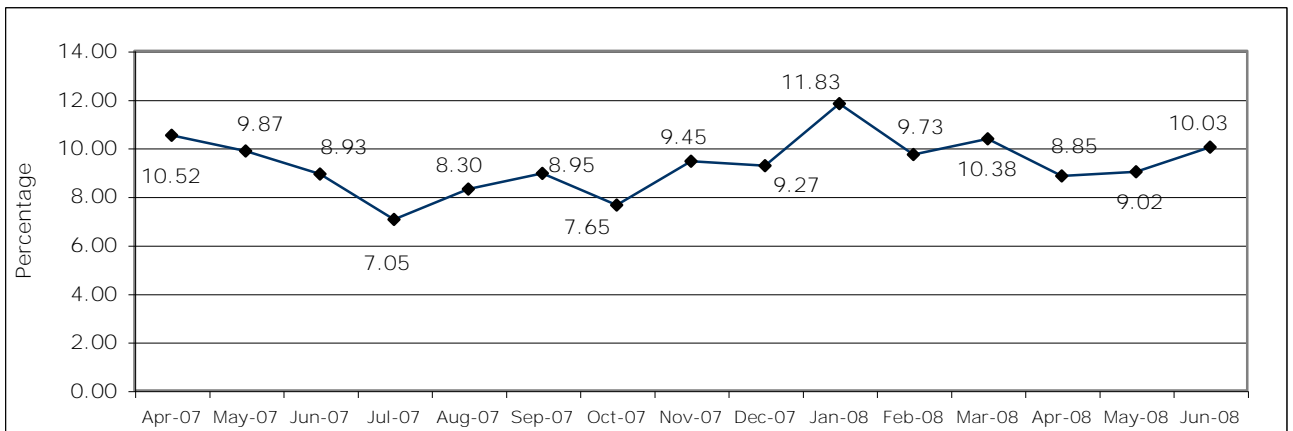
Exhibit 1: Monthly Outstanding Amount of Issuance of Commercial Papers by Corporations



Source: GSIC Research, Reserve Bank of India Publication – Macroeconomic and Monetary Developments First Quarter Review 2008-09

As per the annual report 2008 published by RBI, the total outstanding amount of commercial papers issued by Corporates increased from INR 17,863 Crores (March 2007) to INR 50,062 Crores (January 2008) – a 180% increase in a period spanning 10 months. Although, seasonal year-end redemptions led to a decline in the figures in March 2008 with outstanding amount at INR 32,592 Crores (a y-o-y increase of 82.45%). July 2008 saw the issuance of CPs reaching INR 51,569 Crores. The report also observes that the fortnightly average issuance of CPs during 2007-08 was INR 4,153 Crores as compared to INR 2,322 Crores during 2006-07.

Exhibit 2: Monthly WADR (Weighted Average Discount Rate) [April 2007– June 2008]



Source: GSIC Research, Reserve Bank of India Publication – Macroeconomic and Monetary Developments First Quarter Review 2008-09

The Weighted Average Discount Rate (WADR) on CPs declined from 11.33% on March 31, 2007 to 7.65% at end-October 2007 but hardened to 10.38% as on March 31, 2008 and further to 10.95% as on July 31, 2008. The most preferred tenor of CP issuance was for period 180 days and above.

Table 1: Outstanding Amount of Issuance of Commercial Papers and WADR

Year	Outstanding Amount (INR Crores)	WADR (%)
2005-06	17,285	6.46
2006-07	21,329	8.08
2007-08	33,813	9.20

Source: GSIC Research, Reserve Bank of India Publication – Macroeconomic and Monetary Developments
First Quarter Review 2008-09

The average annual outstanding amount of Commercial Papers issued has shown significant increase over the years and so has the weighted average discount rates. The recent changes seen in market interest rates over the past few months (with a national bank public-lending rate (PLR) appearing in a bandwidth 12.75% to 13.25%) has enabled interest rate on CPs to rise again to 10.03% as on June 30, 2008 as per the annual policy review by RBI.

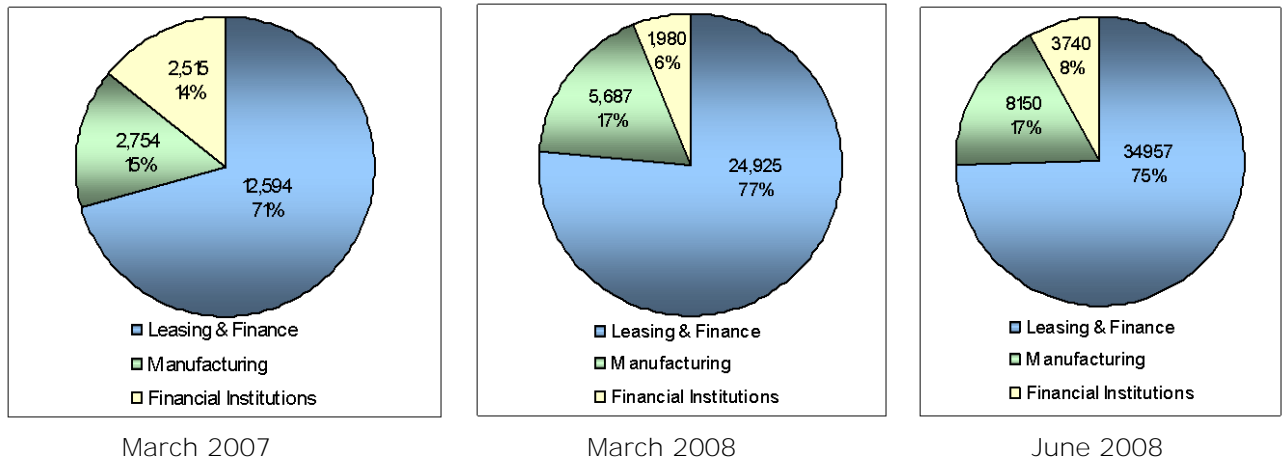
Issuances and Investments

Although the Central Bank of India has initiated a plethora of de-regulations as part of its first-half credit policy (April 2008) in bank lending norms to boost commercial credit on account of the setback faced by rising interest rates, Commercial credit in just a month shrunk by INR 299 Crores. Consequently, RBI statistics reveal commercial papers to be gaining foothold with amount of CPs issued by corporates rising to INR 977 Crores in May 2008 as against INR 702 Crores in April 2008.

In light of the above conversation, one must not forget that basic objective of commercial papers i.e. to provide an influx of funds for a short-duration at a discounted cost to the company for meeting working capital needs and the likes. Corporates will have to eventually fall on other conventional alternatives as Commercial Papers are basically a stop-gap arrangement. In the recent past, prominent corporates like Power Finance Corporation, Rural Electrification Corporation, Tata Power, Tata Motors, Simplex Infrastructure, IDFC etc. have been observed raising short-term funds through commercial papers (CPs) and debentures.

The following exhibit depicts how leasing and finance companies have been the predominant issuers of Commercial Papers holding a share above 70%, followed by manufacturing companies and financial institutions.

Exhibit 3: Major Issuers of Commercial Papers



Source: GSIC Research, Reserve Bank of India Publication – Macroeconomic and Monetary Developments
 First Quarter Review 2008-09

In terms of non-SLR Investments made by Scheduled Banks, observing figures for the year 2007 indicate that Commercial Papers constituted 9.4% (at INR 8,978 Crores) of the total non-SLR investments made, as compared to its preceding year at 5.4% (INR 4,821 Crores). Bonds/Debentures still remain the biggest avenue although their share has been a reasonable decline over the past four years. Shares and Mutual Funds are the other two destinations where the banks are routing their non-SLR investments.

Looking Ahead

Over the past few months, yields on commercial papers have shown considerable increase (by more than 100 basis points) primarily due to the tight cash conditions and hike in the repo rates. Moreover, the sluggish stock market has not helped the companies' cause either. As per estimates by Grant Thornton, total capital raised via IPOs by Indian companies in the first half of 2008 was USD 4.07 billion as compared to USD 7.68 billion for the same period in its preceding year. Corporations are betting on interest rates to come down in the future even though experts beg to differ opining that even if banks start to cut lending rates in the coming six months, overall borrowing costs are expected remain high at least till year end 2009. Meanwhile, Commercial papers being sold by esteemed and well-capitalized companies continue to prove healthy. With the debatable dubious stability of the Indian financial system, Commercial Papers are the current savor for Indian Corporations. Moreover, Converting trade receivable claims into electronic format and creating a structure to allow trading of these as commercial papers would certainly boost credit flow to small and medium enterprises. The essential qualities of commercial papers, that being, short-term maturity, establishing national credit, self-liquidating nature, keeping reserve of borrowing power at local banks, non-speculative nature and purpose of use are only a few factors contributing to the even though minuscule contribution being made by commercial papers in unlocking the door to future growth of India Inc.



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