INVESTING

Pruning interest costs, paying off debts: Indian firms are tidying up the house before winter.

Synopsis

Companies are cutting down their interest costs and paying off debts — something that has been going on for the past two years. This is being done as companies expect the business environment to worsen due to rising costs of capital in a high interest scenario.

Liquor manufacturer and owner of the Kingfisher brand, United Breweries, is enjoying the good times.

Not only has it reduced its interest expenses, it has also been able to improve its interest cover with its rising sales and profit growth year-on-year (yoy).

For the September 2022 quarter, consolidated net profits are up 67% yoy at INR134 crore, revenue from operations are up 11% yoy at INR3,673.

The company paid an interest expense of around INR1 crore as compared to INR4.73 crore, a fall of 79% the previous year. The interest cover improved to 183x from 24x last year.

And it is not just United Breweries.

Pharma major Sun Pharma and the owner of brands like Taj and Vivanta — The Indian Hotels Company — have also managed to reduce their interest costs.

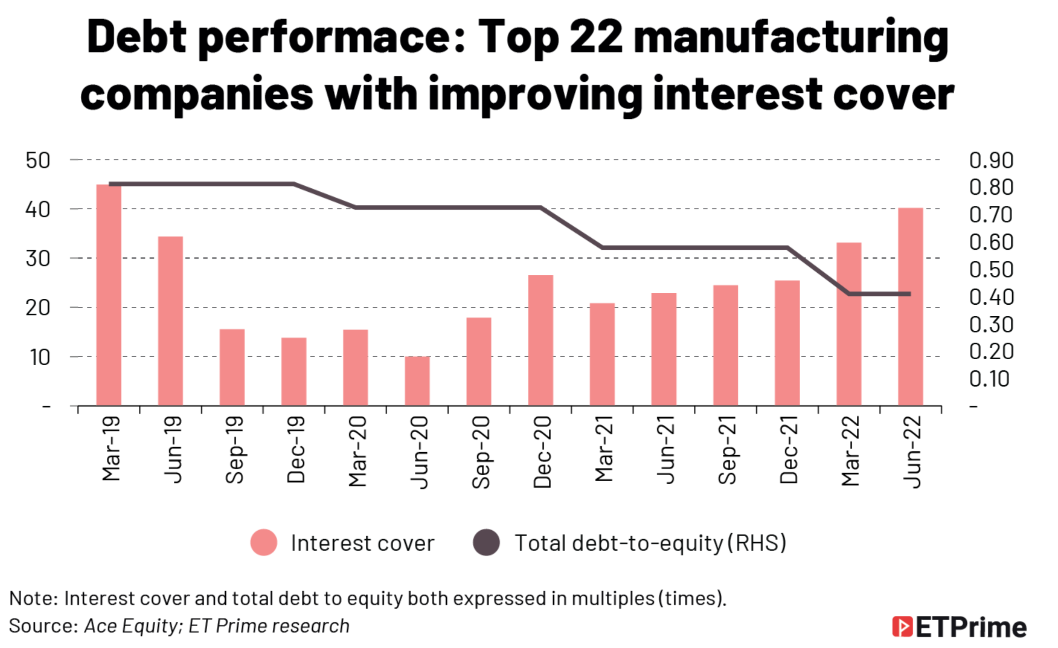
From the quarter of June 2021, Sun Pharma has reduced its **interest cost** by 61% and Indian Hotels has achieved the same feat by 43%. But reducing interest cost is one thing, we also need to see that the companies are able to pay off their debts without hurting their profits.

Why does a reduction in interest cost and paying off debts matter now?

Over the last two years companies have been busy paying out their **debt**s and this may turn out well at a time when interest rates are going up. But going ahead how will these companies fare? Not to forget, the world continues to grapple with high inflation, and central banks go on harping about raising interest rates till the situation is in control. This will have a severe effect on the cost of financing where debt is getting costly.

The good parts

ET Prime looked at top 22 manufacturing companies in Nifty 200 companies with improving interest cover ratio — a debt and profitability measure giving a picture of how easily a company can pay back the interest on its debt (calculated as PBIT/interest expenses) — over the last 15 quarters on an average until June 2022 and compared the results with the debt-to-equity ratio (a measure of a company's financial leverage) over the last four years.



In March 2020, the average interest cover ratio was at 15x. For the quarter ended June 2020, the number went down to almost 10x and since then till June 2022 it has gone up to 40x. From March 2020 to March 2022, the debt-to-equity ratio of these companies has come down from 0.7x to 0.4x.

A Bank of Baroda study from August concluded that the interest cover ratio would decline in FY23 owing to the rising interest rates by the RBI and inflationary pressure.

This may have some effect on the bottomlines of companies who have high debt-to-equity ratios. But then analysts argue that demand on the ground is still strong for commodities as well as automobile companies and there is no reason to hit the panic button especially when it comes to their stock prices.

A research report by Morgan Stanley in September also pointed out the 15-year-low corporate debt and hence anticipation of a **capex** (capital expenditure) boom, with India's investment rate expected to rise to 36% of the GDP.

This gives a lot of confidence to stock market investors because even if the capex cycle might take longer time, the fact is that most companies will be able to manage the high inflation or high interest phase where expenses in general can increase even despite a low debt-to-equity ratio.

'Corporate bond spreads have not moved up much for the AAA rated securities. They are still below their long term averages. The challenge here is that there is not much supply because of deleveraging activities. Even bank credit for the corporate sector has not picked up as much as it has for the retail segment. The spreads will increase only when corporates start to borrow money in a big way like CAPEX or acquisition. The yields have however increased due to RBI rate hikes and drop in liquidity', explains Dhaval Kapadia Director-Portfolio Specialist, Morningstar Investment Advisers India

Worrying bits

The only problem investors are worried about is the overall demand from the consumer. So far, the end consumer has responded well during the festival season. This is true for the automobile industry where sales for SUVs and passenger cars have shown encouraging growth. Tata Motors, Ashok Leyland and TVS Motor companies have debt-to-equity ratios in the range of 3x.

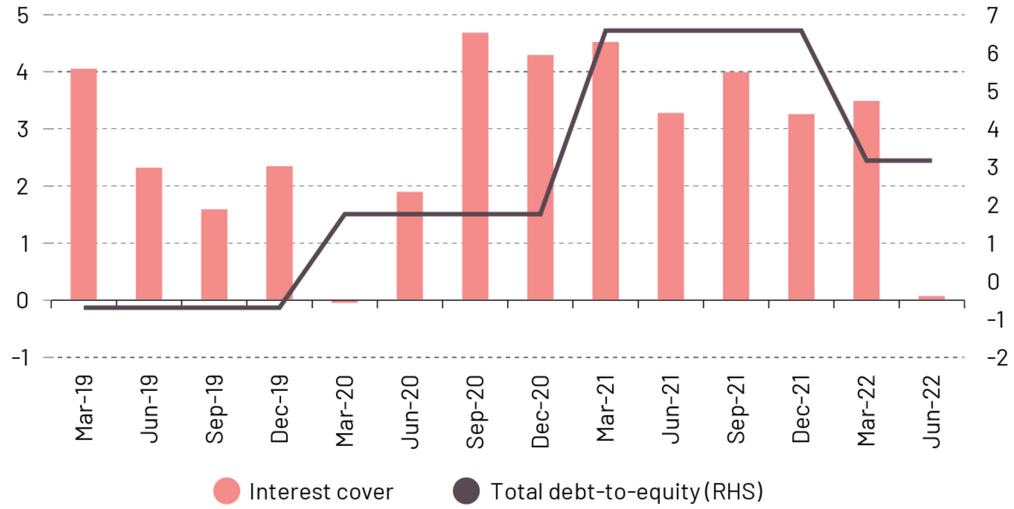
Credit risk funds are owning debt of these companies in spite of the high ratios because they feel that these companies are overall getting better at managing their cost of capital and chances of a default are very low. Credit risk funds invest into debt of companies that are high yielding but also issued by companies that have a track record of paying off their creditors on time.

Sometimes they also invest in companies where interest cover ratios might be low but the returns on these instruments compensates the risk and reward. For instance, JSW Steel has a low interest cover at 1.91x, yet, its debt is in huge demand by credit risk funds.

Top credit risk funds include DSP Credit Risk, ICICI Prudential Credit Risk, Kotak

Credit Risk, Aditya Birla Sun Life Credit Risk and Baroda BNP Paribas Credit Risk Fund. ICICI Prudential manages the largest AUM amongst the five at INR 7,890 crore. Its biggest investments are in REITs and other corporate debt.

Interest cover performance of top 20 high debt companies



Note: Interest cover and total debt to equity both expressed in multiples (times).
Source: *Ace Equity; ET Prime research*

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Top 15 companies that have high debt-to-equity

	March 2020	March 2021	March 2022
Adani Green Energy	6.15	10.85	19.96
Tata Communications	-8.39	86.25	8.51
REC	8.09	7.53	6.49
Adani Transmission	5.27	4.89	4.79
TVS Motor Company	3.46	3.12	3.48
Ashok Leyland	2.86	3.06	3.30
Tata Motors	1.91	2.46	3.14
Power Grid Corporation Of India	3.01	2.60	2.17
Tata Power Company	2.68	2.07	2.12
Bharti Airtel	1.53	2.20	2.00
Adani Enterprises	0.73	0.93	1.82
Mahindra & Mahindra	2.08	1.89	1.59
NTPC	1.73	1.69	1.57
Larsen & Toubro	2.13	1.76	1.51
Adani Ports and Special Economic Zone	1.17	1.14	1.20

Source: *Ace Equity*

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The bottom line

Since January 2022, the world has been affected by the Russia-Ukraine war and the US Fed is increasing interest rates to tackle inflation. Both these events have turned out a disaster for much of the developed world but few emerging markets have been able to manage better due to their size and also due to the fact that many companies are taking a serious look at how to reduce the cost of capital.

For example, UB plans an INR350 crore of capex in 2023 to match the increasing demand for its beer. The stock is traded at a PE multiple of 80x at INR1,652 and on a YTD basis the stock is up almost 5%. ICRA in a recent report reaffirmed the debt instruments of UBL to [ICRA]AA+ (Stable) and [ICRA]A1+. The ratings have remained so since FY19.

"The ratings also favourably factor in UBL's strong financial profile, characterised by robust debt protection metrics, moderate working capital intensity and strong liquidity. Further, though the highly regulated nature of the industry with extensive government controls on advertising and taxes restricts growth to an extent, the same creates entry barriers for new players, thereby providing competitive advantages to incumbents such as UBL," notes ICRA in the October 2022 report.

"In the past, debt had reached a high level for corporates. So they had to deleverage their balance sheets. Now, their debt has been reducing over the last few years, balance sheets are in a good condition and capacity utilisation is happening. So we should see a pickup in the private capex happening in the next few months," says Rajani Sinha, chief economist, Care Ratings.

(*Graphics by Manali Ghosh*)