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OVERSEAS BORROWING, A DOUBLE-EDGED SWORD?

Relevant for: Indian Economy | Topic: Issues relating to Mobilization of resources incl. Savings, Borrowings & External Resources

In the current economic climate, companies that wish to boost their capital can do so in multiple ways.

The first method would be to infuse excess earnings into the company through retained earnings. The second would be to dilute the stake of existing shareholders of the company by creating a rights issue to infuse equity capital into the firm.

The third, and arguably the quickest method, would be to borrow money from banks directly, NBFCs or the open market through issuing bonds/debentures. Many Indian companies have chosen the third route to fund their capital needs by borrowing from domestic sources such as banks and through debentures marked in rupee.

However, a collection of companies with borrowings denominated in foreign currencies makes for an intriguing subject to examine.

The argument behind borrowing in foreign currencies is that when there is interest-rate disparity between the domestic and foreign markets (favouring the latter), it becomes cheaper to service such loans.

It is crucial to note the borrower is still open to exchange risk, notwithstanding the difference in interest to be paid.

Decline in value

If the domestic currency were to decline compared with the foreign currency, the company is liable to pay more than it had bargained for in real terms.

Therefore, the currency risk must be offset by your revenue denominated in the foreign currency or by some other measure.

Vedanta Ltd., a mining company with a market capitalisation of Rs. 93,896 crore (at the time of writing this piece), had borrowed $1.2 billion in February 2021 when the U.S. dollar to rupee conversion rate stood at roughly Rs. 72.6 but touched a high of Rs. 80.03 on July 18 this year. The dollar, in nominal terms, appreciated by 10.6% in over a year-and-a-half.

The problem for Vedanta is that its borrowings, originally $1.2 billion, remained constant nominally and increased by over 10.6% in real terms. Moreover, Vedanta’s woes cease to end there with their holding company listed in the U.S. having $16,377 million in total debt.

It had paid $1.267 billion in interest in 2021 alone.

An increase of 10.6% in the total interest payments amounts to $1.394 billion. The real catch, however, is that Vedanta earns a significant portion of its revenue in the rupee, which has not kept pace with its dollar counterpart.

Additionally, due to the nature of Vedanta’s business in dealing with commodities, volatile prices spell trouble for a company already under significant pressure. Not only have commodity prices sobered from their exuberant highs (viz., copper and steel), but the Zambian courts have also halted their case for liquidating their subsidiary Konkola Copper Mines.

Another company that borrowed in foreign currency is Adani Green Energy. It borrowed a sum to the tune of $6,061 crore in secured bonds. Needless to state, the volatility in energy prices rivals commodity prices. Additionally, Adani Green Energy has issued redeemable NCDs (non-convertible debentures) to Total Solar Singapore Pte Limited worth $4,013 crore, carrying whopping interest rates in the 12.25-13.25% range, according to the notes provided in its annual report.

The advantage of borrowing in a foreign currency (viz., cheaper interest payments) is lost at high rates. Moreover, as in the case of Vedanta, Adani Green Energy Ltd. also earns predominantly in rupee terms. Tata Motors, another company which had borrowed in foreign currencies, had a hedge due to earning their keep in the respective currency. Therefore, when the value of the debt rises or falls, the company's revenue falls accordingly, mitigating the difference between the real and nominal burden of the borrowing.

Insufficient hedge

A revenue earned in foreign currencies may not be a sufficient hedge for companies borrowing excessively due to low-interest rates. The problem with borrowing in the current environment is the impending risk of a recession due to increased interest rates to curb inflation. Central banks worldwide, primarily the Federal Reserve, have raised rates unanimously. Benchmark U.S. rates rose from 0%-0.25% at their lowest and now hover between 2.5%-2.75%. The Federal Reserve seems open to raising it to 4% to forestall inflation.

The effect of rising rates has two facets, the first being the threat of lower earnings from a shrinking economy, and the second being the depreciation of the rupee compared with foreign currencies. Although the borrowing of these companies remains constant, their revenues decrease due to a recession, increasing the real burden of their debt. Sintex Industries and the Anil Ambani group (with considerable sums borrowed in foreign currencies) exemplify how foreign debt has sunk enormous titans. Although borrowing in foreign currencies for cheaper rates might seem attractive in the short term, it is debatable whether it is a sustainable course of action in the long term.

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