

# Recovering From Shock

Whether it likes it or not, India Inc has to learn to live with a weak dollar. And, it is learning fast. Corporates are building natural hedges that could safeguard businesses against global currency volatility

**SANGITA SHAH, NANDITA DATTA and M ANAND**

**I**N THE midst of Wipro's latest earnings call, an analyst from the US sprung a question on CFO Suresh Senapaty. How is Wipro preparing for a dollar at Rs 35? The question was yet another reminder of the frightening prospect of the rupee's appreciation. Every 1% rise of the rupee against the dollar could wipe out 30 to 50 basis points from the profitability of most IT companies.

Already, the rupee has appreciated 7% against the dollar in the last three months and almost 10% since March 2006. The scare is big enough to send a giant like Tata Consultancy Services (TCS) scurrying for cover—it has trebled its forex hedging exposure from \$830 million to \$2.5 billion in the last three months. It is not just the IT sector, but the country's entire \$124.6-billion strong exports industry that's worried.

"It is difficult to adjust your cost structures to cope with such a steep appreciation in so short a time," says Baba Kalyani, Chairman and Managing Director of Bharat Forge. "We have to learn to live with this volatility," adds Bharat Doshi, Executive Director, Finance and Corporate Affairs at Mahindra & Mahindra. The analyst's poser to Wipro rammed home one point—exporters had better prepare to live with a strong rupee and a weak dollar.

At the current level of Rs 40.63, the dollar at Rs 35 might seem like an unlikely scenario. But it is not an improbable one, especially in the longer term. "A poll of corporate treasury managers would tell you that a majority of them



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**Baba Kalyani**  
CHAIRMAN & MD, BHARAT FORGE

expect the rupee to appreciate further in the medium-term," says Shilpa Kumar, Senior General Manager, Global Markets Group at ICICI Bank. DK Joshi, principal economist with Crisil predicts that the rupee will reach Rs 36-37 against the dollar by 2010.

Sachchidanand Shukla, an economist with Enam Securities, sees the dollar at Rs 37.8 in 2010. HSBC put out a report predicting a Rs 39-level for the rupee by the end of this year. "The question is whether the rupee will appreciate less than 5% per annum from here or 8-10% per annum or more," adds a Credit Suisse report.

That's the short-term forecast. In the long-term, given India's aggressive economic growth, the rupee is likely to strengthen further. Moreover, as India moves towards full convertibility, the rupee's ability to find its natural level against the dollar will not be hindered by RBI intervention. "Rupee appreciation is not only a reflection of the robust economy but also a run-up to full convertibility," says Madhoo Pavaskar, Director at the MCX Academia of Economic Research. "Allowing the

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rupee to appreciate during this period is sort of giving the industrial sector a notice period to beef up their efficiency and competitiveness," he adds. That considered, further appreciation of the rupee, perhaps even to the mid-30s is a scenario that no serious exporter can afford to ignore. They may dislike it but they still have to be prepared for it.

Several exporters across industry segments are tweaking global production alignments, favouring countries where the currency has not appreciated as much; they are finding and pulling hard the operating levers that could improve efficiency and, therefore, profitability; they are trying to build in more natural hedges that could safeguard the business against global currency volatility and are putting in place a full suite of forex hedging solutions.

**Broad Trends**

The last major upswing of the rupee was in 2004 end—it rose 6% against the dollar. But since then, the fundamental character of corporate India has changed. Several Indian companies have since built or bought global manufacturing facilities or delivery centres in countries like China, Germany, US and Mexico.

**Poll Apart**

Relative assessment of sectors

	EBIT margins (%)	Impact on EBIT for every 1% rupee appreciation	Extent of hedging	Pricing power	Impact of possible govt sops
Tier-1 IT companies	20-30	30-40 bp	High	Medium	Low
Tier-2 IT companies	10-20	40-60 bp	High	Low	Low
Cotton yarn & fabrics	10-20	50-60 bp	Medium	Low	High
Readymade garments	15-25	50-60 bp	Low	Medium	High
Gems & jewellery	5-15	40-60 bp	Low	Low	Low
Chemicals	5-20	n.a.	Medium	Varies	Medium
Pharma	15-25	Varies	Medium	Varies	Medium
Auto ancillaries	10-20	n.a.	High	Medium	Medium
Other egg. goods	10-25	30-40 bp	High	High	High

Source: CME, Credit Suisse estimates

Now, for the first time, companies have the option of leveraging global capacities to counter the appreciation of the rupee. Four broad trends are in evident.

First, companies are considering the option of driving exports to the US out of their production facilities in countries like China and Mexico where the currency has not appreciated as much against the dollar. Take Mahindra & Mahindra, which is developing a hub in China for tractor exports. Exports from China are more competitive now. But M&M will also continue exporting tractors from India to the US. "Emerging multinationals like us are now exploring alternate production and sourcing locations in order to stay competitive," says Doshi. But the decision will be based on the economics of a country, and not its currency alone. "Currency, including that of competing countries, is one factor, but not the only one," he adds. Similarly, TCS set up a development centre in Guadalajara, Mexico.

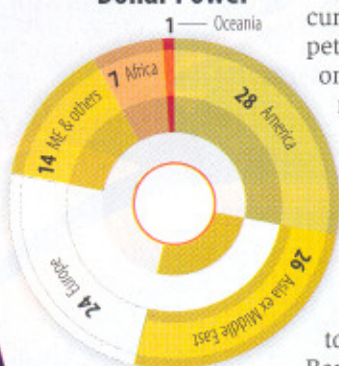
The facility will hire 500 locals in the first year and 5,000 by the fifth. While the rupee has risen against the dollar, the Mexican Peso has not. That is a reason behind the decision. "Corporates in the services sector will expand into cost advantageous countries," says Chanda Kochhar, Deputy Managing Director of ICICI Bank and Head of its international Banking Group.

In the gem & jewellery sector, Shrenuj Diamonds opened offices in Thailand and China. "It is part of our contingency plans. The contribution of these countries to our production is in single digits. But we may increase this depending on the situation," says Vishal Doshi, Group Executive President of Shrenuj Diamonds. Gitanjali Gems is also exploring the possibility of a production centre in China.

"Manufacturing companies would need to set up bases in



**Dollar Power**



Shaded area indicates mostly dollar-denominated exports  
 Source: CME, Credit Suisse estimates

**The depreciation of the dollar has prompted Indian companies to strengthen manufacturing operations in the US**





**"Emerging  
MNCs like us  
are exploring  
alternate  
production bases"**

**Bharat Doshi**

EXECUTIVE DIRECTOR, M&M

low-cost countries such as China, Hungary, Romania and Mexico," says Santosh Singhi, Director, Finance at Amtek Group, an auto component major. "The group has also been looking to spread its risks," he adds.

Second, the depreciation of the dollar is now making US manufacturing more competitive. That is prompting Indian companies to strengthen manufacturing operations in the US. Bharat Forge is one example. It acquired Federal Forge (now renamed as Bharat Forge America) in June 2005.

The company's operations in the US are quite small compared to its European operations. But that will change soon. "We see the US as a major growth area," says Kalyani. "We want to infuse technology from Europe and India into the US, enlarge our product portfolio and grow the business there and manufacture more in the US," he adds. Over the next five years, Bharat Forge hopes to expand its total global capacities from 700,000 tonnes per year to a million tonnes. Kalyani expects most of the fresh capacity to come up in the US, China and India.

Third, companies are also trying to increase their exposure to the euro. Textile firm Spentex acquired Czech Schoeller Litvinov as part of its currency risk mitigation strategy. The acquisition will enhance the company's presence in the European market and will also improve the company's topline by about € 55 million and add another €6 million per year in cash flows.

Finally, companies are also looking to other countries from a sourcing point. "In the components business, China

could be a competitive sourcing base for global production," says Doshi. M&M is also open to the idea of sourcing components from Mexico for its US assembly operations. "The strengthening rupee has brought to the fore the need for geographical diversification," sums up Rakesh Valecha, Director, Corporate Ratings at Fitch Ratings.

#### **Pulling The Levers**

If India Inc is looking for ways to retain its export competitiveness despite a strengthening rupee, it could look to Japan for some lessons. Between 1990 and 1994, the Japanese yen appreciated 40% against the dollar. Yet Japan's trade surplus increased from \$52 billion in 1990 to \$121 billion in 1994. A study by the Federal Bank of New York found that Japanese exporters cut export pricing (through operational efficiencies) and shifted to value-added products during this period. "India Inc has to go the Japanese way," says Crisil's Joshi. "Increase efficiency and productivity and adopt innovation," he adds.

By all accounts, India Inc also seems to be adopting a similar two-pronged strategy. Textile major Arvind Mills is re-drawing its export strategy and plans to focus purely on branded products, which carry more value-addition and are not as sensitive to price rise.

"All our exports will only be branded products," says Karthik Krishnan, its corporate strategist. Low-value commodity exports are ruled out. The company is also planning to step up domestic sales from 18% of total business

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to 33% in two years. Similarly, Alok Industries hopes to beat the rupee's gains by shifting to organic cotton products, an up-market category where consumers don't mind premium pricing.

Even in yarn, it will limit itself to premium yarn exports. "We are also focusing on services like timely delivery, designing and product development. Clients are willing to pay higher prices for these," says Sunil Khandelwal, Chief Finance Officer of Alok Industries. IT companies like Wipro are trying to go beyond predictable revenue streams and are trying to add innovative projects that offer better margins. "We are focusing on increasing revenue productivity by moving up the value chain," says V Balakrishnan, CFO of Infosys Technologies. Companies are also reaching out for another set of operational levers that could mitigate the impact of falling export realisations. "The typical levers are increasing pricing, improving utilisation, driving offshore mix, and reducing sales, general and administration expenses," says Senapathy. Among these, stepping up utilisation levels is perhaps the most important. Cognizant Technology Solutions has been running its offshore manpower utilisation levels at a low 56%. It ensured that the company never lost business for want of people. But now, it intends to step up utilisation to combat a strong rupee.

"We began increasing our utilisation during the second quarter," says R Chandrasekaran, President and Managing Director of Cognizant. "We see utilisation as the quickest lever firms could have adjusted when seeing intra-quarter rupee appreciation," observed a recent Bear Stearns research report. It argues that a one-point increase in utilisation could possibly increase Cognizant's profit margin by 50 basis points and Infosys' and Wipro's by



**"We want to increase revenue productivity by moving up the value chain"**

**V Balakrishnan**  
CHIEF FINANCE OFFICER, INFOSYS



**"We began increasing our staff utilisation during the second quarter"**

**R Chandrasekaran**  
PRESIDENT & MD, COGNIZANT

35-40 basis points.

Analysts also say that companies like Infosys may not push for new customers if it means compromising on the 15-20% price premium they have historically enjoyed. "Instead, Infosys may choose to ramp up business only with existing clients," the analyst says. "Others like TCS may go slow on acquisitions as cash flows may come under pressure," he adds.

Already, there is some early evidence to suggest that the lessons from Japan's experience have been learnt well. "As part of our rated portfolio, we have seen a significant improvement in cost structures during the past four years

across various sectors, and the impact of a rupee appreciation would, in our opinion, accelerate the process," says Fitch Rating's Valecha.

#### Natural Hedges

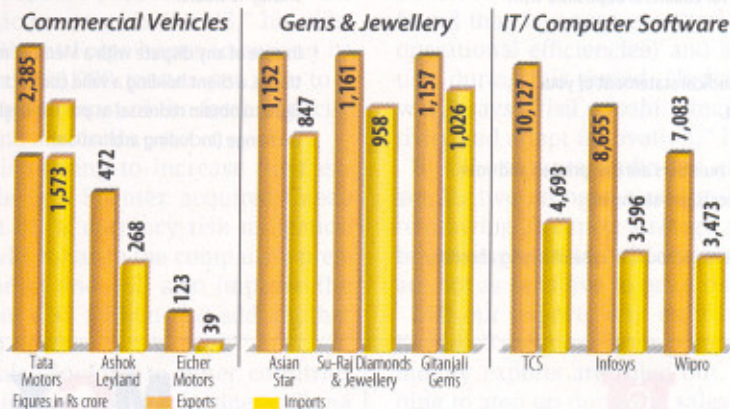
Companies are fortunate to have in-built natural hedges in their business. "Twenty per cent of our revenues and 30% of our expenses are in dollar terms," says Carl Saldanah, CFO of Jet Airways. The two even out each other. So, the rising rupee is not a worry for Jet Airways. In fact, two-thirds of its debt is in foreign currency and all new aircraft that have been ordered are on dollar contracts.

The company registered a \$32 million forex gain last quarter. Aviation is one sector that has emerged unscathed.

"A 10% appreciation of the rupee has meant a 5% saving in margins for low-cost carriers and a 4% saving for full service airlines," estimates Amar Kedia, Research Analyst at ICICI Securities. Gems & jewellery, the second largest forex earning sector, has a 70% import element in the finished product. This gives a natural hedge. "Under no circumstances do we operate below 3-4% net

#### Makers Of Manna

Top three forex earners-sectorwise



**Companies like Infosys may not push for new customers if it means compromising on 15-20% price premium they historically enjoyed**



margins. Any negative change in that margin is passed on to consumers," says GK Nair, Chief Financial Officer of Gitanjali Gems.

"There are natural hedges against our export receivables in terms of our overseas operation expenses," says Raymond Bickson, Managing Director of Indian Hotels. But not all companies enjoy such natural hedges. Many are now trying to build these into their business models. Chennai-based Sundram Fasteners is working on a plan to import raw materials rather than buy locally. This will hedge dollar exports which account for 25% of its revenues. "We are also trying to index our selling price to dollar-rupee parity," says Sampathkumar Moorthy, President of Sundram Fasteners. It also plans to step up exports linked to the euro currency. Ashok Leyland is trying to take on foreign currency liability to hedge dollar exports. The company plans an ECB of about \$200 million shortly (it can still comply with the new regulations because of the import component). The interest differential will be around 6% (with a rupee loan having an interest of 12%, international loans can be accessed at 6%). "We are also planning to increase the price by 3 to 4% in the export market," says Chief Financial Officer K Sridharan.

Bharat Forge also has dollar-denominated debt. Besides, it is trying to 'dollarise' input costs or at least peg the cost of raw materials like steel to the dollar. "If we manage to dollarise the cost of steel, we will have a largely international cost structure," says Kalyani. While a few companies are trying to peg input costs to the dollar, others are trying to book more revenues in other currencies. Wipro is diversifying into the pound sterling and the euro. All its new contracts for European customers are euro-denominated. Alok Industries is planning to beef up presence in Russia, Latin America, Japan, Australia and Africa to diversify risks.

### Buying A Hedge

India Inc is rushing to the hedging counters. Last quarter, Infosys increased its hedges from \$377 million to \$819 billion and Wipro from \$563 million to \$791 million. "At any point in time, we try to hedge 50-100% of our net inflows for over the next few quarters," says Wipro's Senapathy. Arvind Mills has hedged all its \$200 million exposure at a cost of 25 to 200 basis point. "It is worth it. It provides stability to product pricing," says Krishnan. Gitanjali ensures that it buys financial hedging wherever natural raw material import hedges are not available. It has bought forex cover for \$100 million. "We hedge about 50% net export receivables through forward and options trading in the currency



**"Companies are building volatility of the rupee in their financial modelling"**

**Chanda Kochhar**  
DEPUTY MD, ICICI BANK



market. We also hedge our raw material prices such as zinc on the London Metal Exchange which is already dollar-denominated," says NS Paramasivam, the Essar Groups' forex and treasury head. Bankers say they are seeing an exponential growth in the demand for forex cover. "I think, companies are now really learning to build the volatility of the rupee in their financial modelling," says ICICI Bank's Kochhar. While forex cover is helpful in the short-term, it has limitations in the long-term. "Hedging will help us only to a certain extent. The hit from appreciation will come in at some point in time," adds Senapathy. Moreover, Indian companies do not have access to the full range of hedging options that are available globally. "Rupee futures are not available. Also, exotic options are not allowed on dollar-rupee. The lack of active interest rate swaps in the market is also an issue," feels Infosys' Balakrishnan.

But those constraints will go away as India moves towards full convertibility. But a free-floating rupee would only mean more volatility and risk—not less. The lessons exporters learn may well determine their survival and success in the coming free float regime.

(With inputs from Nirmal Menon and Sriram Srinivasan)