



Trends in India's corporate financing

October 27, 2009

Corporate investment has been a significant source of economic growth over the past several years. In the past decade, there has been tremendous growth in overall investment levels in India, from less than 25% of GDP in 2000 to over 35% by 2006. A significant part of this investment drive has come from the corporate sector. Over the past five years, corporate investment as a share of India's GDP grew by 9 percentage points. Given the links between a country's investment levels and its overall economic growth, corporate financing and investment are crucial components of India's future growth potential. This paper focuses on the various sources of corporate financing that are used to fund this corporate investment.

The global financial crisis has hit several sources of corporate financing. Foreign financing of Indian corporations has increased over the past five years. This includes external commercial borrowings, foreign direct investment, credit from foreign banks, and foreign institutional investors that have participated in domestic equity markets. As foreign investors have been hit by the crisis, they have pulled back from the Indian market and turned risk averse. While the second half of 2009 has seen a rebound in foreign inflows, it still could take until 2010 before capital flows fully recover.

SMEs are most at risk from the financing slowdown. Given their lack of significant retained earnings and corporate savings, SMEs are generally considered to be most at risk from the financing slowdown. External financing is not just supplementary capital used to fund growth and expansion plans, but rather essential funds that SMEs use to refinance existing debt and to sustain day-to-day operations.

Equity markets and foreign direct investment could be the most promising sources of financing over the next year. Even if Indian markets correct moderately from the currently high levels, we think domestic equity will be an important source of corporate financing over the next 12 months – both through the primary and secondary market. In addition, the recovery in global equity markets means that GDR and ADR issuance will offer good financing opportunities as well. The expected rebound in the Indian economy and gradual implementation of FDI reforms will enable direct investment to grow strongly once again. Finally, there is potential in external commercial borrowings (ECBs) as interest rates go down in credit markets. However, foreign lenders' willingness and ability to lend to smaller companies may be limited.

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Introduction

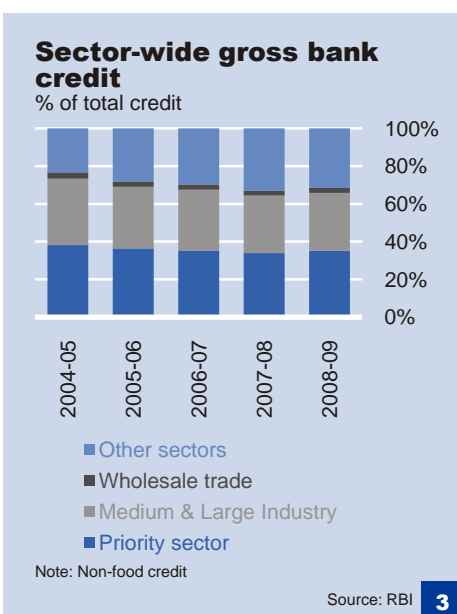
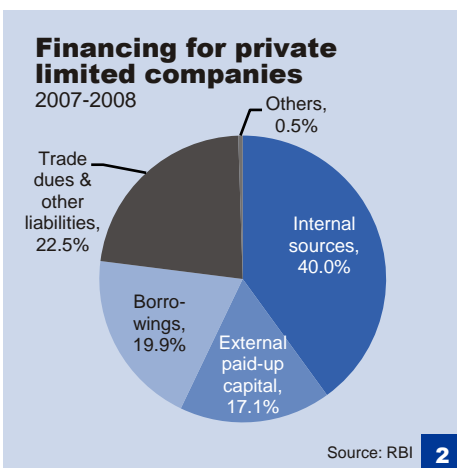
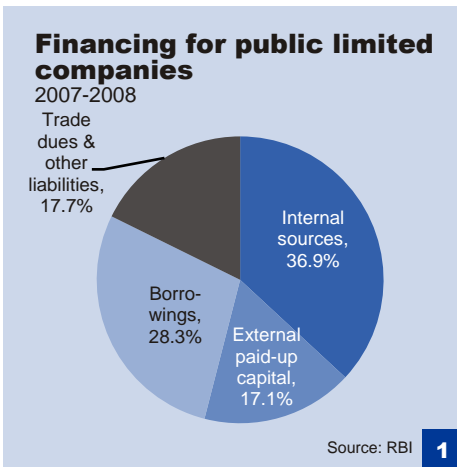
While considerable amounts of firm financing come from internal sources such as retained earnings, sources of external capital remain highly important. These include bank credit, equity markets, corporate bond markets, external commercial borrowings, foreign direct investment, and private equity. As the global crisis took hold over the past two years, many of these financing sources dried up and slowed corporate investment and growth. Liquidity conditions and the stock market have improved since the lows in the second half of 2008 and the early part of this year, but obtaining funds may still remain challenging for many corporations in India. This article seeks to provide an overview of the various sources of financing in India, looking at the trends for the last several years as well the outlook over the next year.

Financing from internal sources is important for large firms

The Reserve Bank of India (RBI) categorises internal sources of funds as paid-up capital, reserves and surplus, and provisions (which includes dividends). Approximately 40% of corporate financing for public and private limited companies comes from internal sources. Charts 1 and 2 highlight the most recent figures. Delving further into the available data, research has found that for large firms involved in either the manufacturing or services industries, internal resources account for 67% and 47% of all funds respectively. However, the picture changes significantly for small and medium enterprises. These firms often do not have significant savings and internal sources average only 10% of total funds.¹ Earlier studies covering the period 1994-2003 also found suggestive evidence that smaller firms face stronger credit constraints vs. their larger counterparts.² Thus, small and medium firms can be considered among the most vulnerable to the drying up of external financing sources. We examine these sources more closely in the following sections.

Banking system remains essential

Bank credit generally forms a part of external funding for many companies. In public limited companies, bank borrowings accounted for 32% of external financing and 20% of total financing according to the 2007-2008 RBI survey of company financing. In private limited companies, bank borrowings accounted for 28% of external financing and 17% of total company financing in the 2007-2008 financial year. Chart 3 on the left shows the sector-wide deployment of bank credit. Some of the constraints on greater bank lending are the regulatory hurdles, such as the high statutory liquidity requirement (which forces banks to keep deposits in government securities) and the priority sector lending requirement (which mandates some banks to have almost 40% of their adjusted bank credit directed to priority sectors).³ Thus, many Indian companies have turned to other sources of external finance. As the Indian economy boomed from 2005 through 2007, the growth of domestic bank credit to the commercial sector gradually declined (see chart 4). While several factors account for this trend, it could be partially attributed to the fact that companies were pursuing other



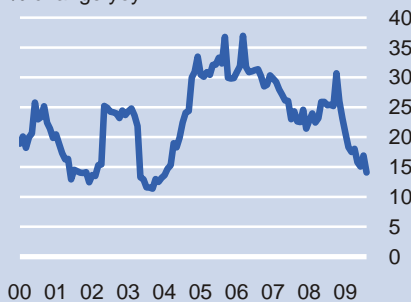
¹ Allen et al. (2007).

² Love (2005).

³ RBI. Master Circular. Lending to the Priority Sector. July 2009.

Bank credit to the commercial sector

% change yoy

Source: RBI **4****Banking stocks on the rise**

Weighted average of leading bank stocks

Source: Bloomberg **5**

sources of financing, particularly in the equity market which was growing significantly during this period. This assertion can be backed by the evidence that capital funds rose as a percentage share of total funding during this time.

When Lehman Brothers collapsed in September 2008, there was a sharp and quick increase in corporate bank credit over the next month as other sources of financing quickly dried up. However, since that point, bank credit to the commercial sector has continued to fall steeply (see chart 4). Some of this fall can be attributed to a slowdown in demand as companies have had to re-evaluate investment and growth plans amidst the global and domestic slowdown and the costs of funding from banks have remained high. On the supply side, despite the loose monetary policy, encouragement from policymakers, and liquidity injections from the RBI, banks have remained reluctant to lend. As they faced profitability pressures and increased provisioning for non-performing loans, most banks made only moderate cuts to their lending rates. Banks have remained concerned about deteriorating asset quality, particularly for smaller firms or industries that are seen as having poor growth prospects.

There is market optimism that bank lending will bottom out in the next 1-2 months and begin to pick up again over the next several quarters. The ongoing rise in banking stocks (see chart 5) highlights this sentiment. Banks are likely to look at equity market performance, quarterly profits, and macroeconomic indicators when evaluating which firms or industries are worthy of new credit. We maintain the view that as Indian equity markets continue to make gains and there are definitive signs of economic growth, credit to the corporate sector will begin to increase. The Q3 (calendar year) GDP results and corporate earnings results will be important to watch as well as more frequent indicators such as price-equity (P/E) ratios, industrial production, retail sales, etc. In addition, recapitalisation of public-sector banks will give these banks more space to increase lending as well. However, even with the strong turnaround in markets and bank recapitalisations over the next year, we think bank lending may not return to earlier growth levels for the next several months. In addition, banks could remain industry-selective and choose low-risk sectors over the next year, particularly as worries linger over asset bubbles rising once again in sectors such as real estate.

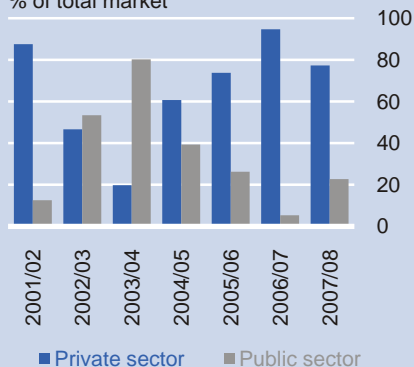
Domestic equity markets are increasingly popular methods of financing

India's domestic equity markets have boomed over the past five years, with market capitalisation increasing from less than USD 300 bn to over USD 1 tr during this time frame. The growth in the market has been fuelled by both domestic and foreign investors. Domestic investors have enjoyed a thriving economy in the past five years. Although the majority of households still keep their savings in bonds and fixed deposits, many are increasingly turning towards equity investments through mutual funds. Foreign investors such as foreign institutional investors (FIIs) and non-resident Indians (NRIs) have also increased their levels of investment as there has been liberalisation of investment caps and participation in derivatives markets that allows them to hedge risks. At the end of 2008, there were 1,591 registered foreign institutional investors in India, an



Sector-wise mobilisation on primary market

% of total market



Source: SEBI **6**

increase of slightly over 50% since 2006.⁴ The surge in investor interest has created large amounts of capital availability for the corporate sector.

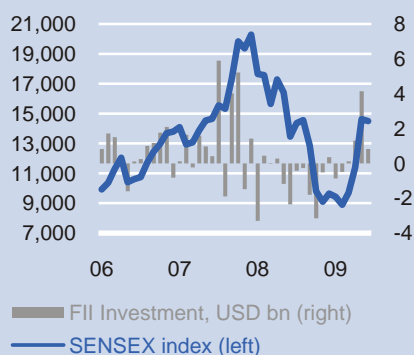
In the primary market, private-sector issuances have been outpacing issuances by the public sector for the past several years (see chart 6). A diverse array of companies from the entertainment to finance industries has raised capital through the primary market. Banks, financial institutions, construction, and infrastructure companies were the most frequent issuers in recent years. While the number of IPOs has declined from the peaks seen in the mid-90s when the markets first began to take off, IPOs in the past several years have been generating ever increasing amounts of capital. In 2008, the amount of capital raised averaged close to INR 500 crore per IPO vs. a mean IPO size of less than INR 10 crore in the mid-1990s.^{5 6} In 2006, India's IPO market made the list as one of the 10 biggest IPO markets in the world.⁷ In 2008, the Reliance Power IPO became the biggest IPO in India's history. The almost USD 3 bn offering was oversubscribed by approximately 10 times.

Markets hit after Lehman



Source: Bloomberg **8**

FII flows drive market



Sources: Bloomberg, SEBI **9**

Resource mobilisation through primary market

Rs. Crore

| | 2005 | 2006 | 2007 | 2008P |
|-------------------|--------|----------|----------|----------|
| Debt | 66 | 389 | 594 | 0 |
| Equity | 30.325 | 32.672 | 58.722 | 49.485 |
| IPOs | 9.918 | 24.779 | 33.912 | 18.393 |
| Private placement | 83.812 | 1,17,407 | 1,84,855 | 1,75,061 |

P: Provisional

Source: Ministry of Finance Economic Survey **7**

In the secondary market, price-equity (P/E) ratios climbed significantly as the market grew. For companies already listed on the market, this enabled them to gather higher returns on subsequent offerings of shares.

When the global crisis hit from mid-2008, the market fell dramatically. Between January 2008 and the Sensex low in March 2009, the market declined 60% and P/E ratios dropped over 45% over the same time period. As can be seen from chart 9, much of this fall was led by foreign investors exiting the market as concerns grew over India's corporate earnings and its general economic outlook. Anecdotally, it appears many investors chose to either repatriate their earnings or keep them in "safe" assets such as government bonds. The fall was also exacerbated by domestic investors who took money out of the market as job losses mounted and the ongoing market decline began to hurt household wealth levels. Due to this decline, many companies delayed equity-raising plans in H2 2008 and H1 2009. India's 40 IPOs in 2008 generated less than USD 5 bn, an over 60% drop in the number of deals and a 45% decline in funds raised compared with 2007.⁸

Between April and July 2009, only five IPOs took place vs. 15 during the same period last year. In the first half of this year, only 6 companies filed draft offer documents with the Securities and

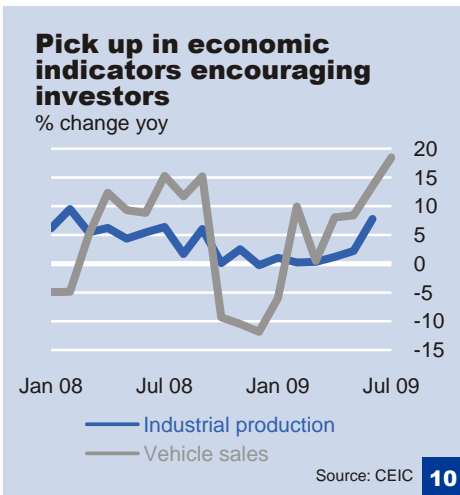
⁴ Ministry of Finance.

⁵ SEBI Handbook of Statistics.

⁶ A crore is equivalent to 10 million rupees.

⁷ www.livemint.com

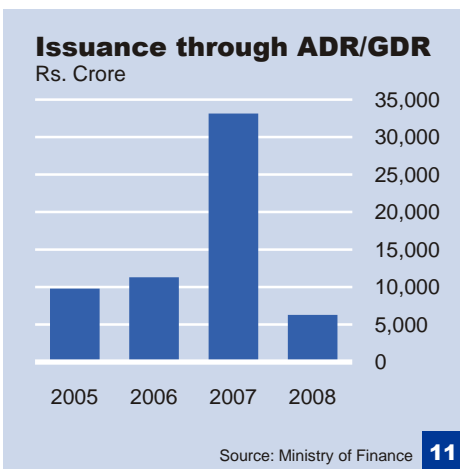
⁸ Ernst & Young. Global IPO trends report 2009.



Exchange Board of India (SEBI) for any public issues vs. over 40 in the same period last year.

The market has recovered from earlier lows, and FII's net investment in equity markets in 2009 turned positive beginning in April. The Sensex has risen over 75% from the beginning of the year until mid-October as investors are hopeful for reforms under the re-elected Congress party and are encouraged by tentative signs that both the global and Indian economies may be bottoming out (such as the higher Q2 GDP results of 6% and the uptick in frequent economic indicators such as industrial production and vehicle sales – see chart 10 on the left). The government and officials at SEBI are also making efforts to ease fundraising. They are planning to set up “dedicated” stock exchanges for SMEs to enable them to access funds. In addition, the government is also considering a requirement for 25% of listed companies to be traded. This should ensure greater liquidity and turnover in the secondary market. The government said the current average public float in Indian listed companies was less than 15%.⁹

The combination of government support and the market rebound has increased the pace of equity offerings since July. From the beginning of July until mid-October, over 35 draft offer documents have been filed with SEBI. The IPO market has begun to pick up in the past three months as well and has been boosted by offerings from the public sector. These offerings have received substantial interest and should clear the way for more IPOs in the next several months, particularly as privatisation plans continue. For many of the IPOs coming onto the market, the pricing has generally been accepted as fair market value. We think these conservative pricings will continue at least into Q1 or Q2 2010 to ensure investor interest. The outlook for equity raising is expected to be positive over the next 12 months. However, uncertainty in the market lingers and there are again concerns that an asset bubble could be forming with foreign inflows. A moderate correction in the market may be on the horizon in the next several months, but the overall trend in the next year should still be positive. Foreign and domestic investors are likely to remain cautious, but should continue to re-enter the market. The main factors to watch will be corporate earnings results, the pace of the government's economic reforms, the turnaround in global markets, and global economic news.



ADRs/GDRs should pick up in the next year

Since 1992, Indian companies have been listing abroad through American Depository Receipts and Global Depository Receipts (ADRs and GDRs). Issuance reached a peak in 2007 (see chart 11) as global markets scaled new heights. According to the Skindia GDR index, which tracks 22 actively traded GDRs from big corporations such as Reliance, Infosys, and the State Bank of India, GDR's reached their peak value in early 2008 (see chart 12).

After falling precipitously in the second half of the year on the back of the Lehman Brothers collapse, the value of outstanding GDRs looks to be making a gradual recovery. This should help encourage new issuance in the market, particularly as global economic and financial news seems to be on the rebound. A recent spate of ADR and GDR offerings show that the market will continue to grow in the next several months and throughout 2010. In July, the beginning of issuances was kicked off by mining company Sterlite Industries,



⁹ Bloomberg (2009).

which raised approximately USD 1.5 bn through ADRs. Tata Steel and Suzlon Energy, global players in the steel and wind energy industries, soon followed and raised over USD 600 m through GDRs.¹⁰ Over the next few months, more companies may choose to raise funds via the ADR/GDR route as opposed to raising debt or equity in domestic markets. This route is likely to be more popular for firms that have overseas operations and thus are able to manage currency risks more effectively than purely domestic companies.

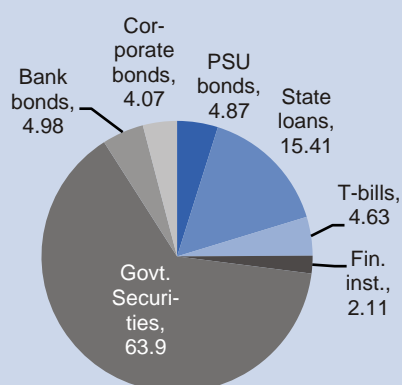
Corporate bond market still lags behind

Compared to the equity market, the corporate bond market is relatively undeveloped. The market capitalisation of India's equity markets is equivalent to over 100% of GDP while the corporate bond market's capitalisation is less than 5% of GDP. The corporate bond market is often criticised for its illiquidity, lack of transparency, onerous regulatory requirements, and the high cost of issuance. Government bonds dominate the bond market, accounting for over 65% of bond market capitalisation and almost 35% of GDP (see chart 13 for more details). This is due not only to the high borrowing needs of the government, but also SLR requirements that mandate banks to hold significant deposits in the form of government securities. Although there has been some progress in reforms of the bond market on the back of recommendations from the Patil committee (such as allowing the set up of trading and reporting platforms), significant work remains to be done. Thus, many companies (including Public Sector Undertakings or PSUs) have taken to private placement of bond issuance where offerings can be tailored to individual issuers' needs and there are low costs of issuance, less onerous regulatory requirements (such as disclosure rules and requirements for credit ratings), and low ongoing servicing costs (see chart 14).

Although the most recent data on private placement is not available, it can be seen from the table on primary market issuance in the equity section above that public debt issuance was negligible in 2008. Issuance has picked up in the first three quarters of 2009 and continuing government reforms may help boost the market in 2010. The government is actively considering the allowance of repo deals on corporate bonds and has discussed the possibility of scrapping the withholding tax. The main risks to corporate bond growth are the equity market rebound and the large amount of government borrowing. As the government seeks to issue a record number of bonds in this fiscal year (gross issuance is expected to be approximately 60% more than in the previous fiscal year) to finance expenditures and boost growth, there are legitimate concerns about the crowding-out of private-sector issuance.¹¹ The government has frontloaded its issuance (over 50% was completed by end-September) to avoid any crowding out as the economy rebounds in the next few quarters and the private sector moves forward with issuances. However, this large amount of government issuance may keep interest rates higher in the near term. Our view is that bond markets will pick up in the coming year, but further reforms will be necessary for strong growth, particularly for public issuance. It will require far-reaching reforms such as streamlining requirements, unifying oversight into a single regulator, and broadening the issuer and investor base (including increasing the limits on FII investment

Government bonds rule the debt market

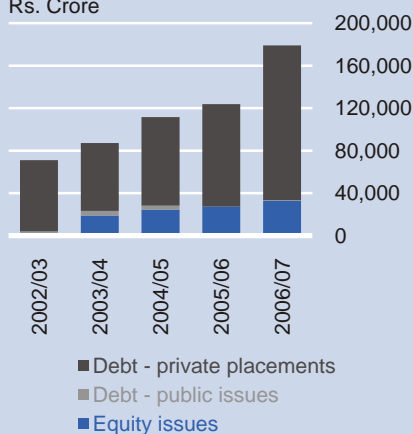
%, as of August 31, 2009



Source: NSE **13**

Private placements rule the corporate bond market

Rs. Crore



Source: SEBI **14**

¹⁰ Wall Street Journal (2009).

¹¹ Deutsche Bank – Global Markets Research.

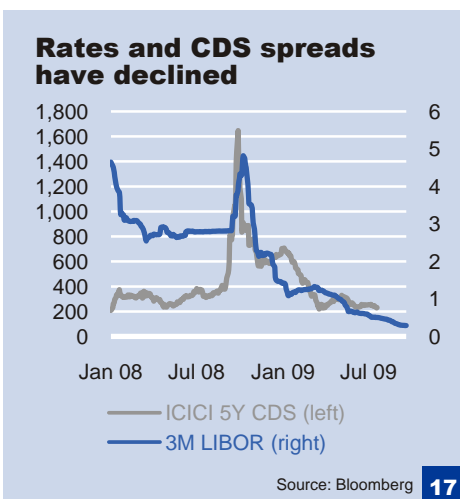
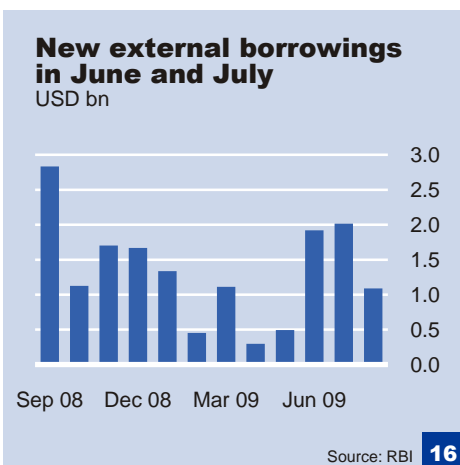
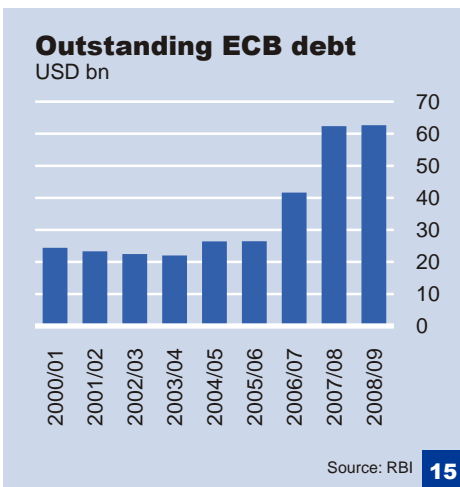
further) before the market can truly compete with equity markets as a source of financing.

External commercial borrowings may remain low in 2009, but should gain momentum in the months ahead

External commercial borrowings (or ECBs) are commercial loans taken from non-resident lenders. They have been an important source of financing for Indian corporations beyond the capital markets as companies can take advantage of lower interest rates abroad and often receive loans with longer maturities. Borrowings can be undertaken either under the automatic or approval route. Total outstanding ECB debt almost trebled between 2004 and 2008, rising to USD 62 bn or 27.8% of India’s total external debt by the end of fiscal year 2007/2008 (see chart 15).¹² The growth has been fuelled not only by increasing investment needs and available foreign capital, but also by the gradual relaxing of regulations. Ceilings for both ECB debt levels and for interest rates related to the debt were increased several times over the past several years and sectoral restrictions on ECB use were relaxed.

Despite this, fundraising through the ECB route was hit significantly by the global crisis and the slowdown in international liquidity. As lending rates spiked, borrowings declined sharply. At the end of fiscal year 2008/2009 in March, the total amount of outstanding ECBs had grown less than 1% over the previous year. This was despite liberalisation efforts that took place throughout the year. After accounting for interest rate and currency risks, it was often still cheaper to borrow in domestic markets – either through corporate bonds or through domestic bank lending.

However, the rise in external borrowings in June and July may signal a rebound on the horizon (see chart 16). This may be due to the decline in the LIBOR (which many investors attach a spread premium to in order to determine lending rates) and the 5Y CDS spreads of major Indian corporations such as ICICI which had spiked during H2 2008 (see chart 17). Despite the positive figures in the recent data, there is still some cautiousness on the prospects for ECBs. Bankers have indicated that current deals are mostly bilateral and there are very few syndicated loans that have involved multiple lenders. This trend of bilateral lending could continue over the next several months. In addition, there is inherent investor cautiousness post-crisis, as well as increasingly strict requirements that domestic governments have placed on foreign banks’ capital levels and provisions that detract from funds available for lending. A recent Institute of International Finance report on emerging market capital flows highlighted that access to external financing for many smaller and lower-rated companies remains severely curtailed.¹³ The government could also intervene if foreign inflows became too strong and put pressure on the rupee. If so, then officials could tighten restrictions on ECBs once again – as in 2007. We are optimistic that ECBs will continue to gradually grow over the next several months, but it may be easier for larger firms to obtain financing through this route than smaller, untested firms.



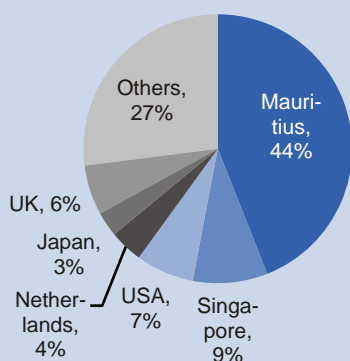
¹² RBI. India’s External Debt as at the end of March 2009.

¹³ IIF (2009).



FDI inflows by country

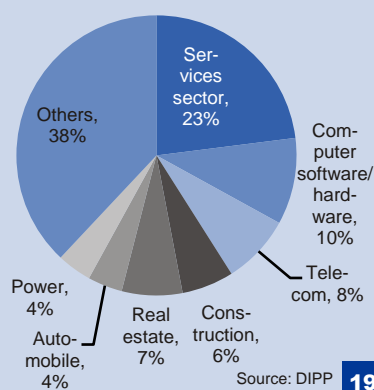
% of total



Source: DIPP **18**

FDI inflows by sector

% of total



Source: DIPP **19**

FDI inflows hit by crisis

USD bn



Source: UNCTAD World Investment Report 2009 **20**

India is top investment choice

% of respondents that selected country as preferred investment destination



Source: UNCTAD **21**

Foreign direct investment holds strong potential in the next year

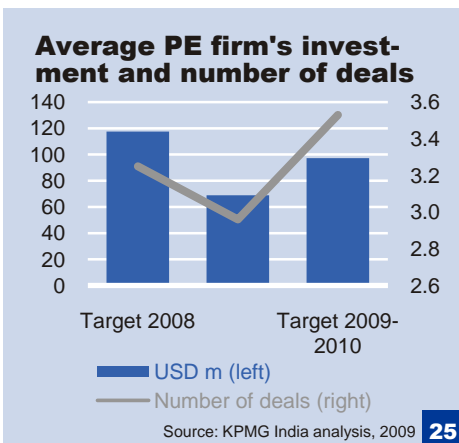
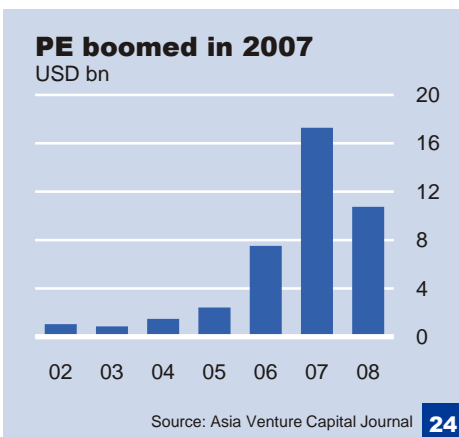
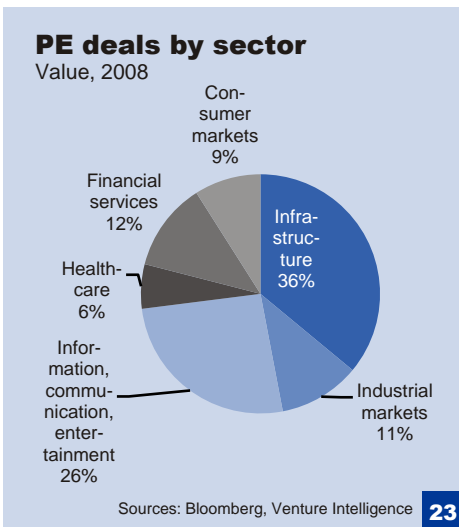
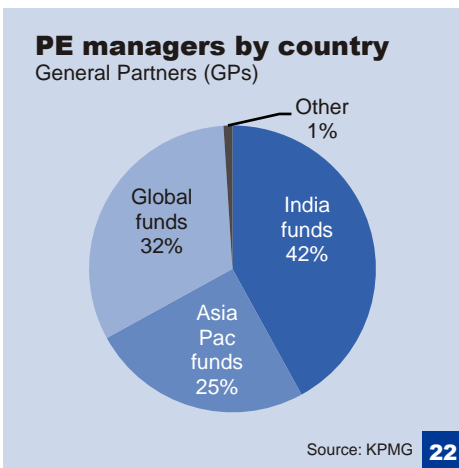
Foreign direct investment in India has increased significantly in the past several years as regulations have been streamlined and corporate growth in India has taken off. Foreign direct investment ceilings have gradually been increased in various sectors over the past five years. In the past year alone, the mining, petroleum, civil aviation and several other industries have had their respective FDI ceilings raised. In addition to increasing these caps, the authorities have also sought to streamline and clarify regulations (i.e. on downstream investments). Between March 2007 and March 2009, total direct investment liabilities in India grew by a factor of 1.6, from USD 77 bn to almost USD 125 bn.¹⁴ According to data from the Department of Industrial Policy and Promotion (DIPP), the majority of the inflows are from Singapore, the US, and the UK. A large number of investments also come through Mauritius given the advantages of the Indo-Mauritian tax treaty. The services sector (both financial and non-financial), computer, real estate, and telecom sectors have traditionally received the highest amount of FDI in recent years (see charts 18 and 19 on the left for more details).

The global crisis, muted earnings results for many Indian corporations, and the Mumbai terrorist attacks in November 2008 drove down investment in the past several quarters. In addition, the Satyam accounting incident in January 2009 increased risk aversion as well. Although data from different sources vary slightly (given different definitions), they all show the impact from the crisis. Data from India's DIPP for the first 6 months of this year show that inflows are approximately 40% lower than the same period last year. According to UNCTAD data (see in chart 20), FDI flows for H1 2009 vs. H1 2008 are down approximately 55%. Dealogic data indicates that inbound cross-border M&A activity fell 27% yoy in H1 2009 as well. Deal cycles for M&A transactions have also increased given the mismatch of valuation expectations between buyer and seller and the greater levels of due diligence being carried out in the aftermath of the Satyam incident.¹⁵

FDI flows have begun to pick up again since July (over 50% yoy growth in both July and August). We anticipate FDI inflows to continue to grow (though with some fluctuation and perhaps not at these very high levels) throughout 2009 and 2010 as there is a stronger rebound in the Indian economy and the turnaround in global markets pushes foreign investors to look for opportunities once again. Also, companies that have been hard-hit by the crisis may strip non-essential segments of their business and offer them for sale to foreign investors. The next several months may see smaller deal sizes as investors look for niche opportunities that maximize potential and minimize risk. Although the government is working to reduce administrative bottlenecks, FDI restrictions in lucrative sectors such as insurance and retail remain in place. Swedish furniture giant IKEA dropped its USD 1 bn plan for retail outlets in India earlier this summer due to FDI restrictions of 51% in single brand retail. A removal of these restrictions (unlikely in the short-term) would create a large jump of inflows. According to a recent KPMG report on the outlook of the mergers and acquisitions (M&A) industry (including cross-border M&A), the pharmaceuticals,

¹⁴ RBI – International Investment Position of India at end the end of March 2009.

¹⁵ KPMG (2009). "The Indian M&A Landscape – A Perspective".



telecom, television, and infrastructure industries are among the most promising in the next several months, while the financial services industry may continue to face challenges.¹⁶ In the medium-term, FDI inflows are likely to grow significantly. A survey of investment prospects by UNCTAD lists India as its 3rd most preferred investment destination between 2009 and 2011 (see chart 21 for list of other countries). India was favoured due to its potential for market growth, its presence of suppliers, its skills and talent, and the cheaper labour costs.

Private equity – the new kid on the block

A variety of international firms, from global private equity players to investment banks to sovereign investment funds, have entered the Indian private equity market in recent years. Thus, the market is often considered to be part of the FDI category. However, given the significant and growing number of domestic players, it can be important to look at PE as a distinct category. As the government has renewed its commitment to infrastructure development, called for a greater number of public-private partnerships, and raised FDI caps, the PE industry has grown tremendously. According to industry estimates, there are over 350 PE firms currently operating in India, with many now focusing on a specific sector such as infrastructure.¹⁷ Global PE funds accounted for 56% of value and 38% of volume in 2008 while the India funds accounted for 28% and 49% respectively.¹⁸ Investments skyrocketed between 2005 and 2007 into a variety of sectors (see chart 23 and 24).

As the global and Indian economies were hit after the collapse of Lehman Brothers, the PE industry suffered. Although growth in the first three quarters of 2008 was strong and the number of transactions outpaced the total during the same period of 2007, the retrenchment in Q4 2008 led to an overall decline in PE transactions for the year and a decrease in deal size as well (see chart 24). Many PE firms have also held back on investments in the first half of this year as they reevaluated risks (particularly the large operating risks taken on earlier) and waited for the right opportunities.¹⁹ In a recent KPMG survey of the Indian PE market, respondents from the industry said the crisis could also impact funding (particularly from endowments and foundations) and the way in which limited partners (LPs) invest. LPs are now more likely to co-invest with General Partners (GPs), switch to new GPs due to poor returns, or make direct investments on their own. Looking forward, some firms have chosen to be risk averse in 2009 while other firms have decided to take on more risk. A majority of the investment professionals participating in the survey expect high returns over the next two years.²⁰ This bodes well for firms looking for PE financing. India remains an attractive investment destination and deals should begin to pick up in the next several months and through 2010. Chart 25 on the left shows expectations for deal size and number of deals over the next year based on the KPMG survey.

In the medium-term, PE firms will face several long-term hurdles they face such as small deal size, onerous regulatory requirements and FDI restrictions, lack of corporate governance and other issues.

¹⁶ Ibid.

¹⁷ Venture Intelligence Estimates.

¹⁸ KPMG (2009). "The Indian M&A Landscape – A Perspective".

¹⁹ KPMG (2009). "Reshaping for future success – What's next for Private Equity in India".

²⁰ Ibid.

These challenges will need to be addressed in the medium-term to ensure that PE can continue to grow as a source of corporate financing.

Conclusion

The various sources of corporate financing highlighted in this paper show great potential for augmenting corporate investment going forward. Although many of these financing streams have been suffering from the global crisis, we are beginning to see a resurgence of capital flows. The environment will remain challenging in the rest of 2009, but we believe that flows will become stronger over the next several months and throughout 2010. The pace of the turnaround will depend on market reforms and the trajectory in both the global and the Indian economy. Domestic and global equity markets, external commercial borrowings, and foreign direct investment hold the most promise. Once financing picks up pace, investment levels will rise again and can help sustain higher economic growth in India.

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