CRISIL RATINGS

RATINGS ROUNDUP

FH 2008-09

Pressure on Indian companies' credit quality increasing

Ajay Dwivedi	Director - Rating Criteria & Product Development	Tel.: +91 (22) 6691 3097	Email: adwivedi@crisil.com
Somasekhar Vemuri	Senior Manager - Rating Criteria and Product Development	Tel.: +91 (22) 6691 3106	Email: svemuri@crisil.com
Chetan Rao	Manager - Rating Criteria and Product Development	Tel.: +91 (22) 6691 3337	Email: crao@crisil.com

Executive Summary

The declining trend in credit quality as indicated by CRISIL's upgrades and downgrades, which began in April 2005, continued in the first six months of 2008-09 (refers to financial year, April 1 to March 31). The past six months have seen three long-term ratings downgraded, and only one upgraded. CRISIL's modified credit ratio (MCR), a key indicator of credit quality, showed a secular decline from a high of 1.16 times in 2004-05, to 0.98 times for these six months. This time the intensity of the decline and the level of the MCR are less adverse than in the previous period of continuous decline, which included a historic low of 0.61 in 1998-99, because both manufacturing and financial sector entities now have much stronger balance sheets.

However, given the unprecedented severity of the global financial sector turmoil and the significant economic slowdown, the next 12 months will be critical for credit quality. CRISIL will closely monitor three macro factors over these 12 months, as they will be the critical determinants of credit quality of Indian companies. These factors are the availability of adequate funding at reasonable rates, the intensity of the demand slowdown, and the exchange rate situation.

MCR is the ratio of upgrades plus reaffirmations to downgrades plus reaffirmations, and is published semi-annually as part of CRISIL's Ratings Round Up. The ratio has established itself as a powerful lead indicator of credit quality.

In the first six months of 2008-09, there were two defaults in CRISIL's portfolio of long-term ratings; both the defaulting companies were manufacturing sector entities. This followed a three-year period without any defaults, the longest such period in the past fifteen years. CRISIL's long-term rating outlooks are a key signal of its credit quality expectations; as on September 30, 2008, a little over 5 per cent of CRISIL's long-term ratings had negative outlooks, the maximum since CRISIL introduced rating outlooks in 2003.

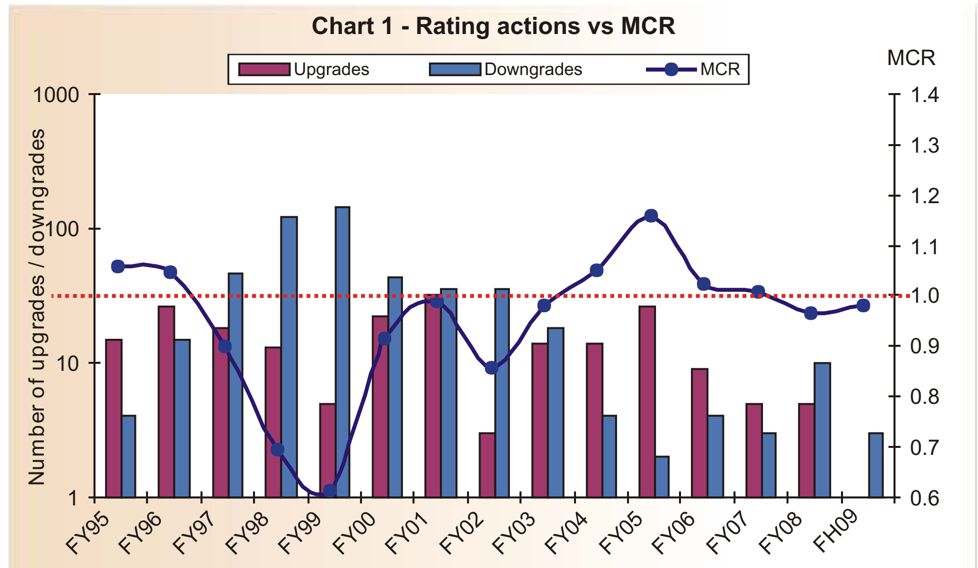
CRISIL expects intensified downward pressure on credit quality. The real estate sector faces an immediate vulnerability to funding pressures affecting creditworthiness. The demand slowdown in sectors like textiles, information technology, and automobiles, has begun. Sectors like telecommunications and power would be less vulnerable to a demand slowdown. The banking sector benefits from government support and strong capitalisation; these mitigate the profitability pressures due to higher funding costs and mark-to-market requirements on investment portfolios, and asset quality pressures due to a slowing economy. While NBFCs are clearly slowing down their business growth, the large ones appear to be relatively well-placed in terms of cash on their books and access to bank funding, and most of CRISIL's NBFC ratings factor in support from strong parents.

About CRISIL Ratings Round Up

CRISIL's Ratings Round Up is a semi-annual publication that analyses CRISIL's rating actions, and traces the linkages between these actions and underlying economic trends and business factors. Because credit rating is an opinion on the likelihood of timely future debt repayments, an analysis of rating actions in a large and diverse portfolio of rated companies is a good indicator of economic prospects. The current issue analyses CRISIL's rating actions in the first half of 2008-09.

Continued pressure on credit quality - MCR remains below 1 and defaults reappear

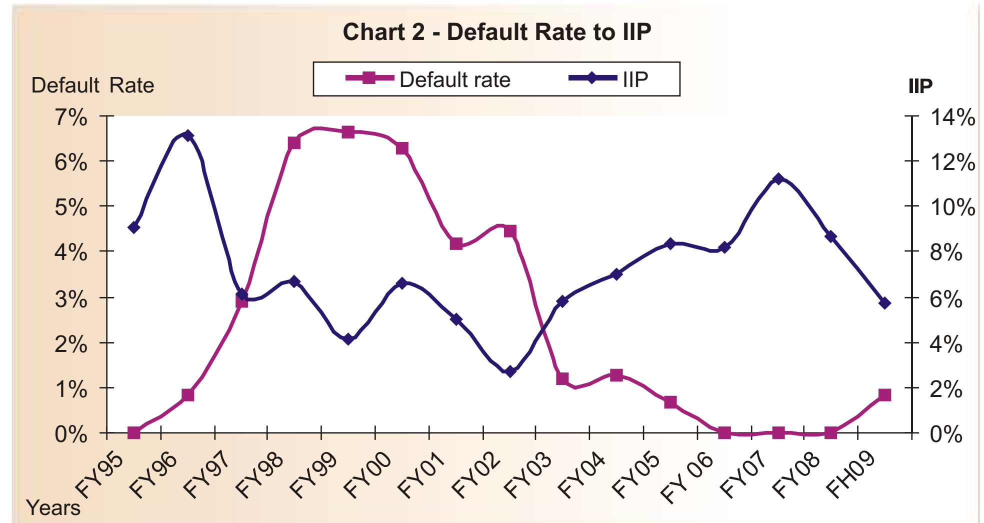
CRISIL's portfolio of outstanding ratings featured two defaults in the first six months of 2008-09. These defaults were seen after a three-year gap - the longest 'default-free' period in the past fifteen years. At 0.98 times, CRISIL's MCR for long-term ratings remains below 1 time, signifying continued pressure on credit quality. (See Annexure 1 for CRISIL's upgrades and downgrades for long-term ratings forming part of the analysis in the first half of 2008-09; refer Chart 1 for the movement of MCR over the years, along with the corresponding numbers of upgrades and downgrades). CRISIL's MCR slipped to below 1 time for the six-month period ended September 30, 2007, and has remained below 1 time since. CRISIL has been consistently highlighting the pressure on credit quality over the past 18 months.



CRISIL's MCR recorded its historic low of 0.61 times in 1998-99, and remained below 1 time from 1996-97 to 2002-03; this was a time of turbulence followed by stagnation for a large number of industries in India. The decline in MCR has been smaller this time, because Indian companies extensively strengthened their balance sheets between 2002-03 and 2005-06.

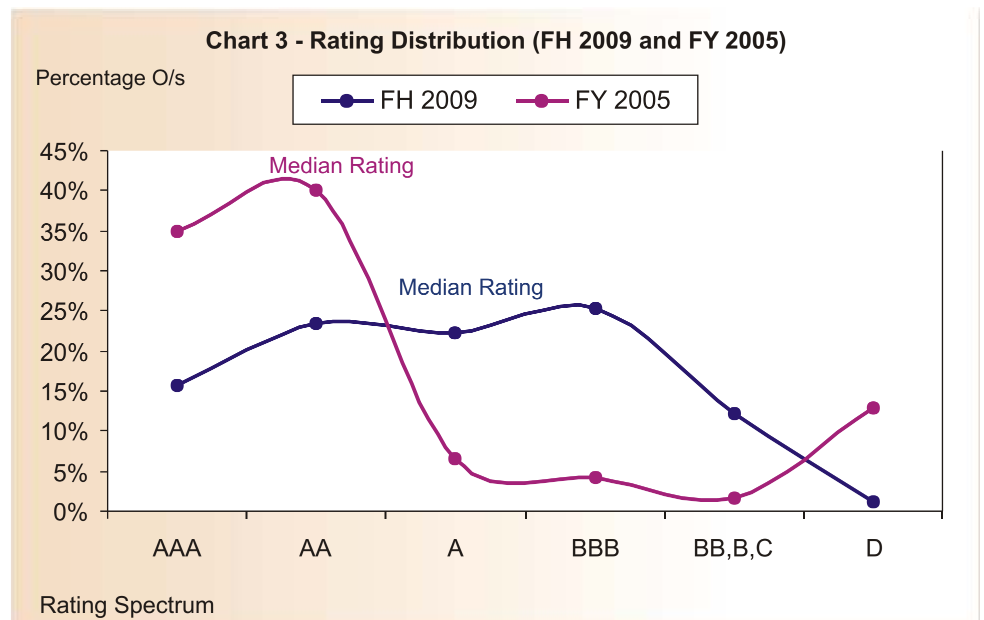
The re-appearance of defaults points to a slowing economy

The number of defaults in CRISIL's portfolio has tended to be inversely correlated with the Index of Industrial Production (IIP), as seen in Chart 2. Notably, in 2005-06, the default rate-the proportion of non-default ratings initially outstanding that went into default during the period-fell to zero for the first time in ten years, as IIP growth increased beyond 8 per cent. The reappearance of defaults in the first half of 2008-09 has, likewise, been accompanied by a sharp pull-back in the IIP growth rate.



The changing credit distribution of CRISIL's outstanding ratings

With the advent of Basel-II guidelines for banks, an increasing number of companies are approaching CRISIL for rating their bank facilities. This has led to CRISIL outstanding ratings as at September 30, 2008, being more than three times the corresponding number as at March 31, 2005. Interestingly, as a large proportion of these new ratings are close to the middle of CRISIL's rating scale (the 'A', 'BBB' and 'BB' rating categories), the distribution of outstanding ratings has altered significantly (refer Chart 3). The median rating has moved to 'A', from 'AA' in 2004-05. As at September 30, 2008, more than 5 per cent per cent of CRISIL's long-term ratings had negative outlooks, the highest since the time CRISIL introduced rating outlooks.



Credit quality outlook for corporate sector entities

The overall pressure on corporate credit quality in India is unlikely to ease in the short to medium term, in view of the slowing economy and the increased cost of raising funds. However, the credit impact on companies would vary across sectors. For instance, CRISIL expects real estate and textiles to be particularly affected - real estate because of a slowdown in sales and a sharp increase in cost of borrowings accentuated by high debt levels, and textiles because of slowing export demand and a fluctuating exchange rate. On the other hand, sectors like telecommunications and power would be less vulnerable to a demand slowdown.

What the ongoing turmoil in financial markets means for the Indian financial sector

The events unfolding over the past 12 months - discussed in detail in Annexure 2 - have brought into question many long-held 'truths' about financial markets, in general, and credit markets in particular. The US credit market turmoil may be attributed to the interplay of low interest rates, the moral hazard embedded in an 'originate-to-sell' mortgage market, investors' lack of understanding of the engineered securities based on these mortgages, and the excessively high leverage of some financial sector entities.

Though the crisis has had global repercussions, the aftershocks have been muted in the Indian market. Indian equity indices have mirrored global sentiments, but few financial institutions have had to make provisions for potential losses due to credit exposure to foreign financial institutions; fewer still have reported major losses. The Indian financial system, and Indian banks in particular, have been left comparatively unscathed by the unfolding crisis, mainly due to their limited exposure to US-mortgage-backed securities.

We now examine whether this 'islanding' of India is temporary, or whether there are fundamental reasons for the Indian financial system's remaining relatively unaffected. Taking the eight key factors that we believe were instrumental in precipitating the US crisis, and comparing these with the corresponding factors for the domestic market, we find that the Indian market is unlikely to face a situation similar to the one that played out in the US. Table 1 is a snapshot of the key differences between the two markets.

Table 1: Comparison on key parameters of Indian and the US markets.

Sr. No	Parameter	India	US
1	Mortgage debt outstanding/ Gross Domestic Product (GDP)	Approximately 7%	Greater than 80%
2	MBS/GDP	Very low at less than 1%	Approximately 50%
3	Loan-to-value (LTV) ratio for MBS	Moderate LTV ratio	High LTV ratio
4	'Originate-to-sell' model	A miniscule proportion of loans originated are securitised	More than 60 per cent of loans are securitised
5	Innovative Products	Plain-vanilla loans predominate	Large proportion of ARM, interest-only loans, 'liar loans'
6	Securitisation market	Regulatory restrictions on synthetic securitisation. Market is characterised by simple products	Presence of complex securitisation products.
7	Leverage of financial institutions	Indian financial entities are leveraged at an approximate 10~12 times	US investment banks were leveraged around 30 times
8	Regulations	Banks and NBFCs stringently regulated by RBI	Regulatory arbitrage for investment banks

Credit quality outlook for financial sector entities

CRISIL believes that the Indian securitisation market is unlikely to spark off a market meltdown of the kind seen in the US. Origination standards continue to be conservative in the asset classes that are securitised, and these are reinforced by a lack of 'engineered securities', based on securities as underlying assets.

With Indian financial sector entities having limited exposure to foreign assets, and strong regulatory supervision ensuring that the leverage of these entities does not increase significantly beyond 10 times, the domestic financial system appears relatively immune to problems of the kind that the financial sector in the US and European markets is grappling with.

CRISIL expects the fortunes of the Indian financial sector to be driven, instead, by domestic factors such as the effect of any economic slowdown on asset quality and credit demand. Profitability may come under pressure because of the impact on liquidity of declining cross-border fund flows, and because of rising domestic interest rates that constrict lenders' interest spreads. CRISIL believes that entities with international exposure are likely to be affected more by mark-to-market provisions in their investment portfolios. However, in CRISIL's opinion, domestic banks' strong capitalisation will cushion the impact of the worsening economic environment on their credit profiles.

For NBFCs, on the other hand, the tight liquidity situation in financial markets is likely to result in a weakening of the resources and business profiles. NBFCs are clearly slowing down their business growth. Nevertheless, the impact of these factors on NBFCs' ratings is likely to be moderated by the fact that most CRISIL-rated NBFCs enjoy support from strong parents. Additionally, the larger NBFCs appear to be relatively well-placed in terms of cash on their books and access to bank funding.

Annexure - 1 : List of rating actions included in the analysis *

CRISIL's Long-Term Rating Upgrades for ratings forming part of the analysis - first half of 2008-2009

Sr. No	Company	Industry	Rating From	Outlook From	Rating To	Outlook To
1	Global Trade Finance Limited	Finance	AA	^	AA+	Stable

^ Rating was on Rating Watch with Developing Implications as on March 31, 2008

CRISIL's Long-Term Rating Downgrades for ratings forming part of the analysis - first half of 2008-2009

Sr. No	Company	Industry	Rating From	Outlook From	Rating To	Outlook To
1	Khatema Fibres Limited	Paper and paper products	BB	Stable	C/D ^ ^	
2	Man Industries (India) Limited	Aluminium	A+	Stable	A	Negative
3	Soma Textiles & Industries Limited	Textile Cotton	BBB-	Stable	D	

^ ^ Khatema Fibres Ltd defaulted on its term loan facility. The ratings on its other bank facilities were taken to 'C' under CRISIL's rating criteria.

CRISIL's Long-Term Ratings on Watch, as of September 30, 2008

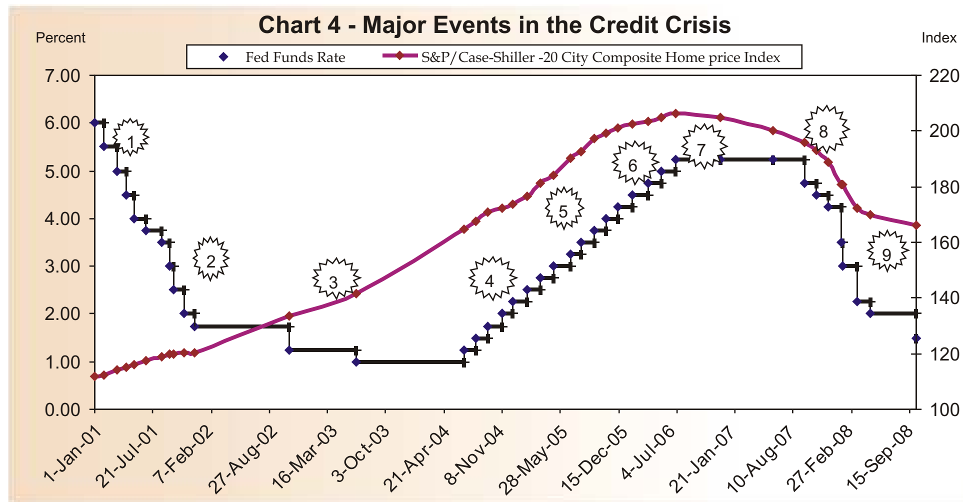
Sr. No.	Company	Industry	Rating	Watch
1	DSP Merrill Lynch Capital Limited	Finance	AA+	Watch Developing
2	DSP Merrill Lynch Limited	Finance	AA+	Watch Developing
3	The Madras Aluminium Company Limited@	Aluminium	AA-	Watch Developing
4	Bharat Aluminium Company Limited@	Aluminium	AA	Watch Developing
5	Sterlite Industries (India) Limited@	Diversified	AA+	Watch Developing
6	Gammon India Limited	Construction	AA	Watch Negative

@ Subsequently Removed from Rating Watch

** Rating actions included in the computation of MCR: MCR is computed using all upgrades and downgrades on the pool of ratings that was outstanding through the period under analysis. Thus, a rating assigned during the period, or one that was withdrawn during the period, would not be considered. Further, a structured rating that migrated to a non-structured rating, or vice versa, would be excluded from the MCR computation.*

Annexure - 2: Anatomy of the credit crisis

The US credit crisis did not manifest itself overnight, but it was a combination of events over a period of time that set the stage for the current financial turbulence (refer Chart 4).



Source: Federal Reserve, S&P/Case-Shiller-20 City Composite Home price Index

1) After the dot-com bubble, the US Federal Reserve (Fed) rapidly reduced interest rates to stave off a recession.

2) Ultra-low interest rates, and mortgage products like Adjustable Rate Mortgages (ARMs, with two-year 'teaser' rates) and 'liar loans' attracted a new set of buyers to the mortgage market. The creation of such mortgage products was aided by the 'originate-to-sell' business model made possible by securitisation. This led to a lowering of mortgage underwriting standards. Moreover, MBSs (mortgage backed securities) based on such mortgages found their way into many CDOs (collateralised debt obligations), which were held by banks, insurers, mutual funds, and other investors.

3) This led to a sharp spurt in housing demand starting around the middle of 2002. US home ownership reached an all-time high of 69.2 per cent by mid-2004. This surge in demand unleashed an unprecedented increase in house prices across the US.

4) Gradually, the threat of recession reduced and the Fed started increasing the interest rate. However, property prices consistently rose faster than interest rates; the consequent increase in 'home equity' allowed sub-prime borrowers to refinance loans. This, along with the two-year teaser rates, helped many of the weaker borrowers to avoid defaulting.

5) With a sustained increase in interest rates coinciding with the end of the low-interest period for many of the early ARM loans, the servicing burden on borrowers increased. Originators tightened lending norms, constraining refinancing opportunities for sub-prime borrowers. This, in turn, caused real estate prices to level off in 2006. The home equity ATM had finally run out.

6) Gradually decreasing house prices, coupled with higher servicing obligations due to rising interest rates, led to the first defaults on mortgage loans. The default rate of sub-prime loans increased beyond the underlying assumptions, resulting in credit rating changes on the MBSs and CDOs (end-2005 to early 2006).

7) The default rates on the 'problem mortgages' continued to rise, leading to the emergence of defaults on MBSs and the synthetic securities based on them. This resulted in a large and unanticipated fall in the market value of these securities (mid-2006 to early 2007).

8) Holders of these securities started announcing write-downs for mark-to-market losses. Some highly leveraged entities sought fresh equity to stay afloat (end-2007 to early 2008).

9) General discomfort emerged about the intrinsic value of these securities; in turn this raised concerns about the solvency of entities holding such securities. These concerns were heightened by the lack of clarity on the quantum of these 'toxic securities' held by various investors. With once-powerful names in the investment banking space falling in quick succession, there was deepening unease in the markets causing liquidity to dry up. Table 2 shows the losses reported by major financial institutions.

Table 2: Losses /Write-downs & Capital Raised (USD billion)

	Losses/Write-downs	Capital raised
Citigroup	55.1	49.1
Merrill Lynch	52.2	29.9
UBS	44.2	28.2
HSBC	27.4	5.1
Wachovia	22.7	11
Bank of America	21.2	20.7
Morgan Stanley	15.7	5.6
IKB Deutsche	15	12.3
Washington Mutual	14.8	12.1
Royal Bank of Scotland	14.4	23.5
World Total	521.9	379.2

Source: Bloomberg, data as of September 25, 2008

Notes

CRISIL Offices

Head Office

CRISIL House
121 / 122 Andheri-Kurla Road
Andheri (East)
Mumbai 400 093
TEL +91 (22) 6691 3001 - 09
FAX +91 (22) 6691 3000

Regional Offices in India

Ahmedabad

303, Paritosh, Usmanpura
Ahmedabad 380 013
TEL +91 (79) 2755 0317 / 1533
FAX +91 (79) 2755 9863

Bangalore

W-101, Sunrise Chambers
22, Ulsoor Road
Bangalore 560 042
TEL +91 (80) 2558 0899, 2559 4802
FAX +91 (80) 2559 4801

Chennai

Thapar House
43 / 44, Montieth Road
Egmore
Chennai 600 008
TEL +91 (44) 2854 6205 / 06, 2854 6093
FAX +91 (44) 2854 7531

Hyderabad

3rd Floor, Uma Chambers
Plot no. 9 & 10, Nagarjuna Hills
(Near Punjagutta X Road)
Hyderabad 500 082
TEL +91 (40) 2335 8103 / 8105
FAX +91 (40) 2335 7507

Kolkata

HORIZON
Block 'B', 4th Floor
57, Chowringhee Road
Kolkata 700071
TEL +91 (33) 2282 3541 / 55294501
FAX +91 (33) 2283 0597

New Delhi

Hindustan Times Bldg., 9th floor
18-20 KG Marg, New Delhi 110 001
TEL +91 (11) 2372 1603 /
2332 1086 / 73 / 2373 6541
FAX +91 (11) 372 1605

Pune

1187 / 17 Ghole Road
Shivajinagar
Pune 411 005
TEL +91 (20) 2553 9064 / 67
FAX +91 (20) 2553 9068

CRISIL Limited

Website: www.crisil.com