Rating Upgrades Surge As Credit Quality Stays Buoyant

Pressure on profitability likely to intensify

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CRISIL has upgraded 253 of its outstanding ratings in the first half of 2010-11 (refers to financial year, April 1 to March 31), the highest number of upgrades in any six-month period in its history. The upgrades have been on a vastly expanded base of around 5300 outstanding ratings as on September 30, 2010, and have been broad-based—across rating categories and industries. Though CRISIL also downgraded 111 ratings during the period, these have been largely concentrated in the rating categories, 'BB' and lower. CRISIL's modified credit ratio (MCR, an indicator of the relative frequency of upgrades and downgrades) has maintained its upward trajectory during the period, exceeding 1 time after a gap of three and a half years; the MCR increased to 1.07 times for the period, from 0.93 times for 2009-10. These trends indicate that the credit quality of India's companies, which had begun to improve in 2009-10, has remained buoyant in 2010-11. The buoyancy in credit quality is reflected not only in a surge in rating upgrades: positive outlooks have increased to a three-year high of 3.8 per cent, while negative outlooks have reduced to around 10.2 per cent as on September 30, 2010, from an all-time high of 16.7 per cent, a year ago. Most ratings with negative outlook are in rating categories, 'BB' and lower.

The stronger credit quality of India's companies has been driven by robust improvement in economic activity, and a healthier funding environment. Domestic demand remains upbeat in most sectors, and is likely to help the economy maintain a high growth rate. Moreover, the availability of funding has improved across the board: both debt and equity are more readily available now than they were 18 months ago, from the domestic and international markets.

Healthy domestic demand, and the resurgence in infrastructure, services, and domestic-consumption-oriented sectors, are likely to support buoyancy in credit quality over the medium term. CRISIL believes that the outlook for credit quality in the second half of 2010-11 is benign, with upgrades likely to significantly outnumber downgrades. Its MCR is, therefore, likely to remain at more than 1 time over the medium term; on account of intensifying pressure on corporates' profitability, however, the MCR may not scale the heights (of 1.16 times) it reached in 2005. The profitability margins of India's companies will be impacted by rising input costs with commodity prices firming up, intensifying competition across sectors, and increased cost of

funding. Recent policy measures to stem inflation have also increased the cost of financing, exacerbating the pressure on profitability margins.

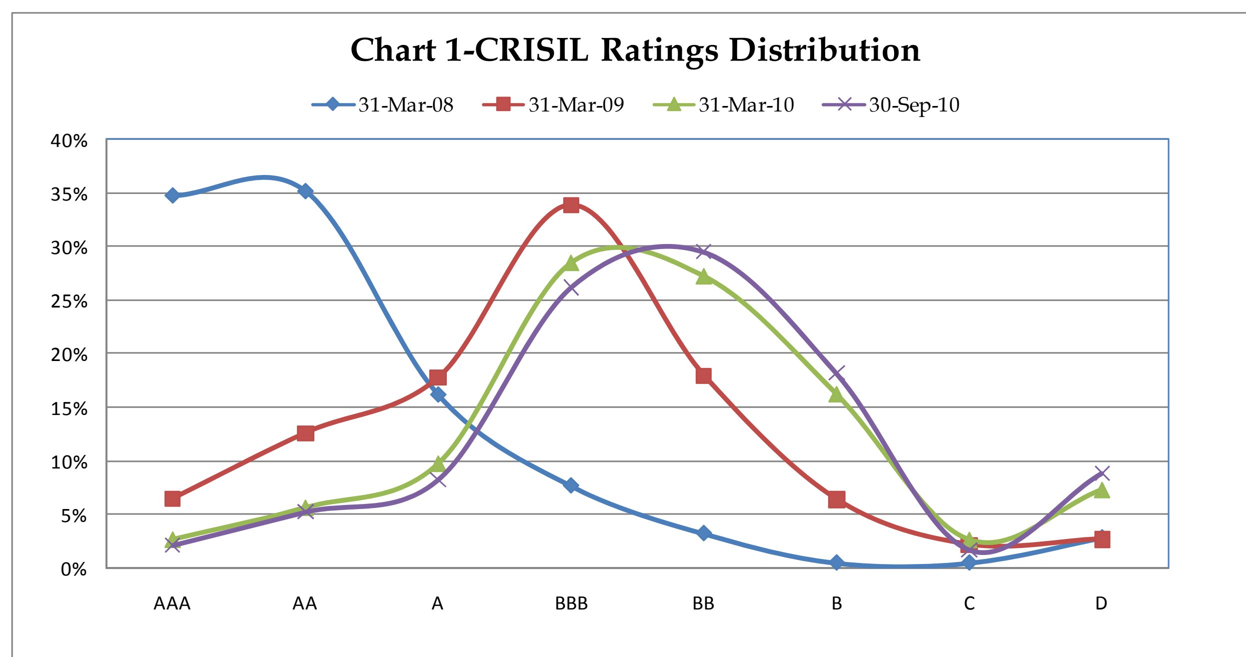
Stronger economic growth and improving customer spending in the past six months have encouraged companies to invest in capacity expansions. While economic growth is expected to remain buoyant, disruptions due to factors such as protracted recovery in the global economy, build-up of inflationary expectations, or severe profitability constraints, can result in pressure on credit ratings, given the likely increase in debt because of capital expenditure.

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 the underlying economic trends and business factors. Credit rating is an opinion on the likelihood of timely future debt repayment; therefore, 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 six-month period ended September 30, 2010 (H1 2010-11).

Scale –up in CRISIL's rated portfolio continues

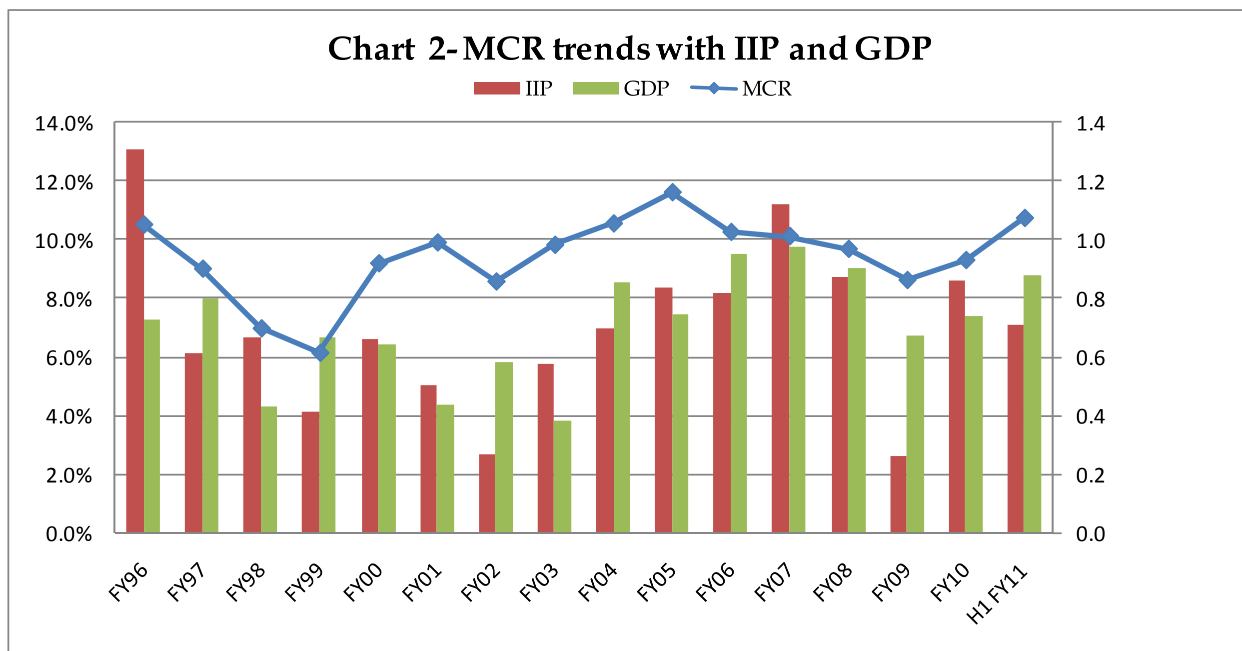
CRISIL's portfolio of outstanding ratings has increased significantly in recent years—to around 5300 ratings as on September 30, 2010 from around 400 as on March 31, 2008. The portfolio's composition has also changed significantly in recent years—as indicated by a shift in median rating to the 'BB' category as on September 30, 2010 from 'AA' as on March 31, 2008 (Chart 1 indicates the movements in rating distribution in the portfolio).



Signs of buoyancy in credit quality: MCR rises above 1 time

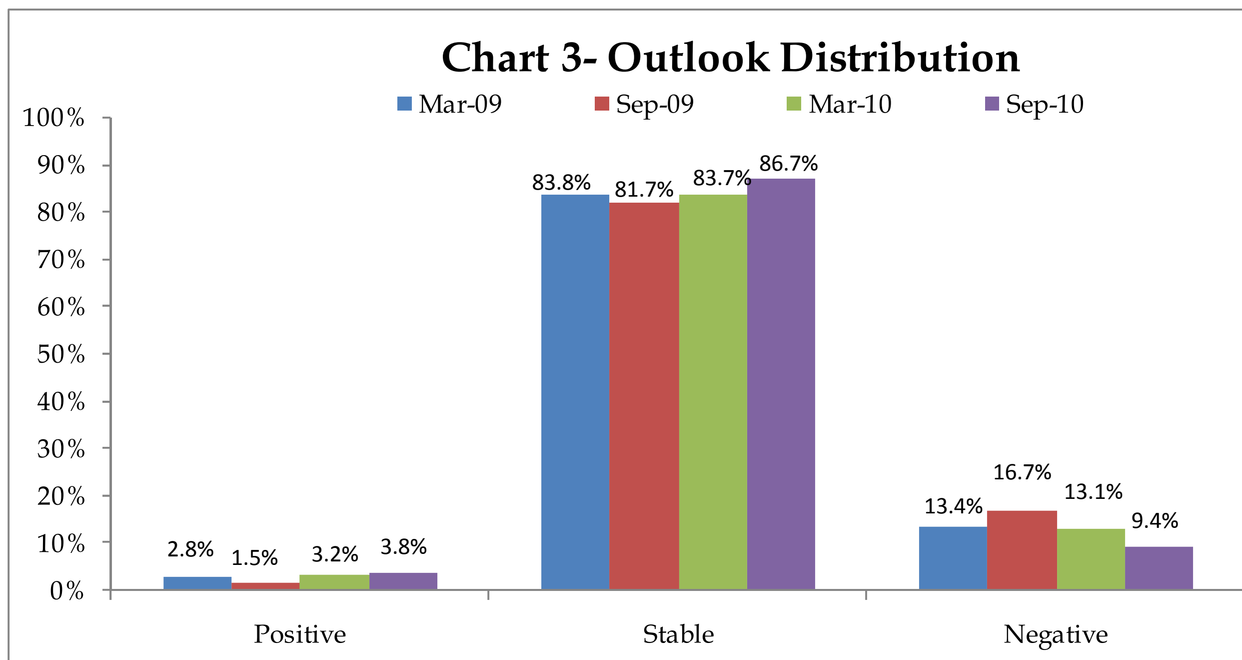
H1 2010-11 has witnessed the highest number of rating upgrades (253) in any six-month period in CRISIL's history, although these upgrades have been on a much higher base of outstanding ratings. As indicated in the previous edition of the Ratings Round-up, CRISIL's modified credit ratio (MCR - the ratio of upgrades plus reaffirmations to downgrades plus reaffirmations) has maintained its upward trajectory in H1 2010-11 and exceeded 1 time for the first time after a gap of three and a half years. The MCR for the period under review stood at 1.07 times, up from 0.93 in 2009-10 and 0.86 in 2008-09 (see Chart 2). The upward trend in MCR

indicates buoyancy in the credit quality of India's corporates, and is expected to continue over the medium term.



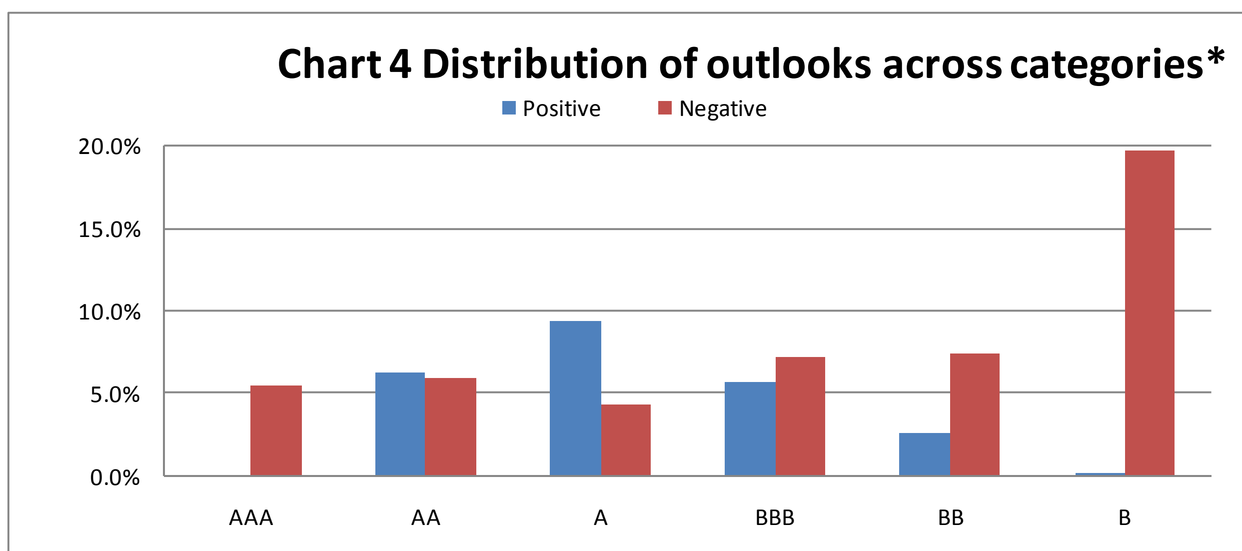
(For a complete list of rating actions, please refer the Annexure II-b and Annexure II-c of Annexure-II under 6.2.2 of Regulatory Disclosures section of CRISIL website).

The buoyancy in credit quality is also reflected in a shift in the distribution of outlooks (see Chart 3): the proportion of ratings with negative outlooks has reduced significantly to 9.4 per cent as on September 30, 2010, from a high of 16.7 per cent a year ago. Correspondingly, the proportion of ratings with positive outlooks has increased to 3.8 per cent, to reach levels achieved three years ago.



Positive outlooks dominate the higher end of rating scale; Negative outlooks, downgrades, defaults concentrated in lower end

The overall proportion of negative outlooks remains higher than that of positive outlooks. The outlook distribution, nevertheless, reveals interesting trends across rating categories (See Chart 4). Entities with positive outlooks outnumber those with negative outlooks in the higher rating categories ('AA' and 'A'); a positive outlook indicates that the entity's rating is more likely to be upgraded than downgraded over the medium term. Even in the 'BBB' category, the proportion of entities with negative outlooks has significantly reduced over the past one year. The number of entities in the 'BBB' category with positive outlooks is almost the same as those with negative outlooks; this is in sharp contrast to the situation a year ago when negative outlooks significantly outnumbered positive outlooks in this rating category. Moreover, almost 70 per cent of entities with negative outlooks are in the 'BB' and 'B' categories; entities in these categories have weak credit quality and are likely to face rating downgrades even in benign economic conditions. This is in contrast to the situation a year ago, when the proportion of negative outlooks was high across rating categories, and entities rated 'BB' and lower accounted for only 46 per cent of negative outlooks.



*As on September 30, 2010

While CRISIL downgraded 111 ratings in H1 2010-11, almost two-thirds of these downgrades were from the 'BB' and 'B' category. While the overall default rate has increased to 0.9 per cent in H1 2010-11, from 0.6 per cent in H2 2009-10, two-thirds of the defaults have been by entities rated in the 'B' and 'C' categories, and the remainder of defaults largely by entities rated 'BB'. Notably, entities in rating categories 'BB' and lower have historically displayed greater vulnerability than entities in higher categories, to downgrades and default.

Additionally, almost half of the downgrades (excluding defaulted entities) has been on entities that were involved in implementation of projects or large capital expenditure. Time and cost overruns in implementation of projects or in stabilisation of revenues from these projects weakened these entities' financial risk profiles considerably. Most of these entities were rated 'BB' and lower even before the downgrade, indicating that the likelihood of delays had already been factored into the previous rating, which, in turn, reflects the robustness of CRISIL's rating approach.

Analysis of the outlook distribution at an overall level and across rating categories also lends credence to CRISIL's belief that the credit quality of India's corporates is in a buoyant mode currently.

Robust economic growth and favourable funding environment drive credit quality

In the aftermath of the global financial turmoil in 2008, the domestic economy had slowed down significantly in 2008-09: a growth rate of only 6.4 per cent in the gross domestic product (GDP) prompted the Reserve Bank of India (RBI) to adopt an accommodative monetary stance, which continued almost through 2009-10. The government also provided fiscal stimuli to revive the slowing economy. Due to these measures, the domestic economy recovered quickly to grow at 7.4 per cent in 2009-10 and 8.8 per cent for the three months ended June 30, 2010. Funding, both as equity and debt, has also been easier to come by for India's corporates in the 15 months through September 2010, than in 2008-09, which was a year of credit crunch. Larger amounts were mobilised as equity and external commercial borrowings (ECBs) in the 15 months through September 2010, than in 2008-09: the reduced credit spreads bear testimony to the fact that the funding environment has been favourable for the corporates in the recent past (see Table 1). India's telecom players, for instance, raised more than Rs.1000 billion in the six months through September 2010 to fund their bids for 3G and broadband wireless access (BWA) licences.

Table 1: Trends in fund mobilisation

Quarter ended	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10
Bank Credit Growth (%)	17.51	0.02	12.63	13.66	16.75	21.57	19.1**^
Repo rate (%)	5	4.75	4.75	4.75	5	5.25	6.0
Credit spreads* (%)	2.1	1.6	1.6	1	1.1	1.2	0.83~
ECB mobilised (Billion USD)	2.90	2.71	4.61	6.51	7.83	5.31	2.25#
Equity Mobilised (Rs. Billion)	20	84	258	229	317	193	120.65@

*AAA spread over 10 year G-sec.
**Also includes large borrowings by Telecom Companies for funding 3G Spectrum License fees.
^ Till September 24, 2010.
# Includes figures for July 2010 and August 2010.
~ As on September 30, 2010.
@ Includes figures only for July and August 2010.

MCR likely to remain above 1 time, but unlikely to touch historical high

Robust economic growth and the conducive funding environment have resulted in the MCR exceeding 1 time after a gap of three and half years. In line with past trends, the MCR continues to display a high degree of correlation with broader growth indicators in the economy, a fact corroborated by the rise in MCR, accompanied by a steep increase in Index of Industrial Production (IIP) and GDP (see Chart 2).

During H1 2010-11, the upgrade rate[1] (the proportion of ratings upgraded to the average number of ratings outstanding[2] stood at 5.4 per cent; this is a significant improvement over the 1.1 per cent upgrade rate witnessed in H1 2009-10. On the other hand, the proportion of ratings downgraded declined significantly to 2.4 per cent in H1 2010-11, from 6.1 per cent in H1 2009-10 These trends support CRISIL's expectation that the MCR will remain above 1 time in the near to medium term. Nevertheless, the decline in upgrade and downgrade rates in H1 2010-11, as reflected in Chart 5 indicates that the pace of rating actions has slowed down, and the MCR may not touch the historic heights of 1.16 observed in 2004-05.

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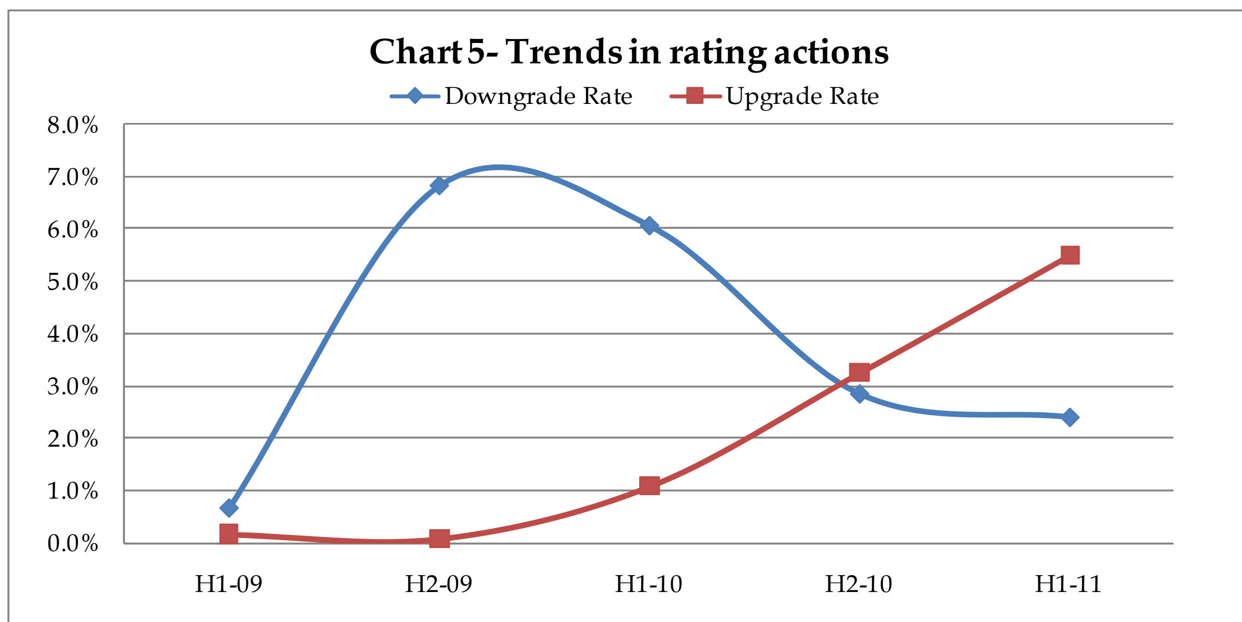
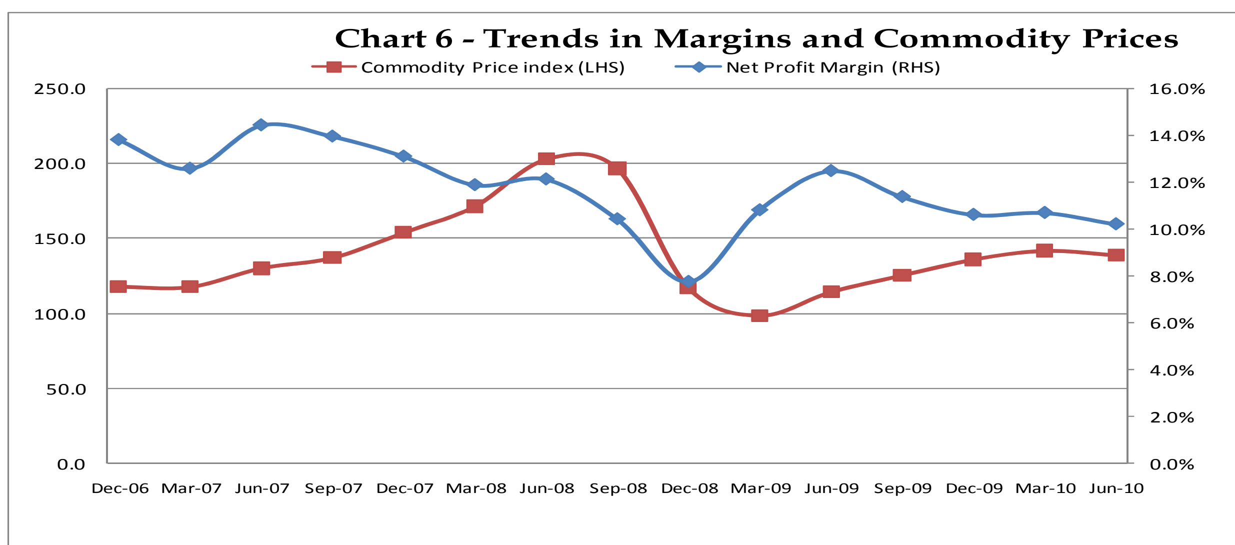
[1] This ratio is computed as the number of rating upgrades in a half year period as a proportion of the average number of ratings outstanding during that period.
[2] Average number of ratings outstanding = (Number of ratings outstanding at the beginning of the period + Number of ratings outstanding at the end of the period)/2



Profitability of Indian corporates under pressure: resumption of capex plans and input cost increases may intensify the pressure

CRISIL's analysis of the aggregate financial performance of listed companies indicates that the profitability of these entities is under pressure. The net profit margin of 406[3] entities in the S&P CNX 500 index has reduced to 10.2 per cent in the three months ended June 30, 2010 from 12.5 per cent in the corresponding period of the previous year (see Chart 6). The net profit growth was also much lower at 7 per cent in the recent period, compared to 29 per cent in the previous quarter. Increase in raw material costs and deterioration in pricing power due to increased competition are the key factors causing pressure on profitability.

[3] These listed companies have reported their results for the quarter ended June 30, 2010, and have remained in the S&P CNX 500 index for the past 15 quarters. The three oil marketing companies (OMCs) have been excluded, because the government controls petroleum product prices. Companies from the financial sector have also been excluded from the sample.



The RBI has begun to reverse its accommodative stance in an effort to control the economy's high rate of inflation. It has increased the repo and reverse repo rates, and the cash reserve ratio (CRR) in the past six months (see Table 1). This is also expected to increase the cost of debt for the India's corporates, thus constraining their profitability.

In the aftermath of the global financial turmoil in 2008, a lot of corporates cancelled or postponed their capital expenditure plans. With the economic growth back on track, and given the expectations of high GDP growth over the medium term, the corporates have already resumed their capital expenditure, or are likely to embark on large capital expenditure in the near to medium term. Given that most players are likely to use debt to fund capital expenditure, CRISIL believes that any abatement in intensifying profitability pressures is unlikely due to the higher outgo towards the interest on the contracted debt.

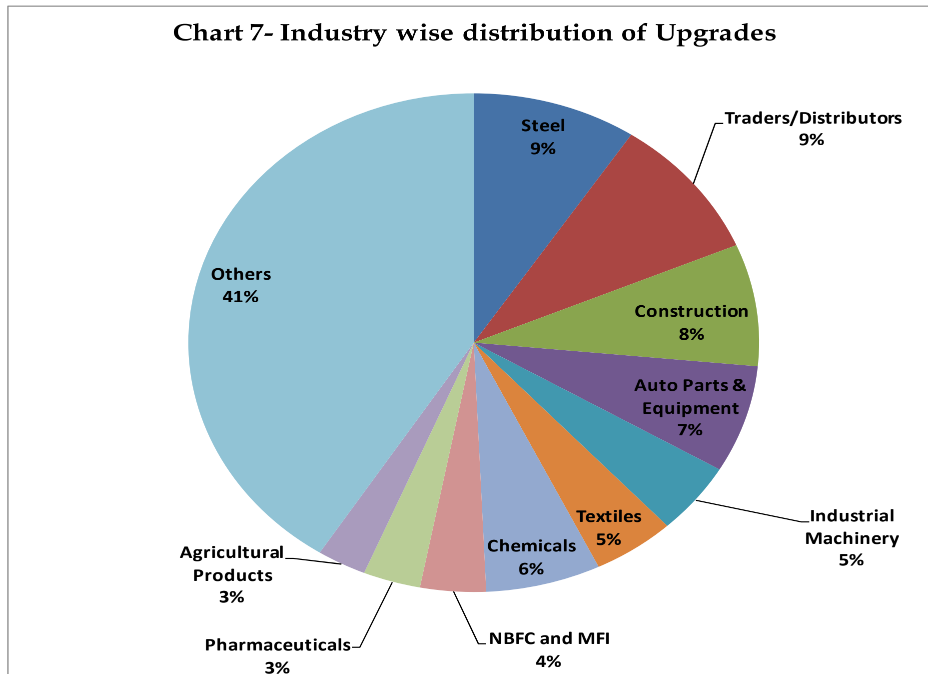
Outlook

CRISIL believes that the outlook for credit quality for H2 2010-11 is optimistic. While present trends indicate that upgrades are likely to outnumber downgrades, any disruptions in global economy due to a protracted recovery, build-up of inflationary expectations, and severe profitability pressures could result in greater pressure on credit ratings.

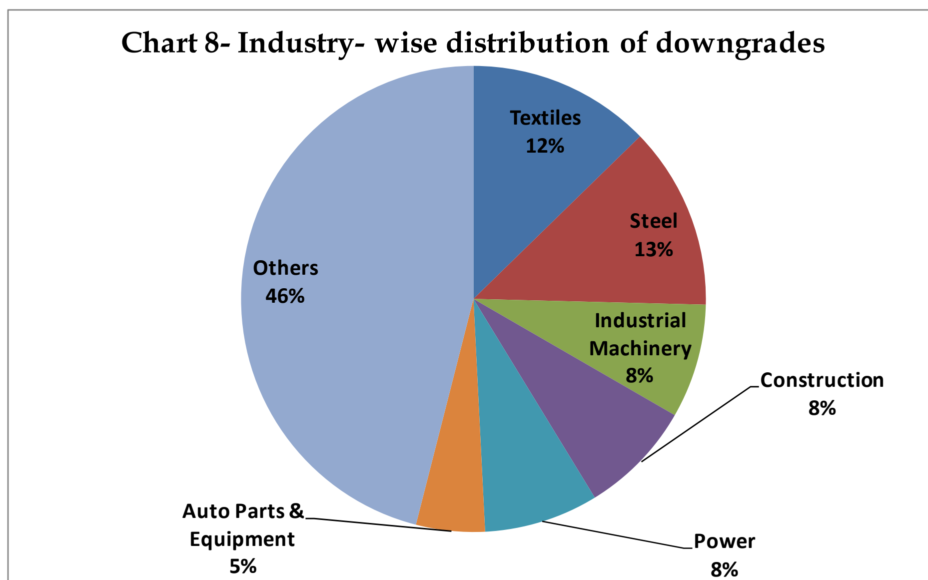
Table 2 presents an analysis of the major industries that witnessed rating actions in H1 2010-11. The table also contains CRISIL's credit outlook for these industries in the near to medium term. Also, real estate and gems and jewellery industry were among industries that witnessed significant stress in the last two years. The demand outlook for the residential real estate segment is likely to improve on the back of robust economic outlook, supported by attractive home loan offerings; this in turn will ease the cash flow pressures faced by developers. CRISIL believes that recovery in the commercial real estate segment will, however, be slow and rentals are likely to remain under pressure given the excess supply of commercial properties. Credit profiles of companies in the gems and jewellery industry are likely to remain stable over the medium term, on the back of improved demand conditions in key markets, and higher prices of polished diamonds in 2010-11.

CRISIL expects banks' credit growth to gather momentum in H2 2010-11, driven by increasing off-take from the infrastructure sector, and increased investments towards capacity expansion by the corporate sector. The implementation of the base rate mechanism and the increasing trend of deposit rates are unlikely to have any major impact on profitability margins in the near term. While a moderate increase in the non performing assets levels is likely over the next few quarters, healthy capitalisation (with a system-wide Tier I capital adequacy ratio in excess of 9 per cent), stable deposit base and government support for public sector banks underpin their credit profiles.

Industry-wise classification of rating actions



** Excludes upgrades from C/D category which were driven primarily by track record of timely debt repayments rather than any industry-specific factors.*



** Excludes rating downgrades to C/D which are caused due to stretched liquidity resulting in delayed term loan repayments and are not primarily driven by industry-specific factors*

Table 2: Key reasons for rating actions and credit quality outlook for major sectors.

Industry	Key Reasons for Rating actions in H1 2011	Credit Quality outlook for the near to medium term
Automobiles and Auto ancillaries	Upgrades in this industry were driven by improvement in capital structure, steady profitability, and prudent working capital management, supported by an improved demand outlook for the industry.	Domestic two-wheeler, passenger car, utility vehicle, and commercial vehicle segments are expected to witness healthy demand growth in 2010-11 due to robust economic activity and increase in disposable income. However, profit margins may come under pressure due to increasing raw material prices, rising competition and higher royalty payouts. The domestic market segment of auto component manufacturers will benefit from healthy off-take by domestic automotive original equipment manufacturers (OEM) and aftermarket. Sustained growth in the domestic markets is likely to offset sluggish export demand. However, rising input costs will exert pressure on the margins of entities in this industry. CRISIL also expects large capital expenditure by domestic component suppliers in the next 18 months to meet incremental demand.
Construction	Upgrades in this industry were driven primarily by good project execution track record and strong order book, and therefore, stronger business and financial risk profiles. The downgrades were primarily on project special-purpose vehicles (SPVs), due to time and cost overruns, leading to stretched liquidity for developers who had to extend funding support to the SPVs.	Government's focus on development of infrastructure, and increased private sector participation will lead to robust demand outlook for players in construction sector. CRISIL expects the credit profiles of companies in construction sector to remain largely stable on the back of healthy order book positions and steady operating profitability. Ability to efficiently manage growing project execution and working capital requirements will remain some of the key factors to be monitored over the medium term.
Steel and Steel Products	Upgrades in this industry were driven by increased demand for steel products, backed by higher investments in the infrastructure sector. Most downgrades in the sector were on account of weak liquidity of entities, caused by increasing working capital requirements.	While there was a surge in iron ore prices, most of the integrated players showed healthy profits by passing on increases in input prices. CRISIL expects the credit profiles of players in the sector to improve, backed by healthy operating profitability, efficient working capital management, and reduced reliance on debt.

Trading/Distrib-utors	Improvement in capital structure because of either equity infusion or significant improvement in working capital management was the key driver of most upgrades.	The credit quality of players will be driven primarily by efficiency in managing working capital and the consequent impact on capital structure.
Textiles	Downgrades in the sector were driven by entities' strained liquidity, large debt–funded capital expenditure and low cash accruals in H1 2010-11. Upgrades in the sector were primarily on players focused on domestic markets, which benefited from healthy demand and consequent improvement in profitability.	CRISIL expects strong demand from the domestic market to continue, and thereby support a high single digit growth for the sector over the medium term. Although apparel exports to USA and EU is reviving, the growth momentum will depend on players' ability to manage costs, and remain competitive. Also, any unfavourable movement in input prices and foreign exchange rates will have an adverse impact on margins, and are, therefore, key monitorables. The credit profiles of players, especially in spinning will remain constrained by the leveraged capital structure.
Chemicals	The upgrades in the sector were driven by increased net cash accruals due to steady growth in revenues, improved operating efficiencies and better working capital management. Improvement in capital structure and lower capex also contributed to better liquidity conditions.	The chemicals industry is poised for stable growth in the medium term due to improved demand from end-use sectors and re-establishment of equilibrium between products and input prices. The operating margins of chemicals manufacturers have begun to revert to historical levels. CRISIL expects improvement in the credit profiles of chemical manufacturers, due to healthy cash accruals and lower reliance on debt.

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