FY 2011-12

CRISIL RatingsRoundup

Default rate at ten-year high of 3.4 per cent

Downgrades to outnumber upgrades; demand and liquidity will be key monitorables

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Executive Summary

Credit quality pressures have intensified for India's corporates in 2011-12 (refers to financial year April 1 to March 31). Instances of default by CRISIL-rated entities increased to 188, the highest for any year. The annual default rate for CRISIL-rated entities has hit a ten-year high—of 3.4 per cent—in 2011-12. These pressures are also reflected in the increase in banks' gross non-performing assets (NPAs; to 2.9 per cent of advances from 2.3 per cent), and in the quantum of debt restructured (to 3.3 per cent of advances from 2.5 per cent) between March 31 and December 31 of 2011.

Downgrades exceeded upgrades in the second half of 2011-12 as CRISIL downgraded 292 ratings and upgraded 266 ratings. This marked a reversal in trend from the first half of 2011-12 when CRISIL upgraded 313 ratings, which was higher than the 207 downgrades. The downgrades were driven by liquidity pressures and weakening demand. Significantly, one-third of the downgrades were to the default category ('CRISIL D'). Weak liquidity caused by elongation of working capital cycles is the primary reason for the defaults. This trend is likely to persist with slowing demand.

Highly indebted industries, including textiles, steel, construction and engineering, accounted for a fourth of the defaults. Textile exports have been hampered by weak demand, especially in the Eurozone. Steel manufacturers have had to contend with higher input prices. Industries dependent on investment demand such as construction and engineering, and industrial machinery have been affected by weak domestic demand, stretched working capital cycles, and high interest rates.

CRISIL's rating action ratio (RAR; an indicator of relative frequency of upgrades and downgrades) declined to 1.01 times in 2011-12 from 1.10 times in the previous year. The decline has been in line with CRISIL's expectations (see October 2011 edition of the Ratings Round-Up). The credit quality of India's corporates will remain under pressure, given the slowdown in demand. However, high operating rates, softening in commodity prices and flexibility to defer capital expenditure will help players offset profitability pressures, and tackle slackening in demand. CRISIL expects RAR to decline further to less than 1 time over the near term. Higher rated ('CRISIL AAA' and 'CRISIL AA') companies have stronger balance sheets, and are, therefore, better positioned to withstand slackened demand. The extent of demand slowdown, access to funding, and degree of recovery in the global economy will be key monitorables over the medium term.

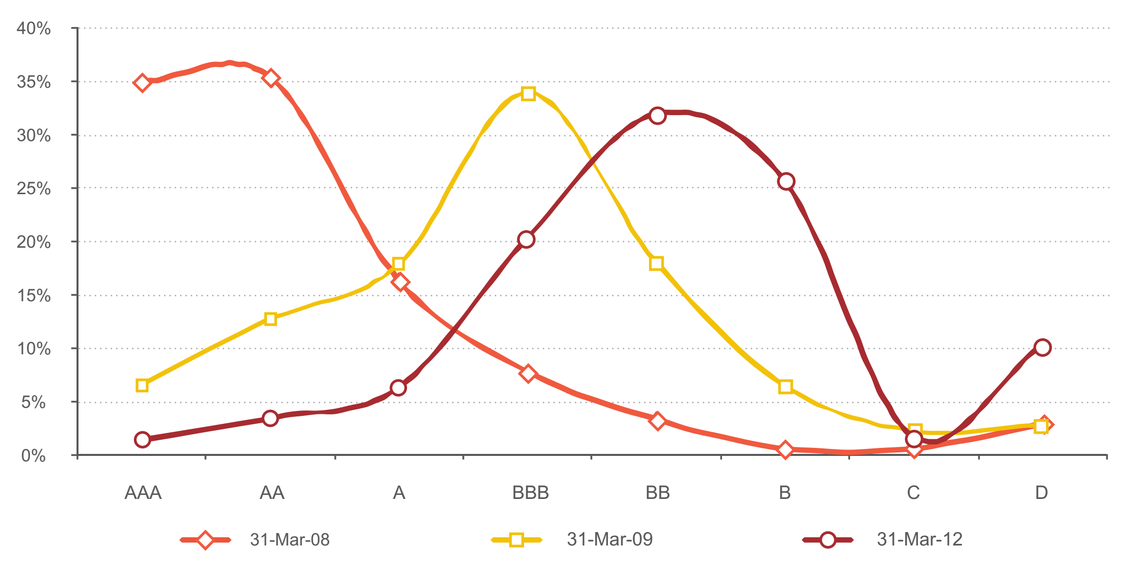
About CRISIL's Ratings Round-Up

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 twelve months through March 2012.

CRISIL's portfolio continues to expand: Outstanding ratings increase by twenty-two times in four years

CRISIL's portfolio of outstanding ratings has continued to expand in recent years, both in numbers and rating composition. The outstanding ratings increased to around 9000 entities as on March 31, 2012, up from around 400 entities, four years ago. There has been a fundamental shift in CRISIL's rating distribution on account of a significant surge in the number of entities in the lower rating categories. Chart 1 indicates the movement in rating distribution: the median rating has shifted to 'CRISIL BB' as on March 31, 2012, from 'CRISIL BBB' as on March 31, 2009 and 'CRISIL AA' as on March 31, 2008.

Chart 1: CRISIL ratings distribution



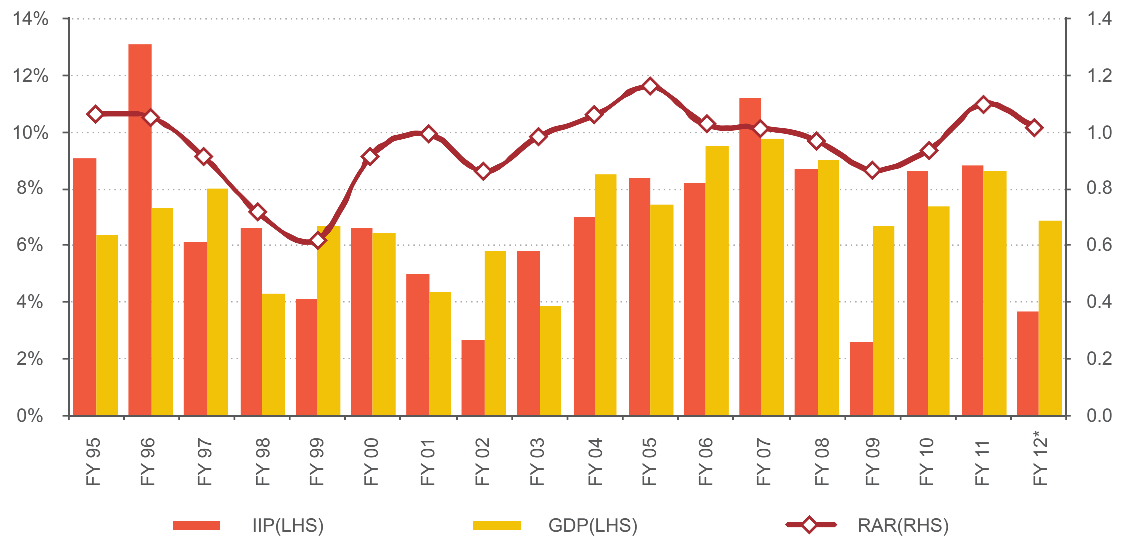
Continued pressure on credit quality; RAR continues to decline

CRISIL downgraded 292 ratings, while upgrading 266 ratings in the second half (H2) of 2011-12. Downgrades outnumbered upgrades in H2 2011-12 as CRISIL had anticipated in its release[1] in January 2012 and in the October 2011 edition of Ratings Roundup. In H2 2011-12, CRISIL upgraded 0.9 ratings for every rating it downgraded, as against 1.5 ratings upgraded for every rating it downgraded in H1 2011-12.

CRISIL upgraded ratings on 562[2] entities in the whole of 2011-12, while downgrading ratings on 492[2] entities. As a result, CRISIL's RAR (the ratio of upgrades plus reaffirmations to downgrades plus reaffirmations) dipped to 1.01 times in 2011-12, from 1.10 times in 2010-11 (see Chart 2). CRISIL expects its RAR to moderate further to less than 1 time, although not to the extent it did during the global financial crisis in 2008-09—when the RAR dipped to a decadal low of 0.86 times.

CRISIL's RAR exhibits a strong correlation with economic indicators such as the index of industrial production (IIP) and gross domestic product (GDP). Notably, the steep fall in RAR has been accompanied by a sharp decline in IIP and GDP in 2011-12.

Chart 2: RAR trends with IIP and GDP



*GDP and IIP growth rates are for the period April 2011 to December 2011.
(For a complete list of rating actions in H2 2011-12, please refer the Annexure II-b and Annexure II-c of Annexure II under 6.2.2 of Regulatory Disclosures section on the CRISIL website).

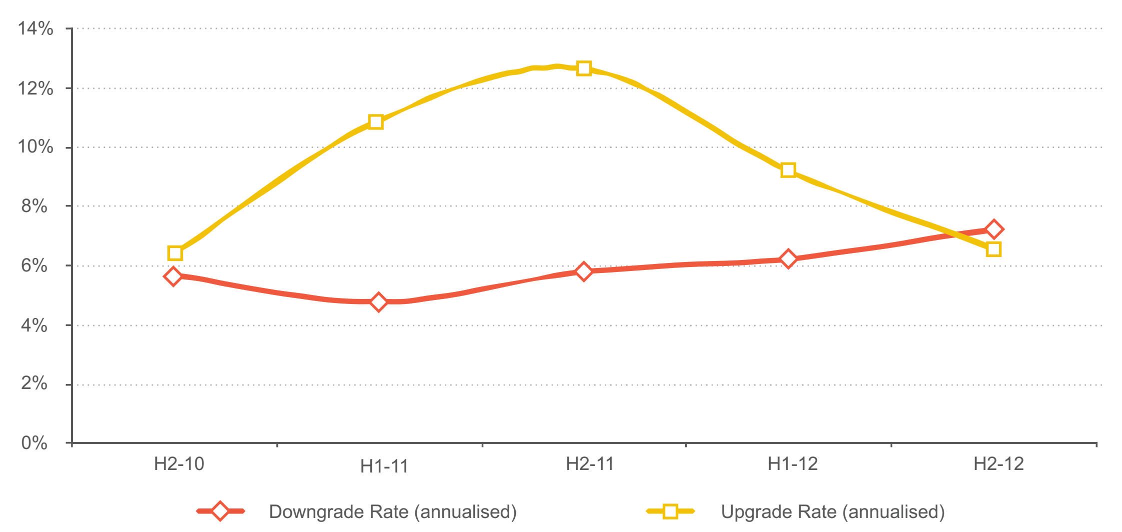
[1] *Refer to releases, "Slowing demand may add to pressure on credit ratings; RAR declining due to weakening profitability" dated 4th October, 2011 and "Downgrades outnumber upgrades after eight quarters: CRISIL" dated 16th January, 2012.*

[2] *The rating actions for the full year will be fewer than the sum of rating actions in H1 and H2. This is because rating actions on the same entity in different halves are considered separately in H1 and H2, while they are considered as a single rating action for the full year.*

Upgrade rate plummets further; downgrades to outnumber upgrades in near term

CRISIL downgraded 292 ratings in H2 2011-12, resulting in an increase in annualised downgrade rate to 7.2 per cent in H2 2011-12 from 6.2 per cent in H1 2011-12. The downgrades were driven primarily by liquidity pressures both due to stretched working capital cycle and capital expenditure undertaken by these entities in 2011-12. The rating downgrades were also on account of slackening in demand. More than a third of the 492 downgrades in 2011-12 were to default category ('CRISIL D'). CRISIL's portfolio witnessed 107 defaults in H2 2011-12 alone, the highest for any half-year period, up from 81 defaults in H1 2011-12. Almost 90 per cent of these defaults were from rating categories 'CRISIL BB' and lower—categories that have historically displayed higher default rates.

Chart 3: Trends in rating actions



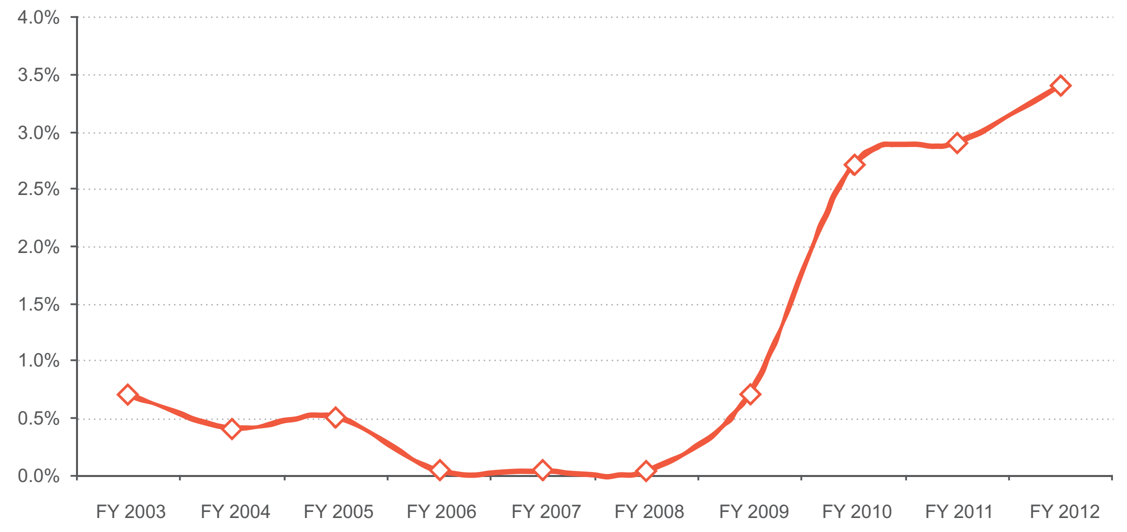
There were far fewer upgrades (266) in H2 2011-12 than in H1 2011-12 (313). The annualised upgrade rate dipped to its lowest in the past 24 months—6.6 per cent in H2 from 9.2 per cent in H1 of 2011-12. The upgrades in H2 2011-12 were primarily on account of improved business performance, driven by stabilisation of expanded capacities, and improved liquidity. While upgrades were spread across rating categories, 'CRISIL A' had the highest annualised upgrade rate of 10.0 per cent in H2 2011-12. This is in line with upward bias displayed by 'CRISIL A' rated credits in the last ten years. This has been largely on account of the ability of these entities to withstand business cyclicality and their prudent capital management. Competitive edges in business risk coupled with strong management competency have also been the key strengths of 'CRISIL A' rated credits.

Downgrades are expected to outnumber upgrades in the next few quarters. CRISIL expects pressure on the credit quality of India's corporates to continue in the near term on account of the slackening domestic economy and weak global economy, and the likelihood of interest rates remaining high for longer than earlier expected.

Higher defaults in H2 2011-12; annual default rate at ten-year high

Credit quality pressures accentuated in H2 2011-12 as profitability of corporate India remained subdued, and liquidity pressures emerged. There were 107 defaults in CRISIL's portfolio in H2 2011-12—the highest for any six month period. The high-leverage industries, including textiles, steel, construction and engineering, accounted for a fourth of the defaults. The overall annual default rate (refer to Chart 4) also reached a ten-year high of 3.4 per cent in 2011-12, with a total of 188 defaults in the same period. This rise in the default rates was also aided by a surge in rated entities in the lower rating categories, which have traditionally been more susceptible to defaults.

Chart 4: Annual default rate



Increase in the gross non-performing assets (NPAs; to 2.9 per cent as on December 31, 2011 from 2.3 per cent nine months ago) in the banking sector indicate a similar trend, with asset quality of India's banks deteriorating. Similarly, the quantum of debt restructured has increased—to 3.3 per cent of advances as on December 31, 2011, from 2.5 per cent as on March 31, 2011.

Investment-demand-linked and export-linked industries impacted by slowdown in economy

During 2011-12, demand conditions moderated as overall economic growth slowed down both in India (refer to Table 2) and abroad. Profitability of companies also came under pressure due to high interest rates, and high input and wage costs. Investment demand-linked industries (including construction and engineering, industrial machinery and real estate) were impacted by weak domestic demand, stretched working capital cycles and high interest rates. Steel manufacturers were adversely affected by higher input prices. Growing uncertainty in the Eurozone and low growth in the advanced economies (refer to Table 1) have impacted export-linked sectors such as textiles.

Table 1: Trends in GDP growth rates of EU nations

Countries	2010	2011 (E)	2012 (E)	2013 (E)
Germany	3.7	3.0	0.6	1.5
France	1.4	1.6	0.5	1.0
Italy	1.4	0.4	-1.0	0.0
Spain	-0.1	0.7	0.0	1.0
EuroZone #	1.8	1.6	0.0*	1.0
U.K.	2.1	0.9	0.5	1.0

Source: S&P

 # Eurozone includes 15 members of the European Economic and Monetary Union
**While S&P has forecasted a baseline scenario of no growth for Eurozone in 2012, it has also forecasted an alternative scenario of decline in GDP growth by 2% with a probability of 40%*

Restricted access to funding - liquidity pressures to persist

The domestic funding environment has remained challenging in the past 12 months, with the Reserve Bank of India (RBI) increasing the repo rate by 175 basis points. The bank credit growth is estimated to moderate to 16.4 per cent in 2011-12 from 21.6 per cent in 2010-11. This has been on account of slowdown in economic and investment growth, high interest rates, and uncertainties in the global environment. India's equity markets have also been hit by the spillover effects of slowdown in the global economy. Funds raised in the equity market have plummeted sharply over the past two quarters - with Rs.98 billion raised between July and December of 2011, down from Rs.720 billion in the corresponding period of 2010.

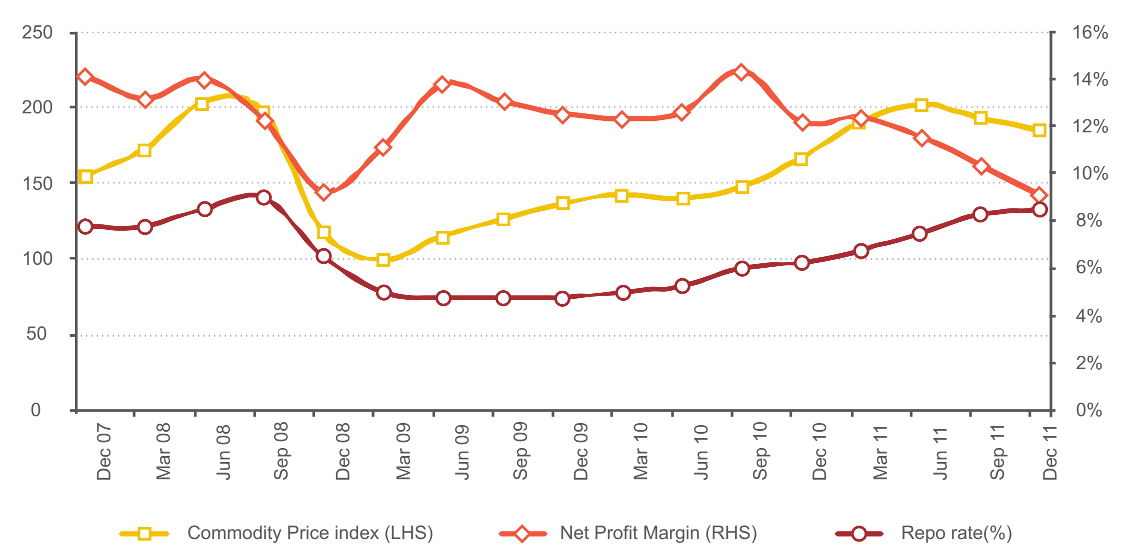
Table 2: Trends in GDP, industrial activity and fund mobilization

Quarter ended	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
Bank Credit Growth (%)^	16.8	21.6	19.1	24.6	21.6	20.1	23.2	16.0	16.4^
Repo rate (%)	5.00	5.25	6.00	6.25	6.75	7.50	8.25	8.50	8.50
Credit spreads (%)#	1.10	1.20	0.78	0.64	0.88	1.08	0.95	0.73	0.84&
ECB mobilised (Billion USD)	7.83	5.31	5.43	5.33	9.78	8.10	10.23	8.53	2.70*
Equity Mobilised (Rs. Billion)	336	198	266	454	210	240	85	13	7*
IIP Growth (% YoY)	15.8	11.9	6.9	8.6	7.9	7.0	3.2	1.2	6.8*
GDP Growth (% YoY)	9.4	8.5	7.6	8.3	7.8	7.7	6.9	6.1	NA

#AAA spread over 10 year G-Sec
^Represents YoY growth in a 12-month period at the end of each quarter. Figures for March 2012 represents 12 month YoY bank credit growth at the end of March 9th, 2012
** Includes figures only for January, 2012*
& Updated till 29th February, 2012

Profitability at its lowest in 16 quarters; high operating rates, softening in commodity prices and flexibility to defer capital expenditure to partially offset pressure

Chart 5: Trends in margins and commodity prices



CRISIL's analysis of the aggregate financial performance of listed companies indicates that the net profit margin (NPMs) of 430[3] entities in S&P CNX 500 Index has been declining over the past three quarters. The net profit margin dropped to 9 per cent, the lowest in the past 16 quarters. The profitability of companies was impacted by high interest rates and input and wage costs. CRISIL expects interest rates to remain high for longer than earlier expected, given that inflation still exceeds RBI's comfort levels. However, pressure on profitability is unlikely to intensify as entities' margins will get support from softening in commodity prices and stabilisation of capacity expansions undertaken in the past leading to high operating rates. The flexibility to defer capital expenditure will also help players offset profitability pressures. The commodity price index has begun to decline in line with CRISIL's expectation (refer to the previous edition of Ratings Round-Up, published in October 2011).

[3]These listed companies have reported their results for the quarter ended December 31, 2011 and have remained in the S&P CNX 500 for the past 17 quarters. The three oil marketing companies (OMCs) have been excluded, because their reported numbers will skew the sample. Companies from the financial sector have also been excluded from the sample.

Outlook:

Demand growth will moderate due to slowing domestic economy and uncertain global recovery. Access to funding was constrained during 2011-12 as domestic interest rates peaked and uncertainties prevailed in the Eurozone, and will remain a key challenge given that the recessionary conditions continue in the Eurozone. Corporate India's credit quality may, therefore, be constrained by slackening in revenue growth, likelihood of interest rates declining at slower pace, and by challenges relating to funding. However, severe pressure on profitability is unlikely as companies may tackle slowing demand to some extent on the back of high operating rates and deferred capacity expansions. Companies may also benefit from decline in commodity prices and interest rates. Smaller companies with limited financial flexibility are more vulnerable to deceleration in demand growth. However, high-rated ('CRISIL AAA' and 'CRISIL AA') companies are better positioned than others to withstand demand slowdown, as they have stronger balance sheets, and have historically maintained higher stability rates.

CRISIL believes that downgrades may outnumber upgrades, and that its RAR may decline further over the medium term. The RAR may reduce to less than 1 time, though not to the extent in 2008-09, when it dipped to its decadal low of 0.86 times.

The extent of demand slowdown, availability of adequate funding, and the degree of recovery in the global economy, especially in the Eurozone will be key monitorables for the credit quality of India's corporates.

Upgrade-rate and Downgrade-rate for major industries

Chart 6: Upgrade rate of top five industries

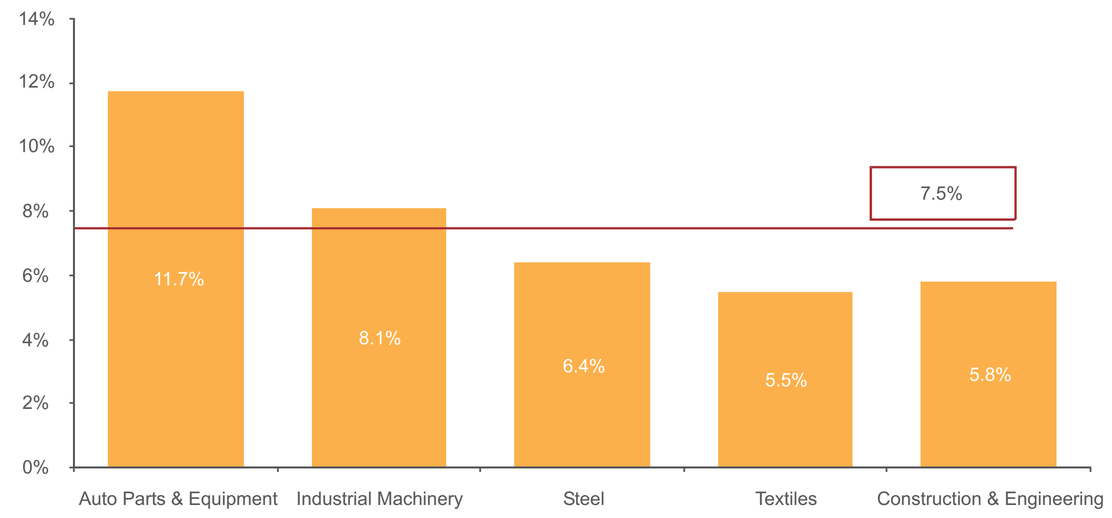
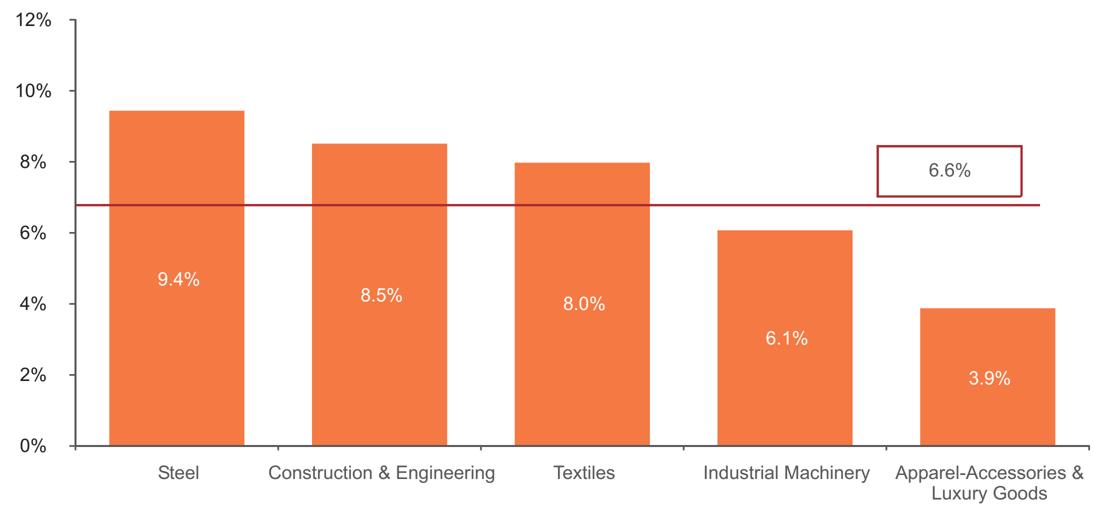


Chart 7: Downgrade rate of top five industries



Key reasons for rating actions and credit quality outlook for major sectors

Industry	Key Reasons for Rating actions in 2011-12	Credit Quality outlook for the near to medium term
Construction	Downgrades in the sector have been on account weakening in business risk profile, caused by slowdown in domestic demand, increasing working capital requirements, and stretched receivables. Upgrades in the sector were driven by stronger business risk profiles, underpinned, in turn, by scale-up in operations and order book.	Construction sector will continue to benefit from Central Government's focus on reducing infrastructure bottlenecks and supporting demand for affordable housing in India. However slower build up of order book over past one year may moderate the growth trajectory in the medium term. Profit margins will also remain constrained due to higher input costs and rising competitive intensity within the sector. Low cost funding options post budget through ECBs and higher limits on infrastructure bonds along-with expected decline in interest rates may help players to partly offset these medium term credit pressure for players in this sector. Execution capability and receivable management will remain the key monitorables
Steel and Steel Products	Downgrades have been on account of weak debt protection metrics on the back of debt-funded capacity expansions, and continuing ban on iron-ore mining in Karnataka. Upgrades in this sector were driven by increasing scale of operations and equity infusions by promoters.	In 2012-13, CRISIL expects domestic steel prices to decline by 7 to 8 per cent as global steel prices remain low. Operating margins of all domestic players may remain under pressure in 2012-13 owing to moderate demand, fall in steel prices and firmness in raw material costs (especially that of iron ore).
Textiles	Downgrades in the sector were driven by slowdown in the demand for cotton yarn in India and abroad, along with fall in the prices of cotton and cotton yarn. Defaults in the sector have been on account of weak liquidity caused by stretched export receivables. Most upgrades in the sector were driven by improved operating margins on the back of scaled-up operations.	CRISIL expects spinners to benefit from the stable domestic demand. The margins may improve marginally from the lows of 2011-12, supported by stabilisation in cotton prices, compared to the previous season. Demand for apparel exports may be impacted by slowdown in key export markets such as USA and European Union. Apparel exporters with established customer relationships and low-cost structures are likely to buck the trend and benefit from the vendor consolidation plans of buyers. CRISIL expects the domestic market to support the apparel segment, over the medium term. Overall, the profitability of ready-made garment players will remain range bound at 8 to 10 per cent, as witnessed historically. Over the medium term, CRISIL expects no significant capacity additions, due to muted demand and power shortages in parts of the country. Decline in profitability in the preceding year, and moderation in current operating rates has eroded liquidity. Some players may, therefore, resort to debt restructuring to overcome cash flow mismatches. Government policies on export of cotton and cotton yarn, and continuation of Technology Upgradation Fund Scheme are the key monitorables for the sector.

Industry	Key Reasons for Rating actions in 2011-12	Credit Quality outlook for the near to medium term
Auto-ancillaries	Most upgrades were driven by increased scale of operations and stronger business risk profiles. Cash generation has been healthy, and capital structures have continued to become stronger, supported by prudent spending on capital expenditure. Most downgrades were to the default rating category. These were on account of weak liquidity arising out of stabilization issues related to large debt funded capex undertaken by these entities, leading to insufficient accruals in relation to debt repayment obligations.	CRISIL expects moderation in revenue growth to 12 to 14 per cent in 2012-13 from 16 to 18 per cent the previous year) for the auto component players. This growth will be driven by moderate demand from domestic original equipment manufacturers (OEMs), and steady aftermarket and export demand. Operating margins may decline by 100 to 150 bps in 2012-13 owing to rising power and employee costs, and volatile input prices. Players may choose to add capacity only if necessary—to avoid pressure on their balance sheets.
Banks, non banking finance companies (NBFCs)	Upgrades in the NBFC sector were on account of equity infusions and therefore, stronger financial risk profiles	CRISIL believes that the asset quality of Indian banks will remain under pressure. Such pressures are visible in a steadily rising trend in gross NPAs of public sector banks (PSBs). High slippages in the last few quarters have been largely on account of high interest rates, rise in delinquencies in the agriculture and small and medium enterprises (SME) segment, and migration to system-based NPA recognition. Stress in the corporate portfolio is also reflected in an increasing incidence of restructuring of relatively large exposures in sectors such as power and aviation. CRISIL expects such trends to continue through a large part of 2012-13, with continuing concerns on growth, policy issues and high interest rates. CRISIL expects banks' gross NPAs to rise to 3.2 per cent by 2012-13. CRISIL nevertheless, maintains a stable outlook on rated Indian banks given the availability of strong support from the Government of India for PSBs, their adequate capital position, and stable resource profiles. CRISIL expects retail NBFCs to maintain healthy growth in business volumes in 2012-13 although a moderation in the strong growth witnessed in 2011-12 is likely. Newer asset classes, increasing penetration in semi-urban and rural areas, and substitution of the unorganised sector continue to drive growth for the retail NBFC sector. The asset quality and the profitability levels may be subject to some pressure, given the weakness in the economy and high interest rates. For capital market players, CRISIL expects the operating environment to remain challenging with severe pressures on the equity broking and investment banking business; many of these players have been gradually diversifying into retail finance to address these challenges.

About CRISIL Limited

CRISIL is a global analytical company providing ratings, research, and risk and policy advisory services. We are India's leading ratings agency. We are also the foremost provider of high-end research to the world's largest banks and leading corporations.

About CRISIL Ratings

CRISIL Ratings is India's leading rating agency. We pioneered the concept of credit rating in India in 1987. With a tradition of independence, analytical rigour and innovation, we have a leadership position. We have rated over 49,937 entities, by far the largest number in India. We are a full-service rating agency. We rate the entire range of debt instruments: bank loans, certificates of deposit, commercial paper, non-convertible debentures, bank hybrid capital instruments, asset-backed securities, mortgage-backed securities, perpetual bonds, and partial guarantees. CRISIL sets the standards in every aspect of the credit rating business. We have instituted several innovations in India including rating municipal bonds, partially guaranteed instruments and microfinance institutions. We pioneered a globally unique and affordable rating service for Small and Medium Enterprises (SMEs).This has significantly expanded the market for ratings and is improving SMEs' access to affordable finance. We have an active outreach programme with issuers, investors and regulators to maintain a high level of transparency regarding our rating criteria and to disseminate our analytical insights and knowledge.

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