CRISIL's INDIA OUTLOOK
ECONOMY • INDUSTRIES • MARKETS

CRISIL
An S&P Global Company

Colours of growth

India Outlook, Fiscal 2018

March 2017

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Executive summary

The next few years will see many new ecosystems coming up, which promise to change the colours and contours of India's economic and corporate landscape.

And in fiscal 2018, given the absent fiscal and monetary stimuli and unsupportive global environment, we foresee only a mild recovery in the economy, with GDP edging up 30 basis points to 7.4% driven by pent-up consumption demand following demonetisation.

But the fiscal rectitude of the government – and its focus on raising the 'trend' rate rather than 'cyclical' growth -- will enhance the credibility of policy making, improve investor confidence, and make India resilient to external shocks. There is enough empirical evidence that shows how improvement in macroeconomic fundamentals lend stability to currency in turbulent times.

The upshot of monetary and fiscal prudence accompanied by repair (power and banking sector) and growth-potential enhancing reforms (Goods and services tax [GST], bankruptcy code) is that it will lift the ability of the economy to grow fast in a sustainable manner.

And a stable macroeconomic environment creates a conducive environment for development of corporate bond markets for funding India's infrastructure build-out.

The focus on digitalisation will usher efficiency gains over a broad spectrum of activities (involving government, citizens and corporates) over the next few years.

Corporate India will also see an uptick in growth next fiscal, with revenue growth reaching a 5-year high, though we are again likely to miss the double-digit mark. EBITDA margins are likely to remain range-bound as higher commodity prices will take a toll on the margins of end-user sectors.

Private capex is likely to remain subdued in fiscal 2018. Capacity overhang, stretched balance sheets and only a moderate pick-up in demand will mean revival in capex cycle gets deferred to fiscal 2019. So government and public sector undertakings will need to do the heavy lifting on the infrastructure side.

We see some key themes driving sectoral performance next fiscal and beyond. GST will be a game changer and can usher in significant efficiencies and benefits in the logistics chain across sectors. Consolidation is another theme that is likely to play out in many sectors driven by diverse factors – intense competition (telecom, cement) GST and other policy action, and increasing formalisation of the economy (real estate, MSME-dominated sectors), and impetus to stressed assets resolution (power, steel). Decline in interest rates over past two years, though not adequate in itself to revive the investment cycle, can help once other factors are also conducive.

The credit quality of India Inc is showing signs of gradual recovery driven by firm commodity prices, stable macros, impact of sustained structural reforms, improving capital structure and lower interest costs. The banking sector will see lower slippages to non-performing assets (NPAs). Turnaround is increasingly visible in some commodity linked sectors (especially metals) and in the mid-sized engineering, procurement, construction (EPC) segment.

Nevertheless, the underlying fragility will continue and keep NPAs at elevated levels given some sectors are continuing to struggle.

The credit ratio has held on even after demonetisation. For the period between November 9, 2016, and January 31, 2017, the credit ratio stood at 1.24 times. That's nearly similar to the 1.16 times seen between April 1, 2016 and November 8, 2018, the day on which demonetisation was announced.

A credit ratio above 1 time indicates rating upgrades outnumber downgrades.

CRISIL's

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Macro **outlook**

- GDP seen up 30 bps to 7.4% in fiscal 2018
- Investments, especially private sector, will continue to be a drag and trail GDP growth
- Material pick-up in investments likely only in fiscal 2019
- Budget only mildly growth supportive, and not enough to spur employment

GDP to rise just a touch next fiscal

We expect GDP growth to rise 30 basis points to 7.4% in fiscal 2018 from 7.1% in fiscal 2017, driven by a rebound in consumption demand, which got postponed after demonetisation.

Aiding consumption growth will be a normal monsoon, benign inflation and softer interest rates. We expect monsoon to be normal in 2017, too, which will ensure agricultural incomes continue to increase. Interest rates will soften due to improved transmission of policy rate cuts by the Reserve Bank of India (RBI). Further, the RBI's Monetary Policy Committee's aim of 4% inflation over the medium run will ensure inflation remains low and stable.

CRISIL's GDP outlook (constant prices, %, y-o-y)

	FY16	FY17	FY18F
GDP	7.9	7.1	7.4
Agriculture & allied	0.8	4.4	3.0
Industry	8.2	5.8	6.9
Manufacturing	10.6	7.7	7.7
Services	9.8	7.9	8.7

Source: CSO, CRISIL Research. F = CRISIL forecast

Why it will be a grind-up

Investments, particularly private, will continue to be a drag. We expect private investments to trail GDP growth in fiscal 2018 and expect to see a material pick-up only in fiscal 2019.

Also, there is limited support from the global economy (see box on Page 18, '*Only risks, no support from global economy*'),

The Narendra Modi-led government's policy actions have focused on lifting the 'trend' rather than 'cyclical' growth. And prudent monetary and fiscal policies have been accompanied by moderate pace of reforms. This stance has continued through fiscal 2017 as well. Despite headwinds, the Union Budget for fiscal 2018 resisted the temptation to raise the fiscal deficit target and support a sluggish economy. The RBI, too, stayed focused on taming consumer inflation to 4% on a durable basis and bucked pressure to wield the scalpel in its February monetary policy review.

The implications of such a policy stance are:

Short term

- In the absence of stimulus, GDP growth will trudge up slowly
- Higher credibility of policy making, improved investor confidence, and an economy resilient to external shocks. We have already witnessed how improvement in macroeconomic fundaments lends stability to currency in turbulent times: the rupee remained stable despite heightened global volatility and shocks

through 2015 and 2016 (including Brexit, Chinese yuan devaluation, and change in the US Federal Reserve's monetary policy stance).

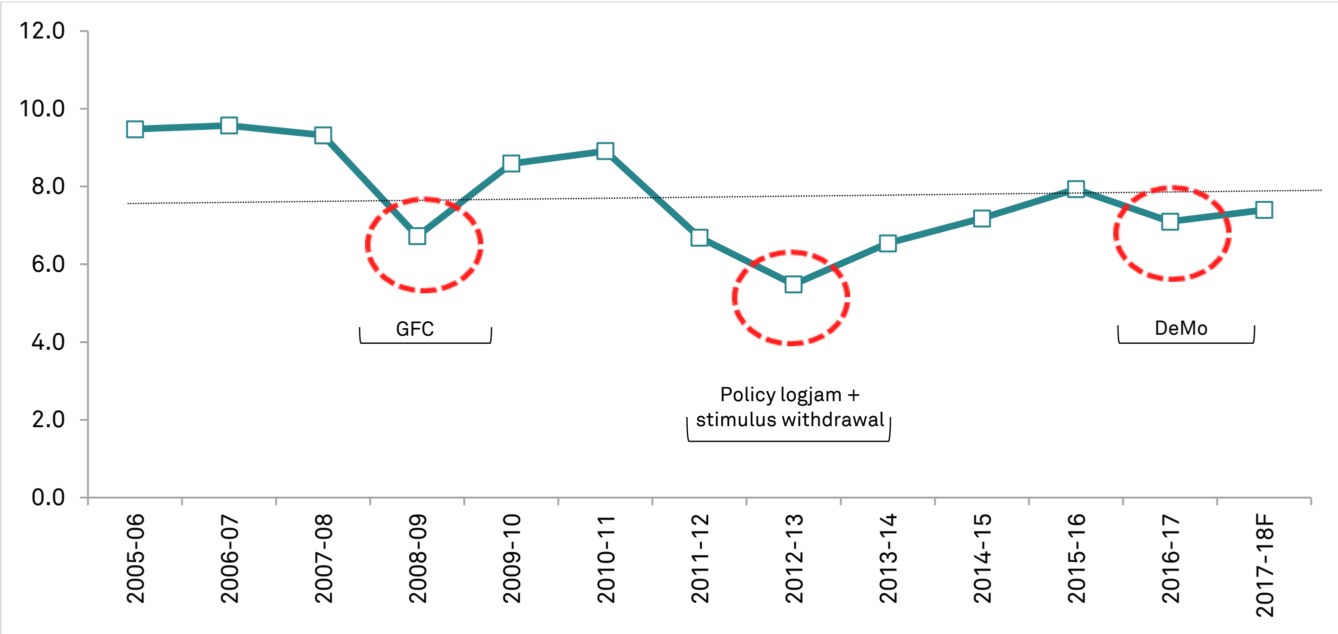
- Calendar 2017 is likely to be quite flighty given the protectionist undercurrents in the US, the possibility of game-changing elections in Germany and France, and a messy Brexit. All of these can be bucketed as 'political risks', and if they materialise, can quickly morph into economic risk. In such an environment, countries with prudent policies will remain relatively resilient to, if not insulated from, turmoil.

Medium term

- Monetary and fiscal prudence accompanied by repair (power and banking sector) and growth-potential enhancing reforms (Goods and Services Tax, or GST, and Bankruptcy Code) will improve India's ability to grow fast in a sustainable manner.
- The focus on digitalisation will usher in efficiency gains in the medium term over a broad spectrum of activities (involving government, citizens and corporates). It will also complement GST in formalising the economy.
- Stable macroeconomic environment creates a conducive environment for development of the corporate bond market *(See section: What Fiscal and monetary prudence means for the economy)*.
- Our bottom-up analysis of key sectors also indicates that while effects of demonetisation are fading away for most sectors, demand is also recovering gradually, but private investments are unlikely to pick up meaningfully. However, the gradual uptick in demand will improve capacity utilisation. That, coupled with the three key themes that will play out over the medium term – which we flag in this report – will be supportive of a revival in the investment cycle in fiscal 2018. These include:
  - Consolidation in many sectors driven by market forces (telecom, cement), policy action for formalisation of the economy (real estate, MSME-dominated sectors) and push for balance sheet repair (power, road).
  - Lower lending rates compared with the past few years, though, on their own, these are not capex decision drivers
  - New frameworks (like Expected Loss-based ratings) and funding tools (InVITs, NIIF, innovative credit enhancement structures) can improve availability of funding

Impact of demonetisation would be transitory

India's growth shocks in perspective (%, y-o-y)



Note: Data till FY12 is on 2004-05 base, FY13 onwards on 2011-12 base new GDP series; F=CRISIL forecast; GFC= global financial crisis 2008-09

Source: CSO, CRISIL Research

Unlike the sharp fiscal and monetary stimulus-led recovery seen after the global financial crisis in fiscals 2008-2009, the rebound from the slowdown in fiscals 2012-2013 has been slow and steady. The Modi government has not used monetary and fiscal tools to pump up growth but rather relied on structural reforms. The positive effects of these are yet to kick in. The macroeconomic policy stance has stayed prudent even after demonetisation.

The steady acceleration in growth, which helped India overtake China in fiscal 2016 as the world's fastest-growing large economy, was on the back of domestic private consumption, which contributed approximately 56% to GDP growth.

However, private consumption growth received a mild setback from demonetisation, which offset the boost from Seventh Pay Commission payouts and a good monsoon. The hardest hit was the informal sector, where the primary medium of transaction is cash – demonetisation not only affected the ability of the sector to transact, but also adversely impacted income and employment.

India's GDP growth decelerated 80 basis points from fiscal 2016 to 7.1% in fiscal 2017 due to moderation in private consumption and dearth of investments. The fall in GDP growth, we believe, hasn't fully captured the impact of demonetisation on the unorganised sector, and could be scaled down further in subsequent data revisions. We believe when that happens, private consumption could show more weakness than seen in the advance estimates.

Demonetisation impact on other macros

- **Decline in inflation transitory:** CPI inflation has trended down sharply after demonetisation due to a slide in food inflation (46% share in overall CPI). Food prices fell due to excess supplies and perishability, and cash crunch following demonetisation forced selling at lower prices. Core (non-food, non-fuel) inflation, on the other hand, has remained sticky. As the cash situation normalises and the favourable base effect goes away, CPI inflation is expected to move up mildly.
- **Surge in deposits and improved transmission should lower lending rates:** Given the possibility of inflationary expectations rising – as core inflation remains sticky and commodity prices continue to move up – there would be limited room for policy rate cuts. But the surge in deposits after demonetisation has left banks with excess funds and this, along with transmission of previous rate cuts, can lead to fresh lending rate cuts. That will benefit the economy, particularly in the next fiscal.
- **Fiscal impact neutral in short run, positive in long run:** Demonetisation is expected to provide impetus to more digital payments and that would help formalise a greater part of the economy. With better payment trails, tax compliance will improve, which would be positive for government revenues in the long run. Further, the economy will gain from GST implementation.

In fiscal 2018, consumption demand is expected to pick up as cash is replenished in the economy and macroeconomic fundamentals – normal monsoon, benign inflation and softer interest rates – remain conducive to consumption growth. The pent-up demand will revive GDP growth to 7.4% in fiscal 2018.

Net-net, demonetisation will not disrupt India's growth trajectory because consumption remains the engine of growth. However, the contribution from investments, whose share in GDP has fallen consistently from 34.3% in fiscal 2012 to 29.2% in fiscal 2017, will remain weak in fiscal 2018.

CRISIL's economic outlook for fiscal 2018

	Unit	FY16	FY17F	FY18F
GDP	%, y-o-y	7.9	7.1*	7.4
CPI inflation	%, average	4.9	4.7	5.0
Fiscal deficit	% of GDP	3.9	3.5	3.2
10-year G-sec yield	%, March end	7.5	6.8	6.9
Current account deficit	% of GDP	1.1	0.9	1.3
Rs per $	March-end	66.3	67.0	68.0

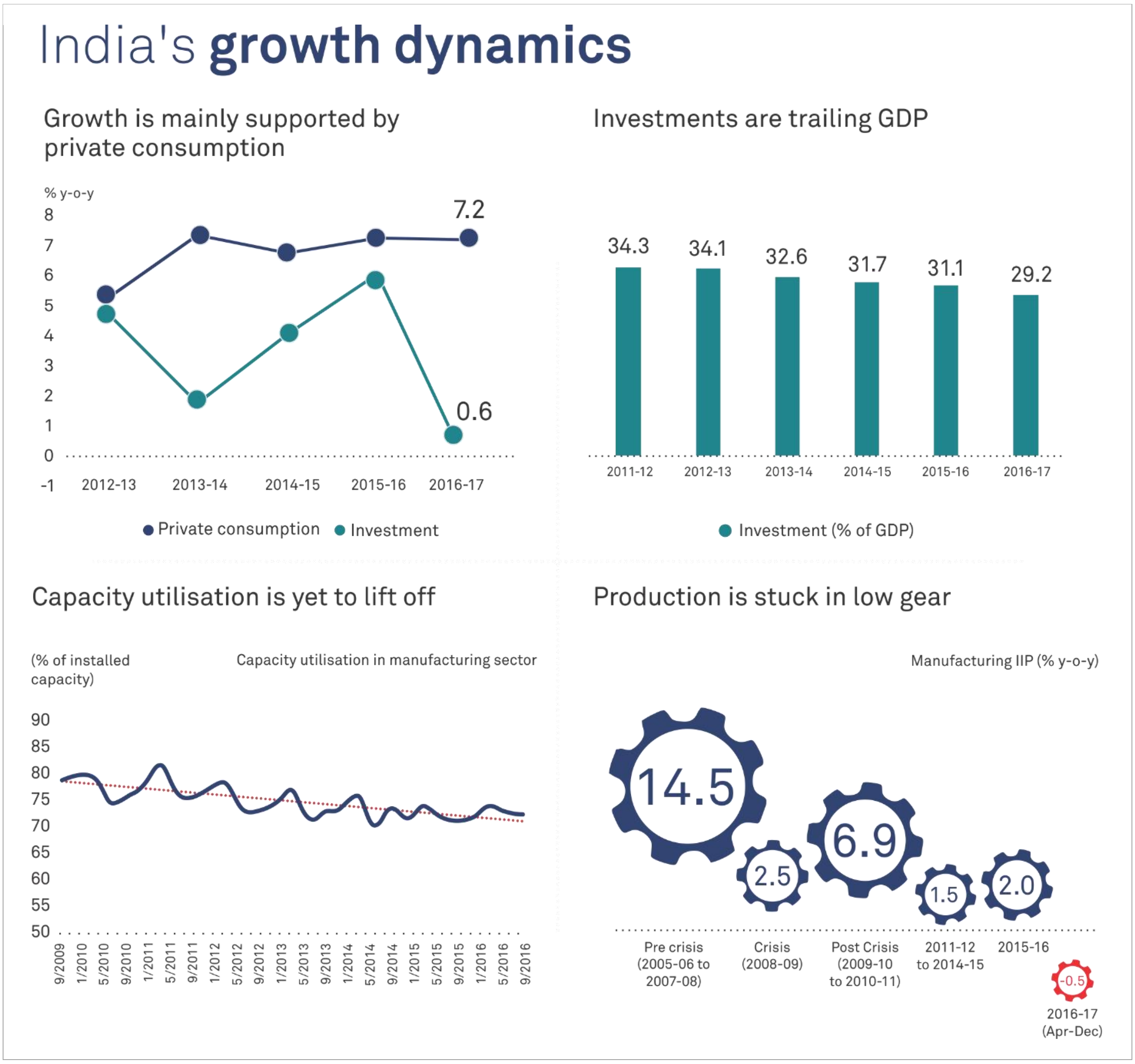
*CSO estimate, F = forecast

Source: CSO, CRISIL Research

Why private investments will be a drag

The narrative on private investment dynamics has not changed in the past 2-3 years as factors such as low capacity utilisation and weak balance sheets of companies continue to deter investments.

Indeed, after fiscal 2011, capacity utilisation in the manufacturing sector has languished, and stood at 72.4% of installed capacity in the quarter ended September 2016, according to data from the RBI. CRISIL's own surveys show this is below the threshold required to trigger fresh investments. In sync, manufacturing sector output also weltered. In the current fiscal, manufacturing output, as reflected by the Index of Industrial Production (IIP), has fallen 0.5% on average, on-year, the slowest growth in a decade.

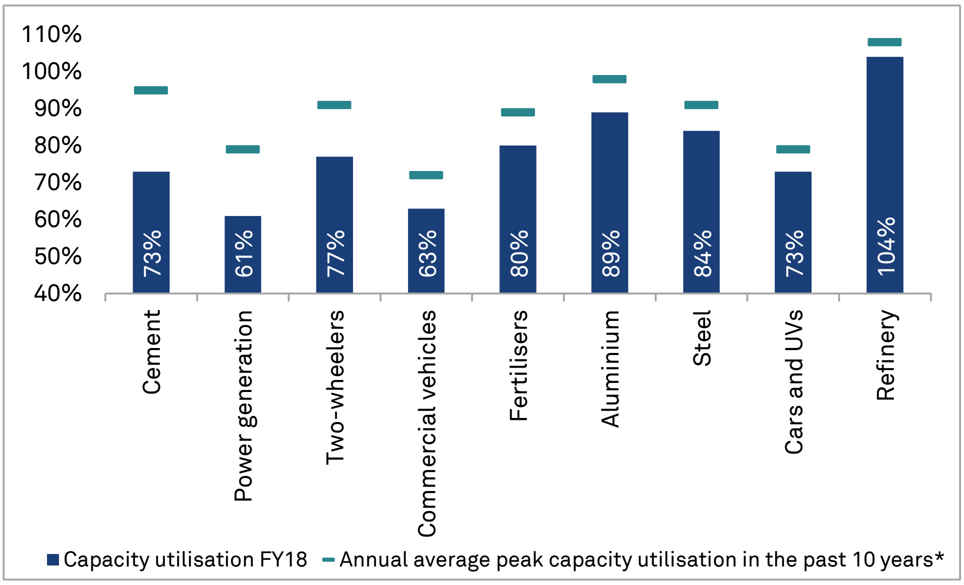


Source: CSO, RBI, CRISIL Research

The current under-utilisation of capacities follows over-investments in 2011-2012, when government stimulus boosted consumption. However, the withdrawal of the stimulus after 2012 and poor agricultural performance for most of the period through fiscal 2016 pulled consumption growth below expectations. And weak global demand dampened industry prospects further.

Demonetisation's impact on consumption growth in fiscal 2017, though transitory, means capacity utilisation will languish for longer. According to CRISIL Research, capacity utilisation will be below optimum for key sectors such as cement, power and auto in fiscal 2018. That would mean a material pick-up in overall private corporate investment would be delayed further.

Capacity utilisation way below optimum in key sectors



Source: CRISIL Research

The government lacks the wherewithal to kickstart the investment cycle. It has budgeted a 10.7% increase in capital spending in fiscal 2018 over the current year. And on its own, the government can only help increase infrastructure investment in areas where it plays a dominant role. The manufacturing sector is dominated by private players, which account for 92% of production, and will need a sustained pick-up in consumption demand to spur investments.

However, some policy parameters are turning a touch positive for investments. The indicators of ease of doing business, for instance, have seen a steady improvement in recent years. India's ranking in World Economic Forum's (WEF's) *Global Competitiveness Index* improved from 55 in 2016 to 39 in 2017. Even on the World Bank's *Ease of Doing Business Index*, India's ranking improved from 131 in 2016 to 130 in 2017.

Once business conditions become favourable (or when capacity utilisation improves and companies deleverage), better ease of doing business and ongoing reforms can hasten private investments.

Budget was only mildly growth supportive

The Union Budget for fiscal 2018 performed a balancing act. Keeping an eye on the deficit reduction goal, Finance Minister Arun Jaitley refrained from stretching the exchequer by offering higher subsidies, even as he announced steps to improve growth prospects in select sectors. Indeed, the Budget was non-expansionary to the extent that it brought down the share of total central government expenditure in GDP to 7.1% in fiscal 2018, from 7.4% this fiscal. However, the expenditure mix tilted in favour of sectors with higher multiplier effects on incomes, such as spending on construction of roads and houses.

The Budget chose to support consumption by increasing investment in employment-generating activities (*see box, 'Not enough to push employment generation'*). Compared with subsidies, such measures are expected to not only boost consumption in the short term, but also create assets that raise growth over the medium term. Sectors such as transport and affordable housing received a shot in the arm, which, in turn, is expected to push demand for cement and steel, generating positive multipliers to employment and income. This will alleviate some stress in the rural areas, which have been hit hard by demonetisation.

The Budget also supported consumption through a reduction in the income tax rate for assessees in the income slab Rs 2.5-5 lakh from 10% to 5%. The lower tax rate will not only encourage people to enter the tax net and comply, but also leave more disposable income in their hands. Going by the number of tax payers, this relaxation should roughly free Rs 33,900 crore for spending.

Thus the budgetary announcements will only have a mild impact on consumption in fiscal 2018.

Not enough push to employment generation

Budgetary allocation to employment-generating schemes is up a bare 2.5% in fiscal 2018 compared with 37.5% in fiscal 2017. The approach in last month's Union Budget was two-pronged. First was to provide a safety net to the rural population – the segment hit hardest by demonetisation – through higher spending on the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS). Second was to provide for durable employment opportunities by increasing allocation to sectors with large employment intensities.

MGNREGS has the highest share in budgetary allocation among short-term employment-generating schemes at 80%, with the balance going to smaller schemes floated by the ministries of labour, skill development, textiles, financial services and micro, small and medium enterprises. In fiscal 2017, the government spent nearly 23% more than budgeted under MGNREGS, primarily to cushion the rural economy from the impact of demonetisation. Accordingly, the Budget has only allocated about 1.1% more funds to the programme for fiscal 2018. The spending orientation under the scheme creates a temporary safety net.

The government has also increased allocation to sectors that have the potential to create durable employment opportunities and simultaneously create infrastructure. There was thus increased allocation to construction activities such as roads (highways and rural roads), bridges, ports and affordable housing. Affordable housing under the Pradhan Mantri Awas Yojana (PMAY) received a special allocation of Rs 29,000 crore, an increase of 38.7% over fiscal 2017, while allocation for transport infrastructure (roads, highways, bridges and ports) rose 11%. The construction sector, in particular, is highly labour-intensive – requiring about 13 workers to produce Rs 1 million of output – and also employs low-skilled workers who are available in plenty. So higher budgetary focus on these sectors can push incomes, act as consumption boosters and have multiplier effect on sectors such as steel and cement.

For the government, pushing the roads sector has always helped in times of crisis. When the monsoon failed in 2002, the thrust on the National Highway Development Project helped create rural jobs. In drought-hit 2009, the expansion of MGNREGS ensured rural jobs were aplenty. And in 2012, when rains were inadequate and poorly distributed causing drought-like situation in certain states, MGNREGS came to the rescue. In the last two years, too, the government has sharpened focus on construction for transport infrastructure – a sector where the government's capacity to invest and create positive spillovers on the economy is huge.

But much more is needed as India faces a massive challenge of employment creation. Even with a low labour force participation rate of 58%, our calculations show that the number of job seekers would rise 15% over the decade spanning 2015-2025. In the global context, by 2025, India will add nearly 27% of the incremental working age population globally. It's a staggering number and challenge. Inability to create employment will keep India from reaping the demographic dividend.

Raising the medium-term growth potential remains work in progress

Global experience suggests structural reforms – as opposed to aggressive monetary and fiscal policies – are not only onerous but also raise the trend growth with a lag. To its credit, the government is focusing on structural reforms and has initiated measures – both incremental and new – that would improve India's competitiveness. Over the past two-and-a-half years, steps have been taken to mend the electricity and banking sectors. More importantly, there has been sharp focus on digitalisation to increase formalisation of the economy, and the government has also been able to pave way for implementation of GST next fiscal. We believe all this will be work in progress for some time and the momentum needs to continue through the political cycle to get the desired bang for buck.

Three factors that make us go long on India are:

- Goods & Services Tax (GST)
- Prudent monetary and fiscal policy
- Digitalisation thrust

Paving the way for the implementation of GST in fiscal 2018

The government is expected to introduce the GST Bills, along with the compensation Bill for clearance in the second half of the Parliament's Budget session. The GST Council in its latest meeting gave in-principle approval to the two key draft laws of Central GST and Integrated GST. Final approval to these laws, along with the other two pending laws of State GST and Union Territory GST, are expected by mid-March.

As for the coverage, while petroleum products are to be brought under GST at a later date, a few goods and/or services – alcohol, electricity and real estate – are likely to be left out.

While complete implementation of GST is expected to bring efficiency gains and lead to higher tax compliance in the long run, there are expected to be disruptions and likely loss of revenue in the short run as the economy shifts to this new regime. It entails setting up huge IT infrastructure, educating all stakeholders about complying with GST and bringing them on board, which is a challenging task. That apart, the diluted GST structure raises concern on its efficacy in rationalising the indirect tax structure in the economy. GST is proposed to have a four-tier rate structure of 5%, 12%, 18% and 28%. Additionally, a cess above the peak rate on luxury and demerit goods such as tobacco has been proposed. It is yet to be decided which goods and services will come under which tax bracket.

Although GST is unlikely to be rolled out in its ideal form, it will yet mark a significant improvement over the current distorted indirect tax structure in the country.

What fiscal and monetary prudence means for the economy

Monetary and fiscal policies are the two pillars of prudent macroeconomic policy, and the government and the RBI have acquitted themselves well on both counts.

Macroeconomic prudence enhances the credibility of policy making, improves investor confidence, and makes the economy more resilient to external shocks. We have witnessed how strong macroeconomic fundamentals lend stability to currency in turbulent times. In 2013, when inflation and current account deficit in India were high and growth low, the so called 'taper tantrum' in the US led to extreme rupee volatility. But during the past two years, the rupee has shown remarkable stability despite multiple global shocks, thanks to its prudent macro policies. In 2017, political risks (such as protectionist stance of the US, elections in Germany and France, and a messy Brexit) have the potential to morph into economic risks. In such an environment, policy prudence makes the economy more resilient – if not insulated – to turmoil.

In a recent instance of policy prudence, fiscal deficit/GDP target for fiscal 2018 was set at 3.2% of GDP (despite a deviation of up to 0.5% allowed through an amendment to the N K Singh Committee on Fiscal Responsibility and Budgetary Management Act), down from 3.5% to be achieved in fiscal 2017. Such prudence allows for better monetary and fiscal policy coordination. Moving away from the path of fiscal consolidation would not have sent the right signal to monetary authorities, which now follow the inflation targeting framework to ensure low and stable inflation regime in India.

This strengthens macroeconomic fundamentals by improving the growth-inflation mix in a slow but steady manner. While a stimulus would have supported the economy in the short run, it may not be sustainable in the long run. Our experience shows that while India managed to achieve high growth in the aftermath of the global financial crisis of 2008 on the back of monetary and fiscal stimulus, its fiscal deficit and inflation surged. Ultimately, the stimulus had to be withdrawn. In the current weak domestic demand and global environment, the government has thus far restrained itself from giving a cyclical push to growth, but, at the same time, has initiated a number of steps (as elaborated in the previous section) that should raise the potential or trend growth of the economy in the medium to long term.

Improved fiscal-monetary policy coordination also bodes well for development of bond markets.

Economic literature tells us that fiscal-monetary coordination can help deepen the corporate bond market. A conservative fiscal policy will help the RBI achieve its monetary mandate, which is the inflation target.

Inflation has been a critical factor in the development of the corporate bond market. According to a study of 49 corporate bond markets by John Burger and Francis Warnock[1], low and stable inflation has a significant positive impact on the ratio of local bond market size to GDP, and on the share of a country's outstanding local-currency bonds.

Fiscal policy also influences private sector participation in the corporate bond market in a number of ways. A high fiscal deficit reduces the available savings pool for the private sector to draw from. Burger and Warnock showed that a higher fiscal deficit expands the government bond market, but not the corporate bond market.

A cross-country comparison shows that countries with robust, stable and predictable macroeconomic fundamentals witnessed rapid development of their bond markets, especially the corporate bond market. For example, local-currency bond markets in Brazil and Mexico grew after their governments took appropriate measures to bring inflation under control.

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[1] John D Burger and Francis E Warnock (2006). *Local Currency Bond Markets*. IMF Staff Papers Vol 53, 2006
[2] Digitisation refers to the change in the form of data from analog to digital. Digitalisation, on the other hand, refers to the use of digital technology to change a business model

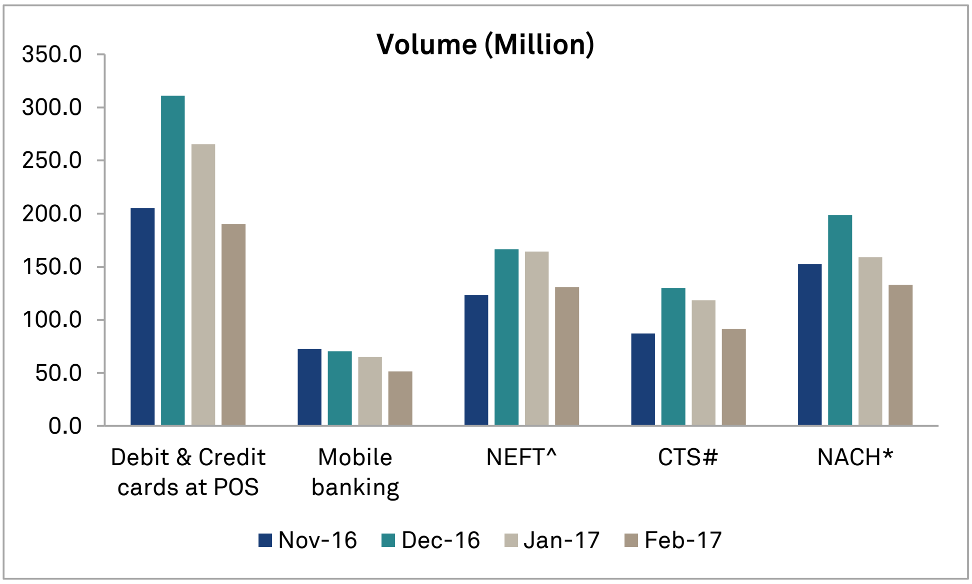
Digitalisation enhances efficiency, improves trails and compliance

Apart from the essential and near-term motive of curbing illegal money, the objective of the government's demonetisation drive was also to push people towards digitalisation[2] (or digital transactions) and make the economy less-cash based. Demonetisation followed a string of measures to expand digital such as through Jan Dhan bank accounts and fast-tracking of Aadhar registrations.

A more formal economy means better transaction trails, which can improve financial savings and also tax compliance because evasion becomes difficult. GST will complement this by narrowing the gap between unorganised and organised firms as input sourcing from compliant firms will be needed for tax set-off.

There are also implications for the central bank (*see box, 'Will digitalisation have an impact on monetary policy?*'). A large part of the RBI's profit comes from issuing or printing currency. Also, given a level of money supply, a rise in digitalisation, with more money in banks than in the form of cash, will boost the money multiplier. This can have positive spillover effects on monetary policy.

Electronic payment systems yet to lift off decisively



*National Automated Clearing House # Cheque truncation system ^National Electronic Funds Transfer

Source: RBI

While all these are welcome steps, the challenges of inadequate IT infrastructure and poor internet connectivity[3] remain, and the shift towards less-cash society will therefore be gradual, requiring consistent push from the government.

[3] India ranked 91 on World Economic Forum's Network Readiness Index 2016, behind most emerging market peers

Will digitalisation have an impact on monetary policy?

Let us consider a scenario where the Indian economy sees a major shift from cash to digital transactions. Does it have implications for monetary policy making?

- ***Impact on money demand:*** Money supply is a crucial policy instrument of the RBI to achieve desired inflation in the economy. To calculate the stock of money in the economy, the RBI considers currency with public, demand deposits, and time deposits. As the economy moves towards digital payments, demand for cash will reduce. If this is met by commensurate rise in demand and time deposits, there will be no change in money demand in the economy.

- ***Impact on seigniorage***: Seigniorage is the profit made by a central bank when it issues domestic currency. The profit equals the monetary value of the currency issued less the cost of issuing it. Given that the rupee notes issued by the RBI constitute 53% of its total liabilities[4], the assets generated against it comprise a major chunk of the RBI's income. So can the shift from cash to digital transactions reduce seigniorage of the RBI?

  Harvard University economist Kenneth Rogoff[5] has considered an interesting scenario where there is a complete phase-out of paper currency. If all cash transactions in an economy goes digital, there is no loss of seigniorage. That's because demand for the domestic currency will remain the same, and hence, the liabilities of central bank will also remain the same. However, if some of the existing cash transactions are not carried out through the digital medium, there will be a reduction in demand for domestic currency, and hence, loss in seigniorage for the central bank. That could happen because transactions that are intended to be anonymous (or illegal) will not be carried out through the electronic medium, which records the trail. Hence, there will be some loss of revenue for the central bank, which can affect its ability to conduct monetary operations.

  In India, Rs 500 and Rs 1,000 bank notes were replaced with new Rs 500 and Rs 2,000 bank notes. If all the demonetised bank notes come back to the RBI, there will be no reduction in its liabilities, but there will be some short-term loss of seigniorage due to the additional cost of printing the new bank notes. It remains to be seen how much of rupee demand from te black economy will get extinguished over time.

- ***Impact on money multiplier***: The money multiplier is the ratio of stock of money in the economy to the cash that the central bank releases in the economy[6]. The reduced demand for cash would, therefore, increase the money multiplier in the economy. As more transactions will be done through the banking channel, the transmission of any monetary policy change can become more effective.

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[4] As in fiscal 2016. Source: RBI Annual Report, 2016.
[5] Rogoff, K (2014): Costs and benefits to phasing out paper currency, National Bureau of Economic Research
[6] Kumar, A (2017): Economic Consequences of Demonetisation: Money Supply and Economic Structure, *Economic and Political Weekly*[7] CRISIL considers proprietorships/partnerships with less than 10 permanent employees as unorganised entities.

Risks to watch out for in fiscal 2018

Divergent policies worldwide can increase uncertainty: Inward-looking trade policies of the US and the UK raise uncertainties with respect to the future of world trade, especially for a country like India, where exports are yet to show a substantial pick-up. Such policies and rising interest rates in the US could restrict foreign capital inflows into India. At the same time, divergent monetary policies – such as tightening in the US and easing in Europe and Japan – can cause uncertainty and volatility in capital flows. Also, any geopolitical tension that triggers policy reactions can add to uncertainty, such as a spike in oil prices.

Inflation risk from global price spikes: Globally, oil and commodity prices are expected to rise. The World Bank foresees global metals prices rising 10-15% in 2017. Similarly, global crude oil prices are also forecast to jump up over 20% in 2017. Since India is a net importer of oil and commodities, any increase in global prices has implications for domestic inflation, the import bill, and the government's fuel subsidy spend. Therefore, any sudden spike in global prices caused by unanticipated geopolitical developments will create macro instability.

Fiscal risks: Two risks to watch out for are disruptions in GST implementation and slippage in disinvestment revenue. While the former doesn't have precedent, the latter has happened often in the past. Both could lead to revenue loss for the government, and can upset its fiscal math.

Monsoon: So far, the prospects of monsoon 2017 appear favourable. Global weather forecasters such as the International Research Institute for Climate and Society, Columbia University, the Japan Agency for Marine Earth Science and Technology and the National Oceanic and Atmospheric Administration have signalled caution as their preliminary forecasts foresee an El Niño event in the second half of 2017, with some assigning a 50% probability of occurrence. However, there is a fair degree of uncertainty associated with these early forecasts, so it will be premature to conclude that an El Niño condition will affect rains in 2017.

According to news reports, the Indian Meteorological Department (IMD) believes it is unlikely to affect the main monsoon season in India as El Niño is forecast to occur towards the end of September when the southwest monsoon season ends. The IMD will formally release its first range forecasts for the season in April 2017. Typically, El Niño conditions impact spatial distribution of rainfall, causing floods in some parts and drought in others. A normal monsoon is crucial to push economic growth this year, given weak investment climate, demand dent caused by demonetisation and the already fragile consumption.

Only risks, no support from the global economy

Protectionist rhetoric is gaining traction in advanced economies. Although the International Monetary Fund (IMF) forecasts the world will grow at a modest pace of 3.4% and 3.6% in 2017 and 2018, respectively, it highlights that recent policy uncertainties and protectionist pressures in advanced economies will act as growth risks. Inward looking policies of the US and the UK have raised uncertainties with respect to the future of world trade.

Trade: Weakening global trade prospects are evident in falling world trade/GDP ratio. A rise in protectionism can hit trade further. The US being one of India's major trading partners (goods trade surplus of $15.5 billion from April to December 2016), US President Donald Trump's 'Buy American, Hire American' agenda can hurt India's trade prospects. Indian pharmaceuticals exporters (40% of India's pharma exports is to the US, and domestic firms have a 5% share of the US generic drug market) could be the hit if protectionist policies enable US-based companies to lower prices.

India's ITeS exports to the US, which account for 62% of India's total ITeS exports, may be hit if the protectionist policy takes wing. The proposed H1-B visa amendment, which suggests to double the annual minimum wage for non-immigrant workers from $60,000 to $130,000, may mar the profits of Indian IT firms. Also, remittance from the US, which is the largest source of remittance for India, could be hurt with rising protectionist sentiments. Attempts to tighten H1-B visa norms have not been successful in the past, but this time, the rhetoric is louder. We need to keep our fingers crossed and monitor President Trump's economic programme closely. India's trade also has the additional risk of bearing the brunt of rising populist sentiments in the upcoming elections in France and Germany.

Foreign investment: India has good macroeconomic fundamentals, making it resilient to capital volatility. However, speedier Fed rate hikes can hurt capital flows into emerging markets, including India. There has been net FII outflows of $1 billion between April 2016 and February 2017. Inward-looking policies in advanced countries can restrict FDI flows, which has been quite strong until now.

CRISIL's

INDIA OUTLOOK

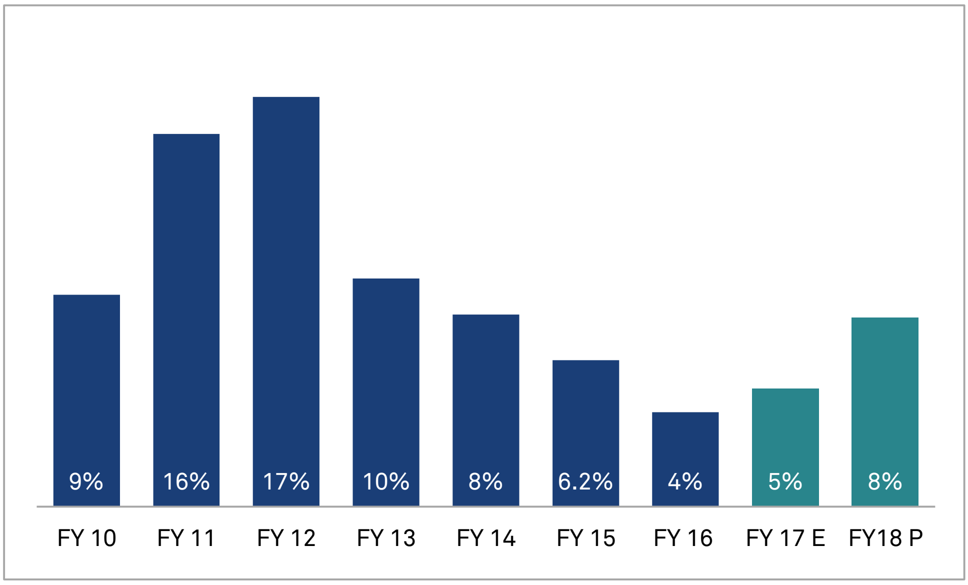
ECONOMY • INDUSTRIES • MARKETS

Corporate **outlook**

- Corporate revenue growth will touch a 5-year high, but stay in single digit
- Demonetisation effect fading away except for real estate and linked sectors
- Transportation sector to see efficiency gains from GST, leading to 1.5-2% lower freight rates
- Effective RERA implementation can change the real estate landscape
- Commodity price rise to increase input cost pressure for many sectors
- Despite lower interest rates capacity overhang to restrict industrial capex
- Consolidation to be a theme throughout the year

India Inc revenues to edge up

But recovery in topline growth would be gradual

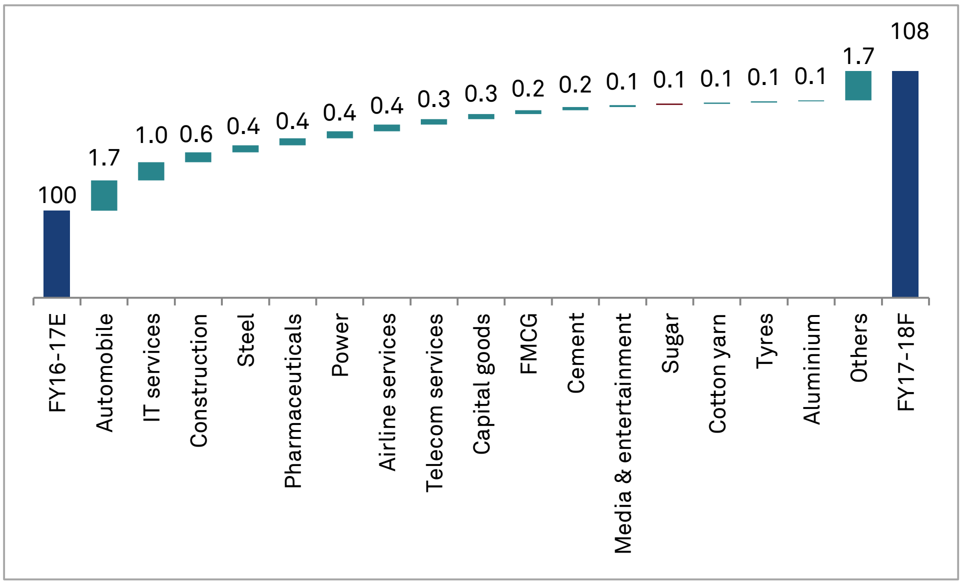


Note: Data for key NSE-listed companies excluding financial and oil companies;
E: Estimated, P: Projected

Source: CRISIL Research

Single-digit revenue growth seems to be the new normal for India Inc. However, fiscal 2018 would log the highest revenue growth after fiscal 2014

Sector-wise revenue growth contribution in fiscal 2018

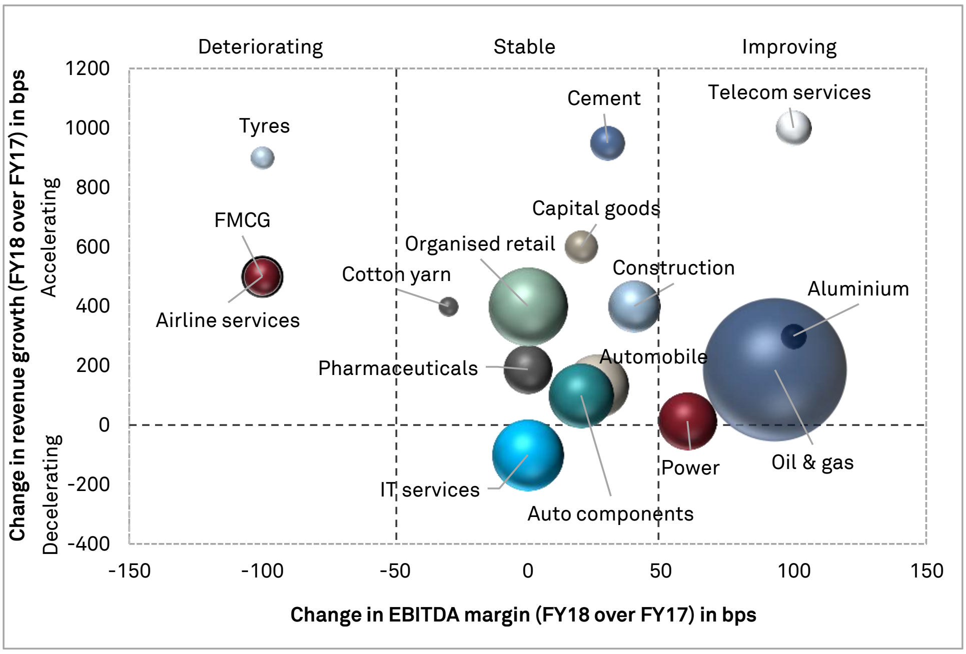


Note: F = Forecast, E = Estimate

Source: CRISIL Research

Revival in the steel and construction sectors is a positive

Growth versus profitability across sectors



The steel sector is not represented in the chart above. Steelmakers posted a significant 20% increase in revenue riding on sharp price hikes in FY17. However, the scene would change in FY18 because of moderation in prices

Bubble indicates relative size of the industry by revenue of listed companies

Source: CRISIL Research

Upside to corporate profitability is limited in fiscal 2018 after the 100 bps improvement seen in fiscal 2017

Key themes that would impact India Inc's performance in fiscal 2018 and beyond:

1. Demonetisation impact
2. GST regime kicking in, and other policy changes being made
3. Continued strength in the commodity cycle
4. Increasing consolidation across sectors
5. Slowing industrial capex despite lower interest rates

Theme 1: Demonetisation effects fading away

Rural-led sectors take a knock; impact on real estate linked sector to continue

	Sectors	Impact* in FY17	Impact* in FY18	Key reasons
Consumption	Gems and jewellery	(8)-(10)%	↔	Large presence of small players who rely heavily on cash transactions
	Two-wheelers	(6)-(7)%	↔	Higher proportion of cash transactions and low finance penetration of 25%
	Consumer durables	~(4)-(5)%	↔	High share of cash-reliant traditional sales channel
	Passenger vehicles	(2)-(3)%	↔	Higher waiting periods and high finance penetration helped minimise the impact
	Real estate	(2)-(4)%	(7)-(9)%	Cautious purchase decisions; implementation of RERA awaited
Industrial	Cement	(2)-(2.5)%	(0.6)%	Housing segment accounting for two-thirds of demand impacted severely. Effects on this would continue.
	Steel	~(1)%	(0.5%)	Building and construction, which accounts for a third of demand, was impacted the most

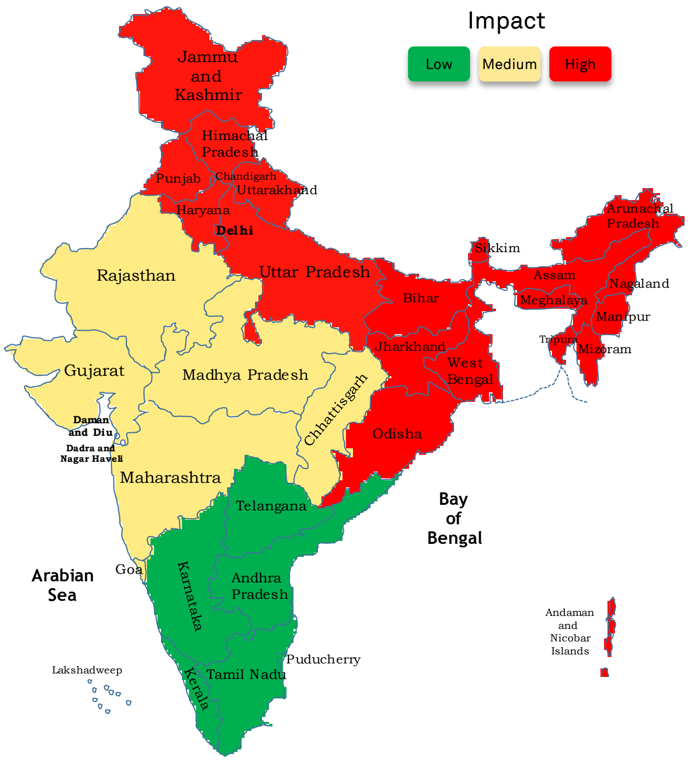
*Impact: Loss in demand due to demonetisation as a percentage of annual volume/value

Consumption demand bore the brunt of demonetisation because of its discretionary nature

Demonetisation impact varied across regions

North hurt the most, south largely unscathed

Passenger vehicle sales growth (Q3 FY17)



Percentage growth in Q3 FY17, year-on-year	
North zone	-7%
East zone	-8%
West zone	3.6%
South zone	9%

South India fared well in passenger vehicles growth, largely due to better access to banking channels and higher financial inclusion

Proportion of cash purchases, urban-rural mix and nature of demand determined extent of impact

Factors affecting demand	Impact on auto segments				
	Passenger vehicles	Two-wheelers	Tractors	Light commercial vehicles	Heavy commercial vehicles*
Finance penetration	Moderate	Low	Moderate	High	High
Rural sales proportion	Low	High	Very High	Moderate	Low
Nature of demand #	High	High	Low	Moderate	High
Volume lost* (% of FY17)	2-3%	6-7%	2-3%	1-2%	3-4%

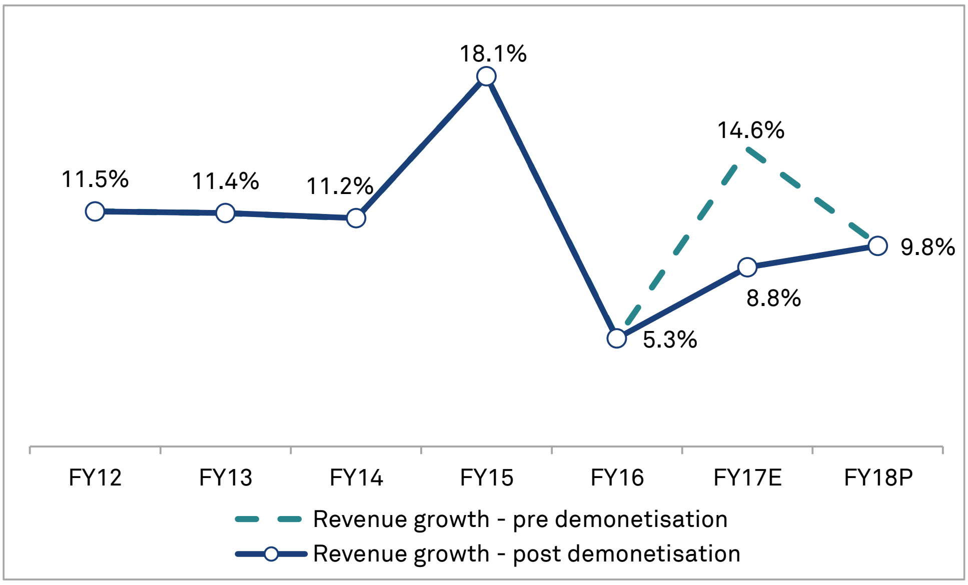
* Sales from manufacturers to dealers

(Discretionary/business driven)

Source: CRISIL Research

While passenger vehicle sales were insulated by higher waiting periods, the tractor industry managed the impact by extending credit

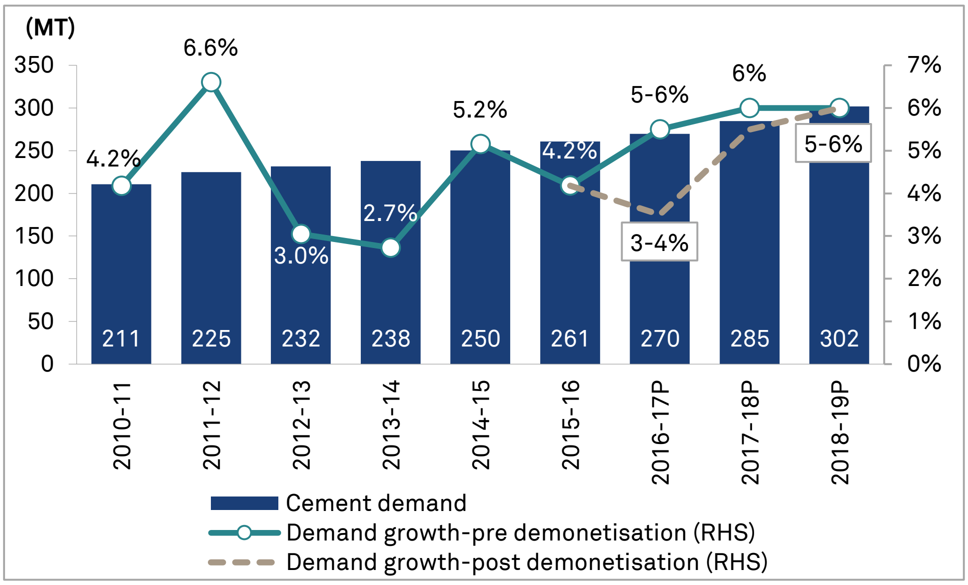
Consumer durables industry to lose out on Rs 4,000 crore revenues in FY17



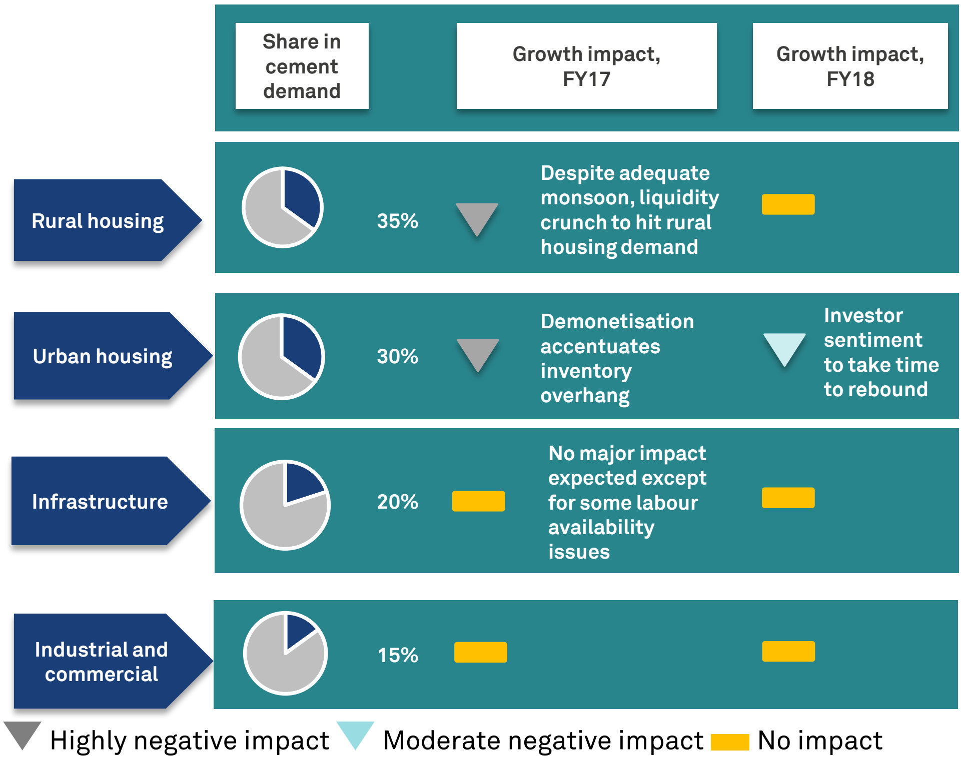
Source: CRISIL Research

The demand revival expected in fiscal 2017 on the back of a good monsoon and Pay Commission payments was dented by demonetisation. While urban markets have since normalised, rural areas are expected to come to be so by April-May 2017

Demonetisation impacted revival in cement demand growth; full recovery seen only by FY19

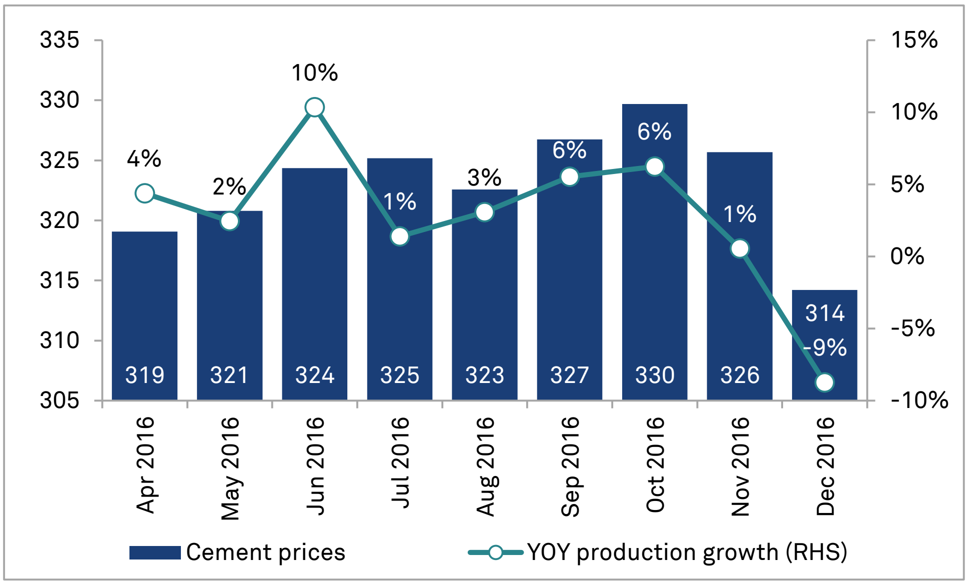


Housing segment, the biggest contributor to cement demand, hit the hardest



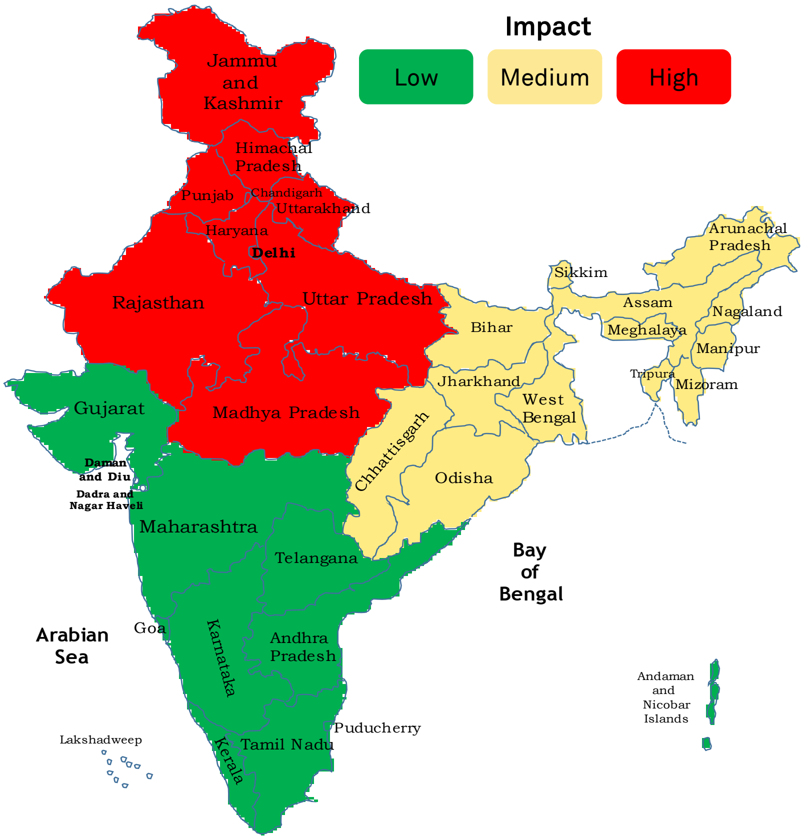
Negative impact on urban housing to continue in fiscal 2018

Cement demand and price movement



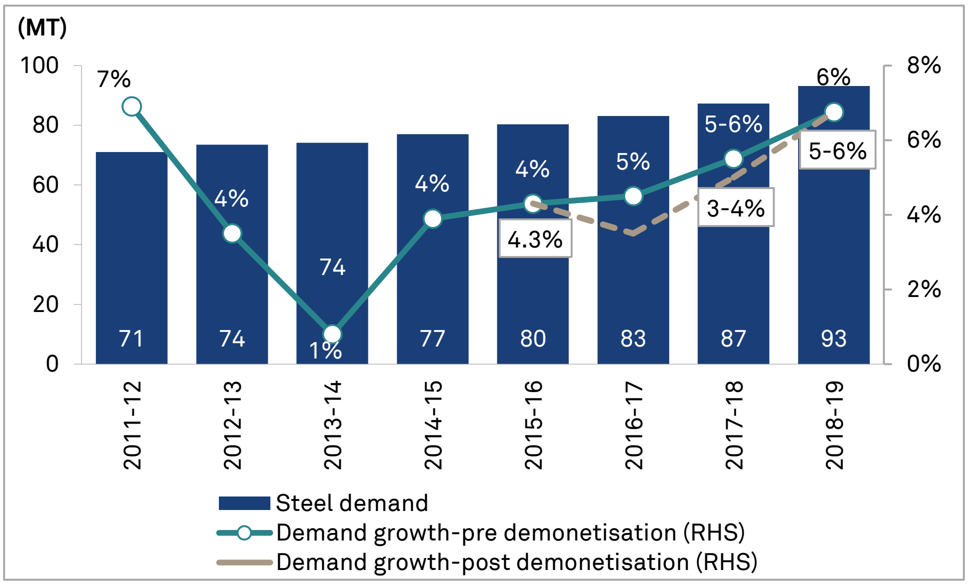
It was a double whammy for the cement sector with both price and volume declining

Cement: South showed the least impact of demonetisation, including in the case of passenger vehicle sales

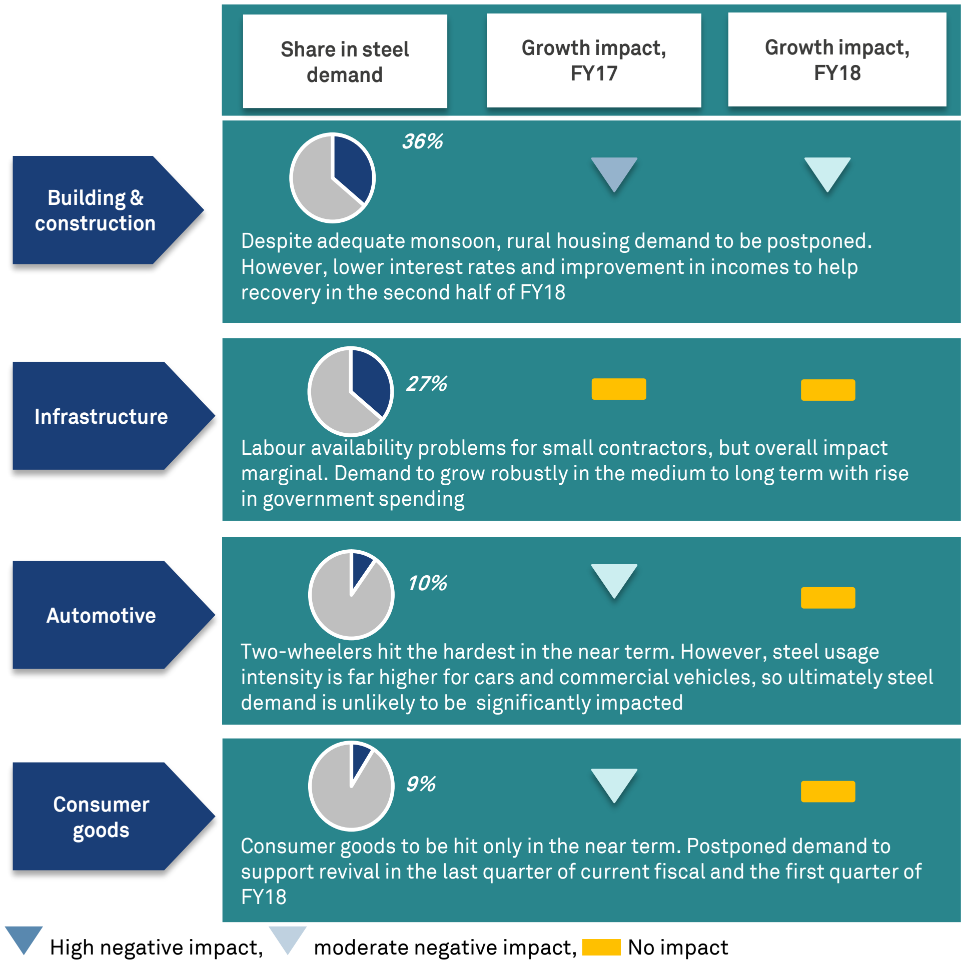


South India fared well in cement, indicating lower proportion of cash trade and/or relatively better access to banking channel

Demonetisation slices 100 bps from steel consumption; full revival only by FY19



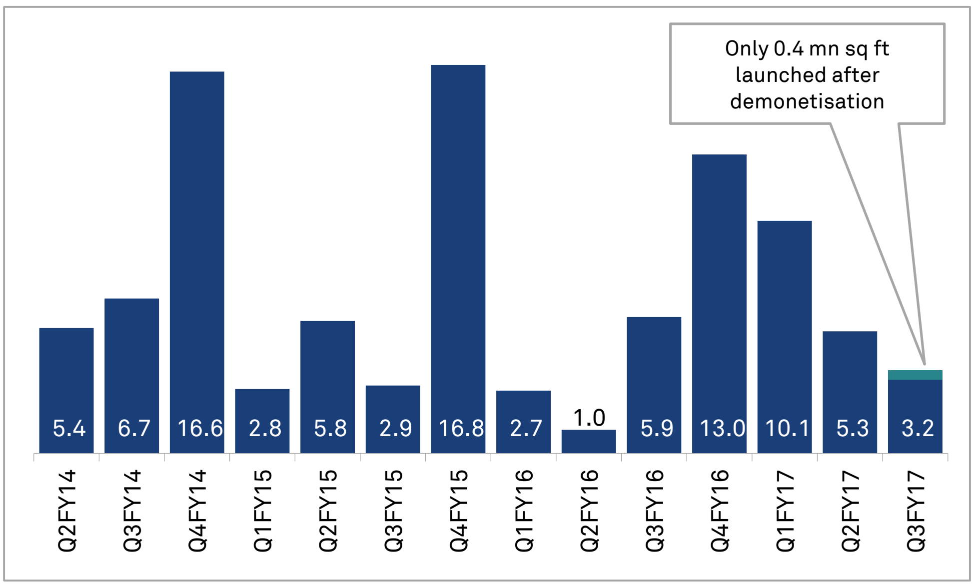
Steel demand has been impacted the most by slowdown in the building and construction segment



While demand recovers in the automotive and consumer goods sectors, impact on the building and construction sector would continue in fiscal 2018

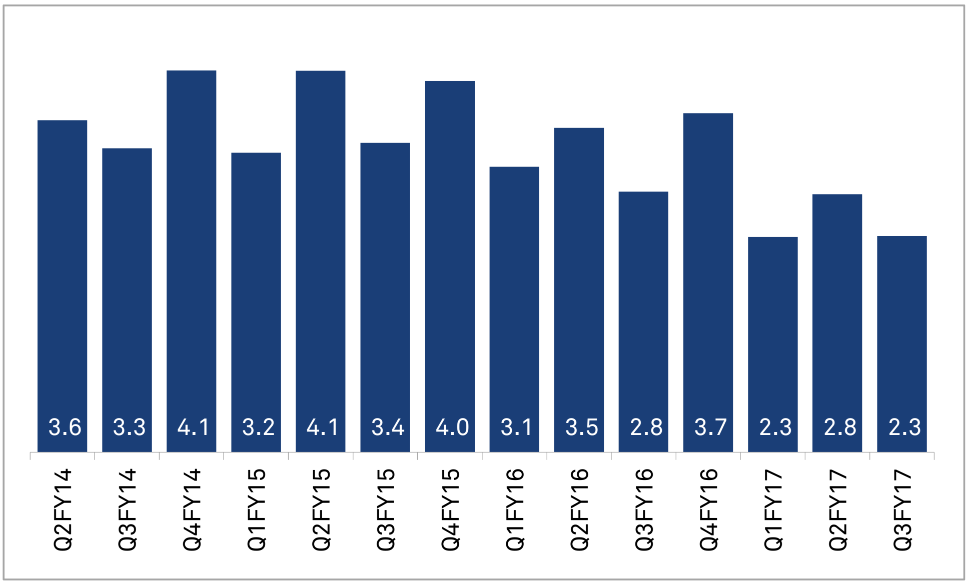
Real estate slowdown evident; new project launches dry up

New launches (in million sq ft)

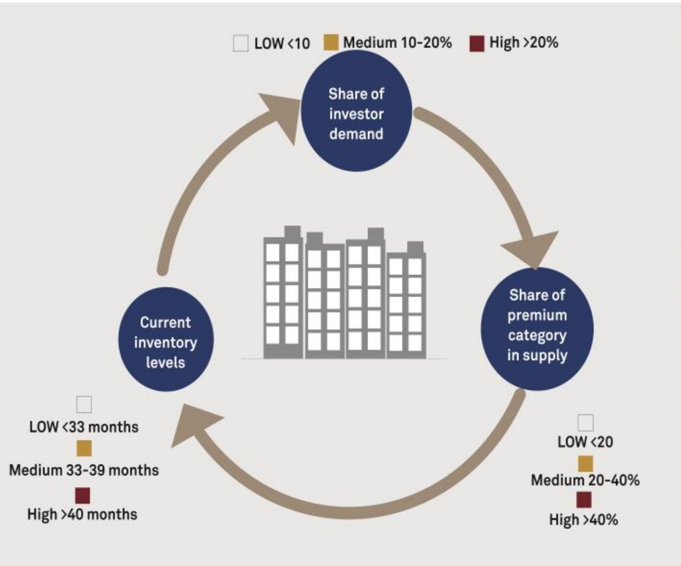


No respite in sight for India's slowing real estate market; even developers have now turned cautious

Area sold (in million sq ft) continued to decline



Impact on residential property demand across top 10 cities



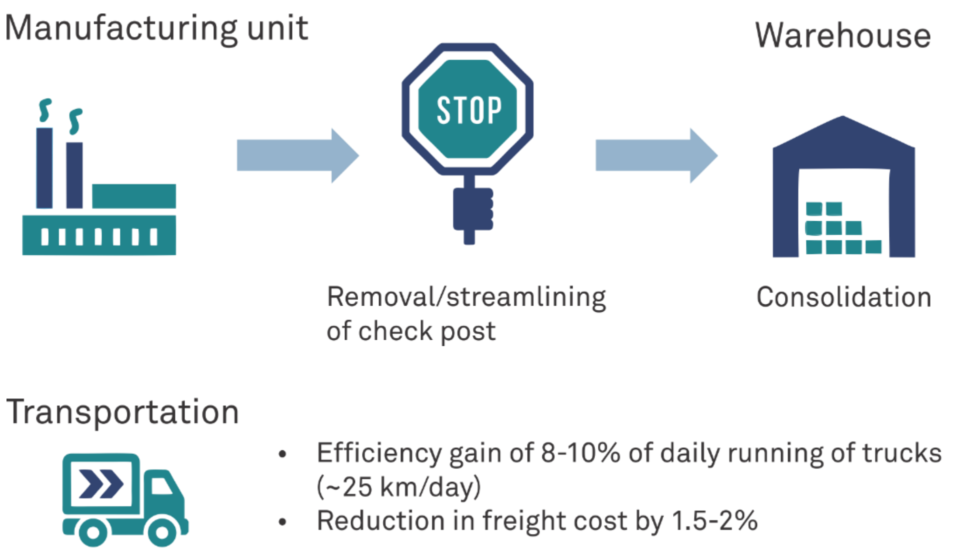
Factor	Pune	NCR
Share of investor demand	Medium	High
Share of premium category in supply	Low	Medium
Current inventory levels	Low	High
Net Impact	Low	High

Cities	Impact of Demonetisation
NCR	High
Mumbai	High
Ahmedabad	High
Bengaluru	Medium
Hyderabad	Medium
Kolkata	Medium
Chandigarh	Medium
Chennai	Low
Pune	Low
Kochi	Low

Larger real estate markets such as NCR and Mumbai impacted the most due to higher proportion of investors and high inventory levels

Theme 2: GST, other policy changes to drive sectoral performance

How GST will spawn efficiencies



Higher efficiencies can potentially bring down freight costs by 1.5-2%

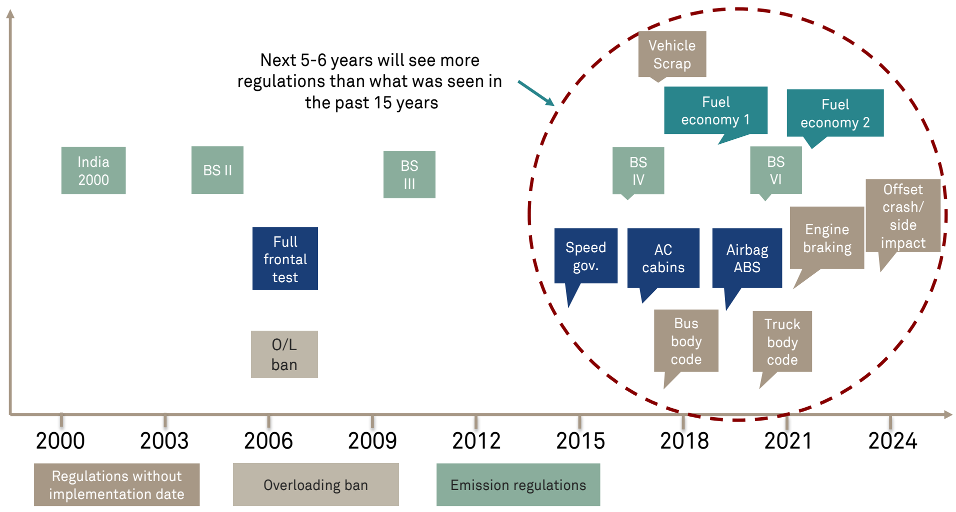
Warehouse consolidation to drive biggest savings

Savings (as a percentage of sales)	Consumer durables	FMCG	Pharma	Automobiles
Overall savings	**High**	**Medium**	**Medium**	**Low**
Warehousing costs	High	Medium	Medium	Low
Reduction in inventory	High	Medium	Low	Low
Transportation costs	Low	Low	Low	Low

Source: CRISIL Research

Consumer durables firms to accrue maximum benefits, followed by FMCG and pharmaceuticals firms

Automobile industry to face significant regulations in coming years



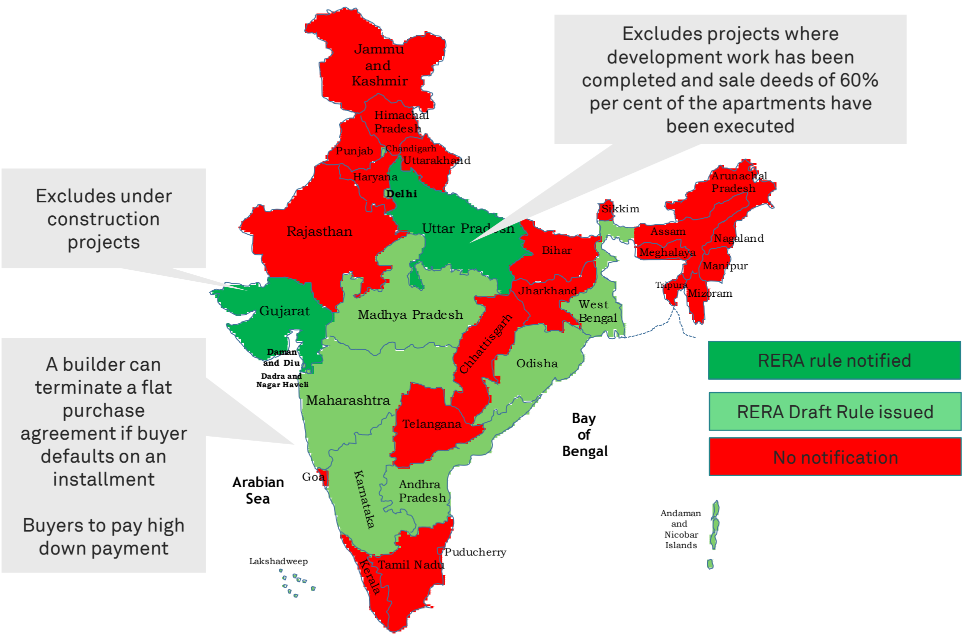
Conforming to new norms would push up vehicle prices

Effective implementation of RERA can change the real estate landscape

Impact on developers	Key rules under RERA
Cost escalation	• Mandatory registration of ongoing projects (residential and commercial) • Submission of details on company history, projects and all stakeholders • Quarterly website updates on Project status, sales and approvals
Ability to launch multiple projects	• 70% of the sales proceeds in a separate escrow account
Penalties and litigation	• Penalties for non-registration of the project or violation of the order of the Real Estate Appellate Tribunal

RERA aims to ease the predicament of house buyers by engendering greater transparency and ensuring timely project delivery

Many states yet to notify RERA, others go for diluted versions



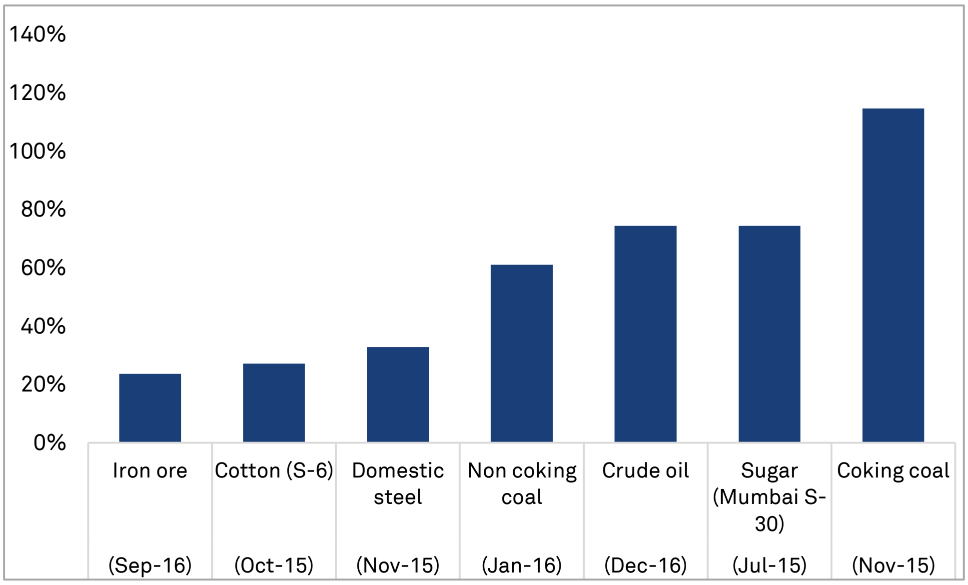
However, upholding of key clauses under RERA in state notification is crucial for the benefits to come through

Theme 3: The commodity cycle

After 3 years, the commodity cycle is on an upward trend, which will put pressure on profitability

Sharp rise in commodity prices in the last 18 months

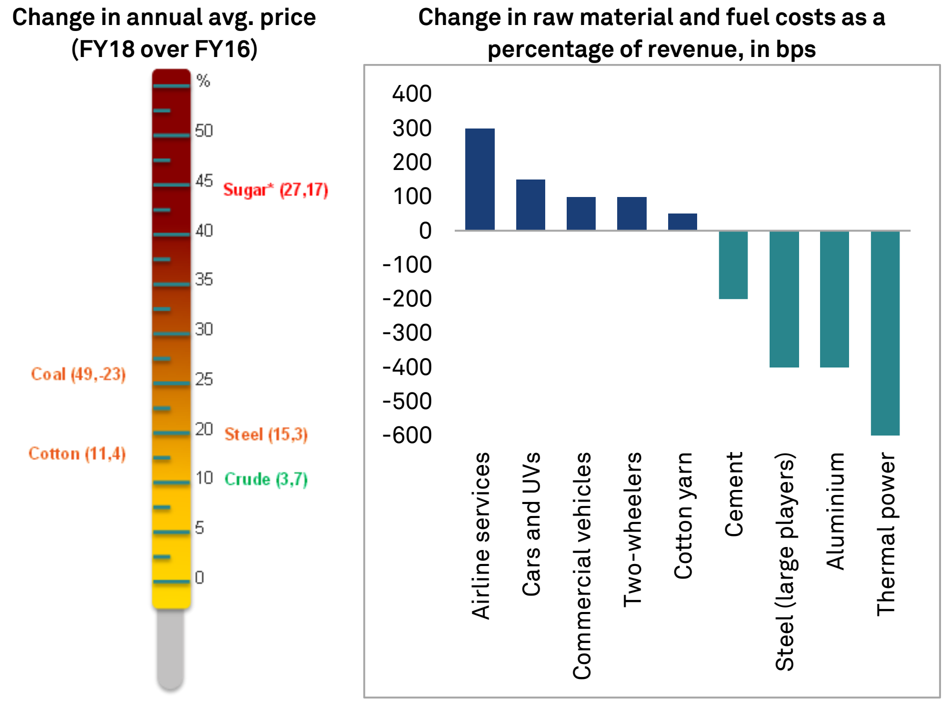
Percentage price increase between December 16 and lowest price month



* Month in the bracket indicates lowest price month during recent period

Source: CRISIL Research

Varied impact of commodity price rise across sectors



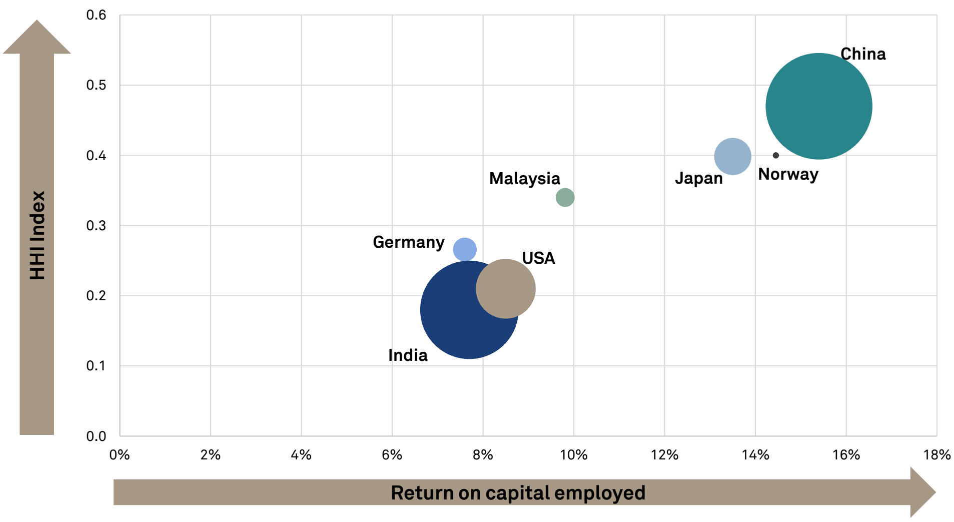
Note: No. in bracket indicates price increases (FY17 /FY16, FY18 /FY17) ; * Sugar season

Source: CRISIL Research

Easing of coal prices after the sharp hike seen in fiscal 2017 would prop up margins in the power generation, aluminum, steel and cement sectors. Other sectors would see rising raw material pressure

Theme 4: Consolidation would gather momentum across sectors next fiscal

Consolidation inevitable in telecom



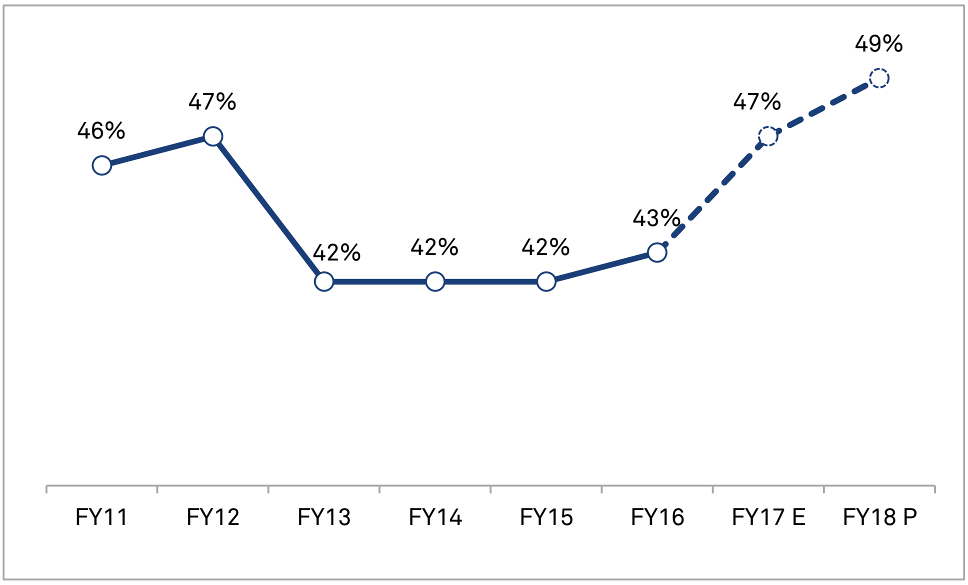
Note: Size of the bubble indicates the number of subscribers of the leading telecom operator
Average 3-year ROCE of leading player for that country is taken
HHI Index is a measure of market consolidation. Lower number indicates higher market fragmentation

Source: CRISIL Research

Fragmented market share, weak pricing power results in weak return on capital to drive consolidation in the Indian telecom sector

Large cement players gaining market share

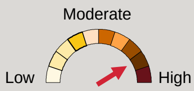
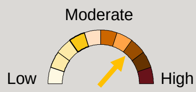
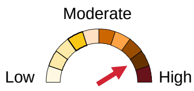
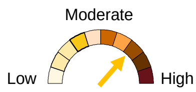
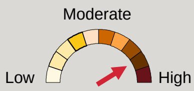
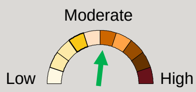
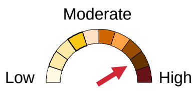
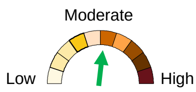
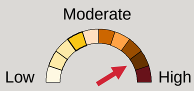
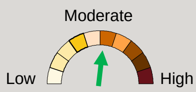
Share of top 5 players' capacity in total industry-wide installed capacity



Source: Industry, CRISIL Research

The past year has seen a fair degree of M&A activity, with four acquisitions totalling 42 mtpa capacity, and a merger (ACC-Ambuja) of 64 mtpa of capacities

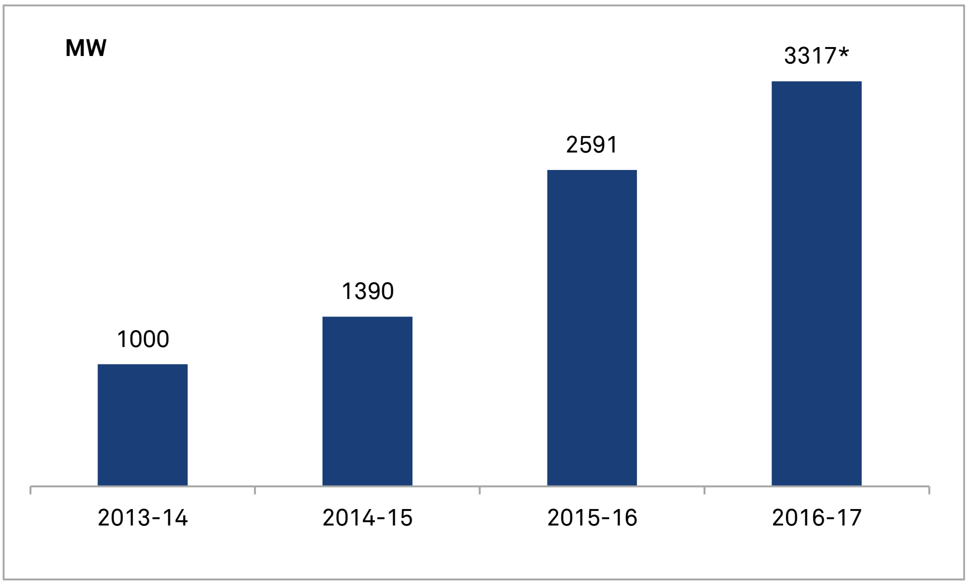
GST to drive gains for organised players in sectors with high share of unorganised players

Source	Size (Rs crore)	Share of unorganised players	Name of the source	Size (Rs crore)	Share of unorganised players
Rice milling	~310,000		Chemicals	~2,600	
Engineering (light)	~310,000		Auto components	~2,550	
Textiles – RMG	~280,000		Plywood and laminates	~215	
Leather & leather products	~75,000		Construction – irrigation	~800	
Wood & wood products	~30,000		Ceramic tiles and sanitary ware	~250	

The self-policing nature of GST would hurt the informal sector and improve the competitiveness of larger firms

Power: Asset sales started but still a long way to go

Thermal power space saw acquisitions of 8.5 GW over fiscal 2014-17

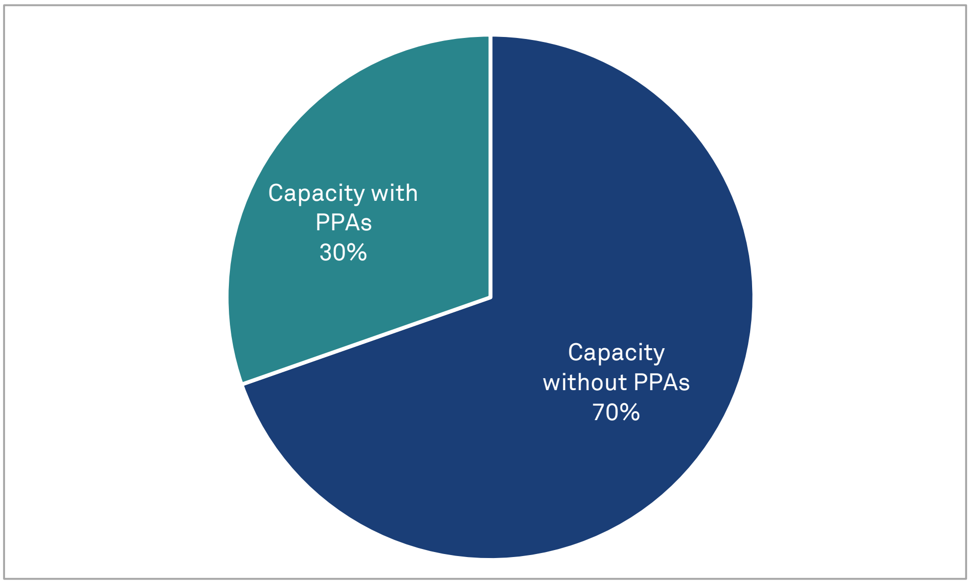


* Includes asset sales that are in process

Source: CRISIL Research; company reports

~26 GW projects still under financial stress. Effective implementation of Bankruptcy Code can accelerate consolidation

Power capacity in financial distress at 26 GW

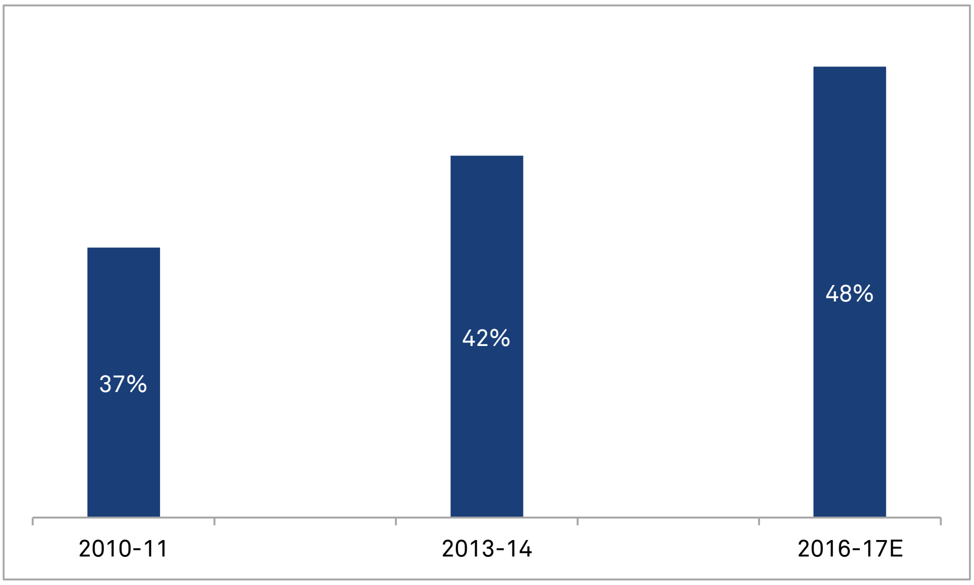


Source: CRISIL Research

Given tepid demand for power, sluggish growth and weak finances of discoms, few fresh PPAs expected in the medium term. Only 9 GW of PPAs were signed between fiscals 2012 and 2016

Financial stress driving consolidation in steel sector, too

Share of top 3 players on the rise



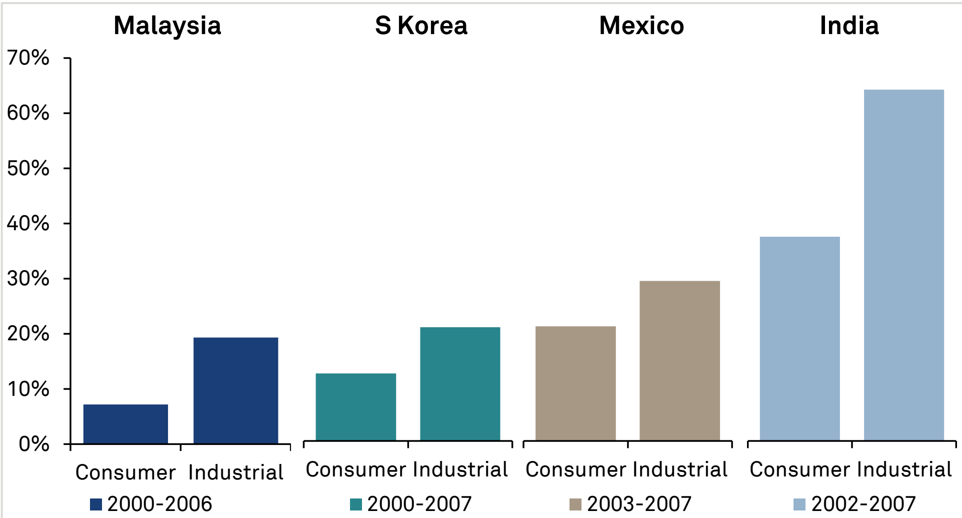
Source: CRISIL Research

High outstanding debt in the steel sector to accelerate exits by weaker players

Theme 5: Slowing industrial capex despite lower interest rates

Lower interest rates have helped capex across geographies

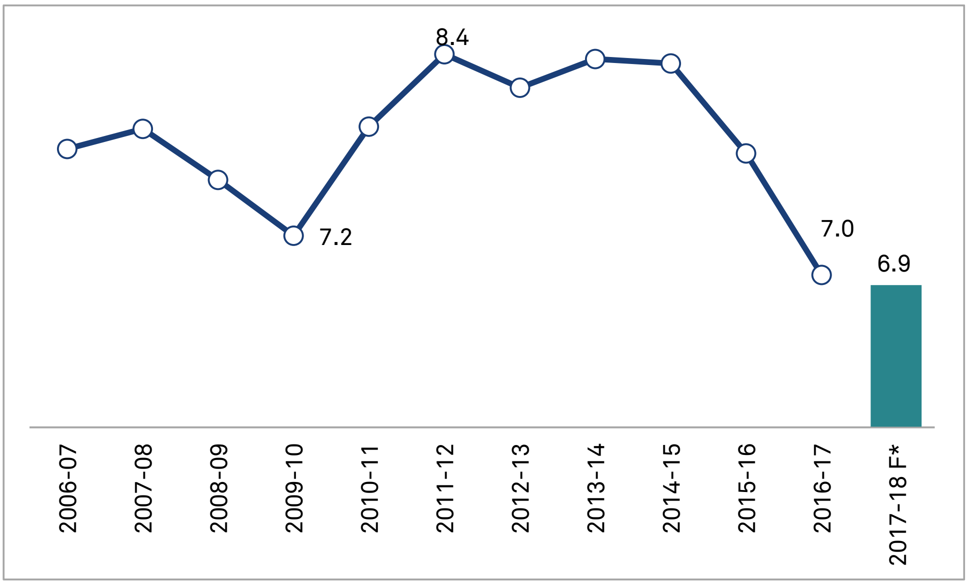
Capex growth was faster in asset-intensive sectors



Source: CRISIL Research

Strong global economic growth and rapidly rising trade were the primary factors

10 year average annual G-sec yield at decadal low in India

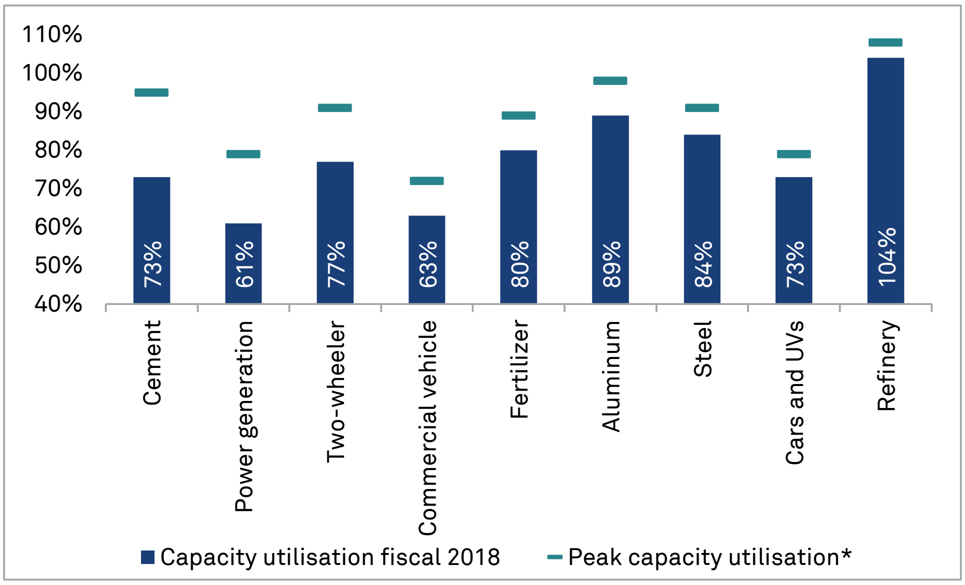


Note: * indicates CRISIL's yearend outlook for FY 18

Source: CRISIL Research, RBI

Lower rates alone may not be sufficient to lift investments. CRISIL's past studies indicate that balance sheet health, demand visibility, economic and policy environment are also critical factors affecting capex

Capacity utilisation in most sectors is below peak

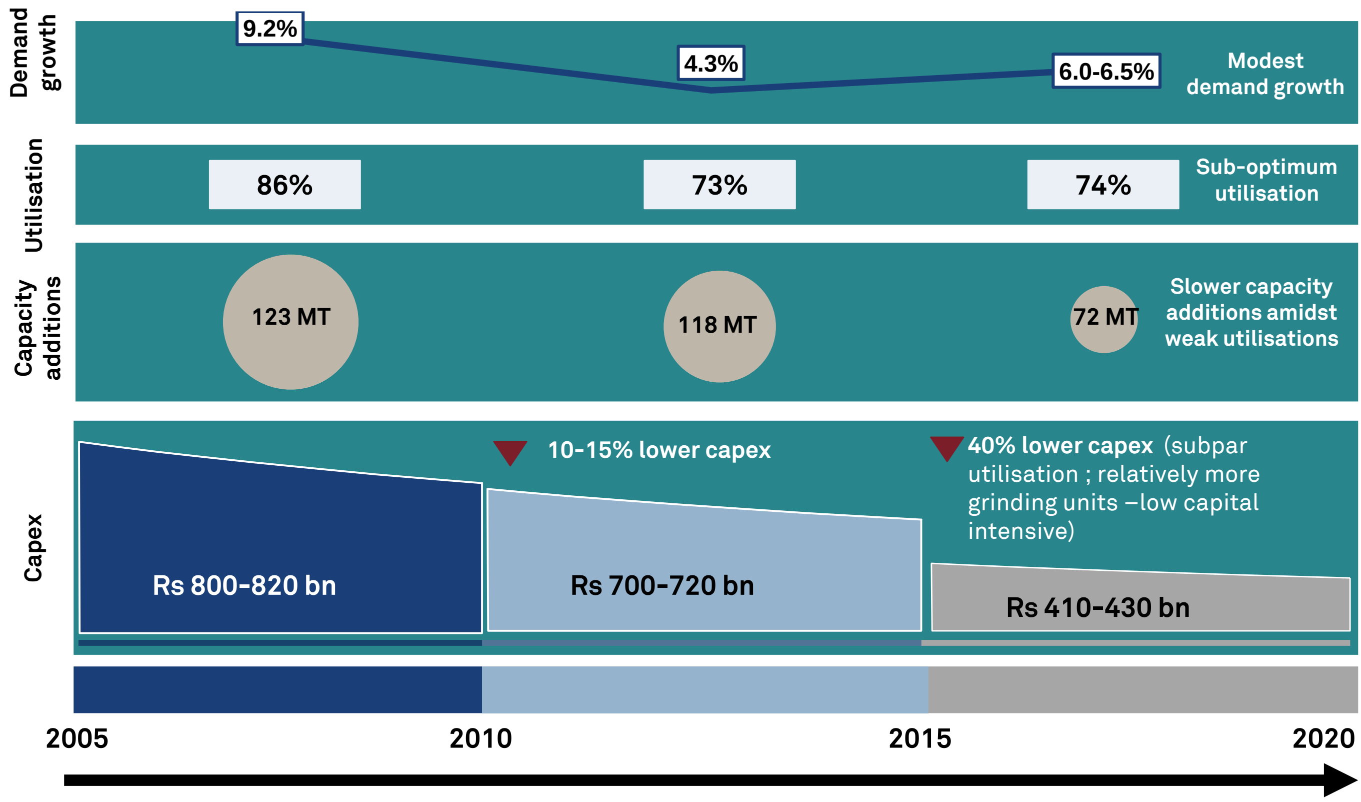


* Annual average peak capacity utilisation in last ten years

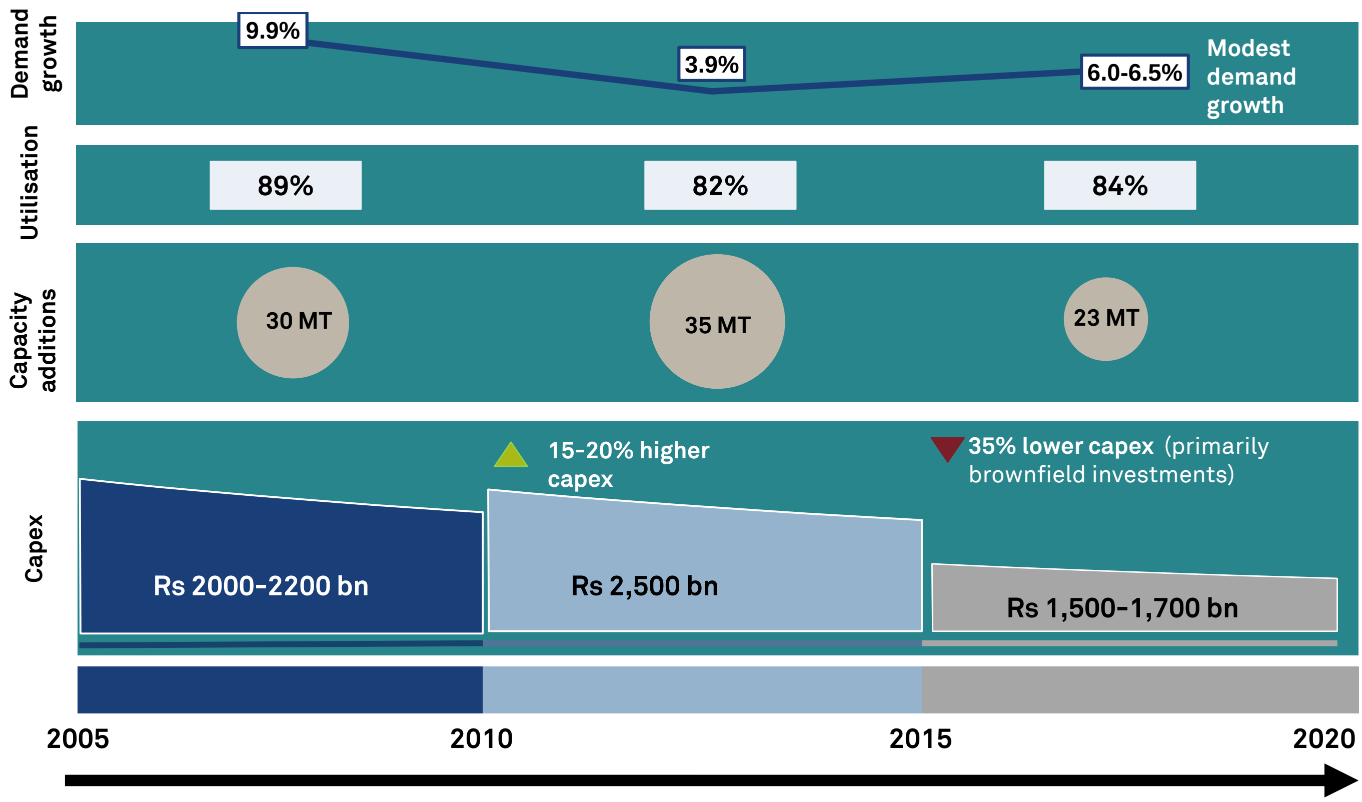
Source: CRISIL Research

Peak capacity utilisation across sectors were reached between fiscals 2006 and 2012

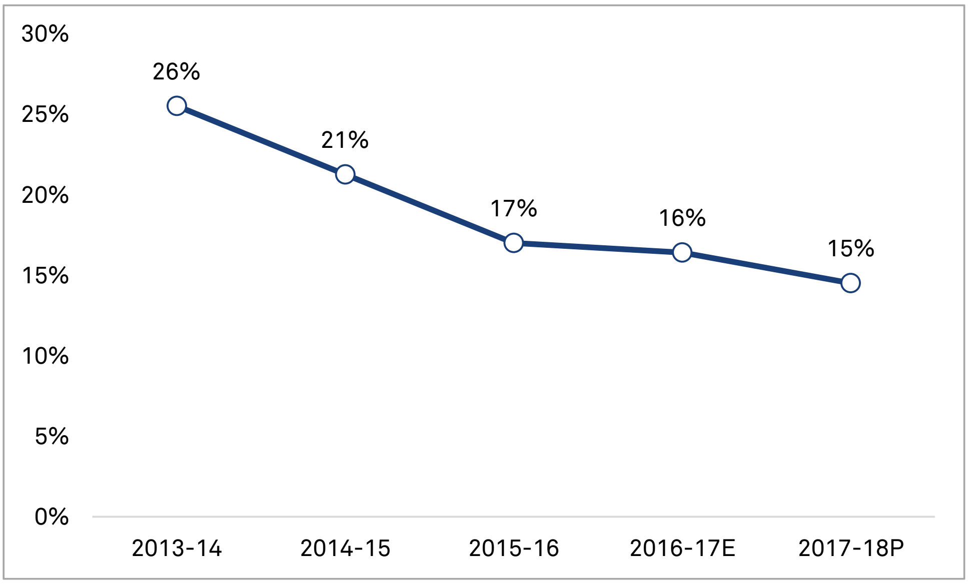
Capex cycle in the cement sector to significantly slow down amid weak utilisation



More brownfield expansions amid muted steel demand to slow down capex by 35% over the next five years



Share of industrial investment by corporates in total capex* has been declining



*Share is calculated based on key sectors tracked by CRISIL Research across industrial and infrastructure. The same accounts for ~45% of the total Gross Fixed assets formation (GFCF) excluding real estate, agriculture, defence and government investments

Source: CRISIL Research

In the near term, given the weak outlook on industrial capex and also its shrinking contribution, infrastructure is the only hope for overall investment growth

In a nutshell

After two years of sub-5% revenue growth, there is a whiff of recovery in the air. We expect India Inc's topline growth to accelerate and touch a five-year high in fiscal 2018 – but not enough to clock double-digit growth.

As for demonetisation demons, rising demand across sectors (barring real estate and those linked to it) will quell them.

The commodity cycle, which started turning around about a year ago, will help manufacturers, but will also exert pressure on the profit margins of end-use sectors. Thus, despite an uptick in revenue growth, the overall Ebidta margin is unlikely to improve. That compares with a near 100 basis points rise logged in fiscal 2017, driven by a spike in commodity prices.

The roll out of GST in fiscal 2018 will indeed be a watershed event. While short-term hiccups cannot be ruled out, the efficiency gains in transportation and logistics that this would engender will accrue across sectors. Other policy changes such as the promulgation of the Real Estate Regulation Act (RERA) will also be seminal, and can transform a chronically opaque sector over the next 3 years.

But the much-awaited revival in private sector investments will be elusive in fiscal 2018 despite decade-low interest rates. With many sectors facing capacity overhang amid modest demand growth and stretched balance sheets, broad-based recovery in industrial capex is ruled out next fiscal.

Our analysis suggests that in some core sectors such as cement and steel, capex even over the next 5 years is likely to be lower than in the preceding 5 years. As a result, government and public sector undertakings are once again expected to do the heavy lifting, especially in the infrastructure space.

But that won't be enough to usher in a meaningful 'crowd-in' effect, at least in fiscal 2018.

On the positive side, however, consolidation is likely to gain momentum across sectors driven by varied forces such as intensely competitive markets (telecom, cement), policy changes and formalisation of economy (real estate and MSME-dominated sectors) and push for resolution of stressed assets by banks (power, steel).

Effective implementation of the Bankruptcy Code can galvanise recovery, resolution process and timeframes. That will pave the way for a more robust and sustainable private investment cycle – beyond fiscal 2018.

CRISIL's
INDIA
OUTLOOK
ECONOMY • INDUSTRIES • MARKETS

Credit **outlook**

- Gradual recovery seen in credit quality trends
- However, the underpinnings remain fragile
- Banking sector to see lower slippages to NPAs
- But bank NPAs to remain at elevated levels; profitability pressures to continue
- Credit ratio and debt-weighted credit ratio to improve
- Several sectors on an uptrend but some continue to struggle
- No impact on broader credit ratios due to demonetisation

Hint of a gradual recovery

However, the underpinnings remain fragile

Credit quality of India Inc is showing signs of gradual recovery driven by firm commodity prices, stable macros, impact of sustained structural reforms, improving capital structure and lower interest costs.

There has been no impact on broader credit ratios due to demonetisation.

Both the credit ratio and the debt-weighted credit ratio are expected to improve in fiscal 2018. Turnaround visible in some commodity linked sectors, especially metals and mid-sized engineering, procurement and construction, or EPC companies.

But underlying fragility remains with several investment-linked sectors continuing to see headwinds.

The banking sector is expected to see lower slippages in non-performing assets (NPAs) next fiscal, yet overall, NPAs would remain elevated. Furthermore, pressure on bank profitability is seen continuing through next fiscal.

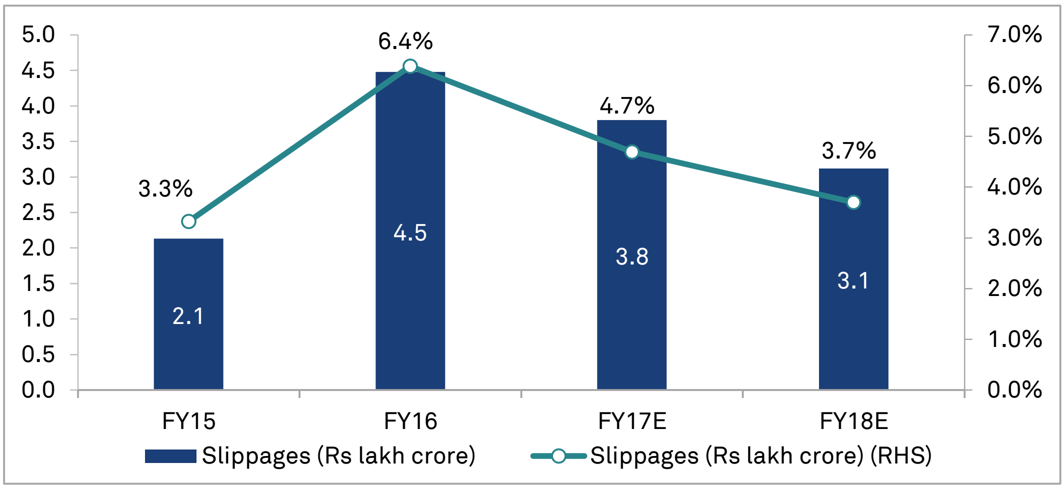
Microfinance institutions are also seeing a build-up in stress.

The sustainability of recovery would depend on continuing deleveraging through asset sales, strengthening commodity prices, pick-up in investment demand, a normal monsoon and no further slowdown in any of India's major export destinations.

Slippages to NPAs in banking sector to decline in fiscal 2018

- Supported by expected improvement in underlying credit profile.
- Stock of restructured standard assets (RSAs) expected to dip, reducing risks of further slippages. RSAs were at Rs 2.4 lakh crore as on December 2016 (Rs 4.3 lakh crore as on March 2015).
- Structuring of loans on the rise, using RBI tools (S4A, SDR, 5:25).

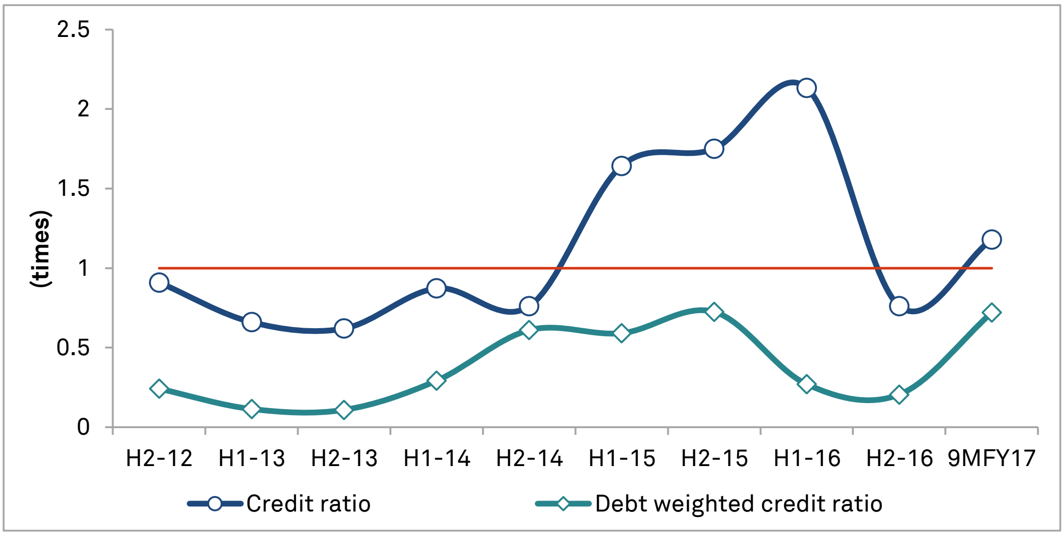
Slippages in fiscal 2018 to be lower compared with the previous two fiscals



Source: RBI, CRISIL estimates

Improving trend in credit ratios to continue

Semi-annual trends in the credit ratio and the debt-weighted* credit ratio



*Credit ratio is the ratio of upgrades to downgrades recorded during a period.
Debt-weighted credit ratio is the ratio of total debt on the balance sheets of firms upgraded versus firms downgraded, excludes financial sector players.

Source: CRISIL

Credit ratio increased to 1.18 times in 9 months of fiscal 2017. Debt-weighted credit ratio also improved.

The trend is expected to continue on account of firm and stable commodity prices, sustained consumption demand, lower interest costs and stable macros, and improving capital structure.

Demonetisation brushed aside

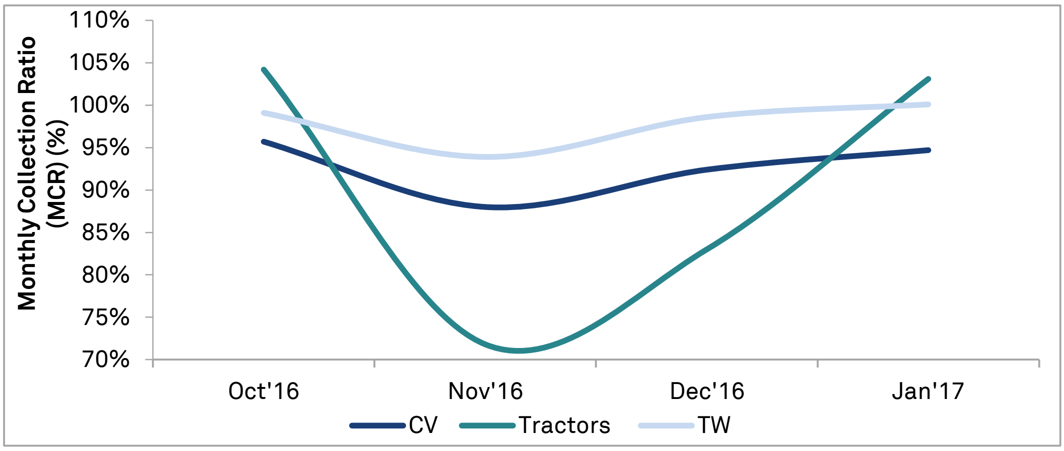
Credit ratio has held on even after demonetisation. For the period between November 9, 2016, and January 31, 2017, the credit ratio stood at 1.24 times. That's nearly similar to the 1.16 times seen between April 1, 2016 and November 8, 2018, the day on which demonetisation was announced.

A credit ratio above 1 indicates rating upgrades outnumber downgrades.

Collection ratios of retail loans already recovering, and CRISIL Ratings sees broader normalcy returning by around June 2017.

Despite high cash component, collection ratios for vehicle loans have recovered. CRISIL rated NBFCs have been able to manage the disruption; realigning collection models.

Recovery in vehicle loan collections in December 2016 and January 2017



Note: Collection efficiency across CRISIL-rated pools

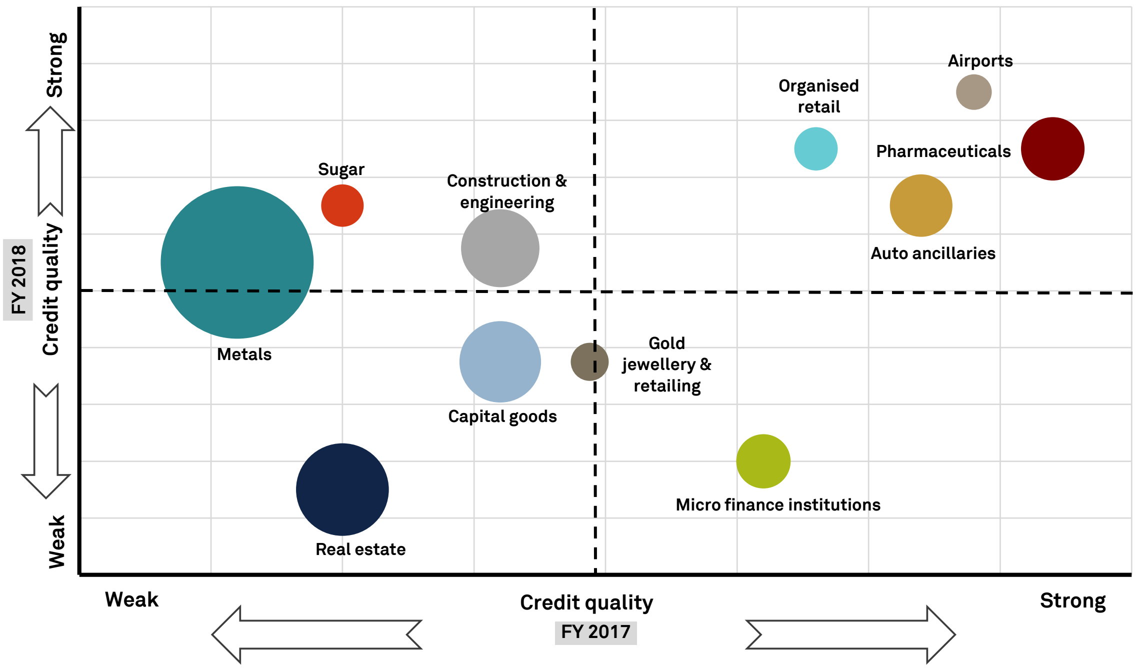
Source: CRISIL

However, the performance of smaller-sized players, especially from the unorganised sectors, remains a monitorable.

Most companies have actively managed the demonetisation challenge by conserving liquidity through efficient inventory management with active support from creditors. Larger companies have increased credit periods to smaller companies.

The outlook on capital structure is also better, as lower demand also means lower capex. At an aggregate level, CRISIL expects gearing of CRISIL A- and above rated companies to improve by 0.1 times

Several debt intensive sectors to show turnaround

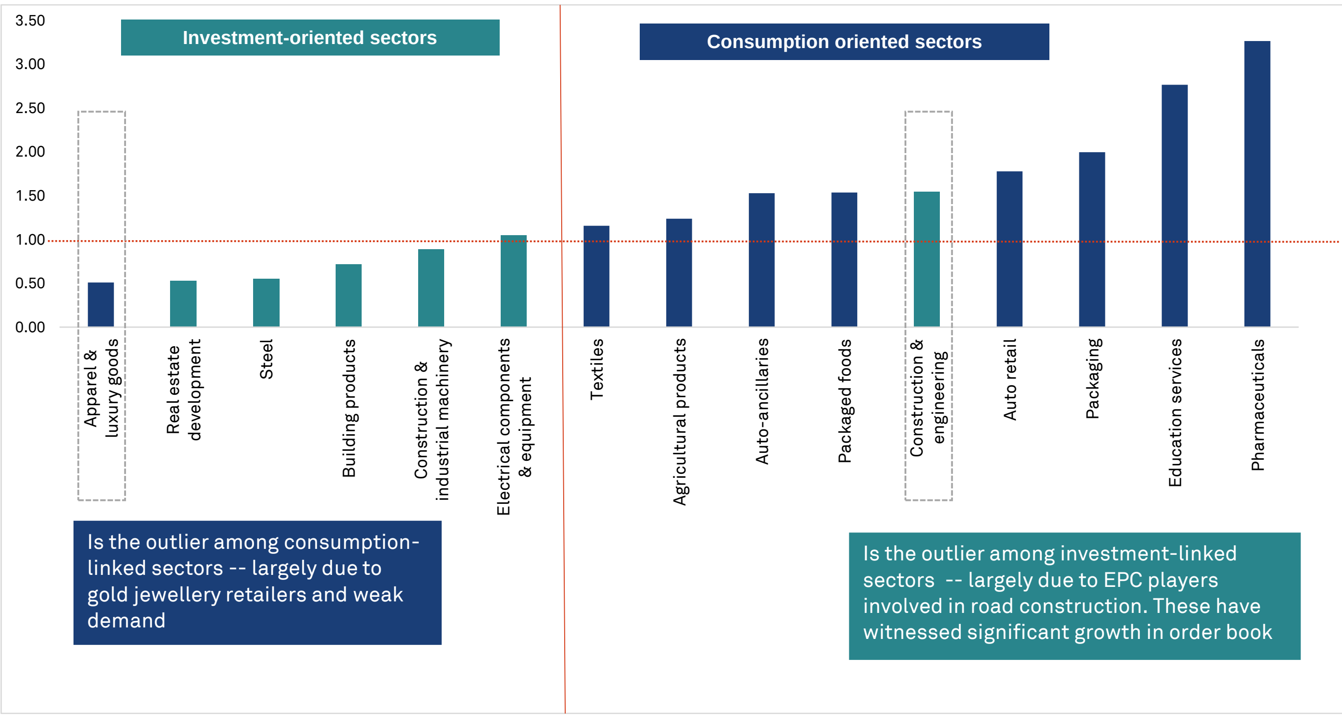


Size of the bubble depicts sectoral book debt in the CRISIL-rated portfolio

Source: CRISIL

Consumption linked sectors continue to fare better

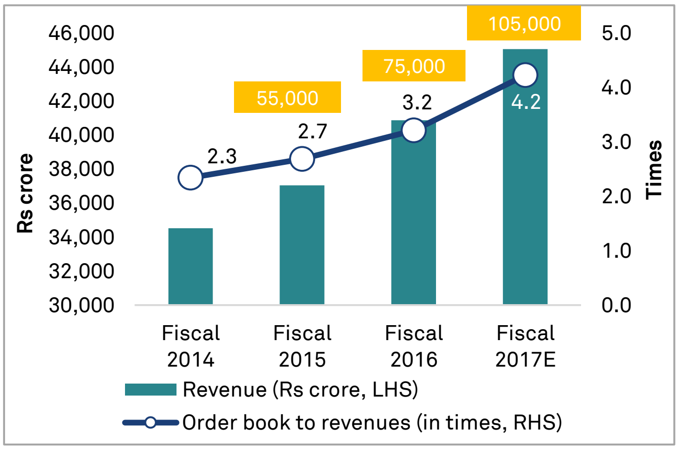
Credit ratio of key industries during the 9 months of fiscal 2017



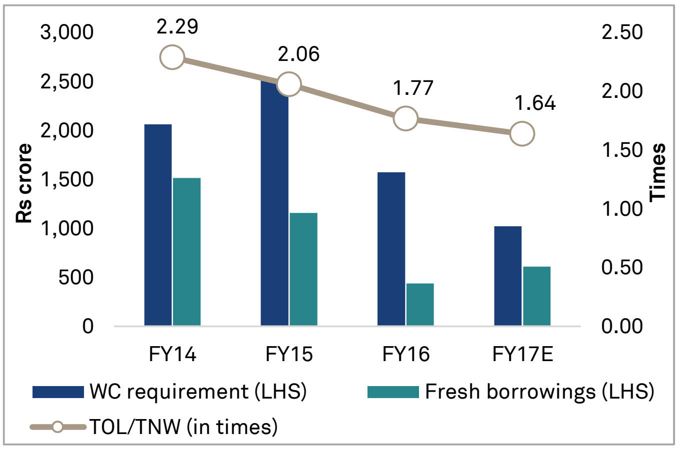
Source: CRISIL

Credit quality improves for mid-sized construction players

Order book expansion led to 12% growth



Efficient working capital management bolstered capital structure



Figures in the box indicate new order flow in Rs Crore

Note: Based on a set of 36 EPC companies rated CRISIL BBB+ and above (excluding L&T). Of these, 24 companies have revenues between Rs 250 crore and Rs 1,000 crore, while 12 companies have revenues greater than Rs 1,000 crore

Source: CRISIL

Mid-sized construction companies is estimated to grow at 12% CAGR through the three years ending 31st March 2017, with PAT growing at 15% during the same period. This is due to significant increase in order book position which drove growth; outstanding order position has doubled over the past three fiscals. This new order inflow has been at the cost of over-leveraged large players.

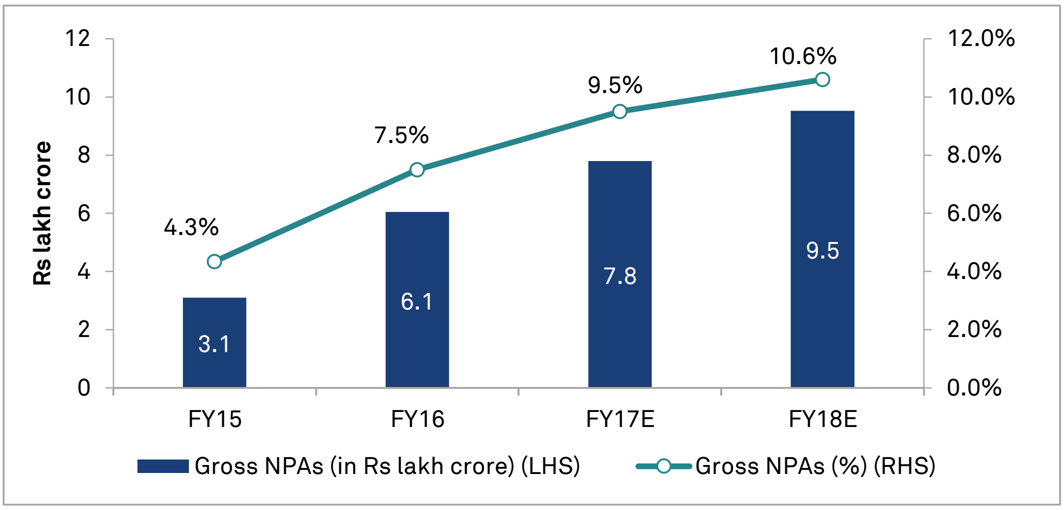
Revenue growth has been coupled with improving operating profitability; resulting in expected return on capital employed of 21% for fiscal 2017.

In congruence with the healthy scale-up, these players have sustained their comfortable capital structure, with TOL/TNW (Total Operating Liabilities *divided by* tangible Net Worth) at around 1.6 times. This has been on account of efficient working capital management, which helped them restrict their dependence on external borrowings

But underlying fragility remains

Gross NPA stock to remain elevated at banks

Gross NPAs to rise as recoveries will be subdued

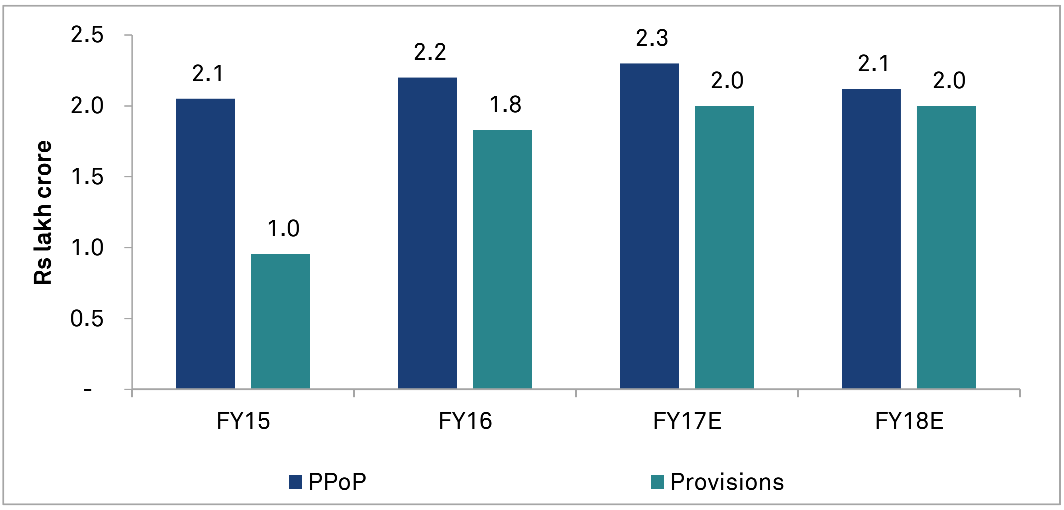


Source: CRISIL

Recoveries will be prolonged given that sizeable NPAs are in highly leveraged companies with stretched cash flows. NPAs from three vulnerable sectors constitute ~25% of total banking sector NPAs. However, economic revival, policy initiatives (in stressed sectors) and effective implementation of Insolvency & Bankruptcy Code can potentially accelerate recoveries.

Higher provisioning costs to impact bank profitability

Rise in provisions to largely absorb PPoP in FY17 and FY18

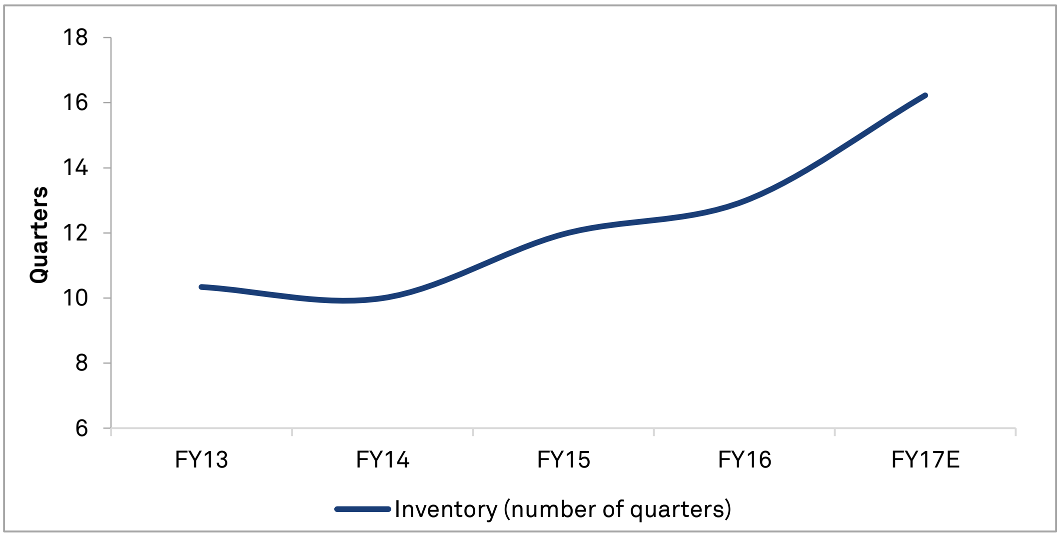


Source: CRISIL: PPoP = Pre-provisioning operating profit

Increase in provisioning costs to impact banks' profitability, mainly those of PSBs. With interest rates firming up, treasury profits will be limited in fiscal 2018. Higher NPA provisions (ageing of NPAs and new NPAs) may result in loss at aggregate level for PSBs in fiscal 2017 and 2018. Retail-heavy private banks are relatively better placed due to lower provisioning costs given their lower exposure to stressed corporate sectors.

Realtors and microfinanciers facing headwinds

Real estate: Pile-up of inventory continues



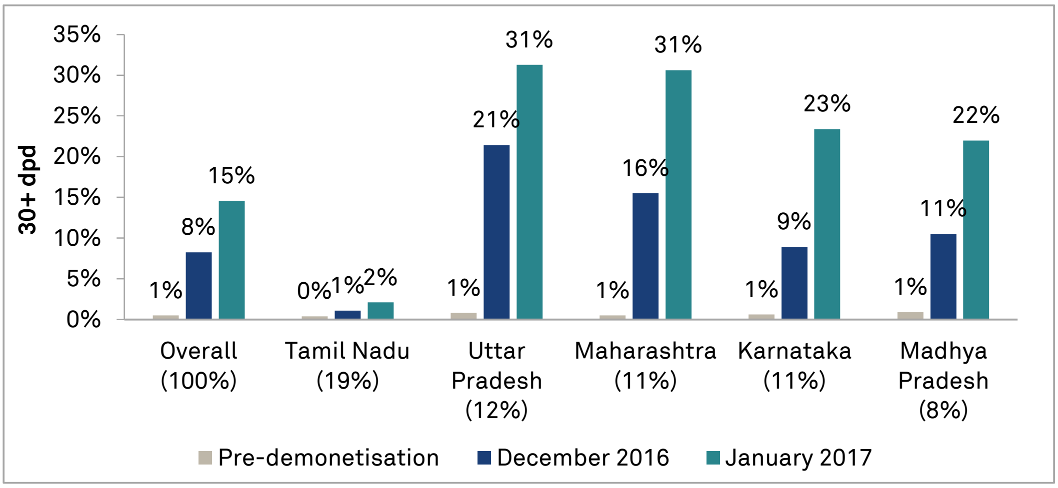
*Based on data from 25 listed companies

Source: CRISIL

Slow offtake, especially in residential real estate sector and high prices have been impacting the credit quality of the sector. Demonetisation has softened the demand further, especially in the premium segment and investor-driven markets.

Several mid and small size developers have significant debt maturing over the near term. Subdued demand heightens the refinancing pressure for such players. Usage of high cost funds to refinance these maturities will be a key monitorable.

MFIs: 30+ dpd has increased substantially in 4 out of 5 largest states after demonetisation



Source: CRISIL estimates based on rated SFBs/ NBFC-MFIs (~60% of industry AUM)

Larger MFIs are withstanding stress so far due to large capital base and access to liquidity. MFIs backed by strong parentage have better ability to withstand idiosyncratic risks through capital support.

MFIs/ SROs/ industry association are taking measures to address these issues. SFBs are expected to have a competitive advantage over NBFC-MFIs.

Going forward, the pace of improvement in credit quality will hinge on:

- Firmness and stability in commodity prices, especially metals
- Progress on deleveraging in corporate balance sheets through asset sales
- Another spell of normal monsoon
- No further slowdown in any of India's major trade destinations
- Pick-up in the investment cycle, especially in investment-linked sectors
- Implementation of reforms, especially GST
- The ability of MSMEs to live with increasing formalisation
- Absence of any sharp swings in the rupee versus dollar

Banking sector credit growth to remain muted

- Due to low industrial capital expenditure and continued refinancing through bond markets
- Retail sector to show higher growth, especially by NBFCs

CRISIL's

INDIA OUTLOOK

ECONOMY • INDUSTRIES • MARKETS

MSME **outlook**

- Organised MSMEs to do well but tough times for unorganised ones
- Both will be forced to adopt digitalisation as way of doing business
- After GST kicks in, unorganised entities will face higher cost burden and will have to cut margins or lose market share to organised rivals

Year of digital disruption looms

Organised space to do well but tough times for unorganised players

Fiscal 2017 could well be a watershed for micro, small and medium enterprises (MSMEs) in India, given that the plethora of initiatives launched by the government could potentially transform the way they conduct business.

One of these was demonetisation, which was primarily targeted at black money, but impacted MSMEs, too. As a result, the sector, which was growing at 14-16% annually before the event, is now expected to close the year up 6-8%.

The year also saw the passage of the Goods & Services Tax (GST) Bill, and a reduction in the corporate tax rate to 25% from 30% for companies with annual turnover up to Rs 50 crore, as announced in the Budget.

All these government initiatives have drawn a wedge between the organised and unorganised[7] space, and altered their fundamental growth prospects. In fiscal 2018, as normalcy returns with remonetisation, structural changes will begin for MSMEs. Here's how we see the next fiscal panning out for them:

- Both organised and unorganised MSMEs will be forced to adopt digitalisation as way of doing business.
- After GST kicks in, unorganised players will witness increased cost burden to meet additional compliances, and will be under pressure to cut margins or lose market share to organised players.
- In the manufacturing sector, organised players with the ability to hold the prices of their products despite lower taxes under GST will witness improved profitability. The services sector, on the other hand, will face increased tax burden under GST. MSMEs unable to pass on increased cost of services to customers will face pressure on margins.
- Raw material and logistics cost will reduce. A unified market will improve competitiveness of organised players and open new markets for their products. The level playing field will also result in increased competition for highly localised players from other states.
- However, the MSME segment will face increased competition from larger players, who will benefit from economies of scale and reduction in pricing distortions on account of varying taxes in each state.
- In its bid to boost digitalisation, the Union Budget for next fiscal has laid the foundation for improving access to formal credit using digital footprint of MSMEs as a tool. This will help some MSMEs to raise funds from institutional lenders. However, given the slowdown in lending to MSMEs and the prevalence of collateral-based funding, a significant number of MSMEs will continue to be under-funded.
- MSMEs with good compliance and sound legal structures will witness improved profit after tax (PAT) margins on account of reduction in corporate tax rate to 25% from 30%.

[7] CRISIL considers proprietorships/partnerships with less than 10 permanent employees as unorganised entities.

Digitalisation rings alarm bells for unorganised MSMEs

A CRISIL study of its rated MSME portfolio shows that between fiscals 2014 and 2016, unorganised players in the manufacturing sector grew faster than their organised peers *(refer chart)*.

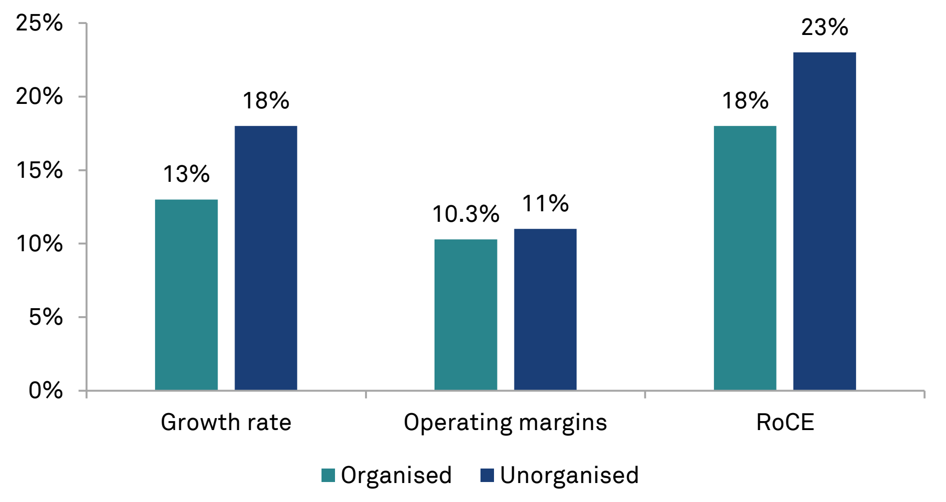
Unorganised players are mostly small scale units with low compliance levels and high dependence on cash transactions. Their small scale allows them to lower their cost structures through exemptions, such as those from paying social security benefits to their employees[8] and taxes such as excise duty[9]. This allows them to lower their prices while maintaining a 10-11% operating margin – nearly the same as organised players.

However, the implementation of GST will slam brakes on this growth. Since the threshold limit for GST exemption has been reduced drastically to Rs 20 lakh from Rs 1.5 crore, promoters who had set up multiple outfits or were understating revenues or employees to avoid the threshold limit will come under the tax net. A large proportion of MSMEs will also be coming under the tax net for the first time, which could make their businesses less profitable, if not unviable.

At the same time, the GST rate for organised players in most industries will be lower than their current effective indirect tax rate, which will reduce their input costs and hence, make them more competitive. As a result, unorganised players will face pressure and given their limited ability to increase prices, will have to reduce margins.

Further, GST and a less-cash economy will make tax evasion difficult, especially for manufacturers and traders as it will create digital transaction trails based on dual authentication of invoices.

FY16 - Unorganised sector was flourishing



8 As per Gratuity Act
9 For enterprises with annual turnover below Rs 1.5 crore.

Despite pressure, MSMEs will continue to play a critical role

From a tax arbitrage business model, MSMEs will have no option but to mainstream if the government follows through with additional regulatory stringency against the cash economy. At the same time, it is expected that once the cash withdrawal limits are removed, businesses will revert to cash transactions, giving some breather to the unorganised sector.

As per the World Bank, SMEs play a major role in most economies, particularly in developing countries. Organised SMEs contribute up to 45% of total employment and up to 33% of national income (GDP) in emerging economies.

In India, as per the latest estimates of the Ministry of Micro, Small and Medium Enterprises, more than 51 million working enterprises employed over 117 million people and contributed nearly 37% to India's GDP by March 2015.

It is expected that MSMEs will continue to play a key role in the Indian economy, though there will be transformational headwinds in their road ahead.

GST largely positive for organised players; services sector to face increased tax burden

After the implementation of GST, organised SME players will do better on the back of administrative ease and greater reach through a unified market. This will make markets more competitive and efficient.

CRISIL's interactions with its SME clients shows a fairy high acceptance of this hugely transformational step, though most have a limited understanding of its actual impact. A CRISIL SME Ratings survey of 1,100 MSMEs shows that 43% of the respondents believe GST will have a positive impact on their businesses, 39% believe it will have no impact and only 5% believe it will impact them negatively, while the remaining are uncertain.

It is commonly believed that a simplified uniform tax structure and ease of filing taxation will release bandwidth and improve productivity, but will also lead to higher administrative costs. Some of the reasons for optimism are increased opportunities for inter-state businesses, lower raw material costs, lower transportation costs and reduction in tax avoidance by competitors helping them compete better. However, all these will benefit larger players more, as wider scale of operations will help them take advantage of logistic costs, product pricing and administrative costs, thereby putting pressure on smaller players.

Further, the services sector will have an additional tax burden, up from the current service tax rate of 15%. So for these and 'first time tax paying' MSEs, the working capital requirements will increase, requiring additional funding.

Also, the ability to claim input tax credit will depend on timely submission of invoices by both purchaser and seller, whether a manufacturer or service provider. Thus, besides working capital management, profitability, too, will depend on the efficiency of stakeholders and discipline in timely filing of documentation.

Budget incentivises digitalisation to improve MSMEs' access to formal credit, but many will remain under-funded

In the Union Budget, the 5% reduction in corporate tax rate for MSMEs will encourage them to adopt better legal structures by converting to private/public limited companies. Better compliance will lead to enhanced opportunities to raise institutional funds. Additionally, the proposal to encourage SIDBI to refinance credit institutions that provide unsecured loans, at reasonable interest rates, to borrowers based on their digital transaction history is a step in the right direction.

With increasing impact of technology in the economy, alternate lending models involving financial technology also deserve mention. RBI is keeping an eye on these channels, including concepts such as peer-to-peer lending. Funding through these modes will see an uptick, but with limited impact, given their nascent stage and evolving business models.

However, MSMEs in India will continue to face significant roadblocks in raising funds from institutional lenders. The average gearing of organised and unorganised players is a mere 1 and 0.4 times, much lower than the norm of 2 times. RBI data also shows that the growth rate of lending to MSE sector had reduced to 3.6% in 2015-16. Given that lending in India is still largely collateral-based and 95% of the MSMEs do not have access to formal credit, the ground situation will take some time to change significantly.

How the year **could turn out in the ecosystem**

Organised MSMEs	Unorganised MSMEs
GST: Unified market to open up opportunities but increase competition from larger MSMEs	GST: Reduced threshold limit to Rs 20 lakh will increase tax incidence
Reduced direct and indirect tax rates, and lower input and logistics costs will improve the profitability of strong MSMEs	Tax evasion + under-reporting of employees will become difficult with digitalisation
Good compliance and digital footprint to increase access to formal funding	Operating margins to be under pressure due to rising costs
Could gain market share from unorganised players	Could lose market share to organised players

Sectoral **outlook**

● Marginally Negative ● Neutral ● Positive

Sector	Outlook
Textiles	Muted growth rate expected GST: Marginally negative impact on domestic market due to higher indirect tax rates Demonetisation: High impact on unorganised players
Leather products & footwear	Muted growth rate expected GST: No significant change expected for domestic market Demonetisation: High impact due to large share of unorganised players
Pharmaceuticals	Moderate growth rate expected GST: Indirect tax structure expected to remain similar to the current rates Demonetisation: Sales moderately impacted due to inelastic demand
Auto components	Moderate growth rate expected GST: Organised players to get advantage of lower indirect tax rates Demonetisation: Witnessed short-term drop in sales
Light engineering	Expected to maintain healthy growth rate GST: Indirect tax rates expected to be lower than the current tax rates Demonetisation: Had a limited downward impact on sales
Electrical equipment	Expected to maintain healthy growth rate GST: Indirect tax rates expected to be lower than the current tax rates Demonetisation: Had a limited downward impact on sales

Textiles: Marginally negative

Growth in the rated, domestic textiles-related MSME segment had nearly halved to 8% last fiscal from 15% in fiscal 2015. Given the impact of demonetisation, the sector is expected to be among the hardest hit due to the presence of significant unorganised players in this space, with growth dipping below 5% this fiscal.

Further, GST will have a marginally negative impact on the sector as the tax rates are expected to be higher than the current effective indirect tax rates. In CRISIL's conversations, some clients raised concerns that a unified market will create more competition in an already price-sensitive market.

In fiscal 2018, though the effects of demonetisation will wane over the next few months, MSMEs are expected to record single-digit growth rates. But organised players dealing with branded apparel are expected to do well.

Leather products and footwear: Marginally negative

Rated enterprises in this domestic segment have reported muted growth over the past couple of years. A large portion of this sector is dependent on MSMEs, which were significantly impacted by demonetisation. GST rates are not expected to change much from the current effective indirect tax rates. MSMEs in this sector are facing tough challenge, both domestically and from China. As a result, average operating margins are under significant pressure and have fallen to as low as 6% for organised players. CRISIL expects the overall growth and margins of players in this sector to remain muted in fiscal 2018.

Pharmaceuticals: Neutral

Within the rated MSMEs, pharmaceuticals has been growing moderately. Growth slowed to 11% in fiscal 2016 compared with 15% in fiscal 2015.

In fiscal 2017, demonetisation impacted this sector only moderately as the government had allowed use of old notes of Rs 500 and Rs 1,000 denomination for an extended period of time to purchase medicines. Besides, the pharma sector has largely inelastic demand and hence, MSMEs are expected to maintain their growth rates this fiscal. GST, too, is not expected to witness any change in rates from the current indirect effective tax rates.

Hence, in fiscal 2018, the moderate growth rates seen in the past 2-3 years are expected to continue.

Auto components: Neutral

Between fiscal 2014 and fiscal 2016, the unorganised players in the auto components space grew at double the pace of their organised peers – at 14% compared with 7%. However, demonetisation resulted in a short-term drop in sales of original equipment manufacturers. This will have a significant impact on the sector in fiscal 2017, which will close at single-digit growth rates now.

In fiscal 2018, sales of OEMs are expected to normalise, which will subsequently improve the sales of auto components players. The sector's growth rates will remain moderate, but organised players are expected to take advantage of lower tax rates resulting from implementation of GST, compared with the current effective indirect tax rates.

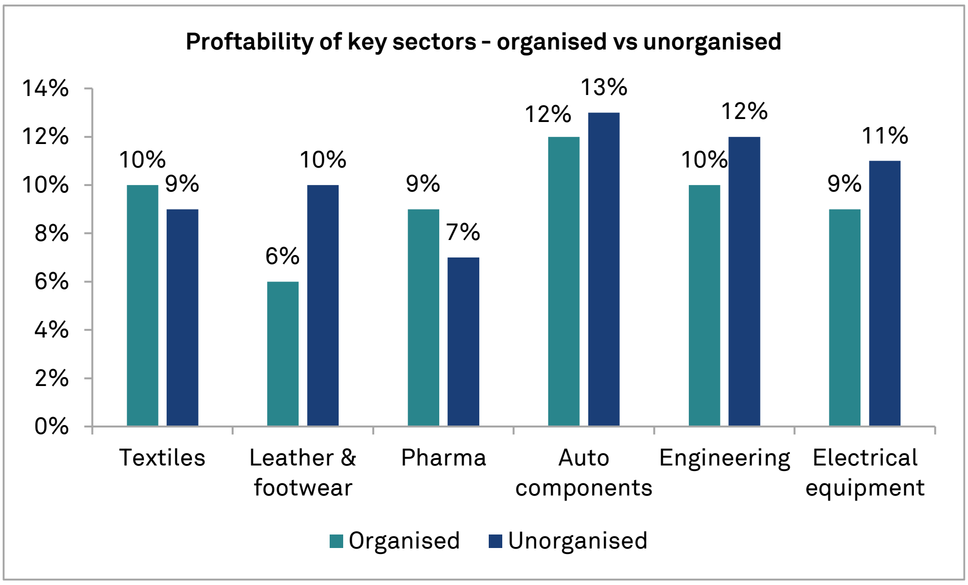
Light engineering: Positive

CRISIL's rated portfolio of MSMEs mostly comprises enterprises engaged in light engineering. This space has fared consistently well for the past couple of years, reporting ~15% growth annually. Even demonetisation has had only limited downward impact on sales. Hence, the sector will close fiscal 2017 on strong note, compared with other sectors.

In fiscal 2018, GST is expected to further boost this sector as the tax rate is expected to be lower than the current effective indirect tax rates. These, coupled with government's thrust on manufacturing sector though initiatives such as 'Make in India' will lead to continued investments in this space, helping maintain its growth momentum.

Electrical equipment: Positive

This has been among the fastest growing sectors in CRISIL's rated MSME portfolio. The sector grew faster in fiscal 2016 at 23% compared with 16% in fiscal 2015. With limited impact of demonetisation, the sector will close strongly in fiscal 2017, though lower than fiscal 2016 growth rates. As per CRISIL Research, GST is expected to bring down freight costs by 1.5-2%. Given the large role of logistics and warehousing in this sector and the lowering of effective indirect tax rate post GST, the sector will log strong growth even in fiscal 2018. However, cheap imports, especially from China, will remain a challenge.



Infra **financing**

- India's infrastructure build-out needs nearly Rs 43 lakh crore in five years to 2020
- 70% of this will be for power, transportation and urban infrastructure
- Almost three-fourth of this investment will be funded through debt
- Innovations in the bond market needed to bridge huge funding gap
- Structural challenges continue in the power and roads sectors

Whither infrastructure financing?

India will need an eye-popping Rs 43 crore in the five years to 2020 to build out its infrastructure. So far, banks have been the largest source of finance. But, given the high exposure of PSU banks to infrastructure, and asset quality and capitalisation issues, as much as three-fourths of this pie will have to be raised on the bond market.

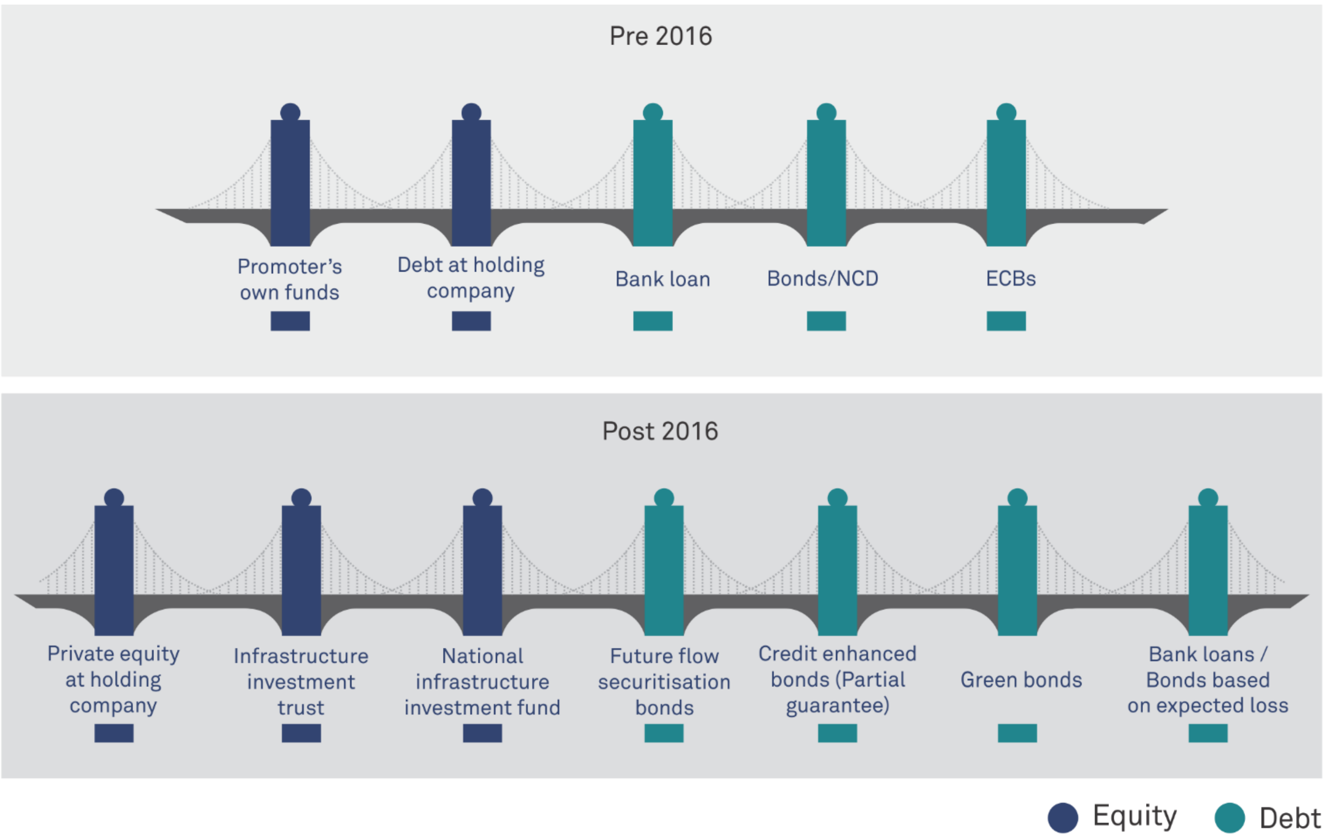
Bond investors generally invest only in highly-rated debt. Hence, there is a need to bridge the gap between the low risk appetite of investors and relatively high credit risk profile of infrastructure projects.

A financing reset has commenced over the past 12 months, in the form of innovative financial instruments and newer vehicles such as infrastructure investment trusts and National Investment and Infrastructure Fund. A good amount of activity has also been seen in credit enhanced instruments so as to match investor risk-appetite – partial guaranteed bonds, securitisation of project cash flows and infrastructure debt funds.

Another means to address the low investor risk appetite is through the new expected loss scale rating, which not only takes into account the traditional probability of default, but also the prospects of recovery post default, thus differentiating two infrastructure projects with similar probability of default ratings.

A key challenge is that the two most important sectors – power and roads – are beset with structural challenges. For investor sentiment to revive, it is imperative that the credit challenges in these sectors are addressed first.

Infrastructure **financing avenues**



Possible solutions for **NHAI's BOT portfolio**

Operational projects
(Rs 20,000 crore of debt at risk)
Projects cannot service debt from their cash flows

- Premium rescheduling
- Conversion of a part of the debt into equity by stronger sponsors such as NIIF
- Refinancing with lower interest rates and longer tenure
- NIIF can exit through the InvIT route

Under-construction projects
(Rs 20,000 crore of debt at risk)
Some partially completed projects also unviable

For unviable, partially completed projects
- Premium payment converted into equity
- Premium reschedulment since traffic growth required for viability is unattainable
- Debt restructuring with longer tenure

For commercially viable under-construction projects
- NIIF/ strong sponsor can provide funding to complete the project
- However, change in sponsor for under construction projects is possible only with policy change

Issues with the **NHAI's BOT portfolio**

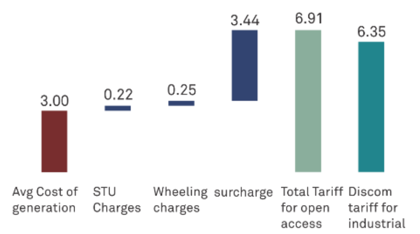
Hybrid annuity projects - 31 bid so far
7 attain financial closure

- Banks cautious on lending given the problems of the past
- Lenders need resolution on Termination Payment Clause - Debt is not covered completely in the case of non-political event and concessionaire default.
- No termination payment till 40% completion of physical progress in the case of concessionaire default
- Developers repeat mistake of bidding aggressively both for project cost as well as O&M
- Bidding process should eliminate this by having a minimum cut-off for these bid parameters.

Operational and under-construction capacities at risk due to lack of PPAs

- Allowing open-access for generation capacities larger than 500 MW with a reasonable cross-subsidy surcharge

Unreasonably high surcharge a adeal breaker for open access



- Developing market for medium-term PPAs with corresponding fuel linkages
- Increasing bank's appetite to lend for shorter durations (say 5 years) with refinancing ability at the end of that term

Demand off-take risk in renewable projects due to backing down by discoms

- Including a 'fixed component' in the tariff structure of renewable projects (similar to that of thermal project)
- Development of vibrant market for renewables purchase obligations

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