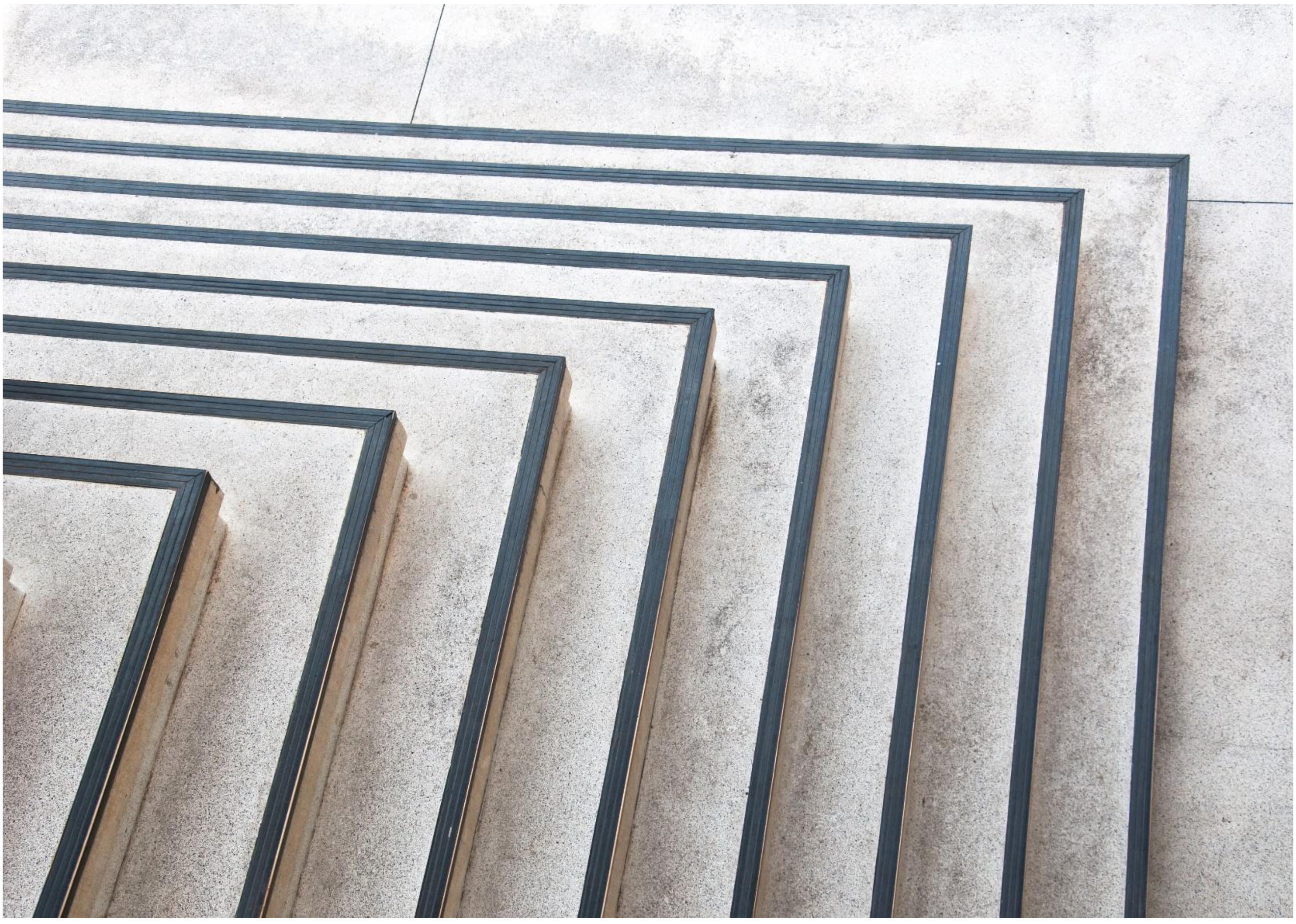
CRISIL
An S&P Global Company

Ratings Round-Up
First half, fiscal 2019

India Inc credit quality remains resilient in first half of fiscal 2019



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Executive summary

CRISIL's credit ratio[1] (or number of upgrades to downgrades) stood at 1.68 times in the first half of fiscal 2019, compared with 1.88 times and 1.45 times in the first and second halves of fiscal 2018, respectively.

There were 685 upgrades to 408 downgrades in the first half of fiscal 2019.

For the first time in five years, the credit ratio for investment-linked sectors at 2.15 times printed higher than the overall credit ratio. The uptick can be seen in sectors such as steel, construction and industrial machinery that, besides buoyant commodity prices, benefited from the government's infrastructure spending even as private investments lag.

As for domestic consumption-linked sectors, the demand growth drivers remain strong, but rising interest rates could act as a mild dampener. Export-linked sectors have seen strong growth revival in recent months backed by buoyancy in the global economy and a sliding rupee.

All is not well, however, India Inc. faces a volatile rupee, rising interest rates and an increase in the risk of tariff disputes between major global economies turning into full-blown trade wars.

CRISIL's analysis of ~2,500 firms in its portfolio that have foreign currency exposure shows that the impact of recent rupee volatility on profitability will be modest. The top 10 sectors with high foreign currency exposure, which include oil and gas, power and telecom, will see their net profit margins eroding this fiscal by up to 150 basis points. But credit profiles will be cushioned by presence of natural or contracted hedges, ability to pass on increased costs to customers in a buoyant demand environment, lean balance sheets, and support from strong parents or government.

After currency, credit and equity markets have recently turned volatile, in turn, bringing non-banks (non-banking finance companies and housing finance companies) squarely into focus.

The asset liability maturity profiles of CRISIL-rated non-banks currently remain consistent with their ratings, even as their dependence on short-term capital market instruments has risen in the past two years. While asset quality and capitalisation are comfortable at present, continued market disruption can constrain access to funding, and it will be a key sensitivity factor for both growth and spreads of non-banks.

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[1] *Credit ratio does not factor in rating actions on non-cooperative issuers.*

Such volatile times are as good a time as any to check the quality of ratings. CRISIL's ratings continue to exhibit the highest stability and lowest intensity of changes in the industry. Of CRISIL's 85 rating actions in 'A' or above categories in first half of fiscal 2019, none has been more than two notches. Over 97% of CRISIL's rating actions in these categories in the past five years have been of low to medium intensity.

Going forward, we expect CRISIL-rated firms to sustain their credit risk profiles even in the face of headwinds, backed by strong demand, increased government spending towards infrastructure and lean balance sheets, and backed by active liquidity management and strong parentage for non-banks. Any continued liquidity strain in the credit market could impact the availability and cost of funds for non-bank financiers and hence would be a key monitorable.

About Ratings Round-Up

Ratings Round-Up is a semi-annual publication that analyses CRISIL's rating actions and traces the linkages between such actions and the underlying economic and business trends.

This edition analyses CRISIL's rating actions in the six months through September 2018.

Note: A credit rating is an opinion on the likelihood of timely repayment of debt. Therefore, analysis of rating actions on a large and diverse portfolio of companies is also a reasonable indicator of an economy's directionality.

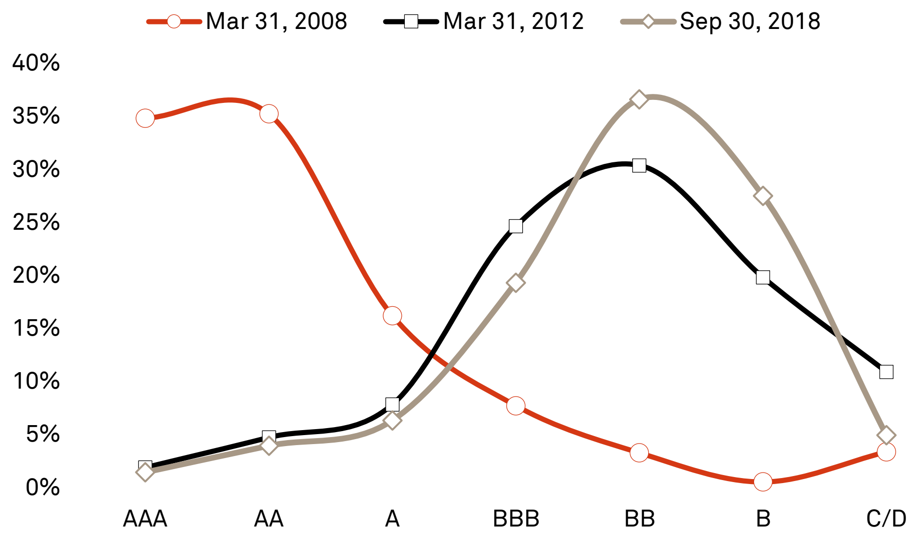
CRISIL's portfolio and median rating unchanged

Ratings outstanding on ~12,000 issuers

Median rating remains in the 'CRISIL BB' category

Over the past five years, CRISIL's portfolio of outstanding ratings has been between 12,000 and 13,000[2]. Of these, 75% is in categories 'BB' or lower. Consequently, the median rating has stayed put in the 'BB' category, whereas, it was in the 'AA' category around a decade ago *(see chart)*.

CRISIL's rating distribution



Source: CRISIL

[2] This excludes companies in the 'Issuer Not Cooperating' or INC category. CRISIL's portfolio had 5305 such issuers as on September 30, 2018. If these are included, CRISIL's outstanding rating list will be of 17082 issuers. But the median rating will remain in the 'BB' category.

Credit and debt-weighted credit ratios continue to exceed 1 time

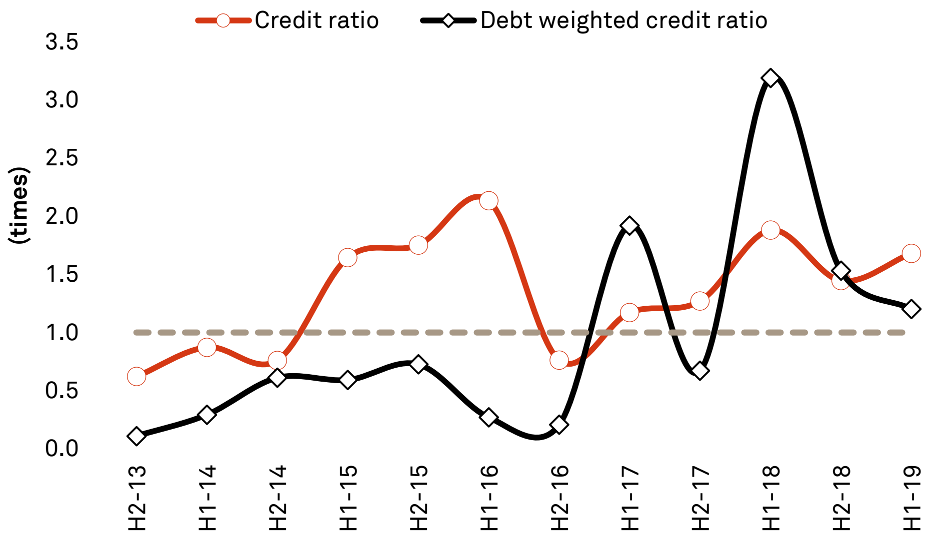
Credit ratio and debt-weighted credit ratio are at 1.68 and 1.20 times, respectively, for the past six months

Credit ratio and debt-weighted credit ratio are at 1.53 and 1.30 times, respectively, for the past 12 months

CRISIL's credit ratio and debt-weighted credit ratio were at 1.68 times and 1.20 times, respectively, for the first half of fiscal 2019 *(see chart)* from 1.45 times and 1.53 times in the second half of fiscal 2018 correspondingly.

Improvement in both credit ratio and debt weighted credit ratio indicates a broad based improvement albeit moderation from the first half of fiscal 2018, when the credit ratio peaked to 1.88 times and debt-weighted credit ratio was 3.19 times.

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



Source: CRISIL

The improvement in credit ratio can be seen in light of the GDP growth which has accelerated to 8.2% in Q1FY19 from 5.6% in Q1FY18. Further, Index of Industrial Production (IIP) has grown by 5.5% between April-July this year, compared with 1.7% in the year-ago period. This was partly due to a low base effect in last year due to the implementation of GST. The IIP growth was also driven by robust growth in the manufacturing sector from infrastructure and construction goods, and consumer goods.

In similar vein, the credit ratio for the first half of fiscal 2019 was in good measure driven by investment linked sectors. The government's spending on infrastructure, especially roads and affordable housing, has been a significant driver for activity in the investment linked sectors. The awarding of road projects continues the momentum from fiscal 2018. Last year saw 17,000 km road projects, the highest ever in a year, being awarded by both the Ministry of Road Transport and Highways and National Highway Authority of India (NHAI). Pace of construction, at 27 km per day, was twice that of fiscal 2014 and is further seen accelerating to 32 km per day by 2020 given NHAI's sharp focus on award of projects under the Bharatmala programme.

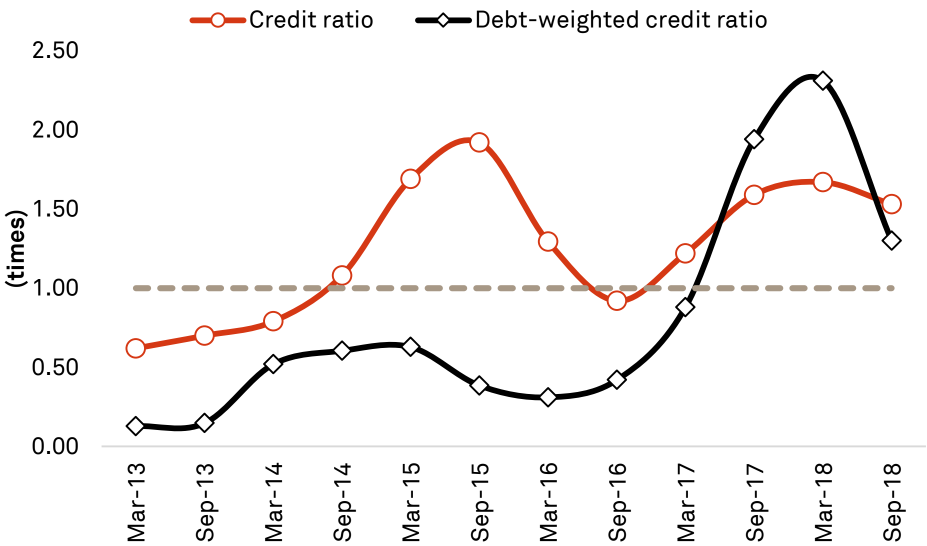
Exports growth has revived in fiscal 2019 after several quarters of sluggishness. During the first five months of fiscal 2019, India's exports grew 15.9% and engineering goods, petroleum products and chemicals were major gainers this fiscal, even as sectors such as gems and jewellery, and readymade garments continued to lag due to structural issues. The export growth is driven by a buoyant global economy, and a depreciating rupee is additional support.

As for domestic consumption linked sectors, first quarter of fiscal 2019 saw the highest increase in private consumption in last six quarters. Private consumption spend increased by 8.6% in first quarter of fiscal 2019 versus 6.7% in the previous quarter.

Credit ratio on 12- month rolling basis remains above 1 time, indicating improvement in credit quality is sustainable

To ascertain the sustainability of the credit quality improvement, the ratios were assessed on a 12-month rolling basis to avoid period bias. Both the credit ratio, and the debt-weighted credit ratio remain well above 1 time (*see chart*) on this basis indicating a broad based sustenance of credit quality.

12 months' rolling credit ratio and debt-weighted credit ratio



Source: CRISIL

However, all is not well given the volatile external environment with recent sharp rupee depreciation, tightness in the credit markets, rising trade protectionism that could potentially impact credit quality outlook. In this backdrop, we have analysed the impact of rupee depreciation in the section titled 'Despite headwinds, corporates are better placed to absorb external volatalities' in Page 13. Given the tightness in credit markets and volatile environment for non-banks, we have presented the assessment of liquidity in non-banks and our expectations in the section titled 'Liquidity management critical for non-banks' in Page 19. The volatile environment also calls for a check on the performance and quality of ratings which we have covered in the section titled "High stability and low intensity of rating actions" in Page 22.

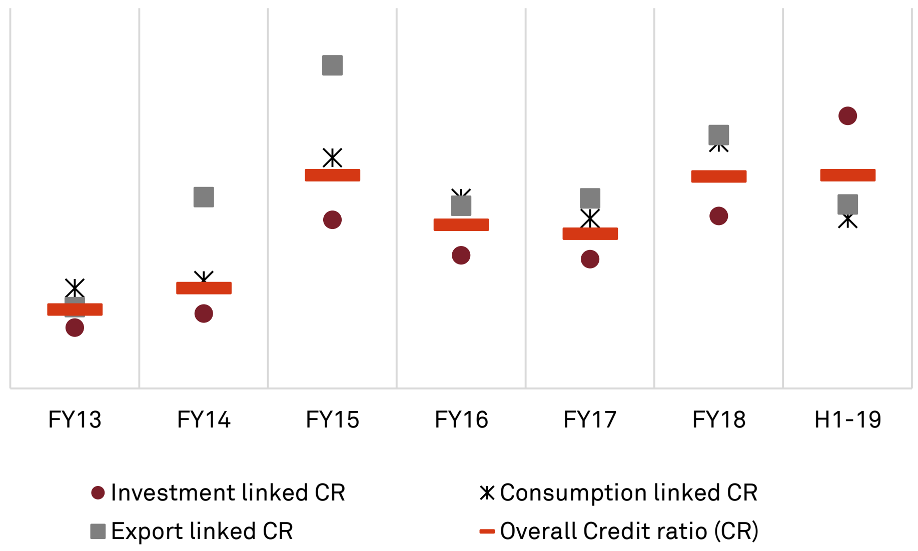
Improvement in credit ratio broad-based, across investment, consumption and export-linked sectors

Investment-linked sectors drive improvement in credit ratio

Consumption-linked sectors have retained their robust fundamentals

CRISIL's credit ratio improved to 1.68 times for the first half of fiscal 2019 from 1.45 times for the second half of fiscal 2018. The ratio is even higher for investment-linked sectors, at 2.15 times, after more than 5 years of sluggishness.

Sector-wise credit ratio



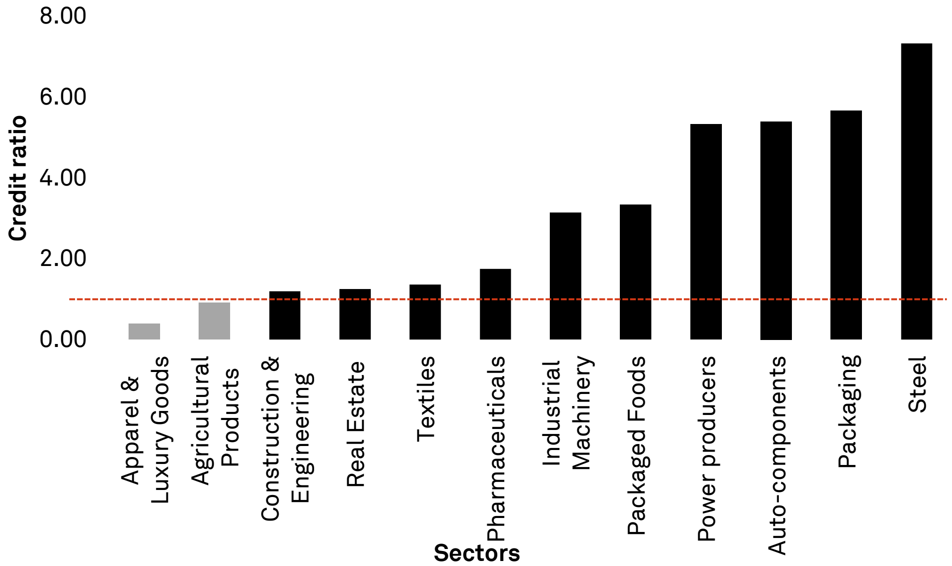
Source: CRISIL

The improvement in the credit ratio for investment-linked sectors was backed by higher domestic demand and realisations; Sectors such as steel, construction, and industrial machinery shall continue to benefit from the buoyant domestic demand for steel and improved government spending. One-time event related upgrades also benefited the sector. Entities owning commercial real estate properties, for instance, witnessed upgrades following a revision in the rating criteria for loans backed by lease rentals. The ratings of renewable power producers were upgraded following changes in promoters and consolidation in the renewable energy space.

Public sector investments are expected to continue to look up, as the government keeps at building roads and houses. A few sectors like automotive original equipment manufacturers (auto OEMs) and auto-component manufacturers are seeing start of capital expenditure driven by emission and safety regulations, but a broad-based recovery in the private sector spending is still delayed with capacity overhang and political uncertainty.

Consumption-linked sectors benefitted from improving demand, driven by benign inflation and implementation of the Seventh Pay Commission recommendations. Despite the upgrade in ratings of players in segments such as auto components, packaging and packaged foods, the credit ratio for consumption-linked sectors still moderated. This was on account of downgrades for players in agricultural products (especially sugar), and gems and jewellery. The downgrades in the gems and jewellery segment were due to lower demand and liquidity issues following the banks' aversion to lending to them. The credit risk profiles of players in agricultural products, specifically sugar, are under pressure due to the continuing weak profitability outlook for the sector.

Rating actions in top industries



(Refer to the section on 'Key reasons for rating actions, and sectoral credit quality outlook' for sectoral updates).

Source: CRISIL

Rupee depreciation to support exports; risks on trade protectionism persist

India's exports grew 15.9% in the first five months of fiscal 2019

IMF forecasts 4.8% global trade growth in 2018

S&P Global Ratings GDP forecasts 3% and 2.1% growth for 2018 for US and EU aided by large fiscal stimulus in the former, and labour market improvements in the latter. The outlook for 2019 is weaker vis-a-vis 2018 as fiscal spending starts waning in US and as rebound in energy prices impact household spending in EU.

S&P Global's GDP growth forecasts for major trade destinations

Countries	2016	2017	2018(F)	2019(F)	2020(F)
Eurozone (excluding the UK)	1.8%	2.6%	2.1%	1.7%	1.6%
UK	1.9%	1.8%	1.2%	1.4%	1.6%
US	1.5%	2.3%	3.0%	2.5%	1.8%
China	6.7%	6.9%	6.5%	6.3%	6.1%

Source: S&P

Further the recently announced and anticipated tariff increases by the United States and retaliatory measures by its trade partners could pose significant downside risks to global trade.

In July 2018, the International Monetary Fund (IMF) forecast that world trade volume would grow 4.8% and 4.5% in 2018 and 2019, respectively, after 5.1% growth in 2017. However, IMF noted that increasing trade tensions could be a key downside risk to these expectation. Beyond its immediate toll on market sentiment, the proliferation of trade measures could increase the uncertainty about the potential breadth of trade actions, thus hindering investment, while higher trade barriers would make tradable goods less affordable, disrupt global supply chains, and slow the spread of new technologies, thus lowering productivity.

CRISIL's credit ratio for export linked sectors was around 1.4 times in first half of fiscal 2019, albeit moderating from 1.72 times in previous six months period, in part reflecting concerns on rhetoric trade wars translating into specific announcements and action on ground by the two largest economies, US and China. While India's reduced competitiveness compared with Asian peers poses key risks for the long term, escalating trade tensions could prematurely derail the global growth momentum thus impacting India's export growth.

Risks on trade protectionism could persist however the impact still needs to be seen

In CRISIL's insight dated July 2018 titled 'Ring fence – How fit is India to fend off 1-2-3 punches', CRISIL had assessed the external risks and had noted that, the risks from rising crude oil prices could ease however those from asymmetric monetary policies and trade protectionism could persist.

Reading the impact of these shocks is not easy as they transmit through multiple channels and over an extended period of time. Besides, these shocks are still evolving, which makes it all the more difficult to decipher their final effects.

Yet, compared with fiscal 2014, we believe that India is way more resilient and looks better prepared vis-à-vis its own past and other emerging markets. But this is no time for complacence.

Large and medium firms drive improvement in the credit ratio

Large and medium firms have a credit ratio of over 2 times

Smaller firms sustain their credit ratio despite challenges

CRISIL has analysed the rating actions on firms in the first half of fiscal 2019, based on operating income (an indicator of scale of operations). Large firms (with annual operating income of more than Rs 500 crore) and medium firms (Rs 100 – 500 crore) outperformed the smaller firms. The healthy performance of the large firms may be attributed to strong revenue growth and efficient working capital management.

Trends in credit ratios based on operating income

Size of the firms	Fiscal 2018	H1 Fiscal 2019
Small firms	1.32	1.33
Mid-sized firms	2.31	2.35
Large firms	2.32	2.11

Source: CRISIL

Revenue of small firms have taken longer to recover from the challenges of Goods and Services Tax (GST) implementation. Businesses with limited pricing power bore the brunt of temporary downturn in demand, due to procedural delays during GST implementation. In addition, the banks especially those under Reserve Bank of India's (RBI) prompt corrective action (PCA), and reeling under pressure of bad loans have been reluctant to extend credit to the weak sectors. Despite challenges, ironing out of GST issues and improvement in demand have led to small firms sustaining the credit ratio in fiscal 2019.

Despite headwinds, corporates are better placed to absorb external volatility

Strong macro indicators and leaner balance sheets continue to support credit profiles

Impact of rupee volatility to be low

In fiscal 2019, corporates have faced the headwinds of rising interest rates, sliding rupee and potential risk of trade disputes translating into full-blown trade wars. While the former risks are predictable given that they have played out in previous years, the complex effects of the unprecedented tariff measures being announced by large economies such as the US and China remain to be seen. We expect strong macro indicators for the Indian economy, leaner corporate balance sheets, and greater caution towards taking on foreign currency exposure to support credit profiles. The impact of intensifying trade wars, however, will need close monitoring.

Strong macro indicators and leaner balance sheets leave corporates better placed to withstand risks

Corporates are better placed to absorb the impact of the current rupee depreciation than they were in the two major depreciations of fiscals 2009 and 2014. In fiscal 2009, corporates were at the peak of capital expenditure (capex) cycles and leverage and, hence, were not sufficiently prepared for the rupee depreciation. The impact of forex losses was, therefore, severe. The corporates were comparatively better placed to absorb forex losses in fiscal 2014. Leaner balance sheets and better macro indicators shall ensure firms are even better placed to cope with the depreciation in rupee value in fiscal 2019.

		Fiscal 2014	Fiscal 2019
Macro indicators		**Weak**	**Strong (forecast)**
GDP growth	%	6.4	7.5
CPI Inflation	%	9.4	4.7
G-sec yields	%	8.8	7.7
Fiscal deficit	%	4.4	3.3
Current account deficit	%	1.7	2.6
External indicators			
Peak exchange rate for first 6 months	Rs/$	61	72
Peak rupee depreciation for first 6 months	%	25%	12%
Crude prices	$/barrel	108	69
Corporate indicators			
Corporates – leverage		*As on March 2013*	*As on March 2018*
Capacity utilisation**		73%	73%
Gearing	Times	1.29	0.99
Interest coverage	Times	2.4	2.9
Credit ratio (12 months rolling)	Times	0.79	1.52

**: OBICUS survey by RBI

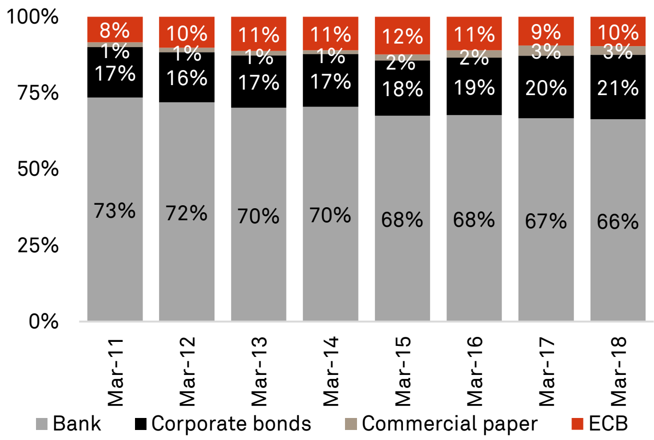
Source: CRISIL

The *Ratings Round-Up* of April 2018 noted that the credit risk profiles of corporates had improved due to healthier financial risk profiles. Stable revenue growth and profitability, lower capex (especially debt-funded), and higher capital infusions were the catalysts for growth in fiscal 2018. The capital infusions have continued in the first half of fiscal 2019. Debt-funded capex remains on the backburner for much of the private sector, given that capacities have headroom for higher utilisation. Therefore, financial risk profiles, may remain stable, barring a marginal moderation in interest coverage, against the backdrop of rising interest rates. The combination of better macro indicators and financial health shall stand the corporates in good stead to absorb foreign currency risks.

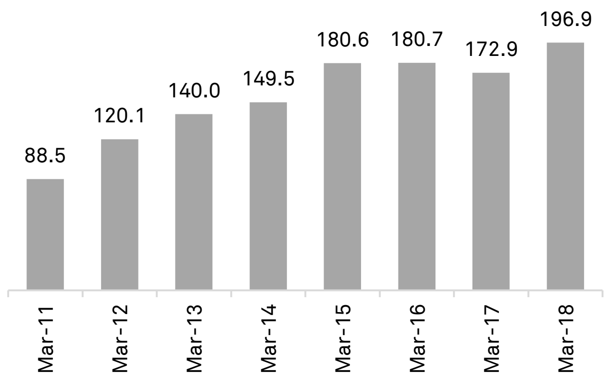
Cautious stance towards ECB borrowings compared with the past

The reliance of corporates on external commercial borrowings (ECBs) has remained largely stable due in part to the benign interest rates at home. There is also a growing aversion to forex risk, especially among firms without a natural hedge. ECB as a percentage of total credit mix remained at around 9-10%. In dollar terms, the borrowings have increased only marginally since 2015. Slowdown in export growth until fiscal 2018 and absence of major capex have also resulted in the reliance on external commercial borrowings remaining stable.

Composition of the Indian corporate credit market



ECB ($ billion)



Source: RBI, CRISIL estimates

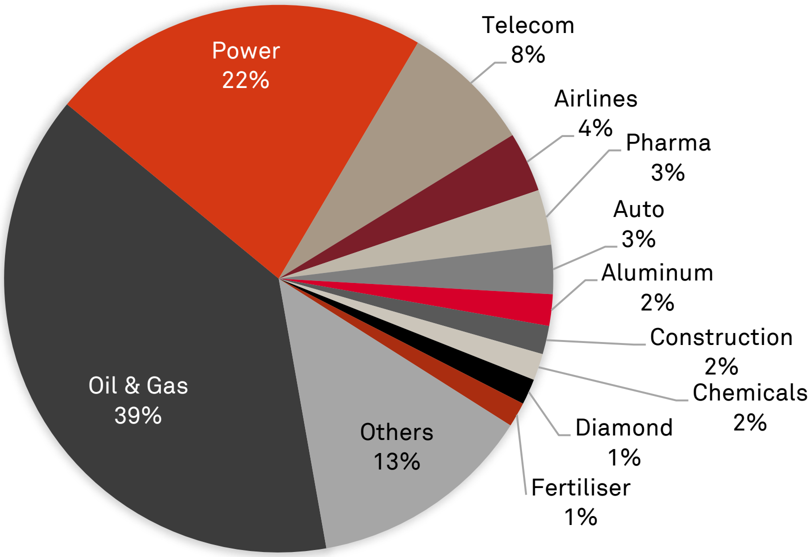
CRISIL's portfolio analysis: limited impact of rupee depreciation

CRISIL's outstanding portfolio of ~12,000 firms has over 2,500 firms (excluding financial sector entities) with sizeable foreign currency exposures – through imports and export, or foreign currency borrowings. Their foreign currency borrowings aggregated Rs 5 lakh crore as on March 31, 2018 – around 40% of the foreign currency borrowings of all Indian corporates. The rated firms are part of the top 10 importing sectors, as per the Ministry of Commerce & Industry.

Balance sheet exposure concentrated in large debt-heavy sectors

Long-term foreign currency loans have, typically, been contracted by the large corporates in debt-heavy sectors such as Oil & gas, Power, Telecom, and Airlines. Smaller companies generally avail of trade credit denominated in foreign currency.

Sectoral break-up of foreign currency borrowings in CRISIL rated firms



(Refers to standalone debt.)

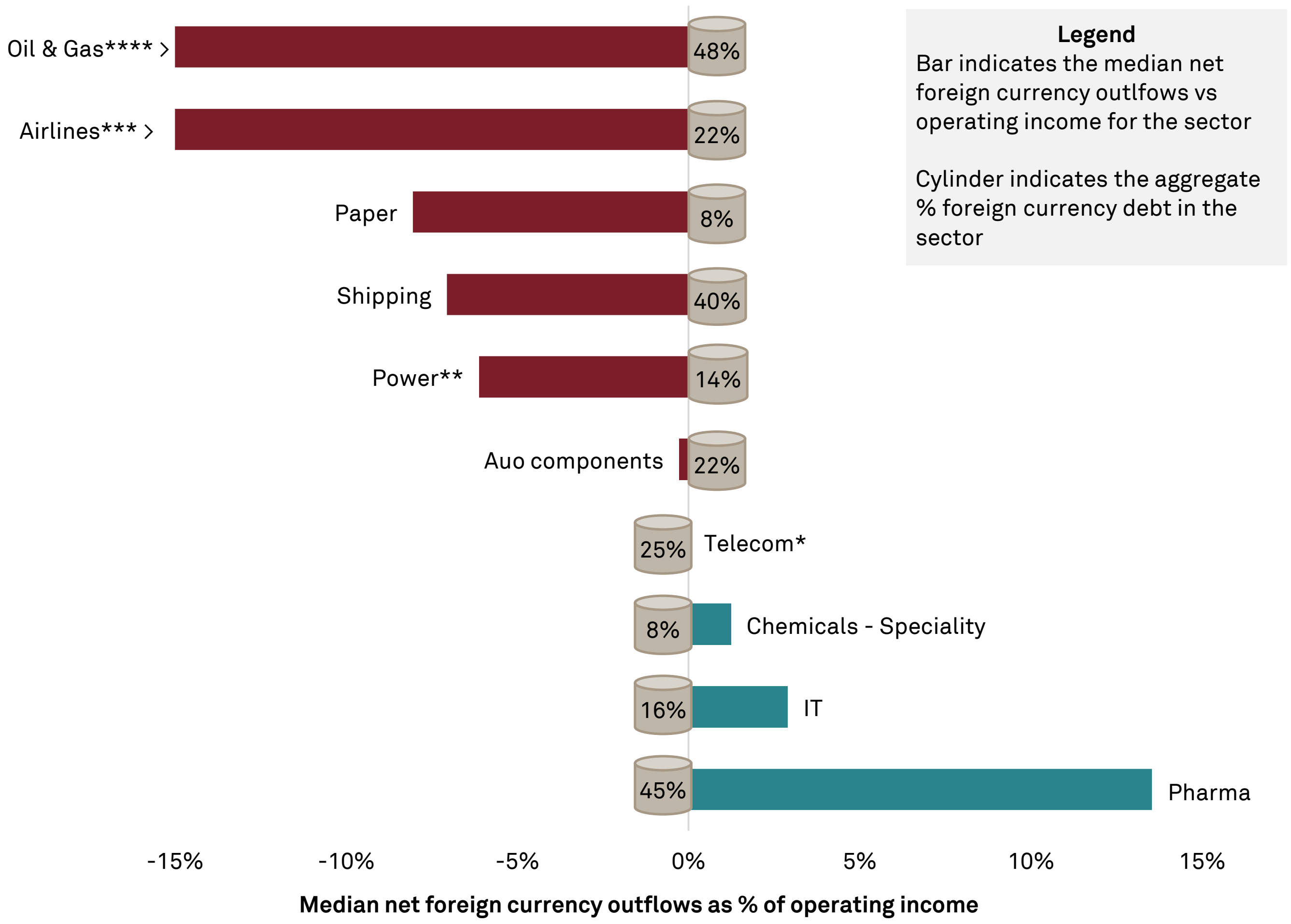
Source: CRISIL

Top 10 sectors with high foreign currency exposure

CRISIL's analysis on top 10 sectors with high foreign currency exposure is presented in the Chart below. Sectors such as Oil & Gas and Airlines have net outflows indicating that they are net importing sectors. Net importing sectors with high balance sheet exposure are exposed to rupee depreciation risks and are highlighted in red.

Also, sectors such as Pharmaceuticals and IT Consulting Services are net exporters which have a natural hedge against rupee depreciation.

Net foreign currency exposure across sectors



Net foreign currency outflow = Foreign currency income – Foreign currency expense

For sectors such as Power, Auto components, Specialty chemicals, IT, Pharma and Paper (refers to Writing and Printing Paper), foreign currency borrowings are concentrated in <20% of the total rated firms.

*Telecom is not estimated to have significant foreign currency expenses or income

**For Power, the estimation is based on the level of coal imports in India and the average cost of coal against income for a domestic coal based producer. However, the % exposure could vary based on the tariff structure and level of imports.

***Airlines the exposure is much above -15% and depends on the international operations

****For Oil & Gas, the exposure could vary depending on the presence in the value chain. (Segments including exploration, production, refining, marketing, storage and transportation are included in this analysis)

Source: CRISIL

Low impact on credit profiles

CRISIL's analysis shows that the level of hedging and pricing power enables the cushion on the impact on net margins on sectors with high net foreign currency outflows. The impact on net margins could be up to 150 bps.

Sectors	Median EBITDA margin	Hedging	Pricing power	Impact on net margins	Impact on credit profile
Oil & gas	15%	Moderate	High^	Low	Low
Power	34%*	Low#	Depends*	Depends*	Low
Telecom	11%	Moderate	Low	Moderate	Low
Auto components	11%	Moderate	Moderate	Low	Low
Shipping	15%	Low	Moderate	Moderate	Low
Airlines	8%	Low	Low	High	Moderate
Paper	10%	Moderate	Limited	Moderate	Moderate

*Depends on the tariff structure; renewable power producers have higher EBIDTA margins# Players with significant forex borrowings are large central utilities which do not hedge; ^under the deregulated pricing mechanism, oil marketing companies are allowed to pass on cost increases to end-consumers. However, the ability of OMCs to pass on cost increases in times of an unprecedented spike in oil prices remains to be seen.

Source: CRISIL

CRISIL believes that the impact on credit profile would be low across these sectors

- For debt heavy sectors such as Oil & gas, Power, Telecom, moderate hedging levels, pricing mechanism or support from parents leads to a low impact on the credit profile.
- In Auto components, exports provides a partial natural hedge. The sector also has moderate levels of contracted hedges and hence impact on credit profile is expected to be low.
- Operating profitability of Shipping industry is high, which would help cushion the impact of rupee depreciation on overall credit profiles.
- Airlines is a debt heavy sector where the impact on margins would be moderate to high whereas impact on credit quality would be moderate and hence needs to be monitored. Small scale of exposure in Paper firms limits the overall impact.

Liquidity management critical for non-banks; capital position adequate, asset quality steady

Asset yields unlikely to rise as much as borrowing costs

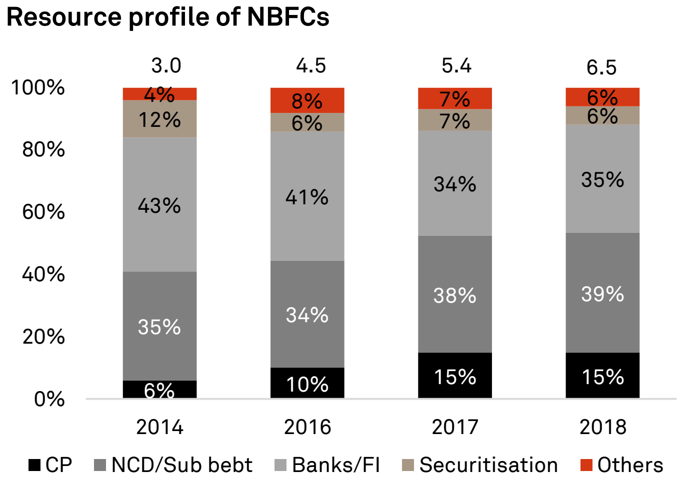
Credit market tightness is key monitorable

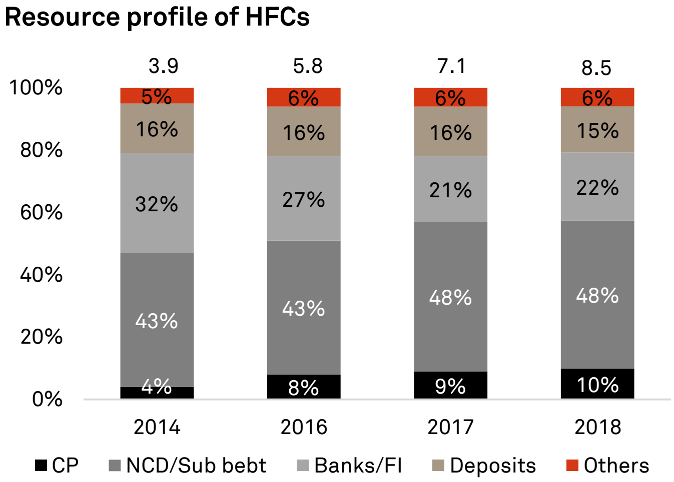
Non-banks (non-banking finance companies (NBFC) and housing finance companies (HFC)) have maintained their growth momentum from past years into first half of fiscal 2019. However, non-banks are facing challenges on the liability side in an environment marked by rising interest rates and increasing competitive intensity in some segments. Asset yields are unlikely to rise as much as borrowing costs. CRISIL in its press release dated July 11, 2018, had highlighted that non-banks were staring at a 50-75 bps squeeze in spreads (asset yield minus borrowing costs) in the face of these challenges and had also highlighted the systemic liquidity tightening and need for sharper focus on asset-liability maturity (ALM) management.

Since then, the environment has further turned fluid with recent defaults and subsequent volatility in the credit and equity markets especially for non-banks, clearly highlighting the need for more active liquidity management. Any continued market disruption potentially leading to constrained access to funding for non-banks will be a key monitorable.

For non-banks, increased reliance on capital market borrowings, especially short-term instruments

Non-banks have increased their share of borrowings through capital market instruments (*refer to chart below*) till fiscal 2018 driven by benign interest rates. The share of commercial paper (CPs) increased, especially for NBFCs. Potential risk in CPs emanates from high dependence on rollovers and refinancing on maturity; the ability to do so is very sensitive to the confidence levels in the market. Given the volatile credit markets, maintaining adequate liquidity cushion is critical; the quantum and quality of which, becomes a key differentiator for non-banks over the near term.





Figures above the bars represent total borrowings in Rs lakh crore

Source: CRISIL estimates

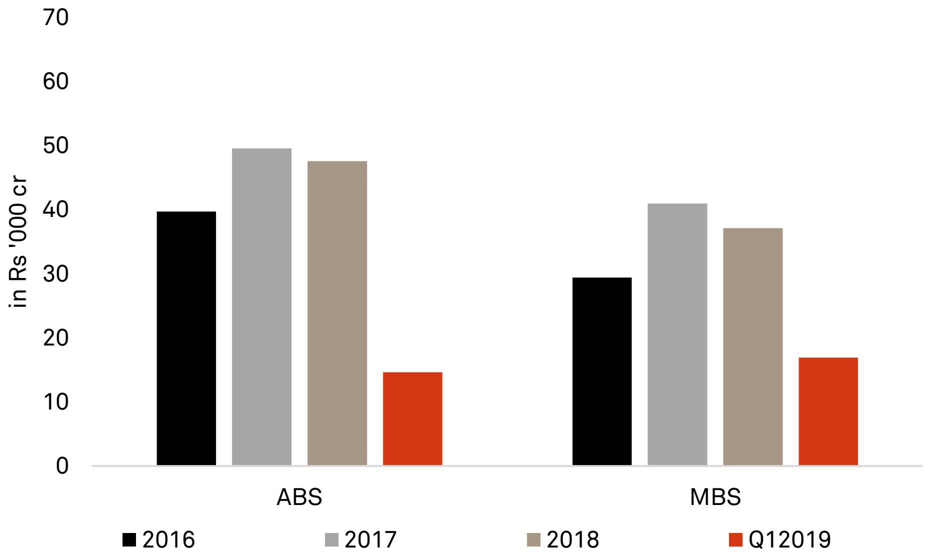
Liquidity profile

Analysis of ALM and liquidity plays a key role in CRISIL's assessment of financial sector entities. CRISIL rated players with high safety ratings, have a close focus on asset liability management and keep liquidity in various forms including cash equivalents and unutilised bank lines.

Based on their asset liability maturity profile, non-banks keep adequate liquidity cushion and also structure the short-term debt maturities so that they are spread out over a period. For wholesale non-banks, even with well-matched asset liability maturity profile, chunkiness of loan assets is an important factor to manage and is a key monitorable.

The option to securitise assets within a short period of time, however, acts as an additional fall back liquidity option for non-banks. Securitisation has been on the rise in the recent years and will provide added support to non-banks.

Securitisation volume



Source: CRISIL

Steady asset quality and capitalisation adequate

Growth prospects of non-banks remain favourable, driven by product/process innovation, ability to reach difficult-to-connect customer segments and vacuum in the market created by public sector banks put under the PCA plan by RBI. Non-banks have adequate internal capital generation and timely equity raises (Rs. 40,000 crore capital raised in past five years itself) have shored up their capital base. The asset quality for non-banking finance companies has improved in recent years, while housing finance companies continue to show resilient asset quality.

Asset liability maturity profiles of CRISIL rated non-banks remain consistent with their ratings. However, any continued market disruption potentially leading to constrained access to funding for non-banks will be a key sensitivity factor.

High stability and low intensity of rating actions in CRISIL's portfolio result from rigorous and scalable processes

Stability rate of above 95% in AA and above rating categories

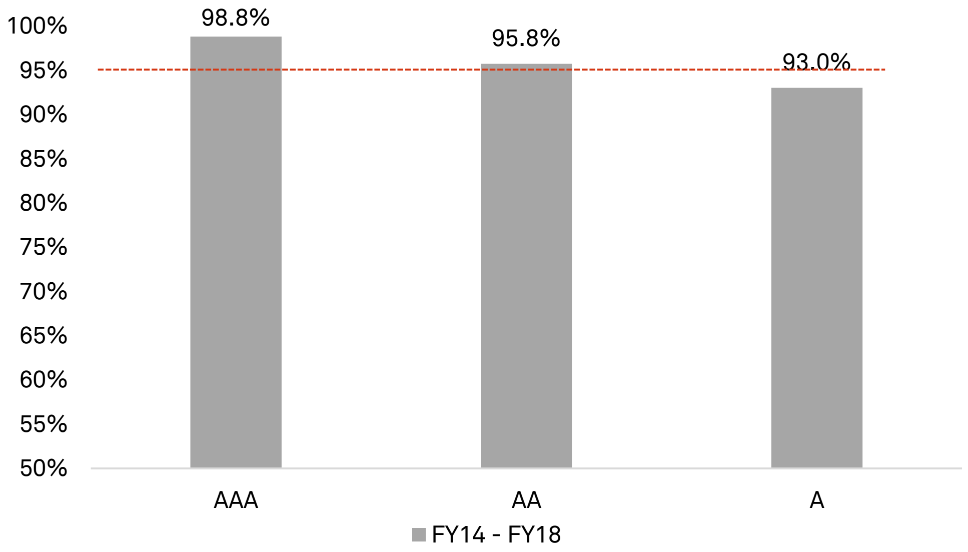
Over 97% of rating actions of low and medium intensity

CRISIL's high stability rates help investors with their long-term investment decisions. The stability rate indicates the percentage of ratings that remain unchanged over a given time horizon.

Consistently high stability rates indicate that ratings have been assigned at the right level, *ab initio*, and that the probability of sudden changes in ratings is low. High stability rates, in other words, indicate a high probability that the ratings will not see unexpected changes over a given time horizon.

CRISIL's rated portfolio has consistently displayed higher stability rates across the industry over the last five years, with an average stability rate of above 95% for AA and above rating categories and above 93% for A category in the five fiscals through March 2018.

Stability rates for A and above rating categories for the past 5 fiscal years



Source: CRISIL

Over 97% of rating actions in high rating categories continue to be of low to medium intensity

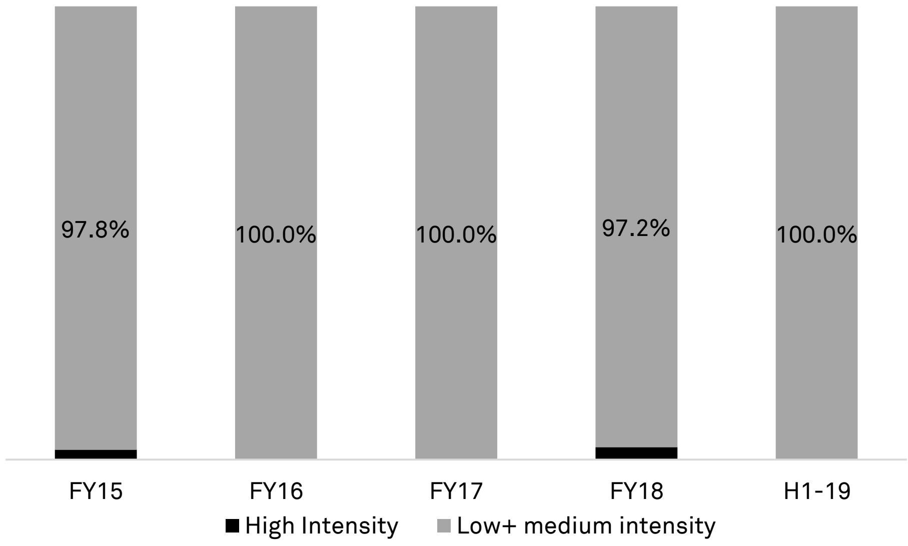
Along with stability rates, investors also consider the intensity of rating actions. If a rating is prone to sharp rating movements during a short period of time, it poses a significant risk to investors with little scope to manage their exposure.

CRISIL remains keenly focused on the quality of its ratings. The regularity of its surveillance minimises sudden and sharp rating actions (both upgrades and downgrades).

The intensity of CRISIL's rating actions has been lowest in the industry over the last five years, especially for high rating categories 'A' and higher (*see chart below*), with over 97% of the rating actions in these categories have been of low to medium intensity. 'CRISIL AAA' and 'CRISIL AA' categories have not witnessed a high intensity rating downgrade (or a downgrade by more than 2 notches) in the last five years.

In the first half of fiscal 2019, there were 85[3] rating actions in the category 'A' and higher out of a portfolio of 1210 ratings in these categories. Of these rating actions, 80 were of low intensity, 5 of medium intensity, and none of high intensity.

Intensity[4] of rating actions for A and above rating categories



Source: CRISIL

[3] This is based on number of instances of rating actions and could include multiple rating actions on the same company.

[4] Excludes ratings placed on 'Rating Watch', which is used to convey to investors that the rating is being monitored for certain critical events and that additional information is awaited. This helps reduce the possibility of any surprise for the investors

Robust and scalable processes at the core of high quality of ratings

- CRISIL's rating process is designed to ensure that all ratings are based on the highest standards of independence and analytical rigour, and also that adequate quality controls are present at each stage of the rating process
- Apart from the annual surveillance, CRISIL has systems to ensure monitoring of market developments including material events, followup of repayment schedules etc which helps respond to credit related events faster. Further, CRISIL also undertakes analytical initiatives such as sector level surveillance and portfolio level surveillance to ensure that macro events in the industry are analysed and credit impact is assessed.
- CRISIL has processes to look back on rating actions that were higher than expected from the rating category, to ensure that processes are placed to avoid recurrences.
- CRISIL's layered approach for proactively analysing events that could pose credit risk and post event analysis in case of any misses, ensure that outstanding ratings continue to reflect the credit quality of the debt instruments and enables robust stability rates for CRISIL.

Outlook

Corporate credit quality to sustain

CRISIL expects corporate credit quality to sustain. This will be driven by strong macro indicators, firming up of domestic consumption due to increase in minimum support prices supporting rural income and implementation of Seventh Pay Commission recommendations, increase in infrastructure spending by the central and state government, and stable commodity price outlook especially for steel. While consumption –linked sectors will benefit from the rising private consumption, export-linked sectors will benefit from the rupee depreciation over the near term and from the buoyant global economy.

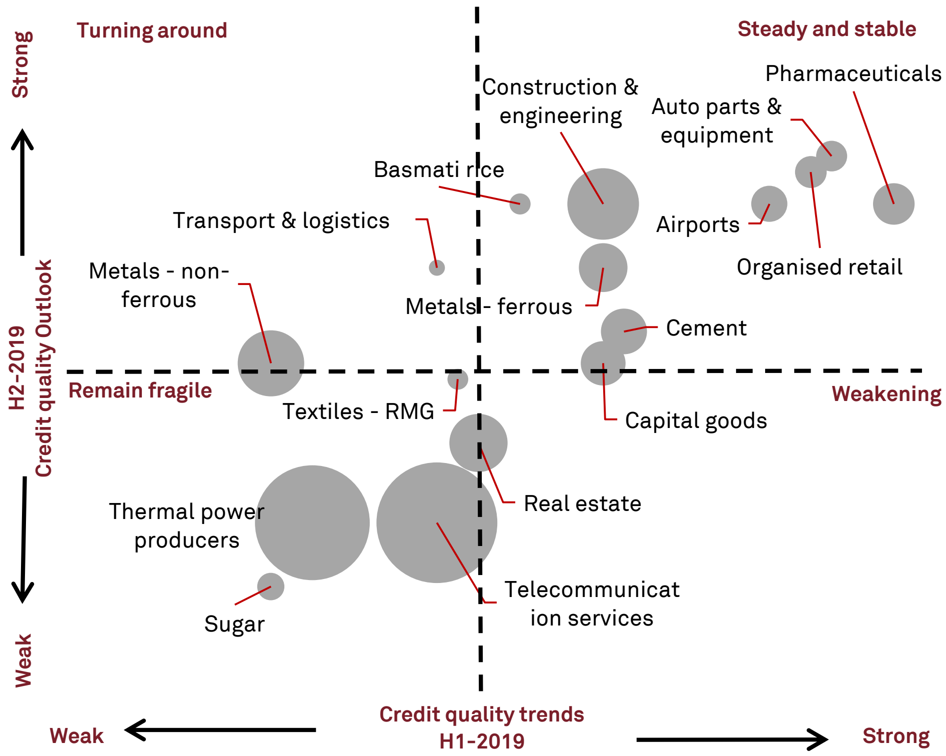
Real investment growth is expected to pick up in fiscal 2019 led by public sector spending. However, the recovery will be gradual as capacity overhang continues to discourage broad-based private investments. Several sectors, including steel, are in the consolidation phase to better absorb existing capacities. Hence, stressed asset resolution via the IBC will also play a key role in reviving private investments.

As for the stressed assets, CRISIL believes that the stock of Gross Non-Performing Assets (GNPA) has peaked at 11.6% in fiscal 2018 and recede by the end of fiscal 2019 driven by resolution of large Non-Performing Asset (NPA) accounts (constituting almost half of the corporate NPAs in the system) under the IBC and limited incremental slippages to NPAs.

Overall, the risks to these expectations are:

- Continued tightness in credit markets for non- banks
- Heightened global trade protectionism
- Sharp rupee depreciation from current levels and rising interest rates
- Re-leveraging due to increase in capex and acquisitions.

Corporates: key reasons for rating actions, and sectoral credit quality outlook



Note: Size of the bubble depicts book debt in the sector of CRISIL-rated portfolio
*Also the bubble chart for thermal power producers excludes book debt of NTPC
Source: CRISIL

CRISIL expects corporates to benefit from improved demand, driven by benign inflation, normal monsoon and rural incomes, implementation of Seventh Pay Commission recommendations, and increase in government spending on construction.

Some investment-linked sectors, such as thermal power producers and real estate, however, continue to face headwinds on account of subdued demand. Real estate upgrades in H1-2019 pertains to upgrades on entities with loans backed by commercial lease rentals. Structural outlook continues to be subdued. The telecommunications sector continues to face intense competition. Similarly, the sugar and textiles- RMG sector faces pressure from a weak profitability outlook.

Automotive components

Upgrades

Upgrades were mainly driven by business related reasons - healthy demand from original equipment manufacturers (OEMs), steady profitability. Prudent capital expenditure and working capital management ensured adequate liquidity, which, in turn, led to stronger financial risk profiles

Downgrades

Downgrades were mainly due to weak liquidity, low cash accrual, and stretch in working capital cycle.

Automotive components advanced towards higher growth

In fiscal 2019, the automotive components industry is expected to grow 12-14% year-on-year over a high base, on the back of steady demand from domestic manufacturers across vehicle segments. Higher disposable incomes, new model launches, and pick-up in infrastructure activities shall continue to drive strong growth rates across passenger vehicle (PV) and two-wheeler segments. The commercial vehicle (CV) segment is projected to expand at 11-13% in fiscal 2019 benefiting from the government's infrastructure push and four consecutive years of good crops.

Export demand is also expected to grow at 8-10% over the medium term, on the back of a revival in demand for Class 8 trucks in the US, steady momentum in the European markets, and increasing penetration into Asian markets.

The upward trend in interest rate and fuel prices may act as dampeners leading to increase in cost of ownership for end-consumers. However, profitability of automotive component makers is expected to remain stable despite rise in raw material prices in fiscal 2019 owing to their ability to pass on the increase in input prices.

Over the medium term, automotive component suppliers that had not raised much debt in the past 2-3 years are expected to see an increase in borrowings to part-fund the capex required to adhere to government's decision to implement Bharat Stage-VI norms from fiscal 2021. Many players are also investing in new technology to capitalise on the rising demand for hybrid and electric vehicles. Steady margins and higher turnover will ensure healthy returns despite higher capex spending. Healthy balance sheets and better cash flows will provide necessary cushion to absorb higher capex requirement, without denting key credit metrics.

Basmati rice

Upgrades

Upgrades were largely in the non-investment grade rating category. Better demand and higher sales realisations led to stronger business risk profiles for players

Downgrades

Downgrades were mainly on account of stretch in working capital cycle, with increases in inventory being funded by debt.

Siginificantly better exports sales realisations seen in fiscal 2018 likely to sustain in fiscal 2019

India exported 4.05 million tonne (MT) of basmati rice, valued at Rs 26,870 crore in fiscal 2018. That was an increase of 1.8% by volume and 25% by value (from 4 MT and Rs 21,512 crore, respectively, in fiscal 2017). Average sales realisations of India's basmati exports improved 23% in fiscal 2018, after three consecutive years of subdued performance. Aided by high demand and depreciating rupee, sales realisations continued to be high in April-June 2018.

Paddy prices are expected to be higher in the upcoming rice season of 2018-19. However, these may be passed on to buyers overseas. The credit risk profiles of basmati rice exporters shall improve over the medium term, backed by better operating profitability and stable demand, especially overseas.

Construction & engineering

Upgrades

Upgrades were driven by healthy growth in revenue supported by sustenance of a strong order book coupled with improvement in the operating margin. Also by, a better financial risk profile driven by low gearing and higher debt protection metrics due to an increase in cash accrual.

Downgrades

Most of the downgrades were due to lower profitability and/or decline in sales on account of intense competition in the roads and bridges segment. Further, a stretched working capital cycle due to higher inventory and slower realisation of receivables impacted liquidity, leading to a few downgrades.

Note: The credit risk profiles of many large, diversified engineering, procurement and construction (EPC) players remain constrained by the after-effects of aggressive bidding in the past, leveraged balance sheet, and policy bottlenecks. Many of these companies are in the process of debt resolution. These are rated 'D' and have seen no change in their ratings. Hence, the analysis excludes stressed assets and is more representative of the non-stressed portion of the corporate loan book.

Infrastructure investments to drive construction spend

A compound annual growth rate (CAGR) of 7-8% is likely in investments in the construction sector over fiscals 2019-2023 as against 2.2% during fiscals 2014-18, driven by increased construction spend in the infrastructure segment. Within infrastructure, the roads segment would dominate construction activity with a contribution of 40% of the total construction spend, followed by irrigation and urban infrastructure.

The sector is expected to benefit from key recent policy reforms such as awarding of national highway projects only after the required land is in possession by the government, payment of 75% of arbitration claims to private players against a bank guarantee, the one-time fund infusion by National Highways Authority of India (NHAI) into stalled projects, premium rescheduling of projects to improve cash flows of developers, and 100% exit in build-operate-transfer projects to release equity tied up by developers and reduce their debt. Further, increase in projects awarded under the engineering, procurement and construction (EPC) mode, and introduction of the hybrid annuity model, wherein project risk is shared by the awarding authority, have improved private participation and boosted execution pace, thus contributing to better performance of the companies. Introduction of schemes from the central government including smart cities is also expected to create new order flow.

Slow project execution and heavy cost overrun in legacy projects dented profitability of many companies in the past and led to highly leveraged balance sheets. Hence, such players may not be able to fully capitalise on the emerging construction opportunities. Asset monetisation by floating of infrastructure investment trusts (InvITs) and equity infusion would help improve the credit risk profiles over the medium term. This, along with recent policy reforms, is expected to aid in better order inflow and improved working capital cycles, thus supporting the credit risk profiles.

Independent power producers

Upgrades

Upgrades were mainly for renewable generation and were driven by commencement of operations, thus mitigating project risk; and timely payments by counterparties.

Downgrades

Weak operating performance, lower realised tariff, and delays in commencement of operations led to downgrades.

Resolution of stressed assets could mark a turning point for the beleaguered sector; safeguard duty is a monitorable for the solar sector while ramp-up in transmission evacuation infrastructure will be a key for both solar and wind

India’s thermal power sector seems to be heading to a turning point, as lenders work towards resolution of stressed thermal-coal assets in the private sector through haircuts and financial safeguards in the form of liquidity support, stretched repayment structures, and adequate working capital financing.

Nearly 22,000 megawatt (MW) of such operational assets remain under stress due to multiple reasons, including lack of adequate power purchase agreements (PPAs) and fuel supply agreements (FSA), over-leveraging due to time and cost overruns, and aggressive bids.

Therefore, the expectation of structural changes through execution of new PPAs and adequate FSAs being in place is fundamental to the de-stressing of these assets.

The recent auctions of 2,500 MW of medium term PPAs (expected at tariff of Rs 4.24 per unit with assured off take of at least 55%) and coal linkages allotted earlier this year under the Scheme for Harnessing and Allocating Koyla Transparently in India (SHAKTI), could prove to be the much needed shot-in-the-arm for such assets.

Government’s continued focus on meeting its 24 x 7 Power for All objective and low per-capita power consumption are likely to drive power demand, which is expected to grow at a healthy pace of over 6% over the next 4-5 fiscals (5.5% in fiscal 2018).

That, coupled with a general slowdown in thermal capacity addition over this period (around 40,000 MW is expected to be added till fiscal 2022, compared with 98,000 MW between in fiscals 2013-17), should benefit existing capacities, as there is a likelihood of another round of fresh, medium-term PPA auctions in the near term.

As these assets become viable through haircuts and other structural and financial safeguards, their cost of generation could significantly reduce, making them a source of cheap power for state distribution companies (discoms).This could also reduce the risk of such assets being exposed to vagaries of the short-term market.

The credit quality of renewable assets has been improving for operational projects with projects getting commissioned and improving payment cycles from counterparties.

Capacity additions in solar power declined in the first half of fiscal 2019 on account of ongoing uncertainty regarding safeguard duty on imported solar modules. If the duty is applied retrospectively, it will lower the cushion for debt servicing of such projects. Thus, the final safeguard duty will be a monitorable for solar assets.

Tendering of solar and wind capacity also slowed in the first half of fiscal 2019 on account of uncertainties with respect to transmission infrastructure.

Distribution remains the weakest link in India’s power sector value chain. With implementation of the Ujwal Discom Assurance Yojana (UDAY) scheme, the likelihood that discoms will re-initiate signing of new PPAs will depend on their ability to adhere to targets set out under the scheme and thereby reduce losses.

Pharmaceuticals

Upgrades

Improving business risk profiles backed by stabilisation of new products and entry into new markets, stemming from steady demand in domestic and international markets, led to most of the upgrades

Downgrades

Downgrades were mainly due to subdued operating performance with lower profitability and cash accrual. A stretch in the working capital cycle of smaller players also impacted their liquidity.

New product launches and steady volume growth ensure stable health of the pharmaceutical sector

The sector is going through a period of relative calm after regulatory hiccups in the domestic industry and competitive pressures in global markets. The expected high single-digit growth shall support the strong credit risk profile of the industry. Pricing pressures both in overseas and domestic markets are key deterrents to overall growth.

The domestic market, which accounts for most of the industry revenue, remains the mainstay as rising healthcare spending and awareness, and strong volume growth, especially in diseases caused by lifestyle disorders and those in the chronic segment, will continue to drive 10-11% growth per fiscal growth. However, smaller players will face hurdles in the form of increased regulatory focus.

Growth in formulation exports will be 6-7% per fiscal over the medium term. The growth in regulated markets is expected to recover with pricing pressure expected to ease over the medium term. The share of the regulated segment in overall sales is expected to increase over the medium term for larger players, backed by higher contribution from complex generics. Further, profitability of large formulation players is estimated to revive in fiscal 2019 due to first-to-file launches and consolidation in pricing. The revival will, however, be slower for mid-sized players. Increasing prices of technical and intermediaries imported from China on account of supply shortage due to pollution norms will continue to weigh on the profitability of domestic formulation manufactures.

The bulk drugs segment growth is expected to be sustained on the back of exports growth and steady demand from the strong domestic formulations segment. Profitability will remain range-bound as increase in demand/expansion into specialty products will be offset by pricing pressure from the traditional segment and continued competition from Chinese players.

Real estate

Upgrades

Higher sales, advanced stage of existing projects, and collection efficiency leading to sizeable cash inflow led to upgrades. Upgrades were also driven by higher-than-expected funding support from promoters and refinancing of debt resulting in improved liquidity and debt service coverage ratios (DSCRs).

Downgrades

Already subdued demand was exacerbated by demonetisation, the Real Estate (Regulation and Development) Act (RERA), and the goods and service tax (GST).

Almost half of the downgrades were in the residential real estate segment on account of lower-than-expected sales. Around 50% of these downgrades were to the default category.

Affordable housing and commercial realty to offer respite

The residential real estate sector has been facing headwinds for the past few years, given weak demand and thereby declining sales velocity, subdued cash collection, fewer new project launches, and large unsold inventory. Developers are likely to face funding challenges in the medium term, with limited flexibility to access funds from other projects and the RERA requirement of timely completion of projects. Although there have been few project launches, uptake has been encouraging for established brands with track record of timely implementation. Developers with better internal controls and compliance systems have successfully navigated the structural changes in the sector. Unorganised/small developers have been opting for collaborations with larger established names to benefit from their processes and financial flexibility.

Demand is expected to recover gradually over the medium term, especially in the affordable housing segment. The government has budgeted a capital outlay of Rs 31,500 crore under the Pradhan Mantri Awas Yojana for fiscal 2019, which is expected to sustain traction in new project launches in the affordable housing segment. In commercial real estate, with limited additional supply, occupancy has remained steady and rentals are expected to stay healthy driven by improving business conditions.

Strong traction continues in the retail sector given the healthy performance of established retail malls across India and hence garnering interest from large foreign institutional investors. Real estate investment trusts (REITs) are emerging as an attractive avenue for large developers and investors with income-generating commercial and retail assets, especially after recent clarifications and amendments. This will enable them to monetise assets, while lowering cost of capital, and help diversify their funding source.

Steel

Upgrades

Most of the upgrades were due to improvement in business risk profiles – healthy demand leading to better capacity utilisation and higher realisations due to increase in domestic steel prices resulting in higher cash accrual.

Downgrades

Downgrades were mainly driven by lower-than-expected revenue and profitability, leading to pressure on debt protection metrics. Working capital cycles remained stretched, thus impacting liquidity.

Around 40% of the total downgrades were to the default category.

Note: The analysis below excludes stressed assets with banks and is more representative of the non-stressed portion of the corporate loan book.

Improving credit quality of steelmakers

The credit quality of steelmakers is likely to get better due to improving industry dynamics in China, robust infrastructure-led demand in the domestic market, and faster resolution of stressed assets.

China accounts for almost half of world steel consumption and supply. It has cut significant capacity and aims to reduce to 1 billion tonne by 2020, and is trying to reduce dependence on exports by encouraging domestic consumption. While a structured slowdown in capacity cuts is expected, any sharp trigger such as a real estate crash in China can impact steel dynamics globally.

Global steel demand is expected to grow at 1-2% through 2022. However, demand from emerging economies is expected to improve. US trade restrictions are expected to have a limited impact on India or China as they export less than 1 million tonne each to the US. However, restrictions by the European Union (EU) through quota tariffs have already reduced India's exports by one-third in fiscal 2019 compared with fiscal 2018.

The domestic spread will remain healthy backed by easing of global pressures and robust domestic demand in fiscal 2019. Domestic demand growth is expected to remain firm at 7-7.5% in fiscal 2019 owing to strong demand from government-led projects. In fiscal 2019, significant improvement in the operating margin of large players is expected. Small and mid-size players (especially long steel) will also benefit from healthy volume growth and modest price hikes. Consequently, the credit quality of steelmakers is expected to continue to improve. Resolution of stressed assets and capex of around Rs 80,000 crore over the three fiscals through 2022 is triggering consolidation with the top three players expected to gain 500-750 basis points market share.

Textiles

Upgrades

Increase in the scale of operations due to capacity additions backed by healthy demand and a diverse client-base, leading to higher-than-expected cash accrual and improved liquidity led to upgrades.

The upgrades were mainly among readymade garments and weaving, knitting, and processing segments (around 45% of the industry).

Downgrades

Most of the downgrades were due to weak liquidity because of lower cash accrual and a stretch in working capital requirement. As a result, there is high dependence on external borrowing.

Almost 60% of the downgrades were to the default category, including two investment grade defaults in the readymade garments segment.

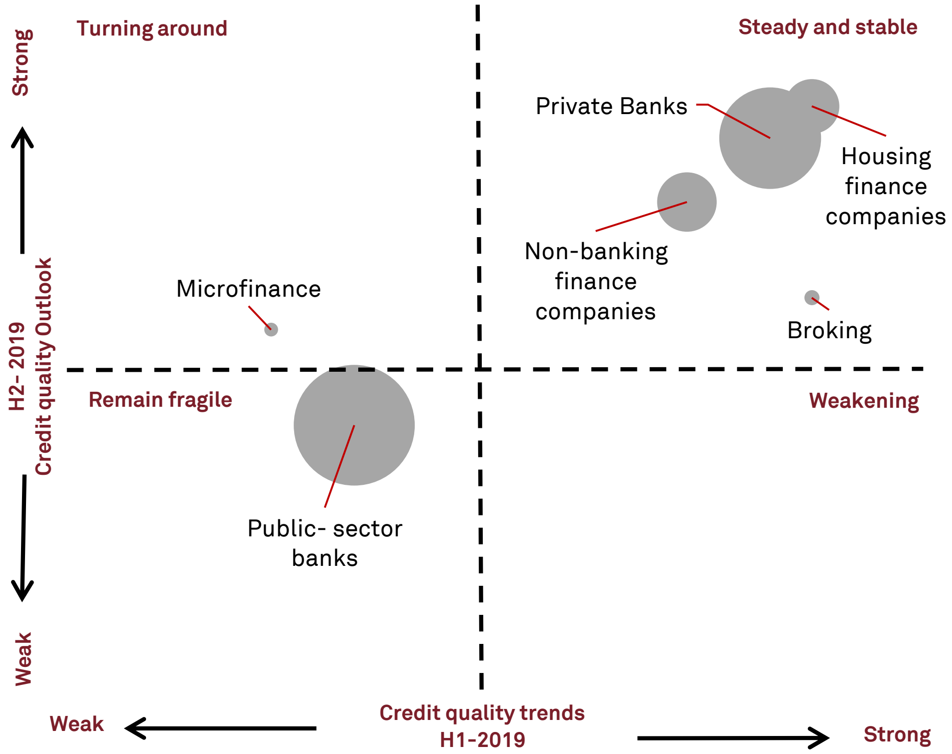
Domestic demand to drive growth, exports to remain impacted by lower competitiveness

A CAGR of 10-12% is expected in domestic demand for readymade garments between fiscals 2018 and 2023, driven by rising income, increased penetration of organised retail, and growing preference for readymade garments. Export demand is expected to decline 5-6% in fiscal 2019 due to increased raw material prices and low cost competitiveness (compared with Bangladesh and Vietnam). CAGR in exports is likely to be lower at 4% in 2018-23 compared with about 7% in the last decade. Accordingly, the share of exports in the overall readymade garments industry is expected to decline.

The financial risk profile of the industry in general and credit risk profiles especially of organised players are expected to improve in fiscal 2019 supported by recovery in global apparel consumption, weaker rupee, and streamlining of operations under GST.

Cotton yarn demand is estimated to grow at 3.5-4% in fiscal 2019 driven by domestic consumption supported by rising disposable incomes. However, substitution by man-made yarn due to cost effectiveness will cap the long term demand growth. Derived demand for cotton yarn is expected to slightly recover in fiscal 2019 as consumption in the US and EU improves; however, the pace of long-term derived demand growth will be slow owing to India’s lower cost competitiveness. Export growth in fiscal 2019 is expected to improve to 2-3% on the back of favourable domestic cotton prices. Over the long term, export growth is likely to be lower than the 5% growth witnessed in the past 10 fiscals. Profitability and credit risk profiles of spinners are expected to improve in fiscal 2019 aided by favourable raw material prices, better domestic offtake, and near-term recovery in export growth.

Banks and financial institutions: Sectoral credit quality outlook



#Size of bubble indicates net worth of rated portfolio

Source: CRISIL

Growth potential for non-banking finance companies (NBFCs) and housing finance companies (HFCs) remains high. NBFCs should continue to strengthen their market position supported by inherent strength in niche customer segments and ability to quickly adapt to market changes. For HFCs, large unmet demand for housing provides structural support for growth. Overall asset quality metrics to remain comfortable. For both NBFCs and HFCs. However, liability side challenges exist and asset yields are unlikely to rise as much as borrowing costs. As a result, profitability is expected to be squeezed by 50-75 bps. Asset-liability maturity (ALM) and liquidity management will occupy centre stage during fiscal 2019.

As for banks, stressed assets are unlikely to increase materially. CRISIL believes that the stock of Gross Non-Performing Assets (GNPA) has peaked at 11.6% in fiscal 2018 and recede by the end of fiscal 2019. This is in line with our expectation published in the Ratings roundup in April 2018. Improvement in GNPAs is expected from the resolution of large Non-Performing Asset (NPA) accounts constituting almost half of the corporate NPAs in the system under the Insolvency and Bankruptcy Code (IBC). This will improve recoveries for banks and help in reduction of existing stock of NPAs. Further, improving credit quality of corporates and recognition of most of the existing stressed assets are expected to limit incremental slippages to NPAs. This is also reflected in the material reduction of SMA-2 (or special mention accounts) accounts thus indicating that the potential NPA's are declining.

CRISIL expects microfinance companies to turn around in fiscal 2019 and report healthy profitability. Asset quality headwinds faced by the microfinance sector as an off shoot of demonetisation have truly passed away and cumulative collection efficiencies for disbursements in the last one year have remained consistently around 99%. Capitalisation will continue to be the key credit profile differentiator for MFIs, given the inherently weak borrower segment, susceptibility to socio-political issues, and the consequent volatility risk to asset quality and profitability metrics.

Banks

Banking sector outlook NPAs edges towards peak as resolutions pick up

Owing to stress in the corporate loan book, and the Reserve Bank of India's (RBI) mandate to proactively recognize NPAs (non-performing assets), banks have recognized over Rs 14 lakh crore worth of NPAs in past three years. Gross NPA levels (as a percentage of gross advances) in the banking system should peak this fiscal and start receding from the second half, driven by three factors

First, incremental slippages to NPAs would be lower due to both recognition of most of the existing stressed assets as NPAs, and improvement in the credit quality of corporates (on the back of firming up of commodity prices, stable macros, improvement in capital structure and debt protection metrics). Second, SMA-2 (or special mention accounts, where loans are overdue for 60-90 days) cases have reduced materially, which means stressed loans that had the potential to become NPAs have declined. Third, the expected resolution of some large NPA accounts under the Insolvency and Bankruptcy Code (IBC). This could improve recoveries for banks and help in reduction of existing stock of NPAs.

Pre-provision profits of banks should further stabilize this fiscal onwards, supported by better credit growth, lesser interest reversal from NPAs and gradual improvement in non-interest income. However, provisioning costs are expected to remain elevated even in the current fiscal thereby continuing to exert pressure on overall profitability, mainly for public sectors banks (PSBs). On the other hand, private sector banks are expected to perform better on account of greater revenue diversity and lower exposure to vulnerable sectors.

Private banks will continue to gain market share from PSBs due to strong presence in the retail segment, healthy capital position, and lending restrictions on many PSBs coming under prompt corrective action (PCA) framework of the Reserve Bank of India (RBI).

Stressed assets in banking unlikely to increase materially

Stressed assets in the banking sector are estimated to be ~14-15% of total advances and not expected to increase significantly hereon. The RBI's revised framework for resolution of stressed asset (introduced in February 2018) has meant that a significant portion of the stressed loans has already been recognised as NPAs by banks.

Ongoing resolutions setting the stage for recovery

Banks' efforts on resolving the big ticket NPA accounts have started bearing fruits with one large steel sector account resolved and few other large accounts are in the penultimate phase of resolution. In the current fiscal, a number of the NCLT-1 accounts (the set of the first 12 large NPA accounts referred for resolution under the IBC) should move significantly on the path towards resolution. Further banks are also pushing the levers on other big accounts under NCLT-2 (the set of the next 28 large NPA accounts referred for resolution under the IBC).

Of the total Rs 10.4 lakh crore NPAs in the system, around Rs 8 lakh crore of NPAs are from corporate segment. With progress in resolution of big ticket NPA accounts, the stockpile of bad loans should decline over the medium term.

Bankruptcy legislation to make a difference

The IBC seeks strict time-bound initiation of corrective action – even at the very first default – either from the bank or the business counterparty. By ensuring certainty and clarity in various aspects of the process, it should achieve speedy resolution and higher recoveries over time. That's a material enabler, and resolves the challenge of prolonged litigations and helps improve recoveries and ease of doing business. Backed by expected resolution of a number of stressed accounts referred to the IBC, recoveries and upgrades as a percentage of opening GNPAs will pick up in this fiscal after declining over the past few years.

Also RBI, by mandating furnishing of weekly information on large delinquent accounts, directing that a resolution plan be scripted immediately on default, and setting stringent timelines (180 days from default) for referring an account for resolution under the IBC process, is establishing an ecosystem where NPAs would get recognised proactively and their resolutions are quicker than that in the past.

Pre-provision profits of banks to stabilize, but bottom line to be remain subdued because of elevated provisioning.

CRISIL expects operating profits of banks to stabilise in fiscal 2019 and improve thereafter, supported by higher net interest income that, in turn, would be aided by higher credit growth and lower interest reversal owing to lesser slippages to NPAs. In the past couple of years, net interest margin of banks had dipped mainly due to high level of interest reversals on NPAs, implementation of marginal cost-based lending rates, and decline in the credit to deposit ratios of banks.

Step-up in credit growth will also help banks improve their fee income. However, this could be partly offset by the impact of hardening yields on treasury income of banks this fiscal. Last fiscal, the banking system's cost of provisioning for NPAs surged ~58% to Rs 3.5 lakh crore, compared with Rs 2.2

lakh crore a year earlier. That led to a loss of over 30,000 crore on aggregate basis. Going ahead, provisioning costs are expected to remain high, mainly due to the stiff haircuts banks will need to take on some of their large NPA accounts on resolution and also due to ageing of NPAs. Consequently, the net earnings are expected to remain subdued in the current fiscal as well. However, due to sharp increase in provisions last fiscal the provision coverage of Banks has touched 50% mark and is expected to increase further in the current fiscal.

PSBs dependent on government support, Capitalization healthy for private banks.

Banks capital position has been impacted mainly due to losses over the past three years driven by sharp rise in NPAs and in provisioning costs. At PSBs, we are witnessing a reduction in their capital cushion over the regulatory minimum over time. In the last fiscal higher provisioning and the resultant losses have materially eroded the Rs 1.2 lakh crore of capital raised by PSBs last fiscal, of which Rs 90,000 crore was from by the government. PSBs remain highly dependent on the government for capital to meet Basel III norms. Given the higher-than-expected losses last fiscal, probable loss in the current fiscal and recall of the Additional Tier 1 instruments by a few PSBs, the Rs 2.1 lakh crore recap program announced in October 2017 may be insufficient to meet the capital requirements by the end of this fiscal.

Private sector banks, however, remain comfortably placed with capital ratios much above the regulatory norms under Basel III, supported by healthy accretion to net worth and demonstrated ability to raise equity.

Improving credit offtake to cushion core earnings of banks this fiscal

In the past couple of years, sluggish investment activity in the economy, deterioration in asset quality, and pressures on capital adequacy have had an impact on the credit growth of Indian banks, which have traditionally been lenders to corporate entities. However, with an expected improvement in consumption demand, projected increase in public investments and rising industrial activity, credit demand is poised to improve over the medium term.

CRISIL expects gross banking credit to rebound to ~11% this fiscal as against ~ 8% in fiscal 2018, driven by sustained growth in retail loans and pick-up in small and medium enterprise credit. Pick up in corporate credit that remains subdued, remains key to broad-based revival of credit in banking system.

NBFCs

Growth fundamentals remain strong; liquidity management takes centre stage as rates rise

NBFCs have steadily grown over the past few fiscals and increased their share in the Indian financial services market. They are likely to continue strengthening their market position supported by product and process innovation, and ability to manage difficult-to-address customer segments.

The market share of NBFCs and HFCs has increased to 17-18% of the total system credit from 13% over the five fiscals through 2018. This trend is likely to continue, and their share should reach about 19% by fiscal 2020. This is amidst intensifying competition from private banks, while PSBs are also active in certain asset classes such as home loans.

In terms of segments, a CAGR of 15% is expected in the vehicle finance portfolio of NBFCs till fiscal 2020. Growth would be driven by improving macroeconomic environment coupled with higher government focus on infrastructure and rural areas. The market opportunity for NBFCs will stem from continued government investments in the roads sector, expected finalisation of the scrap page policy or the Voluntary Vehicle Modernisation Programme, and higher budgetary spends for the rural sector.

The loans against property (LAP) segment, which has been a key growth driver for NBFCs in recent years, is witnessing stronger-than-expected headwinds amid intensified competition from banks and rising delinquencies. Yield compression has been sharper and sooner than expected. Delinquencies are also increasing. Consequently, growth in LAP is expected to be slower than before.

However, wholesale finance, especially structured credit and real estate lending, would drive growth over the medium term. The opportunity in realty and the structured credit space has increased materially after the implementation of the Real Estate (Regulation and Development) Act, 2016, and rising demand for mid-corporate promoter financing.

In terms of asset quality metrics, gross NPAs have moved upwards on account of transition to more stringent asset classification norms. However, underlying asset quality performance in terms of 90+ days past due has been improving since fiscal 2015. With the regulatory transition period ending, asset quality metrics are now likely to stabilise. This is also expected to support overall profitability, as credit costs normalise; current credit costs at 60-80 basis points are higher than the 10-year average.

Comfortable capitalisation and increased investor interest in NBFCs are expected to continue to support growth. NBFCs have raised over Rs 40,000 crore of equity capital over the past five fiscals.

However, in the current environment, rising interest rates are expected to translate into increase in borrowing costs. This, along with the limited ability to pass on the increase in rates in traditional retail asset classes such as new vehicle loans and housing loans is expected to lead to compression in spreads by 50-75 basis points in fiscal 2019. Further, given that the share of shorter tenor commercial paper had increased significantly during fiscal 2017 and remains at similar levels, liquidity management is a critical aspect and can be a key differentiator among NBFCs.

HFCs

The momentum continues

Assets under management (AUM) of HFCs grew by about 24% during fiscal 2018, and crossed the Rs 10 lakh crore mark. Given the structural demand for housing, long-term growth potential also remains high with a CAGR of 20% in the overall AUM expected over the medium term.

Overall growth was supported by healthy growth in both the home loan segment as well as the non-housing segment (such as LAP, developer funding, and corporate loans). This was backed by the ability of HFCs to tap the strong demand in the affordable housing segment, with the slower credit growth of banks providing HFCs room to ramp-up faster and continue gaining market share.

Nevertheless, focus of banks on mortgage finance has increased, especially given the low growth opportunity in the corporate loans segment coupled with lower risk weights and strong asset quality in home loans.

In terms of portfolio quality, there has been an uptick in delinquencies; however, this remains lower than in other asset classes. The overall gross NPAs of HFCs increased to around 1.1% as on March 31, 2018, from 0.8% a year earlier. While the overall sectoral gross NPA trend has been steady, some HFCs focusing on the affordable housing segment have shown an above-average increase in delinquencies with gross NPAs at 4-5%.

Within the non-housing segment, there is expectation of some weakening in asset quality with delinquencies inching up in both developer financing and LAP portfolios. Large HFCs have managed their LAP portfolios better, backed by strong underwriting practices. However, despite robust collateral cover, systemic delinquencies in the segment are expected to rise as portfolios season and growth moderates.

Profitability of HFCs is expected to remain comfortable, with return on assets at 1.8-1.9% over the medium term. However, with the interest rate cycle turning upwards, some of the smaller players may witness pressure on their profitability as lending rate increases commensurate with increase in borrowing cost may be difficult for them on account of competitive dynamics. Also, a sharpened focus towards liability management will be critical in the medium term.

Microfinance

Asset quality improves as demonetisation blues fade

Asset quality of microfinance portfolios of small finance banks (SFBs) and non-bank microfinance institutions (together referred to as MFIs) have been improving since June 2017, shrugging off the demonetisation impact, which had cranked up delinquencies and affected borrower behaviour.

While idiosyncratic risks remain, two factors underscore the improvement:

- Portfolio delinquencies (for a representative set of MFIs[5]), measured in terms of principal due from borrowers who have defaulted on more than one instalment (also called 30 days past due [dpd]), have improved to 4.1% as of June 2018 from 7.6% as of June 2017
- Cumulative collection efficiencies have risen to around 99% for disbursements since April 2017.

The improvement stems from the hard yards put in by MFIs to improve collections and engage and educate borrowers about credit discipline. The presence of credit bureaus and measures undertaken by industry associations and self-regulatory organisations have also helped improve the overall environment, especially credit discipline. Asset quality performance, though, remains weak in Vidarbha, Maharashtra, some districts in central and southern Madhya Pradesh, and select districts in Karnataka and Uttar Pradesh.

Ultimate credit losses due to the impact of demonetisation were 5-7%. This adversely affected the profitability of MFIs in fiscal 2018. Profitability, though, will improve gradually with better asset quality. Credit costs are likely to stabilise at 1.5-2.5% on a steady-state basis. MFIs with a larger rural presence, weekly collections, and lower equated instalments are expected to incur lower credit cost. Post-tax return on assets is likely to stabilise at 2-2.5% on a steady-state basis.

Business prospects for MFIs remain healthy, as total demand is large at around Rs 3.0 lakh crore. MFIs and banks have a microfinance portfolio of Rs 1.25 lakh crore. National Bank for Agriculture and Rural Development (NABARD)-run self-help group linkage programmes have a portfolio of Rs 0.25 lakh crore (excluding Andhra Pradesh and Telangana). Hence, unmet demand potential is large at 50%. A large number of households in central, west, north and east remain under penetrated. More than three-fourth of the households in these regions do not have access to formal credit institutions.

[5] Representative set of MFIs and SFBs covering 50% of the loan assets (excludes one large player)

Stakeholders' confidence remains strong despite the asset quality headwind faced by the sector. MFIs have raised around Rs 9,500 crore of equity and over Rs 20,000 crore of debt in fiscal 2018 (Source: MFIN publications). Additionally, banks and refinance institutions continue to extend funding to MFIs. Dependence on bank finding, though, remains high. Hence, priority sector eligibility for banks on direct lending to MFIs remains critical.

Several large MFIs, which have transformed into SFBs, are diversifying into inclusion adjacencies such as micro, small, and medium enterprise (MSME) loans and affordable housing loans. Demand prospects in these segments remain buoyant over the medium term given the under-penetration in most geographies. Conversion to banks also provides access to stable and granular public deposits over the long run, and reduces the risk of political and regulatory uncertainty. However, SFBs need to build a retail liability-oriented funding profile. SFBs will have an edge over NBFC-MFIs, notwithstanding near-term funding and profitability challenges.

Capitalisation will continue to be the key rating differentiator for MFIs, given the inherently weak borrower segment, susceptibility to socio-political issues, and the consequent volatility in asset quality and profitability.

Broking companies

Broking companies continue to benefit from buoyancy in equity markets; ability to control costs remains critical to maintaining profitability

Indian brokerages continue to benefit from the buoyancy in equity markets. The revenue of CRISIL-rated players increased by around 30% in fiscal 2018 over the previous fiscal, in the backdrop of a significant increase (over 70%) in average daily turnover in equity markets. The derivatives segment continues to outpace the cash segment. Average daily turnover in the derivatives segment went up by 76% as against 39% in the cash segment. Pressure on yields remains due to intense competition. However, large players have been able to control their costs, and their profitability has increased by nearly 50% in fiscal 2018 over the previous fiscal.

Large Indian capital market entities have also undergone a transformation in their business profile over the past few years. While these entities initially diversified into related fee-based activities and capital markets lending, they have also grown their non-capital markets credit books significantly. In the past five years, the credit book in segments as diverse as housing, LAP, loans to small and medium enterprises (SMEs) and other corporates and real estate lending, has more than trebled. This share is likely to continue to increase over the medium term and dependence on capital markets business should reduce further.

Smaller capital market entities remain niche players with limited diversification and hence, more vulnerable to market volatility. Profitability of these companies is estimated to have improved as well due to better market sentiments in fiscal 2018 led by an uptick in volumes in the cash segment, which has been their key focus area. However, with turnover in the cash segment remaining largely stable during the first five months of fiscal 2019, these entities will need to continuously evolve and control their cost structure to be able to manage profitability.

Notes

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