

RATINGS ROUNDUP

FY 2010-11



India Inc's credit quality peaking: CRISIL

**Pressures on profitability to increase;
demand will be key monitorable**

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Our defining trait is our ability to convert data and information into expert judgements and forecasts across a wide range of domains, with deep expertise and complete objectivity.

At the core of our credibility, built up assiduously over the years, are our values: Integrity, Independence, Analytical Rigour, Commitment and Innovation.

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CRISIL Ratings is the world's fourth-largest rating agency, and India's largest and most influential. CRISIL has shaped the development of India's debt markets, having rated more than 32,400 debt instruments and facilities, valuing more than Rs. 36 trillion, pertaining to nearly 10,000 issuers and borrowers.

Executive Summary

CRISIL upgraded 605 ratings and downgraded 269 ratings in 2010-11 (refers to financial year, April 1 to March 31) on a base of around 6200 ratings as on March 31, 2011. As the previous edition of CRISIL's Ratings Roundup, published in October 2010, had predicted, the upgrades outnumbered downgrades in the second half of 2010-11 (H2 2010-11), leading to improvement in CRISIL's modified credit ratio (MCR, an indicator of the relative frequency of upgrades and downgrades) to 1.10 times in 2010-11 from 0.93 times in 2009-10. While the upgrades have been broad-based, across rating categories and industries, the downgrades have been largely concentrated in the low rating categories—of 'BB' and lower. The MCR has maintained its upward trajectory for the second year, after plummeting to a decadal low of 0.86 times in 2008-09. Any further improvement in MCR may, however, be limited; this will be on account of increased pressure on profitability, given the rising trend in commodity prices and interest rates, and intensifying competition. Sustainability of demand across industries will also be a key monitorable for the credit quality of India's corporates.

Upgrades outnumbered downgrades in 2010-11, driven largely by healthy demand conditions and a favourable funding environment. While the upgrades were spread across rating categories, about 70 per cent of the downgrades was from the low rating categories—of 'BB' and lower, which have historically been more vulnerable to downgrades.

Rising commodity prices and interest rates, especially towards H2 2010-11, and moderation in industrial activity led to increased profitability pressures. These pressures are expected to continue, and competition to intensify, over the medium term. The vulnerability of corporates on this account is indicated by the proportion of negative outlooks—7.6 per cent of total outlooks as on March 31, 2011. CRISIL, therefore, believes that India Inc's credit quality is peaking, and that the MCR may not improve further. The profitability of players in the cement, chemicals, construction, automobile and textile spinning industries may be affected by high input prices. Among external factors that can have a large impact on corporate credit quality are: oil price shocks due to unrest in the Middle East and North Africa, and interruption in trade and investments due to unexpected developments in stimuli-supported developed economies.

CRISIL believes that sustainability of demand will be a key determinant of the credit profiles of companies in the medium term. While demand has been buoyant so far, increasing interest rates and commodity prices have potential to slow down investment-driven demand. High interest rates will lead to moderation in retail demand.

About CRISIL's Ratings Round-Up

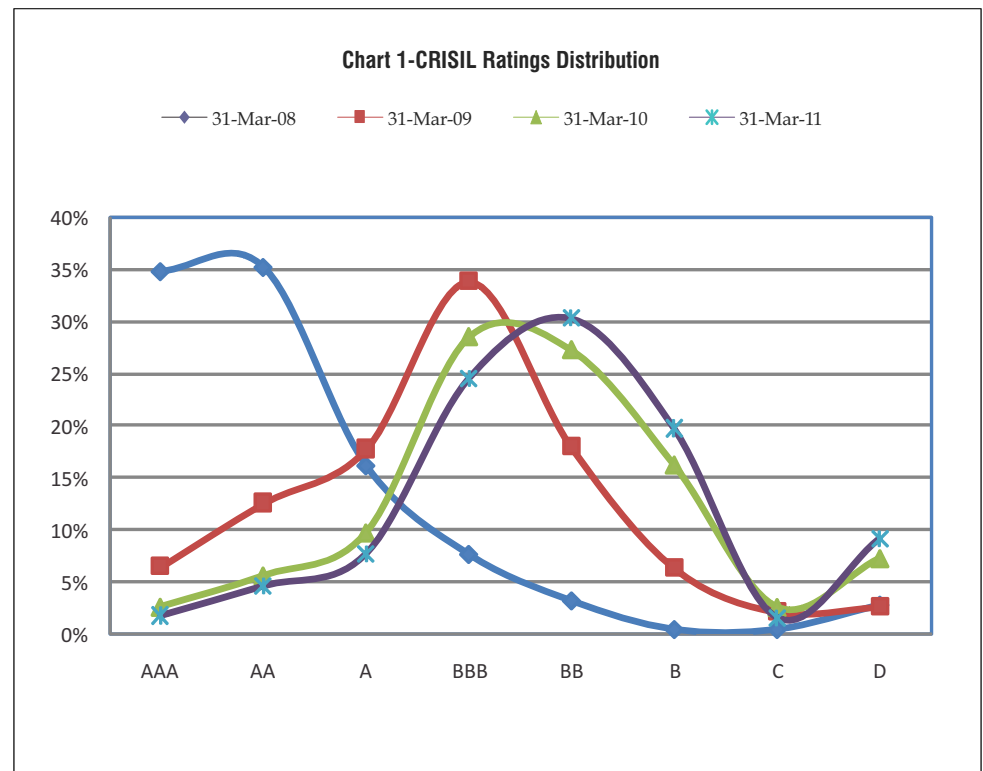
CRISIL's Ratings Round-Up is a semi-annual publication that analyses CRISIL's rating actions, and traces the linkages between these actions and the underlying economic trends and business factors. Credit rating is an opinion on the likelihood of timely future debt repayment; therefore, an analysis of rating actions in a large and diverse portfolio of rated companies is a good indicator of economic prospects. The current issue analyses CRISIL's rating actions in the 12 months through March 2011.

An ongoing story: Scale-up in CRISIL's rated portfolio

CRISIL's portfolio of outstanding ratings has grown significantly in recent years. It continued to expand in 2010-11 and aggregated around 6200 ratings as on March 31, 2011 from around 400, three years ago. The portfolio's composition has also changed significantly—as indicated by a shift in median rating to the 'BB' category from 'AA' category as on March 31, 2008.

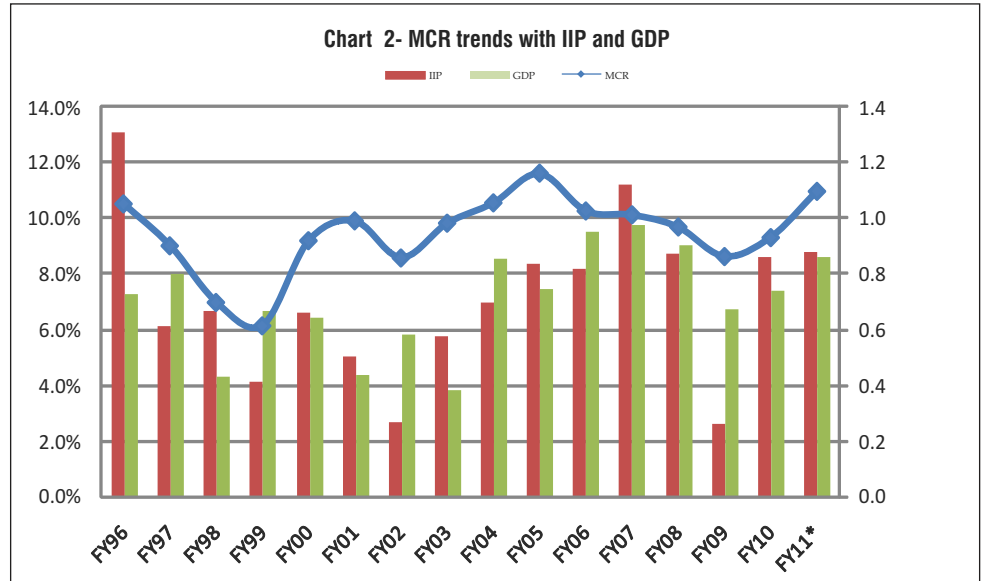
However, the rating distribution as on March 31, 2011 is very similar to the distribution observed a year ago

(Chart 1 indicates movements in rating distribution in the portfolio).



MCR exceeds pre-crisis levels

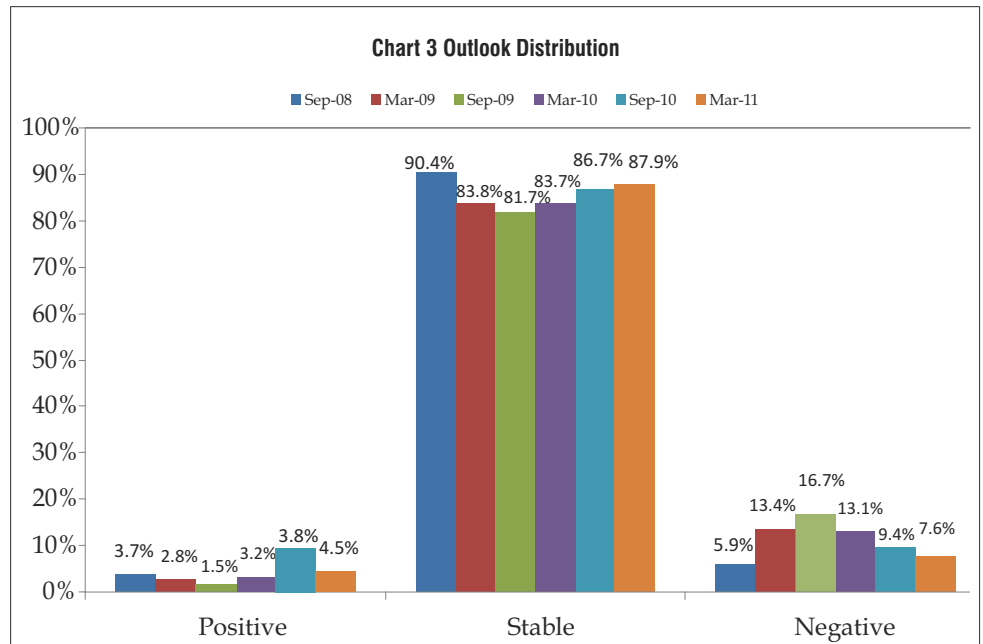
CRISIL upgraded 605 ratings in 2010-11, the highest number of upgrades in CRISIL's entire history for any 12-month period. The upgrades have been on a vastly expanded base of around 6200 ratings. CRISIL's MCR (the ratio of upgrades plus reaffirmations to downgrades plus reaffirmations) increased to 1.10 times from 0.93 times in 2009-10 (see Chart 2). The rise in MCR is broadly in line with CRISIL's expectations for the year (refer to previous edition of Ratings Roundup published in October 2010). The MCR has continued to rise after reducing to a decadal low of 0.86 times in 2008-09, when the economy slowed down on account of the global financial crisis (see Chart 2).



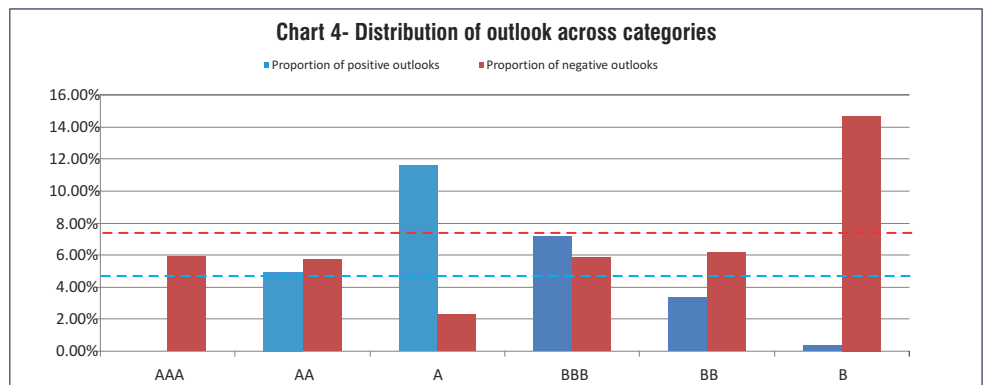
*GDP and IIP growth rates are for the period April 2010 to December 2010.
 (For a complete list of rating actions in H2 2010-11, please refer the Annexure II-b and Annexure II-c of Annexure II under 6.2.2 of Regulatory Disclosures section on the CRISIL website).

**Positive outlooks
 on the rise;
 negative outlooks
 on the decline**

The proportion of ratings with positive outlooks has increased to 4.5 per cent as on March 31, 2011 and is higher than the pre-crisis levels of 3.7 per cent. Though the proportion of ratings with negative outlooks has reduced from a year ago, it remains higher than the levels (5.9 per cent) seen before the credit crunch in 2008-09 (see Chart 3).



Almost 12 per cent of borrowers in the 'A' rating category have positive outlooks, as against 4.5 per cent for all rated entities. The positive outlooks reflect likely improvement in the borrowers' credit risk profiles, driven by strong debt protection metrics and established business models. Most of the 'A' rated entities have been in existence for more than two decades, and have not only withstood cyclicity in business, but also strengthened their performance during the period. Borrowers rated 'A' may soon begin to turn to the capital markets for funds—sound financial performance and a track record of low default rates in the past decade have made 'A'-rated instruments a sound investment option for investors



(In Chart 4, the red dotted line represents the proportion of negative outlooks while the blue dotted line represents proportion of positive outlooks in CRISIL's portfolio)

The negative outlooks are concentrated mostly in the low rating categories, which inherently have lower stability. Around 15 per cent of borrowers in the 'B' category have negative outlooks, an indication of the susceptibility of these ratings to downward revisions over the medium term.

Robust demand conditions and favourable funding environment result in higher upgrades than downgrades in 2010-11

While the credit quality trends started improving in 2009-10, they were driven largely by improved funding environment, as a result of an accommodative monetary policy adopted by the Reserve Bank of India (RBI) in its effort to put growth back on track. Subsequently, industrial growth recovered in 2009-10. The demand conditions and the funding environment remained favourable for the better part of the year 2010-11. Positive growth outlook and favourable funding environment enabled companies to comfortably raise funds to revive capital expenditure plans and meet working capital needs. The funding environment remained favourable, with corporates raising both equity and debt. Debt funds were available at reduced credit spreads from the domestic banking system and from external commercial borrowings. Historically, CRISIL's MCR has displayed a strong correlation with broader growth indicators such as the Index of Industrial Production (IIP) and Gross Domestic Product (GDP). In line with previous trends, the MCR continues to exhibit a high degree of correlation with growth: the fact that increase in MCR has been accompanied by rise in GDP, bears testimony to this correlation.

Table 1: Trends in industrial activity and fund mobilisation

Quarter ended	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11
Bank Credit Growth (%)	12.63	13.66	16.75	21.57	19.1	24.6	23.2#
Repo rate (%)	4.75	4.75	5	5.25	6	6.25	6.75
Credit spreads* (%)	1.6	1	1.1	1.2	0.86	0.63	0.87 @
ECB mobilised (Billion USD)	4.61	6.51	7.83	5.31	5.43	5.33	4.1 ^
Equity Mobilised (Rs. Billion)	258	229	317	193	266	454~	124 ^
IIP Growth (% YoY)	8.6	13.3	15.8	11.9	9.1	5.3	6.1##

*AAA spread over 10 year G-Sec

Till March 11, 2011

Includes figures only for January 2011

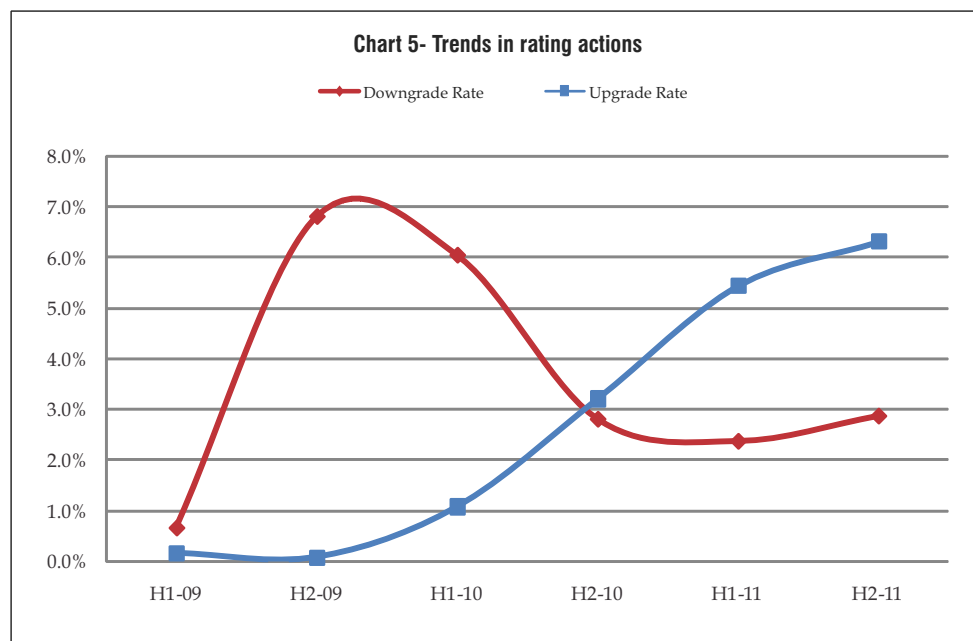
^ Includes figures only for January and February 2011

~Also includes a large public issue of Coal India Ltd

@ As on March 31, 2011.

MCR unlikely to scale historical highs

While the upgrade rate¹ (the proportion of ratings upgraded to the average number of ratings outstanding²) has increased to 6.3 per cent in H2 2010-11, there is a moderation in the pace of improvement. Further, the downgrade rate has been stable during the two halves of 2010-11, indicating the even pace of rating downgrades during the year. CRISIL believes that the credit quality of India's corporates is peaking and further improvement in credit quality is unlikely from these levels; the MCR may not scale the historical high of 1.16 times in the medium term.



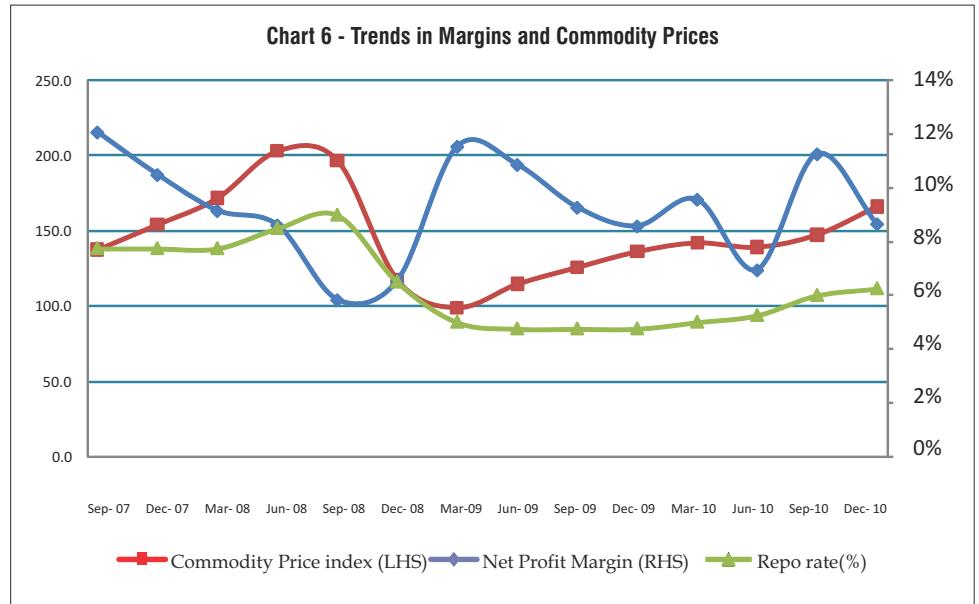
Increased cost of funding, rising commodity prices and heightened competition to constrain profitability

CRISIL's analysis of the aggregate financial performance of listed companies indicates that their profitability has declined sharply towards H2 2010-11. Higher commodity prices, higher costs of debt funding caused by repo rate increases, and moderation in industrial activity have added to the pressure on profitability. The RBI had increased the repo rate by 100 basis points in H1 2010-11 to check mounting inflationary pressures. As the banks began to transmit the effects of repo hikes by raising the lending rates sharply during H2 2010-11, the profitability of companies started to decline in H2 2010-11 due to higher costs of borrowing. The decline in net profit margin (NPM) of 396³ entities in the S&P CNX 500 Index to 8.7 per cent in the three months through December 2010 from 11.3 per cent for the three months through September 2010 bears testimony to this phenomenon (see Chart 6). Rising input and commodity prices, reduced pricing power due to heightened competition, and increased costs of funding exerted further pressure on NPMs towards the end of H2 2010-11.

¹This ratio is computed as the number of rating upgrades in a half year period as a proportion of the average number of ratings outstanding during that period.

²Average number of ratings outstanding = (Number of ratings outstanding at the beginning of the period + Number of ratings outstanding at the end of the period)/2.

³These listed companies have reported their results for the quarter ended December 31, 2010, and have remained in the S&P CNX 500 index for the past 15 quarters. The three oil marketing companies (OMCs) have been excluded, because the government controls petroleum product prices. Companies from the financial sector have also been excluded from the sample

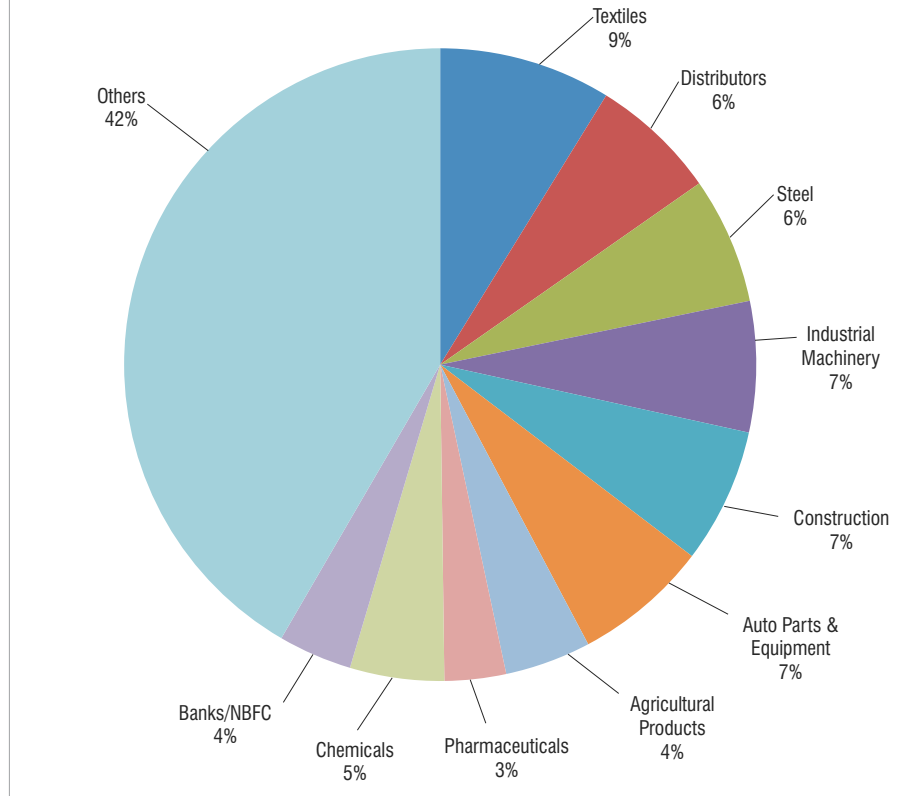


Outlook

CRISIL believes that upgrades may continue to outnumber downgrades over the near term, though the pace of rating actions may moderate. While the demand conditions remain buoyant so far, increased commodity prices and interest rates may slow down investment-driven demand. Any sharp slowdown in demand—on account of factors such as scaling down of capacity expansion plans by corporates, given the high interest rates and commodity prices—may constrain demand for the engineering and capital goods industries. High interest rates will also lead to a moderation in the retail demand. Sustainability of demand will remain a key determinant of the credit profiles of India's corporates in the medium term. Sharp decline in profitability due to persistent increase in commodity prices and interest rates could create stress on the credit quality of India's corporates. Key external factors that may have a high impact on credit profiles include: an oil price shock due to unrest in the Middle East and North Africa region, and disruptions in trade and investments due to unexpected development in the stimuli-supported developed economies.

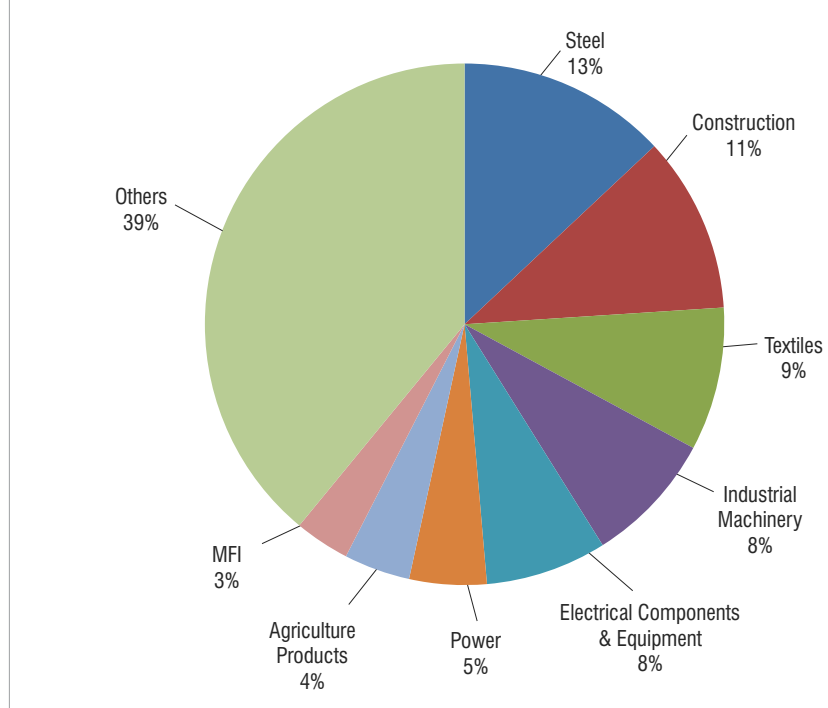
Table 2 presents an analysis of major industries that witnessed rating actions during 2010-11. The table also contains CRISIL's outlook for these industries in the near to medium term.

Chart 7 - Industry wise distribution of upgrades*



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

Chart 8 - Industry wise distribution of downgrades*



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

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

Industry	Key reasons for rating actions in 2010-11	Credit quality outlook for the near to medium term
Automobiles and auto ancillaries	Upgrades have been driven primarily by healthy medium term revenue visibility, supported by strong demand outlook from commercial vehicle and two-wheeler segments. Some upgrades were also driven by prudent working capital management.	<p>Inflationary pressures and increasing interest rates will moderate demand growth in the domestic automobile market from the healthy levels of the previous year. Profit margins, which came under moderate pressure in 2010-11 due to higher royalty, input price increases, and intense competition, will be further constrained, as commodity prices rise further. Higher interest costs will also impact the profit margins of automobile manufacturers.</p> <p>Business levels of auto component manufacturers are expected to benefit from steady demand in the near term. Profitability margins are expected to moderate by 150-200 basis points, due to intense pressure from original equipment manufacturers (OEMs), and increasing input and fuel costs. In the near term, auto component players may continue to add capacity (albeit at a slower pace than in 2010-11), to meet demand from the OEMs and aftermarket.</p>
Construction	<p>Upgrades were driven by equity infusions and strong order book, leading to stronger business and financial risk profiles.</p> <p>Downgrades were driven by pressure on liquidity on account of large, debt-funded capital expenditure.</p>	CRISIL believes that the credit risk profiles of players in the construction segment will gradually improve over the medium term, supported by sustained strong growth momentum on account of infrastructure spending and largely stable operating profitability levels. Despite near-term concerns on hardening of interest rates and rise in input costs (cement and steel), CRISIL expects companies to maintain their debt protection metrics on the back of improved capital structure and sustained healthy profitability. Improving scale of operations, with growing project diversity and scale efficiencies will lend stability to players' business profile. Ability to manage growing project execution and working capital requirements will remain key rating sensitivity factors for players in the industry.
Steel and Steel Products	<p>Upgrades were driven primarily by improvement in the business and financial risk profiles of steel players, and healthy cash accruals from successful stabilization of new capacities commissioned recently.</p> <p>Most downgrades were driven by weak liquidity, due to large capital expenditure and increasing working capital requirements.</p>	Steel demand is likely to be driven by strong growth in sectors such as automobile, infrastructure, and oil and gas. Margins in the short term may come under pressure due to high iron ore prices, and higher coking coal prices on account of floods in Australia. However, given the robust demand outlook, steel manufacturers are better positioned to protect their operating margins by passing on steel price increases to consumers. Healthy cash accruals from business and tighter working capital management are expected to result in a lower reliance on debt, leading to maintenance of the capital structure and debt-servicing parameters. CRISIL expects that steel players will maintain stable credit risk profiles in the medium term
Textiles	<p>Most upgrades were driven by improvement in revenues and margins, and healthy cash accruals as a result of stabilisation of newly commissioned capacities.</p> <p>Downgrades were driven largely by strained liquidity, caused by higher interest outgo on large debt-funded capex, without a commensurate increase in business volumes</p>	<p>Buoyant domestic demand will be the key growth driver for textile companies. Newly added capacities will be able to meet the demand growth. Export demand is also likely to recover in the near to medium term, benefiting from rising costs in China, and limited availability of raw materials in Bangladesh and Vietnam. However, exporters of ready-made garments are expected to face margin pressures on account of firm fabric prices and intense competition.</p> <p>The margins of spinning companies will be adversely impacted by procurement of cotton at high prices. Limited ability to pass on price increases to consumers, and increasing price competitiveness of polyester, will further strain spinners' margins. Ability to maintain operating margins, despite rising cotton prices, competitive pressures, and high gearing will be the critical determinant of textile companies' credit quality. Government policies on export of cotton and cotton yarn will remain key monitorables for the textile industry.</p>

Industry	Key reasons for rating actions in 2010-11	Credit quality outlook for the near to medium term
Chemicals	Upgrades have been primarily on account of continuing healthy demand and increase in scale of operations, leading to stronger business and financial risk profiles.	The credit risk profiles of chemical manufacturers will remain stable due to continued demand from end-use sectors. However, operating margins are expected to reduce due to increasing raw material costs.
Industrial Machinery	<p>Upgrades were driven by equity infusions, stabilization of incremental capacities, and improvement in working capital management.</p> <p>Downgrades were driven primarily by lower cash accruals on account of delays in project implementation.</p>	<p>Growth outlook for industrial machinery players is expected to remain healthy over the medium term driven largely by investments in power and transmission sectors.</p> <p>While risks associated with commodity prices and competition from Chinese imports will continue, improving order books and healthy profitability will lend stability to the credit profiles of companies.</p>
Banks, non-banking finance companies (NBFCs) and microfinance institutions.	<p>The upgrades on banks are driven by Government of India's recent announcement of equity infusions in public sector banks.</p> <p>The upgrades in the NBFC space were driven by stronger market positions, due to scaled-up operations.</p> <p>Most rating actions on MFIs were primarily on account of heightened funding risks due to significant deterioration in operating environment following enactment of law governing MFIs in Andhra Pradesh (AP). MFIs operating in the non-AP region also got impacted by reduced access to bank funding as a contagion effect arising out of the developments in AP.</p>	<p>CRISIL believes that credit growth in the domestic banking sector will continue to be healthy, despite moderating from the levels witnessed in the previous year. CRISIL also expects moderate deterioration in players' asset quality, on account of fresh slippages in erstwhile restructured assets, and in highly leveraged sectors where demand conditions are uncertain. The profitability of banks is also likely to be under pressure, with sharply increased cost of deposits and continuing high provisioning costs to maintain the minimum provisioning cover of 70 per cent. Equity infusions of Rs.60 billion to maintain a minimum Tier-1 capital adequacy ratio of 8 per cent will aid in strengthening the credit risk profiles of public sector banks.</p> <p>CRISIL believes that recent trends of strong growth and improving asset quality and profitability will continue, and further strengthen the credit risk profiles of NBFCs over the medium term. For capital-market-related entities, CRISIL expects the operating environment to remain challenging with margin pressures on the equity broking business and increasing competition from foreign brokerage houses</p> <p>The law governing MFIs operating in AP is likely to have a severe impact on asset quality, profitability and capitalisation of MFIs with sizeable operations in AP. While the recommendations of the Malegam Committee are expected to bring clarity on the regulatory jurisdiction of MFIs, they may also pose operational challenges for MFIs in the medium term. Apart from improvement in the operating environment in AP, clarity on regulatory jurisdiction, and access to bank funding will be key monitorables for the credit profiles of MFIs over the near term.</p>

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