FH 2012-13

CRISIL RatingsRoundup

As profitability stabilises, intensity of downgrades likely to abate

Demand revival will be key for credit quality improvement

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Executive Summary

CRISIL's rating actions in the first half (H1) of 2012-13 (refers to financial year, April 1 to March 31) reflect increased pressure on corporate India's credit quality. CRISIL's credit ratio[1] (ratio of upgrades to downgrades) declined to 0.66 in H1 of 2012-13 from 0.91 in H2 of 2011-12, primarily on account of slowdown in economy. However, with pressure on profitability and on economic growth showing signs of abating, CRISIL believes that the credit ratio has begun to bottom out. Material improvement in credit ratio will, however, take time and need substantial revival in demand. Over the near term, rating downgrades will continue to outnumber upgrades, although their severity and intensity may decline.

Rating downgrades continued to exceed upgrades in H1 of 2012-13—there were 484 downgrades and 320 upgrades, on an expanded base of 10,542 ratings. The downgrades were driven largely by slowing demand and pressure on liquidity, because of stretched working capital cycles. Of the 484 downgrades, 183 were to 'default' category—these were primarily from rating categories 'CRISIL BB' and lower, which are inherently more vulnerable to defaults. The rating upgrades, on the other hand, were supported by improved business performance due to stabilisation of past capital expenditure, and consequently, improved cash flows.

CRISIL believes that the end of the credit quality cycle is now imminent. Having declined continuously for nine quarters, EBIDTA margins are now expected to increase. Also, pressure on GDP growth seems to have eased. Together, these factors may ensure that the credit ratio does not decline materially from current levels. Corporate India's profitability appears to have bottomed out, primarily because of softening in commodity prices. Based on an analysis of the aggregate financials of 280 large companies across 28 key sectors, CRISIL estimates that EBIDTA margins will improve by 20 to 40 basis points in the quarter ended September 2012. GDP growth picked up marginally to 5.5 per cent in the quarter ended June 2012 from 5.3 per cent in the previous quarter. CRISIL expects GDP to grow at 5.5 per cent in 2012-13, and to improve further in 2013-14. Renewed confidence in growth will drive improvement in the working capital situation for corporates, and therefore, support credit quality.

Around a third of the downgrades has been among the highly-indebted industries, including power, construction, engineering and capital goods, and textiles. The highest upgrade rates, on the other hand, were in the retail consumption-linked sectors, such as packaged foods and home furnishing.

The slew of recent policy reforms by the government has helped improve business sentiment. The key to significant upward movement in CRISIL's credit ratio is strong revival in demand as the economic environment improves over the long term. In the near term, rating downgrades are expected to continue to outnumber upgrades, although with reduced intensity.

[1]Refer to section titled, "Rationale for the shift to credit ratio from RAR" on page 4

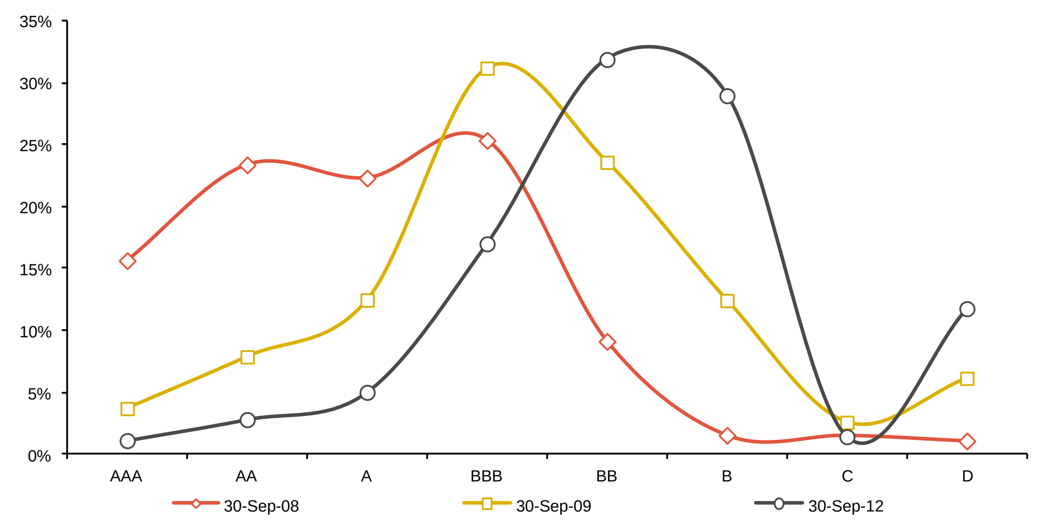
About CRISIL's Ratings Round-Up

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 six months ended September 2012.

CRISIL's portfolio of outstanding ratings exceeds 10,000

CRISIL portfolio of outstanding ratings has continued to expand. CRISIL has ratings outstanding on 10,542 firms as on September 30, 2012 up from 783 firms, four years ago. CRISIL's rating distribution has altered significantly, with a surge in the number of firms in the lower rating categories. The median rating has shifted to 'CRISIL BB' as on September 30, 2012 from 'CRISIL BBB' as on September 30, 2009 and from 'CRISIL A' as on September 30, 2008 (Chart 1 indicates the movement in rating distribution in CRISIL's portfolio).

Chart 1- CRISIL's rating distribution



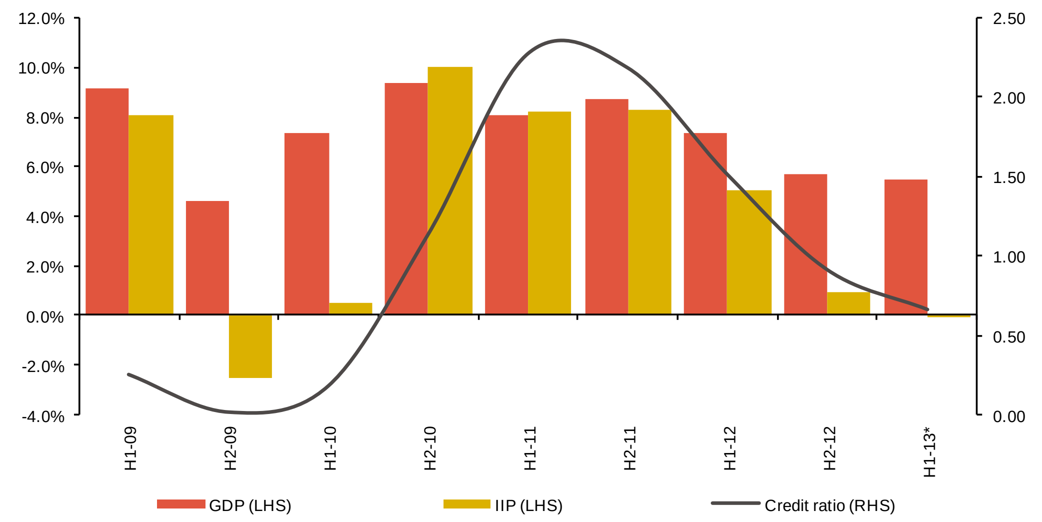
Source: CRISIL

Credit quality pressures mounting:Credit ratio declines sharply

CRISIL downgraded 484 ratings and upgraded 320 ratings in H1 of 2012-13. Downgrades continue to outnumber upgrades in H1 of 2012-13, in line with CRISIL's expectations as outlined in its release[2] for the April 2012 edition of Ratings Round-up. CRISIL's credit ratio (ratio of upgrades to downgrades) declined to 0.66 in H1 of 2012-13 from 0.91 in H2 of 2011-12, primarily on account of a slowing economy. The dip in credit ratio reflects increasing pressure on the credit quality of India's corporates. CRISIL expects the credit ratio to remain below 1 time in 2012-13.

CRISIL's credit ratio exhibits a correlation with economic indicators such as the index of industrial production (IIP) and gross domestic product (GDP). Notably, the steep fall in credit ratio has been accompanied by a sharp decline in IIP and GDP in H1 of 2012-13.

Chart 2- Credit ratio trends with IIP and GDP



*GDP and IIP growth rates are for the period April 2012 to June 2012.
(For a complete list of rating actions in H1 2012-13, refer to Annexure II-b and Annexure II-c of Annexure II under 6.2.2 of Regulatory Disclosures section on the CRISIL website).

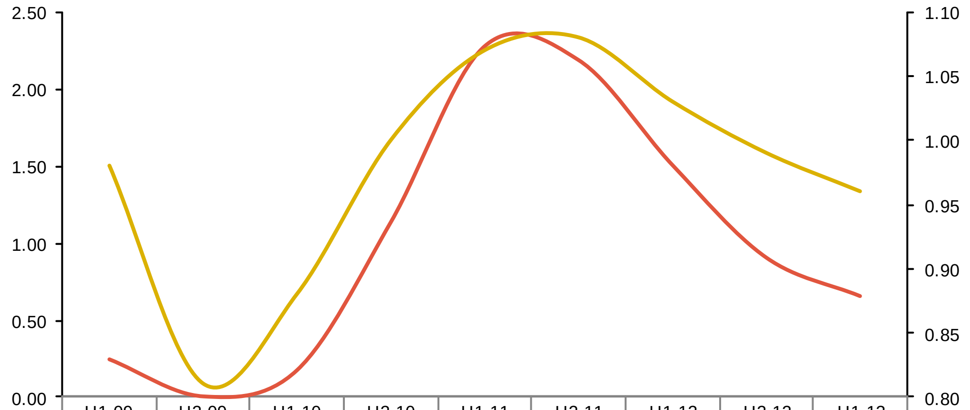
Source: CRISIL

[2] Refer to release, "Default rate at ten-year high of 3.4 per cent; Downgrades to outnumber upgrades; demand and liquidity will be key monitorables" dated April 5, 2012

Rationale for the shift to Credit Ratio from RAR

Starting with this edition of Ratings Roundup, CRISIL will use credit ratio (ratio of upgrades to downgrades) as a relative measure of upgrades to downgrades, and not the rating action ratio (RAR; the ratio of upgrades plus reaffirmations to downgrades plus reaffirmations). Credit ratio, unlike the RAR, is an internationally accepted measure of relative rating actions. CRISIL has employed the RAR thus far, because its small portfolio size would have skewed the credit ratio hitherto. However, with CRISIL's portfolio of outstanding ratings now exceeding 10,000 firms, its credit ratio is expected to be much more stable, going forward.

Chart 3- Trends in Credit Ratio and RAR



	H1-09	H2-09	H1-10	H2-10	H1-11	H2-11	H1-12	H2-12	H1-13
Credit ratio (LHS)	0.25	0.01	0.18	1.14	2.28	2.19	1.51	0.91	0.66
RAR (RHS)	0.98	0.81	0.88	1.00	1.07	1.08	1.03	0.99	0.96
Outstanding ratings	783	1,561	2,695	4,036	5,266	6,173	7,368	8,849	10,542

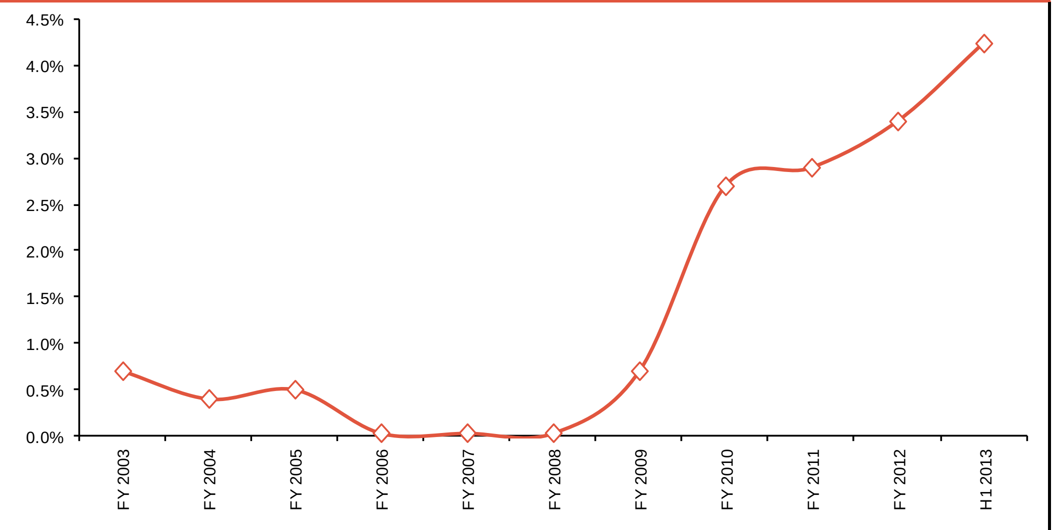
Credit ratio (LHS) RAR (RHS)

Source: CRISIL

Default rate scales a new high of 4.2 per cent

Accentuated pressure on credit quality is indicated by the surge in defaults. CRISIL's portfolio had 183 defaults in H1 of 2012-13, up from 107 defaults in H2 of 2011-12. Textile, steel and hotels accounted for a fourth of the defaults. The overall annualised default rate reached 4.2 per cent in H1 of 2012-13, surpassing the ten-year high of 3.4 per cent in 2011-12. The rise in default rates was on account of surge in the number of firms in the 'CRISIL BB' and lower rating categories—these rating categories constituted 74 per cent of CRISIL's ratings as on September 30, 2012, up from 13 per cent four years ago. Almost 95 per cent of the defaults in H1 of 2012-13 were from rating categories 'BB' and lower, which have displayed higher default rates historically. The default rate was also driven by slowdown in the economy.

Chart 4 - Annual default rate



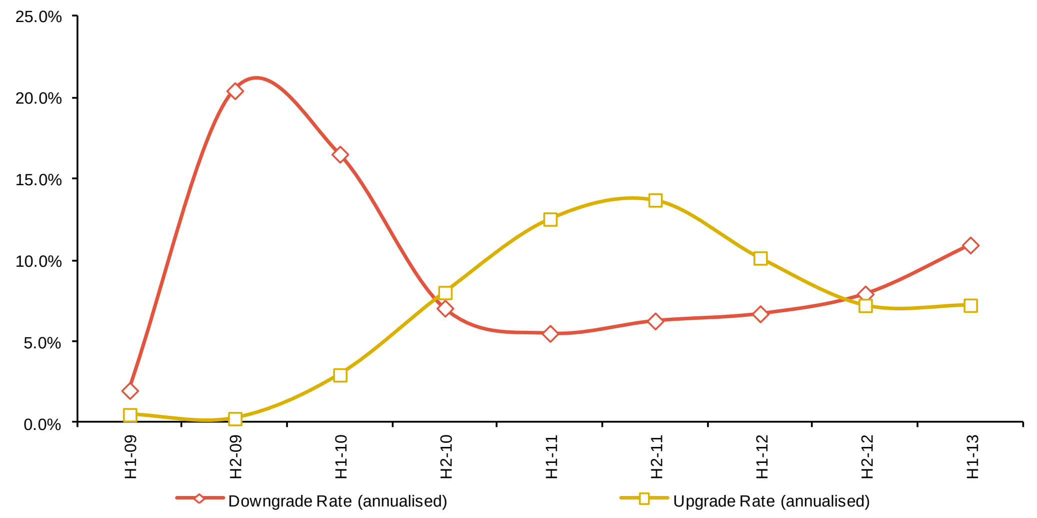
Source: CRISIL

Credit quality pressures are also indicated in the increase in restructured loans and gross non-performing assets (NPAs) of India's banks. CRISIL expects the proportion of loans restructured during 2011-12 and 2012-13, to be high at around 5.7 per cent of bank advances as on March 31, 2013. CRISIL also expects gross NPAs of the Indian banking system to increase to 3.5 per cent by March 31, 2013—from 2.8 per cent as on March 31, 2012.

Downgrades will continue to outnumber upgrades in H2 of 2012-13

CRISIL downgraded 484 firms in H1 of 2012-13, the highest for any six-month period, as compared to 320 downgrades in H2 of 2011-12. This indicates that credit quality pressure has been mounting for India's corporates. The annualised downgrade rate increased to 10.9 per cent in H1 of 2012-13 from 7.9 per cent in H2 of 2011-12. The downgrades were primarily on account of slowing demand, pressure on liquidity, and stretched working capital cycles. Defaults accounted for 38.0 per cent of downgrades in H1 of 2012-13.

Chart 5- Trends in rating actions



Source: CRISIL

The upgrade rate has remained steady at 7.2 per cent in H1 of 2012-13 and H2 of 2011-12. The upgrades in H1 of 2012-13 were driven largely by stronger business performance, supported by stabilisation of past capex and consequently, improved cash flows.

CRISIL believes that with pressure on profitability and economic growth showing signs of abating, the credit ratio has largely bottomed out. The fact that the economy has begun to attain stability will reduce pressure on the credit quality of India's corporates. Nevertheless, material improvement in credit ratio will take longer, and will need substantial revival in demand. Till then, rating downgrades will continue to outnumber upgrades over the near term, although their severity and intensity may decline.

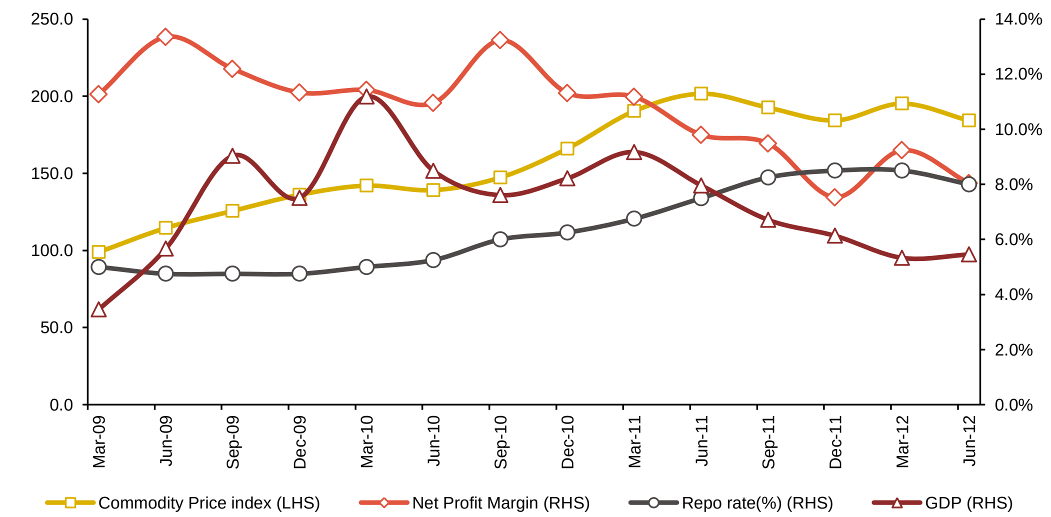
Profitability bottoms out due to softening in commodity prices and interest rates peaking-off

CRISIL's analysis of the aggregate financial performance of listed companies indicates that the net profit margin (NPM) of 402[3] firms in the S&P CNX 500 Index has bottomed out. After steady decline over five quarters through December 2011, profitability has begun to pick up again in the last two quarters and is expected to increase somewhat going forward. This is primarily on account of softening in commodity prices and interest rates, and bottoming out of growth slowdown.

The NPM had fallen to about 7 per cent in the quarter through December 2011, from highs of 13 per cent five quarters earlier, but ranged between 8 and 9 per cent in the quarters through March and June of 2012. The peaking off of interest rates has arrested further decline of NPMs – the interest rates are likely to decline over the medium term. Also, the commodity price index (as published by IMF) has begun to decline in line with CRISIL's expectations (refer to our previous edition of Ratings Round-Up, published in April 2012).

The profitability of companies was impacted in the quarter through June 2012 by sharp currency depreciation. CRISIL, however, believes that there is limited risk of any further decline in the margins of India's corporates in coming quarters, given the softening of commodity prices, supported by the appreciating rupee and decline in interest rates. Flexibility to defer capex will also help players offset profitability pressures.

Chart 6 - Trends in margins and commodity prices



Source: CRISIL

[3] These listed companies have reported their results for the quarter ended June 30, 2012 and have remained in the S&P CNX 500 for the past 14 quarters. The three oil marketing companies (OMCs) have been excluded, because their reported numbers will skew the sample. Companies from the financial sector have also been excluded from the sample.

Investment and consumption demand impacted by slowdown in domestic and global economy

The economic environment in both the global and domestic economy remains uncertain and fragile. During the first half of 2012-13, demand conditions deteriorated as overall economic growth slowed down both abroad and in India (refer to Tables 1 and 2, respectively).

The global economic environment remained weak, as reflected in the grim Eurozone outlook, with Standard & Poor's (S&P) expecting the Eurozone to shrink by 0.8 per cent and the US to grow at a mere 2.0 per cent in 2012. Slower-than-expected recovery in the US and deepening recession in the Eurozone and UK have constrained growth in the emerging economies as well, given the trade and financial linkages among them.

Table 1: Trends in GDP growth rates of EU nations

Countries	2010	2011	2012(E)	2013(E)	2014(E)
Germany	3.7	3.0	0.6	1.2	1.7
France	1.7	1.7	0.1	0.4	1.3
Italy	1.8	0.4	(2.4)	(0.6)	0.9
Spain	(0.1)	0.7	(1.8)	(1.4)	0.7
Euro Zone	1.8	1.6	(0.8)	0.0	1.2
United Kingdom	1.8	0.8	(0.3)	1.0	1.1
USA	3.0	1.8	2.0	2.2	3.4

Pressure on GDP growth appears to be abating. India's economy grew at 5.5 per cent in the first quarter of 2012-13, up marginally from 5.3 per cent in the fourth quarter of 2011-12. The policy reforms announced recently have potential to stimulate investment growth and benefit the economy over the long term. Moreover, the reforms are likely to check slowdown in the economy in the near term. The decision to allow 51 per cent foreign direct investment (FDI) in multi-brand retail will result in investment inflow of between USD2.5 billion and USD3.0 billion[4] in the retail sector over the next five years. However, these measures are unlikely to have a material positive impact on India's economic growth in H2 of 2012-13.

[4] Refer to release, "Policy reforms lift business confidence; follow-up critical: CRISIL Research" dated September 18, 2012

RBI's measures ease liquidity pressure for India's corporates

Bank credit growth has declined by more than 200 basis points (bps) to 16.5 per cent in September 2012 from 18.6 per cent in June 2012. This has been primarily on account of drop in credit off-take by the services and manufacturing sectors. However, monetary conditions have eased gradually in 2012-13 as a result of a two-stage reduction in cash reserve ratio and a repo rate cut (by 50 bps in April 2012).

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

Quarter ended	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12
Bank Credit Growth (%)	16.8	21.6	19.1	24.6	21.6	20.1	23.2	16.0	19.5	18.6	16.5
Repo rate (%)	5.0	5.3	6.0	6.3	6.8	7.5	8.3	8.5	8.5	8.0	8.0
Credit spreads (%)#	1.1	1.2	0.8	0.6	0.9	1.1	1.0	0.7	0.9	0.7	0.9&
ECB mobilised (Billion USD)	7.8	5.3	5.4	5.3	9.8	8.1	10.2	8.5	9.1	8.1	1.07 $
Equity Mobilised (Rs. Billion)	336.2	198.0	266.0	454.0	210.1	239.7	84.8	12.7	67.2	336.3	39.0 $
IIP Growth (% YoY)	15.8	11.9	9.1	5.3	7.9	6.7	8.6	7.9	7.0	3.2	1.2
GDP Growth (%YOY)	9.4	8.5	7.6	8.2	9.2	8.0	6.7	6.1	5.3	5.5	NA

#AAA spread over 10 year G-Sec

^Represents year on year(yoy) growth in a 12-month period at the end of each quarter. Figures for September 2012 represent 12 month yoy bank credit growth at the end of September 7, 2012

$ Includes figures only for July, 2012

& Updated till September 11, 2012

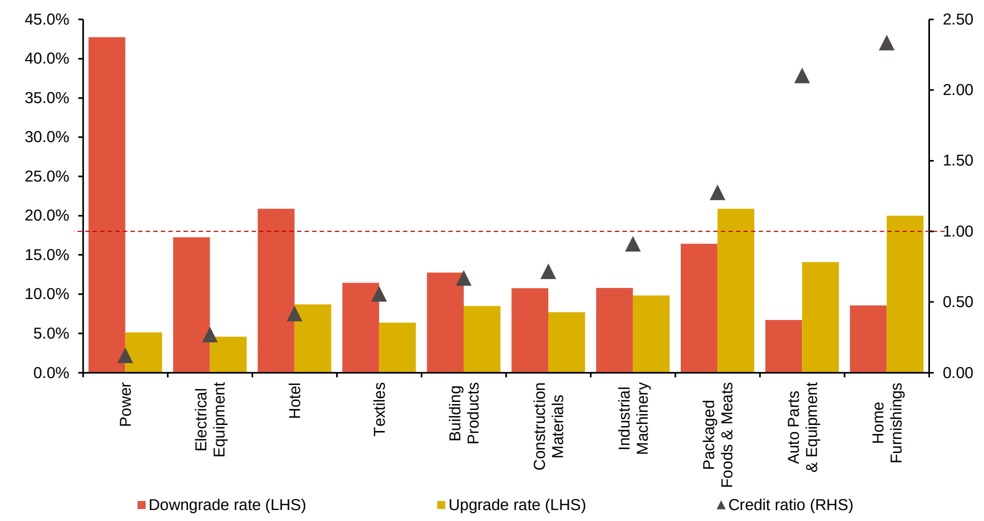
Outlook

The Indian economy is currently in slowdown, and GDP is expected to grow at 5.5 per cent by CRISIL's estimates during 2012-13. This is primarily on account of two factors—the weak domestic demand and grim outlook for growth in the Eurozone (S&P expects the Eurozone economy to shrink by 0.8 per cent in 2012). The recent policy announcements by the government have helped shore up investor confidence, as evident in sharp improvement in the rupee exchange rate. Although, these measures are unlikely to have significant positive impact on growth in the near term, the reform announcements by the government have reduced the pressure on economic growth. Rating downgrades will continue to outnumber upgrades over the near term unless there is considerable revival in demand.

CRISIL believes that the profitability margins of India's corporates will bottom out, and any further decline in margins is unlikely. The stable profitability and halt of slowdown in economic growth will ensure that the credit ratio does not decline sharply from current levels. The extent to which demand revives, the momentum that reforms can instill, and recovery in the global economy will be key monitorables over the medium term.

Key reasons for rating actions and outlook for major industries

Chart 7- Rating actions of top ten industries



Source: CRISIL

Industry	Key reasons for rating actions in H1 2012-13	Outlook for the near to medium term
Power	The downgrades have been on account of increased power procurement costs, high interest costs, and delayed subsidy realisations from state governments in the weak refinancing environment, resulting in cash-flow mismatches for distribution firms (discoms). This in turn resulted in a build-up of receivables for generating companies (gencos), adversely impacting their working capital cycles. Gencos faced sharp increases in fuel costs and where their fixed tariff structure prevented a pass through of these costs, profitability was impacted. Gas-based power plants were impacted by decline in gas availability and lower PLF.	CRISIL believes that despite recent tariff hikes, power discoms will continue to face cash-flow mismatch challenges arising out of the large gap per unit of power procured, high aggregate technical and commercial (AT&C) losses and debt servicing costs. While the restructuring scheme announced by the Central Government will provide some relief as and when implemented, continued progress in reforms will be critical to ensure that further build-up of stress in the discom segment is arrested. For gencos, counter-party risk will continue to be the key rating sensitivity factor. For recently commissioned thermal coal plants, the availability of domestic coal and prices of imported coal will be critical. Continued uncertainty surrounding the availability of gas for upcoming gas-based power plants remains a concern.
Textiles	Downgrades were driven by weak liquidity on account of inventory losses in the preceding year. Around half of the downgrades were driven by insufficiency in cash accruals to service the maturing debt obligations in H1 of 2012-13. Most upgrades were supported by stronger accruals on the back of scale-up in operations.	CRISIL expects readymade garment exporters to offer discount of 3 to 5 per cent year-on-year (y-o-y) in 2012 due to better realisation on account of forex gains due to rupee depreciation, thereby providing support to a gradual recovery in volumes. Volume growth is estimated to be 3 to 4 per cent in calendar year 2012. CRISIL expects margins of spinners to improve to 12 to 14 per cent in 2012-13 from (8 to 10 per cent in 2011-12), mainly on account of improving cotton yarn prices and healthy demand.
Construction	Upgrades were supported by scaled-up operations and growing order book in select sectors, and prudent working capital management, and therefore, stronger business risk profiles. Downgrades have been on account weak domestic demand and deterioration in liquidity, due to increasing working capital requirements and stretched receivables. This resulted in weakening business risk profiles of firms.	CRISIL expects muted growth of 8 to 10 per cent (y-o-y) in players' revenues over the medium term on account of moderate order books. EBITDA margins are likely to decline by 150 to 200 basis points y-o-y to 10 to 11 per cent on account of higher prices of inputs like steel and cement. Ability to efficiently manage working capital requirements will remain a key monitorable for firms.

Industry	Key reasons for rating actions in H1 2012-13	Outlook for the near to medium term
Auto- ancillaries parts	Most upgrades were driven by increased scale of operations and healthy cash generation, leading to stronger credit risk profiles of rated firms. Downgrades in this industry were on account of weakening financial risk profile on account of debt-funded capital expenditure as well as tightened liquidity.	CRISIL expects moderation in the growth rate of the auto component industry. The industry is expected to grow by 12 to 14 per cent in 2012-13, down from 16 to 18 per cent in 2011-12. This moderation will be driven by modest demand from original equipment manufacturers (OEMs), despite steady after-market and export demand. Operating margins are likely to be stable at about 10 per cent, due to continued focus on cost reduction and tepid input prices. Also, component manufacturers are expected to cautiously undertake capex in the wake of moderation in demand from OEMs.
Banks and non banking finance companies (NBFCs)	A few upgrades among NBFCs have been on account of equity infusions and scaled-up operations.	CRISIL believes that the asset quality and profitability of India's banks will remain under pressure. This is visible in the rising trend in gross NPAs of public sector banks (PSBs). CRISIL has observed a sharp rise in slippages to NPAs over the past few quarters. These slippages have been largely on account of high interest rates and slowing economy. CRISIL expects this trend to continue through H2 of 2012-13 as asset quality-related challenges linger. Nevertheless, the capital positions and resource profiles of India's banks continue to be adequate and stable. CRISIL expects moderation in business growth for NBFCs in the near term although their asset quality and profitability may be more resilient than those of banks. NBFCs will continue to face challenges in aligning business models to regulations. For capital-market-related firms, CRISIL expects the operating environment to remain challenging, with margin pressure for equity broking businesses and intensifying competition from foreign brokerage houses.

About CRISIL Limited

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

About CRISIL Ratings

CRISIL Ratings is India's leading rating agency. We pioneered the concept of credit rating in India in 1987. With a tradition of independence, analytical rigour and innovation, we have a leadership position. We have rated over 50,000 entities, by far the largest number in India. We are a full-service rating agency. We rate the entire range of debt instruments: bank loans, certificates of deposit, commercial paper, non-convertible debentures, bank hybrid capital instruments, asset-backed securities, mortgage-backed securities, perpetual bonds, and partial guarantees. CRISIL sets the standards in every aspect of the credit rating business. We have instituted several innovations in India including rating municipal bonds, partially guaranteed instruments and microfinance institutions. We pioneered a globally unique and affordable rating service for Small and Medium Enterprises (SMEs).This has significantly expanded the market for ratings and is improving SMEs' access to affordable finance. We have an active outreach programme with issuers, investors and regulators to maintain a high level of transparency regarding our rating criteria and to disseminate our analytical insights and knowledge.

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