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CRISIL RatingsRoundup

Credit quality pressures intensify for highly leveraged firms: CRISIL

Consumption and export-linked firms, and those with low leverage, do better

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Executive Summary

CRISIL's analysis of rating actions in the first half of the current fiscal shows that credit quality pressures have intensified for highly leveraged firms (those with a debt to EBITDA[1] ratio of more than 2.5 times), especially in the investment-linked and commodity sectors. The deterioration is reflected in the debt-weighted credit ratio (total debt on the balance sheets of firms upgraded versus downgraded), which declined to the lowest level in nearly three years to 0.27 time in the first half, against 0.62 time for the entire fiscal 2015.

In contrast, credit quality improved for firms dependent on consumption or export demand, as well as for those with low leverage. Overall credit ratio (number of firms upgraded versus downgraded) improved to 2.13 times in the first half against 1.68 times in fiscal 2015. In all, there were 981 upgrades to 460 downgrades.

Leverage emerged as a key differentiator of credit quality in the first half. Another critical factor was the extent of linkage firms had to investment cycle, consumption demand and commodity price movement. Around 80% of the upgrades were of firms with low leverage (debt to EBITDA below 2.5 times) or from the consumption and export-oriented sectors such as packaged food, pharmaceuticals, agricultural products and readymade garments. On the other hand, firms in the metals, real estate and infrastructure space continue to face pressure because of high debt or a steep fall in product prices. Those downgraded have a total debt of Rs 2.4 lakh crore of which 90% is owed by firms from either investment-linked or commodity sectors. CRISIL believes they will remain under the pump till deleveraging happens through asset sales.

Of late, there has also been sharper focus on the performance of credit rating agencies because of instances of sudden and sharp rating changes – specifically downgrades – in the higher-rated categories ('A' and above). Such rating changes create credit cliffs, catch the markets by surprise, leave investors in the lurch, and severely constrain the ability of fund managers to handle their exposures.

CRISIL has always focused on quality of ratings and hence strived to minimise sudden and sharp rating actions, especially in the higher-rated categories. Market participants should differentiate between rating agencies based on the performance of ratings, since not all ratings are equal. The very low intensity of rating actions in CRISIL's portfolio of companies having ratings higher than 'A-' was evident in the first half. Of the 55 rating actions[2] (30 upgrades and 25 downgrades) on 1,005 firms in these categories, barring one upgrade by two notches, all were just single-notch changes.

CRISIL expects the credit ratio of its portfolio to remain high in the medium term -- meaning upgrades will be more than downgrades. However, the debt-weighted credit ratio will remain below 1 time, since the stress in the investment-linked and commodity sectors is expected to continue.

A broad-based improvement in India Inc's credit quality will hinge on successful deleveraging of stretched balance sheets, significant improvement in investment demand and commodity prices, extent of interest rate reduction, and the government's ability to continue to push economic reforms.

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[1] EBIDTA = Earnings before interest, depreciation, tax and amortisation

[2] Excludes ratings placed on 'Rating Watch'. This tool 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.

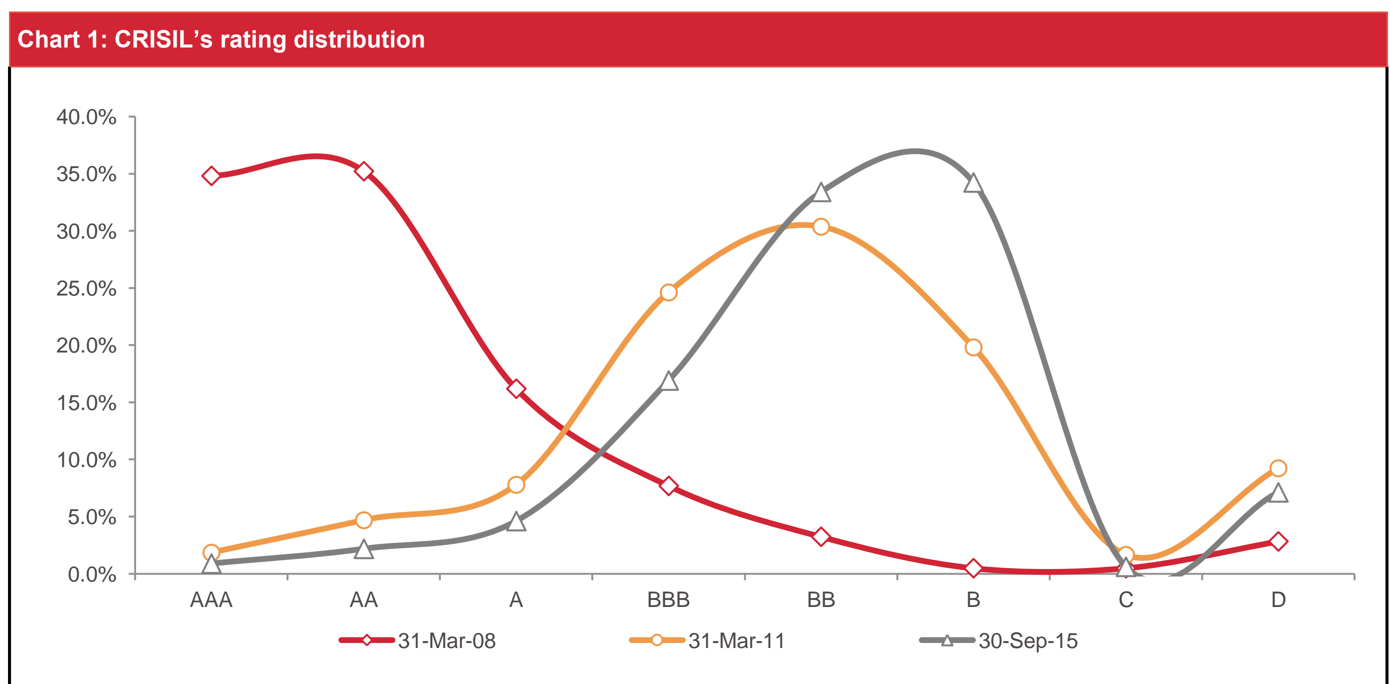
About CRISIL's Ratings Round-Up

CRISIL's Ratings Round-Up is a semi-annual publication that analyses CRISIL's rating actions and traces linkages between these actions and the underlying economic trends and business factors. A credit rating is an opinion on the likelihood of timely debt repayment; therefore, an analysis of rating actions in a large and diverse portfolio of rated firms is an apt indicator of economic prospects. The current edition analyses CRISIL's rating actions in the six months ended September 30, 2015.

CRISIL's portfolio of outstanding ratings has stabilised

CRISIL's portfolio of outstanding ratings has stabilised – ratings on 14,042 firms were outstanding as on September 30, 2015. More than three-fourths of the firms are rated 'CRISIL BB' or lower. The median rating remained at 'CRISIL BB' over the four and a half years ended September 30, 2015, down from 'CRISIL AA' as on March 31, 2008 (*see Chart 1*).

Chart 1: CRISIL's rating distribution



Source: CRISIL

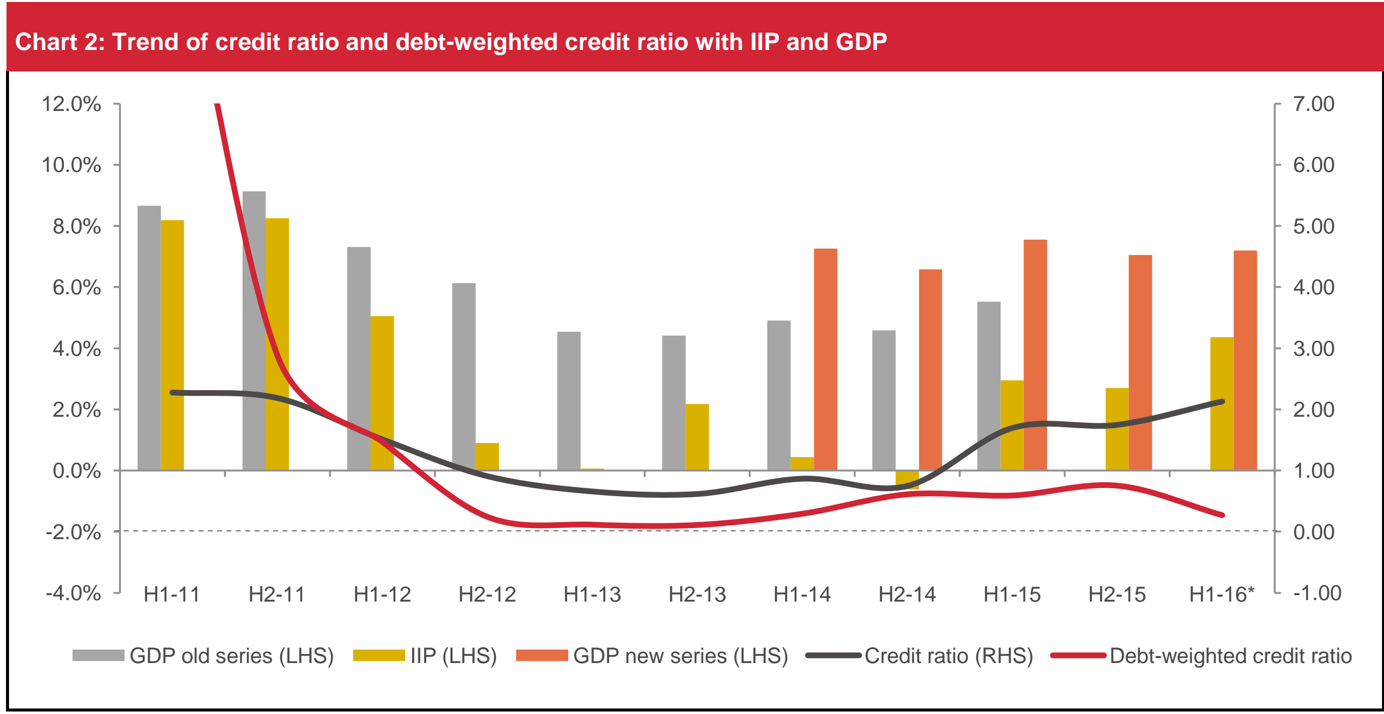
Credit quality pressures persist with debt-weighted credit ratio still below 1 time

The debt-weighted credit ratio for H1 2015-16 continues to be below 1 time, which has been the trend over the past four years.The ratio was at 0.27 times in H1 2015-16, indicating that debt facing downward credit quality pressure is nearly 4 times the debt witnessing credit quality uptick. However, the credit quality pressures are restricted to leveraged firms.

CRISIL's credit ratio frequently exhibits a correlation with economic indicators such as Index of Industrial Production (IIP) and Gross Domestic Product (GDP). Steady GDP growth, coupled with gradual improvement in IIP has resulted in a credit ratio of more than 1 time for the third consecutive half. The improvement is restricted to small and mid-sized firms. Firms with consumption-linked demand and well-managed balance sheets witnessed improvement in their credit risk profiles.

For a broad-based recovery, both credit ratio and debt-weighted credit ratio should exceed 1 time.

Chart 2: Trend of credit ratio and debt-weighted credit ratio with IIP and GDP



Note – CSO recently released new series of GDP growth rates. CRISIL has provided the growth rates in the chart above as per the old as well as new GDP series (*from when it is available*) for reference.

* IIP growth rates are for April 2015 to July 2015; GDP growth rate estimate derived from 2015-16 forecast

(For a complete list of rating actions in H1 2015-16, refer to Annexures II-b and II-c under 6.2.2 of 'Regulatory Disclosures' on the CRISIL website)

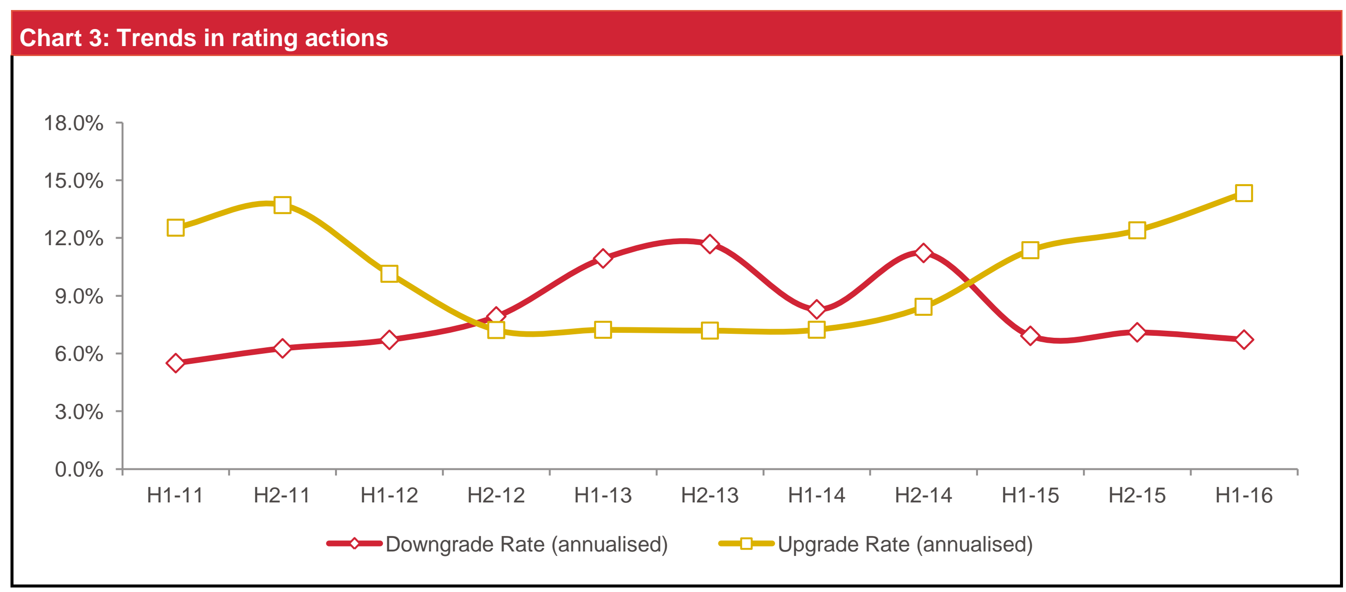
Source: CRISIL

Downgrade rate at four-year low in H1 2015-16; upgrade rate surges further

CRISIL's rating portfolio for H1 2015-16 witnessed 981 upgrades and 460 downgrades. The upgrade rate continued its upward trajectory, increasing to 14.3 per cent in H1 2015-16 from 12.4 per cent in the second half (H2) of 2014-15. A marginal decline was observed in the downgrade rate to 6.7 per cent in H1 2015-16 from 7.1 per cent in H2 2014-15. More than 40 per cent of the downgrades were to default category - most of them defaulted from rating cateogries 'BB and below', which are inherently vulnerable to default.

The economy held on to a growth of 7.0 per cent in the first quarter (Q1) of 2015-16 driven primarily by consumption growth. This could be attributed to sustained low commodity prices, which moderated inflation and led to improvement in consumption demand. Higher consumption demand is expected to trigger capacity utilisation in consumer-facing sectors and support growth over the medium term. However, this growth is not all inclusive, as investment demand continues to languish. The Reserve Bank of India's (RBI's) business expectation survey indicates muted expectations for industrial activity. CRISIL believes capacity utilisation in investment-linked sectors will pick up only by 2016-17, with public spending preceding private capital expenditure (capex).

Chart 3: Trends in rating actions



…..Most of the rating actions in high rating categories were of low intensity

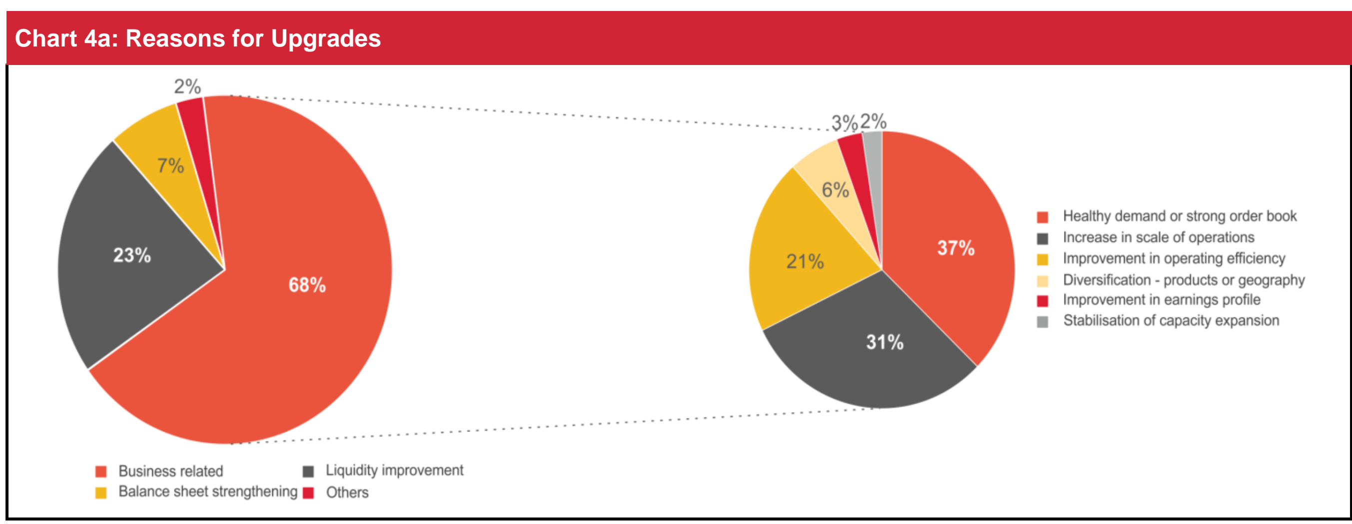
Sharp and sudden rating actions (upgrades as well as downgrades) from high rating categories ('A' and above) are not considered desirable as investors expect these categories to display a high degree of stability. Such sharp rating actions result in huge credit cliffs for investors leaving them with little scope to manage their exposures. CRISIL's portfolio witnessed rating actions on 55 firms – 25 downgrades and 30 upgrades out of a portfolio of 1,005 firms in these rating categories. The downgrades were primarily in capital-intensive sectors, while upgrades were across the board. CRISIL's analysis of intensity of rating actions in H1 2015-16 reveals all but one[3] rating action in rating categories 'CRISIL A' and above were of low intensity – limited to one notch.

[3] The only exception was Inox Wind Ltd, which got upgraded to 'CRISIL AA-/Stable/A1+' from 'CRISIL A/Stable/A1' in June 2015

Upgrades driven by business factors, downgrades by stretched liquidity in H1 2015-16

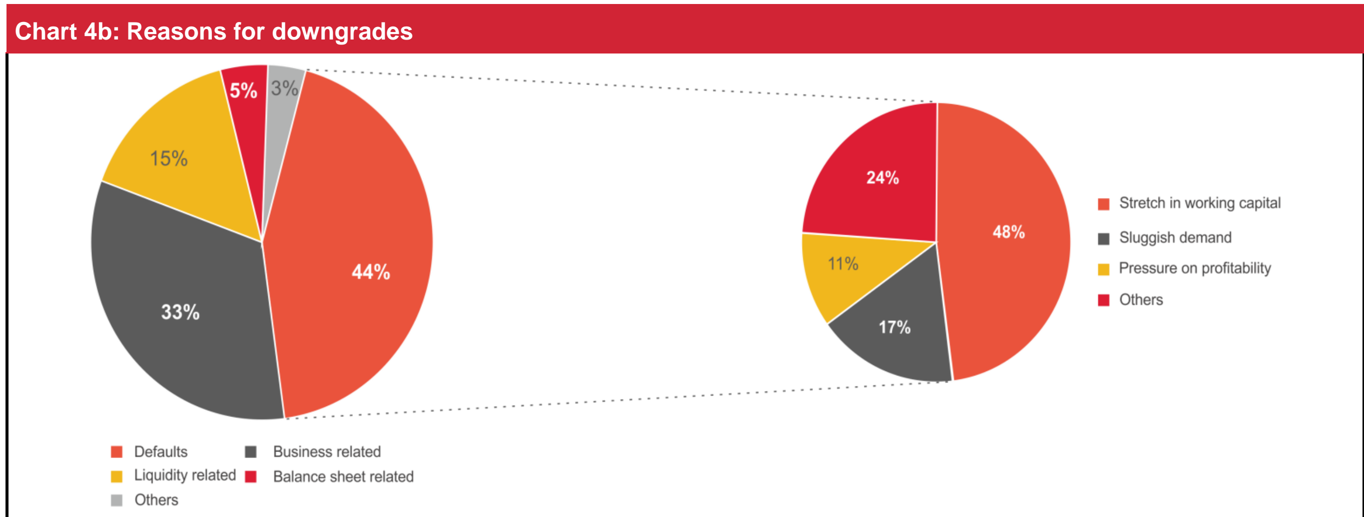
CRISIL's rating action analysis for H1 2015-16 indicates more than two-thirds of the upgrades were primarily due to business-related factors, such as healthy demand, improved operating efficiency, and scale-up in operations. Improved liquidity accounted for a quarter of upgrades, and balance sheet strengthening for 7 per cent.

Chart 4a: Reasons for Upgrades

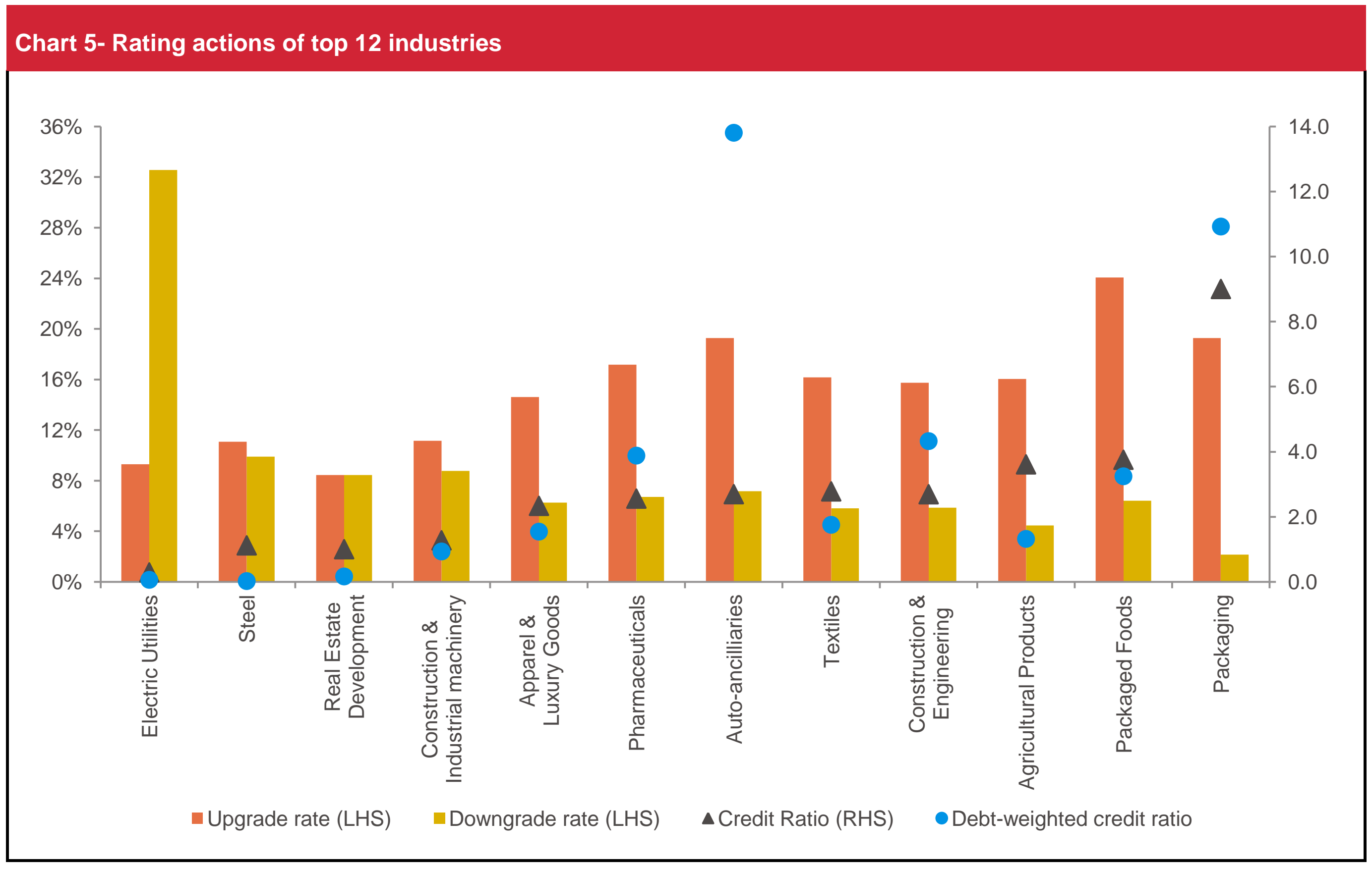


In contrast, weak liquidity led to about 60 per cent of downgrades – this included downgrades to default category. Another third of downgrades was attributable to tepid business performance – including sluggish demand, pressure on profitability, and project delays.

Chart 4b: Reasons for downgrades



Rating actions in key industries



Source: CRISIL

While the usual trend of export- and consumption-oriented sectors having a higher credit ratio than infrastructure ones continued, the credit ratio of investment-linked sectors also exceeded 1 time during H1 2015-16. This does not point to a broad-based recovery yet. The higher number of upgrades in sectors facing demand issues could be attributed to reasons specific to firms in CRISIL's portfolio, rather than the sector as a whole.

In case of real estate, although the number of upgrades equaled downgrades, upgrades were limited to firms with higher sales and to special-purpose vehicles (SPVs) with projects nearing completion, whereas downgrades were driven by high debt without much sales traction. Realtors from the metros building homes for the middle-income strata, which have seen higher sales or are closer to completing projects, saw an uptick in credit quality.

Steel firms that were downgraded had a high leverage: the median debt/EBITDA ratio of downgraded firms was more than 5.5 times for H1 2015-16. The aggregate debt of steel firms downgraded was 50 times that of upgraded firms. This was because of sluggish global demand that put downward pressure on steel prices, and high competition in the sector especially from imports. Upgrades, on the other hand, were primarily concentrated in firms that have heathy balance sheets, primarily due to low debt levels.

Textile firms that were upgraded largely belonged to segments such as ready-made garments (where demand has picked up from the UAE and Japan), processing, and man-made fibre manufacturers. Downgrades were

concentrated in yarn producers, which have been facing demand issues since implementation of China's import substitution policy.

The construction and engineering sector witnessed about five upgrades for every two downgrades. Additionally, the debt-weighted credit ratio of this sector was above 4 times. This was in part due to upgrade of a large construction firm, whose debt constituted two-thirds of the entire debt upgraded in the sector. Other firms upgraded in this sector had prudent working capital management, with a median working capital cycle of 135 days against 250 days for downgraded firms. These firms also had strong order books of about two times their operating income, primarily comprising government orders, providing revenue visibility for the medium term.

The packaging sector witnessed 27 upgrades and 3 downgrades. Strong linkage to consumption-driven sectors, such as fast-moving consumer goods (FMCG), led to healthy demand and consequent scale up of operations for these firms, and resulted in the significant number of upgrades in this sector.

Firms with low leverage exhibit better credit quality

CRISIL has analysed the rating actions on firms during H1 2015-16, based on debt-to-EBITDA ratio (an indicator of leverage) and operating income (an indicator of scale of operations).

Table 1: Analysis of credit quality trends based on leverage

Leverage (Debt/EBITDA)	Debt-weighted credit ratio
Low leverage (Debt/ EBITDA < 2.5 times)	5.59
Medium leverage (Debt/ EBITDA between 2.5 and 4.0 times)	0.23
High leverage (Debt/ EBITDA > 4.0 times)	0.15

Source: CRISIL

Firms with low leverage had a very high debt-weighted credit ratio at around 6 times, as against an overall debt-weighted credit ratio of 0.27 times, in H1 2015-16. The analysis indicates that firms with even medium leverage are facing credit pressures primarily due to contraction in margins because of subdued demand.

Furthermore, when we consider the performance of firms based on size along with leverage (*see Table 2*), it clearly indicates that leverage is a stark credit differentiator for firms across all sizes. Small and mid-sized firms, even with medium leverage, performed well in H1 2015-16. However, among large firms, only those with low leverage did well. This is because smaller firms are much more nimble-footed than the larger ones and are able to support their balance-sheets through promoter funding.

Table 2: Analysis of credit quality based on size and leverage

	Low leverage	Medium leverage	High leverage
Small firms	6.3	2.4	1.0
Mid-sized firms^	3.9	3.1	0.9
Large firms	6.8	0.2	0.1

^ Mid-sized firms defined as firms with operating income between Rs.1 billion and Rs.5 billion
Numbers in the table indicate the ratio of debt of firms upgraded to that of firms downgraded for the segments

Source: CRISIL

As evident from Table 2, large firms with a low debt-to-EBITDA ratio had a very high debt-weighted credit ratio. This indicates large firms which are not burdened with sizeable debt on their balance sheets are placed very well to tide over tough economic conditions.

Furthermore, credit quality pressures continue in large firms which have medium or high leverage – these firms carry huge debt on balance sheets and are mostly from investment-linked sectors such as metals, real estate and infrastructure.

Sectoral analysis of firms clearly reveals that credit quality pressures are much higher for firms in investment-linked sectors than consumption-linked ones. The large debt of investment-linked firms weighs down their balance sheet, especially in an environment where demand is subdued and margins have contracted. Consumption-linked firms, have a debt-weighted credit ratio of 2.8 times against 0.17 for investment-linked firms. This shows that a clear

demarcation exists between the credit risk profiles of the two segments. Within infrastructure, credit quality pressures are most severe in metals, with debt-weighted credit ratio of 0.01 times.

Table 3: Analysis of credit quality trends based on sector

Sectors	Debt-weighted credit ratio
Investment linked	0.17
Metals	*0.01*
Infrastructure	*0.46*
Real estate	*0.16*
Consumption linked	2.78
Export linked	1.81

Credit growth slows further, but may pick up in the second half

Despite measures initiated by RBI to ease monetary pressure, bank credit growth moderated to 9.6 per cent in September 2015 from 9.7 per cent in September 2014. As weak assets continue to plague the banking sector, banks have maintained a cautious stance towards lending in the past few quarters. The decline in credit offtake is more pronounced for corporates, which saw year-on-year credit growth slow down to 4.8 per cent in July 2015 from 10.1 per cent; on the other hand, credit growth in the agriculture sector dipped to 12.2 per cent from 19.5 per cent, over this period. With banks reluctant to extend credit to industries, they are looking towards capital markets to meet their funding requirements. Funds raised through commercial paper grew by 40 per cent, year-on-year in September 2015.

With wholesale inflation remaining in the negative territory for 10 months and consumer inflation stabilising, RBI has slashed the repo rate by 125 basis points (bps; 100 bps equal 1 percentage point) cumulatively in (calendar year) 2015 so far. However, this has been passed on only partially to the corporate sector by banks, which is why the high-rated corporates are accessing the bond/money market, where this transmission has been faster. Credit growth is expected to pick up in H2 2015-16 on account of retail loans and public sector investments, which in turn would fuel corporate credit growth. On the whole, credit growth is expected at 12-14 per cent for 2015-16, as compared with 12.2 per cent in 2014-15.

Table 4: Trends in industrial activity and fund mobilisation

Quarter ended	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15
Bank Credit Growth (%)	15.5	13.7	17.8	14.5	14.6	13.3	9.7	10.5	10.2	9.3	9.6
Repo rate (%)	7.50	7.25	7.50	7.75	8.00	8.00	8.00	7.75	7.50	7.25	6.75
Credit spreads (%) #	0.7	0.6	0.9	0.5	0.6	0.4	0.6	0.4	0.4	0.5	0.4[@]
ECB^^ mobilised (Billion USD)	10.9	5.6	9.4	8.7	9.6	6.5	7.4	6.9	7.5	6.3	2.9[@]
Equity Mobilised (Rs. Billion)	142.3	335.1	120.1	249.06	400.3	210.5	268.8	117.5	193.0	138.9	62.0[@@]
IIP Growth (% YoY)	2.2	-1.0	1.9	-0.8	-0.5	4.6	1.3	1.5	3.3	3.3	4.2[@@]
GDP Growth (% YoY)^	NA	7.0	7.5	6.4	6.5	6.5	8.2	7.5	7.5	7.0	NA

#AAA spread over 10 year G-Sec

@ Updated as of Aug 2015

@@ Updated as of July 2015

^ As per new series of GDP growth released by CSO

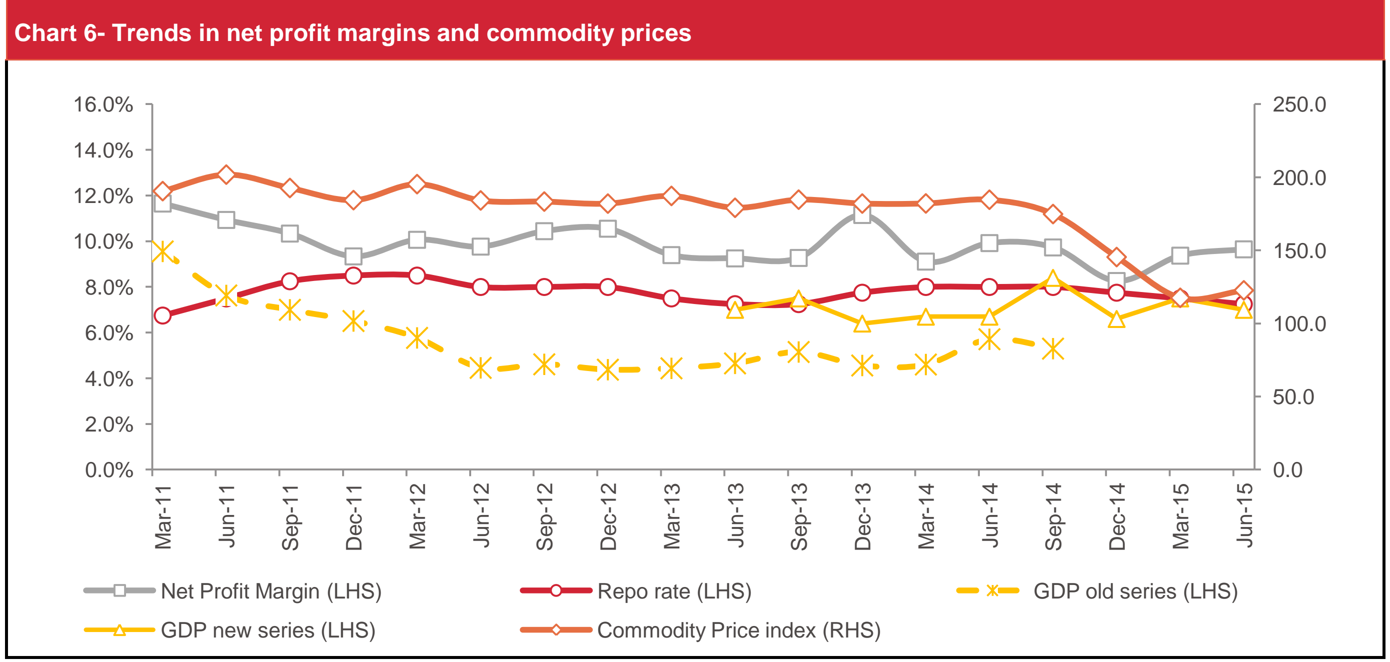
Source: CRISIL

Corporate profitability improves owing to low input costs

CRISIL's analysis of the aggregate financial performance of 407[4] firms listed on S&P CNX 500 indicates that the net profit margin (NPM) improved in the first quarter (Q1) of 2015-16 to 9.6[5] per cent. The improvement is primarily on account of favourable raw material prices, as commodity prices have declined steadily over the last 12 months. In terms of sectoral performance, firms in the car and utility vehicle sector posted better margins due to low input costs and low advertisement spends. Firms belonging to the FMCG sector benefitted from their favourable product mix. Furthermore, margins for telecommunication firms improved due to surging data traffic as well as implementation of cost-control measures.

CRISIL believes that the NPM of Indian companies will remain range-bound over the medium term because of (i) low commodity prices - which will ultimately have to be passed on to the end consumer, (ii) subdued export demand, and (iii) sub-normal monsoon in the country.

Chart 6- Trends in net profit margins and commodity prices



Note – CSO recently released new series of GDP growth rates. CRISIL has provided the growth rates in the chart above as per the old as well as new GDP series (*from when it is available*) for reference.

Source: CRISIL

[4] These listed companies have reported their results for the quarter ended June 30, 2015, and have remained in the S&P CNX 500 for the past 16 quarters. Furthermore, the three oil marketing companies (OMCs) have been excluded from this sample, because their reported numbers will skew the sample. Companies from the financial sector have also been excluded from the sample.

[5] The NPM has been calculated after adjusting for any extraordinary gains/losses by these firms.

Exports continue to decline, core imports stagnate

Global growth is facing downside risks, particularly in the emerging economies. These risks emanate from a variety of factors – China's shift from an investment economy to consumption economy, rising financial market volatility, declining commodity prices, and depreciating currencies in some countries. However, the advanced economies continue to hold the fort – the US economy continues to grow on the back of strong consumer and government spending, and Europe is posting a modest export-led recovery.

Lower demand from emerging economies, along with the downward trend in commodity prices has led to lower export revenues for corporate India. Sectors such as engineering goods, and petroleum products witnessed contraction in export realisations, while realisations from export of gems and jewelery remained rather flat.

Table 5: Trends in GDP growth rates of Europe, UK, USA and China

Countries	2013	2014	2015(P)	2016(P)
Euro zone	(0.3)	0.9	1.6	1.9
United Kingdom	1.7	2.8	2.6	2.8
USA	2.2	2.4	2.3	2.7
China	7.7	7.4	6.8	6.3

Source: Standard & Poor's

Performance of banking sector to remain under pressure in 2015-16

CRISIL believes that the pressure on asset quality and profitability of Indian banks will persist in 2015-16. This will be a year of endurance wherein banks will need to focus on asset quality management while cautiously growing their credit book. With the pace of economic turnaround expected to remain slow in 2015-16, CRISIL expects only a moderate pickup in credit growth at 12-14 per cent year-on-year in 2015-16.

CRISIL believes that gross non-performing assets (NPAs) will increase to 4.5 per cent, thereby increasing the weak assets[6] level to 6.1 per cent by March 2016. Gross NPAs are expected to rise mainly due to withdrawal of regulatory forbearance on restructuring, resulting in higher slippages from standard assets and also from existing restructured assets. While flexible structuring of loans under the 5/25 scheme[7] can provide some relief on asset quality, it can partially mask the true asset-quality pressures. In 2015-16, CRISIL estimates that Rs.800 billion of stressed loans could be structured under the 5/25 scheme. Asset quality pressures will also increase the provisioning requirements, keeping return of assets below 1 per cent for 2015-16.

Adequate capitalisation and stable resource profile, nevertheless, continue to partially offset pressures on asset quality and profitability in the current fiscal. However, as capital requirement under Basel III increases over the next four years, banks, especially public sector banks (PSBs), will have to raise significant capital, both equity and non-equity. Given the riskier features of non-equity Tier-I instruments, raising these instruments can be a challenge.

Indradhanush, the recently announced, seven-pronged plan to revamp PSBs is a positive step as it takes cognisance of, and tries to address the critical problems impacting their performance, including governance reforms, especially accountability, and capitalisation (Rs.700 billion capital infusion by the Government of India expected over the next four years). However, the success of the plan will depend on relentless implementation over the medium term.

Table 6: Weak assets in banking sector

Year ended	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16 (P)
Gross NPA (as a percentage of gross advances)	2.9%	3.3%	3.8%	4.3%	4.5%
Restructed assets (RSA) as a percentage of gross advances	4.8%	5.0%	5.3%	5.9%	4.4%
RSA ex-state power utilities as a percentage of gross advances	3.4%	3.5%	3.8%	4.5%	3.2%
Weak assets(as a percentage of gross advances)	3.9%	4.3%	5.1%	6.2%	6.1%
Gross advances (in Rs.Billion)	**51,655**	**59,700**	**68,700**	**75,300**	85,100

[6] According to CRISIL's definition, weak assets include gross NPAs + 35 per cent of restructured standard assets (excluding those of state power utilities) + 75 per cent of security receipts + 15 per cent of assets structured under 5/25 scheme

[7] As per 5/25 scheme, banks will be encouraged to extend long term loans to infrastructure sector with flexible structuring to absorb potential adverse contingencies

Outlook

Credit quality pressures on the highly leveraged firms in the investment-linked sectors will continue over the medium term, restricting significant improvement in the systemic credit quality.

CRISIL believes the improvement in credit quality will be restricted to small and mid-sized firms, and firms with low leverage, in 2015-16. This will be driven predominantly by improvement in private consumption, favourable commodity prices, and a mild upswing in domestic investments, led by government spending. However, profitability of corporate India will come under pressure primarily due to lack of any material improvement in the demand scenario.

A broad-based improvement in credit quality will hinge on sucesssful deleveraging of stressed balance sheets, significant improvement in investment demand, and the government's ability to continue to push economic reforms.

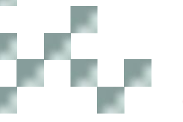
Key reasons for rating action and credit quality outlook for key sectors

Industry	Key Reasons for Rating action in H1 2015-16	Outlook for the medium term
Pharmaceuticals	Upgrades in the pharmaceutical sector were driven by healthy domestic and export demand, and improvement in operating efficiency. This sector witnessed only eight downgrades, four of which were to the default category. These were driven by weak liquidity.	CRISIL believes that the demand outlook for the Indian pharmaceutical industry remains healthy for the medium term. While patent expiries and fall in new novel drug launches in the US continue to benefit exporters, consolidation between the already oligopolistic distributors space in the US may put downward pressure on their realisations. Operating margins are expected to be flat or see only a marginal increase, given high research and development (R&D) and compliance costs.However, for players focused on the domestic market, this will be partially offset driven by price hikes for drugs covered under the Drug Price Control Order (DPCO). The high compliance costs are attributable to increased regulatory scrutiny and also implementation of the Generic Drug User Fee Amendment (GDUFA)[8] Act in the US. The R&D costs are expected to increase as manufacturers prepare for faster drug approvals with GDUFA. Any continued foreign currency volatility in the emerging markets may also impact the profitability of export-focused players over the medium term.
Agricultural products	The three quarters of upgrades in this sector could be attributed to business-related factors - enhanced sales due to better demand or diversification - and increase in operating efficiency. Downgrades may be attributed to pressure on profitability, due to an unfavourable cost structure or increased competition.	India's rice exports will remain flat in 2015 at about 10 million tonnes due to lower offtake of basmati rice by Iran, coupled with deficiency in monsoons during the year. Thailand will maintain its top position as a rice exporter in 2015 for the second consecutive year, with India at the second position in the global rice export industry. Despite decline in India's paddy production by 3 per cent during crop year 2014-15, the paddy prices dropped in 2014-15 (after September 2014) due to high inventories. This is expected to continue in 2015-16 as the excess inventory will take some more time to clear. Low paddy prices in India will attract demand for basmati rice from Iran and other gulf countries.This should support the credit risk profiles of basmati rice exporters in 2015-16. Competition from Thailand will continue to influence the profitability of non-basmati rice exporters.

[8] Generic Drugs User Fee Amendment allows FDA to collect fee from manufacturers, who wish their APIs to be used in generics in USA

Industry	Key Reasons for Rating action in H1 2015-16	Outlook for the medium term
Textiles	Upgrades resulted from enhanced scale of operations and improved operating efficiency with healthy domestic demand. A few upgrades were led by improved liquidity driven by accretion to reserves. Textile firms that were upgraded largely belonged to the ready-made garments segment, the processing segment and man-made fibre manufacturers. More than half the downgrades in the sector were to the default category, driven by weak liquidity and project delays. Downgrades were concentrated in yarn producers, which have been facing demand issues since implementation of China's import substitution policy.	Ready-made garment (RMG) manufacturers continue to witness slowdown in demand from the traditional markets of the US and the European Union (EU). However, increasing contribution from other global markets such as the UAE and Japan, among others, and healthy demand in the domestic market would support revenue growth over the medium term. RMG players' profitability will continue to be supported by decrease in raw material costs; however, demand from key markets and exposure to fluctuation in foreign exchange rates will remain key monitorables for the sector. China's import substitution policy continues to impact cotton yarn demand. However, absence of significant capacity expansion plans, stable demand in domestic market and steady operating profitability of yarn players are expected to support credit risk profile over the medium term.
Automotive components	Improving scale of operations, because of better demand from original equipment manufacturers (OEMs) and global customers, combined with cost optimisation efforts, result in higher cash accruals. This, coupled with prudent capital expenditure and working capital management will lead to improvement in financial risk profiles, particularly liquidity, thereby driving upgrades in this sector. Continued weak demand from specific customer segments such as tractor manufacturers, and the resultant profitability pressures and sub-par liquidity, were key drivers for downgrades in the sector. In some cases, debt funding of capex and the resultant pressure on financial risk profiles, particularly liquidity, drove the downgrades in the sector.	As OEMs in passenger and commercial vehicle segments increase their offtake, auto-ancillary production growth is expected to rise by 8-10 per cent in 2015-16. Export demand will be boosted on account of higher automobile sales in the US and EU, as well as revival of truck demand in the US. Additionally, sourcing by global OEMs is on the rise due to their mounting cost pressures and ability of large Indian exporters to invest in additional capacities and technology. Replacement demand will be supported by higher utilisation rates of trucks. However, a poor monsoon may limit the demand for tractors, light commercial vehicles, and two-wheelers. The benefits of stringent cost-control measures, coupled with high utilisation rates and continuing fall in prices of inputs, such as pig iron and plastics, are expected to benefit the operating margins of component makers. The margins are expected to improve by 40-70 bps in 2015-16.
Packaged foods	Around three-fourths of the upgrades were attributable to business factors – strong demand, diversification in product or geography, and improvement in operating efficiency. The few downgrades in this sector were in the lower rating categories, mostly to default category – attributable to stretched liquidity.	India's beef exports in 2015-16 will register a setback as India's price competitiveness against Brazil has reduced considerably. India overtook Brazil as the largest exporter of beef in the world in 2014. However, with Brazil's currency having fallen by more than 34 per cent year-on-year in 2015, Brazil may regain its place as the world's largest exporter of beef. Indian beef exporters may be able to salvage

Industry	Key Reasons for Rating action in H1 2015-16	Outlook for the medium term
		some pride as regional demand for lower quality meat from South Asia (mainly Vietnam), followed by Malaysia and Thailand will keep their export registers ringing. CRISIL expects Indian beef exporters with high operational efficiencies and diversified market presence to maintain their credit risk profiles over the medium term.
Steel	The primary reason for upgrades in the secondary steel sector has been improvement in financial risk profile, marked by improvement in gearing largely due to funding support from promoters. This led to improved liquidity resulting in upgrades. Downgrades resulted from demand pressure faced by secondary steel manufactures leading to lower revenues and profitability. Players also faced liquidity pressure because of stretched working capital cycle.	Global steel demand is expected to remain subdued on the back of structural shift in demand from China, and steep fall in crude oil prices impacting demand from Russia, the US, and the Middle-East. Weak demand outlook will result in continuing large overcapacities in the global market and pressure on steel realisations. Although demand in the domestic market is expected to grow at a healthy rate driven by the automobile, consumer durables, and infrastructure sectors, higher imports from China, Korea, and Japan will result in heightened competition and pressure on steel realisation even in the domestic market. This decline in realisations will override the fall in key raw material prices, especially iron ore, with the reopening of some of the mines, and result in a decline in profitability for domestic players. The pressure on profitability has coincided with heightened debt levels for most of the players; this is expected to result in weakening debt protection metrics and consequently credit quality.
Construction	Three quarters of upgrades resulted from strong order books, providing revenue visibility over the medium term. Prudent project tendering led to improvement in business risk profiles and increase in operational efficiencies. More than half of the downgrades were driven by weak liquidity, because of stretched receivables.	Supportive government stance in the infrastructure space – especially road, urban infrastructure, and railways – will allow the sector to grow at a healthy pace. Faster execution of national highways is expected to support construction spend in roadways. The investment in urban infrastructure will be driven by the Atal Mission for Rejuvenation and Urban Transformation (AMRUT), and that in railways by metro rail projects. CRISIL believes that the government's impetus on clearing policy logjams and improving financial health of infrastructure companies would help translate into better revenue growth over the medium term. However, companies will need financial muscle to take on new projects. It is essential for large construction companies that are undergoing financial stress to clean up their balance sheets by either selling some operational assets or infusing equity.



Industry	Key Reasons for Rating action in H1 2015-16	Outlook for the medium term
		Companies that are unable to improve their financial position will find it difficult to bag new projects. Faster execution of projects, and the government's policy push in the roads and power sectors may reduce companies' overhead costs and working capital requirements. Competition is also moderating (including for build, operate, transfer projects) as financially weak companies are not bidding for new projects. While these developments may be positive for profitability, an overhang of legacy projects will limit a rise in operating margins until 2016-17, when players reduce debt by monetising assets and their cash flows rise, owing to an improvement in execution capacity.
Real estate	Upgrades were particularly in SPV projects, which have seen higher sales, or were nearing completion. Half the downgrades were to the default category, attributable to a liquidity crunch. This period also saw downgrades of a large real estate group due to weakened capital structure, as the group contracted additional debt.	High capital values and piling up of inventory have resulted in a slowdown in the real estate sector. Demand is expected to remain subdued over the medium term as consumers have been on a 'wait and watch' mode in the hope of price correction and reduction in interest rates. The capital values are unlikely to increase materially as real estate activity will pick up slowly. The lease rentals in the commercial segment will remain stable, backed by moderate pick up in demand. The sector will continue to face credit quality pressures as interest payments and principal repayments are expected to remain high in 2015-16. Banks have been cautious in lending to the sector, resulting in developers moving to alternative sources of funding. Mobilisation through sources such as non-convertible debentures was robust in 2014-15 and is expected to remain an important source of funding over the medium term. Momentum in commercial mortgage-backed securities and favourable changes in regulations for Real Estate Investment Trusts are also expected to enhance access to alternative sources of funds for operational commercial properties.
Packaging	More than 80 per cent of upgrades in the segment are attributable to improvement in business risk profiles – healthy topline or bottom line growth, diversification, and stabilisation of capacity. The only downgrade in this segment was to default category.	The Indian packaging industry is poised to grow at 10-12 per cent annually over the medium term on the back of increasing demand for processed food, amid rising disposable incomes, urbanisation, and favorable demographics. Pharmaceutical, beverages, and personal health care and beauty products, which contribute about 35 per cent of the revenue of the Indian packaging industry, will continue to drive growth. This will be supported by increasing

Industry	Key Reasons for Rating action in H1 2015-16	Outlook for the medium term
		penetration of existing and new product segments from multinationals into India. Profitability will remain healthy on the back of improved capacity utilisation, supported by shorter conversion cycle leading to lower inventory. This would provide players with additional cushion against volatile raw material prices while optimising working capital requirements.
Non banking financial institutions (NBFC)	Half the upgrades in this sector were on account of expected turnaround in commercial vehicle (CV) cycle, resulting in improvement in asset quality. A third of upgrades were driven by business growth and profitability while maintaining asset quality. No downgrades were witnessed in the sector.	The performance of retail-financing NBFCs is expected to revive gradually after falling to a five-year low in 2014-15. CRISIL believes assets under management (AUM) of retail NBFCs will grow by around 17 per cent this fiscal after a period of continued slow growth. The improvement will be supported by recovery in the medium and heavy commercial vehicle (M&HCV) financing business, and an uptick in lending against gold jewellery, while growth in other segments such as used vehicle financing, SME financing, loan against property (LAP) and loan against shares (LAS) will continue at a steady clip. Asset quality performance has begun to show signs of stabilisation after declining sharply over the past few years and will be primarily driven by the vehicle financing segment. However, NBFCs engaged in LAP may face challenges in the near term from intensifying competition and increased risks in the portfolio. While asset quality is expected to improve gradually, the extent of improvement may not be reflected in reported gross NPAs due to transitioning to stringent asset classification norms. The overall gross NPAs for retail NBFCs are likely to be 3.8-4.5 per cent as on March 31, 2016 after touching a five-year high of 4.1 per cent as on March 2015. The profitability of retail financing NBFCs as reflected by RoMA is expected to improve by 20 basis points to 1.9 per cent in 2015-16, supported by higher margins and lower credit costs. Further, NBFCs are augmenting their capital base to support future growth. CRISIL believes that the credit risk profiles of NBFCs, will remain resilient, supported by their healthy capitalisation, providing a cushion against asset-side risks.

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