Ratings Round-Up

Fiscal 2018

Credit quality improvement sustains through the year

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Executive summary

India Inc's credit landscape remains a tale of two distinct loan books – the good one, which is improving, and the bad one, with sizeable stressed assets (~Rs 11.5 lakh crore, or ~14% of bank advances[1] as on March 31, 2017) where resolution has begun.

CRISIL's credit ratio[2] (or number of upgrades vs downgrades), which printed at 1.45 times in the second half of fiscal 2018, continues to reflect the improvement in the good loan-book, though it has moderated from the levels seen in the first half.

There were 1,402[3] upgrades to 839[3] downgrades in fiscal 2018.

Upgrades outnumbered downgrades in the good loan-book on the back of better financial indicators due to lower capital expenditure (capex) and record equity issuances. Continued headroom in capacity utilisation across sectors made corporates go slow on capex, even as India Inc raised a record amount of equity – Rs 1.75 lakh crore in the ten months ended January 31, 2018.

CRISIL-rated companies have shown steady improvement in capital structure and debt protection metrics over the past four years. The median gearing of companies improved to 1.0 time in fiscal 2018 from 1.37 times in fiscal 2015, whereas median interest cover improved to 2.83 times from 2.29 times.

The debt-weighted[4] credit ratio[2] stood at 1.53 times in the second half of fiscal 2018. Credit quality of debt-intensive sectors such as metals (especially non-ferrous), mid-sized EPC (engineering, procurement and construction), and select capital goods improved on account of higher commodity prices and government's focus on infrastructure spending.

As for the bad loan-book, CRISIL expects resolution of stressed assets to provide much-needed respite from fiscal 2019 onwards, and the stock of gross non-performing assets (GNPAs) to peak.

While resolution of the large-ticket corporate NPAs already referred to the National Company Law Tribunal (NCLT) – under the Insolvency and Bankruptcy Code (IBC) route – could result in a reduction in GNPAs, this may be offset by recognition of new NPAs stemming from recent revisions to the resolution framework for stressed assets by the Reserve Bank of India (RBI).

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[1] Most of these stressed assets were either not rated by CRISIL or would have been downgraded to a 'Default' or 'CRISIL D' rating in the past and have not seen any significant change in their credit quality since then

[2] Both credit ratio and debt-weighted credit ratio do not factor in rating actions on non-cooperative issuers

[3] Including the rating actions on non-cooperative clients, there were 1,467 upgrades and 1,975 downgrades in fiscal 2018

[4] Quantum of debt outstanding on the books of the companies upgraded to downgraded (excludes financial sector players)

Effective monitoring of credit quality as well as resolution of stress requires co-operation from the borrowers. From 2017, the Securities and Exchange Board of India (SEBI) has mandated rating agencies to continue surveillance of ratings assigned to non-cooperative issuers on a best-effort basis.

The assessment of such non-cooperative issuers carry a risk of information inadequacy, which is factored into rating actions. Including rating actions on non- cooperative borrowers, the credit ratio for fiscal 2018 stood at 0.74 time, or considerably lower than the 1.67 times for cooperative issuers.

Going forward, barring the stressed assets, CRISIL expects corporate credit quality to continue recovering on the back of firming up of domestic consumption and global demand, stable operating cycles, and steady commodity prices.

Any aversion to lending by banks as a fallout of recent events, continued slowness in exports growth due to disruptions in global trade, prolonged working capital stretch due to Good and Services Tax (GST), leverage levels in corporate balance sheets, and progress in resolution of stressed assets will remain the key monitorables.

CRISIL continues to maintain sharp focus on the quality of its ratings and strives to minimise sudden and sharp rating actions (upgrades and downgrades). Investors also expect ratings in the 'A' and above categories to display a lot of stability. CRISIL's portfolio of 1,187 ratings in these categories saw 145[5] rating actions in fiscal 2018, of which only 14[6] were multi-notch changes.

[5] This is based on the number of instances of rating actions and could include multiple ratings actions of the same company during the year

[6] 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.

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 underlying economic and business trends.

This edition analyses CRISIL's rating actions in the fiscal ended March 31, 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.

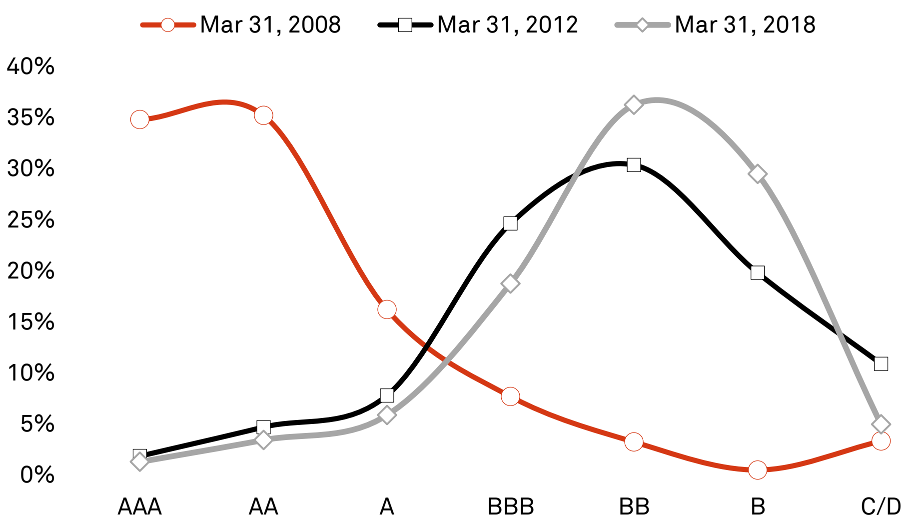
CRISIL's portfolio and median rating unchanged

Ratings outstanding on ~12,500 issuers

Median rating remains in the 'CRISIL BB' category

Over the past five years, CRISIL's portfolio of outstanding ratings has been in the range of 12,000-13,000[7]. Almost three-fourths of these are in the 'CRISIL BB' or lower categories. Consequently, the median rating has stayed put in the 'CRISIL BB' category. For perspective, nearly a decade back, the median rating was in the 'CRISIL AA' category *(see chart)*.

CRISIL's rating distribution



Source: CRISIL

[7] This excludes companies in the 'Issuer Not Cooperating' or INC category. CRISIL's portfolio had 3,890 such issuers as on March 31, 2018. If these are included, CRISIL's outstanding rating list will be of 16,314 issuers. But the median rating will remain in the 'BB' category.

Both credit and debt-weighted credit ratios remain above 1 time

Credit ratio at 1.45 times and debt-weighted credit ratio at 1.53 times for the second half of fiscal 2018

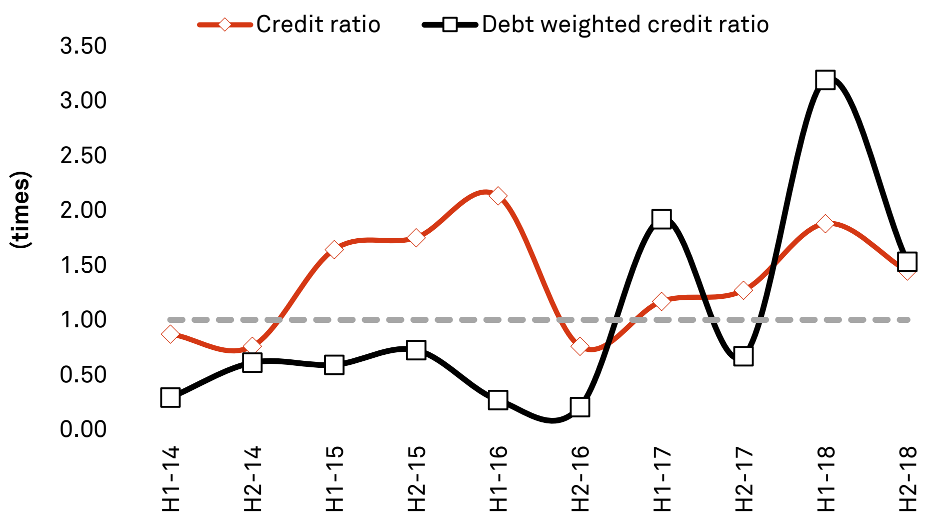
Credit ratio at 1.67 times and debt-weighted credit ratio at 2.31 times for fiscal 2018

CRISIL's credit ratio and debt-weighted credit ratio stood at 1.67 times and 2.31 times, respectively, for fiscal 2018 *(see chart).* That's better than the 1.22 times and 0.88 time, respectively, in fiscal 2017.

The moderation from the first half of fiscal 2018, when the credit ratio was 1.88 times and debt-weighted credit ratio was 3.19 times, was on expected lines.

In the previous Ratings Round-Up published in October 2017 and titled *'Improving financial profiles sustain credit quality recovery'*, CRISIL had expected moderation due to uncertainties on account of change in tax regime over the short-term (GST), subdued growth in India's export, and weak domestic investments limiting the upside of GDP growth.

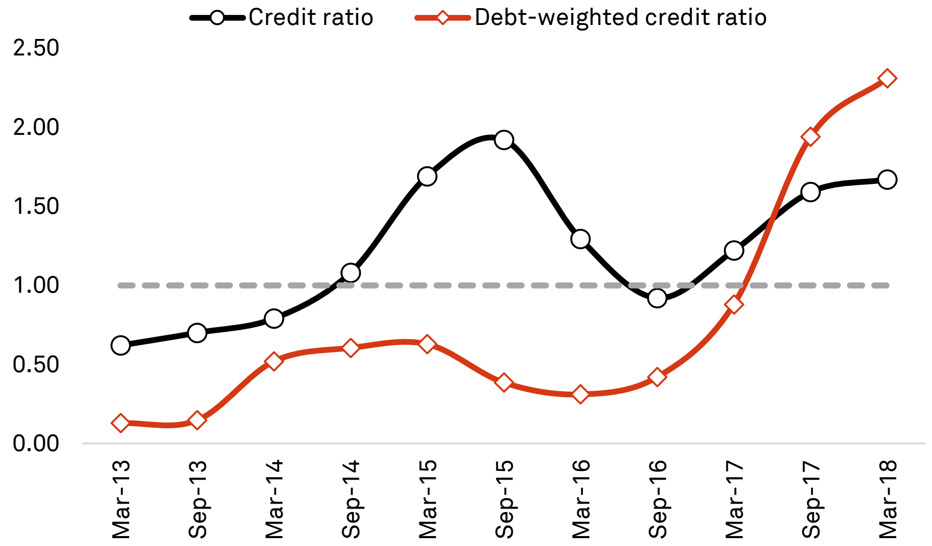
Semi-annual trends in credit ratio and debt-weighted credit ratio



Source: CRISIL

To ascertain the sustainability of the credit quality improvement, we need to assess these ratios on a longer timeframe (12 months basis) to avoid period bias. Both these ratios remain well above 1 time on that basis (*see chart*).

12 months rolling credit ratio and debt-weighted credit ratio



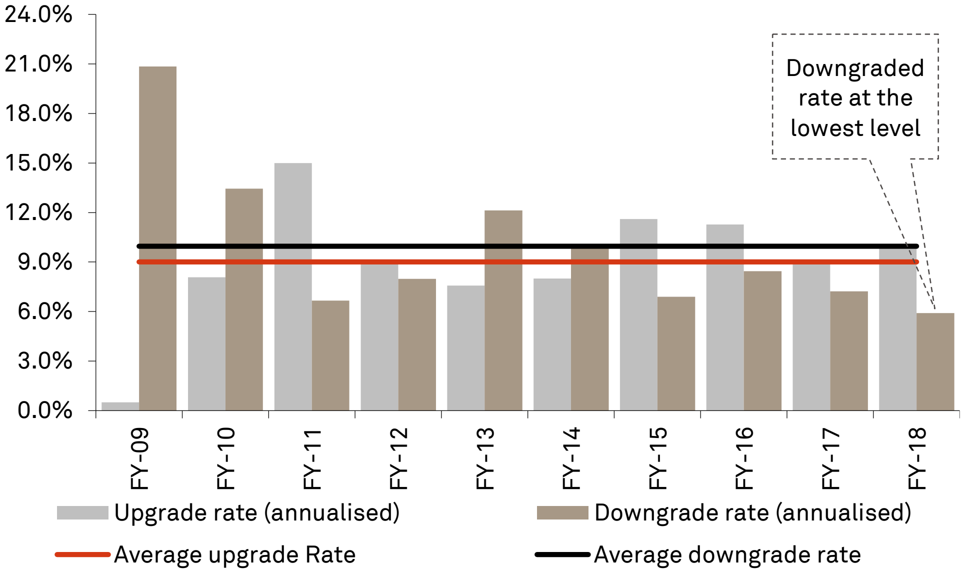
Source: CRISIL

With both domestic and global demand expected to improve, and transitory impact of demonetisation and GST fading out, we expect credit quality improvement to sustain in fiscal 2019. Exports-related sectors should also benefit from strengthening global growth and ironing out of GST issues. Also, budgetary fillip to rural consumption and implementation of the Seventh Pay Commission recommendations at the state level will strengthen consumption demand. Hence, consumption-related sectors are expected to benefit.

Investments, though expected to improve, will only see a gradual recovery. Increase in consumption demand would lead to higher utilisation rates, thus creating some demand for new investments.

The downgrade rate of 5.9% in fiscal 2018 is the lowest recorded in the past five fiscals, indicating a sustained recovery in credit quality, which helps the credit ratio sustain well above 1 time for the fourth consecutive fiscal.

Trends in rating action



Source: CRISIL

Consumption-linked sectors such as pharmaceuticals, agricultural products, auto components and packaged foods continued to drive upgrades, whereas downgrades continued to be dominated in investment-linked sectors such as real estate and independent power producers, especially thermal.

Issuers not cooperating

CRISIL's credit ratings on debt obligations represent its opinion on the likelihood of obligations being repaid in full, and on time. The ratings indicate CRISIL's current opinion on the probability of default on the instruments. It takes into account public and non-public information about the firm to provide a forward-looking assessment of credit quality. Hence, effective monitoring of credit quality requires cooperation from the borrowers.

SEBI's circular, *'Enhanced standards for credit rating agencies (CRAs)'* issued on November 1, 2016, makes it mandatory for CRAs to continue to rate non cooperative issuers on a best effort basis.

To highlight non-cooperation of issuers, SEBI has insisted ratings will use the suffix 'Issuer not cooperating'. This represents a change from earlier industry practice of 'Suspension of Ratings'. Assessment of such non-cooperative issuers carry a risk of information inadequacy, which is factored into rating actions.

In early 2017, CRISIL put together a framework (*Framework for Assessing Information Adequacy Risk published in September 2017*) to assess the risk of information adequacy when reviewing a rating on such non-cooperative issuers. Based on this framework, CRISIL takes appropriate rating action to align the rating to what is commensurate with the assessment under the information adequacy framework.

CRISIL's portfolio had 3,890 such issuers as on March 31, 2018. If these are included, CRISIL's outstanding rating list will be of 16,314 issuers.

Including the rating actions on non-cooperative borrowers, the credit ratio for fiscal 2018 stood at 0.74 time, or considerably lower than 1.67 times for cooperative issuers.

Capital structure, debt protection metrics continue to improve

Gearing and coverage ratio improve

Working capital cycle remains largely stable

Several companies saw their credit profiles continue to improve due to healthier financial risk profiles. Stable revenue growth and profitability, along with a general absence of capex (especially debt-funded), and capital infusion (through record equity issuances/unsecured loans from promoters or market/asset sales), were the catalysts here.

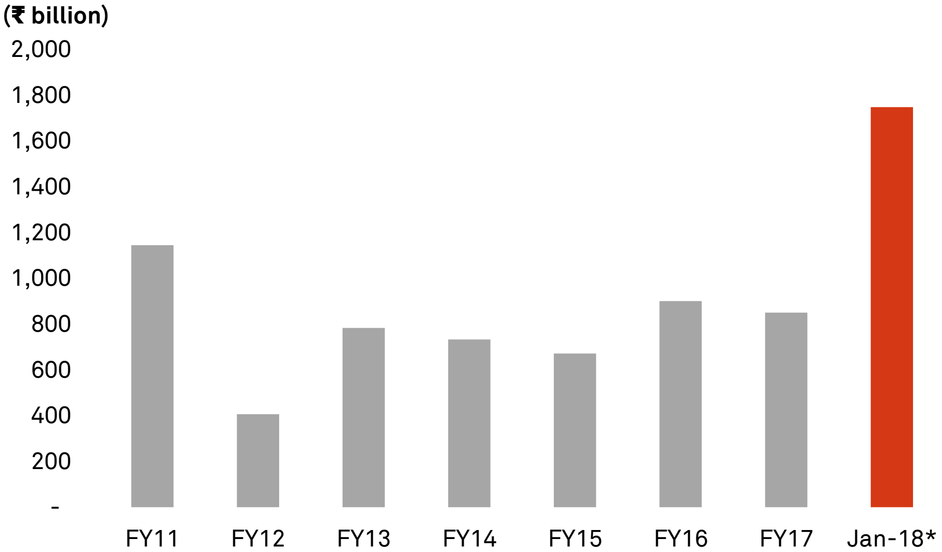
Higher prices in commodity-linked sectors and ability to pass on higher cost because of sustained demand in consumption-linked sectors helped companies maintain or improve profitability in fiscal 2018. That, along with largely stable working capital cycle, lower debt, and declining interest costs improved debt protection metrics and financial risk profiles.

Strengthening economic activity and receding impact of demonetisation and GST will bolster domestic demand and help the cause of corporate profitability.

Since January 2015, the RBI has cut its policy – or repo – rate by 175 basis points. The transmission of this through bank lending rate cuts gathered pace in fiscal 2017 because of excess liquidity following demonetisation. That, in turn, reduced the interest cost for companies.

Equity issuances – public and private placements – have seen good buoyancy with a record Rs 1.75 lakh crore already raised in the ten months ended January 31, 2018 – which is 40% more than the previous high of Rs 1.2 lakh crore in fiscal 2011.

Equity issuances (public and private placements)**



* For April-January 2018
**Public equity issues include IPO, FPO, and Rights issues of common equity shares. Private placement of equity includes amount raised through preferential allotments, QIP, and IPP mechanism.

Source: SEBI Bulletin

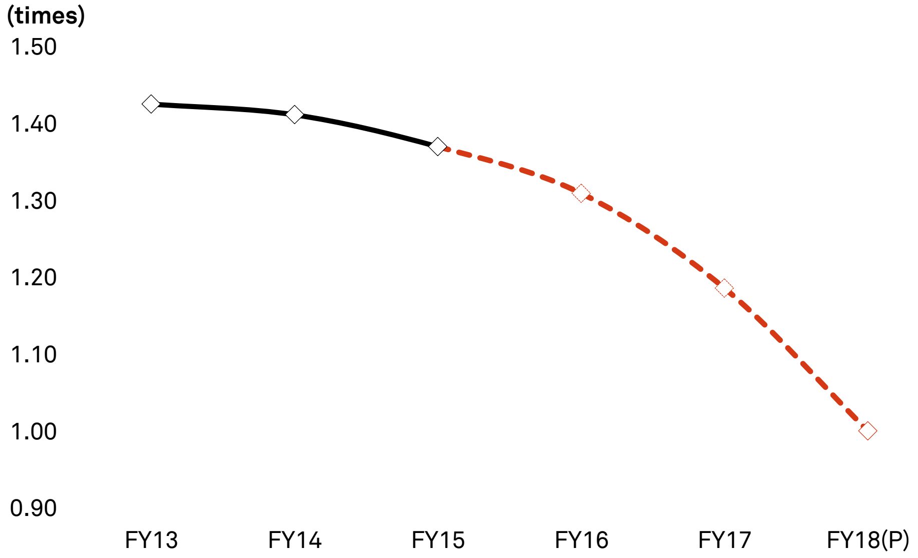
An analysis of a static pool[8] of CRISIL-rated companies shows that capital structure (as reflected in gearing) and debt protection metrics (as reflected in interest cover) have been improving even as working capital cycle has remained stable.

The median gearing of companies improved to 1 time at the end of fiscal 2018, from 1.37 times at the end of fiscal 2015, while median interest cover strengthened to 2.83 times from 2.29 times.

This data set is diverse in terms of rating categories, sectors, and size (in terms of operating income), and hence reflects trends within the CRISIL-rated portfolio well and reiterates the broad-based improvement in metrics.

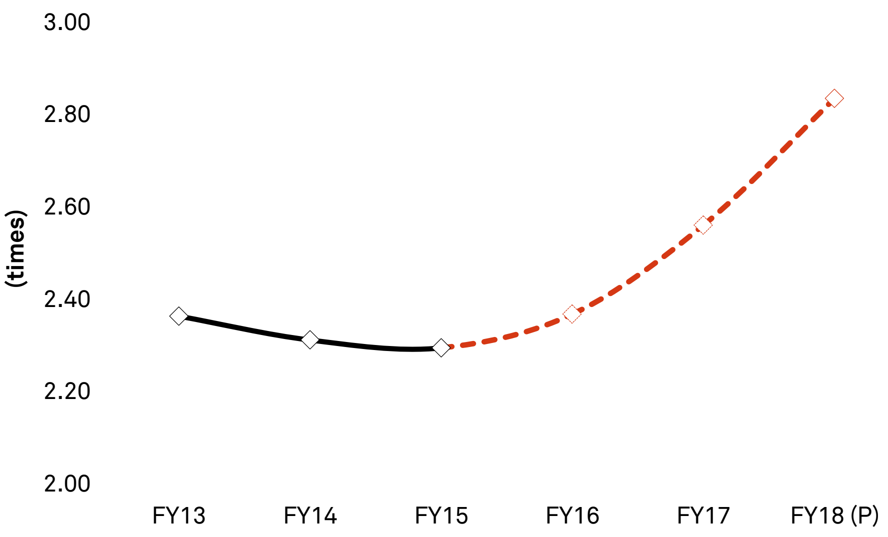
[8] The static pool consists of around 7,000 CRISIL-rated companies (excluding companies in the financial sector and those which are yet to commence operations), where CRISIL has had a rating coverage of at least three years in the past five fiscals or where financials are consistently available for the five fiscals ended March 31, 2018. The pool is reflective of CRISIL's rated portfolio with the median rating of the pool also being in the 'BB' category.

Trends in median gearing



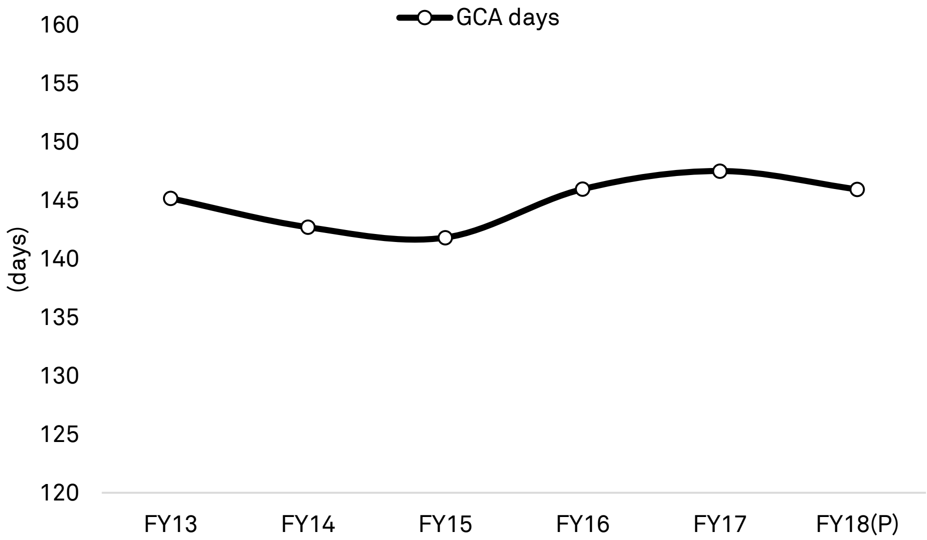
Source: CRISIL

Trends in median interest cover



Source: CRISIL

Trends in median working capital cycle (GCA[9] days)



Source: CRISIL

[9] GCA: Gross current assets

Changes mostly of one notch

90% of rating actions were of low intensity

Only 14 actions were multi-notch

Sharp and sudden rating actions (upgrades and downgrades) from higher rating categories ('A-' and above) are not desirable. Investors also expect such ratings to show a high degree of stability. Rapid rating changes lead to steep cliffs (in terms of returns) for investors, and leave them with little scope to manage their exposure.

In fiscal 2018, there were 145[10] rating actions in the 'A' and above category out of a portfolio of 1,187 ratings in these categories. Of these, only 14[11] were multi-notch changes (high intensity), while the rest were all single notch (low intensity).

[10] This is based on number of instances of rating actions and could include multiple rating actions on the same company.
[11] 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 surprise for the investors.

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

Consumption-linked sectors continue to fare better

Some investment-linked sectors show improvement

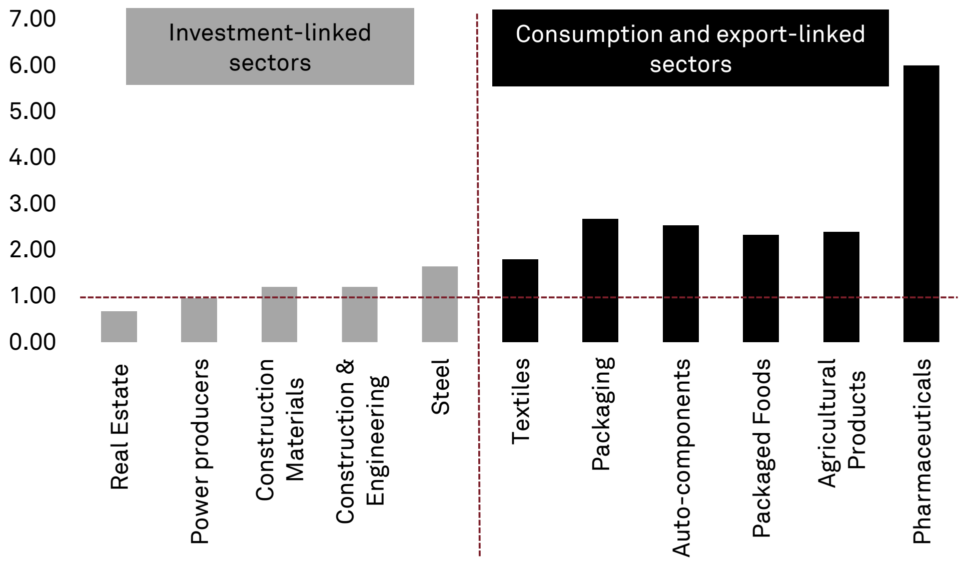
The improvement in the credit ratio in fiscal 2018 was broad-based, spanning consumption, investment, and exports-linked sectors compared with the previous fiscal.

Consumption-linked sectors continued to witness more upgrades than downgrades in the second half of fiscal 2018. They benefitted from improving as well as pent-up demand after demonetisation and GST, benign inflation and implementation of the Seventh Pay Commission recommendation by states.

Higher commodity prices and relatively better demand aided a rebound in commodity-linked sectors such as steel and non-ferrous metals. That, along with continuous improvement in mid-sized EPC players, helped improve the credit ratio for the investment-linked sectors, too. Nevertheless, some investment-linked sectors remained fragile. For example, credit quality remains weak in the real estate, thermal power producers, and capital goods sectors, where demand outlook remains subdued and capex cycle is yet to pick up.

Exports-linked sectors benefited from a recovery in world trade growth. They could have done even better had there been no impact of GST.

Rating actions on top industries



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

Source: CRISIL

Exports recovery supported by synchronised global growth, but risks remain

India's exports grew 10.6% in the first eight months of fiscal 2018

4.4 % IMF forecast on global growth in 2018

In January 2018, the International Monetary Fund (IMF) forecast that world trade volume would grow 4.6% and 4.4% in calendar years 2018 and 2019, respectively, after the 4.7% growth seen in 2017.

The momentum is expected to sustain on account of pick-up in investments, particularly among advanced economies, and increased manufacturing output in Asia. Recent tax reforms and associated fiscal stimulus should raise growth in the US. Sustained domestic demand supported by strong labour market and wage increases, and healthy global demand, will benefit the European Union (EU).

Accordingly, S&P Global Ratings has marked up its forecast for 2018 and 2019 for the US and the EU, considering the boost to economic growth from large fiscal stimulus in the former, and labour market improvements in the latter.

However, increasing inward-looking policies and geopolitical tensions pose risks to these estimates.

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

Countries	2015	2016	2017(e)	2018(f)	2019(f)
Eurozone (excluding the UK)	2.0%	1.8%	2.5%	2.0%	1.7%
UK	2.3%	1.9%	1.8%	1.0%	1.3%
US	2.9%	1.5%	2.3%	2.8%	2.2%
China	6.9%	6.7%	6.9%	6.5%	6.3%

During the first eight months of fiscal 2018, India's exports grew 10.6% versus 3.1% in the comparable period of fiscal 2017.

However, the extent of growth was capped on account of the transient impact of GST implementation. Delays in GST refunds impacted business activity, especially of micro, small and medium enterprises (MSMEs), by way of paucity of working capital. This is reflected in exports slowdown in sectors such as gems and jewellery, readymade garments, and leather, which mostly comprise MSMEs.

Exports growth is expected to recover in fiscal 2019 backed by expected improvement in global growth. However, persistent GST issues and India's reduced competitiveness compared with Asian peers pose key risks.

Outlook

In fiscal 2018, the Indian economy recovered steadily from the twin shocks of demonetisation and transition to GST. We expect this recovery to continue in fiscal 2019, helped by both domestic and global factors.

We expect domestic demand to improve with the transitory impact of the twin shocks abating. That, coupled with central budgetary focus on improving rural spending power, implementation of the Seventh Pay Commission recommendation by states, benign inflation and expectation of another spell of normal monsoon will lend support to consumption growth. Also, the synchronised upturn in the global economy should provide some tailwinds to exports.

However, rising global protectionism, faster-than-expected rate increases by central banks, geopolitical events impacting crude oil prices, and potential inability of corporates, especially small and mid-sized firms, to access alternative channels for credit to counter the recent measure by the RBI to ban banks from issuing letter of comfort/ letter of undertaking will be the key monitorables and may derail growth, if persistent.

Real investment growth is expected to pick up in fiscal 2019 led by the public sector. However, the recovery will be gradual as capacity overhang will continue to discourage broad-based private investments. Increasing demand, both in domestic and export markets, could lead to higher capacity utilisation, which would support investments going forward. Furthermore, speeding up of the NPA resolution via the IBC, and recapitalisation of public sector banks could also support growth.

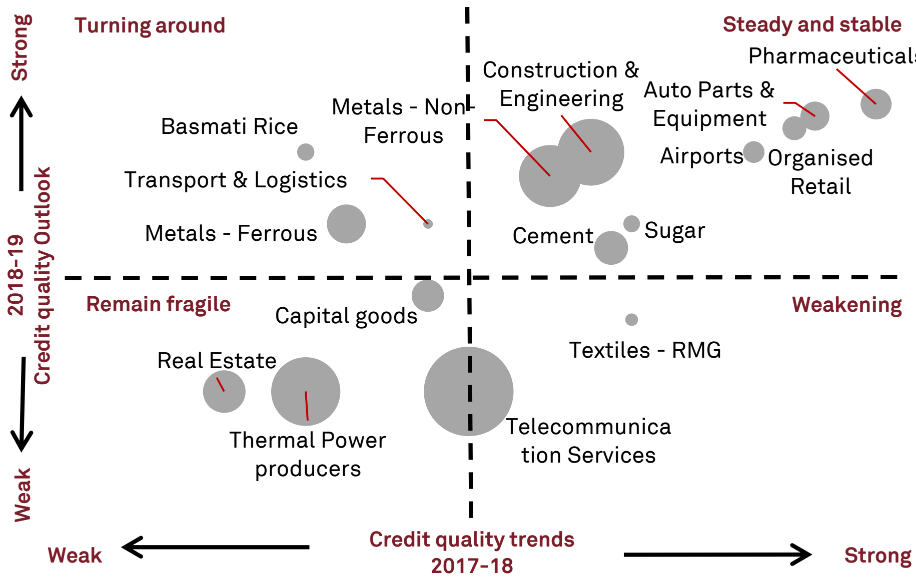
CRISIL expects corporate credit quality improvement to sustain, driven by persistent buoyancy in commodity prices, rising industrial activity, expectation of better rural demand, and improving financial metrics.

Upgrades will continue to outnumber downgrades based on our expectation of relatively better GDP growth in fiscal 2019, recovery in global trade and a gradual pick-up in the investment cycle.

The risks to these expectations are:

- Below-normal monsoon and subsequent slowdown in consumption demand
- Slowdown in India's major trade destinations
- Prolonged glitches in GST weakening recovery in exports growth
- Delay in progress of resolution of stressed assets and recovery of banking sector
- Re-leveraging due to increase in capex and acquisitions.

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



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 sustained consumption demand, improving financial metrics, firm commodity prices, benign inflation and favourable interest rates. Sectors that are turning around, such as steel and basmati rice, are expected to witness improvement due to higher realisation and better demand. In addition, the transport and logistics sector is expected to benefit from improving operating efficiency due to implementation of GST and better economic growth prospects.

Yet, some investment-linked sectors such as real estate, thermal power plants, and capital goods continue to face headwinds given subdued demand. Telecommunication services is facing intense competition. Sectors such as readymade garment exports are facing the heat because of delay in tax refunds after implementation of GST.

Automotive components

Upgrades	Downgrades
Upgrades were driven by business-related reasons: healthy demand for two-wheelers and passenger vehicles in the domestic market, leading to strong demand from original equipment manufacturers (OEMs), and consequently, steady profitability, resulting in higher cash accruals. Prudent capex and working capital management ensured adequate liquidity which led to better financial risk profiles.	Weak operating performance due to reduced demand from the commercial vehicle (CV) segment in the first quarter of fiscal 2018 and stretched liquidity, especially stretch in receivables, and GST-related issues impacted performance. Most downgrades were at the lower end of the rating spectrum.

Automotive components advanced towards higher growth

Demand for automotive components is on an uptick driven by broad-based growth across vehicle segments/markets and higher realisation. CRISIL expects the automotive components industry to grow 12-14% in fiscal 2019, higher than the estimated growth of 11-13% for fiscal 2018.

Higher realisations are on account of passing on of increases in raw material prices and in the cost of components due to changing regulatory norms.

Higher disposable incomes, new model launches, and benign interest rates will continue to drive strong growth in the passenger vehicle and two-wheeler segments. Besides, CV sales, which reported double-digit growth for the 11 months through February 2018, are likely to witness steady growth in the near term. Thus, OEM-led demand is expected to remain healthy in fiscal 2019. Any favourable policy change, such as implementation of voluntary vehicle fleet modernisation programme, will provide an additional impetus to growth.

Growth in the aftermarket segment is expected to be steady at 7-9% in fiscal 2019 as uncertainties related to GST fade.

Recovery of exports will continue in fiscal 2019, largely aided by sales in North America and Europe. Moreover, India's growing prominence as a low-cost manufacturing hub of automotive components will help players penetrate new markets.

Demand over the medium term will be driven by advancement of technologies and more stringent regulatory norms on safety and emission standards.

Profitability of automotive component makers is expected to remain stable despite higher input cost. Raw material prices are expected to have risen 3-5% in fiscal 2018. This, however, was offset by higher utilisation because of increased demand from OEMs and better product mix because of rising exports. Profitability will also be supported by growth in realisation from certain components due to the implementation of stricter emission norms.

Demand-led capex cycle resumed gradually in fiscal 2018. Suppliers to passenger vehicles and two-wheelers, which were operating at high utilisation rates, are leading the capex cycle. The strong growth in CV sales volume in recent months may prompt investments for CV suppliers as well, especially if the vehicle scrapping policy is initiated. Capex is expected to rise in this sector as players upgrade technology to meet new regulatory and safety norms. In addition, government focus on electric vehicles may lead to small but gradual investment in related technology. Financial prudence exhibited by companies in recent years – by way of sweating of existing assets – has led to an improvement in financial risk profile. While there is increasing need for capital spending, higher cash flow backed by strong demand will help companies broadly sustain their financial risk profile. Nevertheless, the quantum and funding mix of expansion will be key monitorables.

Basmati rice

Upgrades

Most of the upgrades were in the non-investment grade rating category. Higher capacity utilisation, high commodity prices, and better demand led to an improvement in business risk profile of companies.

Downgrades

Downgrades were mainly on account of stretch in working capital cycle, primarily because of increase in inventory.

Three-fourths of the downgrades were to the default category because of delays in debt servicing, driven by stretched working capital cycle.

Siginificantly better exports sales realisations alleviate pressure after 3 consecutive years of revenue decline

India exported 4 million tonne (MT) of basmati rice valued at Rs 21,604 crore in fiscal 2017. That was a decrease of 1% volume and 4.9% by value on-year (4.04 MT and Rs 22,718 crore, respectively, in fiscal 2016). Lower sales realisations had hit exporters hard in each of the three consecutive fiscals through 2017. These challenges eased in April-December 2017 as average exports sales realisations improved by 23% to Rs 6,457 per quintal over the corresponding period in the previous year. The exports volumes in the same period remained unaffected at about 2.9 million metric tonnes (MMT).

Paddy prices increased in the current rice procurement season, these are expected to be passed on by exporters to their overseas buyers during 2018-19. Therefore, CRISIL expects credit risk profiles of basmati rice exporters to improve over the medium term owing to better operating profitability levels and stable demand in the overseas market.

Construction & engineering

Upgrades

Majority of the upgrades were supported by healthy orders as a result of customer additions or steady order inflow. Improvement in financial risk profile was driven by better-than-expected capital structure and debt protection metrics due to higher accrual and moderate debt.

Downgrades

Delayed allocation of work contracts and intense competition in the roads and bridges segment led to a decline in sales for some players. Stretched working capital cycle, primarily on account of increasing inventory due to slow execution of large orders, also led to downgrades.

Note: Credit profile of many large, diversified EPC players remains 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 in the banking sector and is more representative of the non-stressed portion of the corporate loan book.

Impetus to the construction sector provided by government policies and reforms

Construction spend in key infrastructure sectors is expected to marginally rise in fiscal 2019 with a 3% increase in capital outlay across infrastructure segments. The roads sector is expected to account for the majority of construction spend, that is, around 40%. Faster execution of national-highway projects and steady funding to the Pradhan Mantri Gram Sadak Yojana will drive investment in rural road construction. Furthermore, four key new policies, Smart Cities Mission, AMRUT, Swachh Bharat, and Ganga clean-up project, will drive investments in urban infrastructure.

The construction industry had been bogged down by slow project execution and poor financial health of infrastructure companies over the past few years. Hence, the government has introduced policy reforms such as immediate payment of 75% arbitral awards to contractors by government agencies, premium rescheduling of projects to improve developers' cash flows, 100% exit in build-operate-transfer projects to release developers' tied-up equity and reduce their debt, the National Highways Authority of India's one-time fund infusion into stalled projects, increase in projects awarded under the EPC mode, and introduction of the hybrid annuity model, wherein most of the project risk is taken up by the awarding authority to boost private participation and boost execution pace, thus contributing to better performance of the companies.

Credit profile of some infrastructure players still remains weak, and hence, they are unable to capitalise on the emerging opportunities in the sector. Financial flexibility remains constrained on account of high gearing, an offshoot of time and cost overruns in previous projects leading to stretched working capital. Asset monetisation by floating of infrastructure investment trusts (InvITs) and equity infusion would help improve the credit profile of the companies over the medium term. This, along with better order inflow and prudent working capital cycle, will pave way the way for improving the debt servicing ability of these players.

Independent power producers

Upgrades

Upgrades were majorly for renewable generation and were driven by track record of healthy plant load factor (PLF) leading to adequate cash accrual. The upgrades were also driven by commencement of operations, thus mitigating project risk; timely payments by counterparties; and reduction in borrowing cost.

Downgrades

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

Lack of long-term PPAs remains the pain point; fuel supply woes to gradually ease; safeguard duty a monitorable for the solar sector

The outlook for India’s thermal power sector remains largely negative due to continued absence of long-term power purchase agreements (PPAs) for private sector capacity. Of the 75,000 megawatt (MW) of total installed private sector, coal-based capacity, nearly 20,000 MW is estimated to be without any long-term PPA.

While demand for power saw healthy growth of 6% in fiscal 2018, it has not translated into new PPAs by state distribution companies (discoms) for thermal generators.

This is because the incremental power demand has been met through a mix of higher capacity addition in renewables (12,000 MW) and central thermal stations (3,000 MW), and by increasing generation (and thus utilisation) of existing state-level thermal capacity with PPAs. The PLF of state generating stations during the first 9 months of fiscal 2018 increased to 55% from 53% for the corresponding period of the previous fiscal. Furthermore, discoms continue to prefer to meet a portion of the demand from short-term markets where tariffs remain benign.

Government’s continued focus on meeting its 24 X 7 Power for All objective and low per-capita power consumption is likely drive power demand. This, coupled with a general slowdown in thermal capacity addition over the next 4-5 years (around 40,000 MW of thermal capacity is expected to be added till fiscal 2022, compared with 98,000 MW added between fiscals 2013 and 2017), should benefit existing capacities.

Thermal capacities with PPAs containing cost reflective tariffs will continue to see improvement in capacity utilisation as fuel availability improves. Recent policies allowing commercial coal mining and introduction of the Scheme for Harnessing and Allocating Koyla Transparently in India (SHAKTI) scheme will aid coal supply to power plants. Capacities without PPA are likely to remain exposed to vagaries of the short-term market. Of these, the capacities under financial stress may require higher portion of haircuts by investors, to make them economically viable, under RBI's revised framework for resolution of stressed assets.

Credit quality of renewable assets has been largely stable for operational projects with stable PLF and payment cycles. The ongoing uncertainty regarding safeguard duty on imported solar modules has led to slowdown in tendering activity for solar capacities as the quantum may have an impact on project cost. If the duty is applied on retrospective basis, it may impact viability of projects under implementation. Thus, the final safeguard duty will be a monitorable for solar assets.

Capacity addition in solar power continued in fiscal 2018 with more than 6000 MW solar power getting commissioned in the first 10 months of the fiscal. However, due to change in regime in wind power to auction mechanism, only 600 MW wind power was commissioned in the period. With auctions of more than 5000 MW completed in 2017, capacity addition in wind power is expected to pick up.

Distribution remains the weakest link in India's power sector value chain. With implementation of the Ujwal Discom Assurance Yojana (UDAY) scheme, 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 expansion in new geographies and higher capacity utilisation, stemming from steady demand in domestic and international markets, led to most of the upgrades.

Downgrades

Downgrades were mainly due to subdued operating performance because of lower sales and realisation for key products, which led to lower profitability and cash accrual.

One-third of these downgrades in the sector were to default category.

Launches in new product segments pave the way for stable health of the pharmaceutical sector

The pharmaceutical sector is going through a transition. After witnessing robust growth historically in conventional generics segment, the growth has moderated, but remains adequate to maintain strong credit profile. The industry has been facing regulatory woes, rising competition, and pricing pressure both in overseas and domestic markets. We expect the trend to continue. Nevertheless, the industry will grow in mid-to-high-single digit over the medium term.

The domestic market, which accounts for 55% of industry revenue, remains the mainstay as rising healthcare spending and awareness, and strong volume growth, especially in the chronic segment, will continue to drive 10-11% growth.

Formulation exports are expected to recover to about mid-single-digit growth, led by faster product approvals from the US Food and Drug Administration ensuring new product launches, improving demand, and renewed focus on the European market. We expect the pricing pressure in the US to continue, but not get worse as some players rationalise their portfolios in the overcrowded segments. Diversification into specialty and bio-similar segments through joint ventures and acquisitions and expansion in newer semi-regulated markets will also drive exports growth over the medium term.

Profitability of formulators is estimated to have declined in fiscal 2018 due to pricing pressure and weak product launches. We expect profitability to stabilise in fiscal 2019 because of better product launches and steady prices.

Some of the larger companies have increased their research and development spend to enter the bio-similar segments or for research on novel molecules. This, along with their strategy to grow inorganically, will be a key monitorable.

The bulk drugs segment growth is expected to sustain on the back of increasing focus on niche molecules and specialty products, where competition is less than in the traditional segment. The domestic bulk drug segment will continue to benefit from strong sales. 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.

The pollution control initiatives by Chinese authorities leading to supply disruptions and implications for both bulk drug and formulations players in India will also be monitorables.

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 ratio (DSCR).

Downgrades

Already subdued demand was exacerbated by demonetisation, Real Estate (Regulation and Development Act) and GST.

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

Affordable housing and commercial real estate to offer respite

The residential real estate sector has been facing headwinds for the past few years, primarily due to weak demand. This is reflected in declining sales velocity and subdued cash collection (both in fiscal 2017 and in the first half of fiscal 2018), fewer new project launches, and large unsold inventory. While demonetisation impacted sales in fiscal 2017, especially in secondary market transactions and in micro markets with high investor concentration, implementation of RERA and GST kept sales subdued in fiscal 2018. Demand remains muted as buyers adopt a ‘wait and watch’ mode. Developers are likely to face funding challenges in the short-to-medium term, with limited flexibility to access funds from other projects and requirement of timely completion of projects under RERA. In addition to high reliance on non-bank funding, developers with a diversified portfolio are further leveraging commercial assets and resorting to sale of assets to tide over fund crunch. On the positive note, implementation of RERA will improve transparency and support the industry’s growth and customer confidence.

Demand is expected to remain muted in the near term and recover gradually over the medium term, with sustained improvement in macroeconomic conditions. In the affordable housing segment, demand is expected to stay strong given the relatively low ticket size and impetus from the government’s ‘Housing for All’ programme. The government has budgeted 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, vacancies have reduced steadily on the back of increasing absorption in the past few years and limited additional supply. Rentals have remained steady and occupancy is expected to stay healthy driven by improving business conditions.

The retail sector continues to witness strong traction given the healthy performance of large and established retail malls across the country. Large foreign institutional investors have been scouting for good properties across metros, and large and small cities, given the strong growth potential over the medium term.

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 due to lower-than-expected revenue and profitability, leading to pressure on debt protection metrics. Working capital cycle remained stretched, thus impacting liquidity.

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

Note: The credit profiles of many companies continue to be constrained by leveraged balance sheet stemming from aggressive capacity expansion undertaken in the past. Many have been referred to the insolvency court for debt resolution. These companies are rated 'D' and have seen no change in their ratings. The analysis below excludes stressed assets with banks and is more representative of the non-stressed portion of the corporate loan book.

Government initiatives to boost domestic steel demand in fiscal 2019

Domestic steel demand picked up in April-December 2017, driven by growth in flat steel demand. In fiscal 2019, we expect demand to accelerate, largely because of rise in long steel demand from affordable housing and infrastructure projects. Capacity utilisation should improve over the medium term with cautious capacity addition amid healthy demand prospects.

In fiscal 2018, global steel demand is estimated to have slowed driven by decline in demand in China on account of withdrawal of incentives by the Chinese government which had largely propelled demand in fiscal 2017. Demand from the rest of the world is estimated to have remained flat.

Domestic prices of flat and long steel products, which rose in fiscal 2017, continued momentum in fiscal 2018, following global price trend and on account of high iron ore and coking coal prices. We expect long steel prices to continue to rise in fiscal 2019 driven by domestic demand pick-up. However, flat steel prices may come under pressure due to expected decline in global prices.

Profitability of players was impacted slightly in fiscal 2018 by rise in input costs, but is expected to be healthy in fiscal 2019 driven by expected decline in raw material cost. However, pricing pressures will keep profitability range bound.

The interest servicing ability of players improved in fiscal 2018, but remains weak as the industry continues to be plagued by large debt.

Textiles

Upgrades

Better capacity utilisation, backed by healthy demand and addition of clients led to more-than-expected cash accrual.

Upgrades were mainly among cotton spinning and ginning players.

Downgrades

Most of the downgrades were on account of stretch in working capital requirement primarily because of higher inventory, thereby impacting liquidity.

Almost 50% of the downgrades were in the readymade garments segment, of which, half were to the default category.

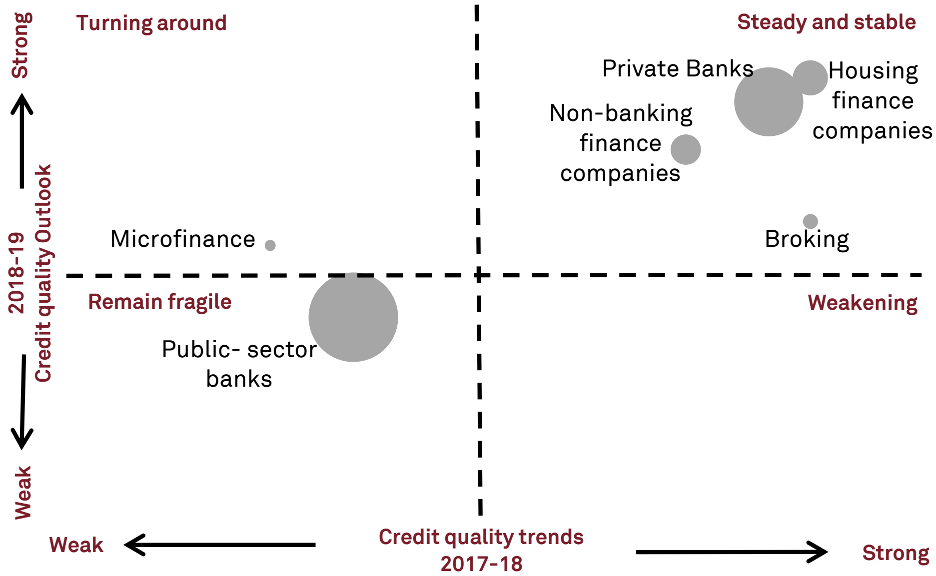
Textiles remain a mixed bag; interplay of domestic and international markets to drive demand

Rising income, increased organised retail penetration, and preference for readymade garments will augur well for domestic demand, which is expected to grow 10-12% over the long term. Despite increased demand from the US and the EU, pick-up in exports demand was muted in fiscal 2018 on account of operational uncertainties/difficulties caused by the GST rollout, and reduction in exports incentives by 2.5-3% compared with the period before GST roll-out. Effective October 1, the government reduced duty drawback rates sharply from 7.5% to 2%. Even though the government has increased the rate under Merchandise Exports from India Scheme (MEIS) from 2% to 4%, overall incentives for the sector fall short of rates prior to GST. Furthermore, exports demand over the long term is expected to grow at a reduced pace of 6-7% owing to low competitiveness of India compared with Bangladesh and Vietnam in the international market.

Profitability of organised players is expected to improve slightly in fiscal 2019 on account of lower input cost and higher competitiveness after GST. During fiscal 2018, liquidity was a bit strained by delayed GST refunds. This led to stretched working capital cycle, which is expected to improve gradually in fiscal 2019.

Cotton yarn demand is estimated to have picked up in fiscal 2018 as compared with fiscal 2017 supported by revival in direct yarn export, moderate growth in domestic demand, and slight improvement in derived demand on account of improvement of consumption in the EU and the US. Yarn demand growth is expected at 4% for fiscal 2019 and at 3-3.5% over the long term, with domestic consumption supporting growth backed by better economic activity. Though derived demand is expected to improve supported by increased demand from the US and the EU markets, direct yarn exports is expected to be muted in line with continuation of China's cotton stock liquidation policy. Domestic cotton prices are expected to decline in fiscal 2019 with increase in cotton production, leading to improvement in profitability of spinners and supporting their credit quality.

Sectoral credit quality outlook: Banks and financial institutions



#Size of bubble indicates networth of rated portfolio

Source: CRISIL

CRISIL expects microfinance companies to turn around in fiscal 2019. Asset quality headwinds faced by the microfinance sector as an off shoot of demonetisation seem to have passed away and a turnaround is visible with a distinct improvement and stability witnessed in asset quality since June 2017.

Non-banking finance companies (NBFCs), housing finance companies (HFCs) and broking companies are expected to deliver a stable performance. NBFCs have grown steadily over the past few years. They should continue to strengthen their market position supported by product and process innovation, and improved funding ecosystem. Growth in the HFC industry remains healthy and with affordable housing emerging as a new growth driver, the growth momentum is expected to be maintained. Broking companies benefitted from the buoyancy in equity markets by recording healthy revenues and profitability.

GNPAs in public sector banks (PSBs) are expected to peak in fiscal 2019, before starting to decline as NPA recognition by banks gathers pace. Also, in absolute terms, slippages will remain high, mainly because of the slippage to NPAs in stressed accounts that were referred to various restructuring tools of the RBI in the past. Though, the government recapitalisation programme, expected resolution of large ticket NPAs and continued improvement in the credit outlook of the corporate sector lend respite for the future, outlook for the near term however, remains fragile.

Banks

A defining year, especially for public sector banks

Government recapitalisation a key rating support factor for PSBs; private sector banks to increase market share

Following the government announcement of capital infusion under its Rs 2.11 lakh crore recapitalisation programme, CRISIL revised its outlook on the long-term debt instruments (excluding Basel III Tier I) of 18 PSBs to 'Stable' from 'Negative', while reaffirming their ratings. CRISIL believes recapitalisation of PSBs will improve the financial risk profile of these banks and help them meet Basel III regulatory capital norms, and provide a cushion against expected rise in provisioning for NPAs.

On October 24, 2017, the government announced its Rs 2.11 lakh crore recapitalisation plan for PSBs, and later on January 24, 2018, gave details of bank-wise infusion of around Rs 88,000 crore for fiscal 2018. Simultaneously, the government has outlined its banking reforms agenda. The strengthening of prudent lending practices through responsible banking – that is, banking based on core strengths, sharper pre- and post-disbursal monitoring for large exposures, and improving NPA resolution mechanisms (including separate asset management verticals) – is expected to structurally improve credit culture at PSBs over time.

Credit growth on revival mode

Gross advances are expected to have increased around 10% in fiscal 2018 and are likely to rise 11-12% in fiscal 2019, against 5% in fiscal 2017, driven by sustained growth in retail and agricultural lending. Expected improvement in consumer demand, projected increase in public sector investments, and rising industrial activity will support higher growth over the medium term. Also, some reversion of loan demand from bond markets to banks as yield differential narrows, and waning effects of structural changes such as GST; Real Estate (Regulation and Development) Act (RERA), 2016; and demonetisation, will result in improved credit offtake. Private banks should continue to lead credit growth and gain market share in fiscal 2019.

GNPAs to cross Rs 10 lakh crore in fiscal 2019; slippages to progressively reduce

GNPAs are expected to continue to increase in fiscal 2019, before starting to decline as NPA recognition by banks gathers pace. GNPAs as a proportion of total advances are expected at around 10.5% by March 31, 2018 (9.4% in as on March 31, 2017) and 10.3% (Rs 10 lakh crore) as on March 31, 2019, after touching a high of 11% during fiscal 2019.

Stressed assets are estimated at around 14% of total advances, and are not expected to increase significantly. More than 70% of the stressed loans have already been recognised as NPAs by banks. The pace of fresh additions to NPAs declined marginally in the first nine months of fiscal 2018, compared with the corresponding period of the previous fiscal. The slippages should moderate in fiscal 2019, supported by continued improvement in the credit outlook of the corporate sector, driven by rising commodity prices, stabilisation of operating cycles, and improved debt protection metrics. The slippages ratio could reduce to 4.3% of opening advances in fiscal 2019 from around 5% in the first nine months of fiscal 2018.

However, in absolute terms, slippages will remain high, mainly because of the slippage to NPAs in stressed accounts that were referred to various restructuring tools of RBI in the past. Any material additional impact due to recent revisions in the resolution framework by RBI will remain a monitorable.

With nearly half of the large-ticket corporate NPAs now referred to the NCLT under the IBC route, the ability of banks to resolve the stressed assets, mainly NPAs referred to NCLT, will enable them to reduce their bad loans over the medium term. Sectors such as steel, which constitute a significant portion of the banking sector NPAs, are seeing an uptick because of firming up of commodity prices. This will help in the resolution process. Backed by the expected resolution in accounts under the IBC, recoveries and upgrades as a percentage of opening GNPAs will pick up in fiscal 2019 after having declined in the past few fiscals.

Operating profits to stabilise as net interest income rises

Operating profits are likely to stabilise supported by an increase in net interest income, which would be largely driven by higher credit growth and lower interest reversal because of lesser slippages. In the past couple of years, the net interest margin of banks dipped by about 15 basis points (bps) to 2.51%, mainly due to sluggish credit offtake, high level of interest reversals on NPAs, and implementation of marginal cost-based lending rates.

Provisioning costs are expected to remain high, mainly due to the stiff haircuts banks will need to take on large corporate NPAs (referred to NCLT under IBC) and ageing of NPAs. Banks would need to set aside around Rs 2.6 lakh crore in fiscal 2018 and around Rs 2.4 lakh crore in fiscal 2019, mainly towards NPA provisioning. Resolution through the IBC route will necessitate an increase in provisioning cover ratio (excluding write-offs) to 55-60% by the end of fiscal 2019. However, the roll-out of the revised framework for resolution of large stressed assets could lead to more progress in resolution compared with previous fiscals, which could also result in acceleration in NPA provisioning. Net profit is likely to remain muted, with return on assets (RoA) at a low of 0.2% and absolute profits at around Rs 32,000 crore in fiscal 2019.

Private banks, however, will benefit from strong capitalisation, revenue diversity, lower exposure to vulnerable sectors, and higher proportion of fee income to total income as compared with PSBs.

Government support means more than adequate capitalisation

The banking system's Tier 1 and overall capital adequacy ratios were 10.9% and 13.4%, respectively, as on December 31, 2017. Amid declining profitability, the current capitalisation of PSBs is supported by capital infusion by the central government and capital investment by quasi government institutions such as Life Insurance Corporation of India. However, the cushion over regulatory minimum capital has sharply depleted for PSBs, given large losses/low profits between fiscals 2016 and 2018. The government's recapitalisation plan (Rs 2.11 lakh crore spread over fiscals 2018 and 2019) will help PSBs meet Basel III regulatory capital norms and provide a cushion against expected rise in provisioning for NPAs.

Banks have raised around Rs 0.6 lakh crore through Tier 1 bonds so far under Basel III. The government's decision on early recall of high-cost AT1 (Additional Tier 1) bonds in the case of prompt corrective action (PCA) by banks will not have any material impact on the capital ratio of these banks. Ability of PSBs to raise capital from government and through the capital markets, including by sale of stake in subsidiaries and of other investments, will remain a key monitorable.

Private sector banks are, however, comfortably placed to meet the regulatory capital requirement up to fiscal 2019, supported by healthy accretion to networth and demonstrated ability to raise capital.

Private sector banks to continue to perform better and gain market share

Private sector banks are expected to continue outperforming PSBs over the medium term and will gain market share both in advances and current and savings deposits. They have lower exposure to vulnerable corporate sectors (infrastructure, construction, real estate, thermal power, and textiles) and higher exposure to the granular and safer retail sector. Furthermore, their profitability is supported by higher share of fee income, better liability profile (higher share of low-cost deposits), and lower credit cost. As a result, there is significant divergence in credit growth, asset quality, and profitability parameters between public and private banks. Advances of private sector banks are expected to grow 21% in fiscal 2019 over the previous fiscal, against 6% for PSBs, and will constitute 33% of total advances of the banking sector (20% five fiscals earlier).

Regulatory changes to result in structural improvements over time

The RBI has taken many critical measures in the past couple of years to structurally strengthen the credit risk profiles of banks in India over the long run, including recommending referring large NPA accounts to IBC for resolution and the announcement of the revised stressed assets framework. These would help banks tide over asset quality challenges, and increase transparency and accountability in the system. Mandatory public disclosure of deviation between reported NPAs and provisions compared with RBI's assessment, increase in standard asset provisioning on exposures to vulnerable sectors, and revision in the PCA framework for banks are aimed at enhancing transparency and ensuring adequate recognition of stress in the loan books.

Furthermore, the RBI's revised framework for the resolution of large stressed assets will result in structural streamlining, standardising, and harmonising of the resolution process (by doing away with the plethora of previous frameworks), leading to greater transparency, credibility, and efficiency. By mandating weekly information on large delinquent accounts, directing that a resolution plan be worked on immediately on default, and setting stringent timelines (180 days from default) for referring an account to the IBC process, the RBI is establishing an ecosystem where stressed assets would get recognised on time and their resolutions would be quicker than before.

Differentiated licensing of banks is an effort to step-up financial inclusion in India and will enhance the competitive landscape in the sector over the long term. However, the effectiveness of differentiated models of specialised banking and their impact on the existing banking scenario will depend on their ability to scale up and build up a strong liability franchise and on how regulations and business models evolve.

NBFCs

Market share to keep growing, wholesale credit to drive growth

NBFCs have grown steadily over the past few years and increased their share of the Indian financial services market pie. They should continue to strengthen their market position supported by product and process innovation, and improved funding ecosystem.

The market share of NBFCs and HFCs increased to 16% of the total system credit pie from 13% over the past 5 fiscals. We expect this trend to continue, and their share to reach nearly 19% by fiscal 2020, amid intensifying competition from private banks and with PSBs expected to claw back into the segment after recapitalisation.

In terms of segments, the vehicle finance portfolio of NBFCs is expected to grow 15% till fiscal 2020, driven by improving macroeconomic environment, and higher government focus on infrastructure and rural areas. The market opportunity for NBFCs will stem from continued government investment in the roads sector, expected finalisation of the scrappage 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 has happened sooner than expected. Consequently, growth in LAP is expected to be slower than before.

However, wholesale finance, especially structured credit and real estate lending, will drive growth over the medium term. The opportunity in realty and the structured credit space has increased materially after the implementation of RERA and rising demand for mid-corporate promoter financing.

In terms of asset quality, while reported gross NPAs have moved up on account of transition to more stringent asset classification norms, underlying asset quality performance in terms of 90+ days' past due (dpd) has been improving since fiscal 2015 and the trend continued in fiscal 2018. With the regulatory transition period ending, reported asset quality metrics are now expected to stabilise. This is also expected to support profitability, as credit costs normalise. Current credit costs are 60-80 basis points higher than the 10-year average.

Comfortable capital position and increased investor interest in NBFCs will continue to support growth. NBFCs have raised over Rs 30,000 crore of equity capital over the past five years. Furthermore, diversifying resource mix, with increasing share of capital market borrowings (in the form of non-convertible debentures and commercial papers) and securitisation, allows them to manage cost of funds better, and thereby enhance earnings.

HFCs

The momentum continues

Growth in the HFC industry remains healthy at 20%, with an estimated loan book of Rs 9.7 lakh crore as on March 31, 2018. Affordable housing has emerged as a new growth driver for HFCs, which have also been able to ramp up their non-housing portfolios, including LAP and wholesale finance (developer funding and lease rental discounting).

Given the growing demand for housing, long-term growth potential remains high with the overall portfolio expected to touch Rs 14 lakh crore by fiscal 2020. Growth in individual home loans will be driven primarily by Tier 2 and 3 cities, with affordability in the metros likely to be lower.

Competition from banks will, nevertheless, remain intense, especially given the low growth rate in the corporate segment's demand for loans, and the lower risk weights and strong asset quality in home loans. Also, with seasoning in the portfolios of rapidly-growing HFCs, many of which are focused on diverse customers, there could be a gradual increase in delinquencies in the home loan segment. The affordable housing finance portfolios are expected to bear the brunt of the delinquency increase given the relatively weaker credit profile of borrowers.

Asset quality in the non-individual segment will see some weakening with delinquencies inching up in both developer financing and LAP portfolios. Large HFCs have managed their LAP portfolio better, backed by strong underwriting practices. However, despite strong collateral cover, systemic delinquencies in the segment should rise as portfolios season and growth moderates.

Profitability is expected to remain stable over the medium term, with RoA expected at 1.8-1.9%. RoA may remain range-bound on account of the competitive dynamics in the home loan market.

Microfinance

Asset quality improves as demonetisation blues fade

Microfinance portfolio of small finance banks (SFBs) and non-bank microfinance institutions (together referred to as MFIs) have shown a distinct improvement and stability in asset quality since June 2017, shrugging off the impact of demonetisation, which had cranked up delinquencies, affected borrower behaviour, and worsened asset quality. The following data points underscore the improvement:

- Portfolio delinquencies for a representative set of MFIs[12], measured in terms of 30+ and 60+ dpd, improved to 5.6% and 5.3%, respectively, as of December 2017, from 7.6% and 6.8%, respectively, as of June 2017
- Cumulative collection efficiency rose to over 99% for disbursements since April 2017

A big takeaway is the improvement in asset quality performance in Uttar Pradesh, Maharashtra, and Karnataka, which were severely impacted in the aftermath of demonetisation. For instance, 30 dpd in Uttar Pradesh improved to 14% as of December 2017 from 23% as of June 2017.

Moreover, weakness in asset quality was not pervasive. Tamil Nadu, Kerala, Odisha, West Bengal, and Bihar remained largely resilient despite demonetisation and its aftermath. These states continue to exhibit strong collection performance with 30 dpd staying below 2%.

Asset quality performance, though, remains weak in Vidarbha, 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 will be in the 5-7% range. This will adversely affect the near-term profitability of MFIs.

Profitability, though, will improve gradually with improvement in asset quality. Credit costs are likely to stabilise at 1.5-2.5% on a steady state basis. MFIs with larger rural presence, weekly collections, and lower equated instalments are expected to have 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 remains large at Rs 3.0 lakh crore. MFIs and banks have a microfinance portfolio of Rs 1.25 lakh crore. NABARD-run self-help group linkage programmes have a portfolio of Rs

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

0.25 lakh crore (excluding Andhra Pradesh and Telangana). Hence, unmet demand potential is large at 50%.

Stakeholders' confidence remains strong despite the asset quality headwind faced by the sector. Since demonetisation, CRISIL estimates MFIs have raised around Rs 4,000 crore of equity and Rs 7,000 crore of debt. 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, will diversify into inclusion adjacencies such as 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 overcome two key challenges:

- Build a retail liability oriented funding profile
- Overcome near-term fall in profitability

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

Benefits from buoyancy in equity markets to continue; ability to control cost critical to profitability

Indian brokerages continue to benefit from the buoyancy in equity markets. The revenues of CRISIL-rated players are estimated to increase by over 20% in fiscal 2018 over the corresponding period in the previous fiscal, on the backdrop of significant increase in average daily turnover in equity markets. Derivative segment continues to outpace the cash segment. Average daily turnover in the derivative segment for the first nine months went up by 73% as against 36% increase observed in the cash segment on a year-on-year basis. Pressure on yields remains due to intense competition. However, large players have been able to control their costs. As a result, cost to income ratio improved to ~65% from ~70%, resulting in an upsurge in profitability by nearly 25%.

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

Smaller capital market entities have limited diversification and hence, are more vulnerable to market volatility. Profitability of these companies is estimated to have improved as well in fiscal 2018 due to the improved market sentiments led by an uptick in volumes in the cash segment, which has been their key focus area. However, while such entities benefit from strong customer relationships, they will need to continuously evolve and control their cost structure to be able to manage profitability.

About CRISIL Limited

CRISIL is a leading agile and innovative, global analytics company driven by its mission of making markets function better. We are India's foremost provider of ratings, data, research, analytics and solutions. A strong track record of growth, culture of innovation and global footprint sets us apart. We have delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

We are majority owned by S&P Global Inc., a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

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