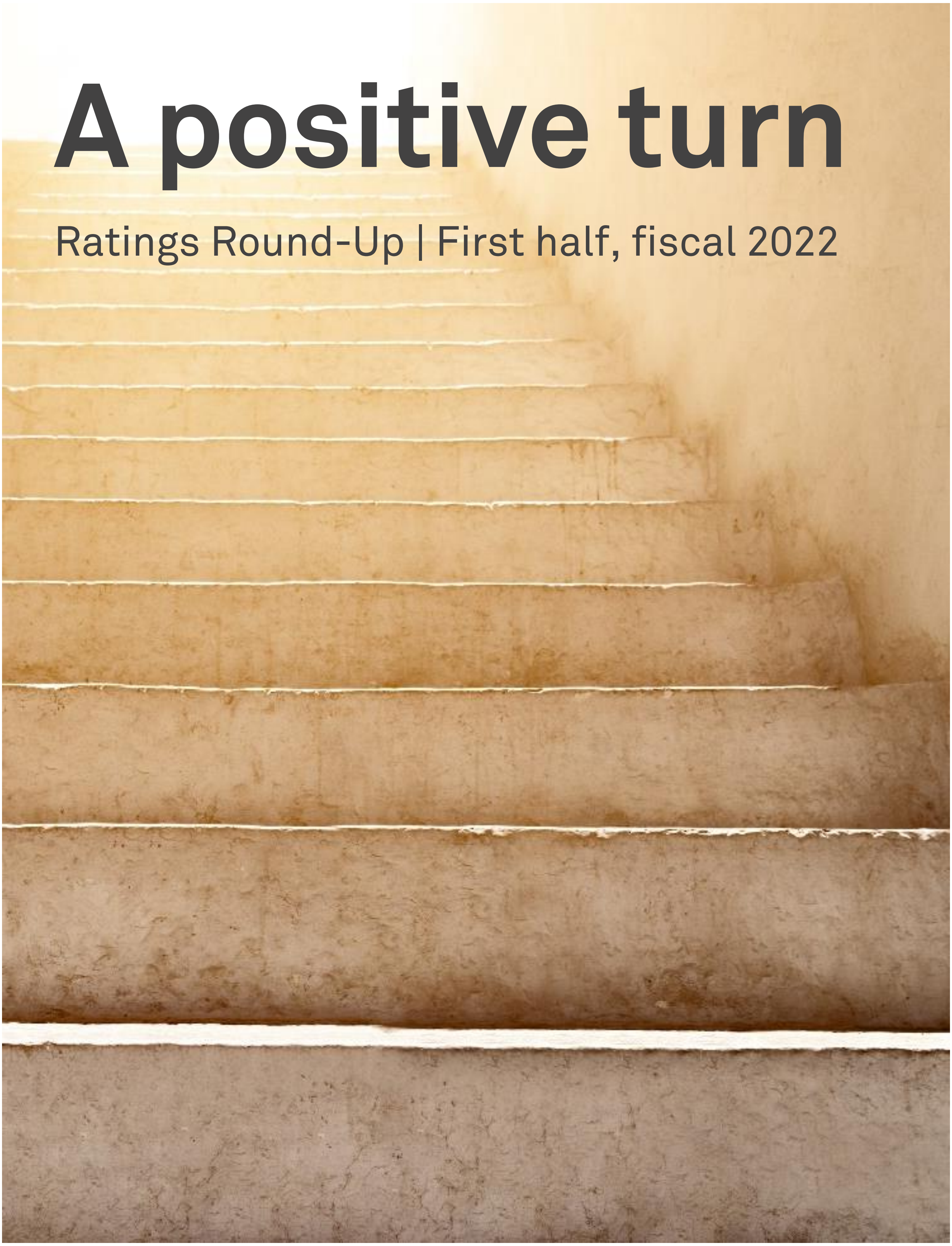
Ratings

CRISIL
An S&P Global Company

A positive turn

Ratings Round-Up | First half, fiscal 2022



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Executive summary

CRISIL Ratings saw its credit ratio[1] increase further in the first half of fiscal 2022, with 488 upgrades and 165 downgrades, reflecting a sharp and sustained recovery in demand despite the intense second wave of Covid-19 infections in the first quarter.

This was the second consecutive rise in the credit ratio, at 2.96 times. It had risen to 1.33 times in the second half of last fiscal from 0.54 times in the previous half.

The outlook for India Inc's credit quality remains 'positive'[2].

A sustained recovery in domestic demand, government impetus to infrastructure spending, and export growth, spurred by a buoyant global economy as well as the 'China plus one' sourcing strategy of global players, have led to a strong rebound in business risk profiles of India Inc, thereby driving the increase in upgrades.

Among manufacturing sectors, steel makers benefitted from a combination of strong global demand and production cutbacks in China owing to environmental concerns, leading to high realizations. Pharmaceuticals and specialty chemicals also sustained their strong performance trajectory, backed by global demand. Agro commodities, such as sugar and edible oil, also benefitted from steady domestic demand growth. In the automobile sector, especially two wheelers, the recovery is delayed to beyond fiscal 2022 extent due to sluggish rural demand, though balance sheets remained strong indicating unscathed credit profiles.

Infrastructure-linked sectors, such as roads, renewable energy, and construction and engineering, continue to benefit from government spending and correspondingly strong order books, as well as the improving pace of execution.

The services sector, too, is finally turning the corner after a debilitating fiscal 2021. Its credit ratio rose to above 1 time for the first time since the onset of pandemic, on the back of select sectors.

To be sure, services continue to lag the manufacturing and infrastructure-linked sectors in demand recovery, and correspondingly, still have a much lower credit ratio. Travel and hospitality, and education services are among sectors still seeing tepid recovery. Health care, among the contact-intensive service sectors, and information technology, among other services sectors, actually benefitted amid the pandemic as they successfully addressed challenges pertaining to health, remote working and information security that emerged during the pandemic.

India Inc also continued the trend of deleveraging for the sixth straight year in the previous fiscal, uninterrupted by cash-flow disruptions and emergency funding requirements caused by the pandemic. A strong run of primary issuances in equity markets also supported the balance sheet strengthening.

Improving financial profiles provide a cushion for future shocks, including a potential third wave, as well as for re-leveraging, when the private capex cycle resumes over the medium term.

With India Inc on stronger footing, the financial sector is better placed today than it was a year ago — the systems and processes put in place for collections after the first wave have helped this time around, coupled

[1] Refers to the ratio of upgrades to downgrades. Excludes rating actions involving ratings with the Issue-not-cooperating (INC) suffix

[2] See 'India Inc credit outlook turns positive, upgrades rise' - CRISIL Ratings Press Release dated August 18, 2021

with the less-stringent containment measures. Improving capitalization levels and provisioning coverage ratios have strengthened the banks' balance sheets. The outlook on credit quality for financial sector, especially banks, is stable.

That said, challenges persist in the retail and micro, small and medium enterprises loan segments as smaller borrowers have seen outsized impact of the pandemic. Banks' non-performing assets are expected to increase to 8-9% by March 2022 from ~7.5% in March 2021.

Banks' credit growth is expected to recover to 9-10% this fiscal from 5% in the previous one. Similarly, assets under management of non-banking financial companies (non-banks) are also expected to see a 6-8% growth compared with 2% in the previous fiscal. Non-banks' credit profiles are cushioned by improving capitalization and liquidity buffers, even as asset quality will be a monitorable.

A potential third wave is the key near-term risk to our 'positive' credit quality outlook. A significant deceleration in economic and demand growth — both global and domestic — most likely due to withdrawal or sharp tapering of monetary and fiscal stimuli, will be the key downside risk over the medium term.

An increase in the pace of inoculation – with nearly 70% of the adult Indian population having received at least one dose already – and expectations that containment measures in the event of a third wave will be less stringent and localized, should contain demand disruption.

Emergence of any virus mutation that dilutes the benefits of vaccination, and any change in the growth-supportive policies of government and regulators will be key monitorables, along with inability to pass on rise in commodity prices and freight costs and its impact on profitability.

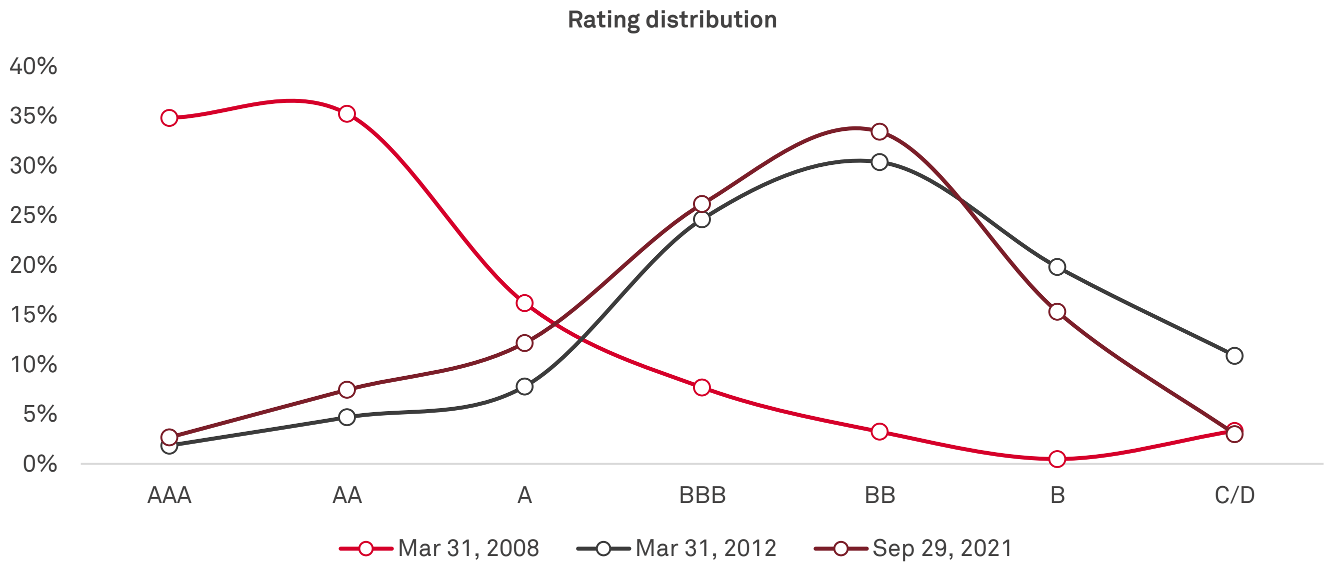
About Ratings Round-Up

The Ratings Round-Up is a semi-annual publication that analyses rating actions by CRISIL Ratings and traces the linkages between such actions and the underlying economic and business trends. This edition analyses the rating actions for the period from March 31 to September 29, 2021.

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 a reasonable indicator of an economy's directionality.

CRISIL Ratings portfolio: Median rating unchanged in H1-22

Chart 1: Trends in rating distribution



Source: CRISIL Ratings

Our outstanding ratings as on September 29, 2021, cover around 7,500[3] companies. Of these, ~50% are in the 'BB' or lower rating categories. Consequently, the median rating has stayed put in the 'BB' category even as we have seen number of outstanding ratings at below BB shrinking with higher incidence of non-cooperation from issuers therein.

Earlier, with the introduction of bank loan ratings in 2007 and rapid expansion of our portfolio, especially into lower rating categories, the median rating had moved to 'BB' as on March 31, 2012, from 'AA' as on March 31, 2008.

[3] This excludes companies in the 'Issuer not cooperating' or INC category. CRISIL Ratings portfolio had ~10,000 such issuers as on September 29, 2021. Including such ratings, our outstanding rating list would comprise ~18,000 issuers. The median rating, however, would remain in the 'BB' category.

Analysis of rating actions in the first half of this fiscal

It's almost two years since the world first encountered the SARS-CoV-2 virus. Humankind has strived relentlessly to overcome the virus, making significant progress in tackling it in terms of treatment protocols and the discovery of vaccines. While an unequivocal victory seems some way away, we have adapted to living and growing in the new normal.

India Inc has adapted to life amid the pandemic too, and is on a stronger footing now, supported by the strong rebound in economic activity since the second half of last fiscal, after almost being brought to a standstill in the first half.

Despite the massive second wave that saw much higher caseload in the first half of fiscal 2022, business and economic activity held up relatively better compared with the first wave, owing to containment measures that were localised and less stringent.

With industrial output increasing sequentially and high-frequency data depicting return to pre-pandemic levels, gross domestic product (GDP) is expected to grow 9.5% this fiscal, albeit on a lower base, even as the possibility of the third wave still lurks.

The government has continued regulatory support measures such as emergency credit line guarantee scheme (ECLGS) and one-time restructuring (OTR) in a more targeted manner. That said, barely 1% of eligible companies in the CRISIL Ratings portfolio have opted for, or are contemplating, the debt restructuring facility offered by the Reserve Bank of India (RBI) under its Resolution Framework 2.0, underscoring the broad-based recovery as well as the greater effectiveness and ease of availability of relief measures.

Amid this backdrop, we present the trend of credit ratio and debt-weighted credit ratio and elaborate on how some sectors in the manufacturing, infrastructure and services categories have fared in the first half of this fiscal.

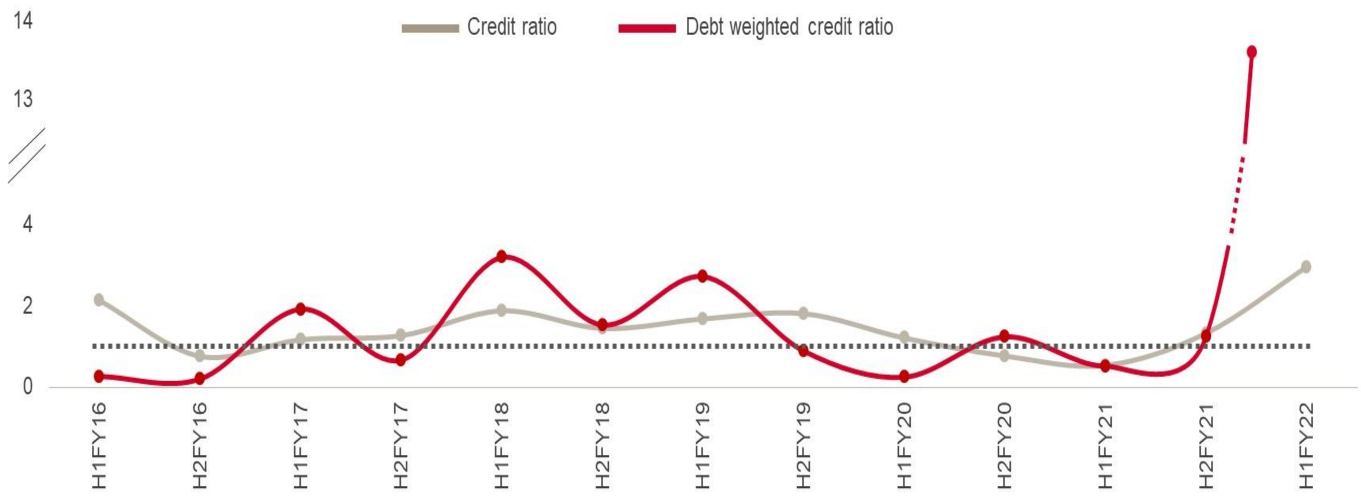
Credit ratio up to 2.96 times in the first half of this fiscal from 1.33 times in the second half of last fiscal

The increase in the credit ratio to 2.96 in first half of fiscal 2022 from 1.33 times in the previous half was backed by pick-up in demand in both the domestic and international markets and supplemented by less stringent containment measures, increased realisations for commodities, improved sourcing from India on the back of supply constraints from China and government relief measures.

The increase in credit ratio is an extension of the trend seen in the second half of last fiscal, when the ratio increased to 1.33 from 0.54 in the previous half. Besides sharp demand recovery, the regulatory and government support measures had cushioned credit profiles back then, too.

While the debt-weighted credit ratio rose to 13.8 times from 1.26 times, the rise was a bit skewed because of upgrades for a few very large corporates. Adjusting for top five upgrades out of 488 upgrades, the debt-weighted credit ratio is about 5.11 times. In general, large corporates have adapted better in the wake of the pandemic by reorienting their operating models, pruning costs, keeping leverage under control, and conserving liquidity.

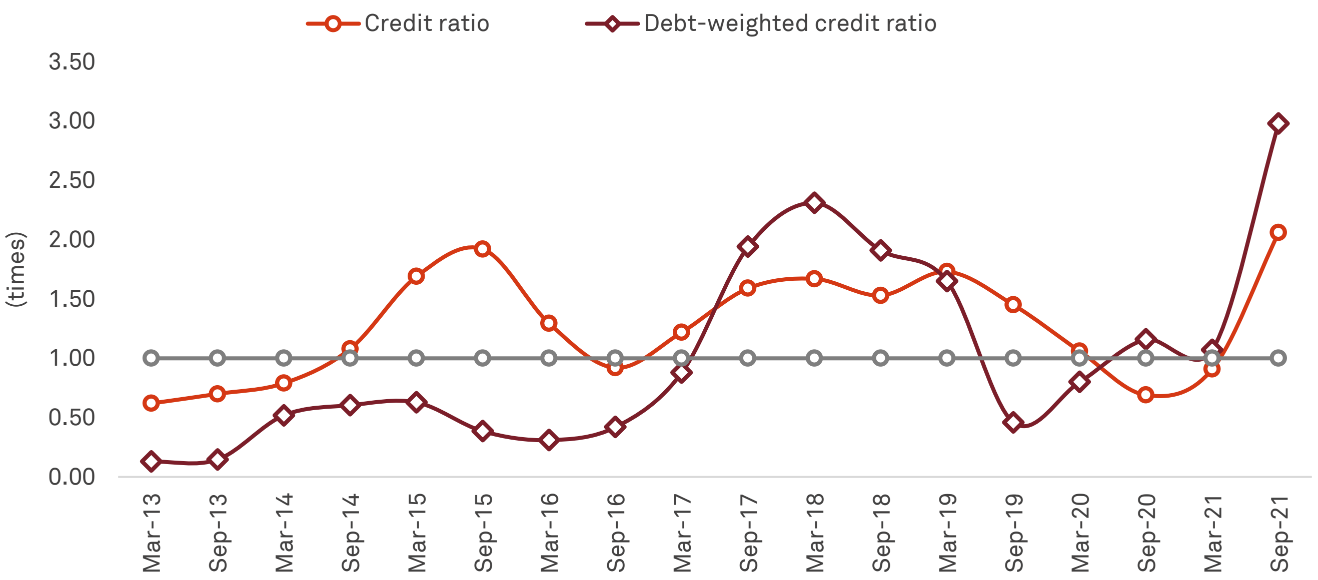
Chart 2: Credit ratio and debt-weighted credit ratio continue to rise



Source: CRISIL Ratings

To ascertain the sustainability of the upward trend, the credit ratio may be assessed on a 12-month rolling basis. The CRISIL Ratings credit ratio and debt-weighted credit ratio for the first half this fiscal on a 12 month rolling basis are 2.06 times and 2.98 times, respectively.

Chart 3: Trends in credit ratio and debt-weighted credit ratio (on a 12-month rolling basis)



Source: CRISIL Ratings

The first half of this fiscal saw 488 upgrades and 165 downgrades vis-a-vis 294 upgrades and 221 downgrades in the second half of the previous fiscal. Recovery was broad-based, as reflected in credit ratio increasing across manufacturing, infrastructure and service sectors. Sectors with the most rating upgrades include construction and engineering, and renewable energy, which benefitted from enhanced infrastructure focus resulting in improved pace of execution and higher capital spending by the central and state governments.

To reduce dependence on China, global businesses are looking at alternative sources and India stands to benefit from this in sectors such as specialty chemicals and pharmaceuticals. Also, China's pollution control initiatives affected its steel production and exports. This benefitted Indian steel players in terms of higher demand as well as realisations. Other key commodity sectors, such as aluminium and copper, have seen similar trends.

The credit ratio for contact-intensive services has also increased as demand has started to rise, though it remains far below the pre-pandemic level and lower than other services and manufacturing sectors. Healthcare continued to see strong performance and drove the credit ratio for contact-intensive sectors to above 1 time. However, sectors such as hospitality and education services continued to suffer because of the pandemic, with more downgrades than upgrades.

Analysis of our outlooks on long-term ratings also corroborates improved prospects with number of long-term ratings on positive outlooks at almost twice the number of long-term ratings on negative outlooks as on September 29, 2021. The outlook trend has changed over the course of pandemic with ratings on negative outlook outnumbering positive outlook during the first wave. As the green shoots of recovery became visible following the unlock measures post first wave, this trend bottomed out by December 2020 and proportion of positive outlooks started outnumbering the negative outlooks in the last quarter of fiscal 2021 and that trend has continued in the first half of this fiscal

'Positive' credit quality outlook for this fiscal

CRISIL Ratings revised the credit quality outlook of India Inc for this fiscal to 'Positive' in August 2021, based on the sustained recovery in demand after the blip caused by the second wave of Covid-19 afflictions in the first quarter. Also, India Inc. has adjusted operating models, focused on cost control, and strengthened balance sheets as evident in the secular deleveraging trend. A strong run of primary issuances in equity markets also supported the balance sheet strengthening. The outlook for credit profiles in the financial sector is stable, supported by higher capitalisation, better provisioning cover, and increased access to liquidity.

We expect rating upgrades to continue to outnumber downgrades this fiscal. Stringent containment measures in the event of an intense third wave and sluggish pace of vaccination – not anticipated currently – pose downside risks to the outlook. A significant deceleration in economic and demand growth – both global and domestic – most likely due to withdrawal or sharp tapering of monetary and fiscal stimuli, will be the key downside risk over the medium term. Impact of any increase in commodity prices or freight costs on profitability will also remain a monitorable.

CRISIL Ratings continues to monitor the impact of the pandemic and potential containment or unlock measures on the credit profiles of rated entities. With economic recovery picking up, CRISIL Ratings has continued its endeavour to keep investors informed, publishing 60 press releases and hosting 17 webinars on sectoral developments in the first half of this fiscal.

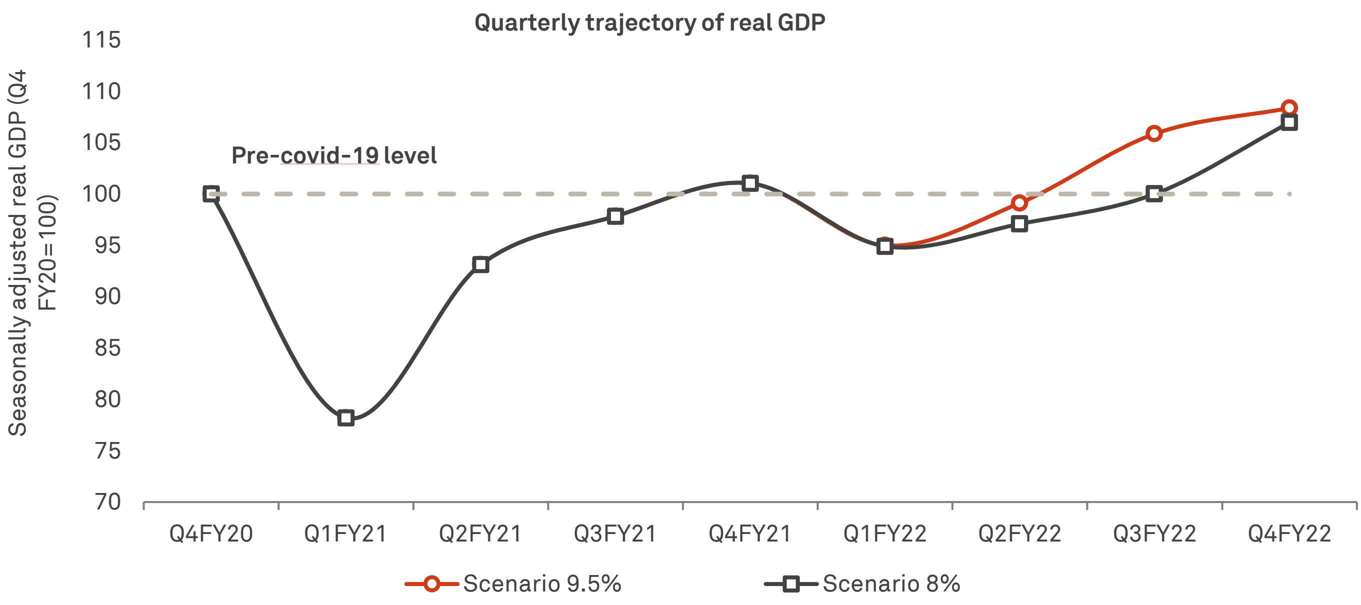
Macroeconomic outlook

CRISIL revisited its GDP forecast in June 2021 to 9.5% from 11% on account of moderation in growth during the second wave. However, calibrated lockdowns softened the second-wave's impact. Thereafter economic activity rebounded sharply as also indicated by high frequency data. GDP growth for the first quarter this fiscal, at 20.1%, was a tad higher than the CRISIL's forecast of 19%. This growth, although, was on a very low base of negative 24.4% in the first quarter of last fiscal

India's real GDP had contracted sharply by 7.3% last fiscal, as the pandemic exacted a heavy toll on the economy. Just as India had recovered from the first wave, came the second, more ferocious one at the start of this fiscal. However, high-frequency data as well as the first-quarter GDP numbers reveal that this far more virulent wave did not hit the economy as hard as the first, mainly because of calibrated lockdowns. Despite uneven monsoon across the country, agricultural output is expected to grow 3% this fiscal as the cumulative deficiency in rainfall is only about 4% of the long period average. Additionally, exports have cruised along even during the second wave, led by the sharp rebound in demand in developed economies.

Inflationary pressure remains with high international prices of commodities such as edible oils and metals, which are at decadal highs, and high crude oil prices. While overall inflation will be kept in check by food inflation as it benefits from the high base of last year, impact of rising global commodity prices will remain a key monitorable.

Chart 4: GDP forecast for fiscal 2022



Source: CRISIL Research

Importantly, Covid-19 cases have started to trend downwards. As per the latest data, the seven-day moving average has come down to 26,000 from around 380,000 in May 2021, the peak of the pandemic. Additionally, India has ramped up its vaccination programme, backed by improving vaccine supplies. In the first half of September 2021, India inoculated 7.8 million people per day, a significant improvement over 5.4 million per day in August and 3.9 million per day in July. India has now vaccinated nearly 70% of its adult population with at least one dose. The increasing pace of vaccination could soften the impact of a third wave, if it occurs.

Also, lockdown measures could be less severe if a large portion of the population is inoculated. While data from developed countries suggests a booster shot for vulnerable population might be more effective in further containing the virus, emerging economies such as India would need to bolster vaccine availability to factor in a third dose, which may be a challenge. A stronger-than-expected third wave could pose a significant downside risk to the growth forecast, as would a slower-than-expected pace of vaccination. CRISIL's pessimistic scenario sees GDP growing at 8%. Having said that, GDP growth is expected at 9.5% for this fiscal, assuming that 70% of the adult population will be fully vaccinated by December 2021 given the current trends.

India to surf on global growth

Global growth is expected at 5.8% for 2021 compared with negative 3.4% in 2020, supported by massive fiscal stimulus in a few large economies (the US and the UK), improved adaptability of governments and businesses and accelerated recovery in the second half of 2021. India's exports rebounded fast this fiscal and had held steady even in the middle of the second wave, growing 8.5% in April 2021. Merchandise exports soared 65% on-year to $164 billion in April-August 2021, led by growth in core exports (non-oil and non-gold).

That said, there is no room for complacency when it comes to Covid-19 as the pandemic is far from over. The global experience, even in sufficiently vaccinated economies, shows that vaccines blunt the virus but have not defeated it, at least not yet, and the intensity of its resurgence remains a key risk.

Similarities to growth spike in early 2000s

In early 2000, strong global growth had spiked export demand across Asian economies such as China and India. China was on a manufacturing spree, the interest rates were benign, and the markets were awash with liquidity. Meanwhile, balance sheets of India Inc had strengthened, backed by sustained cash flows and low interest costs. This was also the beginning of a strong and sustained GDP growth cycle in emerging economies. Some of these aspects such as strong global growth, low interest rates and healthy balance sheets of India Inc are similar to the current scenario. Could this mean that India is at the beginning of an economic upcycle?

But there are also some differences this time around. GDP growth which has now rebounded - both for the world as well as India - is expected to slow down. After a strong recovery in fiscal 2022, CRISIL expects GDP growth to be over 7% in fiscal 2023 and taper down to 5-6%, annually thereafter till fiscal 2025. Global growth is expected to soften to 4.4% in 2022 from 5.8% in 2021, as the fiscal stimulus impact recedes. With recovery at a rapid pace, inflation pressures have intensified. In response, some emerging market central banks have begun raising policy rates. The US Federal Reserve is expected to start tapering its quantitative easing program starting December 2021. This marks a turn in the extremely easy and accommodative monetary policy stance globally, implying that financial conditions could gradually start tightening.

We believe, with domestic growth gradually strengthening, inflationary pressures remaining stubborn and a global shift in monetary policy stance, the Reserve Bank of India too will start to roll back accommodation. We expect a calibrated withdrawal of liquidity to continue and gain pace as more certain signs of economic recovery become visible. A significant deceleration in economic and demand growth, most likely due to withdrawal or sharp tapering of monetary and fiscal stimuli, will be the key monitorable over the medium term

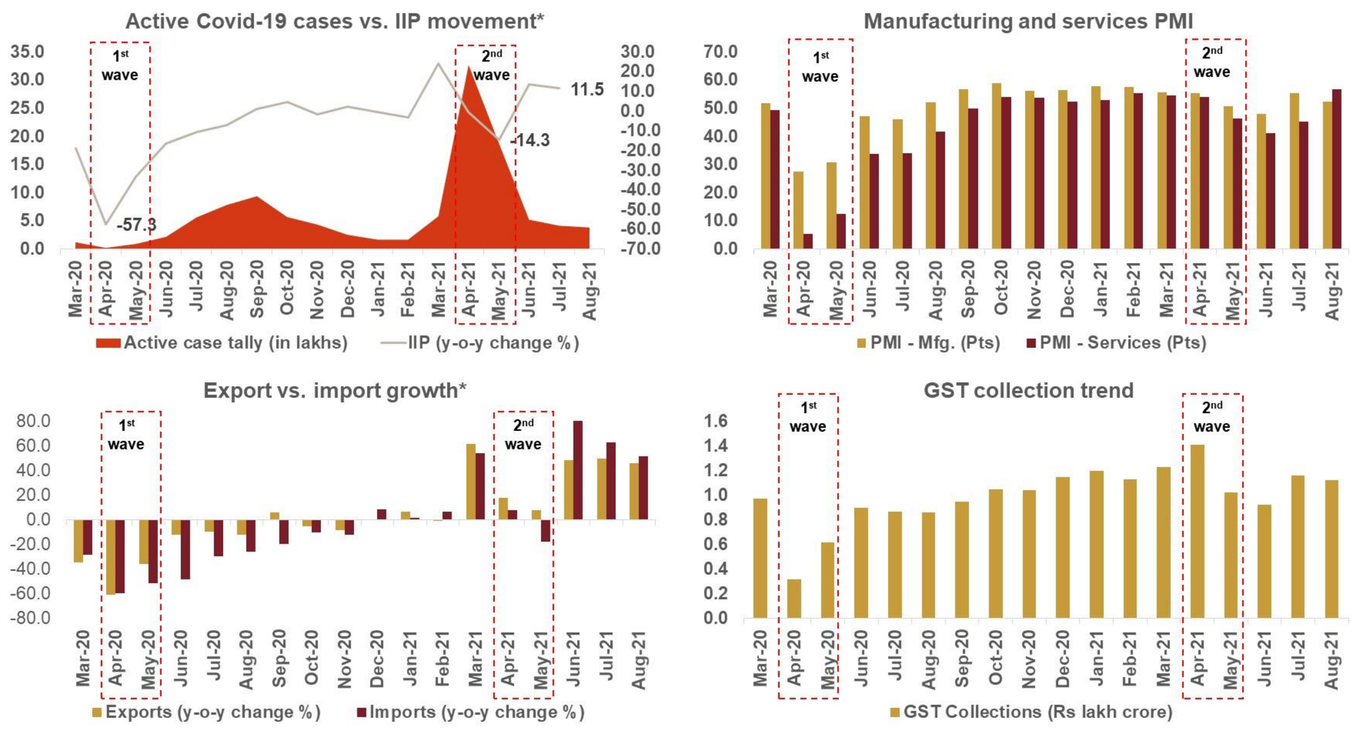
Category-wise credit ratio trends

Largely unscathed by the second wave, India Inc. outlook is 'positive' as demand is likely to sustain in the second half of this fiscal.

Despite the severity of the more virulent second wave, the impact on business activity was short-lived on account of localized and less stringent curbs and high adaptability to the Covid-19 protocols. As a result, most sectors have either recovered fully or are close to their pre-pandemic levels in the first half of this fiscal. This is also reflected in India's high frequency indicators, which showed swifter business recovery compared with the first wave of the pandemic.

Electricity consumption recovered sharply from July 2021, with demand rising on-month across all states, backed by pickup in industrial and commercial activities. The movement of material (transport and logistics) and increase in commercial traffic (based on toll roads, port activity and rail freight trends) also indicate that industrial and commercial activity has returned to pre-pandemic levels.

Chart 5: High-frequency indicators



**For calculation of April and May 2021 % change figures, the comparison is between 2021 and 2019 because of the stringent lockdown in that period in 2020*

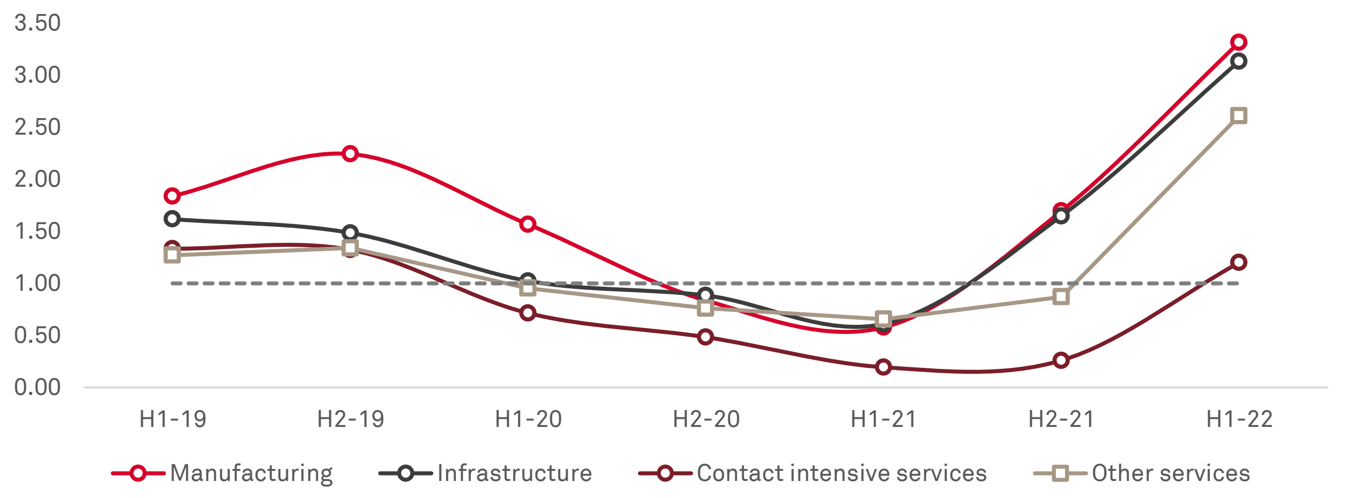
Source: Active covid-19 cases: Health ministry; IIP, Services index: RBI, Ministry of Statistics and Programme Information (MOSPI); PMI data: IHS Markit; Ministry of Finance, GST Collection trend: GST Network; Export and import growth: Dept. of Commerce

The sustained recovery in domestic demand, government impetus on infrastructure spending and export growth spurred by a buoyant global economy as well as 'China plus one' global sourcing strategy, have led to strong rebound in business risk profiles of India Inc., driving the rise in upgrades. The upgrade rate rose to around 12%, not seen at a higher level since first half of fiscal 2016, long before Covid-19 as well as demonetization.

A small section of the Indian corporate sector, accounting for less than 5% of the rated debt, however, continues to struggle to find its footing. This majorly comprises contact-intensive service sectors, such as hospitality, retail and airlines, which continue to face headwinds with recovery still distant.

In the following chart, we have represented the credit ratio trends of key sectors in three categories – manufacturing, infrastructure, and services – to depict the pre-pandemic period, the trough of the pandemic and the recovery period.

Chart 6: Category-wise credit ratio



**The above table excludes financial services*

<u>**Manufacturing sector**</u>: The credit ratio for the manufacturing sector increased to 3.32 times in the first half of this fiscal from 1.70 times in the previous half. Manufacturing activities were largely uninterrupted by the second wave, especially essential production.

Export demand from developed economies augurs well for textiles, gems and jewellery, and specialty chemicals.

The steel sector remained bullish with robust global demand, production cutbacks by China based on environmental concerns, and strong global iron ore prices, though the same has declined recently.

Pharmaceuticals, a highly resilient sector, has seen significant uptick from the second quarter of the previous fiscal; it has continued to improve, led by increased global demand and supply constraints in other countries.

For the auto sector, however, recovery is set to be patchy this fiscal due to shortage of semi-conductor chips in the passenger cars segment and a dent to the demand for two-wheelers from an outsized impact of the pandemic in the hinterland as well as an increase in the cost of ownership following price hikes.

Infrastructure-linked sectors: The credit ratio of infrastructure-linked sectors increased to 3.13 times in the first half of this fiscal from 1.65 times in the second half of the previous fiscal

Continued emphasis on infrastructure spending, including through higher budgetary allocation, helped kick-start construction and project implementation activity following the unlock measures after the first wave, and was unaffected by the second wave. This thrust has improved these sectors' credit quality.

The National Infrastructure Pipeline (NIP) envisages investment of Rs 111 lakh crore during fiscals 2020-25 and acceleration in its rollout is expected to have a multiplier effect on order inflows. Government initiatives and encouraging regulatory framework under the clean energy agenda will continue to drive growth in the renewable power sector.

Releasing payments monthly instead of based on milestones; extension of timelines for completion of projects (under Atmanirbhar Bharat Policy); significant progress in project completion and improvement in traffic flow have also aided growth of infrastructure-linked sectors.

For residential real-estate segment, work-from-home and improved affordability have increased demand for residences in metro cities. Steel and cement sectors are benefitting from increase in demand from government spend as well as real estate, besides increase in price realisations. Cement revenue growth is expected to be robust this fiscal at 9-11% on the back of steady rural housing demand, thrust on infrastructure spends and improved demand for urban housing.

Service sectors: The credit ratio of service sectors increased to 1.87 in the first half of this fiscal from 0.49 in the second half of last fiscal.

Some pockets of service sectors were debilitated last fiscal, but have seen a positive turn in the first half of this fiscal. With increase in the pace of inoculation, some contact-intensive sectors have picked up gradually. With abating of second wave, hospitals occupancy has improved for elective surgeries and outpatient footfalls. Not surprisingly, a few contact-intensive services such as educational institutes and hospitality continue to lag. Restriction on public gatherings and suspension of flight operations throughout the world have had a negative impact on tourism.

Some contact-intensive sectors witnessed demand improvement, with pressure on cash flow and liquidity easing and benefits from targeted regulatory measures during the second wave. However, their trajectory for a return to normal will be flatter and slower. This is reflected in the credit ratio, which has improved since the worst phase of the pandemic and was actually above 1 for contact-intensive services (besides other services) but remained the lowest among all the categories

Key risk to the credit quality outlook

In the near term, the key risk to the 'positive' credit quality outlook is a significant deceleration in economic and demand growth – both global and domestic – most likely due to a potential third wave.

At the onset of the pandemic, CRISIL Ratings developed its sectoral resilience framework to identify its impact on different sectors, their resilience, the extent of recovery after the first wave subsided, and their susceptibility to subsequent waves. An update on this framework to assess the sectoral resilience as well as susceptibility to the potential third wave is presented in the subsequent section.

CRISIL Ratings' resilience framework to assess sectoral risk

Sectoral resilience framework is a multivariate framework which has helped CRISIL Ratings identify sectors requiring close surveillance and take timely rating actions in a rapidly changing environment. The framework also helped regularly communicate views to investors and lenders.

While CRISIL Ratings revised its credit quality outlook for India Inc to 'Positive' in August 2021 implying expectation of improvement in credit profiles, any resurgence in Covid-19 cases and the consequent containment measures and disruption in operations, logistics and demand, pose major downside risks to the outlook.

It is in this context, we present the fourth edition of the CRISIL Ratings' sectoral resilience framework.

Methodology and assumptions

CRISIL Ratings has analysed 43 key sectors on three parameters: a) extent of recovery, b) sectoral resilience, and c) sensitivity to a Covid-19 resurgence. These sectors comprise about 75% of its total rated portfolio (excluding financial services).

Some of the key terminologies used are:

Extent of recovery: Indicates the level of recovery to the pre-pandemic level. It is calculated by comparing estimated revenues for this fiscal with revenues for fiscal 2020.

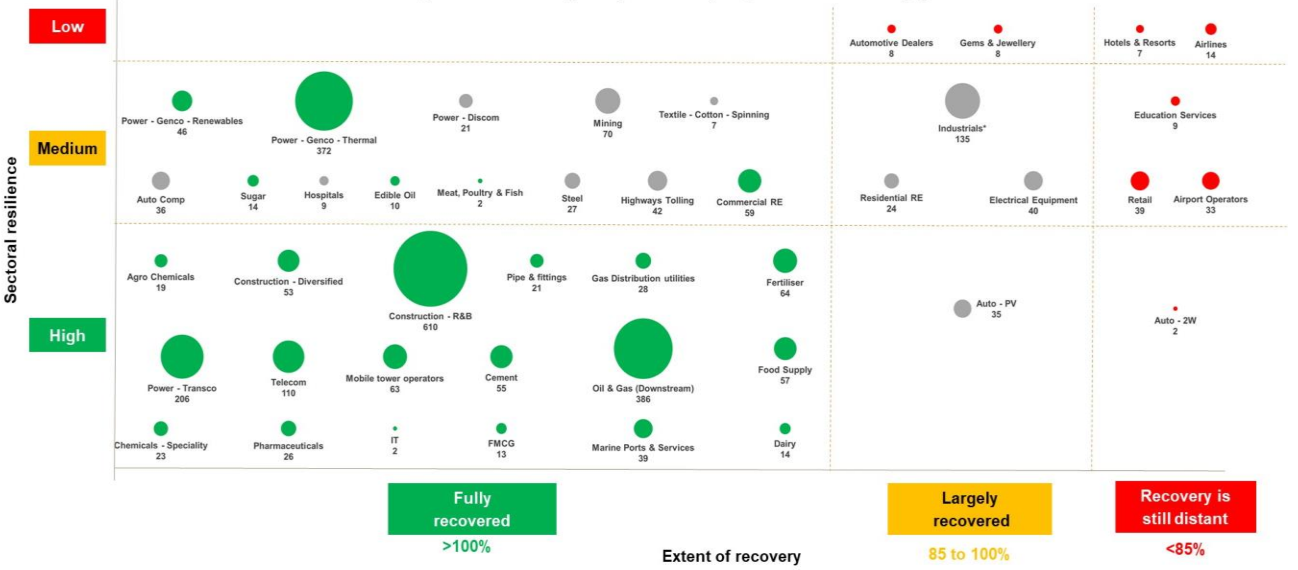
Sectoral resilience: Measures the ability of the sector to withstand disruptions/ shocks. The factors to decide resilience can be multiple - category of goods (essential/ non-essential); nature of demand (discretionary or non-discretionary), balance sheet strength in terms of leverage and liquidity available for entities in the sector; and the level of government/ regulatory support to the sector.

Sensitivity to a Covid-19 resurgence: Gauges the sector's sensitivity to the risk of a third wave of the pandemic. Businesses that have high direct consumer interactions are more sensitive than those that operate with contact-less/ remote business model. This parameter indicates the susceptibility of the sector to regulatory containment measures such as night curfews/ limited public mobility and limited operational timings imposed on retail businesses to curb the spread of the virus.

Sectoral resilience amid the pandemic

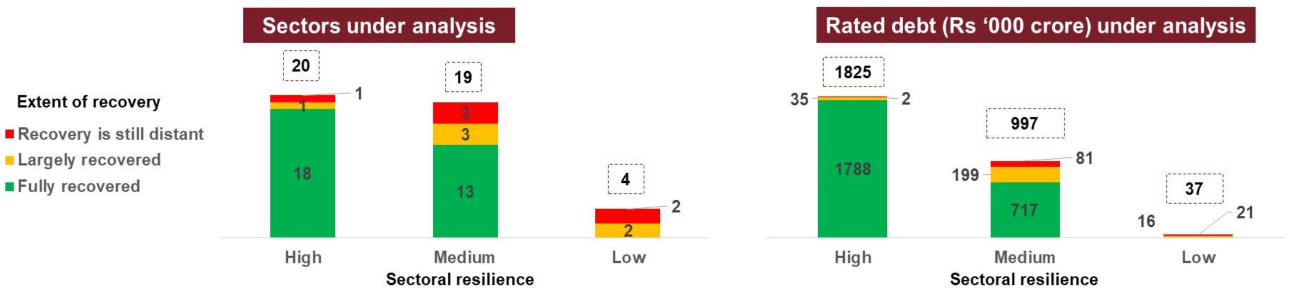
Size of the bubble indicates rated debt quantum (figures in ₹ ' 000 crore)

Colour of the bubble indicates sensitivity to Covid-19 resurgence (Green=Low, Grey=Medium & Red=High)



*Industrials comprise engineering and capital goods, industrial machinery and consumables and heavy electrical equipment

Sectoral resilience amid the pandemic – conclusion

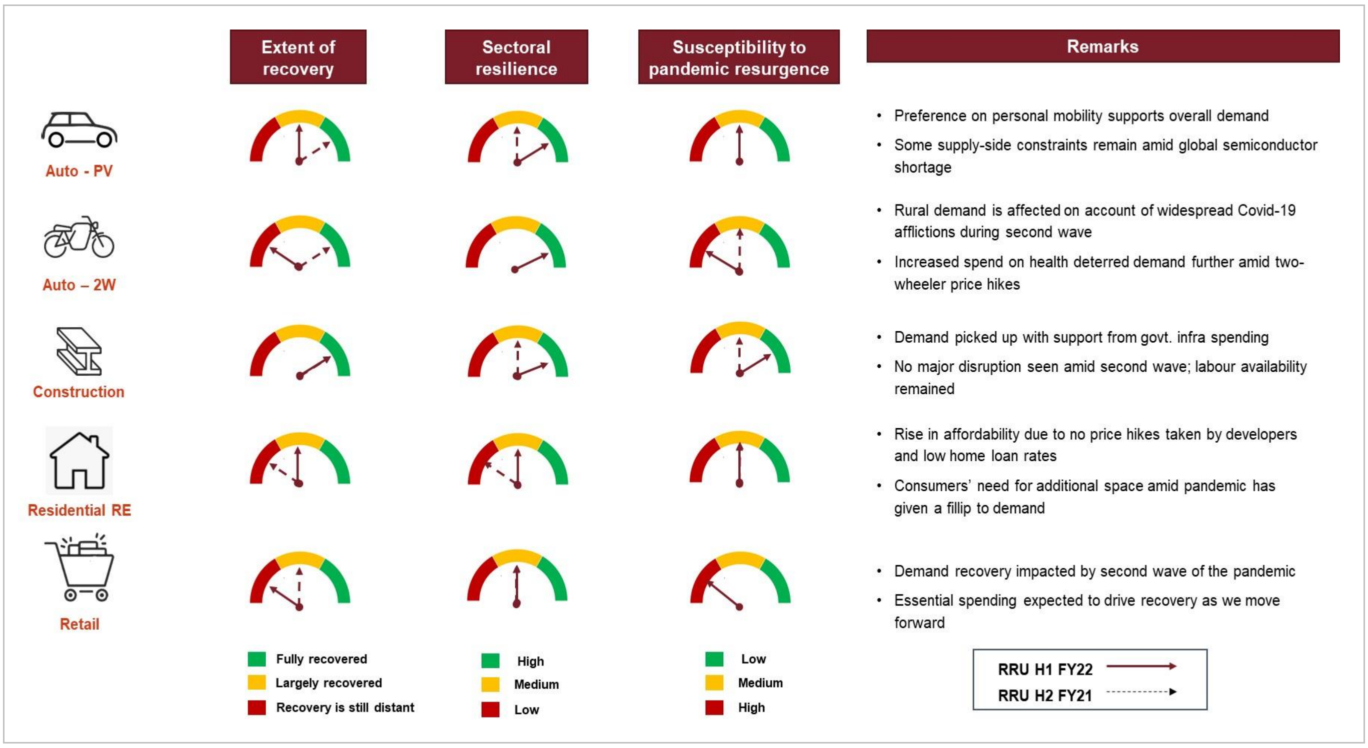


Majority of sectors are expected to reach their **pre-pandemic levels**

88% of the rated debt under analysis is in sectors that have are expected to be fully recovered in FY22

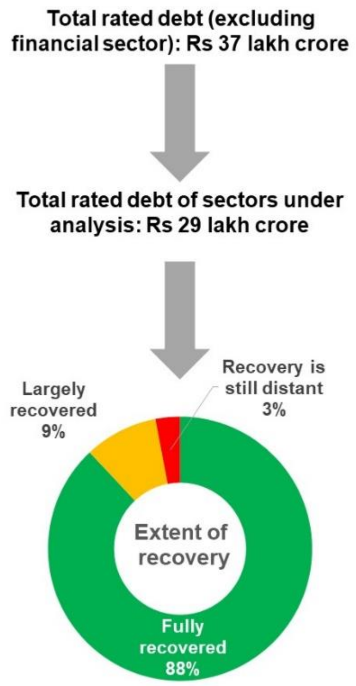
8 sectors (accounting for ~4% of the rated debt under analysis) susceptible to the third wave

- Majority of sectors are expected to recover to the pre-pandemic levels, the sustenance of recovery is crucial
- Faster recovery seen post the second wave of Covid-19 seen due to adaptability and localised or less-stringent curbs
  - We expect only eight sectors, accounting for 4% of rated debt under analysis, to be susceptible to the third wave



The big picture: Outlook for India Inc turns 'Positive' as demand has recovered to the pre-pandemic level for most sectors

Our analysis reveals that 37 of the 43 sectors assessed have either fully or largely recovered. Only six sectors are still a long way from full recovery.



- **88%** of debt is in sectors that are estimated to have 'fully recovered'. These include essentials such as FMCGs, pharmaceuticals, and telecom; and infrastructure-linked sectors such as power, roads and construction, and cement. These sectors have seen significant demand recovery and are currently operating at above their pre-pandemic levels.
- **9%** of debt is in sectors that are estimated to have 'largely recovered'. These include PV and auto dealers, industrials[4], and residential real estate. These sectors have seen gradual demand recovery and are operating at close to their pre-pandemic levels.

[4] *Industrials comprise engineering and capital goods, industrial machinery, consumables and heavy electrical equipment

- **3%** of debt in sectors in the 'recovery is still distant' category, such as retail, airlines, two-wheelers and hospitality. These sectors have seen subdued demand recovery and are operating well below the pre-pandemic levels.
- Of 43 sectors, 8 sectors are vulnerable to a third wave, including above-mentioned 6 sectors which are in 'recovery is still distant' category. These 8 sectors account for 4% of the rated debt under study.

The following sectors witnessed a change in expectation in the extent of recovery by the end of fiscal 2022, as against our expectations in previous ratings round-up of April 2021:

The change in recovery pattern was on account of an unexpectedly virulent second wave during the first quarter of this fiscal and certain sector-specific trends. **In the table below, a deterioration in expectation of recovery is coloured red, while an improvement in expectation of recovery is coloured green.**

	As of March 2021	As of September 2021	
Sectors	Extent of recovery	Extent of recovery	Rationale
Auto - 2W	Fully recovered	Recovery is still distant	Pandemic-hit hinterland saw higher health-related expenses, which, along with price hikes, deterred demand
Auto - PV	Fully recovered	Largely recovered	Production bottlenecks amid global semiconductor shortage
Auto dealers	Fully recovered	Largely recovered	Impacted by intermittent lockdowns during the first quarter of this fiscal and slower recovery in the two-wheeler segment due to faltering demand
Retail	Largely recovered	Recovery is still distant	Reopening of contact-intensive sectors slowed after the second wave and cautious approach of authorities
Education services	Largely recovered	Recovery is still distant	
Gems & jewellery	Fully recovered	Largely recovered	Rise in health expenses due to the second wave curtailed consumer spending on discretionary products
Textile - cotton spinning	Largely recovered	Fully recovered	Buoyant export-led demand resulting in a positive bias
Industrials	Recovery is still distant	Largely recovered	Government thrust on infrastructure reflected in higher order flows and execution
Residential real estate	Recovery is still distant	Largely recovered	Rise in affordability due to no price hikes by developers along with need for more space among consumers amid the pandemic

'Fully recovered' category – 88% of rated debt

- Sectors in this category have displayed healthy demand growth with month-on-month improvement since the economy was unlocked.
- Broad-based recovery ranging from infrastructure-linked sectors such as steel, cement, and construction to essentials such as dairy, FMCG, pharmaceuticals, and telecom.

Sectors	Major driver of recovery
Telecom	Part of essential product/ services
Fertiliser	
Mobile tower operators	
Food supply	
Pharmaceuticals	
Agricultural chemicals	
Dairy	
FMCG	
IT	
Power - genco* - thermal	
Power - genco - renewables	
Power – transco*	
Power – discom*	
Sugar	
Hospitals	
Edible oil	
Meat, poultry & fish	
Oil & gas (downstream)	Improved business activity/mobility
Gas distribution utilities	
Chemicals - specialty	
Commercial real estate	
Highway tolling	
Cement	Uptick in infrastructure and construction activities led by government push
Steel	
Mining	
Construction – roads & bridges	
Construction - diversified	
Pipe and fittings	
Marine ports & services	Revival of discretionary spending led by pent-up as well as festive demand
Textile - cotton spinning	
Auto components	

**Genco: generation companies; transco: transmission companies; discom: distribution companies.*

'Largely recovered' category – 9% of rated debt

- Sectors in this category have displayed steady demand pickup, albeit at a more subdued pace.

Sectors	Major driver of recovery
Auto - PV	Preference for personal mobility, especially in urban and semi-urban areas
Auto dealers	The PV segment is expected to lead the recovery
Gems & jewellery	Return of consumer discretionary spending/ pent-up demand/ festive and wedding seasons
Electrical equipment	Uptick in infrastructure and construction activities led by government push
Industrials	
Residential real estate	Improved demand due to consumer preference of additional space amid the pandemic and improved affordability

'Recovery is still distant' category – 3% of rated debt

- Sectors in this category continue to see challenges to uninterrupted demand pickup.
- This is mainly because of contact intensiveness and/ or highly discretionary nature of products or services.
- Sharp recovery depends on the pace of decline of active Covid-19 cases, improving mobility, and rise in consumer spending power.

Sectors	Major impediment to recovery
Auto – two wheelers	Uneven/ slow demand recovery
Airlines	
Airport operators	
Education services	
Hospitality	Restricted mobility along with higher concentration of consumer spending on essentials
Retail	

Credit quality outlook on key sectors for fiscal 2022

With large proportion of sectors having recovered to pre-pandemic levels, in this section we present the credit quality outlook as reflected through expectations on revenue growth, profitability, and financial metrics for fiscal 2022 for a few key sectors across manufacturing, infrastructure-lined and services categories.

In the respective tables for each of the three categories, credit quality outlook for fiscal 2022 is presented with respect to change in key parameters vis-à-vis fiscal 2021. An improvement in the parameter is represented by a green signal, while amber signal represents marginal improvement or no change, and red signal represents deterioration in the parameter.

Manufacturing sectors

Table 1: Credit quality outlook with respect to change in parameters in fiscal 2022, vis-à-vis fiscal 2021

Credit quality outlook

46%

of ratings outstanding as on date

	Revenue	Profitability	Working capital	Capital structure	Credit quality
Pharmaceuticals					
	Expected for fiscal 2022 - Revenue growth: 10-11%; Operating margins: 23-25% Strong domestic and export growth supplemented by vaccines and acute therapies, namely anti-infective, analgesics and vitamins having direct/indirect role in Covid-19 treatment. The PLI scheme will lend support to the bulk drugs segment.				
Textiles (RMG)					
	Expected for fiscal 2022 - Revenue: ~15-20%; Operating margins: 5-6% Revival in growth expected after muted demand last fiscal. Improved consumer sentiment in developed economies and US ban on sourcing from Xinjiang province in China to boost exports. Domestic growth sluggish but should pick up in the upcoming festive season. High input costs to constrain margins this fiscal.				
Textile (cotton spinning)					
	Expected for fiscal 2022 - Revenue: 16-18%; Operating margins: 14.4-15.4% Lower cotton production in the US and Brazil benefits India with higher realisations in export markets and increased sourcing from the country. Profitability is expected to improve, but volatile raw material prices remain a key risk.				

Ratings

<table>
<tr><th></th><th>Revenue</th><th>Profitability</th><th>Working capital</th><th>Capital structure</th><th>Credit quality</th></tr>
<tr><td rowspan="2">Auto: 2W/PV/CV</td><td>🟡</td><td>🟢</td><td>🟢</td><td>🟡</td><td>🟡</td></tr>
<tr><td colspan="5">Expected for fiscal 2022 - Revenue: 15% (2W), 15-20% (PV), 18-22% (CV); Operating margins: 13% (2W), 8.5%-9% (PV), 6-7% (CV)
Preference for personal mobility, especially in urban and semi-urban areas, to aid growth of passenger vehicles (PVs). Two-wheeler recovery affected with the second wave impacting rural demand. Semiconductor shortage issues will also impact recovery to some extent. The commercial vehicle (CV) segment will benefit from higher replacement volume, steady agricultural output and higher government spend on infrastructure. Gearing of auto manufacturers (PVs/ two-wheelers) has declined over the past few years due to negligible debt-driven capex, but increased last fiscal (mainly in the two-wheeler segment)</td></tr>
<tr><td rowspan="2">Auto components</td><td>🟡</td><td>🟢</td><td>🟡</td><td>🟡</td><td>🟢</td></tr>
<tr><td colspan="5">Expected for fiscal 2022 - Revenue: 18-22%; Operating margins: 12.3-12.5%
Increase in OEM demand across the PV and CV segments should aid growth, despite the impact of the second wave. Better sentiment in the key export markets of North America and Europe, uptick in freight demand amid economic recovery in the US and expected revival in PV demand across Europe should bolster exports, which would be a key driver. Further, pent-up demand and increased vehicular movement should support recovery in aftermarket segment.</td></tr>
<tr><td rowspan="2">Chemicals-specialty</td><td>🟢</td><td>🟢</td><td>🟢</td><td>🟢</td><td>🟢</td></tr>
<tr><td colspan="5">Expected for fiscal 2022 - Revenue: 19-20%, Operating margins: 18-20%
Robust exports helped by the ‘China plus one’ strategy of global players, steady offtake by domestic customers in the pharmaceuticals and FMCG sectors, and higher realisations amid rising crude oil prices. Capital expenditure to rise 50% this fiscal. Sizeable equity raise and healthy cash flows to support credit profiles.</td></tr>
<tr><td rowspan="2">Steel</td><td>🟢</td><td>🟢</td><td>🟢</td><td>🟢</td><td>🟢</td></tr>
<tr><td colspan="5">Expected for fiscal 2022 - Revenue: 10-12%; Operating margins: 33% (Primary producers), 6.5% (secondary producers)
Higher price realisation and better capacity utilisation, given the global shortage, have significantly improved cash flows of integrated players. Many have also pared down debt. However, secondary producers face higher input costs, and thus, moderation in profitability.</td></tr>
<tr><td rowspan="2">Packaging</td><td>🟢</td><td>🟡</td><td>🟡</td><td>🟢</td><td>🟢</td></tr>
<tr><td colspan="5">Revenue and operating margins will depend on the sub-sector as this sector is highly diversified
Pandemic-induced behaviours such as online purchases and heightened hygiene consciousness have resulted in robust demand for paper and plastic packaging. Profitability improved considerably in the previous fiscal and may moderate this fiscal.</td></tr>
</table>

Source: CRISIL Ratings and CRISIL Research

Infrastructure-linked sectors

Table 2: Credit quality outlook for fiscal 2022 with respect to change in parameters vis-à-vis fiscal 2021

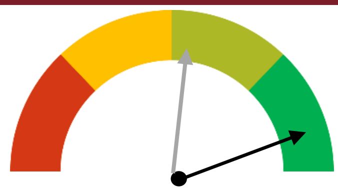
Credit quality outlook

27%

of ratings outstanding as on date

H2-21

H1-22



Source: CRISIL Ratings

	Order book /Revenue visibility	Profitability	Working capital	Credit quality
Construction & engineering				
	Growth in order book with healthy rise in central and state capex. Roads will be the largest contributor to construction spend, followed by railways and irrigation.			
Residential Real estate				
	Large residential real estate developers increased their market share with higher demand amidst work-from-home and low home loan interest rates, mainly in metros whereas smaller ones have continued to face demand challenges.			
Capital goods*				
	Economic recovery, higher infrastructure budgetary allocation expected to lift revenues. Despite extended working capital cycle this fiscal, higher cash generation and healthy order books should improve leverage and stabilise credit profiles.			

**includes engineering and capital goods, industrial machinery and consumables, electrical equipment and heavy electrical equipment*

Ratings

	Debt service coverage	Working capital	Credit quality
Highway tolling			
	Economic recovery, continued improvement in industrial production and preference for personal mobility to boost road traffic volume. Healthy cash balances augur well for debt-servicing capability.		
Commercial real estate			
	Stable outlook for commercial real estate led by steady office rentals and supplemented by warehousing demand. Debt servicing capability to remain adequate for offices and warehouses, barely enough for malls.		
Power Genco Renewables			
	With thrust from central government, states have also come out with aggressive targets under solar policies which bodes well for the sector. Receivables expected to come down as seen in release from select counterparties leading to higher cash flows. Leverage is expected to remain stable. Wind generation continues to remain. Volatility in state utility payments impacting wind projects.		

Service sectors

Table 3: Credit quality outlook for fiscal 2022 with respect to change in parameters vis a vis fiscal 2021

Credit quality outlook

22%

of ratings outstanding as on date

	Revenue	Profitability	Working capital	Capital structure	Credit quality for fiscal 2022
Healthcare*					
	Expected for fiscal 2022: Revenue growth: 15-18% Operating margins: ~14% Improvement in operating revenue and profitability following recovery in elective and preventive procedures and Covid-19 treatments, higher pandemic-related testing volume in the diagnostics business and continued cost-optimisation measures				
Education services					
	Pandemic-led disruptions continue to upend business-as-usual, with subdued fee collections constraining cash flows and profitability. De-leveraging in fiscal 2021, capital structure to stabilize in fiscal 2022				

	Revenue	Profitability	Working capital	Capital structure	Credit quality for fiscal 2022
Automotive dealers					
	Expected for fiscal 2022: Revenue growth: ~20% Operating margins: 2.5-3% Leaner inventory levels and cost-cutting measures softened the impact of the second wave. Demand is expected to improve due to new model launches and upcoming festive season sales, but to remain subdued for two-wheelers. Controlled inventory to keep short-term debt under control.				
Information technology					
	Expected for fiscal 2022: Revenue growth: 10-11% Operating margins: 24-25% Increase in operating income following higher outsourcing and digital transformation of end-use verticals, and improvement in operating margin aided by higher business volumes, continued lower travel costs and higher offshore delivery due to the pandemic.				
Hospitality					
	Expected for fiscal 2022: Revenue growth for premium segment: 35-45% Operating margins for premium segment: 6-11% Restrictions on mass gatherings and fear of a third wave are key drivers of muted demand, resulting in lower occupancy. That said, domestic tourism is a major contributor, which is expected to recover relatively faster. Delayed recovery could constrain cash flows and moderate increase in leverage. The sector has witnessed de-leveraging trend so far.				
Airlines					
	Expected for fiscal 2022: Revenue growth: ~25% Operating margins: 0-5% Revenue of airlines was substantially lower in fiscal 2021 due to pandemic led restrictions. The aviation industry continues to face turbulence with the second wave deferring recovery in passenger traffic. Rising vaccination and easing norms for inter-state travel remain key monitorables.				
Retail					
	Expected for fiscal 2022: Organised brick and mortar retail to grow 17-19%. Diversified segment with revenue and profitability varying across sub-segments Localised restrictions resulting in temporary store closures and restricted footfall impacted recovery for offline retail players, with the non-essential category impacted harder. The food and grocery segment, being more 'essential' in nature, is recovering faster, while normalisation of apparel, being discretionary in nature, is more gradual.				

**healthcare includes hospitals and other services*

Note: Total % of rating outstanding category-wise does not add up to 100% as the balance is financial sector

Source: CRISIL Ratings and CRISIL Research

Deleveraging trend across corporate India

A secular deleveraging trend across India Inc, led largely by lower capex and improved working capital cycle, has provided balance sheet strength to cushion the impact of pandemic. Despite systemic disruption caused by the pandemic, secular deleveraging continues. While this was helped by lower capex plans, corporates also kept a leash on costs, notably overheads and advertisement costs, by remodelling their business operations. This was visible across many sectors, even conventionally leveraged ones such as textiles.

An analysis data for about 4,200 entities (excluding financial sector entities) - entities having outstanding ratings as on September 29, 2021, and consistent availability of data over fiscals 2015-21 shows a decline in gearing (adjusted debt to adjusted networth) to an estimated 0.7 time as on March 31, 2021, from over 1 time as on March 31, 2015. In line with the lower leverage and relatively benign interest rate environment, the debt protection metrics have improved over the years. For instance, interest coverage for these companies increased to 3.7 in fiscal 2021 from 2.7 in fiscal 2015.

Chart 7: Median gearing

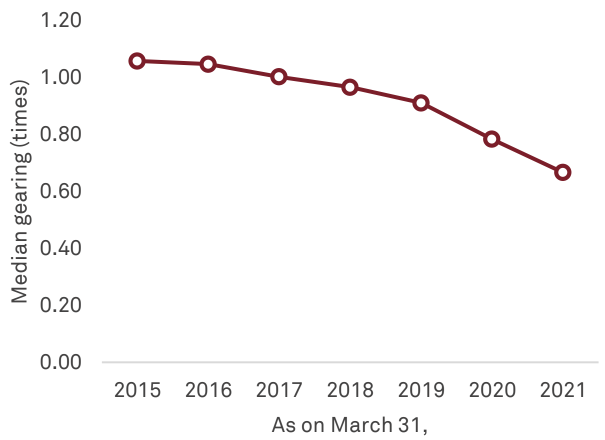
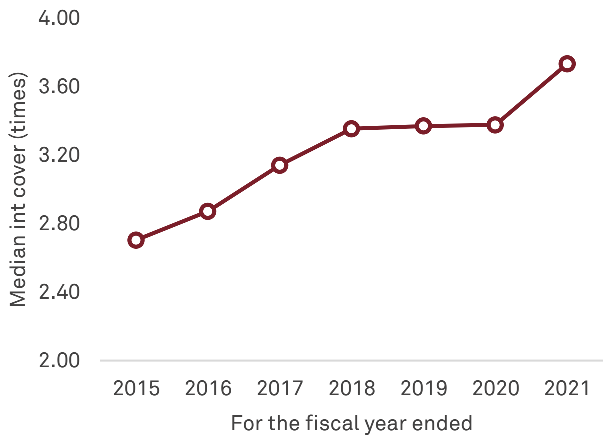


Chart 8: Median interest coverage



In the steel sector, improved realizations and capacity utilization augmented cash flows and, thus, helped trim debt. Spurred by high demand and optimum capacity utilization, a few steel players have also announced brownfield capex.

The textile sector had mixed fortunes with healthy export demand but subdued domestic demand, which kept capex low. Additionally, with prudent working capital management, gearing declined in fiscal 2021 and should remain low this fiscal. Gearing of auto manufacturers (PVs/ two-wheelers) has declined over the past few years due to negligible debt-driven capex, but increased last fiscal (mainly in the two-wheeler segment). However, with capex planned in fiscal 2022 to be funded largely through internal accruals, the deleveraging trend should continue. While cash flows were constrained in the educational services sector last fiscal, strong balance sheets and liquidity cushion contained the impact.

As the below table shows, decrease in gearing trend is evident in most of the key sectors.

Sectors	2016	2017	2018	2019	2020	2021
Decreasing gearing						
Auto components						
Construction & Engineering						
Education Services						
Fertilizers & Agricultural chemicals						
Healthcare*						
Hospitality						
IT						
Packaging						
Pharmaceuticals						
Chemicals - specialty						
Steel						
Textiles (overall)						
Increase in gearing in Fiscal 2021						
Auto 2W/PV/CV						
Automotive Retail						

*Healthcare includes hospitals and other services

The legends depict the delta in gearing vis-à-vis previous year

Legends	Delta change in basis points	Colour scale
Increase in gearing	Greater than 0.1	
Marginal increase in gearing	Between 0 and 0.1	
Marginal decrease in gearing	Between 0 and 0.15	
Decrease in gearing	Greater than 0.15	

Conclusion

Over the past 18 months, Indian corporates have adapted fairly well to the turbulence caused by the pandemic and majority of the businesses are expected to fully recover by the end of this fiscal. Demand recovery should sustain in most sectors on the back of strong economic growth, both domestic and global, and localized and less stringent containment measures, which should keep domestic demand buoyant even if there is a third wave.

Besides regulatory relief measures (Restructuring framework 2.0 and extension of the ECLGS scheme), a secular deleveraging trend has provided India Inc the balance sheet strength to cushion the impact of further disruptions.

Till mid-September, India had administered almost 77 crore vaccine doses. The vaccination rate has also accelerated considerably over time. Around 20% of the adult population is fully vaccinated, while nearly 70% has received at least one dose. High vaccination will be pivotal to avoid pandemic-related disruptions and usher back normalcy in various segments of the economy.

All said, India Inc is on a much stronger footing to counter the risks related to a resurgence of the pandemic.

Let's now look at the credit quality outlook for the financial sector.

Credit quality outlook for the financial sector

Bank credit growth to rebound, regulatory support to limit rise in NPAs

Bank credit growth is seen increasing to 9-10% this fiscal as the Indian economy recovers with demand uptick across sectors as well as budgetary stimulants from the Indian government and measures by the RBI. In fact, dispensations announced last fiscal enabled bank credit to expand ~5% in the fiscal despite the sharpest contraction in the Indian economy since Independence.

That said, corporate credit, which forms almost half of overall bank credit, was muted last fiscal as companies put their capex on the backburner. Also, sizeable incremental lending by banks to corporates had happened through the investment book because of availability of low-cost funds under Targeted Long Term Repo Operations (TLTRO) and Partial Credit Guarantee (PCG) windows, which kept corporate credit subdued. Nevertheless, the government's infrastructure push and likely revival in demand are expected to increase credit to this segment by 5-6% this fiscal.

Retail segment growth, which also slowed last fiscal, is expected to return to the mid-teens this fiscal. Within retail, housing loans, which continue to constitute more than half of retail advances for banks, saw slow growth last fiscal. However, fundamentally, demand for housing remains strong over the long term, and the rising affordability and recent trend of working from home is also increasing demand for own houses and larger houses than was the case in the past. Here, banks will benefit from lower competition from non-banks as well as surplus liquidity.

Micro, small and medium enterprise (MSME) loans, riding on the government's stimulus package — particularly the Rs 3 lakh crore ECLGS — had increased 8-9% on-year last fiscal; and the trend should continue given the enhancement of the ECLGS to Rs 4.5 lakh crore.

Overall, the recovering economy, along with the government's budgetary stimulants, will drive credit growth this fiscal. However, the extent and distribution of rainfall and another surge in Covid-19 cases leading to lockdowns and other containment measures and their demand impact pose downside risks.

On the asset quality front, the economic trajectory last fiscal pointed to a sharp rise in non-performing assets (NPAs). But, reported numbers reveal that this fear did not come true, mainly because of supportive regulatory and legal pronouncements, including a six-month debt moratorium and restructuring measures and a standstill on NPA recognition till March. NPAs are expected to increase to 8-9% by March 2022, though, from ~7.5% in March 2021, largely due to slippages in the MSME and retail loan segments, which have been impacted the most due to the pandemic's second wave. But Restructuring 2.0 and enhancement of the ECLGS quantum should rein a further rise in NPAs. Also, institutionalisation of National Asset Reconstruction Company Ltd and/or resolution of a few large ticket accounts would prevent a sharp rise in NPAs.

Given the restructuring dispensation, it is also important to look at stressed assets —i.e., gross NPAs and restructured assets —which were ~9% as of March 2021, almost 100 bps higher than that as of March 2020. Here, taking into account Restructuring 2.0, it is expected that the stressed assets should settle at 10-11% as of March 2022.

At the same time, the performance of the restructured portfolio is a monitorable. That said, it may not be comparable with the earlier experience of restructuring in the corporate portfolio, wherein there were sizeable slippages. The entry barriers to restructuring this time are far more stringent, which will likely ensure that by and large it is accounts that are viable post restructuring are the ones that actually get the benefit, while the rest will be allowed to slip into NPAs. Therefore, the risk of incremental slippages from the restructured portfolio this time around should be much lower.

Consequently, the profitability of the banking sector is set to improve over the medium term. Public sector banks (PSBs) turned profitable last fiscal after five years of losses. Provisioning coverage ratios have improved significantly in the past few years, thereby strengthening the balance sheets.

In terms of capital levels for absorbing asset-side risks, leading private sector banks continue to be well-placed. For PSBs, too, there has been a significant uptick in capital ratios, supported by capital infusion by the government as well issuance of hybrid bonds.

Overall, banks are expected to exhibit reasonable stability in credit quality. For private sector banks, this will be driven by strong capitalisation, while PSBs will continue to benefit from government support. However, privatisation of two PSBs as announced in Union Budget 2021-22 will be a monitorable.

Non-banks: Capital buffer and liquidity cushion provide comfort to credit quality; Asset quality performance in second half a key monitorable

Non-banks have in the past three years focused on shoring up liquidity buffers, and creating a strong capital base and an adequate provisioning cover. Liquidity buffers are estimated to have improved over the last fiscal, driven by improvement in collections and increased fund raising on account of several government initiatives. Non-banks have raised substantial capital in the past two years, which has kept leverage in control.

However, post signs of recovery towards the fourth quarter last fiscal, asset quality challenges for non-banks[5] resurfaced amid the fierce second wave of the pandemic in the first quarter of this fiscal. Collection efficiencies were impacted across segments by localised lockdowns, albeit the impact was not as pronounced as last year. MSME[6] finance, unsecured loans and wholesale finance were the most impacted. Consequently, asset quality metrics deteriorated, with gross NPAs rising 150-300 bps in June 2021 over March 2021. This could also be attributed to the lack of moratorium on debt servicing this fiscal, unlike last year when the moratorium had kept asset quality metrics in check.

Nevertheless, since July 2021, with steady easing of lockdown restrictions and uptick in economic activity, collection efficiencies have improved, and are estimated to have touched by September 2021 levels seen in the fourth quarter of last fiscal. The improving collection efficiencies are expected to arrest the slide in asset quality metrics in the near term.

The sustainability of the improvement in collections efficiencies, and, therefore, the asset quality metrics, remains a key monitorable, though. In this milieu, restructuring under Restructuring 2.0, although still limited

[5] Non-banking financial companies, including housing finance companies and microfinance institutions
[6] Micro, small and medium enterprises

as Non-banks will remain cautious in extending restructuring, is expected to have more takers than Restructuring 1.0.

Non-banks will likely stay cautious this fiscal and focus on traditional asset classes, such as home loans, vehicle finance and gold loans, with unsecured loans and wholesale finance expected to continue to lose favour. Nevertheless, with the rebound in economic activity, assets under management of Non-banks should grow 6-8% on-year this fiscal compared with 2% last fiscal.

At an overall level, segmental performance will differ going forward:

- Home loans, the largest segment for Non-banks, are expected to be the core focus area supporting growth this fiscal. However, growth is expected to be lower than the pre-pandemic level owing to intensified competition from banks. On the asset quality front, home loans have been resilient even during the second wave. While asset quality metrics did weaken, a stronger rebound and roll-back in delinquencies is expected, given that more than two-thirds of the portfolio constitute loans to the low-risk salaried segment
- Growth for vehicle finance, the second-largest segment, is expected to be better this fiscal, albeit lower than the pre-pandemic days, as Non-banks continue to adopt tighter underwriting standards in the backdrop of the impact of Covid-19 on cash flows. However, the impact on asset quality is likely to be transitory, and collection efficiency should continue to rise in the next few quarters as economic activity improves. The stress in this portfolio is likely to be limited to sub-segments such as tourist bus, school bus and commercial car loans
- In the MSME and unsecured loan segments, which have been growth drivers for the sector in the past, Non-banks remain cautious given the challenges faced by borrowers in these segments. For unsecured personal loans especially, credit bureau scores reflect increased delinquencies across bands, and, hence, there was no meaningful delinquency differentiator during the second Covid-19 wave. These segments saw declining disbursements last fiscal because of the cautious stance of Non-banks. While growth is expected this fiscal, it will be lower than that before the pandemic. Asset quality in these segments continue to be impacted the most, with delinquencies rising almost 300 bps in June 2021 over March 2021 even amid higher restructuring and write-offs last fiscal compared with other asset classes. Delinquency levels for these segments will remain elevated given the expectation of higher recovery period for borrowers therein.
- Operations of the microfinance sector had revived towards the end of last fiscal, but were impacted again in the first quarter this fiscal by the second wave of the pandemic. As an immediate aftershock, monthly collection dropped to ~75% in May from over 90% in March. Nevertheless, it started to revive from July, thanks to gradual lockdown relaxation. The pace of disbursement also bounced back — it was negligible until June as the primary focus was on collections. The second wave of the pandemic severely disrupted cash flows of many borrowers. As a result, the 30+ portfolio at risk more than doubled to ~15.00% as of June 2021 from 6.85% as of March 2021. Considering the rise in delinquencies and likely restructuring by microfinance institutions (MFIs) under Resolution Framework 2.0, higher-than-normal provisioning is warranted even in the first half of this fiscal to absorb future credit shocks. The performance of the restructured portfolio, besides the overall loan book, will have a bearing on delinquencies in the coming months.

Performance on asset quality and its impact on earnings, though, will remain key monitorables. In this setting, the spread, intensity and duration of a third wave of the pandemic, if and when it comes, will bear close watching.

Securitisation pool collections improve with lifting of restrictions

Following the relaxation of restrictions on movement of goods and travel with the abating of the second wave of Covid-19 infections, collection ratios in securitised pools rated by CRISIL Ratings have started to improve, as seen from the July and August 2021 pay-outs[7]. This rise in collections has been seen in various asset classes, including mortgage, CV, two-wheeler, and small and medium enterprise (SME) loans.

CRISIL Ratings consistently tracks the monthly collection ratio (MCR; = collections excluding prepayments as a % of billing for the month) for all transactions rated by it. The broader market, including banks, originating Non-banks (includes housing finance companies and MFIs), investors in securitised pools and intermediaries such as deal arrangers, view MCRs as the barometer of underlying economic activity, especially since the outbreak of the pandemic.

Demonstrating their resilience to disruptions in economic activity, median MCRs in mortgage-backed securitisation (MBS) pools rose to near-100% — their pre-pandemic normal — in the pay-out months of July and August 2021 (see charts below). These pools, with home- or property-backed loans as underlying, had also withstood short-term issues in the months immediately after the pandemic-induced restrictions came into effect in the first quarter of fiscal 2021.

Other asset classes, too, showed remarkable recovery in collection ratios in recent pay-out months among asset-backed securitisation (ABS) pools. Median MCRs for CV pools for the August 2021 pay-out touched 100%, almost in-line with the April 2021 pay-out MCR of 101%. For SME loan pools, MCRs that had declined to ~86% and 78% in May and June 2021 pay-outs, respectively (from 98% in April 2021 payouts), rose to 90% in August 2021. The launch of government schemes for SMEs to have aided this recovery.

For two-wheeler pools, collection ratios moved up to 98% in August 2021 pay-outs (almost in-line with the April 2021 pay-out ratio of 99%), helped by the government's focus on rural areas and agriculture. April 2021 pay-outs, denoting March 2021 collections, saw higher MCRs, as is typically seen every year as collection teams go all out to ensure a high level recovery of dues at the fiscal end.

Impact on ABS pool performance

In ABS pools, median overdues and delinquencies declined sequentially in April 2021 pay-outs as collection teams redoubled efforts at the end of last fiscal. However, as infection rates rose and restrictions were reintroduced, collection ratios reduced, and there was a spike in overdues in the May and June 2021 pay-outs. As a result, credit enhancement was utilised in nearly 30% of the pools in the June 2021 pay-outs. However, as restrictions eased, many of these pools had higher collections that helped replenish the credit enhancement levels.

[7] Data is with a month's lag; so July and August pay-out data refers to collections made for June and July, respectively

Particulars	Pay-out months				
	Mar-21	Apr-21	May-21	Jun-21	Jul-21
Median 0+OD	1.4%	1.3%	1.5%	1.8%	1.6%
Median 90+DPD	1.6%	1.5%	1.8%	2.4%	1.8%
Pools witnessing credit enhancement utilisation	24%	22%	26%	30%	25%

**Pools witnessing credit enhancement utilisation indicates proportion of transactions where outstanding credit enhancement is less than stipulated (as per transaction structure) at the end of the specified payout month.*

Impact on MBS pool performance

MBS pools have demonstrated their resilience even amid the second wave, with 0+ overdue and 90+ days past due (dpd) levels well under control. This can be attributed to the heightened collection efforts by originators, increase in digital collections and priority attached by borrowers to repayment of mortgage-backed loans.

Particulars	Pay-out months				
	Mar-21	Apr-21	May-21	Jun-21	Jul-21
Median 0+OD	0.1%	0.0%	0.1%	0.1%	0.1%
Median 90+DPD	0.0%	0.0%	0.0%	0.0%	0.0%
Pools witnessing credit enhancement utilisation	18%	11%	14%	14%	14%

**Pools witnessing credit enhancement utilisation indicates proportion of transactions where outstanding credit enhancement is less than stipulated (as per transaction structure) at the end of the specified payout month.*

Regulatory dispensations

The RBI had announced a Covid-19 Regulatory Package during the first wave of the pandemic, which offered a moratorium to borrowers on debt obligations due between March and August 2020. This was critical for many borrowers, especially given the nationwide lockdown, as it helped conserve cash in times of uncertainty. However, there was no blanket and overarching moratorium scheme during the second wave of the pandemic this fiscal. Furthermore, there has been limited demand for restructuring of obligations among borrowers in securitised pools. This may be because of the localised nature of restrictions in contrast to the complete shutdown last fiscal, and borrowers were somewhat experience and hence better prepared to handle the fallout of the disruption in economic activity this fiscal.

Trend in securitization market activity and outlook

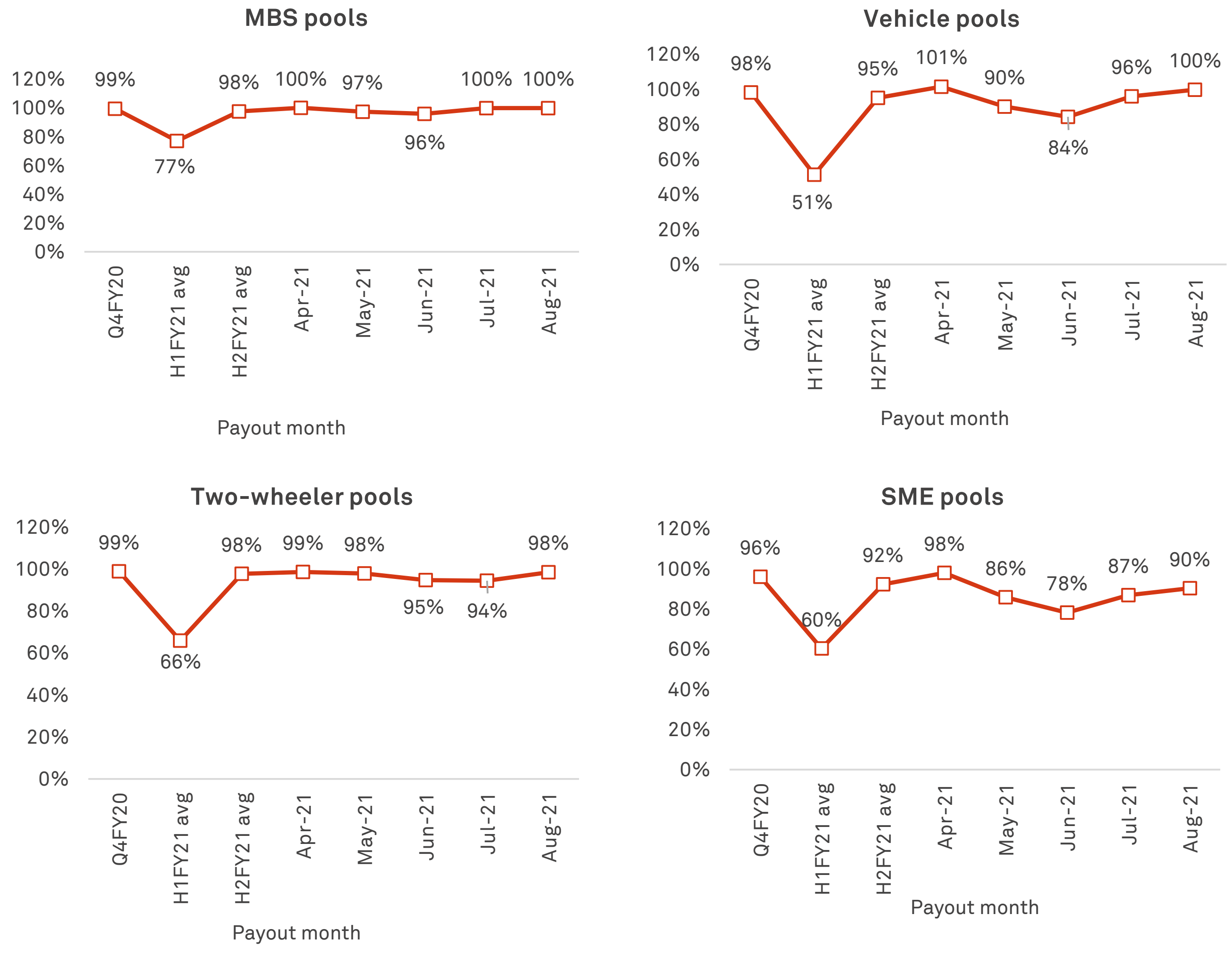
Securitisation volume in fiscal 2021 was a pale shadow of what it was before the pandemic. In the first quarter of this fiscal, volume was Rs 20,000 crore, higher than Rs 6,200 crore in the first quarter of last fiscal, given only the localised disruption in business activity. However, this is less than half of the quantum seen in several quarters of fiscals 2019 and 2020. Most transactions in this segment continue to be structured as 'timely interest and ultimate principal' to reduce the risk of falling collections on the credit quality of the issuance. As collections pick up, securitisation volume will likely see an uptrend. However, restoration of investor interest will be contingent on stability in collections and demonstrated resilience of collections to any disruption in economic and business activities across asset classes and portfolios amid the threat of a third wave of Covid-19 infections.

Conclusion

Collection ratios of securitisation pools have displayed susceptibility to restrictions introduced to contain the pandemic spread. However, contraction in activity during the first quarter of this fiscal was far less pronounced across asset classes as compared with the impact seen during the first wave last fiscal. Nevertheless, a potential third wave of the pandemic and consequent containment measures will be monitorables for all rated securitised pools. Any rise in delinquencies or increased stress in the portfolio of originators seeping into the performance of securitised pools will also need to be assessed on an ongoing basis.

Apart from the performance of businesses, the pace of vaccinations will bear monitoring. Other factors such as supportive government policy will be crucial influencers for the securitisation market.

Chart 9-12: Collection ratios in securitisation transactions rated by CRISIL Ratings



Source: CRISIL Ratings

Epilogue

The second wave of Covid-19 hit India hard, causing immense pain. However, its impact on the credit profiles of India Inc was not as severe as a year ago. The first half of fiscal 2022 was marked by sharp recovery of demand – both global and domestic, elevated government spending and strong government and regulatory support. Besides regulatory relief measures, a secular deleveraging trend also provided corporates the balance sheet strength to cushion the impact of further disruptions.

The pace of upgrades accelerated in the first half, prompting CRISIL Ratings to revise its credit quality outlook for the fiscal in August to 'positive' from 'cautiously optimistic.' The sharp recovery in demand draws on the fact that containment measures were localised and not as stringent as the first wave.

A study of sectors contributing to around 75% of our rated debt substantiates the improved credit environment, with almost 88% of the debt being in sectors that are fully recovered. However, certain contact-intensive service sectors such as hospitality, retail and education services are still a long way from pre-pandemic levels.

As the Indian economy recovers with demand uptick across sectors as well as budgetary stimulants, bank credit growth and AUM under Non-banks are poised to improve in fiscal 2022. However, slippages in MSME and retail are set to increase the NPAs of banks to 8-9% by March 2022 from ~7.5% in March 2021.

The key monitorables from here would be an intense third wave which could impact the demand drivers. Small businesses, in particular, will be more vulnerable to any slack in demand. However, nearly 70% adults having been vaccinated with atleast one dose and increasing pace of vaccinations is expected to contain impact on demand in case of a third wave.

As rate of inoculations and coverage of vaccinations increases across eligible Indians, the India Inc's credit profiles are also seen building immunity to the pandemic!

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