CRISIL
An S&P Global Company

Ratings Round-Up
Second-half of fiscal 2019

Credit ratio edges up, some headwinds ahead

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Executive summary

CRISIL's credit ratio – or the number of upgrades to downgrades – at 1.81 in the second half (H2) of fiscal 2019, is marginally up from 1.68 in the first half.

There were 594 upgrades and 328 downgrades in the second half, a period marked by rebound in exports, and continued government spending.

Nearly 60% of the upgrades were in investment-linked and export-linked sectors. The former benefited from government spending on infrastructure, while benign global growth, weaker rupee and easing of GST glitches helped up exports.

The positive trend in credit ratio is also consistent with asset quality as seen in the banking sector, where incremental slippages in non-performing assets declined sharply to 3.7% in H2, compared with 3.8% in H1 and an average of ~6% in fiscal 2017 and 2018.

CRISIL's debt-weighted credit ratio stood at 0.89 in H2, a dip from H1, primarily on account of downgrade of two large telecom companies[1]. Shorn of these two, which accounted for nearly 56% of downgraded debt by value, the ratio was higher at 2 times.

Among consumption-linked sectors, brick & mortar retailers and consumer goods companies are well-positioned to benefit from demand growth, especially in the value segments. Auto component makers will continue to gain from more stringent emission norms and other regulations for vehicle makers.

While increased private consumption supported by budgetary announcements augur well for the fiscal 2020 credit outlook, some headwinds are gathering. We expect moderation in the credit ratio as global growth slackens and pace of government infrastructure spending slows.

Slower growth in government spending on infrastructure also means investment-linked sectors such as construction, engineering, steel, and construction equipment will see only moderate buoyancy. Demand in real estate remains weak and refinancing risks also cloud the overall outlook. And competitive pressure is unlikely to ease for telecom operators with the newest entrant expanding into more segments.

Among export-linked sectors, weak demand and constrained credit access will be a drag on the gems & jewellery sector, even as pharmaceuticals (especially

[1] The debt of telecom firms does not include the liability to the Government of India towards spectrum charges

bulk drugs and shrimp segments), will continue to benefit over the near-to-medium term from global capacity and supply constraints.

Exports performance in fiscal 2020 will also be a function of how Brexit pans out and the US slows.

In the financial sector, non-performing assets in banking are set to decline with fewer fresh slippages. Infusion of capital, emergence of public sector banks out of the Prompt Corrective Action framework, and sharper focus on retail credit will help banks move into a higher growth trajectory.

The liquidity squeeze in H2 following default by a large non-bank (not rated by CRISIL) has hampered the near-term outlook for select non-banks, even as most others have already reoriented their resource profiles by reducing reliance on short-term borrowings and focusing on asset-liability maturity management. Growth for non-banks will be lower than that seen before September 2018 as they seek to conserve liquidity.

The role of quality in credit assessments and ratings becomes even more critical as the environment turns cautious from a credit outlook point of view. Therefore, it is imperative that lenders and investors focus on quality metrics as they differ across providers. CRISIL's default and stability rates have remained rock-solid in this environment, and are a testimony to our analytical rigour and proactive surveillance.

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 the underlying economic and business trends.

This edition analyses CRISIL's rating actions in the six months through March 2019.

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.

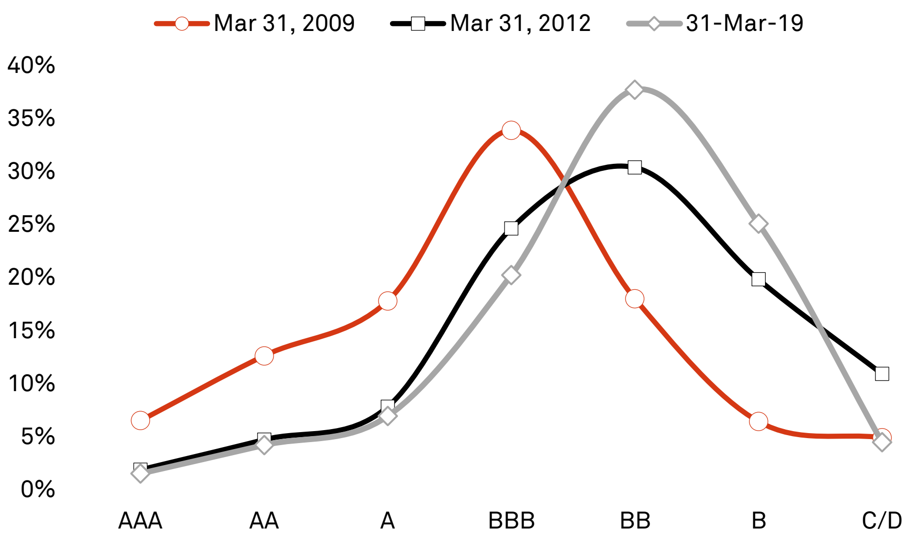
CRISIL's portfolio and median rating unchanged

Ratings outstanding on over 11,000 issuers

Median rating remains in the 'CRISIL BB' category

Over the past five years, CRISIL's portfolio of outstanding ratings has been between 12,000 and 13,000[2]. Of these, 75% is in the 'BB' category or lower. Consequently, the median rating has stayed put in the 'BB' category. A decade back, this was in the 'BBB' category. The median rating had moved from 'AA' category as on March 31, 2008 to 'BBB' category by March 31, 2009, with the introduction of bank loan ratings and rapid expansion of CRISIL's portfolio, especially into the lower rating categories.

Chart 1: CRISIL's rating distribution



Source: CRISIL

[2] This excludes companies in the 'Issuer Not Cooperating' or INC category. CRISIL's portfolio had 6,397 such issuers as on March 31, 2019. If these are included, CRISIL's outstanding rating list will be of 17,729 issuers. But the median rating will remain in the 'BB' category.

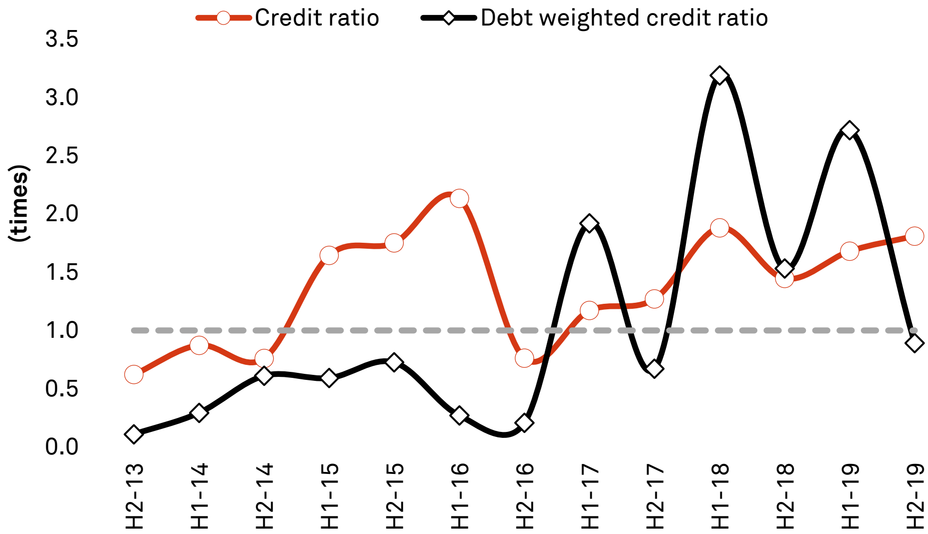
Credit ratio and debt-weighted credit ratio show divergent trend

Credit ratio and debt-weighted credit ratio[3] at 1.81 times and 0.89 time, respectively, for the second half of fiscal 2019

Credit ratio and debt-weighted credit ratio at 1.73 times and 1.65 time, respectively, for fiscal 2019

CRISIL's credit ratio and debt-weighted credit ratio were at 1.81 times and 0.89 time, respectively, for the second half of fiscal 2019 *(see chart)*, against 1.68 times and 2.72 times, respectively, in the first half.

Chart 2: Semi-annual trends in credit ratio and debt-weighted credit ratio



Source: CRISIL

[3] The debt of telecom firms does not include the liability to the Government of India towards spectrum charges for the purpose of calculation of debt-weighted credit ratios for fiscal 2019. Debt-weighted credit ratio adjusted for two large telecom firms that accounted for nearly 56% of downgraded debt stood at 2 times

Credit ratio and macroeconomic trends

While macroeconomic indicators such as gross domestic product (GDP) and Index of Industrial Production (IIP) started decelerating in the second half of fiscal 2019, a look at data sub-parameters indicate slowing but continuing pace of government investment, mild uptick in private investment, improving private consumption, and moderate growth in exports. This is consistent with the fact that 59% of CRISIL's upgrades was in the investment and export-linked sectors.

Table 1: Trends in growth of GDP and its components (in %)

	Q1FY18	Q2FY18	Q3FY18	Q4FY18	Q1FY19	Q2FY19	Q3FY19
Government consumption	21.9	7.6	10.8	21.1	6.5	10.8	6.5
Private consumption	10.1	6.0	5.0	8.8	6.9	9.8	8.4
Investments	3.9	9.3	12.2	11.8	11.7	10.2	10.6
Exports	4.9	5.8	5.3	2.8	11.2	13.9	14.6
Imports	23.9	15.0	15.8	16.2	10.8	21.4	14.7
GDP	**6.0**	**6.8**	**7.7**	**8.1**	**8.0**	**7.0**	**6.6**

Source: Central Statistics Office (CSO), CRISIL

GDP growth slowed to 6.6% in the third quarter of fiscal 2019 and to 6.5% in fourth quarter of fiscal 2019 based on advanced estimates by CSO. Data shows the slowdown has largely emanated from the agriculture sector due to the weak rabi crop and a gradual pullback of government spending even as private consumption improves. It is also important to note that the ratio of gross fixed capital formation to GDP improved on a sequential basis to 33.1% in the third quarter of fiscal 2019, the highest since the second quarter of fiscal 2014, supported by both government spending and a mild uptick in private investment.

Table 2: Trends in IIP by end-use classification (in %)

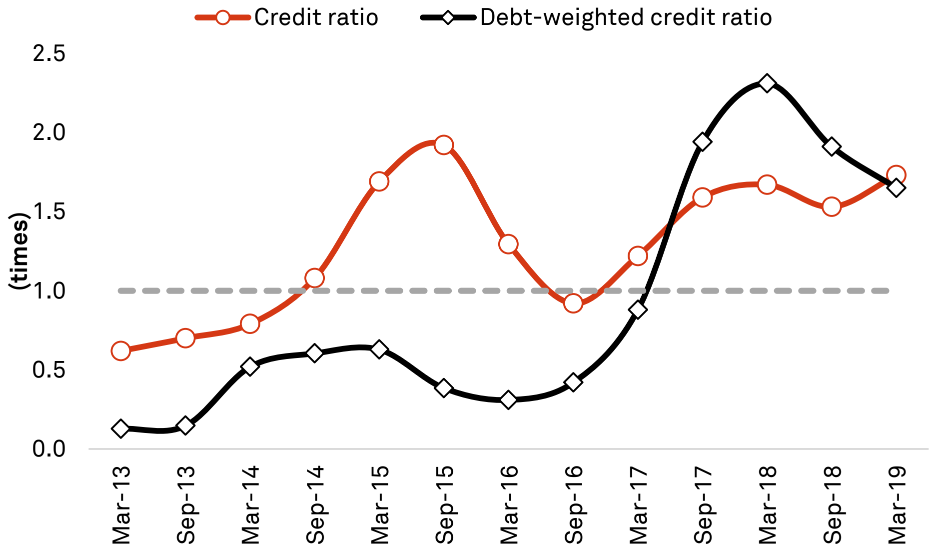
	Q1FY18	Q2FY18	Q3FY18	Q4FY18	Q1FY19	Q2FY19	Q3FY19
Primary goods	4.7	1.3	3.2	4.2	5.9	3.9	2.6
Capital goods	0.1	4.7	7.5	7.5	8.6	6.6	6.4
Intermediate goods	-1.1	1.5	4.7	3.7	0.7	1.9	-1.5
Infrastructure and construction goods	3.2	4.1	8.5	9.8	8.5	8.9	8.0
Consumer durable	-6.8	-2.4	-1.5	7.0	8.0	8.1	6.2
Consumer non-durable	6.5	8.2	16.2	10.7	1.9	6.1	4.3
IIP	1.8	2.5	5.9	6.5	5.1	5.3	3.6

Source: CRISIL Research

IIP slowed to 3.6% in the third quarter of fiscal 2019 from 5% in the preceding two quarters. The decline was led by the manufacturing and electricity sectors. According to end-use classification data, the infrastructure and construction goods sectors maintained strong growth momentum. However, the capital goods and consumer goods sectors slackened. This further bolsters the fact that continued government spending, albeit at a slower pace, has propped up demand for infrastructure and construction goods.

However, the ratio of debt of firms upgraded to those downgraded declined to less than 0.89 time, weighed down by the downgrade of two telecom companies. Excluding these two, the debt weighted credit ratio was 2.03 times.

Chart 3: 12 month rolling trends in credit ratio & debt-weighted credit ratio



Source: CRISIL

To ascertain the sustainability of, and removing bias in, the credit ratio, it is assessed on a 12-month rolling basis. For fiscal 2019, the ratio increased to 1.73 times against 1.67 times in fiscal 2018. However, the debt-weighted credit ratio declined to 1.65 times from 2.31 times.

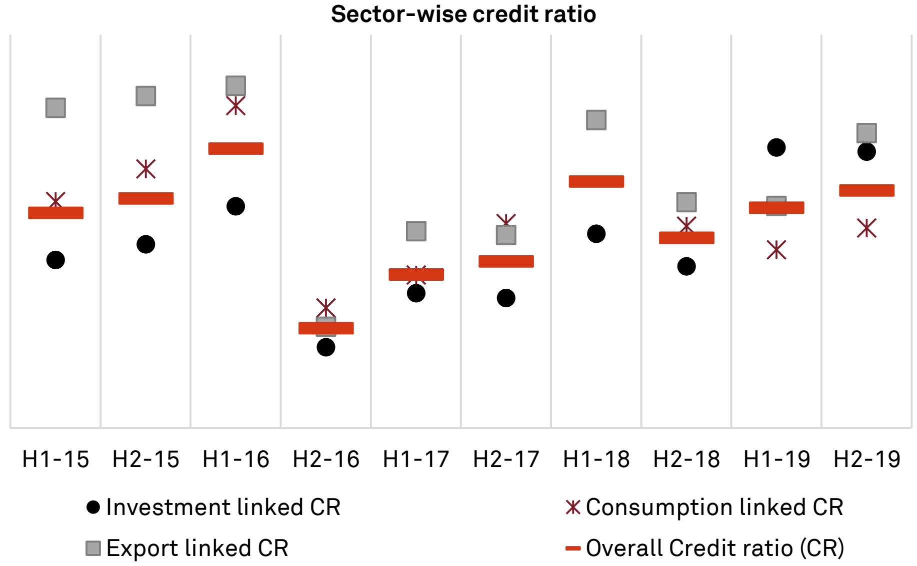
On a 12-month rolling basis, it remains above 1 time, indicating that the improvement in credit quality has sustained.

Overall, while government spending has been the key driver for rating actions, a broad-based recovery remains elusive. As government investment in infrastructure slows, revival in private consumption and capex will be critical to ensure a broad uptick in credit quality.

Government spending to continue to support demand prospects for fiscal 2020, albeit at a slower pace

Investment-linked sectors expected to continue growth momentum even as fortunes reverse for consumption and export-linked sectors

Chart 4: Trends in sector-wise credit ratio



Source: CRISIL

Investment linked sectors – Continued favourable outlook supported by government spending

In the Ratings Round-Up of September 2018, CRISIL had noted that investment-linked sectors drove the credit ratio for the first time in 5 years, because of government-led spending on infrastructure, even as private investment continued to lag, and realisations improved, especially in steel. As it can be seen from the chart above, investment-linked sectors continued to drive the credit ratio in the second half of fiscal 2019. Steel, construction, and heavy equipment sectors were key sectors where upgrades continue to largely outpace downgrades.

Outlook

The pace of government spending in investments, while continuing to be strong, slowed down in the second and third quarters of fiscal 2019 (*see Table 1*). The focus is shifting towards government consumption. Furthermore, order flow for new projects is likely to decelerate in first half of fiscal 2020 because decisions will be kept in abeyance because of the elections. With government spending on infrastructure likely to grow at a slower pace, investment- linked sectors will see only a moderate buoyancy in credit quality.

Export-linked sectors – outlook turns negative because of global economic slowdown

Export growth rebounded in fiscal 2019 driven by buoyant global economic growth, falling rupee and easing of GST-related hiccups, but there also were sector-specific drivers and constraints.

The credit ratio in the second half was driven by upgrades in the pharmaceuticals sector – majority of these were in the bulk drugs segment, which benefited from a supply disruption in China, which led to better demand for domestic manufacturers. This is expected to sustain in the near-to-medium term as Chinese players adjust to domestic policy changes. Most of the upgraded players in the bulk drugs sector derive a major portion of their revenues from export.

Textiles, especially the readymade garments segment, is a major export-driven sector. But upgrades here were mainly of domestic-focused cotton yarn manufacturers and spinners, which witnessed better demand after GST-led disruptions hampered growth in fiscal 2018. Readymade garment exporters, on the other hand, accounted for major part of the downgrades because of high competitive intensity.

Outlook

We expect exports growth to decelerate going ahead, mainly because of a slowdown in global growth and trade frictions. Major trade destinations are expected to witness slower economic growth in calendar 2019:

- **US:** Slowdown in GDP growth due to fading fiscal stimulus, cumulative monetary tightening, and trade-related issues weighing on business
- **UK and Eurozone:** Brexit will have a significant impact particularly in the current scenario with a high probability of no-deal Breaxit. Trade disruption is expected in the near term.
- **China:** Apart from trade frictions, a rise in defaults and crackdown on shadow banking will restrict growth.

Table 3 – Trends in world GDP growth

GDP growth		2016	2017	2018	2019(P)
US	%	1.6	2.2	2.9	2.5
UK	%	1.8	1.7	1.4	1.5
Eurozone	%	1.9	2.4	1.8	1.6
China	%	6.7	6.9	6.6	6.2
Advanced economies	%	1.7	2.4	2.3	2.0
Developing economies	%	4.4	4.7	4.6	4.5
Global	%	3.3	3.8	3.7	3.5

Source: IMF

International Monetary Fund (IMF) has revised its forecast for 2019, down to 3.5% in January 2019 due to persistent decline in growth forecasts of advanced economies and a temporary decline in growth rate for emerging and developing economies.

Except pockets of growth opportunity for bulk drug manufacturers, export-linked growth is expected to be weak in fiscal 2020.

Consumption linked sectors – outlook to turn around, propelled by pickup in consumption

Fiscal 2019 was a mixed bag for consumption-linked sectors. Auto components witnessed upgrades benefitting from higher spending by vehicle makers to conform to more stringent emission and other norms. So did packaged foods and meats sector, driven by better demand, especially from the US, following changes in regulations.

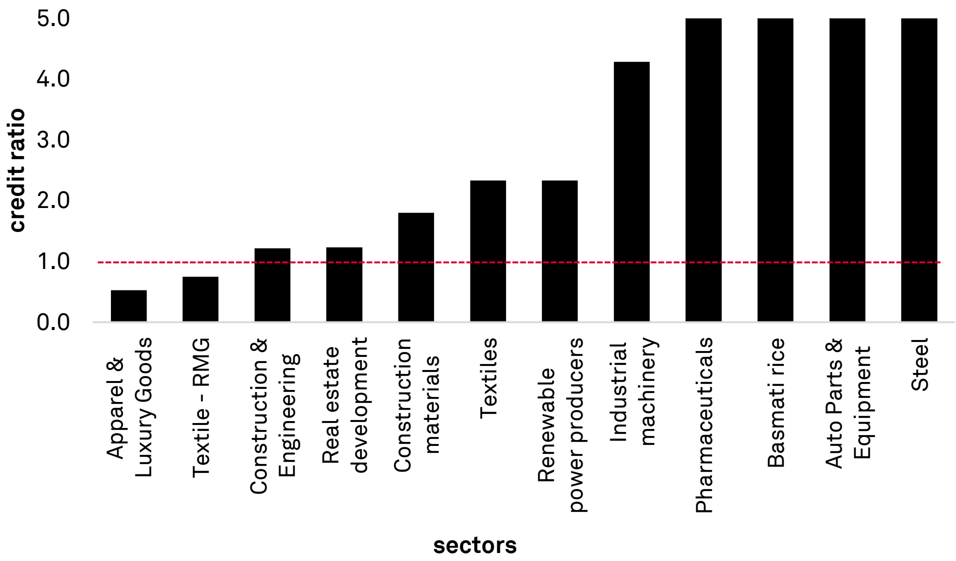
Sectors such as gems & jewellery faced lower demand and liquidity issues because of the aversion of banks to lending, leading to a decline in the credit ratio. The sugar sector, too, witnessed downgrades because of weak realisations and profitability outlook, especially for non-integrated players. However, the pace of downgrades slowed in the second half of fiscal 2019 after policy support measures.

The telecommunications (telecom) sector saw downgrades in two companies on account of heightened competitive intensity after the entry of a new player. This led the consumption-linked credit ratio to be much lower than the overall credit ratio.

Outlook

Revised GDP estimates show a pick-up in private consumption in the third quarter of fiscal 2019. The interim budget for fiscal 2020 focuses on several measures that are expected to drive up consumption. Key announcements such as PM-KISAN are expected to improve cash in hand with farmers and change in tax brackets will leave more cash in the hands of the middle-class. Thus, an uptick in private consumption is expected in fiscal 2020 leading to a positive outlook for domestic consumption-linked sectors, compared with fiscal 2019. The key risk to this expectation, however, is an El-Nino event leading to inadequate monsoon.

Chart 5: Rating actions in top industries



(Refer to the section on 'Key reasons for rating actions, and sectoral credit quality outlook' for sectoral updates). (*Textiles excludes Textiles-RMG)

Due to limited number of downgrades in Pharmaceuticals, Basmati Rice, Auto Parts & Equipment and Steel, credit ratio is well above 5 times.

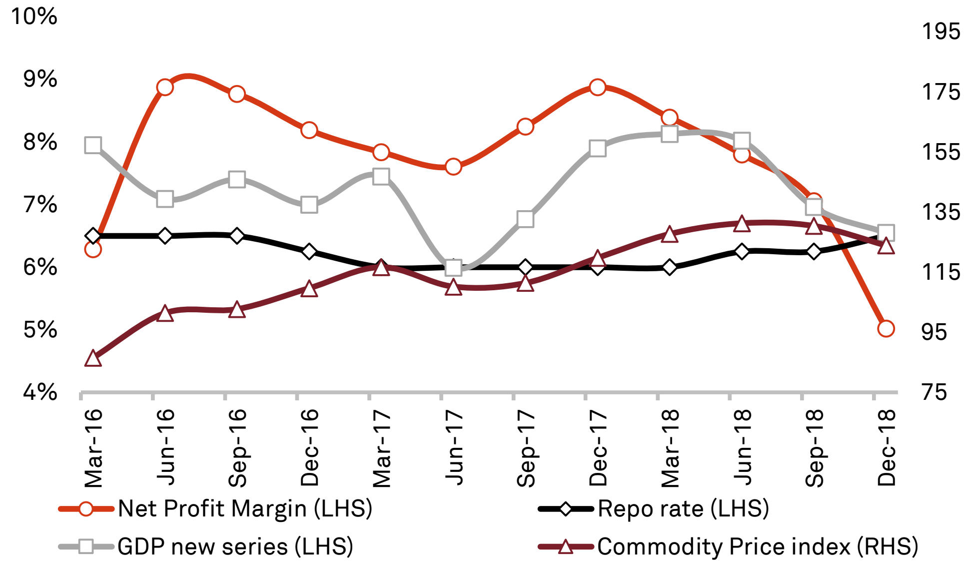
Source: CRISIL

Corporate profitability to moderate

Corporate profitability expected to moderate even as private investment witnesses a gradual pickup

CRISIL's analysis of the aggregate financial performance of 347 firms listed on S&P CNX 500 shows net profit margin (NPM) fell 500 basis points (bps) to 5% in the third quarter of fiscal 2019 from the corresponding period of fiscal 2018. This was driven by higher interest rates and sharp depreciation of the rupee in the first half, even as commodity prices remained supportive.

Chart 6: Trends in net profit margins and commodity prices



Source: CRISIL

For fiscal 2019, Ebitda (earnings before interest, taxes, depreciation, and amortisation) margins for these companies remained stable at 15-17% with commodity prices staying soft. But with prices now rebounding, Ebidta growth is expected to decelerate a touch and impact margins, especially in large sectors such as airline services, auto, cement, and construction.

In its latest review meeting in February 2019, the Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) slashed the policy rate by 25 bps, bringing the repo rate down to 6.25% from 6.5%. Going ahead, benign inflation could lead to further cuts in the repo rate, which would supporting net margins of India Inc in fiscal 2020.

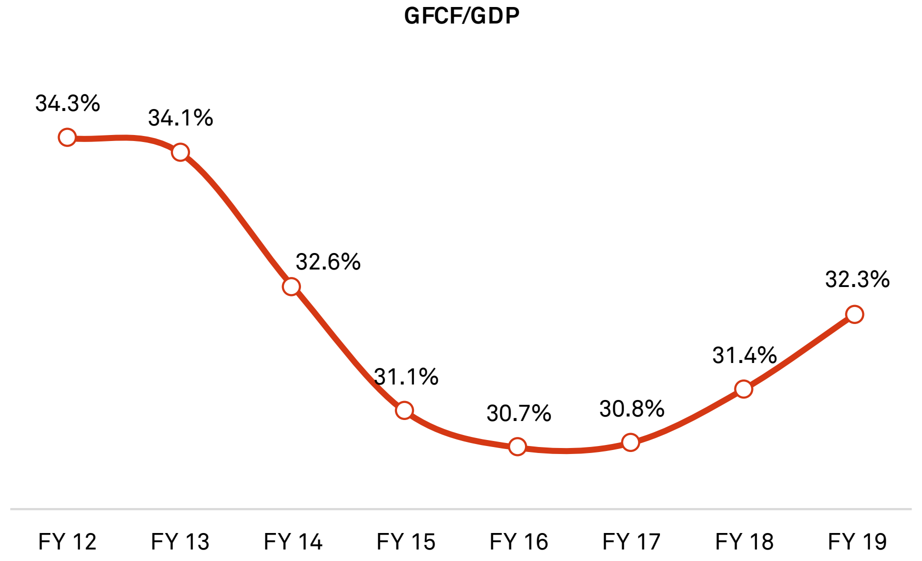
Private investments – a gradual ascend underway

Private investments could witness a gradual pick-up after sluggish growth in the past couple of years

Over the past 5 years, private investments contracted significantly with high commodity prices, muted demand and a rise in the non-performing assets.

While government spending has propped up overall investments in the past 2 years, a material pick-up in private investments has been elusive. However, some green shoots are visible in the ratio of gross fixed capital formation (GFCF) to GDP showing (*see chart below*). Growth in GFCF was in double digits in 2019 after showing sluggishness between fiscals 2012 and 2018.

Chart 7: Trends in GFCF/GDP



Source: CSO

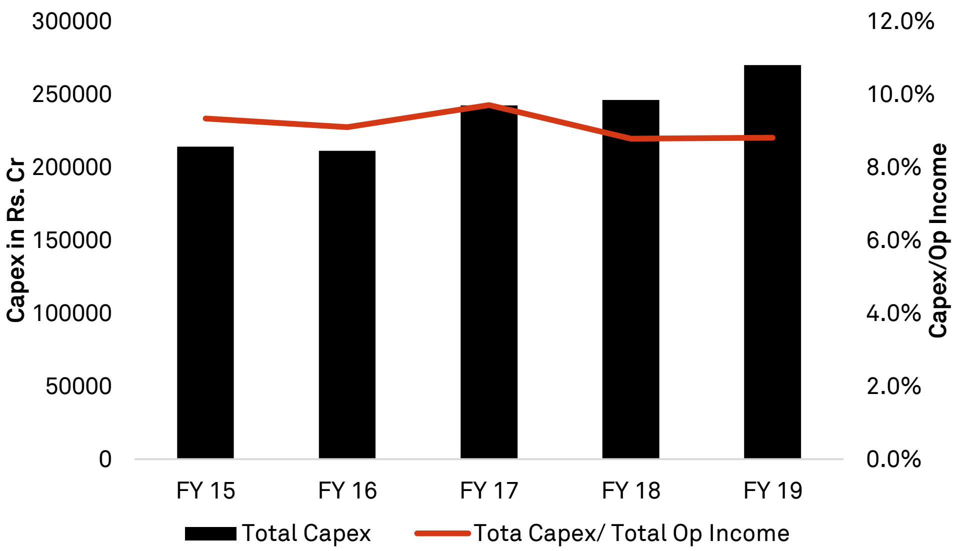
While government spending did support GFCF in the past two fiscals as well, it grew at a faster clip in fiscal 2019. This growth, coupled with a moderate uptick in private consumption in fiscal 2019, could support a rise in private investments.

In its report on '*India's Investment Cycle: An Empirical Investigation*' in October 2018, the RBI has noted in its findings that "The current upturn in the investment cycle is estimated to last up to 2022-23 when the investment rate could rise to 33.0% from the current rate of 31.4%."

CRISIL's study on a pool of 4,500 companies in 118 sectors in its portfolio indicates that capital expenditure of these companies in fiscal 2019 is estimated to have increased by nearly 12% to Rs 270,000 crore in fiscal 2019. Some of the large sectors which constituted more than 25% of capex for the period include oil & gas (including gas utilities), chemicals, construction materials, tyres & rubber, electrical components & equipment, two-wheeler makers, and soft drink manufacturers and bottlers. They constituted more than 25% of capex in the pool.

Lean balance sheets to support credit profiles

Chart 8: Trends in capex and capital intensity in CRISIL's portfolio



Source: CRISIL

However, capex intensity (or the ratio of capex to income) shows a flattish trend, indicating limited optimism on a sharper revenue growth.

CRISIL believes a broad-based uptick in private investment will hinge on a pick-up in private consumption. Any material changes to policy and direction of spending by the next government after elections, adequacy and timeliness of monsoon, and movement in crude prices will be the key monitorables as they can have an impact on private investments as well as consumption.

Strong financial risk profile to support investment pickup and credit quality outlook for fiscal 2020

In its Ratings Round-Up in April 2018, CRISIL had noted the improvement in leverage and financial risk profiles of corporates, with combined equity infusion of Rs 8.13 lakh crore[4] in the period between April 2013-December 2018 and stable operating cycles.

[4] Source : Monthly SEBI Bulletin between April 2013 to Dec 2018

Rating actions in the second half of fiscal 2019 also indicate that low leverage and favourable industry outlook were key drivers for upgrades

CRISIL has analysed the rating actions on firms during the second half of fiscal 2019, based on debt-to-Ebidta ratio (an indicator of leverage) and industry orientation. Not surprisingly, firms with favourable industry outlook and low leverage accounted for a major portion of the upgrades.

Table 4: Analysis of trends in credit ratio based on size and leverage

Debt/ EBIDTA ratio	Low leverage <2.5	Medium leverage 2.5-4.0	High leverage >4.0
Investment-linked	3.25	2.60	0..84
Consumption-linked	3.97	1.89	0.57
Exports-linked	4.44	2.50	1.20

Source: CRISIL

Furthermore, firms with larger scale and leading market positions within their segments saw the most number of upgrades. This indicates that a pervasive improvement in credit quality is still a while away.

However, lean balance sheets will continue to be critical to a pick-up in the investment and credit outlooks over the medium term.

Robust rating quality metrics through credit cycles

Not all ratings are equal

CRISIL pioneered credit ratings in India with its incorporation in 1987. Over the past three decades, credit rating agencies (CRAs) have played an important role in the domestic financial markets. From pure name or reputation-based lending, ratings have enabled risk-based lending. A simple alpha-numeric symbol has enabled stakeholders to benchmark credit across sectors and instruments in an independent manner.

Credit ratings have served the Indian markets well. However, steep downgrades in fiscal 2019 (*see Box 1*) resulted in various stakeholders raising questions around the operations and performance of CRAs – and rightly so.

In this context, this section highlights the key metrics to assess the performance of a rating agency and presents an analysis of how quality metrics of CRISIL's ratings have fared through the cycles.

Metrics to assess rating agencies

From the US sub-prime crisis in 2008 to the default by a large non-banking financial company (NBFC; not rated by CRISIL) in India in late 2018, the performance of CRAs has been debated threadbare across economic cycles. These have provided an opportunity for stakeholders to introspect and discern the difference in the performance of CRAs *because not all ratings are equal*.

Key objectives of ratings and CRAs include:

- Ensuring that as one moves up the rating scale, the probability of default decreases. This is the test of 'ordinality'
- Ensuring that higher ratings (investment grade) are more stable through economic cycles to enable investors to price credit risk appropriately
- Ensuring that the time taken to default is the lowest for the highest rating category

Key credit shocks in fiscal 2019:

- Default by a large non-bank (not rated by CRISIL). This had a domino effect on credit available to non-banks in the capital market
- Capital market fluctuations also had an impact on some highly leveraged promoter companies. These companies negotiated a standstill agreement with investors to not revoke pledged shares to enable the firms to meet their debt repayment, leaving investors in distress. CRISIL did not rate any of these promoter group deals
- Then there was a sharp rating action on the infrastructure special purpose vehicles (SPVs) of the large non-bank because of legal and non-credit risks, and driven by an unprecedented and questionable legal interpretation by their managements. Questionable because the SPVs had ample liquidity to service the repayments due. Questionable also because this was against the basic principle of project financing that legally separates and ringfences SPVs from their sponsor and other SPVs, with specific covenants protecting the payment structure and waterfall mechanism.

Based on these objectives, key metrics that can be used to assess a rating agency include:

- Default rates and ordinality
- Stability rates
- Intensity of rating actions

Each of these metrics is addressed in detail in the following sections. These need to be assessed over a long tenure to establish the performance of CRAs through economic and credit cycles.

CRISIL's ratings exhibit robust quality metrics through economic and credit cycles

In this section, we have underlined the metrics that assess if CRISIL's ratings have withstood the test of time and volatile credit environment.

Backed by highest analytical rigour, robust criteria and proactive surveillance, CRISIL's ratings have displayed best-in-class quality metrics in the Indian credit rating industry, which is evident from its lowest default rates, highest stability rates, and the lowest intensity of rating actions.

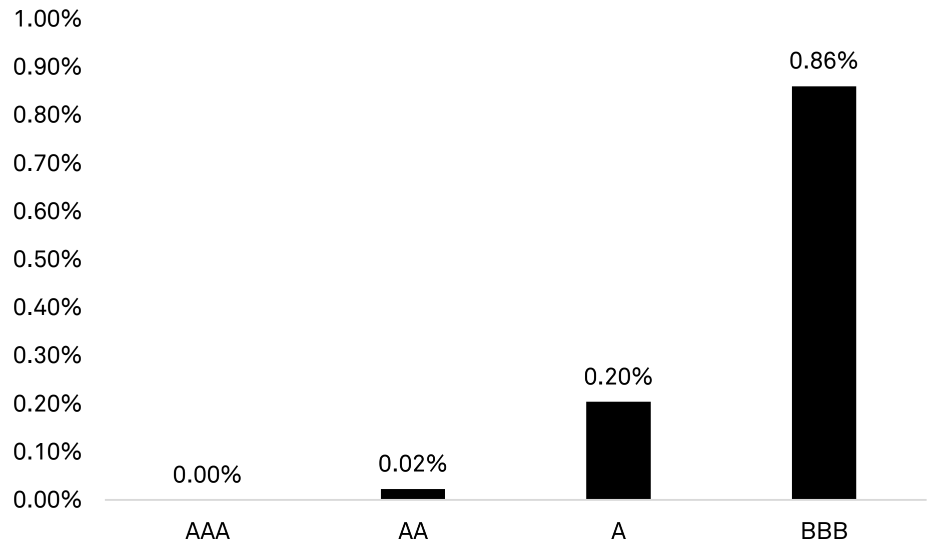
Default rates remain low even during the toughest of times

Credit ratings are opinions on default risk: The higher the rating, the lower the probability of default. An inverse correlation between credit ratings and default probability is desirable for CRAs, and is called the test of ordinality. If ratings are reliable, default rates should reduce as one moves up the rating scale.

Also, accurate and reliable default rates are critical inputs for pricing debt and loan exposures. Default probabilities associated with ratings help investors and lenders quantify credit risk in their debt exposure, and provide inputs on whether, or how much, to lend and at what price.

Default rates in investment-grade rating categories have remained low even during times of financial stress. One-year average default rates for CRISIL's AAA rating is nil over a 10 year period as can be seen in the chart below.

Chart 9: One-year average default rates (2008-18)



Source: CRISIL

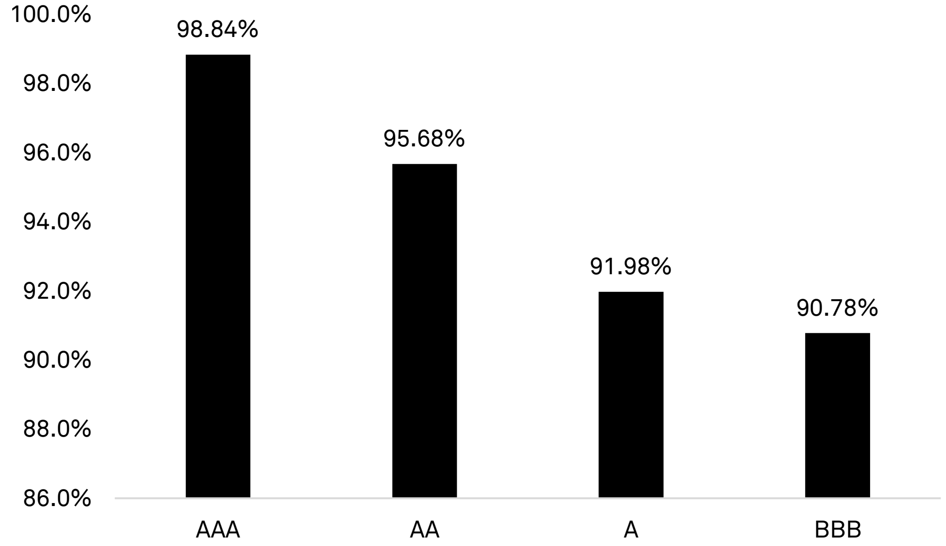
Highest stability rates

CRISIL's high stability rates help investors with their long-term investment decisions. The stability rate indicates the percentage of ratings that remain unchanged over a given time horizon.

Consistently high stability rates indicate that ratings have been assigned at the right level, *ab initio*, and that the probability of sudden changes in ratings is low. High stability rates, in other words, indicate a high probability that the ratings will not see unexpected changes over a given time horizon.

CRISIL's rated portfolio has consistently displayed higher stability rates across the industry over the past five fiscals through 2018, with average stability rate of above 95% for 'AA' and above 93% for 'A' category ratings.

Chart 10: One-year average stability rates (2008-18)



Source: CRISIL

Sharp rating actions as a percentage of CRISIL's investment grade portfolio at 0.5%

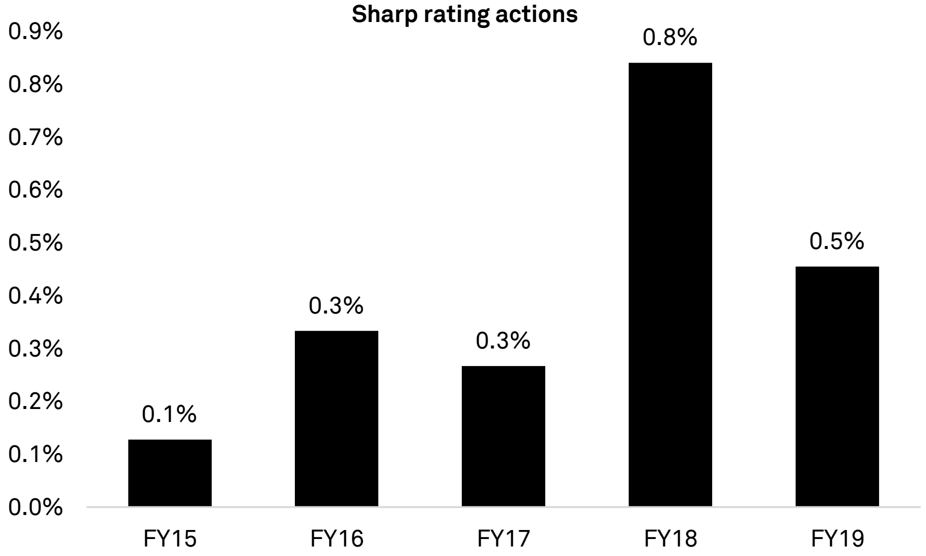
Along with stability rates, investors also consider the intensity of rating actions. If a rating is prone to sharp rating movements during a short period of time, it poses a significant risk to investors with little scope to manage their exposure.

CRISIL's focus on the quality of its ratings remains unwavering. The regularity of its surveillance minimises sudden and sharp actions (both upgrades and downgrades).

The intensity of CRISIL's rating actions has been lowest in the industry over the past five years, especially for investment-grade ratings (*see chart below*), with less than 1% of the rating actions being more than 3 notches.

For CRISIL, the intensity of sharp rating changes from investment grade fell in fiscal 2019 – a year that saw the rating industry witnessing a slew of sharp rating actions, including default by a non-bank that was rated AAA!

Chart 11: Intensity of sharp[5] rating changes from investment grade



Source: CRISIL

Robust and scalable processes at the core of the high quality of CRISIL's ratings

- CRISIL's rating process is designed to ensure that all ratings are based on the highest standards of independence and analytical rigour, and there are adequate quality controls at each stage of the rating process
- Apart from the annual surveillance, CRISIL has systems to ensure monitoring of market developments, including material events, and follow-up of repayment schedules, which helps respond to credit-related events faster. Furthermore, CRISIL undertakes analytical initiatives such as sector-level surveillance and portfolio-level surveillance to ensure that macro events are analysed and their credit impact is assessed
- CRISIL has processes to look back on rating actions that were higher than expected for the rating category, to ensure that processes are placed to avoid recurrence
- CRISIL's layered approach for proactively analysing events that could pose credit risk and for post-event analysis for misses, ensures that outstanding ratings continue to reflect the credit quality of the debt instruments and enables robust stability rates

[5] The Securities and Exchange Board of India in its circular dated November 13, 2018, mandated credit rating agencies to disclo se sharp rating actions in the investment grade category. A sharp rating action is defined as a change of more than 3 notches. Intensity is calculated as sharp rating actions to the total outstanding investment grade portfolio.

The AAA ratings debate

There has been a lot of debate recently on the supposed ease of getting n 'AAA' rating in India compared with developed countries such as the US. However, such a comparison is incorrect because:

- **The global and national rating scales serve different needs**
  Comparing global scale and national scales is akin to equating the Fahrenheit and Celsius scales.
  - Investors in developed economies consider investment options across the world. Credit risk assessments that benchmark issuers across the world on a global scale provides them with comparable information to make investment decisions.
  - A national rating scale provides a more granular benchmarking of issuers and factors in domestic realities such as support from stronger national or international parents, and from the government.
- **Depth and width of the corporate bond market make a big difference**
  - Unlike India, in advanced economies such as the US, corporate bond markets have material depth and width. The size of the US bond market is 120% of GDP, whereas in India it is 16%. Corporates in the US often choose leveraged growth over high ratings, given the availability of funds in debt capital market at reasonable rates even at lower ratings.
  - In India, large investors, including insurers and pension funds, have mandates to invest only in highly rated paper. As a result, 85-90% of the corporate bond issuances are in the AAA and AA rating categories (on the national scale). Beyond this rating category, the financial flexibility to tap capital market instruments drops drastically. Thus issuers strive to maintain balance sheet strengths worthy of high rating category in emerging markets like India and China.

We believe that it is not the lower number of AAA rated companies that determines the quality of the assessment of a CRA, but the default rates exhibited over a period of time.

No 'CRISIL AAA' has ever defaulted over one, two or three year period.

Outlook

The credit outlook turns cautious as slowing global economy will cast a shadow on exports in fiscal 2020. While the trade frictions between the US and China have eased compared with the initial apprehensions, they remain a key monitorable. Further, government spending on infrastructure is expected to decelerate as focus sharpens on consumption.

However, CRISIL expects India Inc's credit ratio to stay well above 1 time in fiscal 2020. This will be driven by likely increase in private consumption including through budgetary announcements that support improvement in rural income. Private consumption would also be bolstered if there's another spell of normal monsoon and inflation stays benign. That will provide an impetus to private investments, but a broad uptick is still a while away. Investment linked sectors will continue to benefit from slower but continued pace of government spending.

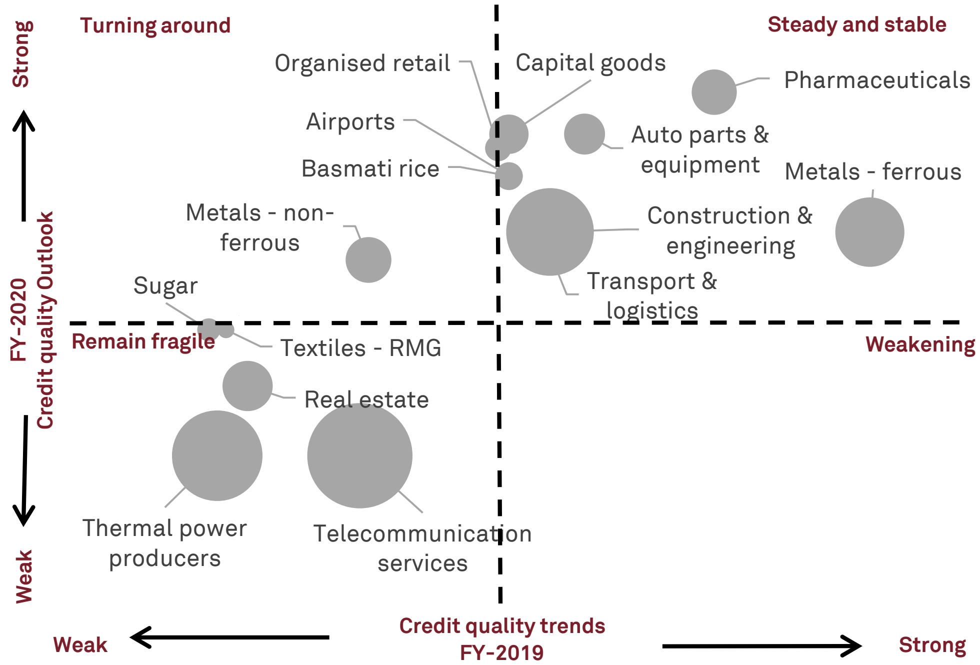
As for the banking sector, gross NPAs are estimated to have declined 100 bps to around 10% by March 2019 from 11.5% at the end of fiscal 2018. CRISIL expects bank credit to grow 14% in fiscal 2020 compared with 13% in Fiscal 2019 and 8% in Fiscal 2018. This would be driven by strong growth in retail banking and services, while corporate credit will see a gradual pick-up. Re-capitalisation of public sector banks, and many of them coming out of the PCA will also benefit the sector.

For select non-banks, the near-term outlook remains challenging because of liquidity events in the third quarter of fiscal 2019. Growth will be lower than what it was prior to September 2018 as they conserve liquidity in the near term. However, the long-term outlook is promising with growth of around 15% expected in fiscals 2020 and 2021. Traditional retail classes such as home loans and vehicle finance constitute over 50% of the overall credit. These segments are expected to see steady growth. Non-banks are also reorienting their resource profiles by reducing reliance on short-term borrowings and focusing on asset-liability management.

Overall, the risks to these expectations are

- An El-Nino event affecting monsoon and its impact on rural incomes
- Electoral outcomes leading to any change in policy towards capital spending and fiscal stance
- Extent of global slowdown, trade frictions, and the impact on trade
- Stretch in working capital cycles
- Re-leveraging because of increase in capex and acquisitions

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



Note: Size of the bubble depicts book debt in the sector of CRISIL-rated portfolio
Bubble chart for thermal power producers excludes book debt of NTPC Ltd
Source: CRISIL

Automotive components

Upgrades

Upgrades were mainly driven by business related reasons - healthy demand from original equipment manufacturers (OEMs), steady profitability. Prudent capital expenditure and working capital management ensured adequate liquidity, which, in turn, led to stronger financial risk profiles

Downgrades

Downgrades were mainly due to decline in operating margins, lower-than-expected cash accrual, and stretched working capital cycles.

Automotive components advanced towards higher growth

Automotive component demand is expected to grow at 9-11% on-year in fiscal 2020, compared with 11-13% in fiscal 2019, owing to moderation in most OEM volume as well as exports, even as aftermarket demand remains steady.

While passenger vehicle volumes are expected to grow moderately at 4-6%, commercial vehicle volume is likely to grow by 5-7% and the two-wheeler segment is expected to grow at 6-8%. Some advancement of sales due to BS VI will also aid demand.

Export demand is likely to grow at around 10% in fiscal 2020, largely driven by fairly steady Class 8 truck production volume in Europe and the US. However, passenger vehicle sales in both these regions are likely to come under moderate pressure. Global economic conditions and trade tariffs will remain monitorables.

Profitability of automotive component makers is estimated to decline by 80-90 bps in fiscal 2019 due to continued increase in raw material prices and demand slowdown in the second half. However, CRISIL expects the prices of raw materials to stabilise by fiscal 2020, which should lead to a gradual improvement in margins.

Players have already initiated investments to cater to the new regulatory norms (including BS VI and anti-lock braking systems) and healthy medium-to-long term demand potential. Many of them are also investing in new technologies/products associated with electric vehicles (EV) on account of likely focus on EV adoption in the long term. Capital expenditure is therefore expected to remain high in fiscal 2020 as well. However, healthy balance sheets and stable cash flows will provide the necessary cushion to absorb any increase in capital expenditure requirement, and higher working capital borrowing due to possible stretch in payments from OEMs, without materially denting key credit metrics

Basmati rice

Upgrades

Upgrades were largely in the non-investment grade rating category. Better demand and higher sales realisation led to stronger business risk profiles

Downgrades

Downgrades were mainly on account of stretched liquidity following the lengthening of the working capital cycle

Credit risk profiles of basmati rice exporters should remain stable over the medium term, backed by better operating profitability and stable demand.

Construction & engineering

Upgrades

Upgrades were driven by healthy growth in revenue, sustenance of a strong order book and improvement in operating margin, and supported by a better financial risk profile.

Downgrades

Most of the downgrades were due to lower profitability and/or decline in sales on account of intense competition in the roads and bridges segment. Further, a stretched working capital cycle, because of higher inventory and slower realisation of receivables, impacted liquidity, leading to a few downgrades.

Note: The credit risk profiles of many large, diversified engineering, procurement and construction (EPC) players remain 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 and is more representative of the non-stressed portion of the corporate loan book.

Investments in the construction sector are likely to clock a compound annual growth rate (CAGR) of 7-8% over fiscals 2019-2023 compared with 2.2% during 2014-2018, driven by increased construction spend in the infrastructure segment. Within infrastructure, roads would dominate construction activity (40% of the total spend), followed by irrigation and urban infrastructure.

The sector is expected to benefit from increase in projects awarded under the engineering, procurement, and construction mode. Benefits are also expected from the introduction of the hybrid annuity model, wherein project risk is shared by the awarding authority; this has improved private participation and boosted execution pace, thus improving performance of companies. Central government schemes such as the Smart Cities Mission are also expected to create new order flow.

Further, the sector is expected to benefit from initiatives such as awarding of national highway projects only after the required land is in government possession, payment of 75% of arbitration claims to private players against a bank guarantee, and the one-time fund infusion by National Highways Authority of India into stalled projects. Reforms such as premium rescheduling of projects to improve cash flows of developers, and approval of 100% exit in build-operate-transfer projects to release equity tied up by developers and reduce their debt, will further strengthen the sector.

Asset monetisation by floating of infrastructure investment trusts and equity infusion, would help improve credit risk profiles over the medium term.

Independent power producers

Upgrades

Upgrades were mainly for operational renewable assets. The upgrades were driven by a track record of healthy plant load factors (PLFs) and timely receipt of money from counterparties, thus providing higher confidence on future cash flow visibility.

Downgrades

Weaker-than-expected operating performance, lower realised tariff, and delays in commencement of operations led to downgrades.

India's thermal power sector is at a pivotal juncture. Generation companies (gencos) are being revived through structural improvements (announcements of new power-purchase agreements, coal linkage policies) and ongoing resolution of stressed thermal-coal assets in the private sector. However, stretched financial risk profiles of state distribution companies threaten to plummet the sector again into darkness.

Recent auctions of 2,500 megawatt (MW) for medium-term public-private agreements (tariff of Rs 4.24 per unit with assured offtake of at least 55%), and likelihood of auctions for additional 2,500 MW have provided the much-needed shot in the arm for gencos without assured offtake arrangements. Further, coal supply through linkages allotted under the Scheme for Harnessing and Allocating Koyala Transparently in India (SHAKTI) have eased fuel constraints to some extent, though coal availability under e-auction remains a concern.

Further, 22,000 MW of stressed, operational thermal assets are likely to see a turnaround in their fortunes in fiscal 2020 through implementation of their respective resolution plans or bidding under the National Company Law

Tribunal. Resolution of these assets was stuck in fiscal 2019 for the want of approval from all lenders and the final verdict from the Supreme Court.

These steps will bode well for the generation sector. Electricity consumption is expected to grow at a healthy 6.0-6.5% annually over the medium term. The government's continued focus on meeting its 24 × 7 Power for All objective, higher penetration of consumer electronic goods and increasing industrial consumption will be the key drivers for growth. This, coupled with a general slowdown in thermal capacity addition over the next five fiscals (around 32,000 MW is expected to be added till fiscal 2023, compared with 67,000 MW in fiscal 2013-2018), should benefit existing capacities.

The credit quality of renewable assets has been largely stable, driven by the improved performance of projects, in line with expectations. However, payment cycles from counterparties remain key monitorables.

Capacity additions were slower in fiscal 2019, impacted by uncertainty regarding pass-through of the safeguard duty mechanism and availability of transmission infrastructure.

Credit risk profiles of power generators will, however, remain exposed to their weak counterparties. Financial risk profiles of state distribution companies are expected to weaken as their operational performance under the Ujwal Discom Assurance Yojana, though improving, has still been lower than expectation. Consequently, the gap between average revenue realised (ARR) and average cost of supply (ACS) for 15 large states for fiscal 2020 is expected to increase to 30 paise per unit from 24 paise in fiscal 2019. This could result in higher dependence on external borrowing. A concerted effort on further improving operational efficiencies along with continued state support, is a must to light the way for the power sector.

Pharmaceuticals

Upgrades

Improving business risk profiles backed by stabilisation of new products and entry into new markets, stemming from steady demand in domestic and international markets, led to most of the upgrades. Majority of the upgrades were for bulk drugs manufacturers, who also benefitted from global supply constraints leading to higher revenue growth that is expected to sustain.

Downgrades

Downgrades were mainly due to subdued operating performance with lower profitability and cash accrual. A stretch in the working capital cycle of smaller players also impacted their liquidity.

Limited competition and complex generics to lead export growth over the medium term – domestic segment remains the mainstay

Revenue growth in the pharmaceutical sector is expected to recover to 11-12% over the medium term from 8-10% in last three years ended fiscal 2018. This will be largely led by formulations in domestic and regulated markets, and gradual easing of pricing pressure in the US generics market.

Domestic revenues will benefit from steady volume growth, increasing healthcare penetration and higher incidence of lifestyle diseases. 'Ayushman Bharat' – government sponsored healthcare scheme will provide growth impetus over a longer horizon. Strengthening of primary healthcare centres will be critical for success of the scheme.

In the regulated markets, formulation players launching complex drugs and receiving Para IV approvals will experience better export prospects between fiscal 2018 and fiscal 2023. Large generic players in the US have rationalized their product basket and are withdrawing from high competition products, providing an opportunity for Indian players to step up exports. Pricing pressures have abated and with steady product launches, exports to regulated markets is expected to recover to over 11%, in rupee terms over the medium term.

Short-term disruption of Chinese supplies will provide opportunity for Indian bulk drug manufacturers to grow revenues at 5-6% over the medium term, backed by better realisations which are expected to sustain over near to medium term, even as Chinese competitors adjust their businesses to new local government policies. Players are also moving to speciality segments and high-value products to counter Chinese threat.

Overall, operating profitability for large formulation players, which dipped in fiscal 2018, has seen a marginal uptick in fiscal 2019 and is expected to remain stable thereafter. On the other hand, medium and small formulation players' margins are expected to be flat. Also, margins for bulk-drug players are likely to come under pressure with low bargaining power with formulators.

Regulatory environment, rupee exchange rate and competition will continue to remain key monitorables in the sector. Credit quality for large pharmaceutical players is expected to remain stable, supported by mostly strong balance sheets, which will also allow for absorption of rising working capital levels, mainly due to extended credit period for exports. On the other hand, credit profiles of mid-sized and small players will remain moderately vulnerable to steep changes in input prices, exchange rate and competitive intensity.

Real estate

Upgrades

Upgrades were led by higher sales, advanced stage of existing projects, and improved collection efficiency leading to sizeable cash inflow. Upgrades were also aided by more-than-expected funding support from promoters and refinancing of debt resulting in improved liquidity and debt-service coverage ratios.

Downgrades

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

Already subdued demand was exacerbated by the Real Estate (Regulation and Development) Act, 2016, and GST.

The residential real estate sector has been facing headwinds for the past few years, given weak demand and thereby declining sales velocity, subdued cash collection, fewer new project launches, and large unsold inventory. Implementation of GST cut from April 1, 2019, is expected to impact near-term demand for under-construction projects.

Developers are likely to face funding challenges in the medium term, with limited flexibility to access funds from other projects and the RERA requirement of timely completion of projects. Further, access to funding has recently been affected due to liquidity issues in the non-banking financial company (NBFC) sector. As a result, the refinancing risk has increased considerably for companies relying primarily on NBFC funding.

However, uptake has been encouraging for established brands with a track record of timely implementation. Developers with better internal controls and compliance systems have successfully navigated structural changes in the sector. Unorganised/small developers have been opting for collaborations with larger established names to benefit from their processes and financial flexibility.

Demand is expected to recover gradually over the medium term, especially in the affordable housing segment. The government has budgeted a 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, with limited additional supply, occupancy has remained steady and rentals are expected to stay healthy driven by improving business conditions.

The retail sector continues to see strong traction, given the healthy performance of established retail malls across India. This has attracted large foreign institutional investors. Real estate investment trusts 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 driven by the improvement in business risk profiles – healthy demand leading to better capacity utilisation and higher realisation due to increase in domestic steel prices, resulting in larger cash accrual.

Downgrades

Downgrades were mainly driven by stretched working capital cycles due to increase in receivables. Liquidity was also stretched because of high bank limit utilisation.

Note: The analysis below excludes stressed assets with banks and is more representative of the non-stressed portion of the corporate loan book.

The credit quality of steelmakers is expected to remain stable despite narrowing of margins by up to 100 bps, and moderation of domestic demand to 5-6% in fiscal 2020 from an average 8% in the past two fiscals. This will be due to moderation in automobile sales and construction activity. However, the long-term demand outlook continues to be favourable at 6-8%, led by infrastructure investments (roads, railways, metros, and irrigation). A pick-up in affordable housing and healthy underlying growth in passenger cars and two-wheelers will also aid growth.

Decline in global steel prices led by moderation in steel demand from China and global protectionist measures will put domestic prices under pressure; prices are expected to decline by 3-4% in fiscal 2020. The spread is expected to narrow in fiscal 2020, thereby weighing on profitability. Fiscal 2019 was a strong year for the sector with large players improving their earnings before interest, depreciation, tax, and amortisation (EBIDTA) margins by 200-300 bps, driven by the strong first half.

Resolution of stressed assets and capital expenditure (capex) of around Rs 80,000 crore over the three fiscals through 2022, is likely to trigger consolidation among large players. Some small- and medium-size players continue to face liquidity issues

Textiles

Upgrades

Increase in the scale of operations due to capacity additions backed by healthy demand and a diverse client base, leading to higher-than-expected cash accrual and improved liquidity, led to upgrades.

The upgrades were mainly among ginning, spinning and weaving players (over 40% of the industry).

Downgrades

Most of the downgrades were due to weak liquidity because of lower cash accrual and a stretch in working capital requirement. As a result, there is high dependence on external borrowing.

Over 30% of the downgrades were in the readymade garments segment, Including the two investment grade defaults, out of 27 downgrades to defaults.

Domestic demand for readymade garments is expected to increase to 10.0-10.5% in 2019 against 8.7% during 2016-2018, driven by rising income levels, increased penetration of organised retail, and growing preference for readymade garments over tailor-made ones. Readymade garment exports declined in 2018 due to unfavourable currency movement and increased competitiveness of peers from Bangladesh, Vietnam, and China. Export growth is expected to halve to 3-4% during 2018-2023, from 7% in the past decade, owing to continuing stiff competition from Bangladesh, China, and Vietnam.

Overall cotton yarn demand will grow at a slower pace in fiscal 2020 at 3-4% on-year against 6% in fiscal 2019 due to weak demand in China besides slower growth in exports as China will continue to procure more from Vietnam. Unless further trade barriers are imposed by the US and China, cotton procurement from the US by China could increase, benefitting its yarn production. That's in contrast to fiscal 2019, wherein exports from India grew by around 16% on the back of higher demand from China and favourable domestic cotton prices.

In the long run, overall cotton yarn demand is expected to grow at 3% per fiscal, marginally faster than 2% in the previous five fiscals, with steady growth in domestic demand.

Profitability and the credit risk profiles of spinners are expected to remain stable in fiscal 2019 and fiscal 2020, aided by improved domestic off take, higher capacity utilisation and lower capital expenditure intensity.

Financial risk profiles of players, especially those in the organised sector, are likely to remain stable in fiscal 2020. This will be supported by healthy domestic demand and expected improvement in profitability owing to weaker rupee benefitting exports. Liquidity is also expected to benefit from the ironing out of issues related to implementation of GST.

Banks

Banks

Banks and financial institutions: Sectoral credit quality outlook

The banking sector is steadily heading towards a positive trajectory as indicated by early signs of credit growth revival and peaking of asset quality challenges, which have been key factors impacting the sector in recent years. Stringent stressed asset resolution norms of the RBI coupled with increased resolution of large-ticket NPAs under the Insolvency and Bankruptcy Code (IBC) framework have been key contributors to asset quality recovery.

The IBC has been a game changer in strengthening credit discipline and practices among the borrower and lending communities. Further, the recapitalisation of public sector banks has helped allay difficulties faced by them. Also, the bold step towards consolidation among public sector banks clearly outlines government objectives towards enhancing operational efficiencies in the sector and structurally strengthen it.

Better macro variables and steady improvement in credit risk profiles of the corporate sector are other tailwinds for the sector even as stress persists in some critical sectors. However, NPAs remain high at public sector banks and it will take a couple of years for these to reduce to levels seen before the surge in the past few years. Also, provisioning should continue to be high, which will pressurise overall profitability despite expected improvement in operating profits.

Asset quality pressures receding, hopes pinned on big-ticket resolutions under IBC

After witnessing a sharp rise in NPAs in the past few years, asset quality concerns for the sector have peaked. About Rs 14 lakh crore worth of NPAs have been recognised by banks in the past three fiscals. CRISIL estimates the banking sector gross NPAs (aggregate) to drop to around 10% by March 2019 as against 11.5% at the end of fiscal 2018. Further, CRISIL expects that the gross NPAs would improve to 8.5% by March 2020.

There are three factors at work

First, incremental slippages to NPAs are trending lower. That's because most of the existing stressed assets have been recognised as NPAs and credit quality of corporates is on the mend (on the back of firm commodity prices, stable macros, and improvement in capital structure and debt protection metrics). Second, cases under Special Mention Accounts (SMA)-2 – where loans are overdue for 60-90 days – have reduced materially, which means the quantum of stressed loans that had the potential to become NPAs in the near term have declined. Third, the expected resolution of some large-ticket NPA accounts under IBC in fiscal 2019 would improve recoveries for banks and help reduce the existing stock of NPAs.

Healthy credit offtake will support recovery in earnings

Banking credit growth has been in double digits for the past several months driven by sustained momentum in retail credit and revival in corporate credit, in part, resulting from the tightening of the bond markets. This is against single-digit growth seen in the past three fiscals. The growing credit book of banks coupled with upward repricing of loans should help support operating profitability, especially for public sector banks. This will be further accentuated as a number of them have now come out of the RBI's PCA framework and will have more flexibility in growing their loan book.

CRISIL expects bank credit to grow at around 14% in fiscal 2020 from an estimated 13% on-year in fiscal 2019 and 8% in fiscal 2018. This would be largely driven by strong growth in retail segments, followed by improved credit offtake in the corporate segment (mainly the services sector). Public sector banks, especially the ones which continue to face lending constraints due to the PCA framework and inadequate capital buffer, are expected to grow slower than the system. However, private banks, supported by strong balance sheets and a significant presence in the retail segment, are likely to grow significantly higher than systemic credit growth. As a result, CRISIL estimates the market share of these banks in the total system credit to increase to around 40% over the next three years from 30% currently.

Profitability remains subdued, though provisioning coverage is inching up

Public sector banks are likely to continue facing high NPA provisioning pressures, given the expected haircuts on resolution of stressed loans and ageing of NPAs. As a result, they will incur losses in fiscal 2019, too, albeit lower than the previous fiscal. CRISIL expects the return on assets of the banking system as a whole at 0.1% in fiscal 2019 (a negative 0.2% in fiscal 2018). It will further increase to 0.75% in fiscal 2020. Public sector banks are also expected to be back in the black after few years of losses. Any further moderation in bond yields or potential large ticket recoveries from NPAs could cushion earnings.

Nevertheless, the provisioning coverage is expected to increase to 55-60% in fiscal 2019. That will give reasonable cushion against future challenges in resolution of outstanding NPAs.

Capital infusion and the RBI's extension of timeline for capital conservation buffer tranche will help

The government has infused Rs 2.01 lakh crore of capital in public sector banks (including Rs 12,000 crore raised from the market) under the Rs 2.11 lakh crore[6] recapitalisation programme announced in October 2017. This should enable them to maintain the required level of regulatory capital under Basel III regulations. Due to higher allocation of capital towards weaker public sector banks, five of the total 11 of them have come out of the PCA category, which will enable them to resume lending. Further, the RBI's recent decision to extend the timeline for implementation of the last tranche of capital conservation buffer (CCB; 0.625% of the risk-weighted assets) under Basel III has come as a breather. CCB is the capital buffer that the banks have to accumulate in normal times to be used for offsetting losses during a period of stress.

Despite capital infusions by the government, the capital cushion of public sector banks vis-à-vis regulatory requirement remains inadequate and, hence, revival in earnings is necessary.

Most private sector banks, however, remain comfortably placed with capital ratios much above the regulatory norms under Basel III, supported by healthy accretion to net worth and demonstrated ability to raise equity.

[6] The recapitalisation plan included Rs 1.53 lakh crore of direct capital infusion and remaining Rs 58,000 crore to be raised from markets, of which only Rs 12,000 crore was raised by PSBs.

NBFCs and HFCs

Growth of non-banks to slow down

Growth in assets under management (AUM) of non-banks – comprising NBFCs and housing finance companies, or HFCs – is expected to halve to 9-10% (annualised) in the second half of fiscal 2019 because of constraints in access to funding, after a robust 20% (annualised) increase in the first half. While the recent liquidity crunch they faced is easing slowly, it is not business as usual yet. During October-December 2018, non-banks curtailed disbursements by 20-40%, especially in the non-retail segments with some players even reducing disbursements more sharply to conserve liquidity.

A subdued second half will lower AUM growth in fiscal 2019 to around 15%, compared with a compound annual growth rate (CAGR) of 18% in the five fiscals through 2018. Since March 2014, the share of non-banks in financial system credit has increased by around 500 basis points (bps; 100 bps equal 1 percentage point), reaching 18% in March 2018. The share is unlikely to change this fiscal given the expected moderation in growth.

Non-banks are expected to grow at ~15% per fiscal over fiscals 2020 and 2021. Traditional retail classes such as home loans and vehicle finance constitute over 50% of the overall credit. These segments are expected to continue to grow steadily over the medium term. Despite this, competition will remain intense, especially from the private sector banks and potentially from some large public sector banks.

However, wholesale lending – primarily, real estate developer financing and structured credit – which has been one of the growth engines in recent times, will decelerate.

Still evolving liquidity situation

The strong 18% compound annual growth rate of non-banks during fiscals 2014 to 2018 was supported by the benign interest rate environment, especially the lower cost of capital market funding.

This resulted in a changing resource mix with the share of capital market borrowings increasing considerably during this period. Within this, too, the share of short-term commercial paper (CP) increased materially to 16% for NBFCs and 12% for HFCs as on September 30, 2018, from 7% and 4%, respectively, as on March 31, 2014.

This led to a mismatch in asset-liability management profiles for entities with long-term assets, which was evident during the recent tight liquidity situation. While most non-banks had maintained adequate bank lines for these mismatches, access in a timely manner became challenging, putting the spotlight on cash and equivalents in balance sheets.

Various regulatory initiatives and measures taken to enhance availability of funds improved market sentiments to some extent in the past few months. Securitisation emerged as a preferred option for both banks and retail lenders, with volumes in the first nine months of fiscal 2019 well exceeding those for the entire fiscal 2018. The share of CPs in the overall borrowings is estimated to have reduced to ~13% for NBFCs and 8% for HFCs as on December 31, 2018.

CRISIL believes there will be a structural shift in liquidity and liability management of non-banks. In an environment where access to funding has become a function of market confidence, the quantum and quality of liquidity cushion would become a key differentiator. Non-banks are also expected to re-orient their resource profiles, with reducing reliance on short-term borrowings and stricter monitoring of asset-liability gaps. That's especially critical as some of them have become very large. There needs to be more resilience by maintaining sound liquidity policies to cushion them through business cycles.

Asset quality of retail segments is likely to remain steady, while that for wholesale segments will be the key monitorable.

Asset quality of retail segments such as home loans and vehicle loans is not expected to be materially impacted given the granularity in loan portfolios. Even within vehicle finance, while the headline gross NPAs over the four fiscals through 2018 may have shown an increasing trend with NPA recognition transitioning from 180 days past due (dpd) to 90 dpd, the like-to-like comparison of 90 dpd shows a declining trend.

Non-banks have clearly reoriented their collections infrastructure and that has helped improve the delinquency metrics despite demonetisation and challenges from implementation of GST.

On the other hand, the loan against property (LAP) portfolio has led to stress for some non-banks. Amid a tightening liquidity scenario, balance transfer cases have reduced, which could lead to manifestation of underlying stress.

With growth in the wholesale book falling sharply, there could be second-order effects on the asset quality of this book, which typically has high concentration risk. While asset quality has held up so far given the way loans are structured and closely monitored, delinquencies could increase, given that credit flow to the sector is slowing down. In the infrastructure financing book, too, till fiscal 2018, non-banks did not face the same challenges as banks did, given their lower proportion of exposure in the thermal power segment.

However, the performance of this book, especially given the recent developments, needs to be monitored. In case of real estate finance, while 30% of the book is backed by lease rentals and carries lower risk, refinance/take-out has been very prevalent in the construction finance segment, which has also reduced considerably in the current scenario. Finally, recovery of these assets could be a long process.

Margins to be under pressure

Given the recent challenges in funding access, and shift towards longer tenure funding sources, borrowing costs are expected to increase by 70-90 bps in fiscal 2019. However, the ability of players to pass on the rate increase is constrained in some segments such as home loans and new vehicle finance.

There are two factors that impact this. One is the competitive intensity, which is very high in these segments. The other is structurally some of these asset classes are fixed rate in nature so even if non-banks could increase lending rates, it would be only on fresh loans and not on the existing portfolio; vehicle finance typically comes under this category.

Consequently, non-banks will find it difficult to fully pass on the increase in borrowing costs, and overall margins are expected to be under pressure in the near term.

Notes

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CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better.

It is India's foremost provider of ratings, data, research, analytics and solutions, with a strong track record of growth, culture of innovation and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

It is 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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