



CRISIL RatingsRoundup

FH 2011-12



Slowing Demand Could Further Pressurise Credit Ratings

Rating Action Ratio already declining due to weakening profitability



About CRISIL Limited

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

About CRISIL Ratings

CRISIL is India's first, largest, and most prominent credit rating agency. CRISIL pioneered the concept of credit rating in India more than 20 years ago, and has played a pivotal role in the development of India's debt market. Today, CRISIL rates two-thirds of corporate bonds outstanding in India. As of 30 June 2011, CRISIL has rated more than 11,011 borrowers, covering around 34,342 debt instruments of a value exceeding Rs. 38 trillion. CRISIL has also assigned more than 20,000 Small and Medium Enterprise (SME) Ratings, and has the highest number of SME ratings outstanding in India.

Executive Summary

CRISIL's Rating Action Ratio (RAR, an indicator of relative frequency of its upgrades and downgrades) declined to 1.03 times in the first half (H1) of 2011-12 (refers to financial year, April 1 to March 31) from 1.10 times in 2010-11. This trend reflects an increasing pace of downgrades and a sharply declining pace of upgrades. In its earlier release in April 2011 on corporate India's credit quality, CRISIL had anticipated such a downward move, primarily on account of profitability pressures, and had also identified demand scenario as a key monitorable. Pressures on profitability have clearly been visible and are expected to continue. CRISIL believes that the slowing down of demand across a wide range of sectors over the second half (H2) of 2011-12 could reduce its RAR further.

Profitability pressures on Indian corporate entities are evident - this has resulted in an increase in CRISIL's downgrade rate to 3.1 per cent in H1 of 2011-12 from 2.9 per cent in H2 of 2010-11. The upgrade rate has also sharply moderated to 4.6 per cent in H1 of 2011-12 from 6.3 per cent H2 of 2010-11. The contraction in margins is expected to continue because of high interest rates, wage and input costs.

While the RAR has already started moving down on account of profitability pressures, CRISIL is expecting further downward pressure, primarily driven by demand moderation. Signs of demand moderation are visible. Our analysis reveals that 10 of the top 20 industries (in terms of loans outstanding of the Indian banking system) are showing clear signs of slowdown in growth.

Consumption-linked industries such as automobiles, real estate, textiles, and retail have seen significant impact on demand. CRISIL Research has cut its growth estimates for passenger vehicles close to decadal lows of 2-4 per cent. Investment demand-linked industries such as cement, capital goods, and construction have also witnessed decline in sales growth. While exports are buoyant so far, slowdown in the US and the uncertain environment in Europe are expected to result in a moderation in export growth.

If the demand moderation leads to a lower revenue growth of 15 per cent in 2011-12, CRISIL's analysis on its sample portfolio of 5500 rated companies reveals a clear weakening of credit quality of the Indian corporate sector. The interest cover ratio (measures sufficiency of an entity's operating profitability in servicing interest on borrowings) of the corporate portfolio is estimated to decline to 3.5 times in 2011-12 from 4.8 times in 2010-11.

Other increased risk factors include greater vulnerability to unhedged foreign exchange exposures, given the sharp movement in the foreign currency rates recently. Also, access to global funding may be adversely affected by increased risk aversion by global investors due to the uncertain global economy. In addition to the demand scenario, we will be monitoring these factors closely.

About CRISIL's Ratings Roundup

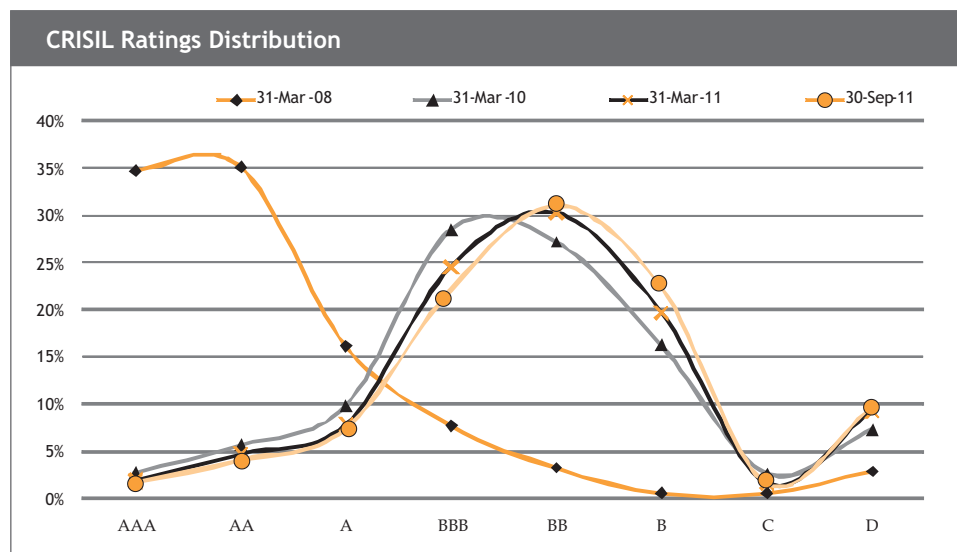
CRISIL's Ratings Roundup is a semi-annual publication that analyses CRISIL's rating actions, and traces the linkages between these actions and the underlying economic trends and business factors. Credit rating is an opinion on the likelihood of timely future debt repayment; therefore, an analysis of rating actions in a large and diverse portfolio of rated entities is a good indicator of economic prospects. The current issue analyses CRISIL's rating actions in the six months through September 2011.

CRISIL's portfolio continues to expand: Outstanding ratings double in 18 months

CRISIL's portfolio of outstanding ratings has been expanding over the recent years. It continued its growth in the first half of 2011-12, and doubled to around 7300 ratings as on September 30, 2011, within 18 months from 3627 ratings as on March 31, 2010. The expansion in the rating portfolio has also been accompanied by a change in CRISIL's rating distribution with an increasing number of ratings being assigned in the lower rating categories. This trend has been clearly seen in recent years, wherein, more than 60 per cent of the ratings have been concentrated in categories of 'CRISIL BB' and below. This has resulted in the median rating being stable at 'CRISIL BB' for the past two years, as compared to 'CRISIL AA' as on March 31, 2008.

The rating distribution as on September 30, 2011, is very similar to the distribution observed a year ago (Chart 1 indicates movements in rating distribution in the portfolio).

Chart 1

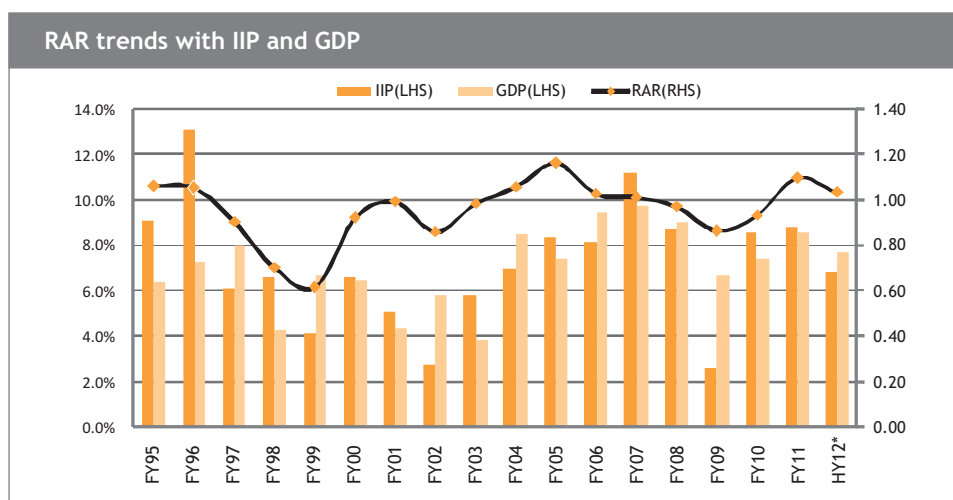


*Commodity price index as published by IMF

RAR declines as expected; further moderation expected

CRISIL upgraded 313 ratings, while 207 companies saw their ratings downgraded in the first half of 2011-12. CRISIL's RAR (the ratio of upgrades plus reaffirmations to downgrades plus reaffirmations) decreased to 1.03 times from 1.10 times in 2010-11 (see Chart 2). The moderation in RAR is in line with CRISIL's expectations for the period (refer to previous edition of Ratings Roundup published in April 2011). The RAR has turned southwards after a continuous increase when it reached to 1.10; this rally was after it had reached a decadal low of 0.86 times in 2008-09, when the economy slowed down because of the global financial crisis (see Chart 2).

Chart 2



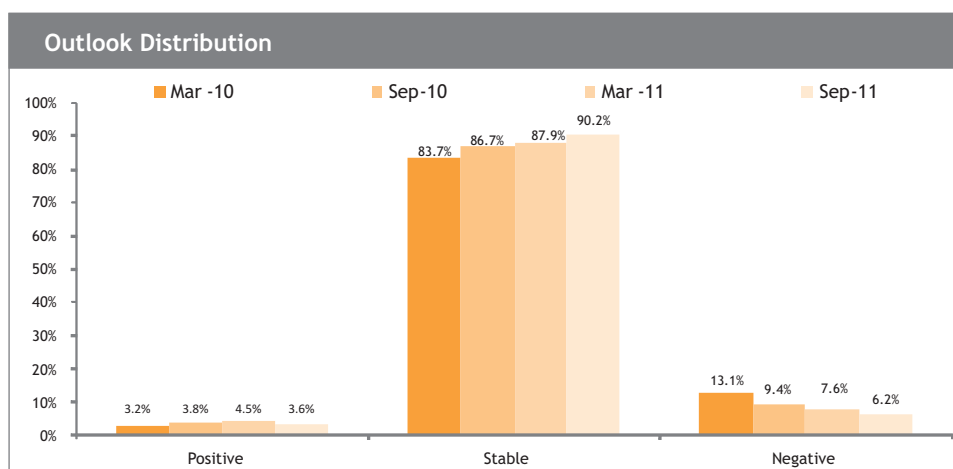
*Gross domestic product (GDP) and Index of industrial production (IIP) growth rates are for April 2011 to June 2011. (For a complete list of rating actions, please refer the Annexure II-b and Annexure II-c of Annexure II under 6.2.2 of Regulatory Disclosures section on the CRISIL website).

Incidentally, a closer observation of the trends of RAR with IIP and GDP reveals that there exists a close correlation of the RAR with these economic indicators. The period of the lowest level of RAR in the past five years was also accompanied by a low IIP of around 2.5 per cent. CRISIL believes that the RAR is likely to moderate further over the medium term because of pressures on profitability of entities on the back of increased commodity prices, increase in interest rates and slowdown in demand.

Proportion of 'Positive' outlooks reduces; negative outlooks concentrated in lower rating categories

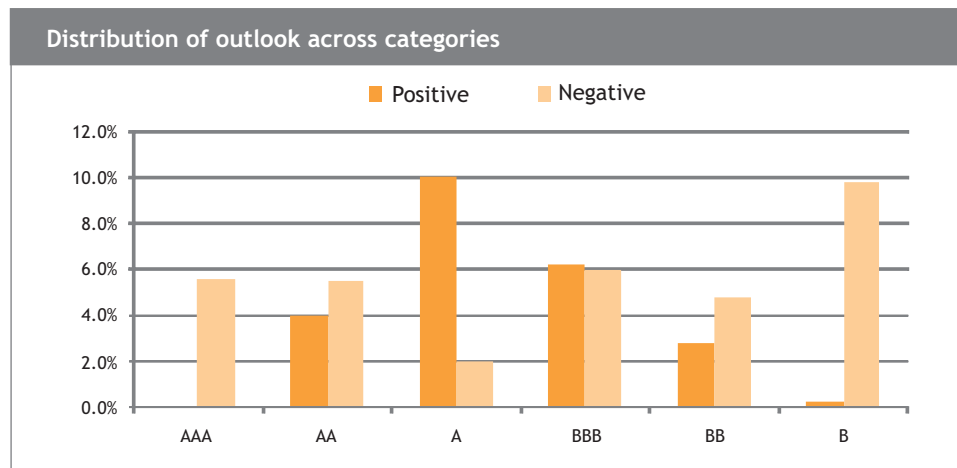
CRISIL's portfolio has also seen a moderation in the proportion of 'Positive' outlooks to 3.6 per cent, which is similar to those witnessed on March 31, 2008. The proportion of ratings on 'Negative' outlook also decreased to 6.2 per cent as on September 30, 2011, from 7.6 per cent as on March 31, 2011 (See Chart 3).

Chart 3



A deeper analysis of the distribution of outlooks reveals that entities in higher rating categories ('CRISIL BBB' and above) have higher proportion of 'Positive' outlooks and lower rating categories have higher proportion of 'Negative' outlooks. Almost 10 per cent of the ratings in the 'CRISIL B' category have 'Negative' outlooks - an indication of the inherent susceptibility of these ratings to downward revisions. On the other hand, around 10 per cent of ratings in the 'CRISIL A' category have 'Positive' outlooks, indicating that these entities have a moderate likelihood of improvement in their credit quality.

Chart 4



Rising input costs and liquidity pressures lead to majority of downgrades; improvement in capital structure was key driver of upgrades

The peaking of the credit quality of Indian companies was clearly seen with the moderation in the upgrades in the second quarter of 2011-12. The portfolio also saw an increasing number of downgrades, as the demand started showing signs of slowing down and the increasing interest rates began to adversely affect the funding costs of companies. The downgrades were because of the entities facing liquidity pressures resulting from increased outgo on their capex and larger working capital requirements. Around 70 per cent of the downgrades were on lower-rated companies which are inherently more susceptible to downward revisions.

The ratings were upgraded on entities which saw an improvement in their capital structures. The promoters of these companies infused equity into the companies to support their business levels, which also resulted in correction in the capital structures of these companies. Additionally, the upgrades in CRISIL's portfolio were primarily driven by entities which saw a better-than-expected demand for their products and services. This demand and a strong expected order book in these companies supported the profit margins of these companies.

Rising interest rates, wage and input costs have increased pressure on profitability of entities

The domestic funding environment has become more challenging over the past six months with the Reserve Bank of India (RBI) raising the repo rate by 150 basis points since March 2011. The bank credit growth has currently dropped to an 18-month low because of RBI's aggressive anti-inflationary stance of frequently raising the interest rates. This resulted in higher interest outgo for corporate entities which lead to lower profitability. The economic conditions were further negatively impacted by a drop in industrial activity, as indicated by the industrial growth numbers which slowed down significantly by the end of the second quarter of 2011-12.

Table 1:

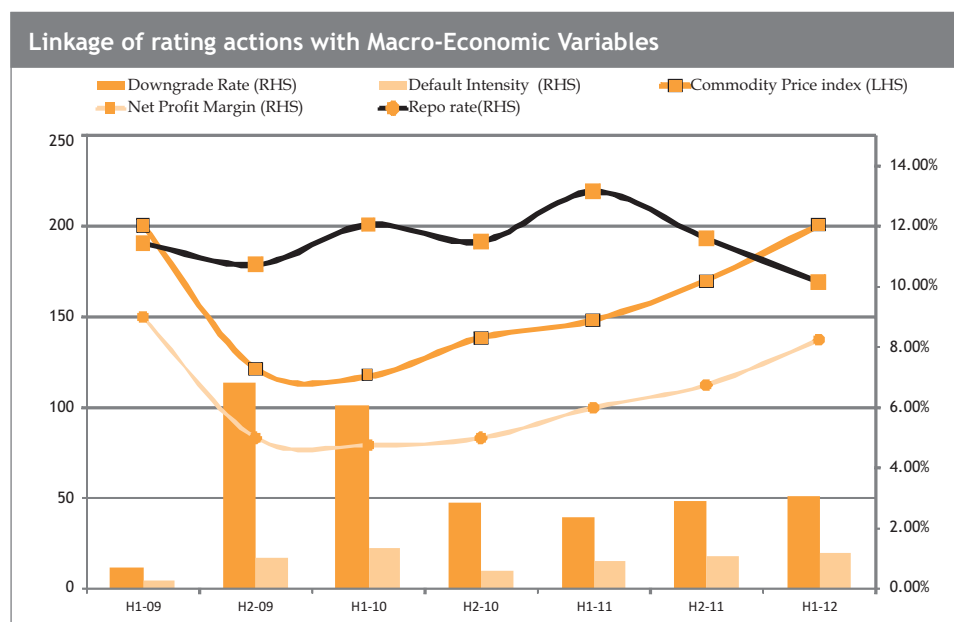
Trends in industrial activity and fund mobilization									
Quarter ended	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Bank Credit Growth (%)	12.63	13.66	16.75	21.57	19.1	24.6	21.55	19.3	17.45 [^]
Repo rate (%)	4.75	4.75	5.00	5.25	6.00	6.25	6.75	7.50	8.25
Credit spreads (%) [#]	1.60	1.00	1.10	1.20	0.83	0.63	0.87	1.08	0.95 ^{&}
ECB mobilised (USD Billion)	4.61	6.51	7.83	5.31	5.43	5.33	9.78	8.10	4.20 [*]
Equity Mobilised (Rs. Billion) [@]	258	229	317	193	266	454	210	240	41 [*]
IIP Growth (% YoY)	8.60	13.30	15.80	11.90	9.10	5.30	7.90	6.70	3.30 [*]

[^]Updated till 9th September, 2011, & Updated till 31st August, 2011, ^{*} Updated till July, 2011

[#]AAA spread over 10 year G-Sec, [@]Equity raised in the Indian markets

Additionally, the steep rise of commodity prices has adversely affected the profitability of the entities, with prices reaching similar levels seen just prior to the economic downturn. This increase in input costs, along with rising interest rate and an increase in the wages, has led to increased pressure on profitability. This is evident from the declining net profit margins (NPMs) of 400¹ entities in S&P CNX 500 over the past four halves. High interest rates may lead to a moderation in demand. Further, the slowing economies in the EU and the US may further lead to demand pressures on export-driven companies. Persistent slowdown in the advanced economies may, however, lead to softening of commodity prices, thereby giving some respite to the Indian companies. The trend in interest rates will be driven by the trend in inflation. CRISIL believes that interest rates will increase marginally and then move downwards when inflation would be under control.

Chart 5



*Commodity price index as published by IMF

¹ These listed companies have reported their results for the quarter ended June 30, 2011, and have remained in the S&P CNX 500 for the past 15 quarters. The three oil marketing companies have been excluded, because their reported numbers will skew the sample. Companies from the financial sector have also been excluded from the sample.

Moderating demand may result in downward pressures on RAR; 10 of the top 20 industries expected to see a slowdown in demand

While profitability pressures were expected to continue, CRISIL had also identified demand scenario as a key monitorable. The pressure on profitability remains, while drop in demand growth across industries is becoming increasingly visible. As a result, the RAR which has started moving downwards on account of profitability pressures is expected to face further pressure due to moderation in demand. CRISIL conducted an analysis to identify the industries which are expected to witness moderation in the demand. The analysis reveals that 10 of the top 20 industries (in terms of loans outstanding of the Indian banking system) have shown clear signs of slowdown in demand growth.

The analysis also showed that consumption-linked industries such as automobiles, real estate, textiles, and retail have seen significant impact on demand. CRISIL Research has also cut its growth estimates for passenger vehicles close to decadal lows of 2-4 per cent. This is primarily on account of the rise in interest rates leading to decrease in the quantum of expendable income for the consumers. Investment demand-linked industries such as cement, capital goods, and construction have also witnessed decline in sales growth. While exports are buoyant so far, slowdown in the US and the uncertain environment in Europe are expected to result in a moderation in export growth.

CRISIL also carried out a sensitivity analysis on its portfolio of around 5500 rated companies to assess the impact of the moderation of demand on the Indian corporate sector. The analysis factored in moderation of demand growth to 15 per cent, an increase in the interest rates of 225 basis points on domestic loans contracted by these companies and margin contraction of 150 basis points. The analysis indicates that the above factors will result in a 13 per cent drop in the pre-tax profitability of these entities. The interest cover ratio (measures sufficiency of an entity's operating profitability in servicing interest on borrowings) of these entities is expected to decline to 3.5 times in 2011-12 from 4.8 times in 2010-11.

Table 2 :

Impact of demand moderation on profitability of Indian corporates			
	Units	2011-12	2010-11
Operating Income	Rs. Bn	22585	19639
Operating margin	%	13%	15%
Operating Profit Before Depreciation Interest and Taxes	Rs. Bn	2955	2864
Interest and Finance Charges	Rs. Bn	852	591
Profit Before Tax (PBT)	Rs. Bn	1331	1525
Interest Coverage	Times	3.47	4.85

Global economic and business environment may impact companies with foreign exchange exposures; sustenance of demand in developed economies will be a key monitorable

In the past few weeks, the Indian rupee has seen sharp depreciation on the back of weak global cues. Such sharp foreign currency movements may negatively impact companies with significant unhedged foreign exchange exposure. The rupee has depreciated by almost 8 per cent in a month with respect to the US dollar, which is as steep as the fall seen during the 2008 crisis. Such movements may result in pressure on the profitability of entities which rely on imports for their raw material requirements. Such adverse currency movements along with high commodity prices may result in significant pressure on the credit risk profiles of such entities.

The events unfolding over the past six months in the EU and the US have heightened the risk perception and uncertainties in a global economy. The economic outlook for the EU and the US looks austere, with GDP growth weakening during the current financial year. Sovereign risks in Europe (Greece, Ireland, Portugal, and Italy) remain high, and the market fears their spillover to the other EU nations. The GDP growth of the US has slowed down and fears of a recession are getting stronger. This may lead to waning in the demand in these economies and adversely impact the export growth of Indian corporate entities. An increase in risk aversion with global investors may also reduce appetite for investments in the emerging market and could adversely affect the ability of Indian entities to raise money externally. However, the slowdown in demand in these economies may lead to a correction in the commodity prices, including that of crude oil, which would benefit the Indian economy, which is a net importer.

Table 3:

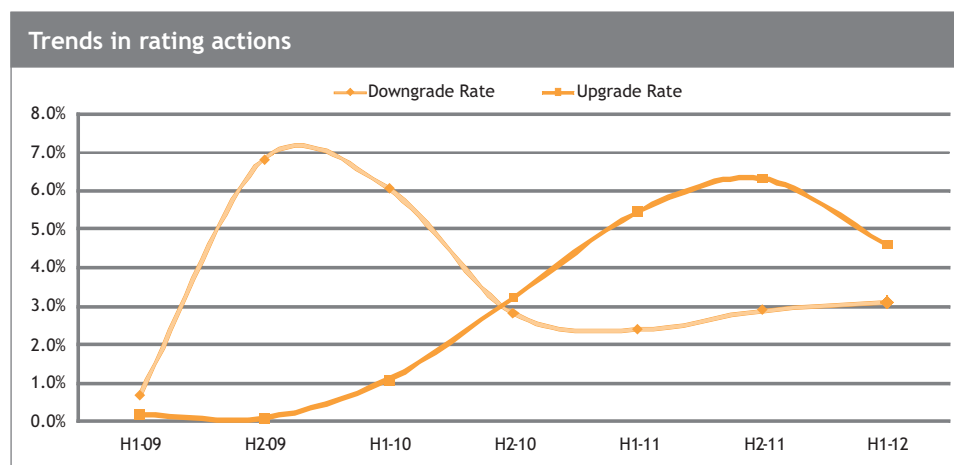
Trends in GDP growth rates of EU and US			
Countries	Growth rates in %		
	2010	2011(E)	2012(E)
Germany	3.6	3.3	2.0
France	1.5	1.7	1.7
Italy	1.2	0.8	0.8
Spain	-0.1	0.8	1.0
Portugal	-1.3	-1.8	-1.5
UK	1.3	1.3	1.8
USA	3.0	1.6	1.9

Source: S&P

Upgrade rate decreases sharply; downgrades may catch up with upgrades over the near term

CRISIL's rating actions over the past six months indicate a slowdown in the intensity of upgrades. The upgrade rate in this period dipped to 4.6 per cent in the first half of 2011-12 from 6.3 per cent in 2010-11; this was in line with CRISIL's expectation of the credit qualities of Indian corporate entities peaking. The downgrade rate has remained between 2.5 per cent and 3.1 per cent for the past four halves. CRISIL believes that, with the credit quality having peaked, there may be an increase in the number of downgrades, as rising input costs would result in pressures on the profitability of entities; the RAR is expected to moderate further. CRISIL's portfolio has also witnessed 81 defaults in the first half of 2011-12 (more than in any other half-year period), primarily because of weak liquidity.

Chart 6



² This ratio is computed as the number of upgrades in a half-year period as a proportion of average number of ratings outstanding

Outlook

CRISIL believes that the RAR is likely to moderate further. The spiraling interest rates may dampen the overall demand, and thereby reduce the flexibility of entities to pass on the impact of the hike directly to customers. Demand may moderate for industries such as automobile, real estate, and retail, which are especially sensitive to consumer demand if they hike product prices to cover interest costs. Given the steep rise in funding costs, and the slowdown in demand in the domestic and global markets, the revenue growth and profitability and, therefore, the credit quality of India's corporate sector is expected to be under pressure through 2011-12. The uncertainties in the global financial markets, including the EU and the US, will also dictate the intensity of the recovery in the credit quality of the entities.

In addition, smaller companies have limited flexibility in terms of raising money from the overseas markets at reasonable rates, resulting in challenges for access to funding. Larger companies with stronger balance sheets may have a greater financial cushion to tide over decelerating growth as well as a higher interest rate scenario. Access to foreign currency funding will be dependent on the global financial condition, which is currently uncertain, given the fears of financial contagion in the Euro zone.

Chart 7

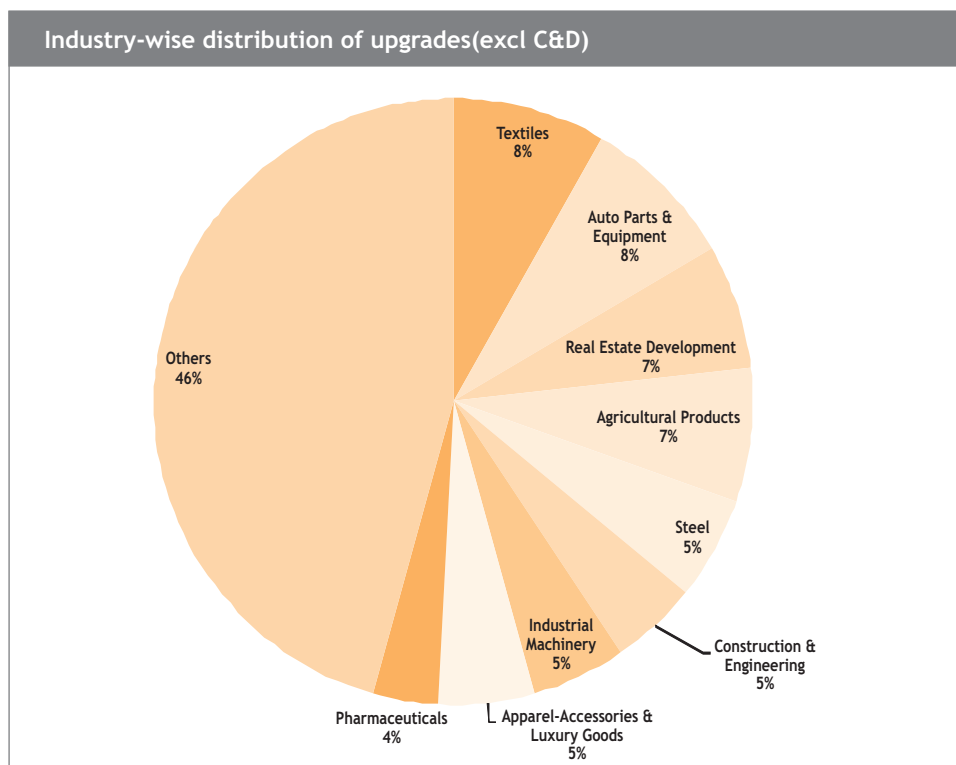
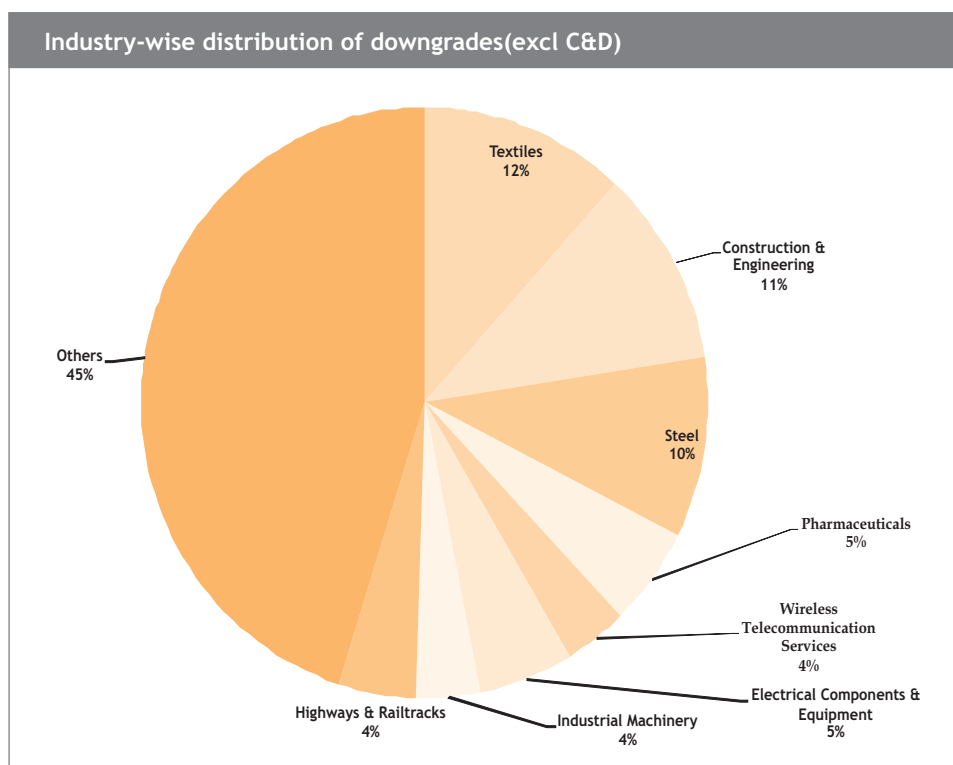


Chart 8



Key reasons for rating actions and credit quality outlook for major sectors

Industry	Key Reasons for Rating actions in the first half of 2011	Credit quality outlook for the near to medium term
Auto-ancillaries	Upgrades in this sector were supported by stronger than anticipated performance in 2010-11, and continued steady performance in Q1 2011-12. No major rating changes were seen in Q2 2011-12, as demand from auto OEMs has slowed down in some segments.	Despite steady aftermarket and export demand, the overall growth in the domestic auto-components industry is expected to moderate as a result of slowdown in OEM demand for auto-components. Profitability of suppliers is expected to witness some pressure in the near term because of moderate revenue growth, rising input, wage and interest costs. However, the credit quality is expected to be largely sustained, as players are expected to prudently temper capex and manage working capital levels.
Construction	Upgrades in this sector were driven by robust increase in revenues and increased order book, eventually leading to strong business risk profiles. Downgrades in this sector have been because of sluggish demand and stretched receivables leading to deterioration in business risk profiles.	CRISIL believes that the ability of the players in the industry to monitor working capital will be a key monitorable. The Government of India's increased focus on sectors such as roads, power, ports, and urban infrastructure will support the growth in the construction sector. However, any inaction or delay on the policy front may lead to pressure on the credit profile of these players.

Key reasons for rating actions and credit quality outlook for major sectors

Industry	Key Reasons for Rating actions in the first half of 2011	Credit quality outlook for the near to medium term
Steel and Steel Products	<p>Upgrades in this sector were driven by increasing scale of operations, leading to strong growth in revenues.</p> <p>Downgrades in this sector were because of an increase in input prices leading to increased working capital requirements.</p>	<p>CRISIL believes that intensifying competition will negatively impact the credit risk profiles of non-integrated rolling mills. Players with leveraged capital structures—even if their operations are well integrated—will also be adversely affected, as a decline in revenues or profitability can considerably constrain their debt servicing ability.</p>
Textiles	<p>The majority of upgrades in this sector have been primarily caused by buoyant demand scenario.</p> <p>Downgrades in the sector were driven by the entities' weakening liquidity as a result of increasing working capital requirements. Downgrades were also driven by insufficient cash accruals vis-a-vis maturing debt in the first half of 2011-12.</p>	<p>CRISIL believes that garment manufacturers will benefit from healthy offtake in the domestic market because of the festival demand. Their operating margins are likely to improve, supported by moderation in raw material prices, and improving realisations, especially in export markets, given the favorable currency movements.</p> <p>Yarn spinning companies may face liquidity pressures in the near term, because of likely mismatches in cash flows because of a temporary fall in demand and realisations in the first half of 2011-12, and the impending need for liquidity for cotton procurement, and debt repayments. Overall, liquidity management and impact of interest rate movements on profitability are the key monitorables for the textile sector over the medium term.</p>
Banks and non-banking finance companies (NBFCs)	<p>The upgrades in the banking sector were caused by improvement in asset quality and equity infusion.</p>	<p>CRISIL believes that the credit growth in the banking sector will moderate from the levels in the previous year, given the high interest rates and its impact on consumption and investment demand. CRISIL also expects a moderate deterioration in the banks' asset quality because of weakening in debt servicing ability of the corporate sector, especially the small and medium enterprises segment. Moreover, CRISIL believes that the banks' limited ability to pass on any further increase in funding costs to borrowers may result in a decline in their return on assets to below 1 per cent in 2011-12. Despite deterioration in asset quality and pressures on profitability, the credit risk profile of banks is expected to remain stable, given the healthy capitalisation and their stable resource profiles.</p> <p>CRISIL also expects a moderation in the business growth for NBFCs in the near term, although their asset quality and profitability are likely to be relatively resilient as compared to that of banks. For capital-market-related entities, CRISIL believes that the operating environment will remain challenging, with margin pressures for equity broking business and increasing competition from foreign brokerage houses.</p>

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