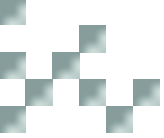
CRISIL RATINGS

FY 2013-14

CRISIL RatingsRoundup

Credit quality pressures bottoming out

But improvement will be gradual due to fragile economic recovery



Analytical Contacts

Somasekhar Vemuri

Senior Director - CRISIL Ratings
Tel: +91 22 3342 3106
Email: somasekhar.vemuri@crisil.com

Darshan Lad

Associate Director - CRISIL Ratings
Tel: +91 22 3342 8235
Email: darshan.lad@crisil.com

Prateek Nichani

Senior Rating Analyst - CRISIL Ratings
Tel: +91 22 3342 8264
Email: prateek.nichani@crisil.com

Chahana Kacker

Senior Rating Analyst - CRISIL Ratings
Tel: +91 22 4040 5978
Email: chahana.kacker@crisil.com

Executive Summary

Corporate India's credit quality is on course for recovery, albeit gradually, in 2014-15 (refers to financial year, April 1 to March 31). CRISIL believes the credit ratio – the ratio of rating upgrades to downgrades – may recover from the low levels seen last fiscal as pressure on profitability and demand eases. Nevertheless, the overall credit quality will be far from buoyant in the near term, given the fragile economic growth and limited scope for reduction in interest rates.

The credit ratio, at 0.79 times in 2013-14, has remained weak for two years now as downgrades outnumbered upgrades on slowing demand, tight liquidity and high interest rates. However, moderation in downgrade intensity—to 10.1 per cent from 12.1 per cent in 2012-13—has helped the credit ratio recover marginally from 0.62 times in the previous fiscal. These rating actions were witnessed on a very large base of over 13,000 ratings, making them quite representative of the trends in corporate credit quality in India. Notably, CRISIL also downgraded its ratings on four banks because of persistent pressure on asset quality and earnings.

CRISIL downgraded ratings of 1,165 firms and upgraded those of 921 in the last fiscal. Around 90 per cent of the downgrades was on account of slowing demand, tight liquidity, and stretched working capital cycles. Companies in investment-linked sectors such as power, construction, engineering and capital goods, and transport had more downgrades than firms in other sectors.

More than a third of the upgrades was on account of company-specific factors such as sustained track record of timely debt servicing and stronger-than-expected capital structure. Another third of upgrades was driven by improved business conditions for firms in sectors—such as packaged foods, textiles and agricultural products—that have linkages with exports, agriculture, and non-discretionary consumer segments.

CRISIL's analysis indicates that firms with better profitability and low leverage have survived the downturn in economy well. Firms with a return on capital employed (RoCE) of more than 15 per cent saw 58 per cent more upgrades than downgrades. Similarly, upgrades outnumbered downgrades by 30 per cent for firms with low leverage — those with a ratio of debt to earnings before interest, tax, depreciation and amortisation (debt/ EBIDTA) of less than 3 times.

CRISIL believes that corporate credit quality will improve as GDP growth touches 6 per cent in 2014-15 from sub-5 per cent levels seen in the last two fiscals. The credit ratio will, however, remain below 1 time in the near term.

Significant improvement in credit ratio is possible only if there is strong and sustainable recovery in investment as well as in consumption demand. The underlying assumptions for any improvement in credit quality are progressive policies and continuity in reforms. The degree of economic recovery, availability of liquidity, performance of monsoon, continued recovery in export markets, the outcome of the forthcoming general elections, and success in deleveraging the balance sheets through sale of assets will all be critical for India's corporates.

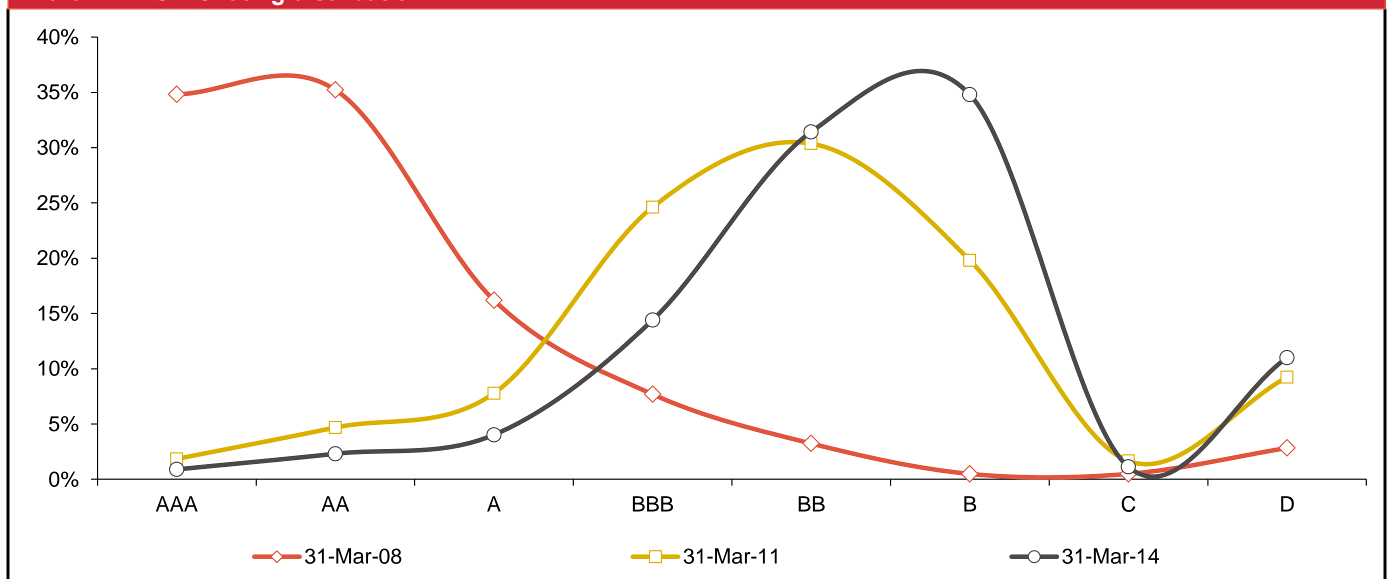
About CRISIL's Ratings Round-Up

CRISIL's Ratings Round-Up is a semi-annual publication that analyses CRISIL's rating actions, and traces linkages between these actions and underlying economic trends and business factors. A credit rating is an opinion on the likelihood of timely debt repayment; therefore, an analysis of rating actions in a large and diverse portfolio of rated companies is a strong indicator of economic prospects. The current issue analyses CRISIL's rating actions in the 12 months through March 2014.

Scale-up in CRISIL's rated portfolio continues: Outstanding ratings more than double in three years

CRISIL's portfolio of outstanding ratings has expanded substantially in recent years, to over 13,000 ratings as on March 31, 2014, from 6200 ratings three years ago, and around 400 ratings as on March 31, 2008. The expansion of the rated portfolio has been accompanied by changes in CRISIL's rating distribution, with an increasing number of ratings being assigned at the lower end of the rating scale. In recent years, more than 75 per cent of ratings have been at either 'CRISIL BB' or lower. This has resulted in the median rating being stable at 'CRISIL BB' category since March 2011, unlike in March 2008, when it was at 'CRISIL AA' (*refer to Chart 1*).

Chart 1: CRISIL's rating distribution

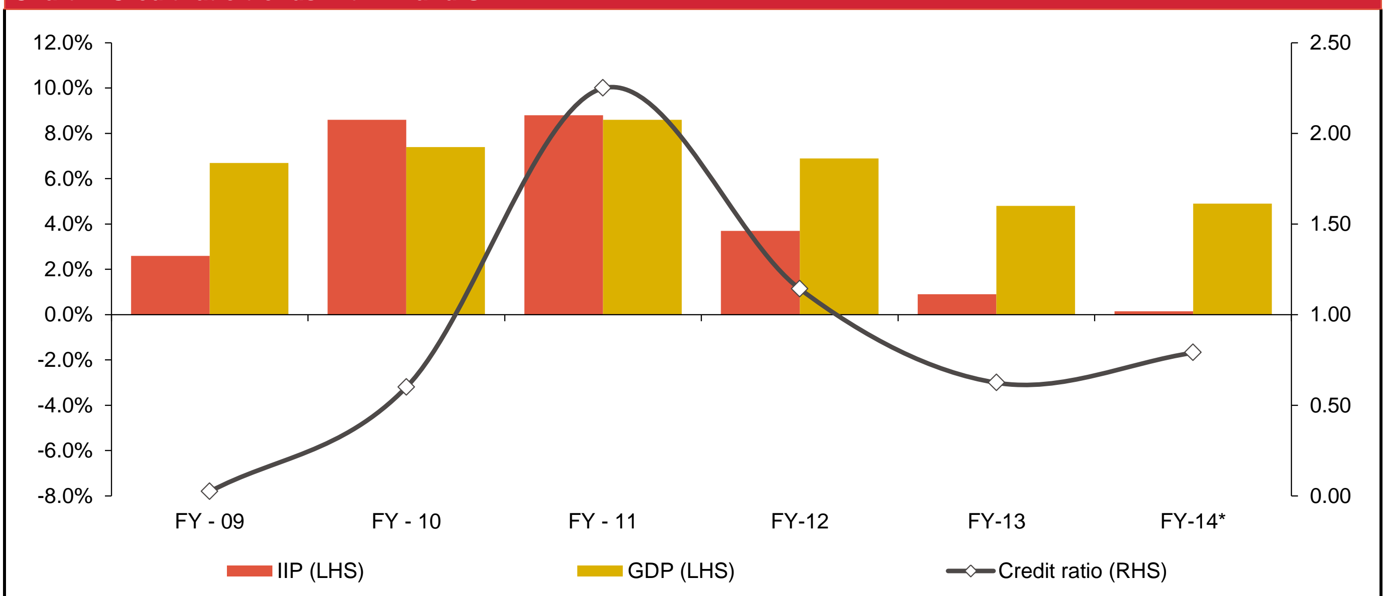


Source: CRISIL

Credit quality pressures continued in 2013-14; demand slowdown, tight liquidity and high interest rates impacted corporates

Downgrades continued to outnumber upgrades during 2013-14, reflecting unrelenting pressure on the credit quality of corporate India. Sluggish demand, tight liquidity and high interest rates were the primary reasons for the weak credit quality. The credit ratio (0.79 times for 2013-14) has remained below 1 time over the past two years, indicating the difficult credit environment. However, the credit ratio is marginally better than in 2012-13, when it was at 0.62 times.

Chart 2: Credit ratio trends with IIP and GDP



* Index of Industrial Production (IIP) growth rate is for the period April to December 2013 and Gross Domestic Product (GDP) growth is estimated.

(For a complete list of rating actions in FY 2013-14, refer to Annexures II-b and II-c under 6.2.2 of 'Regulatory Disclosures' on the CRISIL website)

Source: CRISIL

CRISIL's credit ratio frequently exhibits a correlation with economic indicators such as the index of industrial production (IIP) and gross domestic product (GDP). Weak GDP growth, accompanied by zero growth in IIP has resulted in the credit ratio staying below one time during 2013-14.

CRISIL believes that the credit ratio may improve marginally on the back of stronger demand and profitability in 2014-15. However, the improvement will be restricted to firms with low leverage levels and prudent working capital management. CRISIL expects the credit ratio to remain below 1 time on account of fragile economic recovery over the near term.

Firms with high profitability and low leverage had more upgrades than downgrades

CRISIL's analysis of firms that faced rating actions during 2013-14 indicates that firms with better profitability and low leverage were able to manage the downturn well, as their credit ratio indicates.

Firms whose RoCE (an indicator of profitability) exceeded 15 per cent had a credit ratio of more than 1.50 times. On the other hand, downgrades outnumbered upgrades for firms with RoCE of less than 10 per cent.

CRISIL also analysed the credit quality of firms based on their leverage (their debt-to-EBITDA ratio). Firms with a debt-to-EBITDA ratio of less than 3 times had a credit ratio of more than 1 time, while firms with a higher leverage (with debt-to-EBITDA ratios of more than 5 times) had a low credit ratio of 0.42 times.

Table 1: RoCE and Debt-to-EBITDA and their impact on credit ratio

ROCE	Credit ratio
Greater than 15%	1.58
Between 10%-15%	0.77
Lower than 10%	0.34

Debt/EBITDA	Credit ratio
Lower than 3 times	1.30
Between 3-5 times	0.77
Greater than 5 times	0.42

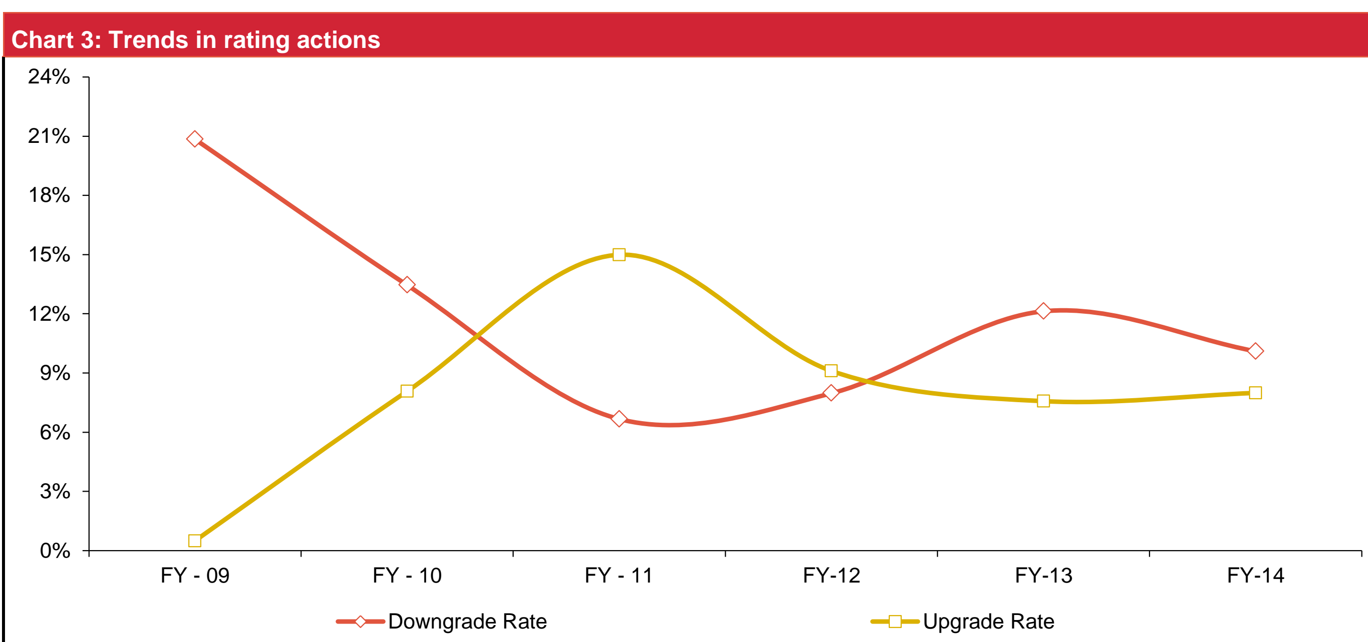
Source: CRISIL

Downgrade rate declined during 2013-14; upgrade rate remained high

CRISIL upgraded ratings on 921 firms and downgraded ratings on 1165 firms in 2013-14, indicating persisting pressure on credit quality. Despite the weak macro-economic environment, the upgrade rate remained stable and high at 8.0 per cent in 2013-14. Two-thirds of upgrades were either on account of firm-specific factors, or in sectors not associated with investment demand. More than fifth of the upgrades has occurred from the default category; a sixth of upgrades was because of better capital structures, following equity infusions or reduction in debt; another one third of upgrades resulted from business improvements in non-investment-linked sectors such as textiles, agricultural products and packaged foods.

Sluggish off-take, pressure on liquidity, and stretched working capital cycles were the primary cause of almost 90 per cent of downgrades in 2013-14. Defaults accounted for around a third of downgrades. Around two thirds of the downgrades occurred in the rating category of 'CRISIL BB' and lower. The downgrade rate moderated to 10.1 per cent in 2013-14 from 12.1 per cent in the previous year.

Chart 3: Trends in rating actions



Source: CRISIL

Demand and profitability pressures are expected to ease in the next fiscal, leading to further decline in downgrade intensity. However, the upgrade rate is not expected to improve significantly as recovery in economic growth will be gradual.

Credit quality to improve in 2014-15, as pressure on profitability and demand eases

India's economy grew at an estimated 4.9 per cent in 2013-14; the pace of growth was low despite the low base of the previous year. Agriculture and exports witnessed strong growth while industry growth declined. Manufacturing growth was pulled down due to low domestic demand and a near-standstill in investments—the manufacturing sector experienced contraction in 2013-14 for the first time since 1991-92. Investment demand was weak due to low domestic demand, slow pace of policy reforms, and political uncertainties prior to elections.

However, the pressures on demand and profitability are expected to abate in 2014-15, driven primarily by higher GDP growth of 6 per cent (as against less than 5 per cent over the last two years). The growth in GDP will be driven by implementation of stalled projects, debottlenecking in the mining sector, and some recovery in industry on the back of higher demand in the global markets.

The global economy is expected to revive, with higher growth rates of 2.8 per cent and 2.3 per cent in 2014 for USA and UK, respectively, up from 1.9 per cent and 1.5 per cent in 2013. The economy in the Eurozone appears set for gradual recovery from the standstill of the past two years. Growth in these markets is expected to enhance the fortunes of export-linked sectors such as information technology (IT) and pharmaceuticals. We also expect some rebound in services growth, led by higher exports and the positive spillover from improvement in industry. However, recovery will be fragile and dependent on factors such as sustainable recovery in demand, and continuity in policy and reforms.

Table 2: Trends in GDP growth rates Europe, UK and USA

Countries	2012	2013(P)	2014(P)	2015(P)
Eurozone	(0.6)	(0.6)	0.9	1.3
United Kingdom	0.1	1.5	2.3	2.7
USA	2.8	1.9	2.8	3.3

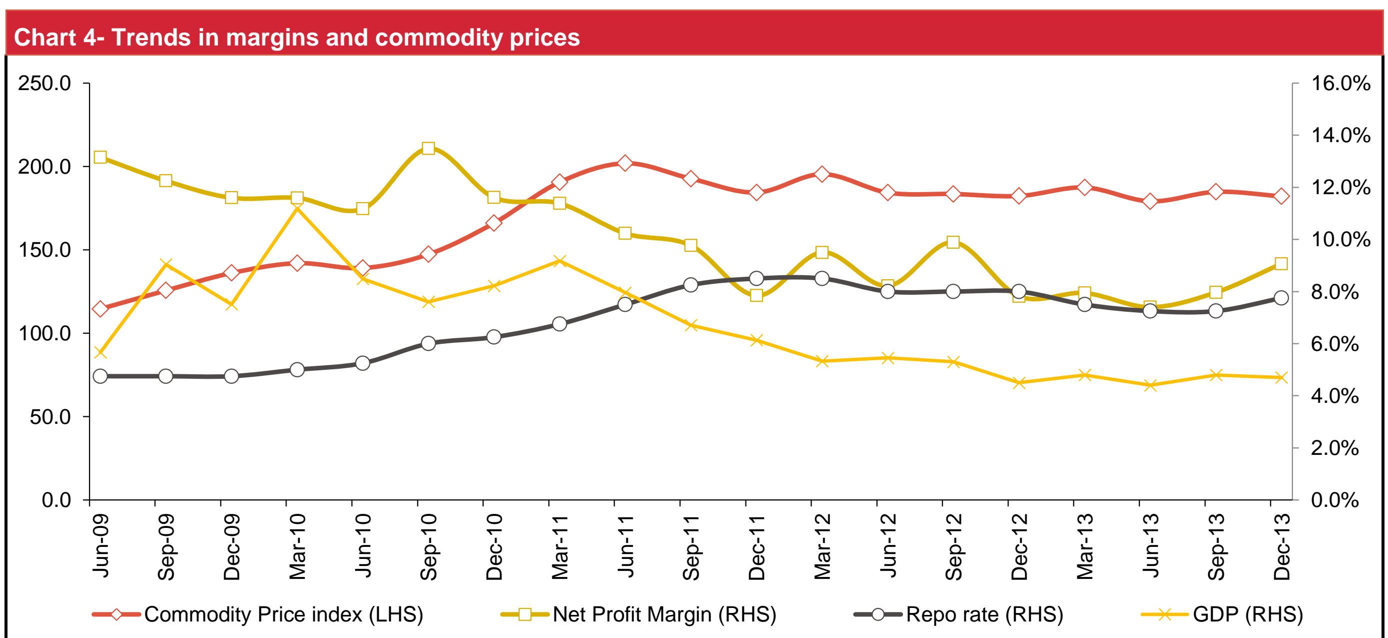
Source: Standard and Poors

Profitability to improve marginally, supported by higher capacity utilisation

CRISIL's analysis of the aggregate financial performance of listed companies indicates the following: the net profit margin (NPM) of 402[1] companies in the S&P CNX 500 Index has begun to improve over the previous two quarters. The NPM has improved over the last two quarters and has reached 9.0 per cent in the third quarter (Q3) of 2013-14.

CRISIL believes that the NPM of Indian companies will improve marginally in 2014-15 on account of stable commodity prices and improved capacity utilisation, although high interest rates will continue to constrain profitability.

Chart 4- Trends in margins and commodity prices



Source: CRISIL

[1] These listed companies have reported their results for the quarter ended December 31, 2013, and have remained in the S&P CNX 500 for the past 19 quarters. The three oil marketing companies (OMCs) have been excluded, because their reported numbers will skew the sample. Companies from the financial sector have also been excluded from the sample.

Liquidity remains weak in 2013-14; interest rates to remain high

Weak liquidity contributed to more than 50 per cent of downgrades during 2013-14. During the year, the Reserve Bank of India (RBI) revisited its liquidity and monetary policy in response to changes in the macroeconomic environment. RBI's measures during Q2 2013-14—capping the access of banks to systemic liquidity, and mandating a higher minimum daily cash reserve requirement—caused interest rates to increase again, tightening liquidity. However, the policy-induced tight liquidity eased considerably in October 2013 with monetary measures returning to normal, and exchange rates regaining a measure of stability. The banks' credit growth (year-on-year) declined to 14.7 per cent as on March 7, 2014 from 17.8 per cent as on September 6, 2013. The sharp uptick in the credit growth during quarter through September 2013 was on account of higher cost of non-bank funds, leading to corporates resorting to cheaper bank credit.

Table 3: Trends in industrial activity and fund mobilisation

Quarter ended	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14
Bank Credit Growth (%)	16.0	19.5	18.7	16.5	15.2	15.5	13.7	17.8	14.5	14.7*
Repo rate (%)	8.50	8.50	8.00	8.00	8.00	7.50	7.25	7.25	7.75	8.00
Credit spreads (%) #	0.7	0.9	0.7	0.9	0.6	0.8	0.6	0.8	0.5	0.6@
ECB mobilised (Billion USD)	8.5	9.1	8.1	6.2	6.8	10.9	5.6	9.4	8.7	1.8@
Equity Mobilised (Rs. Billion)	12.7	67.2	336.3	171.3	129.7	142.3	335.1	120.1	113.4	8.8@
IIP Growth (% YoY)	1.2	0.8	-0.3	0.4	2.36	2.2	-1.1	1.9	-0.9	0.1
GDP Growth (% YoY)	6.0	5.1	5.5	5.3	4.7	4.8	4.4	4.8	4.7	NA

#AAA spread over 10 year G-Sec

*Represents year-on-year (Y-o-Y) growth over 12 months at the end of each quarter. Figures for March 2014 represent Y-o-Y bank credit growth at the end of March 7, 2014

@ Updated for January 2014

Source: CRISIL

RBI's recent 25-basis-point increase in repo rate in January 2014 signals its intent to control inflation in a slowing economy. CRISIL believes that there is little scope for any material reduction in interest rates over the medium term.

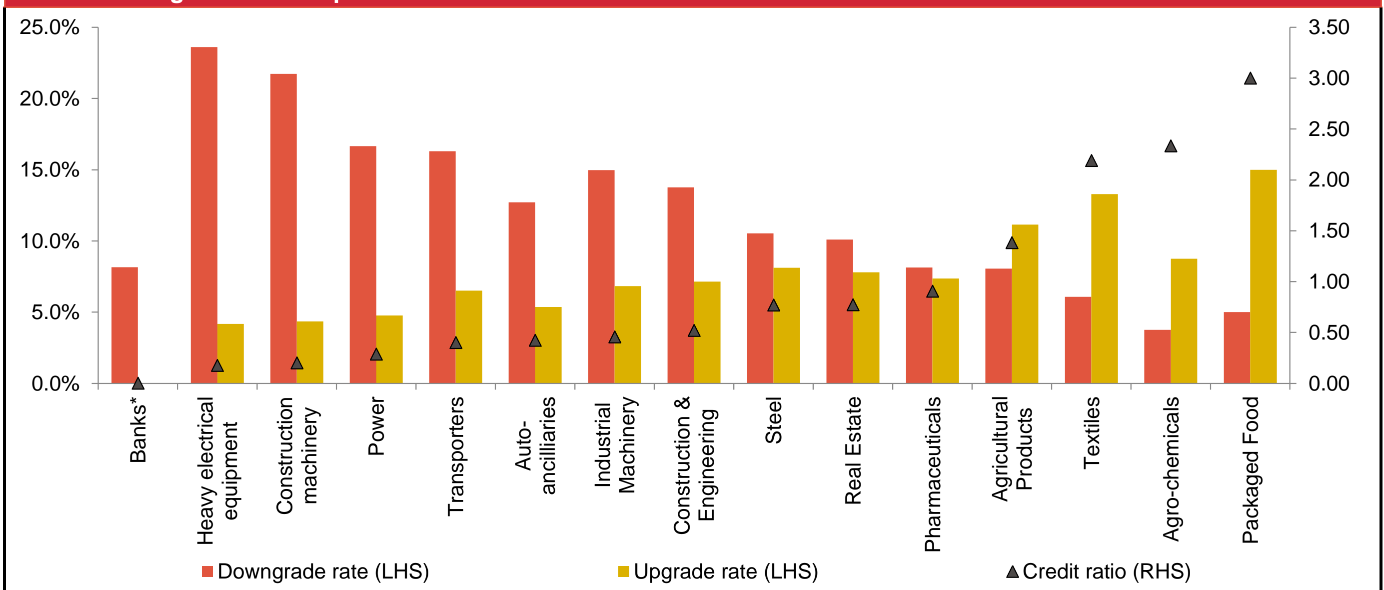
Outlook:

CRISIL believes that 2014-15 will bring some respite to India's corporates. Corporate credit quality appears set for improvement, with the economy likely to grow at 6 per cent, unlike in the past two years, when it grew at less than 5 per cent. However, the improvement will be restricted to companies operating in sectors that are less capital intensive. Profitability should see marginal growth on the back of stable commodity prices and improved capacity utilisation.

Nevertheless, despite a marginal improvement in credit ratio, the credit quality trends will be far from buoyant in 2014-15, given the slow economic growth and high interest rates. Downgrades will continue to outnumber downgrades in the near term. CRISIL believes that any significant improvement in credit quality is possible only if there is strong and sustained recovery in demand. Liquidity, performance of monsoon, the outcome of the forthcoming general elections and success in deleveraging the balance sheets through sale of assets will remain key monitorables during 2014-15.

Key reasons for rating actions and outlook for major industries

Chart 5: Rating actions of top industries



*No bank was upgraded during 2013-14

Source: CRISIL

Rating actions and credit quality outlook for major sectors

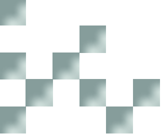
Industry	Key reasons for rating actions in 2013-14	Outlook for the near to medium term
Power	Downgrades were on account of systemic challenges such as fuel shortage, weak financial profiles of distribution companies (discoms), and delays in commissioning of projects. The sizeable costs of importing coal and low cash accruals also impacted the financial risk profiles of players. Half of the downgrades in 2013-14 were to the default category. Weak liquidity owing to low cash accruals delayed debt servicing.	CRISIL believes that demand for power will grow at a modest 4.0 per cent in 2014-15, because of weak industrial demand. The discoms' financial health is set to improve with implementation of the financial restructuring plan and regular tariff hikes. However, higher power availability (from capacity additions undertaken in the past) and improvement in discoms' health will be partly offset by weak economic growth, and low demand growth from industrial and commercial segments. The plant load factors of thermal plants are expected to remain low at around 70 per cent due to weak demand and limited coal supply. Profitability will be constrained by high interest costs, increase in cost of imported coal, and depreciation in the rupee. The financial flexibility of most private developers has been weakened considerably on account of sizeable debt-funding of acquisitions or projects in the infrastructure space. Furthermore, cash flows from operational projects have been under severe pressure due to weak volume growth.
Construction	Downgrades were driven primarily by slowdown in the infrastructure sector, and in revenue growth. Working capital requirements increased on account of stretched receivables and substantial inventory. Most upgrades resulted from scale up in operations, stronger business risk profiles, efficient working capital management, improved operational efficiencies, and in some cases, equity infusions by promoters.	CRISIL expects revenue growth in the sector to remain sluggish on account of regulatory hurdles and issues in land acquisition and clearances. While order inflows from the international markets and urban infrastructure segments will improve, slowdown in roads and power segments will continue over the medium term. Weak demand and continued low capacity utilisation will keep industrial capex low. Profitability will remain under pressure in the near term on account of delays and aggressive bidding on projects. Large working capital requirements (on account of slower execution and stretched receivables) and high interest costs will severely restrict improvement in net profitability. Sizeable debt, combined with weak profitability will constrain debt servicing abilities and financial flexibility of players. Firms will look to sell non-core assets to reduce overall debt.

Industry	Key reasons for rating actions in 2013-14	Outlook for the near to medium term
Domestic Road Freight Transportation	Downgrades were driven by weak demand from end-user industries and continued pressure on working capital requirements due to stretched receivables. The few upgrades in the sector were on account of stronger financial risk profiles on the back of healthy cash accruals, and deferred capital expenditure (capex).	CRISIL believes that freight demand will remain subdued in the first half of 2014-15. Marginal improvement is likely thereafter, backed by pick up in core sector activity, and resumption of stalled projects and mining activity. Domestic primary freight demand could grow at 5 per cent to 6 per cent during the year. However, fleet oversupply and continuous increase in diesel prices will constrain profitability for players. Weak capital structure and debt protection metrics may constrain the financial risk profiles of players.
Textiles	Most upgrades were driven by equity infusions by promoters, and stabilisation of operations following recent capacity expansions. Improved liquidity and lower reliance on external debt on account of efficient working capital management was also a reason for upgrades. More than half of the downgrades resulted from insufficient cash accruals vis-à-vis maturing debt obligations, leading to defaults. Increased working capital requirements due to stretched receivables and debt-funded capex also resulted in downgrades.	Exporters of readymade garments (RMG) are expected to report healthy growth at 8 per cent to 10 per cent in dollar revenue in 2014-15. RMG exporters will benefit from improved demand from major markets such as UK and USA, weak rupee, and implementation of labour safety issues in Bangladesh, a major competitor for Indian RMG exporters. Driven by healthy demand outlook and stable operating profitability, RMG exporters are expected to report robust cash accruals during 2014-15. Growth in demand for cotton yarn from domestic market is likely to compensate for the dip in export demand especially from China, over medium term. Further, healthy profitability will help spinners sustain their credit risk profile.
Steel	Downgrades were driven by weakening financial risk profiles, resulting from significant debt-funded capex programmes and paucity of raw materials iron ore and coal. Players' business risk profiles were also impacted by slowdown in demand for domestic steel. Upgrades were on account of stronger financial risk profiles, aided by steady cash accruals following successful stabilisation of enhanced capacities. A few upgrades were also supported by continued funding support from promoters.	CRISIL believes that the steel sector volumes will remain weak, growing at 3 per cent to 5 per cent due to weak demand from the construction, automobile and consumer durables sectors. Capacity utilisation rates may improve marginally in 2014-15 but will still remain weak on account of low demand. While India may become a net exporter over the medium term, Indian manufacturers are unlikely to benefit from the weaker rupee; this is because of low pricing power, fragile domestic demand, and sizeable inventory. EBITDA margins could decline further on account of firm prices of coking and non-coking coal and availability constraints related to iron ore. The global and domestic prices of steel are expected to reduce, constraining margins.

Industry	Key reasons for rating actions in 2013-14	Outlook for the near to medium term
Real estate	Around two thirds of the downgrades resulted from insufficient cash accruals vis-à-vis maturing debt. Delays in project completion and funding challenges arising from tight systemic liquidity during the financial year also resulted in downgrades. Most upgrades were on account of gradual reduction in project-related risks, as projects reached advanced stages of completion.	The economic slowdown and high property prices have adversely impacted transaction volumes in the real estate sector in 2013. Mumbai and the National Capital Region have witnessed substantial decline in demand. Demand for residential real estate across the 10 key cities of India is expected to decline by another 4 per cent in 2014. On the other hand, construction activity continues to grow at a steady pace resulting in inventory build-up. Continued decline in demand and increasing inventory will force developers to reduce capital values. CRISIL believes that prices will decline by 6 to 7 per cent in 2014. Lower collections from customers could necessitate higher borrowing and refinancing. Lenders have begun to adopt a cautious approach. Nevertheless, the sector has been able to attract funding from alternate sources such as non-convertible (NCDs), and private equity.
Auto-ancillaries	Downgrades were due to subdued demand from end users—the original equipment manufacturers (OEMs), and increased debt-funding of working capital and capex requirements. Most upgrades were on account of better diversification of revenues (customers and segments), as well as prudent management of capex and working capital requirements. Some players also pruned capex in view of the subdued offtake from OEMs.	The prospects of auto component manufacturers is expected to improve marginally during 2014-15, supported by better demand from end-user segments. OEM demand is expected to grow by 7 per cent in 2014-15 supported by gradual improvement in sale of new passenger and commercial vehicles (CVs), and steady two-wheeler sales. Growth in demand from the replacement market is expected at about 8 per cent, supported largely by demand from vehicles sold in earlier years. Better prospects for the US CV market and increased demand from EU, Latin American and Asia-Pacific nations is expected to result in export growth of 10 per cent to 12 per cent in 2014-15. Operating profitability is expected to remain steady at 10 per cent to 11 per cent in 2014-15, supported by gradually improving revenue, and continued cost control initiatives. Labour costs are expected to increase. Capex intensity could increase in the second half of 2014-15 as well as in 2015-16, in line with better demand from end-user segments. Nevertheless, auto-component players are expected to fund capex prudently, to limit significant deterioration in credit metrics.

Industry	Key reasons for rating actions in 2013-14	Outlook for the near to medium term
Pharmaceuticals	Most upgrades resulted from an increase in the scale of operations, supported by strong domestic and export demand. Downgrades were on account of weakening capital structure, which in turn was the result of debt-funded capex or working capital requirements.	CRISIL believes that the Indian pharmaceutical industry's growth during 2014-15 will be driven by increased exports to regulated and semi-regulated markets. Patent expiry and cut in healthcare spends in developed market is expected to aid Indian pharma exports. However, compliance with stringent regulatory requirements will remain a key challenge for the Indian pharmaceutical industry. In the domestic market, the growth is expected to be driven by increased per capita expenditure for healthcare, and may help the domestic players recover from the impact of price control order in 2013-14.
Financial sector	There were four downgrades in the banking sector primarily on account of persistent pressure on asset quality and earnings profile. There were six downgrades in the non-banking finance company (NBFC) sector. Two gold finance companies were downgraded because of expected weakening in profitability due to increasing delinquencies, gold price volatility and operating costs. The downgrades also indicate possible funding constraints, due to recent regulatory developments. There were five upgrades in the housing finance sector, primarily led by consistent business growth over the years and improvement in asset quality and healthy profitability.	CRISIL believes that the asset quality and profitability of Indian banks (particularly public sector banks) will remain weak for most of 2014-15. The pressure on asset quality could start receding gradually from the second half of the year. Interplay of several factors will determine the asset quality of banks. These include extent of pick up in industrial activity, progress on implementation of stalled projects and increased collections and recovery efforts. Reported gross NPAs (as a proportion of gross advances) are likely to be contained at around 4 per cent as on March 31, 2015 as compared to an estimated 4.2 per cent as on March 31, 2014 due to moderation in slippages and sale of NPAs to asset reconstruction companies. While there would be some improvement in gross NPAs, the loan restructuring by banks is likely to remain at the current elevated levels because of i) removal of regulatory forbearance on restructuring from April 2015 and ii) implementation of RBI regulations on revitalising distressed assets. The total weak assets[2] in banking system are likely to stabilise at around 5.7 per cent as on March 31, 2015 after witnessing a sharp increase to 5.6 per cent in 2013-14. Profitability of Indian banks will remain weak due to high provisioning costs and continued pressure on spreads. Return on assets (RoA) is estimated to have declined to a 10-year low of 0.8 per cent for 2013-14 and will only marginally improve in 2014-15.

[2] Weak Assets = Reported gross NPAs + 30% of outstanding restructured advances (excluding State Power Utilities) + 75% of investments in security receipts



Industry	Key reasons for rating actions in 2013-14	Outlook for the near to medium term
		The resource profiles of Indian banks remains strong. Additionally, the pressure on capital raising to comply with Basel III norms has eased marginally with the deferring of the additional equity requirement for building the countercyclical capital buffer by a year. CRISIL believes that the weakness in retail NBFCs' performance witnessed in 2013-14 will continue atleast in the first half of 2014-15. The growth in vehicle finance, the largest segment, is expected to remain moderate at around 8-9 per cent in 2014-15. Nevertheless, the overall growth of retail NBFCs is expected to improve marginally to 10 per cent -12 per cent in 2014-15 after declining to a five-year low of around 9 per cent in 2013-14, supported by the revival in gold financing and sustained healthy growth in loan against property segment. While asset quality is not expected to improve significantly from the current levels, it will start stabilising towards the second half of 2014-15 and overall GNPAs are expected to settle at around 2.8 per cent by March 2015. The profitability levels are expected to bottom out in 2013-14 and return on managed assets is likely to improve marginally by around 20 bps to 2.0 per cent in 2014-15 with likely reduction in credit costs. The capitalisation levels of NBFCs, nevertheless, remains comfortable and continues to support their credit profiles. CRISIL expects housing finance companies (HFCs) to maintain their relatively stable performance in 2014-15. Growth is expected to remain steady at around 19-20 per cent, driven primarily by individual home loans in Tier-II and Tier-III cities, and loans against property. HFCs will maintain their comfortable asset quality; gross non-performing assets are expected to remain at around 0.8 per cent by March 2015, after witnessing a slight uptick in 2013-14 on account of higher delinquencies in the non-individual portfolio, as well as in the self-employed category of individual home loans. The profitability of HFCs is expected to remain adequate with return on assets in the range of 2.1 per cent to 2.2 per cent.

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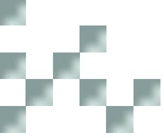

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About CRISIL Ratings

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Last updated: May, 2013

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Our Offices

Ahmedabad
Unit No.706, 7th Floor, Venus Atlantis
Near Reliance Petrol Pump
Prahladnagar Satellite
Ahmedabad - 380 015
Phone: +91 79 4024 4500
Fax: +91 79 4024 4520

Bengaluru
W-101,1st Floor, Sunrise Chambers
22, Ulsoor Road
Bengaluru - 560 042
Phone: +91 80 4244 5399
Fax: +91 80 4244 5300

Chennai
Thapar House, Mezzanine Floor,
No. 37 Montieth Road,
Egmore, Chennai - 600 008
Phone: +91 44 2854 6205
Fax: +91 44 2854 7531

Gurgaon
Plot No. 46
Sector 44
Opp. PF Office
Gurgaon - 122 003
Phone: +91 124 6722 000

Hyderabad
Uma Chambers, 3rd Floor
Plot No. 9 &10, Nagarjuna Hills
Near Punjagutta Cross Road
Hyderabad - 500 082
Phone: +91 40 2335 8103
Fax: +91 40 2335 7507

Kolkata
Convergence Building
3rd Floor, D2/2, EPGP Block
Sector V, Salt Lake City
Kolkata - 700 091
Phone: +91 33 4011 8200
Fax: +91 33 4011 8250

Pune
1187/17, Ghole Road
Shivaji Nagar, Pune - 411 005
Phone: +91 20 4018 1900
Fax: +91 20 4018 1930

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CRISIL Limited
CRISIL House, Central Avenue, Hiranandani Business Park, Powai, Mumbai– 400076. India
Phone: +91 22 3342 3000 Fax: +91 22 3342 3001
www.crisil.com