CRISIL
An S&P Global Company

Ratings RoundUp
First Half, Fiscal 2018

Improving financial profiles sustain credit quality recovery

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Executive summary

CRISIL's credit ratio* (or number of upgrades to downgrades) improved to 1.88 times in the first half of the current fiscal, compared with 1.22 times for fiscal 2017. A reading above 1 indicates upgrades outnumber downgrades.

The debt-weighted[1] credit ratio* surged to 3.19 times, versus 0.88 times for fiscal 2017. There were 817** upgrades to 434** downgrades in the first half of fiscal 2018.

And for the first time in the past five years, both these ratios have been above 1 on a rolling 12 months basis, with the credit ratio at 1.59 times and the debt-weighted credit ratio at 1.94 times. This indicates the trend of recovery in credit quality has sustained for a year now. Both these measures, when assessed on a longer timeframe (12 months), negates period bias.

The improvement has come about primarily because of better financial indicators as corporates kept away from capital expenditure given the output gap – or substantial headroom in capacity utilisation – in many sectors.

We expect this trend to continue till demand firms up. Lower interest costs will provide further support.

CRISIL-rated companies have shown steady improvement in capital structure and debt protection metrics over the past three years. The median gearing of these companies improved to 1.13 times in fiscal 2017 from 1.35 times in fiscal 2015, and median interest cover to 2.58 times from 2.28 times.

These improvements are broadly on expected lines. In the previous edition of Ratings Round Up, published in March 2017, titled '*Credit quality improves, but remains fragile*', we had highlighted that the credit quality of several debt-intensive sectors such as metals (especially non-ferrous), sugar, and mid-sized engineering, procurement and construction (EPC) players was improving. This bolstered the debt-weighted credit ratio in the first half of this fiscal.

But what continues to choke the economy's plumbing is the sticky, high level of stressed assets in banking. CRISIL estimates stressed assets to be around Rs 11.5 lakh crore, or ~14% of total advances as on March 31, 2017.

That means the credit quality of India Inc is a tale of two distinct loan books. The good one is where we have been seeing improvements over the past year, and which should sustain. The bad one is where there are sizeable stressed assets. The only salutary part in the latter is that the process of resolution and asset sales has been initiated.

Barring stressed assets, CRISIL expects corporate credit quality to continue recovering, driven by further improvement in balance sheets. Additionally, lower

* Both credit ratio and debt-weighted credit ratio do not factor in rating actions on non-cooperative issuers
** Including the rating actions on non-cooperative clients, there were 835 upgrades and 1407 downgrades in the first half of fiscal 2018.
[1] Quantum of debt outstanding on the books of the companies upgraded to downgraded (excludes financial sector players)

interest rates, stable operating cycles, firm commodity prices and improving domestic consumption demand will also help.

However, the credit ratio and the debt-weighted credit ratio would moderate from here and will track GDP growth. That's because small and mid-sized firms could see cash-flow pressure as they adjust to the new Goods and Services Tax (GST) regime. And some investment-linked sectors such as real estate and capital goods would continue to face headwinds. Progress on resolution of stressed assets will remain a key monitorable.

CRISIL continues to maintain sharp focus on the quality of its ratings and strives to minimise sudden and sharp rating actions (upgrades and downgrades). Investors also expect ratings in the 'A' and above categories to display a lot of stability.

CRISIL's portfolio of 1,275 ratings in these categories saw 93[2] rating actions in the first half of this fiscal, of which just 8[3] were multi-notch changes.

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

3 Excludes ratings placed on 'Rating Watch', which is used to convey to investors that the rating is being monitored for certain critical events and that additional information is awaited. This helps reduce the possibility of any surprise for the investors.

About CRISIL's Ratings Round-up

Ratings Round-Up is a semi-annual publication that analyses CRISIL's rating actions and traces the linkages between such actions and underlying economic and business trends.

This edition analyses CRISIL's rating actions in the six months ended September 30, 2017.

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.

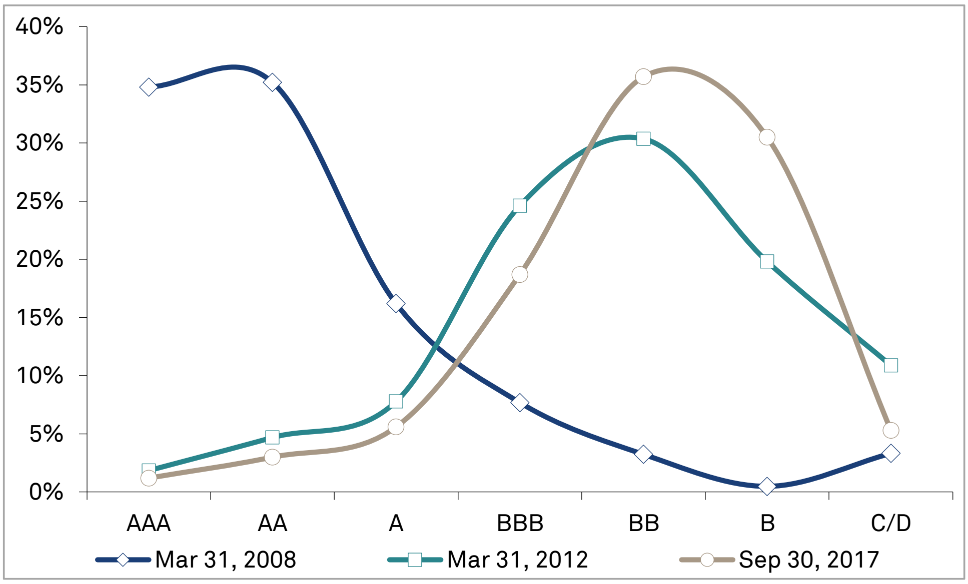
CRISIL's portfolio, median ratings unchanged

Ratings outstanding on ~13,000 issuers

Median rating remains in the CRISIL BB category

Over the past five years, CRISIL's portfolio of outstanding ratings has stabilised at ~13,000[4]. Almost three-fourths of these are in the 'CRISIL BB' or lower categories. Consequently, the median rating has stayed put in the 'CRISIL BB' category. For perspective, nearly a decade back, the median rating was in the 'CRISIL AA' category *(see chart)*.

CRISIL's rating distribution



Source: CRISIL

4 This excludes companies in the 'Issuer Not Cooperating', or INC category. CRISIL's portfolio had 2,709 such issuers as on September 30, 2017. If these are included, CRISIL's outstanding rating list will be of 15,340 issuers. But the median rating will remain in the 'BB' category.

Both the credit and debt-weighted credit ratios were above 1 on a rolling 12 months basis

Credit ratio at 1.88 times and debt-weighted credit ratio at 3.19 times in the first half of fiscal 2018

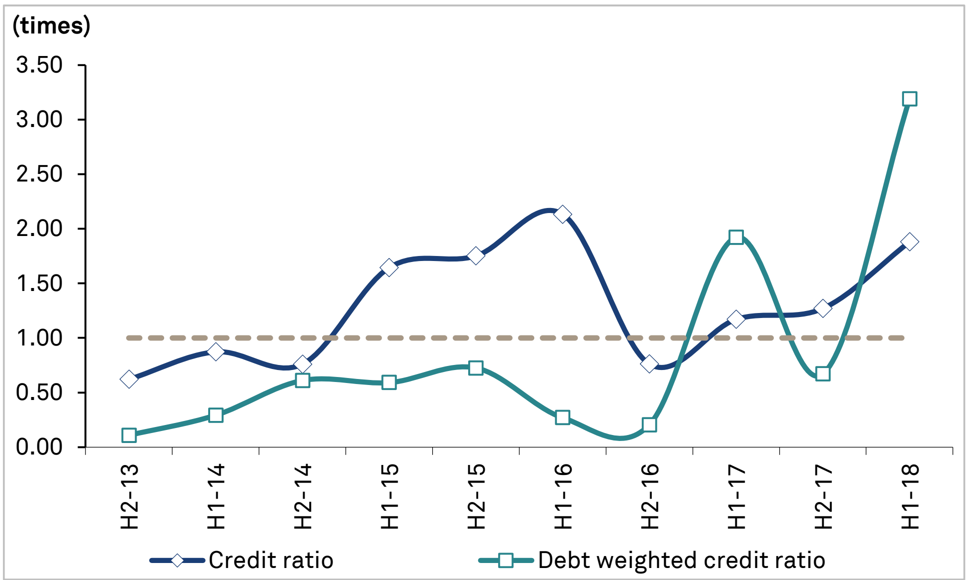
Credit ratio at 1.59 times and debt-weighted credit ratio at 1.94 times for the 12 months ended September 30, 2017

CRISIL's credit ratio and debt-weighted credit ratio stood at around 1.88 times and 3.19 times, respectively, for the first half of fiscal 2018 *(see chart).* That's better than the 1.27 times and 0.67 time, respectively, seen in the second half of fiscal 2017.

That's also an improvement from the first half of fiscal 2017, when the credit ratio was 1.17 times and debt-weighted credit ratio was 1.92 times.

The improvement is on expected lines. In our previous Ratings Round-Up published in March 2017 and titled '*Credit quality improves, but remains fragile*', we had expected upgrades to outnumber downgrades going forward. The credit quality of several debt-intensive sectors such as metals (especially non-ferrous), sugar, and engineering, procurement and construction (EPC) were also expected to improve. This was expected to bolster the value of debt upgraded.

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



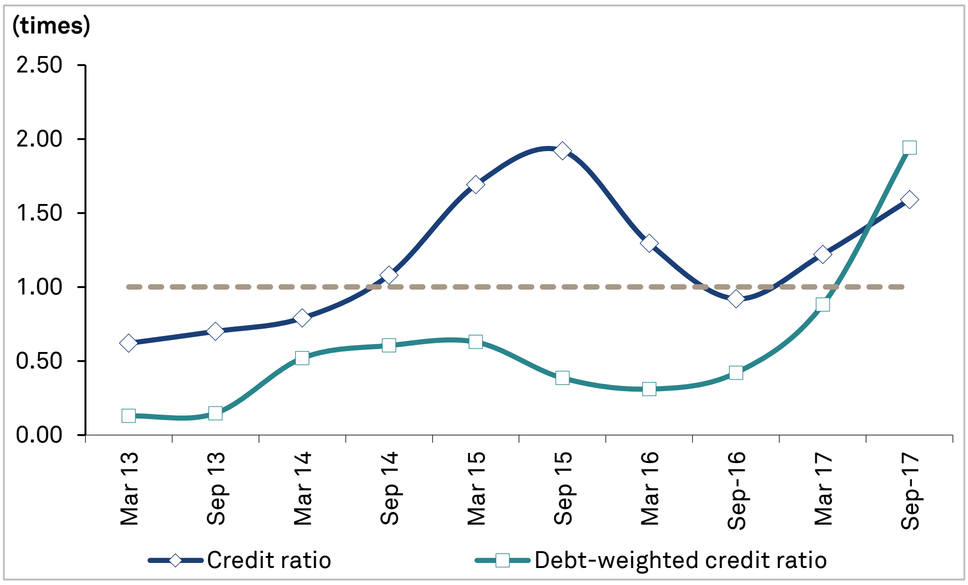
Source: CRISIL

To ascertain whether credit quality recovery is sustainable, two measures – the credit ratio and the debt-weighted credit ratio – need to be assessed on a longer timeframe (12 months basis) so as to avoid period bias. They also need to be above 1 time.

And for the first time in the past five years, on a rolling 12 months basis, both the credit ratio and the debt-weighted credit ratio are above 1 time *(see chart)*, indicating sustenance of recovery in credit quality seen during the last year.

The debt-weighted credit ratio increased to 1.94 times in the 12 months ended September 30, 2017, compared with 0.88 time in the 12 months ended March 31, 2017. Similarly, the credit ratio increased to 1.59 times compared with 1.22 times.

12 months rolling credit ratio and debt-weighted credit ratio



Source: CRISIL

Among sectors, too, the recovery is seen to be broad-based with some investment-linked sectors also witnessing more upgrades than downgrades, even as the consumption and export-linked sectors continued to do well.

This was led by improving capital structure, debt protection metrics, and stable operating cycles, which improved the financial health of companies. Our rating actions also factor in the following expectations: domestic demand will grow over the near- to medium-term spurred by near-normal monsoon, commodity prices will remain firm, high government spends on infrastructure will continue, and economic conditions in India's major export destinations will not see any substantial slowdown.

Note: This analysis excludes the stressed assets in the banking system (estimated at Rs 11.5 lakh crore, or ~14% of total advances). CRISIL does not foresee a significant increase in stressed assets over the medium term because of expected credit quality recovery in a chunk of corporate loans.

Downgrade rate at the lowest level in the past five years

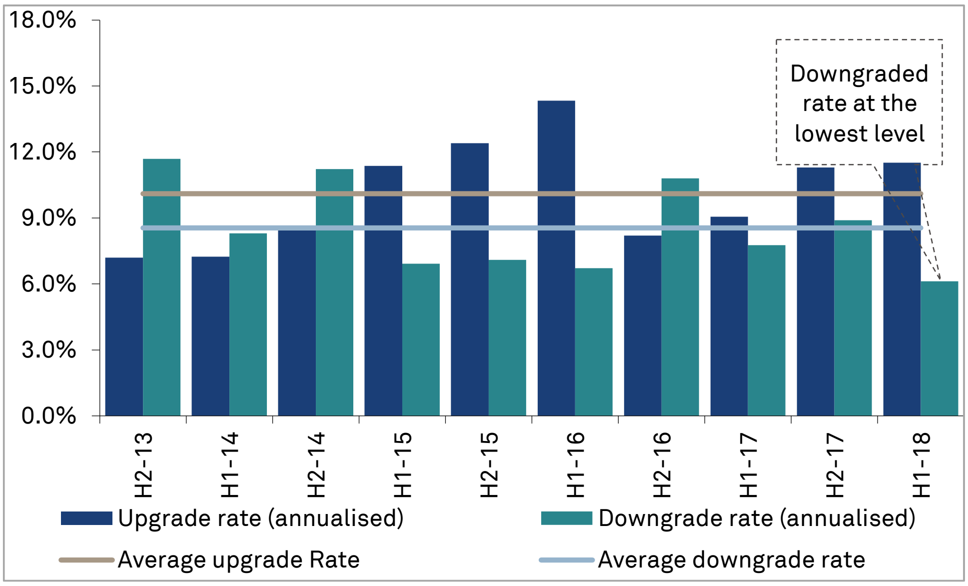
12%
upgrade rate

6%
downgrade rate

CRISIL's rating actions indicate pressure on credit quality has abated, as underscored by 817 upgrades in the first half against just 434 downgrades.

At 6%, the downgrade rate for the first half is at a five-year low, and well below the average of the past 10 semi-annual periods *(see chart below)*. And at 12%, the upgrade rate is slightly above average. This has lifted the credit ratio to well above 1 time – to 1.88 times – for the first half.

Trends in rating action



Source: CRISIL

Only 7% of the sectors (or 8 sectors, excluding financial sectors) that we track had a credit ratio of less than 1 time (meaning downgrades outnumbered upgrades) or only downgrades. This is also the least in the past 10 semi-annual periods.

Capital structure and debt protection metrics show improvement

Gearing and coverage ratio improve

Working capital cycle remains stable

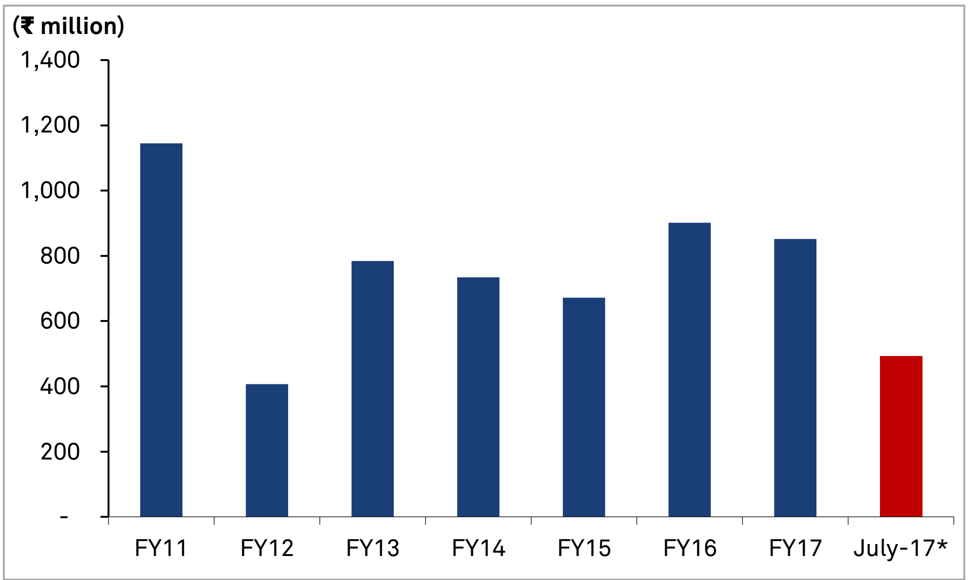
Several companies have seen their credit profiles improve due to healthier financial risk profiles. A general absence of capital expenditure (especially debt-funded), and capital infusion (through equity issuance/unsecured loans from promoters or market/through asset sales), were the catalysts here.

Firmer prices in commodity-linked sectors and the ability to pass on higher costs owing to strong demand in consumption-linked sectors helped companies maintain or improve their profitability last fiscal. That, along with stable working capital cycles, lower debt, and declining interest costs improved debt protection metrics and led to an improvement in the financial risk profiles.

Since January 2015, the Reserve Bank of India (RBI) has cut its policy – or repo – rate by 200 basis points. The transmission of this through bank lending rate cuts gathered pace in fiscal 2017 because of excess liquidity following demonetisation. That, in turn, reduced the interest cost for companies.

Equity issuances – public and private placements – has also started to see some buoyancy. It increased in the past two fiscals *(see chart below)*, though it remains below the peak of Rs 1.2 lakh crore seen in fiscal 2011 when capex reached an apogee. In the four months of April-July 2017 alone, equity raisings have touched ~Rs 50,000 crore (or about 60% of what was raised in fiscal 2017).

Equity issuances (public and private placements)**



* For April-July 2017
**Public Equity Issues includes IPO, FPO & Rights issues of common equity shares. Private placement of Equity includes, amount raised through preferential allotments, QIP and IPP mechanism.

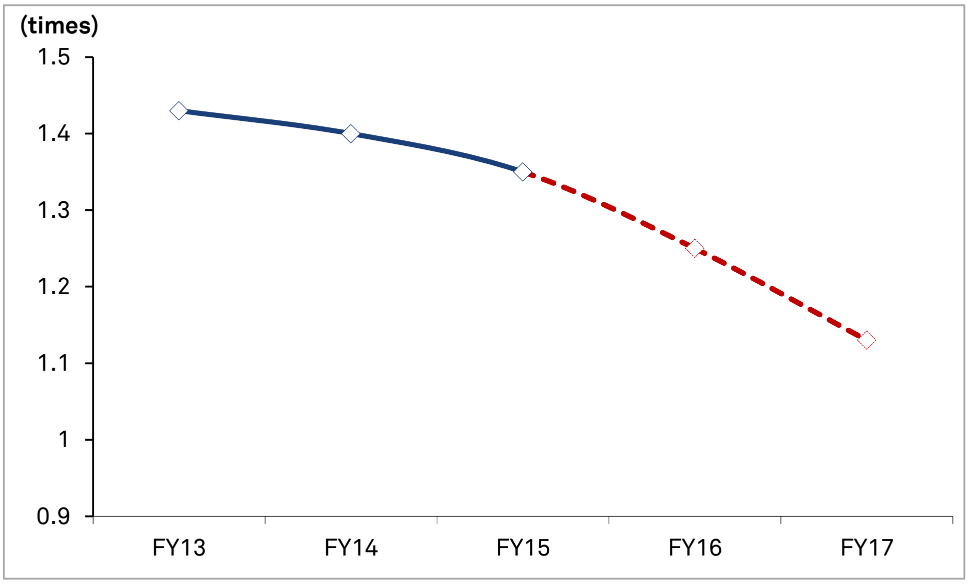
Source: SEBI Bulletin

An analysis of a static pool[5] of CRISIL rated companies shows that capital structure (as reflected by gearing ratio) and debt protection metrics (as reflected by interest cover) have been improving even as working capital cycle has remained stable.

The median gearing of companies has improved to 1.13 times in fiscal 2017 from 1.35 times in fiscal 2015, whereas median interest cover improved to 2.58 times in fiscal 2017 from 2.28 times in fiscal 2015.

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

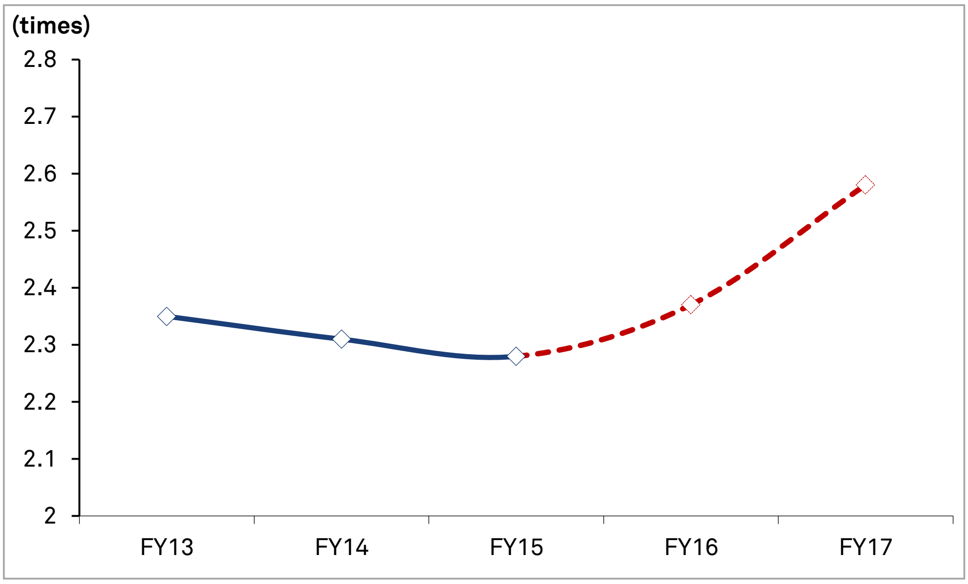
Trends in median gearing



Source: CRISIL

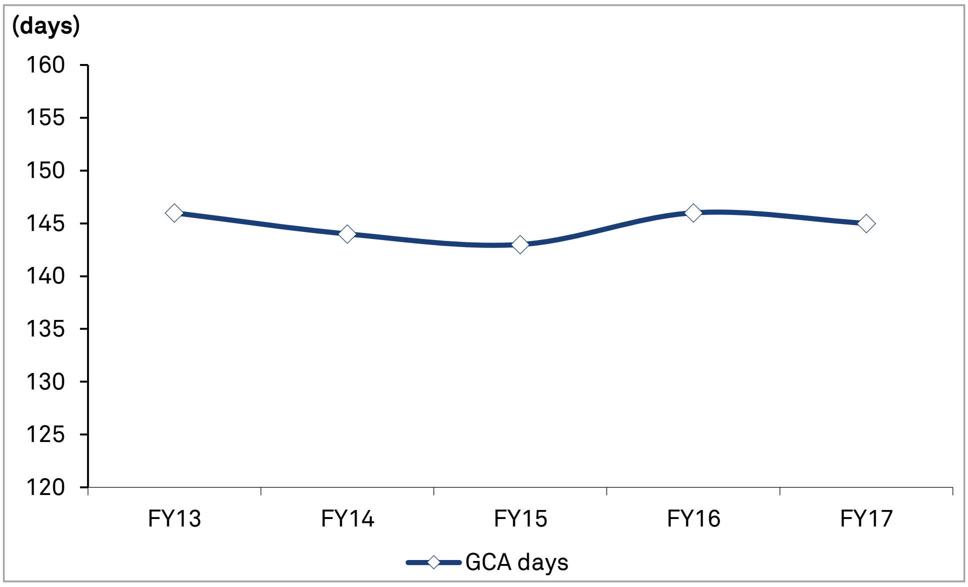
[5] The static pool consists of over 7,000 CRISIL-rated companies (excluding companies in financial sector and those which are yet to commence operations) where CRISIL has had a rating coverage of at least three years in the last five fiscal years or where financials are consistently available for the last five fiscals to March 31, 2017. The pool is reflective of CRISIL's rated portfolio with the median rating of the pool too being at 'BB' rating category.

Trends in median Interest cover



Source: CRISIL

Trends in median working capital cycle (GCA[6] months)



Source: CRISIL

[6] GCA: Gross current assets

Changes mostly of one notch

~90% of rating actions were of low intensity

Only 8 actions were multi-notch

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

In the first half, there were 93[7] rating actions in the 'A' and above category portfolio, which consists of 1,275 ratings. Of these, only 8[8] were multi-notch changes (high intensity), while the rest were single notch (low intensity).

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

[8] Excludes ratings placed on 'Rating Watch', which is used to convey to investors that the rating is being monitored for certain critical events and that additional information is awaited. This helps reduce the possibility of surprise for the investors.

Consumption sectors do well, followed by export and investment sectors

Consumption sectors continue to fare better

Some investment-linked sectors show improvement

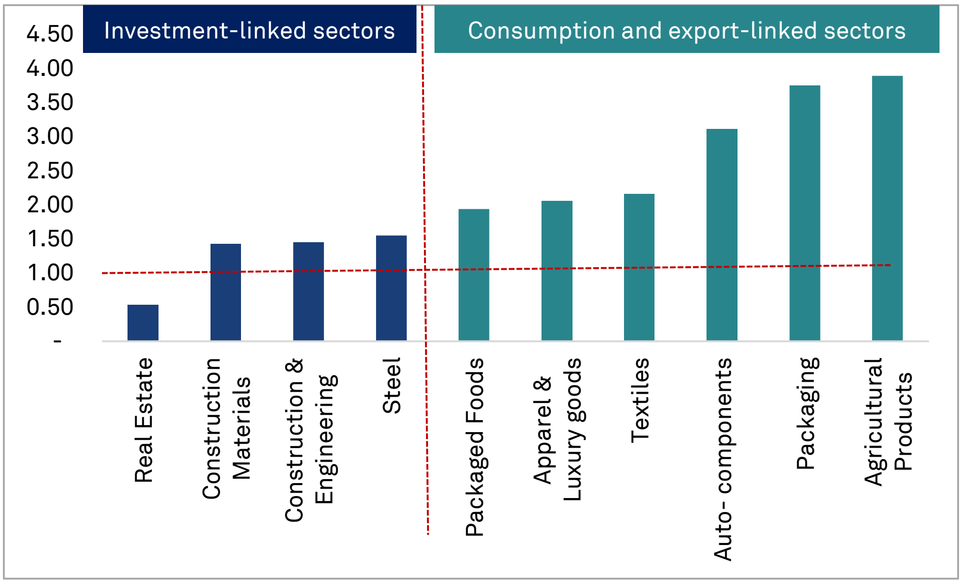
Apart from improvement in financial metrics (gearing, interest cover) and stable operating cycles that bolstered the credit profiles of companies across sectors, there were business reasons as well for upgrades outnumbering downgrades.

Consumption-linked sectors continued to see more upgrades than downgrades in the first half. Domestic demand, especially rural, which was dealt a hard blow by demonetisation in the second half of the last fiscal, is in recovery mode. A near-normal monsoon, softer interest rates and payment of Pay Commission-recommended arrears are seen driving overall growth in the coming quarters.

Better-than-expected economic improvement in India's major export markets such as the US and Europe (excluding UK) propped the credit quality of export-linked sectors in the first half.

On the other hand, firm commodity prices and high government spends (especially on roads, affordable housing, railways, urban infrastructure) aided the credit quality of investment-linked sectors.

Rating actions on top industries



Source: CRISIL

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

Exports have had a better five months this fiscal

4% IMF forecast on global growth in 2017

3.9% IMF forecast on global growth 2018

In July 2017, the International Monetary Fund (IMF) predicted world trade volume will grow 4% and 3.9% in calendar years 2017 and 2018, respectively, after rising 2.3% in 2016.

The pick-up in global trade is expected to be driven by improving consumer spending in both the US and Europe (excluding the UK) as political uncertainties diminish. On the other hand, continued fiscal support and supply-side reforms are seen bolstering China.

As for the UK, lingering uncertainties around Brexit have lowered growth expectations.

S&P Global Ratings has more or less maintained its growth forecast for the US in 2017 and 2018, while marginally increasing it for the Eurozone (excluding the UK) and China since our last Ratings Round-Up. It has also sliced its prediction for the UK.

Increasing geo-political tensions and rising protectionism remain risks to these estimates.

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

Countries	2015	2016	2017(f)	2018(f)	2019 (f)
Eurozone (excluding the UK)	1.9%	1.7%	2%	1.7%	1.5%
UK	2.2%	1.8%	1.4%	0.9%	1.3%
US	2.9%	1.5%	2.1%	2.3%	2%
China	6.9%	6.7%	6.7%	6.3%	5.9%

During the first five months of fiscal 2018, India's exports increased 8% after declining by 3% in the comparable period of fiscal 2017.

Oil exports rebounded, increasing 26% between April and August this fiscal, after declining 18% in the comparable previous period.

Sectors such as textiles, engineering goods and rice have seen growth in exports during April-August, while these had de-grown last fiscal. Other sectors such as organic and inorganic chemicals grew faster, while pharmaceuticals and gems & jewellery decelerated.

CRISIL expects exports growth to moderate in the rest of this fiscal if the rupee remains stronger relative to competition.

Resolution of NPAs through IBC route holds the key

Two-thirds of stressed assets recognised as NPAs

Stock of GNPAs to remain elevated given low recoveries

Banks continue to weather asset quality challenges, mainly in their corporate loan books. CRISIL estimates stressed assets in the banking system to be around Rs 11.5 lakh crore, or ~14% of total advances. We do not see this number increasing significantly from here because of a gradual recovery in credit quality driven by higher commodity prices, lower interest rates and improved capital structures.

With two-thirds of the stressed assets already recognised as non-performing assets (NPAs) as on March 31, 2017, we expect incremental NPA creation to decelerate in fiscal 2018. However, the overall stock of gross NPAs would continue to rise as slippages outpace recoveries.

Large corporate stressed assets remain a drag on recoveries. Reductions (as a percentage of gross NPA at the start of the fiscal) were at a multi-year low in fiscal 2017, and was largely supported by high write-offs. In fiscals 2016 and 2017, the share of write-offs by public sector banks (PSBs) had surged to 46% compared with an average 37% in the five preceding fiscals.

The gross NPA ratio is expected to rise to ~10.5%, or Rs 9.5 lakh crore, by March 31, 2018. Faster resolution of stressed assets through the Insolvency and Bankruptcy Code (IBC) route, and other structuring schemes, will be critical to improving the asset quality of banks. In the near term, asset quality could also be driven by implications of the GST, if any, on the micro, small and medium enterprises (MSME) sector, and the impact of loan waivers on agriculture NPAs.

With the ageing of NPAs and higher provisioning ordered by the RBI for specific large NPAs, banks are expected to provide more over the medium term. Provisioning cover for NPAs (excluding technical write-offs) is expected to rise to above 50% by March 2018 compared with 44% as of March 2017.

Nevertheless, lower interest reversals (as slippages decline) and muted growth in operating expenses are expected to support pre-provisioning profits of banks in the current fiscal. However, a few weak PSBs would continue to report losses in fiscal 2018 as their provisioning requirement keeps rising. Also, another spurt in treasury profits, as witnessed in fiscal 2017, is unlikely this fiscal to cushion the earnings profiles. On the other hand, private sector banks, especially the retail-focused ones, have been able to weather the asset-quality storm well.

With private investments unlikely to pick up momentum, credit growth is expected to be around 8% this fiscal, compared with ~5% in fiscal 2017. Moderation in credit growth, however, has helped banks meet Basel III capital norms. It has also partly offset the impact of weak profitability. Additionally, banks have raised Rs 62,000 crore non-equity Tier I capital over the past 2 years to meet Basel III requirements. But the capital challenge remains and what the government has promised under the Indradhanush plan up to fiscal 2019 will be insufficient for PSBs to meet the minimum regulatory threshold.

The weak assets matrix

	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18 (P)
Gross NPAs (as a percentage of gross advances)	3.8%	4.3%	7.5%	9.4%	10.5%
Gross NPAs (Rs lakh crore)	2.6	3.2	6.1	8.0	9.5
Gross advances (Rs lakh crore)	68.7	75.6	81.7	85.3	92.0

Source: CRISIL

Outlook

The overhang of demonetisation and fears around the impact of GST rollout has led to a sharper-than-expected deceleration in GDP in the first quarter of fiscal 2018. As a result, CRISIL has shaved its GDP growth forecast for fiscal 2018 by 40 basis points to 7%. This implies a GDP growth of 7.4% on average in the remaining three quarters of this fiscal.

We expect growth to be consumption-led because of a near-normal monsoon (just 5% below the long period average as on September 15), softer interest rates and inflation, the implementation of the Seventh Pay Commission recommendation by states, and remnants of pent-up demand that was postponed due to demonetisation.

Private investment, which was already low because of large headroom in capacity utilisation, would weaken further if growth slows afresh. And, as stated earlier, exports growth would moderate in the remaining part of this fiscal if the rupee stays strong relative to competition.

Barring stressed assets, CRISIL expects the corporate credit quality to continue recovering, driven by further improvement in balance sheets. Additionally, lower interest rates, stable operating cycles, firm commodity prices and improving domestic consumption demand, will help.

However, CRISIL expects the credit ratio and the debt-weighted credit ratio would moderate from here as uncertainties on account of change in tax regime over the short-term, still subdued global growth in India's major export destinations and weak domestic investments could limit the upside of GDP growth. Moreover, small and mid-sized firms could also see cash-flow pressures as they adjust to the new GST regime. And some investment-linked sectors such as real estate and capital goods are expected to continue to face headwinds.

The risks to these expectations are:

- Sharp changes in commodity prices
- Slowdown in India's major trade destinations
- Prolonged implementation glitches in GST
- Inability of MSMEs/unorganised sector to adjust to the new business enviorment or to formalise
- Sharp swings in the rupee versus the dollar

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Key reasons for rating actions, and sectoral credit quality outlook

Automotive components

Upgrades	Downgrades
Upgrades were mainly driven by higher cash accrual stemming from steady profitability, healthy offtake driven by existing domestic original equipment manufacturers (OEMs) and customer wins. Moreover, moderate capital spending and prudent working capital management had also helped in improving capital structure. Median leverage (debt/EBIDTA) of upgrades was almost half of median leverage of downgrades.	Downgrades were mostly due to weak liquidity, resulting from stretch in receivables and lower than expected revenue growth.

Smooth ride to continue as temporary disruption ahead of GST implementation subsides

The automotive component industry is poised for higher growth at 9-11% in fiscal 2018 as against an estimated 7-8% in fiscal 2017. This will be driven by increased offtake by OEMs, particularly passenger vehicle (PV) makers, steady aftermarket demand and slight uptick in exports.

Near-normal monsoon, increase in disposable incomes, and a raft of launches resulted in good growth across OEMs (except medium and heavy commercial vehicles {M&HCVs}) in the first half of fiscal 2018, despite some stock correction due to GST implementation. Demand for M&HCVs is expected to remain subdued due to higher cost of BS IV vehicles, surplus fleet in the market and slowing GDP. Still, overall OEM demand is expected to increase by 11-13% in fiscal 2018, while demand from aftermarket will remain steady.

Exports recovery in fiscal 2018 will be aided by improving traction in Class 8 truck production in the US and steady new registrations in PVs in the European Union.

Over the medium term, demand will be supported by changing dynamics of the auto industry with increasing safety measures, emerging new technologies, and higher regulatory standards.

Profitability of component makers is expected to remain stable despite higher input cost. Raw material prices are expected to rise another 3-5% in fiscal 2018. This, however, will be offset by higher utilisation because of higher OEM offtake and better product mix because of higher exports. Margins will also be supported by growth in realisation from certain components due to the implementation of Bharat Stage IV emission norms.

Better operating efficiencies and increasing demand will lead to further improvement in the credit quality of the sector. In the past, companies had shown financial prudence by controlled capital spending and efficient working capital management. Higher research & development spends are expected as companies upgrade technology to meet tightening regulatory and safety norms, and uptick in demand could lead to a revival in the capex cycle. We expect suppliers to PVs and two-wheelers, which are currently operating at high utilisation rates, to lead the capex cycle.

Nevertheless, the funding mix of increasing capex and automotive-component sales growth to M&HCV segment will be key monitorables.

Basmati rice

Upgrades

Most of the upgrades were in the non-investment rating category driven by improvement in the financial risk profile. This was attributable to improved gearing/capital structure driven by higher profitability as the companies expanded both in the domestic and export markets due to better demand. Higher capacity utilisation and better operating efficiencies led to increase in profit margins. Few companies also supported the expansion by infusing equity.

Downgrades

There was only 1 downgrade for 3 upgrades in this sector.

And more than three-fourths of the downgrades were to the default category because of delays in debt servicing, which emanated from elongated working capital cycles leading to weaker liquidity.

Rebound in export volumes and better realisations alleviate pressure after 3 consecutive years of revenue decline

India exported 4 million tonne (MT) of basmati rice valued at Rs 21,604 crore in fiscal 2017. That was a decrease of 1% volume and 4.9% by value on-year (4.04 MT and Rs 22,718 crore, respectively, in fiscal 2016). Lower sales realisations had hit exporters hard in each of the three consecutive fiscals through 2017. These challenges eased in April-June 2017 as exports jumped up 24% to Rs 8,172 crore by value over the corresponding period the previous year. The exports volume also increased by 6% as demand from major importer-countries rose.

While paddy prices increased in the previous rice procurement season, these were passed on by exporters to customers during April-June 2017, which alleviated some pressure from the high cost of inventory carried in fiscal 2017. CRISIL expects credit risk profiles of basmati rice exporters to improve over the medium term if Iran lifts imports ban this year and paddy prices remain stable. The volume of exports to Iran has increased significantly by 37% in April-June 2017 over the comparable previous period.

Construction & engineering

Upgrades

Majority of the upgrades were due to higher cash accrual and improvement in gearing ratios stemming from executing more orders and better return on capital employed (ROCE). Median ROCE for upgrades was 24% whereas for downgrades it was 14%. Similarly, median leverage was at 0.9 time versus 1.6 times.

Healthy flow of orders continued to improve business profiles.

Downgrades

Downgrades were mainly driven by lower-than-expected revenues as execution of existing work contracts slowed. Intense competition and project delays also reduced revenues, while a stretch in receivables weakened liquidity profiles. This could be seen in the median GCA months for downgrades, which was more than 7 months, whereas for upgrades it was close to 5 months.

Note: Credit profiles of many large diversified EPC players continue to be constrained by the after-effects of aggressive bidding in the past, leveraged balance sheets, 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 below excludes these stressed assets in the banking sector and is more representative of the non-stressed portion of the corporate loan book.

Policy reforms and investments help construct better credit profiles

Budgetary support to key focus areas such as roads, railways and urban infrastructure has increased this fiscal over last. Construction spend is expected to grow ~8-10% over the next 2 fiscals driven by a pick-up in investments in the roads sector. Most construction opportunities in infrastructure are expected to come from the roads sector. Faster execution of national highways, and higher funding for the Pradhan Mantri Gram Sadak Yojana projects will be the major drivers of spending. Metro rail projects, the Smart cities Mission and the Swachch Bharat initiative will drive investments in urban infrastructure.

Investments in railways will be aided by the development of freight corridors, addition of new lines and electrification. Also, policy reforms such as the introduction of the hybrid annuity model, and one-time fund infusion by the National Highways Authority of India (NHAI) into stalled projects, full exit from build-operate-transfer (BOT) projects so as to release developers' tied-up equity and thus reduce their debt, are expected to boost execution pace, lower implementation risk and contribute to better performance of companies.

Also, the situation has significantly improved for many road EPC companies driven by better flows, prudent working capital management, and capital structure. These have brought about a gradual improvement in key debt protection metrics such as interest coverage in fiscal 2017, and is expected to improve further this fiscal.

Pharmaceuticals

Upgrades

Upgrades were driven by higher demand in the domestic and semi-regulated markets coupled with steady profitability, resulting in higher cash accrual, and improvement in the financial risk profiles. Around a third of the upgrades were in the bulk drugs segment.

Downgrades

There were two downgrades. One was due to subdued operating performance because of lower offtake and realisations for key products, which led to lower profitability and cash accrual. The other was due to a delay in the commencement of operations.

Health of pharma companies to remain stable despite moderation in growth

Pharmaceuticals companies are expected to maintain their strong credit profiles, despite moderation in growth compared with the past. The industry is expected to grow at 10-11% in fiscal 2018. Growth in the domestic market will outpace exports in fiscal 2018 because of pricing pressures, especially in the US, and currency volatility in emerging markets.

Rising healthcare spending and awareness, increasing market penetration, and new product launches, especially in the chronic segment will continue to drive growth in the domestic market. While sales and profitability of companies with a large domestic presence was impacted in the first quarter of fiscal 2018 due to destocking ahead of GST implementation, things are expected to normalise, given inherent demand stability.

Many companies, with substantial export presence, have made material progress on remediation following US Food and Drug Administration citings. Consequently, abbreviated new drug approvals have risen sharply in the first quarter of fiscal 2018. However, formulation exports (both regulated and semi-regulated), will still see sluggish growth. Rising pricing pressures due to increasing competition, supplier consolidation and continuing regulatory scrutiny[9] will curb significant improvement in exports to the US. On the other hand, subdued economic scenario and currency fluctuations will continue to impact exports to semi-regulated markets, leading to low export growth in the near term.

The bulk drugs segment growth is expected to sustain on the back of increasing focus on niche molecules and specialty products, where competition is less than the traditional segment.

[9] Food, Drug & Administration

The industry's profitability, while remaining healthy, is expected to see a drop of 150-200 basis points in fiscal 2018 because of the impact of GST implementation in the first half, pricing pressures in the US, and appreciation of rupee against dollar. High research & development spends and compliance costs will also impact profitability.

Despite business pressures, credit profiles, especially of companies with good revenue diversity, is expected to remain stable backed by strong financial risk profiles.

Real estate

Upgrades

Upgrades were driven by advanced construction stages of projects and healthy bookings, which helped builders be less dependent on borrowings for construction costs. Furthermore, there were instances, where promoters infused equity to reduce reliance on debt. In addition, there have been improvements in debt service coverage ratio as companies refinanced their debt.

Downgrades

Almost half of total downgrades were in the residential real estate segment because slower-than-expected sales led to lower cash accrual. Saleability was also affected by subdued demand, which declined further on demonetisation, the Real Estate (Regulation & Development Act) and GST. Consequently, liquidity was impaired.

More than half of the downgrades were to the default category.

A hard reality check

The residential real estate sector has been facing headwinds for the past few years, primarily due to weak demand. This is reflected in declining sales velocity and subdued cash collections (both in fiscal 2017 and in the first half of fiscal 2018), fewer new project launches, and large unsold inventories. While demonetisation impacted sales in fiscal 2017 – especially secondary market transactions and in micro markets with high investor concentration – the implementation of RERA and GST subdued demand further this fiscal.

Clearly most buyers are adopting a 'wait and watch' mode. Developers are likely to face funding challenges in the short-to-medium term, with limited flexibility to access funds from other projects and requirement of timely completion of projects as mandated by RERA.

In addition to high reliance on non-bank funding, developers with a diversified portfolio are leveraging commercial assets to tide over their funds crunch. On a positive note, the implementation of RERA will improve transparency and support the industry's growth and end-user's confidence.

Demand is expected to remain muted in the near term and recover gradually over the medium term, with sustained improvement in macroeconomic conditions. In the affordable housing segment, demand is expected to stay strong given the relatively low ticket sizes and impetus from the government's 'Housing for All by 2022' programme.

The Pradhan Mantri Awas Yojana has received a special allocation of Rs 29,000 crore for fiscal 2018, an increase of 38.7% over previous fiscal. Subsequently, there has been traction in new project launches in the affordable housing segment this fiscal.

In commercial real estate, vacancies have reduced steadily on the back of increasing absorption over the past couple of years and limited additional supplies. Rentals have remained steady and occupancy is expected to stay healthy driven by improving business conditions.

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

Steel

Upgrades

Majority of the upgrades were due to higher cash accrual and improved liquidity driven by growth in revenues and profitability. Higher realisations due to increase in domestic steel prices and better capacity utilisation further supported growth.

Downgrades

Downgrades were mainly because of operating performance issues and high gearing. Also, stretched working capital cycles led to weak liquidity.

Half of the total downgrades were to the default category.

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

Improved domestic demand scenario provides support

India's domestic steel demand is expected to increase in mid-to-high single digit range over the near term, driven by a rise in government outlay on infrastructure and affordable housing, restrained imports, and a surge in exports.

The imposition of safeguard measures on imports, and positive growth momentum in Asian countries along with antidumping duty on China's steel products in developed markets made India a net exporter in fiscal 2017.

We expect this trend to continue in the medium-term, though increasing domestic demand or rising protectionism in countries that import Indian steel could alter the arithmetic.

Global steel demand growth is expected to remain muted (0-1%) because of overcapacity, continued slowdown in major economies, and structural weakening in China as the government there tries to turn the economy into a more consumption-driven one. This will be partly offset by healthy economic outlook in Nepal, Vietnam, and Malaysia, and steady growth in the US construction and energy segments.

Elevated coking coal prices, import safeguards, and a gradual pick-up in demand will lead to domestic steel prices rising 1-3% this fiscal. Profitability of steel makers is expected to improve on better domestic demand and prices. Large producers are seen benefiting more compared with the mid-sized and small ones.

Historically, credit quality of steel makers has been impacted by the mountains of debt contracted to expand capacity. Now, with business prospects better and capacity utilisation improving, we could see their credit quality to be better. However, the improvement would be limited to a few companies because most others continue to be deeply indebted with high interest burden.

Textiles

Upgrades

Majority of the upgrades were driven by higher cash accrual resulting from efficient working capital management and better profitability. Furthermore, median gearing ratio for upgrades was around 1 time, almost half that for downgrades.

Upgrades were mainly witnessed among cotton ginners and textiles weavers.

Downgrades

Most of the downgrades were due to a stretch in working capital requirement and higher inventory. This impacted liquidity and other key credit metrics.

Around 70% of the downgrades were to the default category.

Organised RMG players to benefit from the introduction of GST

CRISIL forecasts the readymade garments (RMG) industry to grow at 8-9% over the near to medium term. The industry will depend more on domestic demand than exports for overall growth due to competition from Vietnam and Bangladesh and lower-than-expected growth in the US and European Union.

This fiscal, we expect the profitability of the domestic organised branded segment to improve after passing on the GST benefit for apparel priced below Rs 1,000. However, the unorganised segment (units that specialise in job-work) are expected to experience margin pressure. The profitability of exporters will also be under pressure on account of rupee appreciation and scaling back of duty drawback benefits after GST (unless these are substituted with equivalent sops) in the second half of the year.

CRISIL expects growth in the cotton yarn industry to pick up to 4-5% this fiscal after a muted last fiscal, driven by a revival in domestic demand and lower GST incidence. Derived demand is also expected to revive as non-traditional markets recover and Europe shows higher clothing consumption.

Domestic cotton prices are expected to decline in the cotton season 2017-18 on higher supplies following increase in sowing areas. Over the medium term, we expect capacity addition to be limited due to lowering of sops by the government and overcapacity.

Last fiscal, cotton fabrics production grew a meagre 1% due to decline in RMG exports and slowdown in domestic demand because of demonetisation. This fiscal, CRISIL forecasts production to pick up to about 3% on recovery in RMG exports and domestic demand.

We believe the credit profiles of RMG players, especially those focused on the domestic market, will be better than cotton spinners, and supported by higher profitability. The financial risk profiles of spinners would improve gradually over the medium term supported by muted capacity additions. However, large spinners may look to forward integrate into weaving to take advantage of the capital subsidy available under the Amended Technology Upgradation Fund Scheme and will remain a key sensitivity factor.

Non-banking financial companies

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Upgrades

Upgrades were driven by improved market position as companies diversified into new segments and geographies. Companies have also been able to maintain better asset quality and adequate capitalisation.

Downgrades

Downgrades were because of stress in asset quality and consequent impact on earnings and capitalisation. One company has also entered into a business transfer agreement which could impact its earnings because the better quality – and interest-earning – portfolio would move out of its books.

Market share to continue to expand, capital position remains comfortable

Non-banking finance companies (NBFCs) have steadily grown over the past few years and increased their share of the Indian financial services market pie. They are seen continuing to strengthen their market position supported by product diversification and improved funding ecosystem.

The market share of NBFCs and housing finance companies (HFCs) has increased to ~16% of the total system credit pie, up from 12% over the past 5 years

We expect this trend to continue, and their share should reach to nearly 18% by 2019. New businesses are expected to constitute 40% of NBFC advances by fiscal 2019 compared with 16% in fiscal 2016.

Vehicle and gold loans are expected to pick up in the coming years after low growth in fiscals 2012-2016. CRISIL also expects MSME financing and structured credit/real estate financing to drive growth for NBFCs.

However, there is intense competition, particularly in retail asset classes, from private banks because of subdued demand for corporate credit.

Moreover, demonetisation and GST have led to a new set of challenges. Loans to MSME, vehicles and the loan against property (LAP) segment could see some asset quality challenges in the near term because of demonetisation and the need to conform business processes to the GST regime. Reported gross NPAs will increase on account of transition to more stringent asset classification norms. However, at an overall level, underlying asset quality performance of NBFCs in terms of 90+ day past due is expected to be stable.

Comfortable capital position and increased investor interest in NBFCs, however, provide respite. NBFCs have raised over Rs 26,000 crore of equity capital over the past five years. Further, diversifying the resource mix, with increasing share of capital market borrowings (in the form of non-convertible debentures and commercial papers) and securitisation allows them to manage their cost of funds better, and thereby the earnings profile too.

CRISIL believes that technology and operational innovations will be the next game changers in the financing space. Early adoption of best practices will enable NBFCs to deal with rising competition from banks.

About CRISIL Limited

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

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