Research

CRISIL Q3 FY17 Results Outlook

January 2017

Corporate profitability: Review and Outlook

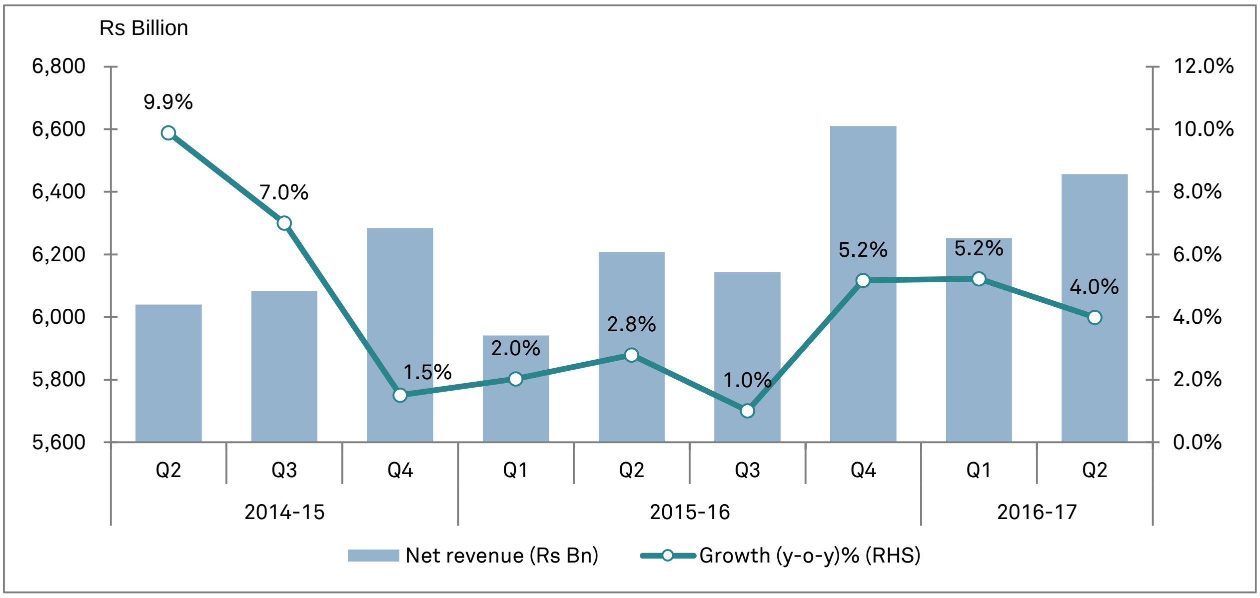
Results review (July – September 2016)

Growth momentum weakened in Q2FY17

India Inc reported 4% y-o-y revenue growth during Q2FY17, compared with 2.8% growth in Q2FY16. However, an analysis of the performance of 390 companies across 50 sectors (excluding financial services and oil) in the quarter to September 30, 2016, shows that growth momentum across some key sectors has been gradually weakening over the past two quarters.

While the revenue of export-linked segments grew 9%, segments linked to consumer discretionary spending posted revenue growth of 8%. On the other hand, revenue of sectors related to investments remained stable.

Industry's revenue, year-on-year basis



Source: CRISIL Research

A snapshot of key sectors

Revenue Growth (y-o-y)	Q2FY15	Q3FY15	Q4FY15	Q1FY16	Q2FY16	Q3FY16	Q4FY16	Q1FY17	Q2FY17
Overall Industry	**9.9%**	**7.0%**	**1.5%**	**2.0%**	**2.8%**	**1.0%**	**5.2%**	**5.2%**	**4.0%**
Key sectors	**9.4%**	**7.0%**	**0.6%**	**1.6%**	**3.6%**	**0.8%**	**7.2%**	**6.3%**	**5.3%**
Automobiles	13.0%	9.6%	8.3%	11.2%	10.4%	13.6%	15.3%	10.1%	10.9%
IT services	9.4%	11.4%	9.4%	14.6%	15.2%	12.0%	17.1%	15.1%	9.7%
Power	7.2%	8.7%	-2.8%	2.8%	13.9%	3.7%	9.8%	4.5%	0.8%
Steel products	9.3%	-0.8%	-9.2%	-10.2%	-13.2%	-17.7%	-4.0%	-2.5%	6.9%
Telecom services	8.1%	8.7%	7.1%	5.8%	6.0%	4.6%	7.7%	6.0%	3.1%
Pharmaceuticals	26.3%	20.6%	16.9%	22.9%	9.1%	7.2%	15.6%	8.9%	8.2%
FMCG	17.2%	10.7%	5.4%	3.2%	2.4%	5.9%	-3.1%	-1.4%	-2.4%

Note: **Key sectors** include Airline services, Aluminium, Automobiles, Auto components, Capital Goods, Cement, Chemicals, Construction, FMCG, Housing, IT services, Media & Entertainment, Natural gas, Pharmaceuticals, Power, Retail, Steel products, Sugar, Telecom services, Textiles and Tyres; **Overall Industry** covers Key sectors and other sectors (Automotive castings, Ceramic Tiles, Chlor Alkalies, Coal, Coffee, Distillers and breweries, Edible oil, Educational services, Ferro Alloys, Fertilisers, Gems and jewellery, Hotels, Hospitals, ITeS, Material handling, Oilfield equipment, Paper, Ports, Power cables and conductors, Power transformers, Roads and highway, Shipping, Steel Intermediates, Steel pipes, Tea, Transmission towers and Telecom towers)
Source: CRISIL Research

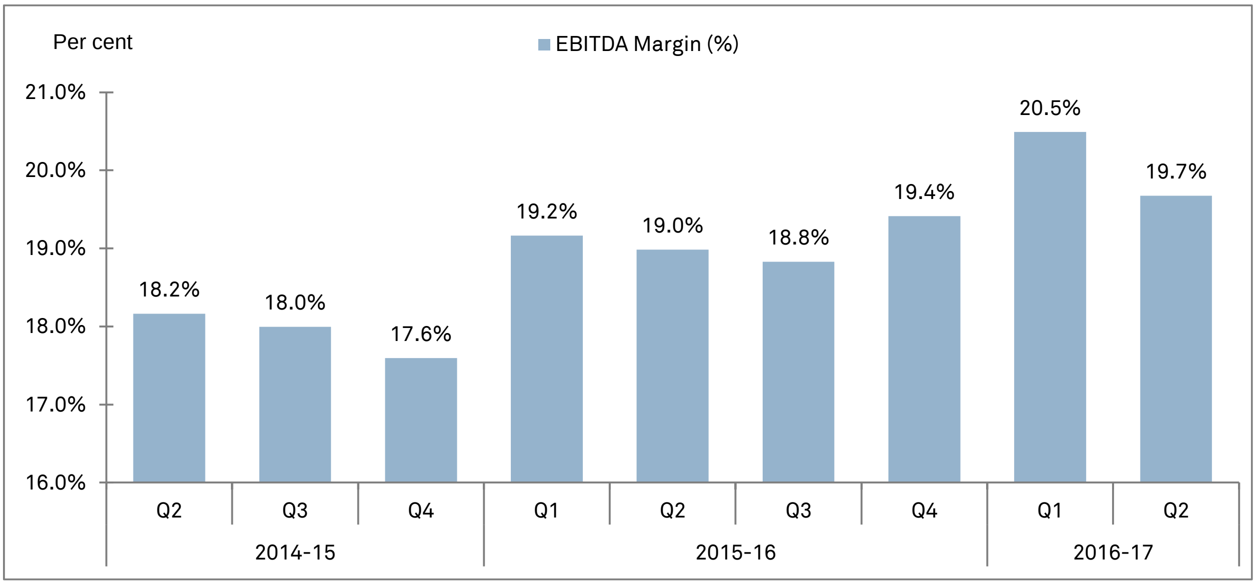
Key segments that supported revenue growth in Q2FY17 were:

- **Automobile sector:** The automobile sector posted 10.9% y-o-y growth, mainly because of strong growth in cars and utility vehicles (UVs) segment (29% y-o-y growth backed by robust growth in volume). Tata Motors' consolidated revenue rose 7% on-year, supported by a 23% increase in JLR's GBP revenue. The revenue growth was due to a healthy 19% growth in volume. However, a 12.6% GBP/INR depreciation partially offset the sharp revenue contribution of JLR. Companies in the two-wheelers segment also posted growth of 10%, mainly because of growth in domestic sales - however, export volume dropped due to sluggish demand from the key markets.
- **Steel products sector:** In Q2FY17, revenue of companies in the steel products sector grew 6.9% on-year due to higher sales volume, because of export opportunities and an improvement in realisation after the imposition of safeguards by the government (anti-dumping duty on flat products until February 4, 2017).
- **IT services:** Over the past couple of quarters, revenue growth in IT services has been gradually declining, but is better compared with other sectors. INR revenue of IT services companies grew 9.7% y-o-y in Q2FY17, driven by volume growth. The INR depreciated 3% y-o-y against the USD during the quarter. Continued pressure on billing rates in traditional services resulted in a slight decline in the blended billing rate.
- **Pharma sector:** The sector recorded 8.2% revenue growth on-year, with a few firms registering strong growth in the US exports and the domestic market.
- **FMCG sector:** Revenue of FMCG companies decline by 2.4% y-o-y, led by volume growth.
- **The two key sectors – power and telecom services** – witnessed lower growth compared with the industry average. Revenue of power companies improved marginally due to lower generation, while the aggregate revenue of telecom services grew 3.1% Q2FY17.

Key sectors' operating margin remains at 21%

EBITDA margin of the industry declined sequentially to 19.7% in Q2FY17, after touching its highest level (in past four years) of 20.5% in Q1FY17. However, the margin grew 70 bps y-o-y.

Industry's EBITDA margin



Source: CRISIL Research

A snapshot of key sectors

EBITDA margin (%)	Q2 FY15	Q3 FY15	Q4 FY15	Q1 FY16	Q2 FY16	Q3 FY16	Q4 FY16	Q1 FY17	Q2 FY17
Overall Industry	**18.2%**	**18.0%**	**17.6%**	**19.2%**	**19.0%**	**18.8%**	**19.4%**	**20.5%**	**19.7%**
Key sectors	**19.3%**	**18.8%**	**18.4%**	**19.9%**	**20.1%**	**19.6%**	**20.6%**	**21.5%**	**21.2%**
Automobiles	9.6%	8.5%	10.5%	12.9%	13.4%	12.9%	12.6%	12.6%	13.3%
IT services	25.0%	25.3%	20.3%	23.7%	25.3%	23.7%	24.2%	23.8%	24.2%
Power	29.3%	29.3%	30.6%	31.1%	32.9%	34.0%	34.1%	33.3%	33.5%
Steel products	20.3%	16.5%	12.6%	11.6%	9.5%	4.3%	9.6%	16.1%	13.3%
Telecom services	33.0%	33.4%	35.1%	34.3%	33.7%	34.7%	35.8%	34.9%	35.1%
Pharmaceuticals	24.2%	22.8%	17.7%	25.2%	24.9%	23.7%	22.4%	24.5%	24.4%
FMCG	23.4%	23.4%	23.5%	23.9%	24.6%	24.9%	25.7%	24.8%	25.4%

Source: CRISIL Research

The y-o-y increase in EBITDA margin was driven by:

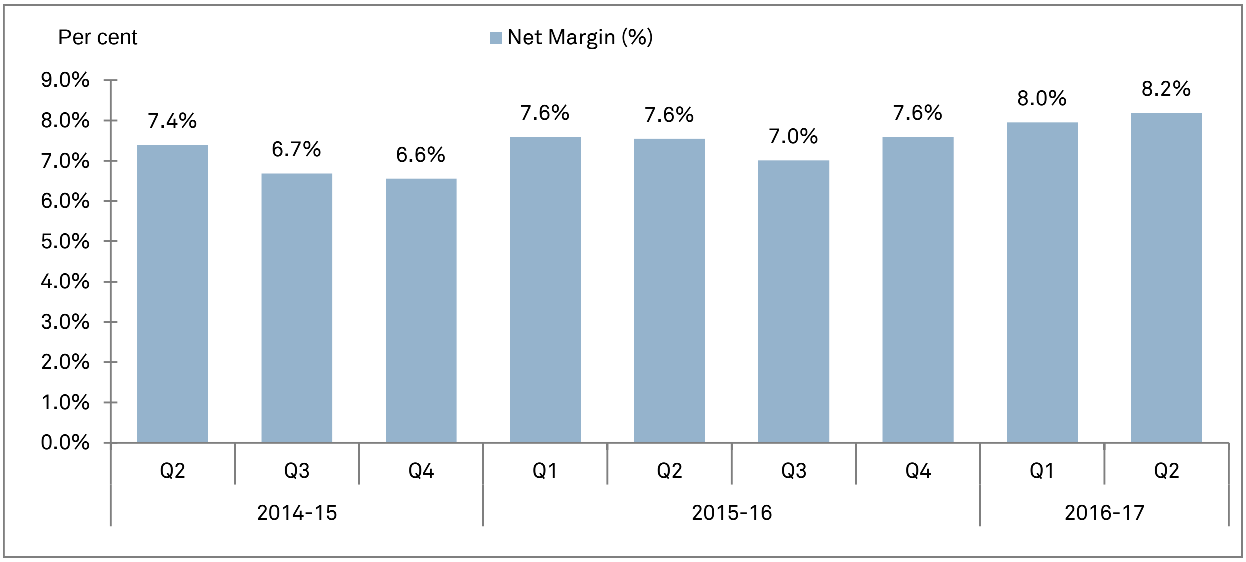
- **Steel products**: Steel product companies witnessed a 380 bps y-o-y improvement in EBITDA margin due to an improvement in realisation (because of the imposition of safeguards by the government).
- **Telecom services and Power**: EBITDA margin of telecom services and power companies improved more than 150 bps y-o-y and 50 bps y-o-y, respectively, because of a moderation in operating expenses.

- **FMCG:** EBITDA margin improved nearly 80 bps y-o-y to 25.4%, due to a decline in raw material prices, such as Brent crude, PFAD (palm fatty acid distillate) and copra.
- Other than these key segments, a marginal decline in the operating margin was witnessed in sectors, such as automobiles (due to an increase in raw material cost), IT services (due to the pressure on billing rates) and pharma (due to the expiry of the exclusivity period of some mid-sized and small formulation players).

Industry's net profit margin remains stable in Q2FY17

During Q2FY17, net profit margin of the industry remained stable at 8.2%. Among the key sectors, automobile and Steel Products were the only sectors that reported an improvement in the margin on a y-o-y basis, while the aggregate of the steel products sector reported a substantial decline.

Industry's net margin



Source: CRISIL Research

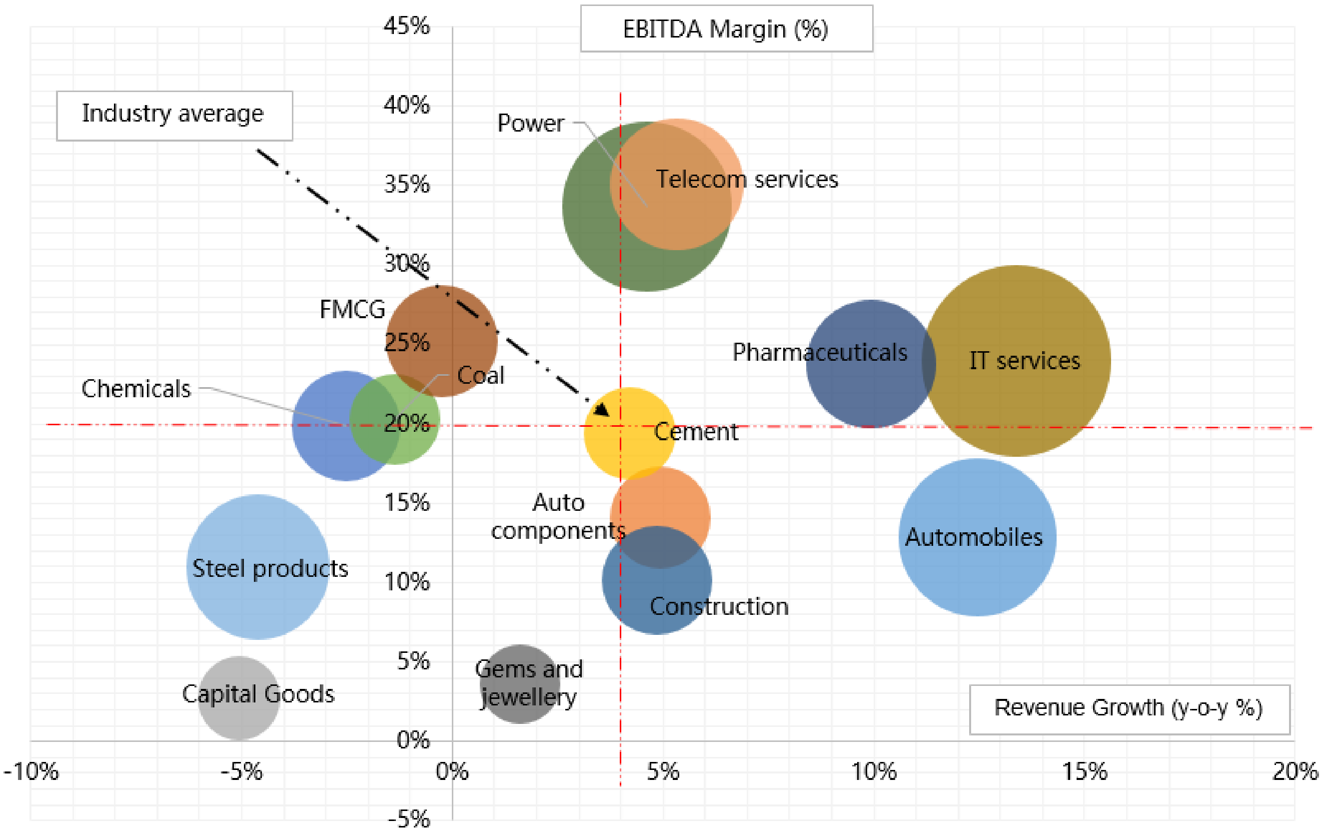
A snapshot of key sectors

Net margin (%)	Q2 FY15	Q3 FY15	Q4 FY15	Q1 FY16	Q2 FY16	Q3 FY16	Q4 FY16	Q1 FY17	Q2 FY17
Overall Industry	7.4%	6.7%	6.6%	7.6%	7.6%	7.0%	7.6%	8.0%	8.2%
Key sectors	7.8%	6.8%	7.0%	7.8%	7.8%	7.1%	8.1%	8.2%	8.8%
Automobiles	3.1%	2.4%	4.0%	8.5%	8.1%	6.4%	6.6%	8.4%	9.2%
IT services	20.1%	20.0%	16.9%	18.9%	19.0%	19.1%	19.0%	18.0%	18.1%
Power	7.6%	7.8%	11.1%	8.8%	10.6%	9.1%	10.1%	8.4%	10.2%
Steel products	6.8%	-1.3%	-0.6%	-3.1%	-6.4%	-10.3%	-5.1%	-3.4%	-4.6%
Telecom services	5.9%	6.2%	5.5%	8.5%	6.3%	5.5%	5.1%	4.1%	3.3%
Pharmaceuticals	15.0%	12.2%	12.5%	15.0%	16.2%	16.0%	13.5%	16.1%	15.8%
FMCG	0.0%	0.0%	0.0%	0.1%	0.1%	0.0%	0.0%	0.0%	0.1%

Source: CRISIL Research

Performance metrics of major sectors

Revenue growth versus EBITDA margin across key sectors (past four quarters)



Source: CRISIL Research

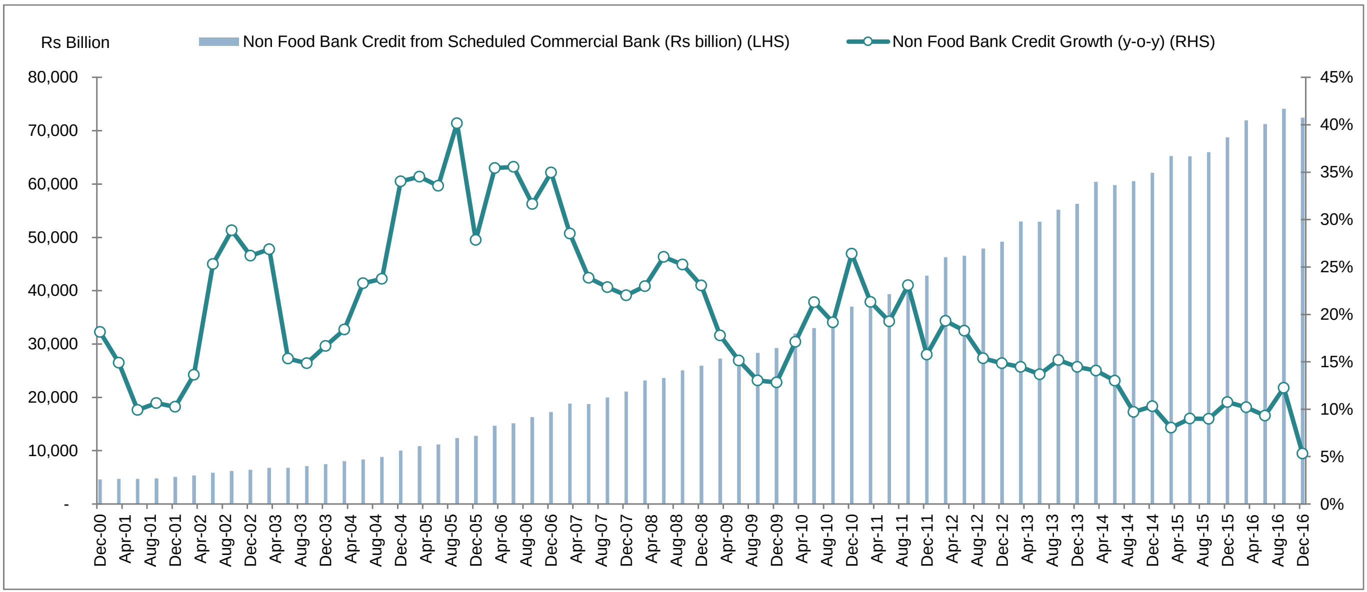
Note: Data represents aggregate performance of the mentioned sectors for the *past four quarters (Q3FY16 to Q2FY17)*; size of the bubble indicates sector's share in overall industry's revenue

Revenue outlook (October - December 2016)

Banks' non-food credit growth slips to a decade low of 5.3% in Q3FY17

A lot has changed in the past two months after demonetisation, with the short-term impact clearly visible on corporates. Consumer spending on discretionary items has almost dried up, while the sales volume of automobile companies has been impacted. The impact of demonetisation is not just restricted to sectors linked to consumer behaviour. Non-food credit growth of scheduled commercial banks has slipped to a decade low of 5.3%. In the past two months, Nikkei India Composite PMI Output Index has consecutively slipped below 50 (average benchmark), recording 47.6 in December 2016 from 49.1 in November 2016.

Non-food bank credit of scheduled commercial banks



Source: Reserve Bank of India

Consumer-linked sectors to witness de-growth because of demonetisation

After witnessing three consecutive quarters of revenue growth above 6.3%, CRISIL Research foresees a muted revenue growth of 4.1% in key sectors in Q3FY17. The industry had witnessed a similar downturn during H1FY16 as well, because of lower growth in investment-linked sectors. However, this time, demonetisation is likely to dampen the industry's growth due to cautious spending by consumers. The effect of demonetisation is likely to be severe in sectors directly linked to consumer behaviour. Accordingly, sectors such as FMCG, housing, retail, telecom services and textiles are likely to de-grow in Q3FY17.

Snapshot of key sectors

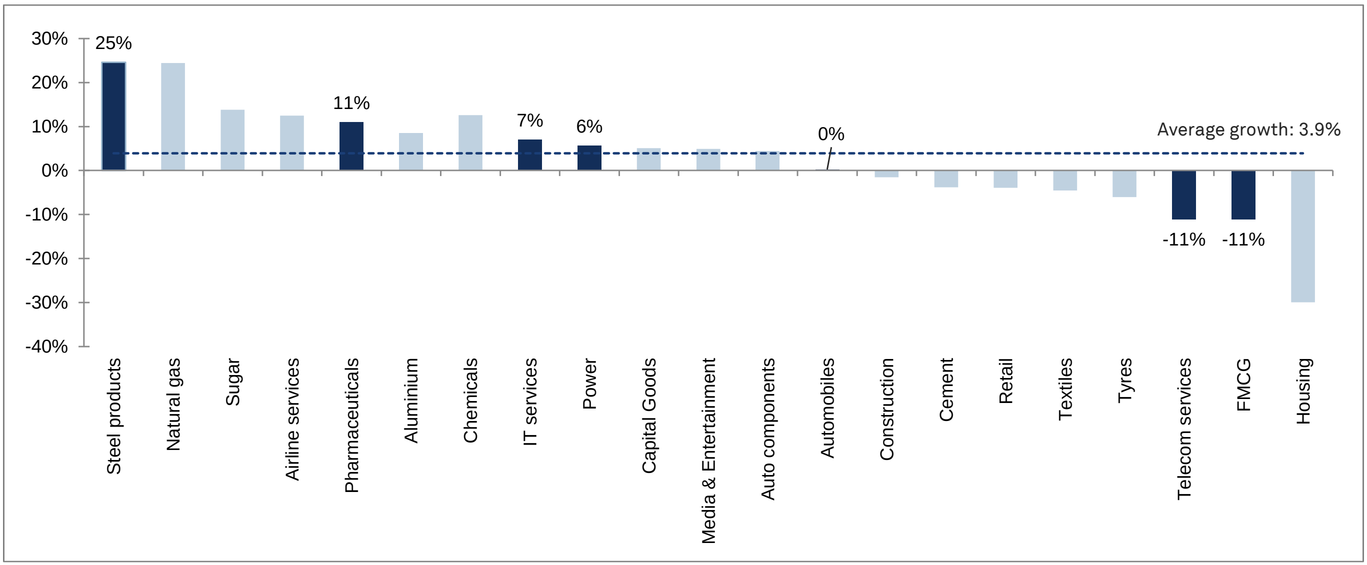
Revenue Growth (y-o-y)	Q2FY15	Q3FY15	Q4FY15	Q1FY16	Q2FY16	Q3FY16	Q4FY16	Q1FY17	Q2FY17	Q3FY17
Key sectors	**9.7%**	**7.5%**	**0.8%**	**1.7%**	**3.7%**	**0.8%**	**7.2%**	**6.4%**	**5.3%**	**4.1%**
Automobiles	13.0%	9.6%	8.3%	11.2%	10.4%	13.6%	15.3%	10.1%	10.9%	0.2%
IT services	9.4%	11.4%	9.4%	14.6%	15.2%	12.0%	17.1%	15.1%	9.7%	7.0%
Power	7.2%	8.7%	-2.8%	2.8%	13.9%	3.7%	9.8%	4.5%	0.8%	5.7%
Steel products	9.3%	-0.8%	-9.2%	-10.2%	-13.2%	-17.7%	-4.0%	-2.5%	6.9%	24.6%
Telecom services	8.1%	8.7%	7.1%	5.8%	6.0%	4.6%	7.7%	6.0%	3.1%	-11.1%
Pharmaceuticals	26.3%	20.6%	16.9%	22.9%	9.1%	7.2%	15.6%	8.9%	8.2%	11.0%
FMCG	17.2%	10.7%	5.4%	3.2%	2.4%	5.9%	-3.1%	-1.4%	-2.4%	-11.1%

Source: CRISIL Research

- **Steel products:** Gross revenue of companies in the steel products sector is projected to increase 25% on-year, led by higher realisation, which is attributable to the government support and robust export growth (global HR prices are witnessing a recovery). While domestic steel demand is expected to be muted, exports are likely to increase significantly.
- **Pharmaceuticals:** The aggregate revenue of large formulation firms is expected to surge 11%, due to new product launches in the US, with a few products having market exclusivity. Growth is likely to be restricted because of truncated sales in the domestic market (especially in the consumer wellness segment) post-demonetisation.
- **Power:** The aggregate revenue is estimated to grow 6%, due to strong growth in power distribution. However, for power generation, subdued power demand is likely to exert pressure on revenue.
- **IT services:** INR revenue is projected to increase at a slower pace of 7% on-year, because of the Brexit (the UK's exit from Eurozone) impact, as the UK alone accounts for 17% of overall exports. The economic uncertainty in the EU and the consequent impact on discretionary spending, such as IT, would hurt domestic software companies. However, large IT service providers in India do not have much exposure to the pound and the euro. Also, the election of Donald Trump as the US President is likely to be unfavourable for the Indian IT industry, as a sizeable portion of the industry's revenue comes through the jobs outsourced by the US companies.
- **Automobiles:** Revenue of the automobile sector is estimated to remain stable (y-o-y) in Q3FY17. Revenues of companies in segments, such as cars and UVs, are expected to grow 5-7% on-year (volume growth is estimated to decline to 5-7% in Q3FY17 due to demonetisation). Tata Motors' consolidated revenue is projected to drop 1-2% on-year, as revenue growth support from JLR will be offset by the foreign-currency translation loss (the GBP depreciated 16.3% against the INR during the quarter). Revenues of companies in segments such as two-wheelers are expected to decline 2-4% on-year (two wheelers' sales to dip by 1-2% in Q3FY17 on demonetisation, compared with growth of 14% in Q2FY17).
- **Telecom services:** The gross revenue of the telecom services industry is expected to fall 11% on-year, due to the twin impact of Reliance Jio's (RJio) entry and demonetisation. The impact of RJio's entry on revenue is expected to be the highest for urban areas. With the affordability of handsets and digital literacy being a concern in the rural areas, the impact of RJio's entry will be the least. The impact of demonetisation will be minimal in the urban areas, as consumers in these regions are internet-savvy and are expected to shift to digital platforms easily. Hence, the impact of demonetisation will be maximum in the rural areas, as most are prepaid subscribers.

- **FMCG:** The aggregate revenue of FMCG companies is expected to decline 11% on-year. While realisation is expected to remain stable, volume is expected to take a hit.

Revenue growth outlook across key sectors in the December quarter, year-on-year basis:



Note: Major sectors are highlighted above
Source: CRISIL Research

Other sectors that are expected to drive revenue growth are:

- **Capital goods:** While revenue is estimated grow 5% on-year, it is estimated to decline 2-3% on a sequential basis, due to a decline in the order book in Q2FY17 and expected tepid growth in orders in Q3FY17
- **Sugar:** Revenue of sugar mills is expected to increase 13-15% on-year in Q3FY17, driven by the steep increase in sugar prices amid lower supply. However, growth will be partially offset by the decline in sales volume.
- **Airline services:** Although CRISIL Research projects that air fares will decline marginally on-year in Q3FY17, the aggregate revenue of airline services is estimated to increase 11-13% on strong growth in passenger traffic, primarily in the domestic sector. Domestic passenger traffic is expected to increase 20-22% on-year, due to lower fares.
- **Aluminium:** Revenue is expected to increase on-year, with higher sales volume from Hindalco's new capacity complemented by higher prices (and, therefore, realisation).
- **Chemicals**: The aggregate revenue of companies in the petrochemical segment is expected to rise 13% on-year in Q3FY17, because of an improvement in realisation. Despite healthy demand growth, domestic players' sales volume growth will be marginal, as they are operating at high utilisation rates

EBITDA margin outlook

Key sectors' EBITDA margin to remain stable

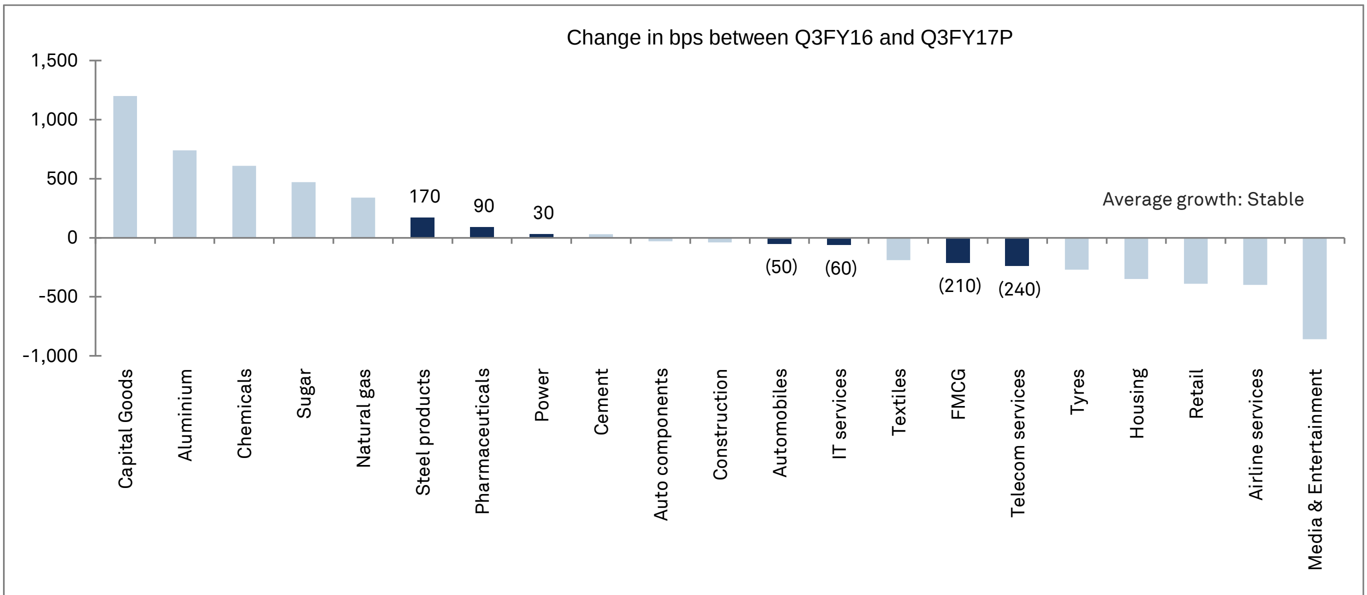
CRISIL Research expects the key sectors' operating margin to remain stable (y-o-y) in Q3FY17. Major sectors, such as IT services, power, telecom services, pharmaceuticals and FMCG, bring higher margins compared with the industry average. In Q3FY17, power, steel products and pharmaceuticals are expected to record better operating margins compared with last year. On the other hand, automobiles, IT services, telecom services and FMCG are estimated to witness a contraction in the operating margin.

Snapshot of key sectors

EBITDA margin (%)	Q2FY15	Q3FY15	Q4FY15	Q1FY16	Q2FY16	Q3FY16	Q4FY16	Q1FY17	Q2 FY17	Q3 FY17
Key sectors	**19.4%**	**18.9%**	**18.4%**	**20.0%**	**20.2%**	**19.7%**	**20.7%**	**21.6%**	**21.3%**	**19.7%**
Automobiles	9.6%	8.5%	10.5%	12.9%	13.4%	12.9%	12.6%	12.6%	13.3%	12.4%
IT services	25.0%	25.3%	20.3%	23.7%	25.3%	23.7%	24.2%	23.8%	24.2%	23.1%
Power	29.3%	29.3%	30.6%	31.1%	32.9%	34.0%	34.1%	33.3%	33.5%	34.3%
Steel products	20.3%	16.5%	12.6%	11.6%	9.5%	4.3%	9.6%	16.1%	13.3%	6.0%
Telecom services	33.0%	33.4%	35.1%	34.3%	33.7%	34.7%	35.8%	34.9%	35.1%	32.3%
Pharmaceuticals	24.2%	22.8%	17.7%	25.2%	24.9%	23.7%	22.4%	24.5%	24.4%	24.6%
FMCG	23.4%	23.4%	23.5%	23.9%	24.6%	24.9%	25.7%	24.8%	25.4%	21.0%

Source: CRISIL Research

Change in EBITDA margins (outlook) across key sectors in the December quarter, year-on-year basis:



Note: Major sectors are highlighted above
Source: CRISIL Research

- **Steel products**: With continued government support, domestic steel prices are expected to increase 17-19% on-year. However, the improvement in EBITDA margin for companies in steel products is expected to be restricted to 170 bps, despite a very weak Q3FY16, because of a 22% increase in material cost (largely coking coal). Coking coal contract prices spiked in Q3 to $206 per tonne (a 131% increase on-year), coupled with marginal increase in iron ore prices.

- **Pharmaceuticals:** For large formulation players, EBITDA margin is estimated to expand 80-100 bps, because of expected higher margins from product launches. Also, research & development (R&D) and staff expenses are projected to be steady. On the other hand, for mid-sized and small formulation players, operating margins are expected to fall slightly from a high base in Q3FY16 (as margins were skewed by Alembic's robust sales of newly launched products) because of competition from emerging markets and price uncertainty due to the government regulations in the domestic market.
- **Power:** Companies in power generation are expected to expand their EBITDA margin by 20-40 bps on-year, due to an increase in domestic coal supply, the benefit of which will be partly offset by higher prices of imported coal. On the other hand, operating margin for distribution companies is forecast to decline 250-350 bps, as the power-purchase cost and other expenses are expected to increase.
- **FMCG:** EBITDA margin is likely to decline 350-400 bps, due to a rise in the cost of raw material, such as Brent crude and copra, and heavy investments in advertising and brand-building.
- **IT services:** EBITDA margin for companies in the IT services segment is forecast to contract 50-70 bps on-year, because of the downward pressure on blended realisation and investments in digital capability.
- **Automobile sector:** EBITDA margin is expected to shrink 30-70 bps. Tata Motors' margin is likely to drop 50-100 bps, due to its continued hedging loss. However, the quantum of hedging and, in turn, the loss is expected to narrow during the quarter.
- **Telecom services:** EBITDA margin is estimated to decline 250 bps in Q3FY17, as the industry's profitability will come under pressure (due to RJio's entry and demonetisation). The launch of new networks on the spectrum acquired during the October 2016 auctions will also add to network operating expenses of the players. Their marketing costs are also expected to rise due to 4G rollouts, leading to a margin decline.

Other sectors that are expected to report an improvement in margins are:

- **Capital goods:** EBITDA margin is likely to improve to 5% in Q3FY17. Last year, the Q2FY16 margin was -6.7% due to the impact of huge losses from Bharat Heavy Electricals Ltd (BHEL). Hence, the y-o-y comparison shows a significant jump. The margin is expected to improve, due to an improvement in order execution, short cycle of the order inflow, higher-margin orders and cost indigenisation.
- **Aluminium:** The operating margin is likely to be 9.2% in Q3FY17. However, it still shows an on-year improvement, largely driven by lower input cost and higher realisation (due to the low base of last year).
- **Chemicals:** EBITDA margin for petrochemical companies is estimated to expand 600-650 bps on-year, as key petrochemical spreads are expected to improve; petrochemical prices are likely to rise steeper than those of feedstock naphtha.
- **Sugar:** The operating margin is likely to increase 400-500 bps on-year, due to an increase in sugar realisation. However, the increase will be partially offset by a drop in ethanol realisation.

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