

**Ratings
Round-Up**

First-half of fiscal 2020

Credit quality pressures intensify in first half of fiscal 2020



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Contents	Executive summary	2
	About Ratings Round-Up	4
	CRISIL's portfolio and median rating unchanged.....	4
	Credit ratio and debt-weighted credit ratio both moderate,.....	5
	Across-the-board moderation in credit ratio	9
	Despite demand pressures, leaner balance sheets to provide support	13
	Stable outlook for banks even as non-banks and capital markets turn cautious in fiscal 2020	19
	Robust rating quality metrics through credit cycles	21
	Credit outlook cautious; impact of fiscal measures and demand pickup among monitorables	25
	Sectoral credit outlook for corporates	26
	Banks and Non-banks: Sectoral credit quality outlook	36

Executive summary

Credit quality pressures intensified for India Inc in the first half of fiscal 2020, driven by an interplay of factors including global and domestic economic slowdown, sharp fall in consumption demand, and slower government spending. Constrained access to funding also affected the credit profiles of entities across sectors, especially non-banks and real estate.

CRISIL's debt-weighted credit ratio (value of debt¹ upgraded to downgraded) plunged to 0.25 time in the first half of fiscal 2020, compared with 1.65 times for fiscal 2019.

The value of debt downgraded more than trebled to Rs 1.38 lakh crore in the first half of fiscal 2020 from Rs 39,000 crore in the first half of fiscal 2019. That's the highest for any half since fiscal 2016.

Across rating categories, entities with higher leverage saw more downgrades as pressure from the demand slump intensified. Declining profitability and stretch in working capital cycles also were reasons for the downgrades. On the other hand, those with lower leverage withstood the demand-side challenges better.

Over the past five fiscals, the median gearing for CRISIL-rated companies² has improved from 1.3 times to 0.9 time, which reflects both, deleveraging that's been underway and resilience to demand pressure.

That also explains why, upgrades continue to outnumber downgrades despite a sharp decline in CRISIL's credit ratio (upgrades to downgrades) for the first half of fiscal 2020 to 1.21 times³ – the lowest in the past six half-yearly assessments, and down from 1.73 times for fiscal 2019.

The fall in credit ratios was across investment-, export-, and domestic-consumption-linked sectors.

Among investment-linked sectors, construction and allied accounted for over 30% of downgrades because of delays in project execution and stretched liquidity.

Export-linked sectors reported a mixed performance, with pharmaceuticals (especially bulk drugs) continuing to benefit from supply constraints in China. Gems & jewellery and readymade garment exporters saw more downgrades

¹ Debt upgraded or downgraded refers to the total domestic financial obligations for the entities whose ratings were upgraded or downgraded. Financial sector entities and non-cooperative issuers are excluded.

² Excluding financial sector entities and non-cooperative issuers

³ 529 upgrades to 438 downgrades. Does not factor in rating actions on non-cooperative issuers.

because of constrained access to funding, lower export competitiveness, and weak demand.

Among consumption-linked sectors, auto components and other auto-related sectors accounted for ~15% of the downgrades. However, the credit profiles of automobile manufacturers remain cushioned by strong balance sheets.

In the financial sector, a year since the funding squeeze began for non-banks, challenges persist for those with wholesale-oriented loan books. While measures announced by the government and the Reserve Bank of India to improve flow of credit to the sector, and sharper focus of non-banks on their asset-liability maturity profiles, are welcome, access and cost of funding will remain the key monitorables.

For banks, non-performing assets are expected to continue to decline from the 9.3% estimated at the end of fiscal 2019, because of fewer fresh slippages and faster recoveries after the recent changes to the Insolvency and Bankruptcy Code. Infusion of capital, especially for public sector banks, and emphasis on retail credit book expansion, should drive growth.

We remain cautious about the credit outlook for the second half because demand pressures persist. Going forward, how well demand recovers after a good monsoon, the sharp cut in corporation tax, faster and automated release of Goods and Services Tax refunds, and higher export incentives will be the key monitorable.

It is pertinent to note that CRISIL's default and stability rates have remained robust despite the sharp decline in credit ratios in this challenging credit environment. Best-in-the-industry performance of CRISIL's ratings is a testimony to its analytical rigour and proactive surveillance.

About Ratings Round-Up

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

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

Note: A credit rating is an opinion on the likelihood of timely repayment of debt. Therefore, analysis of rating actions on a large and diverse portfolio of companies is also a reasonable indicator of an economy's directionality.

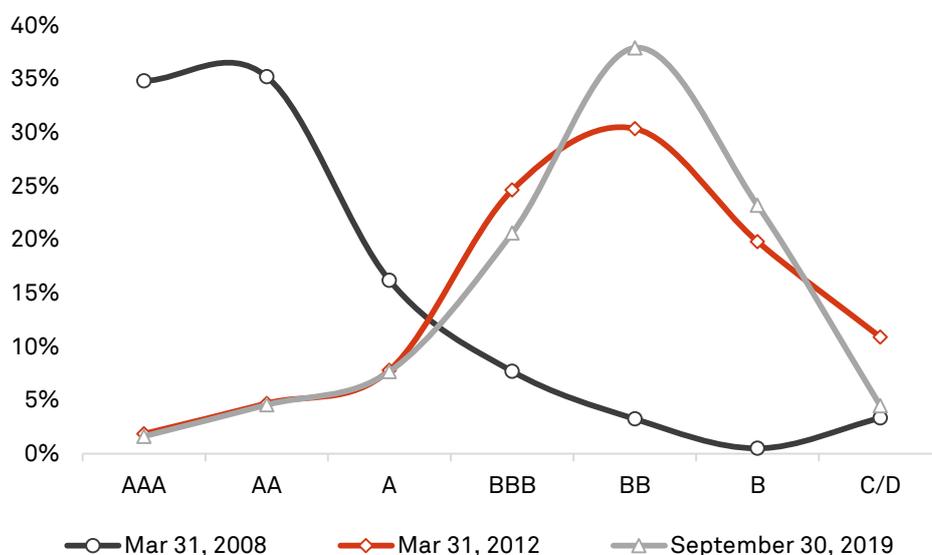
CRISIL's portfolio and median rating unchanged

Ratings outstanding on over **11,000** issuers

Median rating remains in the **'CRISIL BB'** category

Over the past five years, ratings outstanding in CRISIL's portfolio have numbered between 11,000 and 13,000⁴. Of these, 65% are in the 'BB' or lower categories. Consequently, the median rating has stayed put in the 'BB' category. With the introduction of bank loan ratings in 2007 and rapid expansion of CRISIL's portfolio, especially into the lower rating categories, the median rating has moved from 'AA' as on March 31, 2008 to 'BB' as on March 31, 2019.

Chart 1: CRISIL's rating distribution



Source: CRISIL

⁴ This excludes companies in the 'Issuer Not Cooperating' or INC category. CRISIL's portfolio had 7,528 such issuers as on September 30, 2019. If these are included, CRISIL's outstanding rating list will be of 18,078 issuers. But the median rating will remain in the 'BB' category.

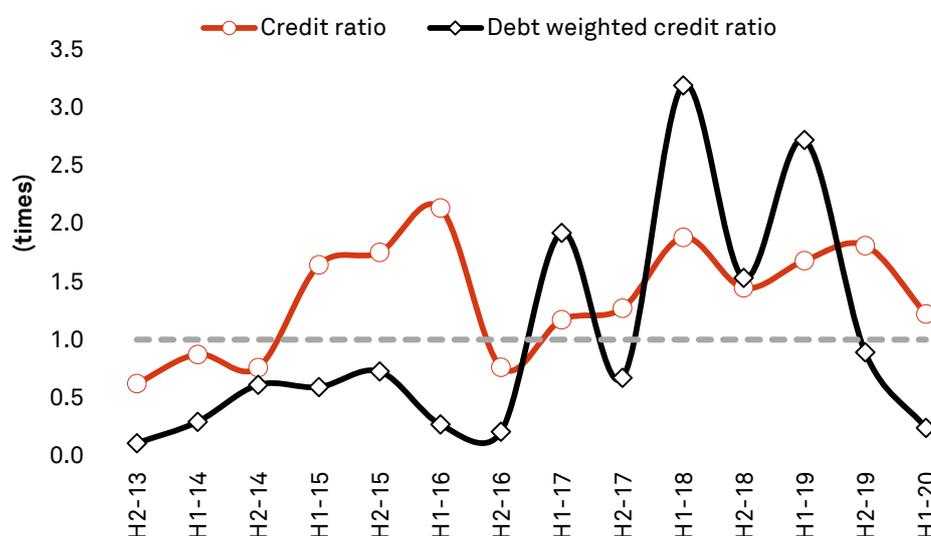
Credit ratio and debt-weighted credit ratio both moderate

Credit ratio and debt-weighted credit ratio⁵ at 1.21 times and 0.25 time, respectively, for the first half of fiscal 2020

Credit ratio and debt-weighted credit ratio at 1.44 times and 0.46 time, respectively, for rolling 12 months

CRISIL's credit ratio and debt-weighted credit ratio were at 1.21 times and 0.25 time, respectively, for the first half of fiscal 2020 (see chart), against 1.81 times in second half of fiscal 2019 and 1.73 times for whole of fiscal 2019.

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



Source: CRISIL

In the *Ratings Round-Up* of April 2019, we had expected the credit ratio to moderate in fiscal 2020 because of slowing government spending and weakening global economy. The moderation, however, has been sharper because of slower-than-expected economic growth, slippage in demand growth across sectors, and consequent elongation of working capital cycles.

⁵ The debt-weighted credit ratio includes a telecom firm which constituted major portion of the debt downgraded. Spectrum debt is excluded from their overall debt for the calculation of debt-weighted credit ratio.

Credit ratio and macroeconomic trends

The moderation in CRISIL's credit ratio can be viewed in line with macroeconomic trends. Macroeconomic indicators such as gross domestic product (GDP) and Index of Industrial Production (IIP) decelerated sharply since the fourth quarter of fiscal 2019. A plunge in domestic private consumption demand, slump in manufacturing, halving of merchandise exports growth, and a high-base effect from last year gnawed away at first-quarter growth. In line with these trends, CRISIL's credit ratio moderation was also an across-the-board phenomenon for investment-, export- and consumption-linked sectors.

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

	Q3FY18	Q4FY18	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20
Government consumption	10.8	21.1	6.6	10.9	6.5	13.1	8.8
Private consumption	5.0	8.8	7.3	9.8	8.1	7.2	3.1
Investments	12.2	11.8	13.3	11.8	11.7	3.6	4.0
Exports	5.3	2.8	10.2	12.7	16.7	10.6	5.7
Imports	15.8	16.2	11.0	22.9	14.5	13.3	4.2
GDP	7.7	8.1	8.0	7.0	6.6	5.8	5.0

Source: CRISIL Research

GDP growth slowed to 5.8% in the fourth quarter of fiscal 2019, and to 5% in the first quarter of fiscal 2020, based on advance estimates by the Central Statistical Office.

- Private consumption has fallen sharply to the lowest in the past 18 quarters, as is evident from the challenges faced by the automobiles and fast-moving consumer goods (FMCG) sectors. The slowdown has been driven by the rural sector impacted by lower wage growth.
- Falling private consumption has impacted private capital expenditure (capex), which was already tardy given moderate utilisation of capacities. In addition, government spending on infrastructure has declined in recent quarters, which has impacted demand for investment-linked sectors.

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

	Q3FY18	Q4FY18	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20
Primary goods	3.2	4.2	5.9	3.9	2.7	1.8	2.5
Capital goods	7.5	7.5	8.6	6.6	5.4	-7.5	-3.3
Intermediate goods	4.7	3.7	0.7	1.9	-0.9	1.8	9.8
Infrastructure and construction goods	8.5	9.8	8.5	8.9	7.6	4.5	-0.3
Consumer durable	-1.5	7.0	8.0	8.1	6.1	-0.1	-2.7
Consumer non-durable	16.2	10.7	1.9	6.1	4.3	3.4	6.9
IIP	5.9	6.5	5.1	5.3	3.7	1.5	3.0

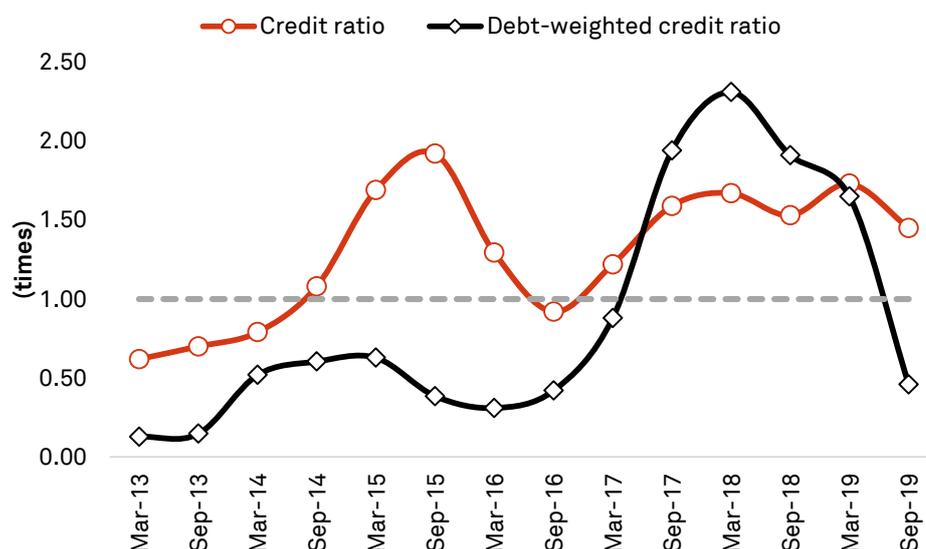
Source: CRISIL Research

IIP growth has been subdued for the past three quarters, mirroring the slowdown in GDP growth. The capital goods, infrastructure and construction goods segments have been the big drags, which reflects tapered public spending and the extended funk in private investments.

Debt-weighted credit ratio well below 1 time

The first half of fiscal 2020 saw a sharp drop in the debt-weighted credit ratio (value of debt of firms upgraded to those downgraded), besides the credit ratio. This indicates pervasive credit quality pressure, especially for companies that are highly leveraged. The debt-weighted credit ratio stood at 0.25 time for this period.

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



Source: CRISIL

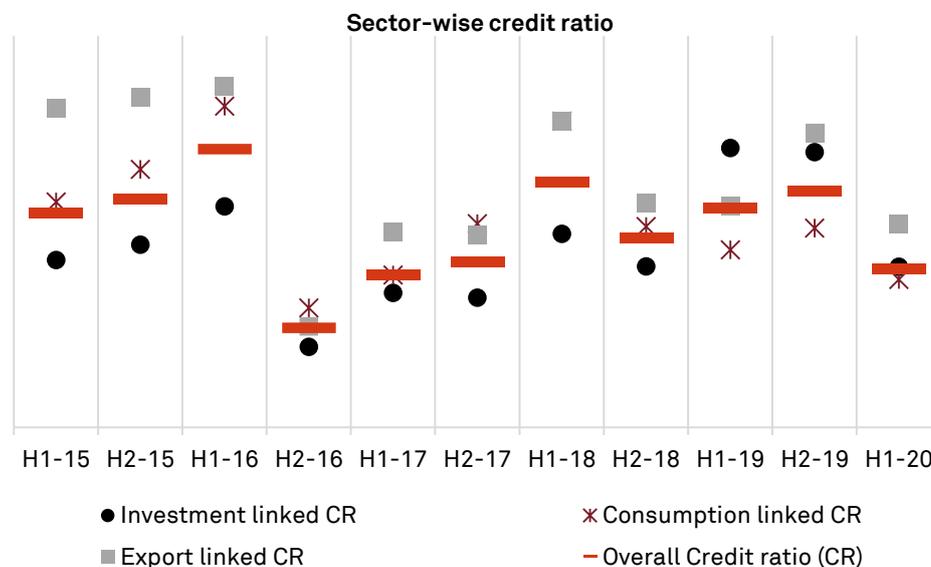
Ratings

To ascertain the sustainability of, and removing any recency bias in, the credit ratio and the debt-weighted credit ratio, we also assess these on a 12-month rolling basis. For the first half of fiscal 2020, on a 12-month rolling basis the credit ratio slid to 1.44 times as on September 2019 compared with 1.73 times as on March 2019, while the debt-weighted credit ratio plunged to 0.46 time from 1.65 times. The drop in the 12-month rolling debt-weighted credit ratio to significantly below 1 time indicates continuing distress for highly leveraged firms.

Across-the-board moderation in credit ratio

Credit ratio moderates for investment-, export- and consumption-linked sectors

Chart 4: Trends in sector-wise credit ratio



Source: CRISIL

Investment-linked sectors: public spending in key infrastructure sectors to drive growth

The credit ratio of investment-linked sectors for the first half of fiscal 2020 has skidded on-year. Growth in the gross fixed capital formation (GFCF) component of GDP has declined to 4% in the first quarter of fiscal 2020 compared with 13% in the corresponding quarter of fiscal 2019, indicating both, government and private spending have reduced. Continuing headroom in capacity utilisation has been the bane of private investments.

- The construction material sector, including heavy machinery, saw more downgrades than upgrades because of stretched working capital cycles, even as there were pockets of better credit quality in sectors such as industrial machinery benefitting from orders from niche sectors in domestic and export markets.
- Non-banking financial companies (NBFCs) and housing finance companies (HFCs), together referred to as 'non-banks' hereinafter, have been the major source of funding for the real estate sector. But with refinancing requirements increasing and demand subdued, credit pressures have been elevated.
- Independent power producers also witnessed higher downgrades because of delays in realisation from distribution companies (discoms), which impacted their liquidity and financial risk profile.

- Discoms, too, witnessed downgrades because of deteriorating working capital position and financial risk profile.
- The construction & engineering sector was a mixed bag with equal proportion of upgrades and downgrades. Government investments, although slower, continued, which bolstered the order books of some companies and led to upgrades. But there were others that saw a sharp slowdown in execution and stretched working capital cycles, which led to their downgrades.
- Steel continued to witness higher upgrades over downgrades supported by better realisations, even though steel prices have been moderating since fiscal 2019.

Outlook

In the second half, credit outlook is expected to improve as central and state initiatives lead to higher spending. Further, fiscal measures to release receivables such as GST refunds and release of receivables from PSUs could augur well for the liquidity and working capital position of companies. Realty demand, however, would remain sluggish. Overall, increase in public investments will be key monitorable for the second half of fiscal 2020.

Export-linked sectors: outlook expected to be moderate

The credit ratio of export-linked sectors declined sharply in the first half, but remained well above 1 time and also above the overall credit ratio for first half of fiscal 2020.

The pharmaceuticals sector has benefited from product diversification. The upgrades were largely in the active pharmaceutical ingredients (APIs or bulk drugs) segment. As noted in *Ratings Round-Up* published on April 2019, the bulk drug segment continued to benefit from supply disruption in China. Going ahead, we expect the credit quality of large pharmaceutical entities to remain stable, supported by strong balance sheets and steady operating performance. The regulatory environment, exchange rate and competition will remain the key monitorables.

The textiles sector saw upgrades outpacing downgrades, but the performance of its sub-sectors was mixed.

Sectors such as ginning and spinning, which is at the lower end of the textiles value chain, saw more upgrades than downgrades. These are smaller firms that saw an improvement in financial risk profile or domestic demand, which enhanced their credit profiles.

Export-oriented readymade garment (RMG) entities benefited from a depreciated rupee as well as higher export incentives. However, subdued demand from key markets played spoilsport, leading to downgrades outnumbering upgrades. Exports for fiscal 2020 are expected to decline 8-10% because of low demand from China. That, and higher domestic cotton prices could reduce the competitiveness of Indian RMG players despite a depreciated rupee.

Outlook

We expect export growth to decelerate in the second half, mainly because of a slowdown in global growth and a spurt in trade friction, which would moderate the credit outlook of export-oriented sectors. Major trade destinations are expected to see slower economic growth next fiscal as well.

Table 3 – Trends in world GDP growth

GDP growth		2017	2018	2019(P)	2020(P)
US	%	2.2	2.9	2.6	1.9
UK	%	1.7	1.4	1.3	1.4
Eurozone	%	2.4	1.9	1.3	1.6
China	%	6.8	6.6	6.2	6.0
Advanced economies	%	2.4	2.2	1.9	1.7
Developing economies	%	4.8	4.5	4.1	4.7
Global	%	3.8	3.6	3.2	3.5

Source: IMF

In July 2019, the International Monetary Fund (IMF) lowered its forecast on global GDP growth for calendar 2019 to 3.2% from 3.5% earlier, because of persistent decline in growth forecasts of advanced economies amid uncertainty surrounding Brexit, deceleration in Eurozone, and trade tensions between the US and China. The IMF has also revised down its growth forecast for emerging and developing economies, primarily because of slower growth foreseen in China.

The impact of the recent measures announced by the government (especially the reduction in corporate tax rate for ‘start-ups’ commencing production by the end of fiscal 2023) on investments in export-oriented capacities, leading to higher exports, will be the key monitorable – albeit over the medium to longer term.

Consumption-linked sectors: weak outlook for fiscal 2020

Weakening private consumption impacted the credit outlook for consumption-linked sectors in fiscal 2020.

Domestic auto sales were impacted by subdued retail sentiment because of higher cost of ownership, impending change in emission norms, low growth in rural wages, and the NBFC crisis impacting credit flow. Consistent decline in automobile sales since December 2018 hit the automobile value chain; the credit ratio of automobile retailers saw a sharp decline as inventories piled up. However, the credit profiles of automotive component manufacturers and automobile manufacturers remained relatively resilient, supported by strong balance sheets.

Structural issues continued to impact the credit profiles in the gems & jewellery and telecommunications sectors. While the gems & jewellery sector continues to face lower demand and liquidity issues, the telecom sector continues to be impacted by intense competition and leveraged balance sheets.

On the other hand, sectors such as agricultural products saw a higher number of upgrades compared with downgrades. Sub-sectors such as rice and basmati constituted a major portion of upgrades, driven by volume growth and better financial risk profiles of smaller entities. Lower-rated entities in edible oil and sugar also saw upgrades because of improved liquidity profiles.

Outlook

The credit outlook for consumption-linked sectors is likely to remain weak, on account of slow recovery in household incomes and sluggish jobs growth. Easing monetary policy, improved transmission of interest rate cuts, the government's minimum income support scheme for farmers, rising rural incomes and a good monsoon would be the upward risks to this expectation. The impact of recently announced fiscal measures on consumer sentiment also needs to be keenly watched.

Despite demand pressures, leaner balance sheets to provide support

Intensifying demand pressures in fiscal 2020

Slowing private consumption and global economic growth, and slower government funding of infrastructure projects intensified demand pressure for several sectors in fiscal 2020.

Figure 1: Demand pressures across sectors

	2019 (Actual)	2020(Estimated)
 Pharmaceutical		
 Aluminium		
 Steel		
 Automotive retail		
 Automobile manufacturing		
 Automotive components		
 Construction and engineering		
 Cement		
 Gems & jewellery		
 Real estate		
 Textiles		

Favourable  Unfavourable 

Source: CRISIL

As seen in chart above, demand pressures have intensified for the following sectors:

- The automobiles sector was affected the most by consumption slowdown because of an increase in the total cost of ownership owing to rising fuel prices, new emission norms, and low rural wage growth. This has had a significant impact on ancillary industries i.e., automotive retail and auto components.
- Order books in the construction & engineering sector have been impacted by slowing pace of investments and execution of public projects in the roads sector. Faster government spending can boost the sector and hence is a key monitorable.
- The cement sector is likely to be affected by demand pressures in the construction and real estate sectors.
- Demand growth in steel is expected to see a mid-cycle slowdown to 4-5% from 7.5-8% in last two fiscals owing to muted construction investments and weak automotive market. Declining steel price realisations are also expected to reduce operating margins by ~350 bps this fiscal.

- Despite the rupee's depreciation, increased cotton prices are likely to impact the cost competitiveness of Indian RMG entities and hence, increase demand pressure in times of intense competition.

However, despite the slowdown, some sectors have continued to have robust demand:

- Robust demand in pharmaceuticals is expected to be driven by new formulations, with limited competition and high value-addition, apart from abbreviated new drug application (ANDA) approvals obtained by domestic entities and increased penetration into semi-regulated markets. Trade frictions between the US and China have also created new markets for pharmaceutical players. They continue to benefit from demand for bulk drugs.
- In aluminium, rising aluminium intensity of the automobiles sector in the US and China has increased exports. Domestic demand was hit by a slowdown in automobile sector, but is to be partially offset by increase in demand from the power cable and conductor sectors.

Structural issues continue to mire the demand outlook for sectors such as real estate and gems & jewellery. While the NBFC crisis accentuated the pressure on the real estate sector, the gems & jewellery sector felt the impact of social unrest in Hong Kong, a key consuming and re-exporting destination, surging gold prices, and constrained funding.

Despite demand pressures in the first half of fiscal 2020, credit profiles were supported by stronger balance sheets

An analysis of rating actions in fiscal 2020 reveals that low-leverage entities have been able to weather demand pressure relatively better.

Table 4: Credit ratio across different categories

Debt/ EBIDTA ratio	Low Leverage <2.5	Moderate leverage 2.5-4.0	High leverage >4.0
Investment-linked	2.11	1.32	0.64
Export-linked	7.40	1.78	0.55
Consumption-linked	1.98	1.55	0.62

Source: CRISIL

Deleveraged balance sheets

CRISIL analysed over 5,000 companies in 112 sectors for leverage trends. Debt/EBITDA has been taken as the yardstick to assess the impact of growth in leverage and profitability. The median debt/EBITDA indicates that half of the entities are at, or above, the given leverage. The table below is revelatory in this regard.

Table 5: Trends in median Debt/EBITDA across sectors

Sector wise Debt to EBITDA trend	FY15	FY16	FY17	FY18	FY19 (E)	FY20 (F)
Sectors with decreasing leverage						
Industrial machinery	2.83	2.55	2.41	2.65	2.24	2.00
Pharmaceuticals	2.33	2.36	2.06	2.01	1.83	1.62
Auto parts & equipment	2.73	2.42	2.43	2.22	2.10	1.85
Independent power producers & energy traders	3.98	3.62	3.26	3.30	2.77	2.51
Apparel- accessories & luxury goods	4.15	3.87	3.93	4.10	3.85	3.69
Aluminium	3.73	3.78	3.47	3.36	2.52	2.17
Steel	3.99	3.81	3.56	2.98	2.71	2.46
Sectors with moderating leverage						
Construction & engineering	2.23	2.13	2.09	2.34	2.13	1.82
Textiles	4.02	4.10	4.23	4.22	3.86	3.42
Automotive retail	4.84	4.83	4.66	4.84	4.66	4.34
Sectors with increasing leverage						
Automobile manufacturers	1.04	0.74	0.75	0.81	1.32	1.45
Overall median	3.37	3.34	3.26	3.25	2.97	2.71

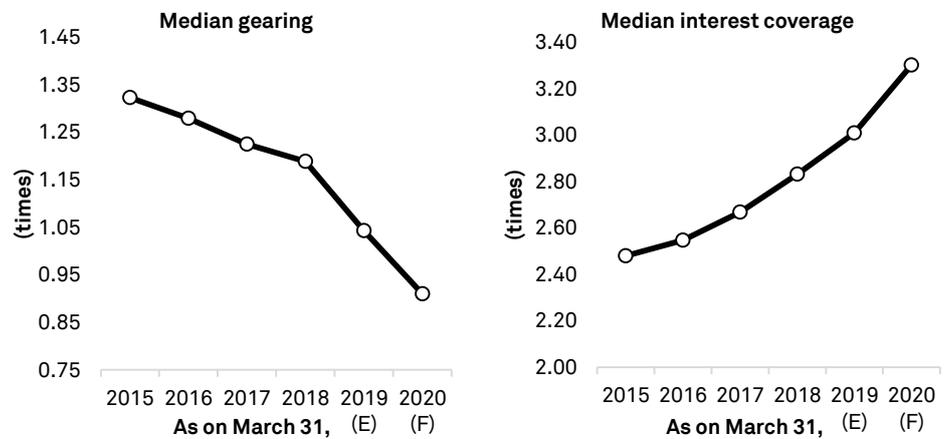
E: Estimated; F: Forecast

Source: CRISIL

As it can be seen from Table 5, leverage in several sectors have declined sharply over the years, helped by lower pace of private capex and improving working capital cycles.

Assessment of other metrics such as gearing and interest coverage also confirm the improving trend in the financial profiles of CRISIL-rated entities.

Chart 5 & 6: Median gearing and interest coverage of overall CRISIL portfolio



E: Estimated; F: Forecast

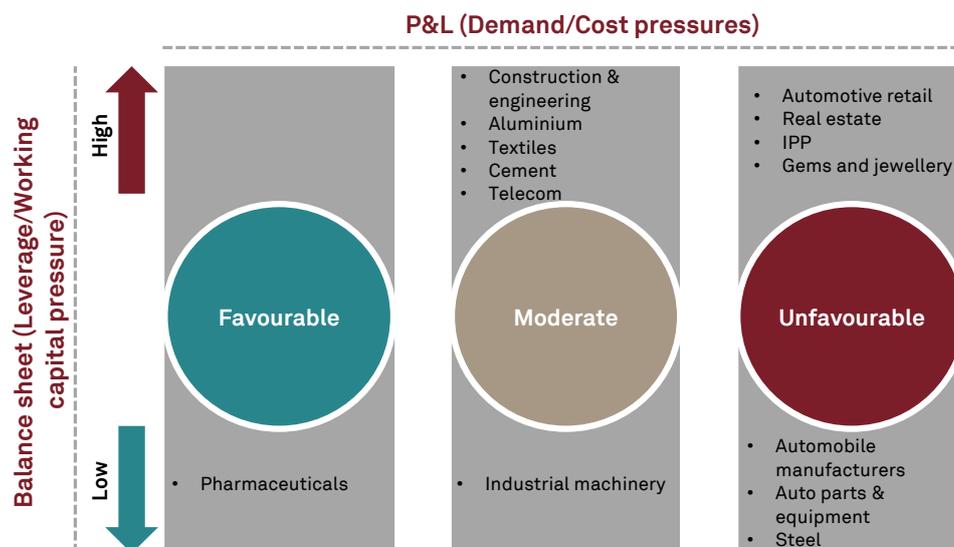
Source: CRISIL

While there have been pockets of re-leveraging because of consolidation following resolutions under IBC, it has been largely restricted to a few large-sized firms, and the trend of improvement continues with or without the inclusion of these large acquirers in the analysis.

Financial risk profiles are expected to cushion credit profiles this fiscal

Resilience of sectors facing pressure on business and financial risk profiles in fiscal 2020 will vary, even as balance sheets continue to get deleveraged. Figure 2 below represents business pressures – primarily demand and cost pressures, while pressures on financial risk profile have been assessed through a combination of leverage and working capital requirement assessment.

Figure 2: Sector-wise assessment of P&L vs balance sheet pressures



Source: CRISIL

We expect sectors with higher balance sheet or financial pressure to be more vulnerable in case they are also facing business, demand or cost-side challenges. Sectoral credit ratios in the second half of fiscal 2020 will likely mirror the pattern seen in the first half, given that demand-side challenges are likely to persist due to the domestic and global slowdown.

Trend analysis of sector wise credit ratios and outlook

Table 6 shows trends in credit quality changes across such sectors over the past five years. Entities in the following sectors constituted 52% of CRISIL's portfolio as on September 2019. Credit quality pressures have intensified across sectors in fiscal 2020, as reflected in the sharp change in credit ratio.

Table 6: Trend analysis of sector-wise credit ratios

Sectors	FY15	FY16	FY17	FY18	FY19	H1-20	H2-20
Construction & engineering	Green	Green	Yellow	Yellow	Yellow	Yellow	Yellow
Agricultural products	Green	Red	Red	Green	Red	Yellow	Yellow
Textiles	Green	Red	Yellow	Green	Red	Yellow	Yellow
Distributors	Green	Red	Yellow	Green	Red	Red	Yellow
Industrial machinery	Green	Yellow	Yellow	Yellow	Green	Red	Red
Real estate development	Yellow	Red	Yellow	Yellow	Green	Red	Yellow
Apparel -- accessories & luxury goods	Yellow	Green	Red	Green	Red	Yellow	Yellow
Automotive retail	Green	Green	Green	Red	Yellow	Red	Yellow
Steel	Yellow	Red	Yellow	Green	Green	Red	Red
Auto parts & equipment	Green	Green	Red	Green	Green	Red	Yellow
Overall credit ratio	Green	Red	Yellow	Green	Yellow	Red	Yellow

Legend		Decline in credit ratio over previous period by >0.3 time
		Decline in credit ratio over previous period by 0-0.3 time
		Increase in credit ratio over previous period by 0-0.3 time
		Increase in credit ratio over previous period by >0.3 time

Source: CRISIL

In fiscal 2014, which was the last time CRISIL's credit ratio was below 1 time, intensifying demand pressures coincided with leveraged financial risk profiles of corporates. As a result, downgrades outnumbered upgrades. However, there has been limited uptick in private capex over the past 5 years and hence the balance sheets of players have seen considerable deleveraging as discussed earlier. We believe credit profiles of corporates will continue to be supported by financial risk profiles even as demand pressures persist in fiscal 2020.

Stable outlook for banks even as non-banks and capital markets turn cautious in fiscal 2020

Banks: Private ones to see credit growth amid asset quality improvement

CRISIL expects bank credit to grow at around 12% in fiscal 2020 compared with estimated 12% on-year in fiscal 2019 and 8% in fiscal 2018. Banking credit growth has been in double digits for the past several months driven by sustained momentum in retail credit and revival in corporate credit, resulting in part from the tightening of the bond markets.

On the asset quality side, about Rs.14 lakh crore of NPAs have been recognised by banks in the past three fiscals. CRISIL estimates the banking sector gross NPAs (aggregate) to have dropped to around 9.3% as of March 2019 as against 11.5% at the end of fiscal 2018. CRISIL expects gross NPAs to continue declining through March 2020, driven by big-ticket resolutions under IBC.

Non-banks: Funding challenges continue

One year after the funding availability issues emerged for non-banks, timely access to funding remains a challenge for many of them barring those that are backed by strong parents. Non-banks with wholesale-oriented loan books and without strong parentage continue to be most impacted in accessing funds. Overall, growth is expected to remain subdued in fiscal 2020. Overall assets under management (AUM) growth for the year is estimated at 12-13% with growth in off-book AUM being higher.

Various regulatory initiatives and measures taken to enhance availability of funds have improved market sentiment to some extent in the past few months. In an environment where access to funding has become a function of market confidence, the quantum and quality of liquidity cushion would become a key differentiator between non-banks.

Capital market investors remain cautious

Default by IL&FS (non-CRISIL rated) in September 2019, resulted in capital market investors turning risk averse and cautious.

As a ripple effect, the credit shock from IL&FS default also had an impact on some highly leveraged promoter companies. Some of these companies negotiated standstill agreements with investors to not revoke pledged shares to enable the firms to meet debt repayments (in January 2019). CRISIL did not rate any of the promoter group deals.

The confidence-sensitive capital markets were irked by these credit shocks leading to constrained availability of funds. They preferred to restrict their exposures to public sector undertakings (PSUs) or those with strong parentage (Refer Table-7). The bond spreads also increased significantly during the same period.

Table 7: Trends in bond market issuances for fiscal 2019 and fiscal 2020

Value of bond issuances (Rs cr)	H1-19	H2-19	H1-20^
Private sector banks	5,601	64,210	12,711
NBFCs/ FIs	66,525	88,344	42,034
Corporates	53,522	79,492	39,929
PSUs*	51,855	225,686	128,528
Total	177,502	457,732	223,203

Proportion of bond issuances	H1-19	H2-19	H1-20^
Private sector banks	3%	14%	6%
NBFCs/ FIs	37%	19%	19%
Corporates	30%	17%	18%
PSUs*	29%	49%	58%

^Until September 16, 2019

*including all india public sector financial institutions, state level undertakings and institutions

Source: PRIME Database, CRISIL

This had a domino effect leading to further defaults in fiscal 2020. Firms with high refinancing requirements, and with exposure to risky sectors faced difficulty in access to funds, impacting their liquidity.

CRISIL's ratings have performed well in this environment and have seen the lowest defaults among all CRAs with capital market presence. This is just one testimony to CRISIL's analytical rigour, proactive surveillance and endeavour to assign the right ratings always.

Robust rating quality metrics through credit cycles

CRISIL's ratings have exhibited robust, best-in-class quality metrics across credit cycles

CRISIL's quality metrics stand testimony to its analytical rigour despite the changing credit landscape and volatile credit environment. In this section, we assess if CRISIL's ratings have withstood the test of time and volatile credit environment using consistent and globally accepted performance metrics for ratings.

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

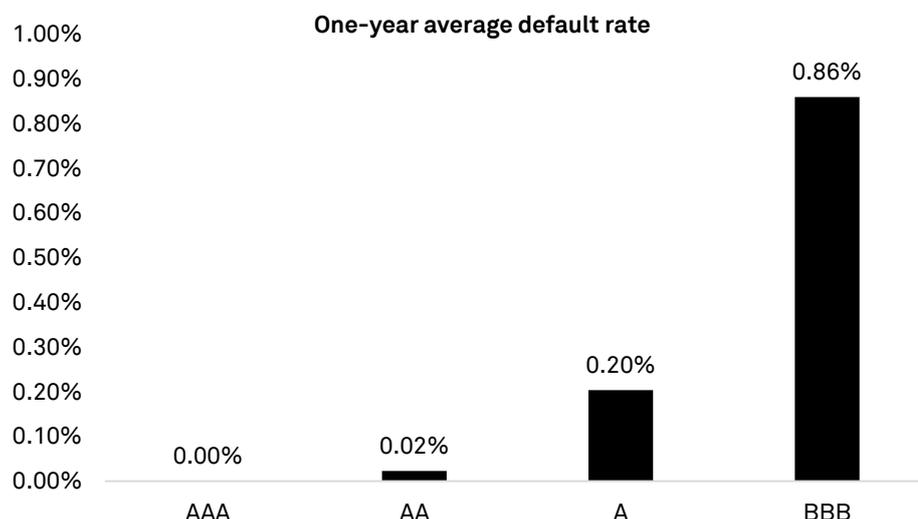
Default rates remain low even during the toughest of times

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

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

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

Chart 7: One-year average default rates (2008-18)



Source: CRISIL

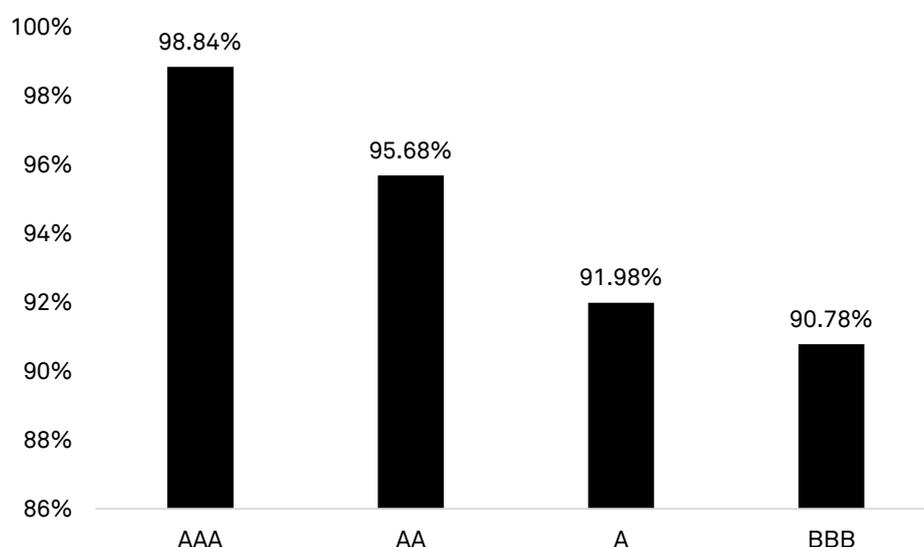
Highest stability rates

CRISIL's high stability rates help investors with their long-term investment decisions.

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

CRISIL's rated portfolio has consistently displayed higher stability rates compared with the industry, and across rating categories. In the five fiscals through 2018, for instance, the average stability rate was above 95% for 'AA' category and above 93% for 'A' category ratings.

Chart 8: One-year average stability rates (2008-18)



Source: CRISIL

Sharp rating actions as a percentage of CRISIL's investment grade portfolio at 0.1%

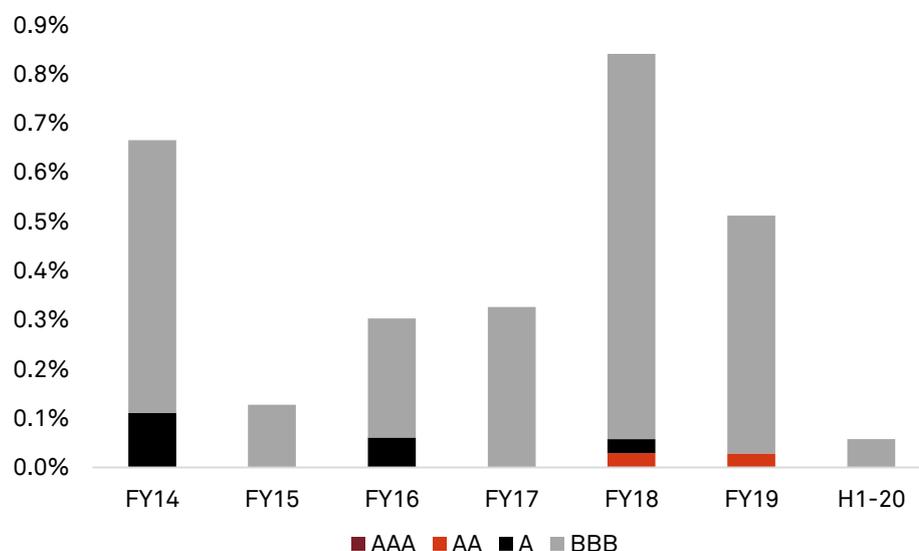
Along with stability rates, investors also consider the intensity of rating actions (defined as downgrades of more than three notches for investment grade categories). If a rating is prone to sharp rating movements during a short period of time, it poses a significant risk to investors with little scope to manage their exposure.

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

The intensity of CRISIL’s rating actions has been the lowest in the industry over the past five years, especially for investment-grade ratings (*see chart below*), with less than 1% of the rating actions being more than 3 notches. It may be noted that high-intensity rating actions have been 0% for AAA category and less than 0.1% for AA category over the years.

For CRISIL, the intensity of sharp rating changes from investment grade fell in the first half of fiscal 2020 to 0.1% compared with fiscal 2019 as well as both halves of the year, even as credit quality pressures remained.

Chart 9: Intensity of sharp rating changes from investment grade



Source: CRISIL

The Securities and Exchange Board of India in its circular dated November 13, 2018, mandated credit rating agencies to disclose sharp rating actions in the investment grade category for securities. A sharp rating action is defined as a change of more than 3 notches. Intensity is calculated as sharp rating actions to the total outstanding investment grade portfolio. CRISIL’s sharp rating actions in securities inline with the SEBI definition is at 0%.

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

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

Credit outlook cautious; impact of fiscal measures and demand pickup among monitorables

The credit outlook continues to be cautious on account of demand pressures stemming from the ongoing economic slowdown, slowdown in consumption spending, lower pace of government spending on infrastructure projects, and constrained funding access for some sectors.

However, improvement in consumption due to higher rural incomes following a good monsoon, improved transmission of monetary policy easing, and better pace of government investments in infrastructure projects are expected to support credit outlook in the second half of fiscal 2020.

A series of fiscal measures have been taken to boost consumption and sentiment, and for structural improvement in particular sectors. While the government's initiatives of easing GST refunds and also the push to PSUs to clear their dues are likely to improve liquidity of smaller firms, impact of measures such as corporate tax rate cut, and consolidation of PSBs will be visible only over the long run. The ability of the measures to improve sentiment and liquidity will be crucial to the credit outlook of corporates in fiscal 2020.

For banks, NPAs are set to decline in fiscal 2020, with fewer fresh slippages, besides improved and faster recovery following recent changes to the IBC. Infusion of capital, especially for PSBs, and focus on retail credit will drive growth for the sector.

For non-banks, while funding challenges remain, the quantum and quality of liquidity cushion would become a key differentiator.

Key upside to this expectation may arise from:

- Greater-than-expected economic boost from the recent fiscal measures announced by Government of India
- Improved pace of consumption driven by faster transmission of interest rates and better rainfall

Overall, the risks to these expectations are

- Extent of economic slowdown and its impact, especially on consumption demand
- Extent of global slowdown, trade frictions, and the impact on trade
- Stretch in working capital cycle

Sectoral credit outlook for corporates

Automotive components



Upgrades

Upgrades were driven by better operating margins among players having long-term contracts with key customers in some segments, enhanced capacity levels, efficient working capital management, and improved liquidity, which led to stronger financial risk profiles

Downgrades

Downgrades were led by decreased revenues on account of muted demand, leading to lower operating margins and poor business risk profiles. Subdued demand in commercial vehicles and two-wheelers led to higher inventory holding period pushing up the working capital requirement, and led to higher dependence on external debt

Revenue growth in the automotive components sector is expected to be flattish to slightly negative in fiscal 2020, compared with a growth of 12% in the preceding two fiscals, because of an expected steep decline in new vehicle sales across segments. In fiscal 2020, CRISIL expects domestic sale of passenger vehicles (PVs) to decline 14-16%, of two-wheelers by 8-10%, and commercial vehicles (CVs) by 17-19%. This is largely due to the liquidity crunch prevalent in the market affecting availability of financing, along with subdued retail sentiment due to higher cost of ownership and low growth in rural wages.

Sales of CVs were impacted by relaxed axle load norms introduced in fiscal 2019, fewer stoppages due to smoother clearances at check-posts, and an overall dip in volume of goods transported. Furthermore, the cost to comply with regulatory requirements has increased, and so have vehicle registration fees in some states. This will impact the automotive components sector as well, original equipment manufacturers (OEMs) account for 65% of the demand for components.

However, the new safety and emission norms offer hope to component manufacturers as these will increase the component content in vehicles. The new regulations alone are expected to account for 25-30% of the incremental demand for automotive components in fiscals 2020 and 2021. Aftermarket demand (16% of the sector's revenue) is expected to maintain growth of 6-8%.

Export (around 19% of revenue) is projected to grow 3-5% in fiscal 2020, much lower than the 18% seen in the preceding two fiscals, because of sluggish demand in the traditional markets such as the US and Europe. However, exports growth should improve to 6-8% in fiscal 2021 as India moves towards higher global standards in terms of quality and safety measures with the

implementation of BSVI from fiscal 2021. This will help players expand in new geographies and give them an edge over players in other low-cost countries.

Overall, sluggish OEM demand will affect the revenues of component manufacturers. Operating margins are also expected to decline 100-200 basis points to 10-11% in fiscal 2020 following sluggish revenue and despite measures to rein in cost. Given the challenging business environment, automotive component players are also pruning capital expenditure.

In the past decade, balance sheets of most component manufacturers had improved due to steady cash accrual and financial prudence. In fiscal 2020, CRISIL expects players with diverse revenue streams and customer profiles to face less moderation in credit metrics than those with limited segmental and geographical diversification, or those that undertook material capacity addition in the recent past.

Basmati rice



Upgrades

Upgrades were largely in the non-investment grade rating category, and were led by stronger business risk profile because of increased demand and sales realisation.

Downgrades

Downgrades were mainly on account of stretched liquidity because of lengthened working capital cycle.

Though the basmati rice export volume is expected to decline 7-9% in fiscal 2020 over that in fiscal 2019, credit risk profiles of basmati rice exporters should remain stable over the medium term because of tight control over working capital cycle and stable operating profitability.

Construction & engineering



Upgrades

Upgrades were driven by healthy growth in revenue and higher operating margin, continued strong order inflow providing revenue visibility, and improved financial risk profile.

Downgrades

Downgrades were due to lower profitability or sales on account of intense competition in the roads and bridges segment. Stretched working capital cycle, due to increased inventory and slower realisation of receivables, impacted liquidity.

Note: The credit risk profiles of many large, diversified engineering, procurement and construction (EPC) players remain constrained by the aftereffects of aggressive bidding in the past, leveraged balance sheet, and policy bottlenecks. Many of these companies are in the process of debt resolution. These are rated 'D' and have seen no change in their ratings. Hence, the analysis excludes stressed assets and is more representative of the non-stressed portion of the corporate loan book.

Investment in the construction sector is likely to clock a compound annual growth rate of 8-9% over fiscals 2020-2024, compared with 5% during 2015-2019, driven by increased construction spend in the infrastructure segment. Within infrastructure, roads will dominate construction activity (50% of the total spend), followed by irrigation and urban infrastructure.

The sector should benefit from the increased number of projects awarded under the engineering, procurement, and construction (EPC) mode.

The hybrid annuity model (HAM) was introduced in fiscal 2016, wherein project risk is shared by the awarding authority given 40% of the project is funded by National Highways Authority of India (NHAI). The share of projects awarded under HAM has increased to about 50%.

Improved private participation has boosted execution pace, thus improving performance of companies. Central government schemes, such as the Smart Cities Mission, are also likely to enhance order flow.

Working capital management and maintenance of adequate liquidity remain critical for the sector. Asset monetisation by selling operational infra project SPVs to infrastructure investment trusts and other investors as well as equity infusion will be key in maintaining financial risk profile.

Independent power producers



Upgrades

Upgrades were driven by track record of healthy plant load factor (PLF), thus increasing confidence in cash flow visibility.

Downgrades

Downgrades were mainly due to stretched liquidity on account of delays in payments by counterparties.

India's thermal power sector is at a critical juncture and efforts are being made to revive generation companies (gencos) and improve the financials of discoms. Gencos are being revived through structural improvements (announcement of new power-purchase agreements, or PPAs, and coal linkage policies) and resolution of stressed thermal-coal assets in the private sector. State discoms remain the weakest link in the power value chain, because of stretched financial risk profiles.

The auction of medium term-term PPAs in the past 12-18 months is a step to help gencos that lack assured offtake arrangements. Around 1,900 MW capacity was allocated in the first auction, while capacity of 2,500 MW was up for grabs in the recently concluded auction. In light of the evolving capacity mix and upcoming generation capacity, the structure of PPAs is expected to move towards short-/medium-term from long-term arrangements. Furthermore, fuel constraints are expected to ease with the commencement of operations of captive coal mines and incentives to operationalise previously allocated ones. While policy initiatives regarding commercial mining are expected soon, evacuation infrastructure and transportation framework will remain bottlenecks.

Furthermore, 22,000 MW of stressed, operational thermal assets are likely to see a turnaround in fiscal 2020 through implementation of resolution plans or bidding under the new RBI's stressed asset framework.

Electricity consumption is expected to grow by a healthy 5.5-6.0% annually over the medium term. The government's continued focus on meeting its 24x7 Power for All objective, higher penetration of consumer electronic goods, and increasing industrial consumption will be the key drivers of growth. This, along with a general slowdown in thermal capacity addition (around 32,000 MW is expected to be added till fiscal 2023, compared with 69,000 MW added from fiscals 2015-2019), should benefit existing capacities.

The renewables sector witnessed an increased flow of equity capital and generation, in line with expectations. However, the credit ratio of the renewables

portfolio has been negative in 2019 so far, implying more downgrades than upgrades.

This is primarily because of longer delay in payments from the discoms of Andhra Pradesh. The state's decision to review and bring down the purchase cost of wind and solar energy stretched their payment cycle by more than 240 days, leading to cash flow issues for standalone projects. Although renewable energy developers got a court stay on the state government's order, the delay in payments by the discoms persists.

Thus, credit risk profiles in the renewables sector will be sensitive to the time taken for tariff renegotiation by the Andhra Pradesh government and restoration of the payment cycle.

Credit risk profiles of power generators will remain susceptible to stretched receivables from their weak counterparties.

Financial risk profiles of state discoms will remain constrained as their operational performance under the Ujwal Discom Assurance Yojana, though improving, remains below expectation. Consequently, the gap between average revenue realised (ARR) and average cost of supply (ACS) for 15 large states for fiscal 2020 is expected to increase to 30 paise per unit from 24 paise in fiscal 2019. This could result in higher dependence on external borrowing.

Also, discoms now having to mandatorily provide letters of credit (LCs) to gencos will likely put an additional financial burden on them. Therefore, a concerted effort to improve operational efficiency, along with continued state support, is the way forward for the power sector.

Real estate



Upgrades

Upgrades were aided by changing revenue mix towards lease income or more-than-expected funding support from promoters and refinancing of debt resulting in improved liquidity and debt service coverage ratios. Few upgrades were led by higher sales, advanced stage of existing projects, and improved collection efficiency, leading to substantial cash inflow.

Downgrades

Majority of the downgrades were in the residential segment on account of lower-than-expected sales. Half of the downgrades were to the default category. Already subdued demand was exacerbated by the liquidity crisis among NBFCs and the Real Estate (Regulation and Development) Act, 2016.

The strong performance of the commercial real estate segment downplays the stress in the sector.

The ongoing liquidity crisis in the NBFCs segment, and jitters from implementation of the Real Estate (Regulation and Development) Act, 2016, have hit small residential developers, with collections diminishing year-on-year due to low incremental sales and slowdown in construction due to lack of funds. While large, established players with healthy balance sheets and a sizeable operational commercial portfolio to lean on are seeing double-digit growth in collection and sales, small players have been left smarting by the twin blows.

Residential ticket sizes have been coming down as developers launch units at 7-15% lower prices and with reduced average area per house, led by market needs and the impetus to affordable housing. End users have been gravitating towards established players with a track record of completing and delivering projects on time. Improvement in the business risk profile of small players hinges on resolution of the recent NBFC liquidity issues.

Unlike the tepid residential segment, the commercial portfolio is seeing steady lease rentals and healthy demand. Indeed, even as investor interest in the residential segment has been fading due to limited price appreciation and inability to monetise assets, commercial real estate is becoming a hub for new investment. This has helped cushion the blow for developers who need to refinance their debt and take on more debt for construction. Larger developers with a portfolio of commercial assets have been able to manage liquidity better and are expected to continue doing so in a market where raising capital is becoming challenging.

The retail segment continues to see strong traction, given the healthy performance of established retail malls across India. This has attracted large

foreign institutional investors. Real estate investment trusts are emerging as an attractive avenue for large developers and investors with income-generating commercial and retail assets.

Pharmaceuticals



Upgrades

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

Downgrades

Downgrades were mainly due to subdued operating performance with lower profitability and cash accrual, and stretched working capital cycle of small players impacting their liquidity.

The pharmaceutical sector's revenue is expected to grow 11-12% in fiscal 2020 to reach Rs 4,000 billion, compared with 10% growth in fiscal 2019.

Revenue growth would be driven by increase in volume, especially in the domestic formulations segment, and recovery in the regulated markets. However, pricing pressure continues due to intense competition and supplier consolidation in the regulated markets.

The domestic formulations segment, which accounts for 65% of the sector's revenue, is expected to register revenue growth of 11-12% in fiscal 2020, backed by increase in per capita income, expansion in healthcare penetration, and increasing incidence of lifestyle diseases. Revenue from chronic therapies is expected to grow 15-16% and from acute therapies by 10-11%. However, competition has intensified, particularly in the acute segment which accounts for 60% of domestic formulations.

Government initiatives such as Ayushman Bharat will improve healthcare coverage and aid the sector's growth. However, the increased number of medicines under the Drug Price Control Order could impact drug pricing and will remain a monitorable.

Export formulations (28% of the industry) will grow 12-13%, in rupee terms, led by recovery in the regulated markets, primarily the US. Pricing pressures have eased in the US with the exit of large US-based manufacturers from some highly-competitive generic drugs. The growth will be driven by complex generics, specialty, and biosimilars. In semi-regulated markets, lower penetration of healthcare facilities and generics, and high population growth will provide

opportunities to Indian pharmaceutical players. For instance, recently, new regulations in China have opened up the market for Indian players. Export will also benefit from rupee depreciation.

In fiscal 2019, the bulk drug segment (7% of the industry) benefitted because of supply disruption in China and increase in bulk drug consumption by formulators. In the long run, transition towards specialty and niche segment and high-value APIs will aid growth of 11-12%.

Profitability of formulations players will sustain, supported by better pricing stability in the regulated markets and continued high expenditure in research and development (8% of revenue), particularly for large players. Formulations players will continue to undertake capital expenditure for the regulated markets, particularly for specialised generics. Similarly, margins for bulk drugs are expected to improve as the pharmaceutical companies move on to manufacture high-value APIs and niche molecules. However, ability to pass on high input cost to formulators will be limited.

Credit quality of large pharmaceutical companies is expected to remain stable, supported by strong balance sheets and steady operating performance. Large working capital requirement will continue to be funded through debt and internal accrual. On the other hand, credit risk profiles of mid-sized and small players will remain vulnerable to steep changes in input prices, foreign exchange rate, and competitive pressures. The regulatory environment will also be a key monitorable.

Textiles



Upgrades

Upgrades were led by entities with better operating margins, which have diversified to new markets and new customer profiles and had the ability to pass on the rise in input cost to end users.

Upgrades were seen mostly in players which have been able to optimise their raw material cost by better logistics, and have better cash flow to aid working capital

Downgrades

Majority of downgrades were seen among entities with high working capital intensity and poor cash flow management, which stretched their liquidity. Entities with increased leverage due to capex and poor operating margins on account of increased raw material cost were also downgraded. Majority downgrades were seen in RMG entities, which faced intense competition from import destinations.

Growth in demand for readymade garments is expected to moderate to 5-6% over the medium term (from 10-10.5% in fiscal 2019), on account of stagnant domestic demand.

While the domestic readymade garment business witnessed growth in fiscal 2019 due to increased penetration of organised retail and brands, revenue was flat in the first quarter of fiscal 2020 on account of lower consumer spending.

Export declined in fiscal 2019 due to increasing competition from Bangladesh and Vietnam and drop in export to the UAE, the third-largest export destination after the US and the European Union. Export picked up 7% in the first quarter of fiscal 2020 over the corresponding period of the previous fiscal due to partial restoration of export incentives and rupee depreciation. A similar trend is expected for the fiscal. While India will continue to face intense competition from Bangladesh and Vietnam, revival in export to the UAE will support RMG export from the country.

In fiscal 2020, while domestic demand for cotton yarn is expected to increase 3-4%, higher domestic supply due to reduced export will put pressure on cotton-cotton yarn spreads. Global destocking has led to a sharper fall in international cotton prices, while domestic prices have not fallen in proportion because of the minimum support price, which has rendered Indian cotton yarn manufacturers uncompetitive in the global market. As a result, cotton yarn export from India declined 34.9% during April-July 2019 over the corresponding period of 2018.

Export is expected to decline 8-10% in fiscal 2020 due to low demand from China and falling competitiveness of Indian players due to higher domestic cotton prices. An expected bumper cotton crop and reduction in cotton prices may provide some respite and lead to recovery in export in the second half of fiscal 2020.

Because of lower volume and spreads, and adverse operating leverage, operating margin of cotton spinners is expected to take a hit of 300-500 basis points in fiscal 2020. However, the impact on credit risk profiles may be limited, as capital spending is likely to remain moderate given current capacity utilisation of 70-75%. Also, spinners will likely continue to manage working capital prudently.

In the long run, cotton yarn demand is expected to grow 3% per fiscal, marginally faster than 2% in the five fiscals through 20xx, with steady growth in domestic demand.

Banks and non-banks: Sectoral credit quality outlook

Banks



The banking sector is steadily overcoming the challenges faced in the past few years, as indicated by reducing NPAs and largely stable credit growth, which have been key factors impacting the sector in recent years.

Stringent stressed asset resolution norms of the RBI, along with traction in resolution of large-ticket NPAs under the IBC, have been key contributors to asset quality recovery.

The IBC has been a game changer in strengthening credit discipline and practices in the borrower and lender communities. The recapitalisation of PSBs has also helped. Also, the bold step of consolidating PSBs underscores the government's objective to enhance operational efficiency and structurally strengthen the sector.

Fiscal 2020 is expected to see four major trends. First, bank credit will continue to grow in double digits at ~12%, second, the gross NPA (GNPA) ratio should decline further led by lower slippages and higher resolutions. Third, PSBs' profitability will get back into positive territory after four consecutive years of losses. And fourth, the capital profile of PSBs will improve.

Credit growth to remain stable, driven by retail lending

Credit growth improved to 12% in fiscal 2019, after three consecutive years of single-digit growth. CRISIL expects bank credit to grow ~12% in fiscal 2020. The retail segment will continue to drive growth. Within the retail segment, secured loans are rising steadily, whereas unsecured loan products such as credit cards and personal loans are showing strong traction.

PSBs, which were growing much slower than the industry in the past few years due to paucity of capital, will report better growth post the recapitalisation by the government and with more PSBs coming out of Prompt Corrective Action (PCA) framework. On the other hand, private banks supported by strong balance sheets and significant presence in the retail segment, will continue to beat the systemic credit growth.

Asset quality pressures receding with GNPA's trending down after tripling between fiscals 2015 and 2018

The banking sector's GNPA's are expected to continue to decline from the peak of 11.5% in March 2018 and from 9.3% in March 2019, driven by reduction in fresh accretions to NPAs as well as increased recovery from existing NPA accounts. Resolution of large NPA accounts, especially under the IBC, should

particularly help, assuming higher recovery rates and faster resolution times than seen in the past.

Slippages have been on the wane since fiscal 2019, with the rate of accretion of fresh NPAs halving to 3.7% from 7.4% in fiscal 2018. It is expected to drop further in fiscal 2020, despite some additional slippages into NPAs from large ticket accounts. Banks have already recognised around Rs 17 lakh crore of stressed loans as NPAs since fiscal 2016, led by accelerated NPA recognition following the RBI's stringent norms and asset quality reviews.

In terms of segmental performance, a substantial reduction in NPAs is expected in the corporate loan accounts, riding on expectation of resolution of some large NPA accounts under NCLT-1 and NCLT-2 fructifying by the end of fiscal 2020. Although delinquencies have inched up in the retail segment and portfolios are yet to fully season, and with strong growth in the past few years resulting in possibility of further increase in retail NPAs going forward, the granular nature of these loans should provide diversification benefits and support asset quality. Also, given the RBI's stance on restructuring of loans to small and medium enterprises (SMEs) till the end of fiscal 2020, NPAs in this segment may not see a material uptick despite the sector facing stress. Nevertheless, NPAs in SME loans could rise going forward. In sum, seasoning of the retail portfolio and performance of the SME portfolio post the restructuring period will be key monitorables.

PSBs getting back into black

PSBs incurred losses in the past four fiscals, mainly due to high credit cost due to increasing slippages and ageing of loans. Given that much of the stress in asset quality is now recognised by the system, and provision for stressed loans has improved, PSBs are expected to turn profitable in fiscal 2020 as incremental provisions are likely to be lesser than that in the past. Along with expected normalisation of return on assets for private banks, profitability of the banking system should improve in fiscal 2020.

PSU consolidation and upfront capital infusion of Rs 55,250 crore to support capitalisation

The announcement of multiple bank amalgamations at one go by the Ministry of Finance on August 30, 2019, reveals the decisive intent of the government to go ahead with its consolidation agenda for PSBs. The consolidation of PSBs is expected to bring in economies of scale and business synergies, and increase operating efficiency.

While there will be clear long-term benefits of the proposed amalgamation if implemented successfully, any such large integration does entail some short-term challenges, such as managing cultural differences, manpower and branch rationalisation, technological integration, and potential opposition from trade unions. If these issues are handled well, the consolidation can bring in structural benefits, enabling PSBs to compete more effectively with other constituents in the financial sector.

Of the proposed capital infusion of Rs 70,000 crore in fiscal 2020, the government has announced upfront capital infusion of Rs 55,250 crore into 10 PSBs. This will improve the banks' capital ratios. The government has infused Rs 2.01 lakh crore into PSBs (including Rs 12,000 crore raised from the market) under the recapitalisation programme announced in October 2017.

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

NBFCs and HFCs



Non-banks still facing funding challenges, barring those with strong parentage

One year since liquidity issues surfaced for NBFCs and HFCs, timely access to funding remains a challenge for them unless they are backed by strong parents. To be sure, many non-banks have reduced shorter tenure borrowings, increased on-balance sheet liquidity, and are now reporting positive gaps in asset liability maturity profiles. However, interest from institutional investors in the debt capital market remains tepid. While the share of capital market funding (especially commercial paper) is reducing, bank funding has not yet fully bridged the gap. Banks are more comfortable purchasing securitised pools at this juncture, rather than direct lending.

Leading parent-backed NBFCs and large retail-oriented standalone entities are able to access capital markets and avail bank facilities and at competitive costs. Some NBFCs/HFCs have successfully managed to tap the overseas markets and raise foreign currency funds. However, NBFCs Non-banks with wholesale-oriented loan books and without strong parentage continue to be the most hit by funding challenges.

Various regulatory initiatives and measures to enhance availability of funds have improved market sentiments to some extent in the past few months. In an environment where access to funding has become a function of market confidence, the quantum and quality of liquidity cushion will become a key differentiator among non-banks. The need of the hour is to demonstrate resilience by maintaining sound liquidity policies to navigate business cycles.

Amid all this, growth in the second half of fiscal 2019 was around half of that in the first half. However, the strong growth in the first half led to growth of 15% in overall non-bank credit in fiscal 2019, with assets under management reaching Rs 23.7 lakh crore as of March 2019. However, growth is expected to be subdued in fiscal 2020, with overall AUM expected to increase 12-13% and growth in off-book AUM being higher.

Growth and asset quality trends will vary across asset classes. The unsecured loans and gold loans businesses are unlikely to witness any material impact. In traditional retail asset classes such as vehicle finance and home loans, while there could be some moderation because of intensifying competition from banks, these segments are expected to grow and aid growth of the overall non-banks space.

However, wholesale segments, especially real estate developer finance, are expected to be impacted the most, as reflected in curtailed disbursements. With

incremental funding toward real estate dropping, asset quality concerns have increased. With growth in the wholesale book falling sharply, there could be second-order effects on the asset quality of this book, which typically has high concentration risk. While asset quality has held up so far given the way loans are structured with moratorium periods provided in most cases, delinquencies could increase, given that credit flow to the sector is slowing.

Furthermore, asset quality of retail segments is likely to moderate amid the weakening economic environment. Asset quality in retail segments, such as home loans and vehicle loans, is not expected to be materially impacted, given the granularity in loan portfolios. Non-banks have clearly reoriented their collection infrastructure, which has supported their delinquency metrics despite demonetisation and challenges arising from GST implementation.

The loan against property portfolio has led to stress for some non-banks. Amid tightening liquidity, asset quality concerns have increased. Furthermore, balance transfer cases have reduced, which could lead to increased manifestation of underlying stress going forward.

Notes

About CRISIL Limited

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

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

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

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

About CRISIL Ratings

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