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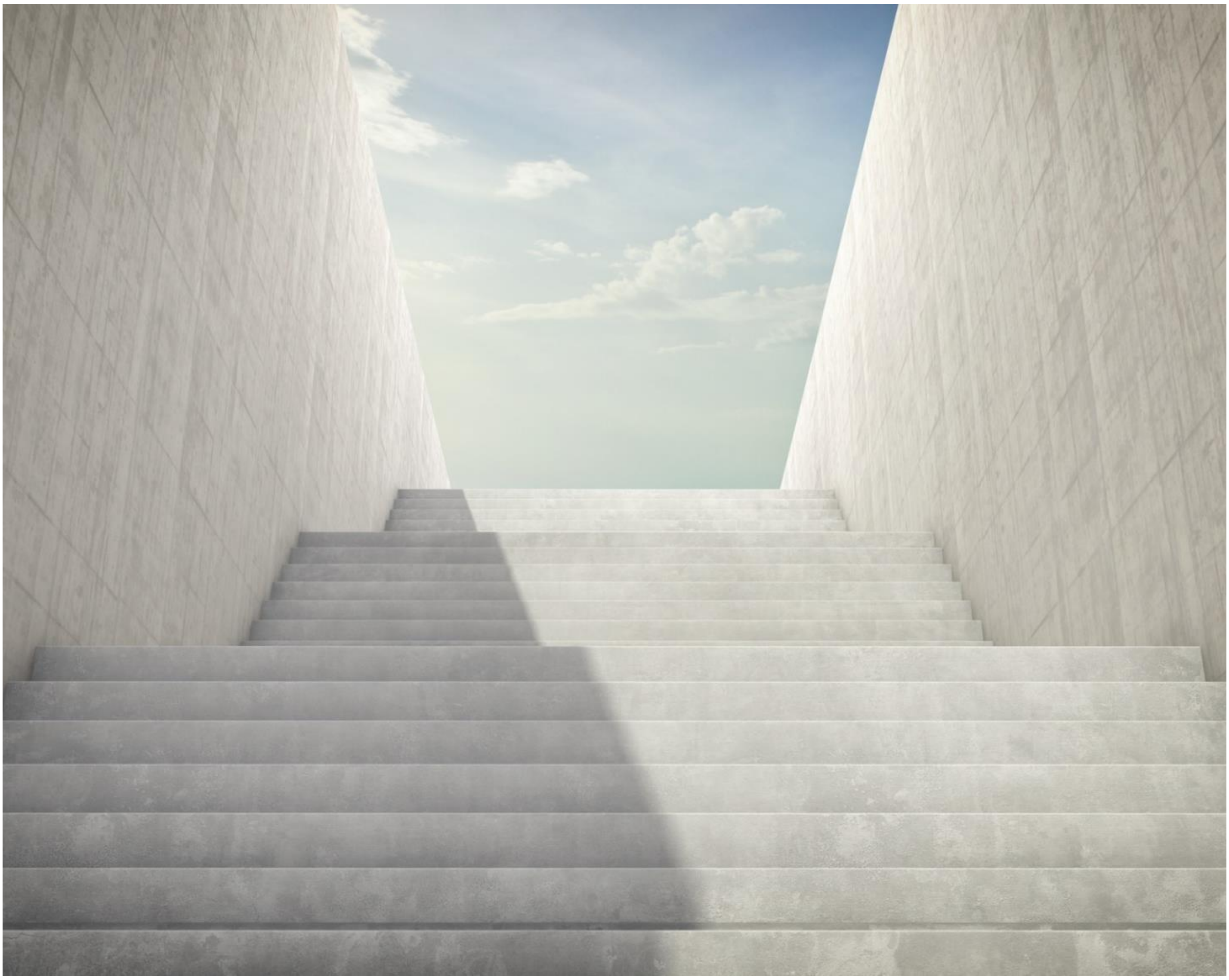
Ratings Round-Up: First half, fiscal 2023



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Executive summary

The CRISIL Ratings credit ratio[1] (upgrades vs downgrades) continues to be high — at 5.52 times in the first half of this fiscal (H1-FY23) — underscoring ongoing broad-based improvement in India Inc's credit quality. The credit ratio was 5.04 times in the second half of last fiscal (H2-FY22).

The credit ratio is in line with the positive credit quality outlook CRISIL Ratings had articulated earlier — that upgrades will far outnumber downgrades through this fiscal.

To be sure, ratings on nearly 80% of the CRISIL Ratings portfolio was reaffirmed, or there was no change during H1-FY23. That compares well with the historical average of 83%.

For the rest of the portfolio, what has changed is the upgrade rate, which increased to 16.70%, while the downgrade rate was flattish at 3.02%. In all, there were 569 upgrades and 103 downgrades.

Three reasons stand out: 1) strengthening domestic demand, with the economy expected to grow 7.3% this fiscal; 2) higher realisations leading to better cash flows; and 3) continuation of debt-light balance sheets as capex remains low. The performance of upgraded companies improved significantly over the past three fiscals despite severe pandemic-related disruptions. This is reflected in the median expected growth in Ebitda[2] at a 3-year CAGR[3] of 25% for the upgraded companies which is much better than the 12% expected for the rest of the portfolio.

Around 35% of all upgrades were from the infrastructure sector (including large realty players). Infrastructure sector is in a unique position of largely being a domestic story and generally decoupled from the global headwinds. Here, upgrades were driven by improved operating cash flows, completion of crucial project milestones and equity infusion. Over the last few years increasing share of central counterparties in infra projects has led to more predictable payment cycles providing additional comfort to credit quality.

The deleveraging trend has continued with median gearing of the CRISIL Ratings portfolio expected to touch a decadal low of less than 0.5 time this fiscal. While capacity utilisation is on an improving trajectory backed by healthy offtake, private capex is not expected to pick up substantially in the near term. This has arrested the downgrade rate, despite some sectors facing challenges such as higher input costs and rising interest rates.

Strong balance sheets are expected to hold India Inc in good stead even though global uncertainties persist.

CRISIL Ratings' proprietary 'Corporate Credit Health Framework' analysed the operating cash-flow strength (measured by expected change in absolute Ebitda) and balance sheet strength of the top 43 sectors that account for over 70% of rated debt (excluding the financial sector) in fiscal 2023 over fiscal 2022.

The framework was conceptualised to give shape to our credit quality outlook on various sectors. Notably, sectors which were classified under 'the most buoyant bucket' in the first edition of this study in April 2022, including pharmaceuticals, specialty chemicals, hospitals, and education services, saw the highest credit ratio in H1-FY23.

[1] Excludes rating actions involving ratings with the Issuer Not Cooperating (INC) suffix
[2] Earnings before interest, taxes, depreciation and amortisation
[3] 3-year CAGR – compound annual growth rate for three years from fiscal 2020 to fiscal 2023

Key takeaways from the H1-FY23 study:

- 13 sectors, accounting for 18% of rated debt, are in the most buoyant bucket with robust balance sheets. Their operating cash flows are expected to grow over 10% in fiscal 2023 on-year which is higher than other sectors. These include sectors expected to turn around after dismal pandemic years — hospitality, airport operators, industrials, and marine ports. They moved into this bucket driven by better operating cash flows
- The balance 30 sectors would log favourable trends in one of the two parameters — operating profits or leverage — and hence their credit quality outlook would be between positive and neutral. These include some of the infrastructure sectors such as highway tolling and renewables which will see steady growth in operating cash flows while balance sheet remains healthy
- Export-oriented sectors such as textiles, pharmaceuticals, and information technology would see a moderation in cash flows vis-a-vis earlier expectations due to slowdown in demand from end-user markets. Sectors such as agrochemicals, dairy, education services would also see a moderation in their performance due to elevated costs and inability to fully pass them on.

The financial sector's credit quality outlook is seen stable, with bank credit growth seen up 14-15% this fiscal versus 12% last fiscal, while for non-banks[4], credit growth is expected at 11-12% versus 6-8% last fiscal.

As for asset quality, gross non-performing assets (GNPA) of banks is likely to improve 90 basis points (bps) on-year to 5% this fiscal, riding on post-pandemic recovery and higher credit growth. For non-banks, the GNPAs are expected to be ~3% as on March 31, 2023, versus 3.5% as on March 31, 2022. A key monitorable would be the performance of restructured portfolios, especially MSME[5].

Our credit quality outlook on India Inc remains positive led by resilient domestic demand and impetus from the government's infrastructure spends. However, persistent high inflation, hike in interest rates, and slowdown in large economies remain a risk to our outlook and may result in moderation of credit ratio. Export-oriented sectors could see an impact on their cashflows as the ongoing slowdown in global demand would offset the benefits of a depreciated rupee and the diversified sourcing strategy of global companies.

[4] Non banks include non bank finance companies and housing finance companies
[5] Micro, small and medium enterprises

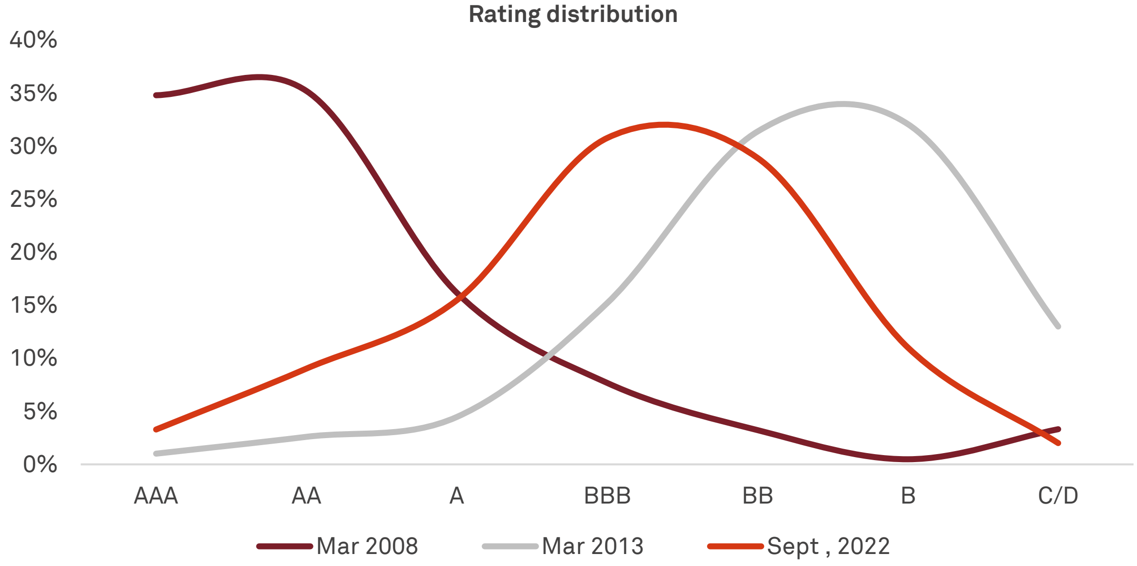
About Ratings Round-Up

The Ratings Round-Up is a semi-annual publication that analyses rating actions by CRISIL Ratings and traces the linkages between such actions and the underlying economic and business trends. This edition analyses the rating actions from March 31, 2022, to September 29, 2022.

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 a reasonable indicator of the economy's outlook.

CRISIL Ratings portfolio: Median rating unchanged in H1-FY23

Figure 1: Trends in rating distribution



Source: CRISIL Ratings

Our outstanding ratings as on September 29, 2022, cover around 6,800[6] companies. Of these, 59% are in the 'BBB' or above rating categories. With the introduction of bank loan ratings in 2007 and rapid expansion of our rated portfolio, especially into the lower rating categories, the median rating had moved to 'BB' as on March 31, 2010, from 'AA' as on March 31, 2008.

Notably, after staying at the 'BB' category until fiscal 2021, the median rating shifted to the 'BBB' category in fiscal 2022 and has stayed in the category this fiscal as well.

In fact, the proportion of ratings in the 'BB' or lower categories reduced from ~76% as of March 2013 to 41% as on September 29, 2022. This was attributable to the portfolio shrinking at the lower end of the rating spectrum — a phenomenon seen across the rating industry in India. In recent years, several banks have increased the threshold of minimum exposure that requires an external credit rating, leading to withdrawal of ratings or, more commonly, non-cooperation in the rating process by rated entities, especially those in the sub-investment-grade categories.

[6] This excludes companies in the Issuer Not Cooperating (INC) category. The CRISIL Ratings portfolio had ~11,500 such issuers as on September 29, 2022. Including such ratings, our outstanding rating list would comprise ~18,300 issuers. The median rating, however, would move to the 'BB' category.

Analysis of rating actions in the first half of fiscal 2023

In its previous Ratings Round-Up, CRISIL Ratings had noted a 'Positive' credit quality outlook for this fiscal with upgrades expected to outnumber downgrades. It's no surprise then that the credit ratio remained high at 5.52 times for the first half of this fiscal, with 569 upgrades and 103 downgrades. Strengthening domestic demand, higher realisations leading to better cash flows, and continued deleveraging along with low capex helped India Inc continue its upward march. The pandemic years did provide an opportunity to corporates to significantly improve operating efficiencies and pare down debt.

That said, ratings on about 80% of the portfolio were reaffirmed or unchanged during the first half of this fiscal. That compares well with the historical average of 83%. Hence, the modified credit ratio (MCR)[7] did not change materially and stood at 1.16 times in the first half this fiscal, against 1.15 times in the second half last fiscal.

Around 35% of the upgrades were from the infrastructure segment, as improved cash flows and progressive completion of project milestones led to a positive bias in credit profiles. Further, transfer to pooled assets in the infrastructure segment is delinked from the broader macroeconomic environment. In the consumer-facing discretionary sectors, such as domestic textiles, auto ancillaries and large realtors, steadfast domestic demand has been driving upgrades.

While the pandemic may be winding down, supply-side challenges remain. In fact, the prolonged Russia-Ukraine war and the ensuing energy crisis in Europe have exacerbated these challenges. With central banks globally increasing policy rates, demand is expected to soften across the world, particularly in developed economies. Global gross domestic product (GDP) growth is expected to slow to 3.1% in calendar year 2022 and to 2.4% in 2023.

Having said that, India does stand out among the *largest* economies today, having clocked a quicker- and sharper-than-envisaged recovery from the pandemic, and is set to clock the *fastest* growth this fiscal. It will be amongst the few large economies to sustain healthy growth next fiscal as well.

So, what shields India Inc from the expected global turbulence? Three reasons stand out. First, buoyant domestic demand; second, improved cash flows led by higher realisations; and third, the debt-light balance sheets of India Inc.

Of the three key factors, sustenance of domestic demand bears watching given the challenging macroeconomic environment. Global headwinds such as inflation, the energy crisis in Europe and the expected global slowdown could impact India's export growth, which had a spectacular run last fiscal. Slower exports may have an outsized impact on MSMEs, which are already facing trouble recovering from the blow dealt by the pandemic. That said, the CRISIL Ratings portfolio does not reflect this stress as quite a large number of MSMEs have moved out of the rated portfolio. This could be attributed to MSMEs turning non-cooperative or seeking withdrawal of ratings given that lenders have increased the threshold for minimum debt required to be

[7] MCR is defined as the ratio of rate of upgrades and reaffirmations to rate of downgrades and reaffirmations

rated. Unsurprisingly, MSMEs constituted almost three-fourths of the non-cooperative issuers in CRISIL Ratings' portfolio as on September-end of 2022.

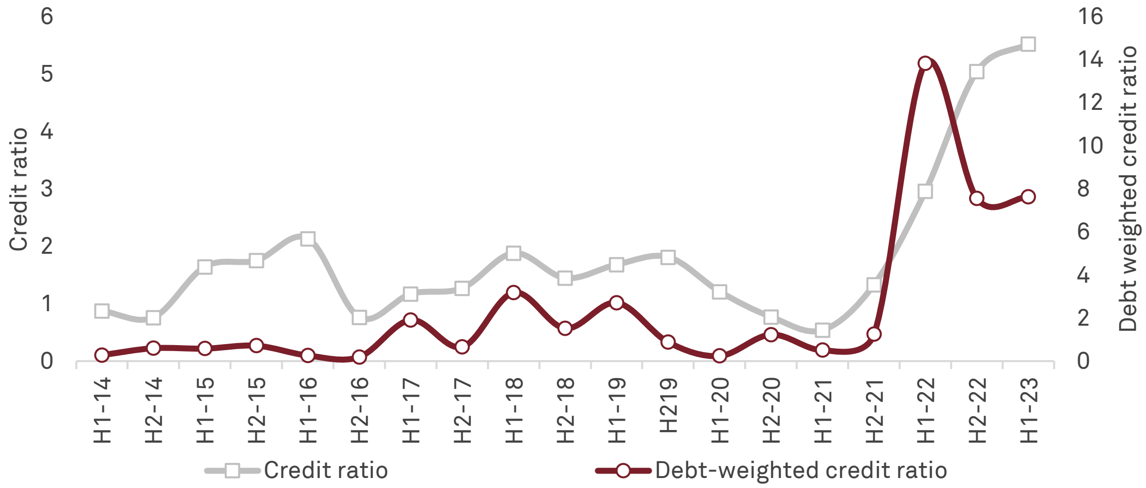
In the forthcoming section, we address how global and domestic trends will impact our credit quality outlook. We also present the credit ratio and debt-weighted credit ratio trends for the first half of this fiscal and compare them with previous halves.

Credit ratio at 5.52 times in the first half of fiscal 2023, up from 5.04 times in the second half of fiscal 2022

Ratings actions in the CRISIL Ratings portfolio for the first half of this fiscal indicate that India Inc is on a stronger footing despite external global headwinds, with upgrades outnumbering downgrades by a wide margin.

MCR was stable at 1.16 times in the first half of this fiscal as the majority of the ratings were reaffirmed, implying no rating action. MCR was 1.15 times in the second half of last fiscal.

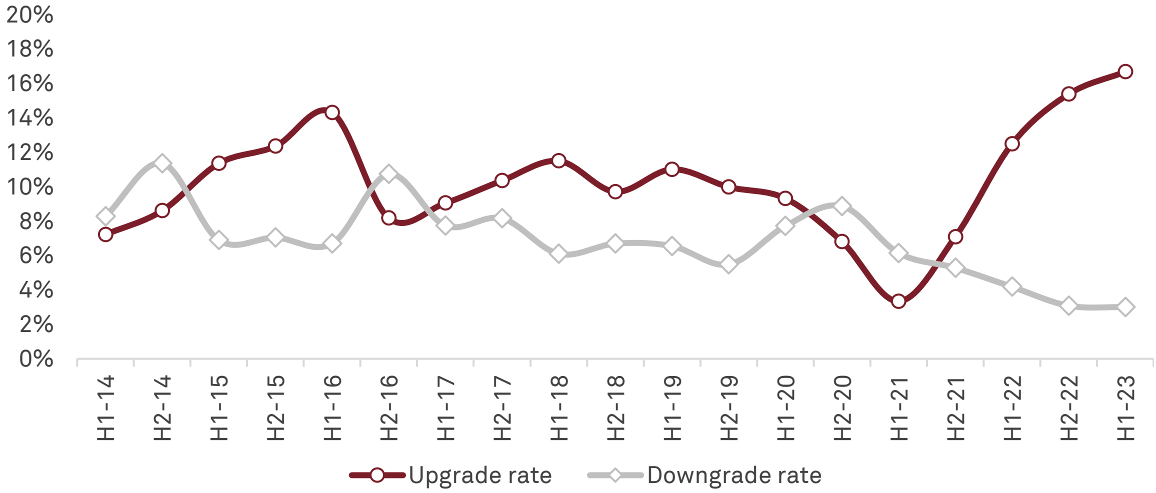
Figure 2: Credit ratio and debt-weighted credit ratio on the rise



Source: CRISIL Ratings

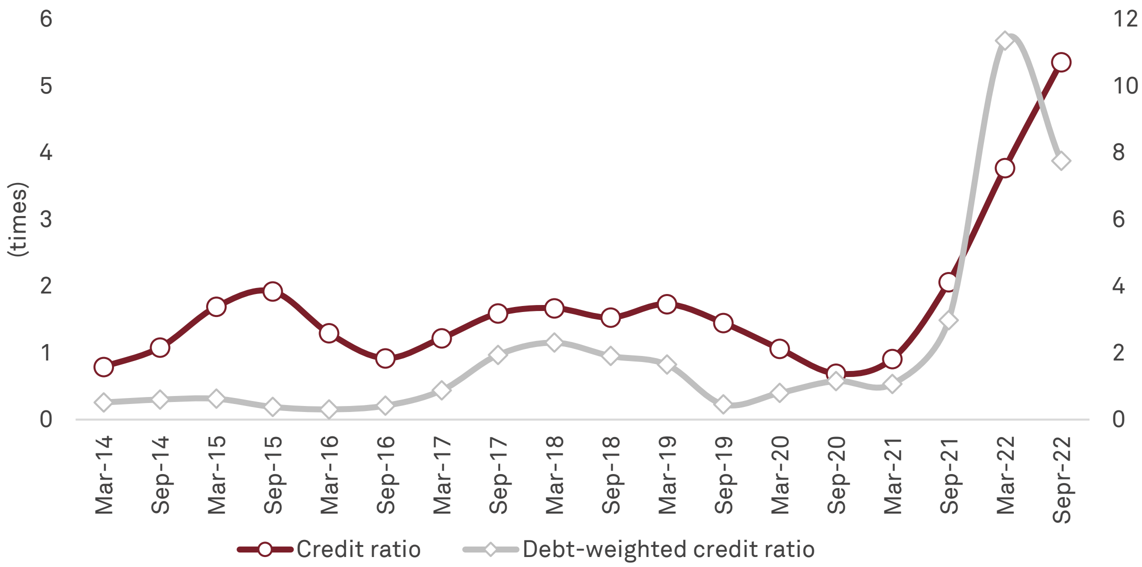
The debt-weighted credit ratio remained high in the first half of this fiscal compared to historical levels, at 7.64 times, because of upgrades on a few corporates with sizeable, rated debt and downgrades remaining low.

Figure 3: Trends in upgrade and downgrade rates



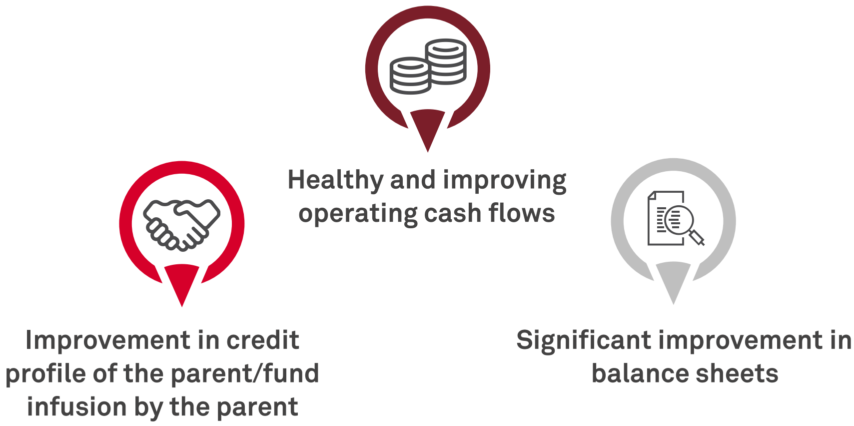
The upgrade rate rose to 16.70% in the first half of this fiscal from 15.41% in the second half of last fiscal, while the downgrade rate remained flattish at 3.02%. Having said that, a vast majority of the portfolio (~80%) continued to see reaffirmations or no change. This compares well with the historical average of 83% in the past decade.

Figure 4: Trends in credit ratio and debt-weighted credit ratio (on a 12-month rolling basis)



What supported India Inc in the first half of fiscal 2023?

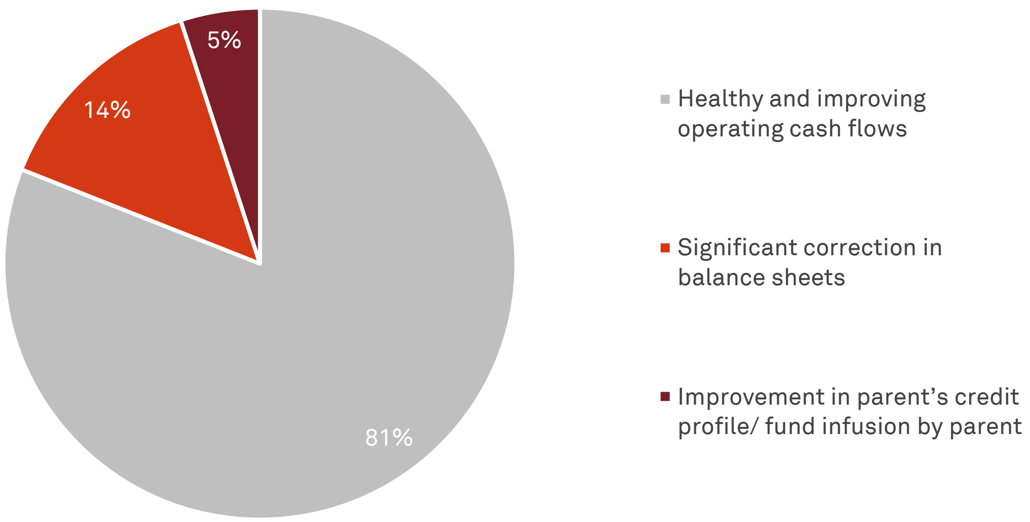
An analysis of rating actions by CRISIL Ratings within its portfolio in the first half of this fiscal reveals the credit profile of India Inc remained robust, driven by steady demand and sustained domestic consumption, leaner balance sheets, and stable capex. To understand this further, we analysed the 10 sectors with the highest number of upgrades (accounting for 55% of total upgrades). The primary reasons for rating upgrades in these sectors are enunciated below:



It's not surprising that of these three, healthy operating cash flows and strong balance sheets — the two key parameters on which the CRISIL Ratings Corporate Credit Health Framework stands — emerged as the strongest reasons for upgrades in the first half of this fiscal.

While the upgrades were spread across multiple sectors, infrastructure topped the charts, accounting for around 35%. For sure, infrastructure has become the buzzword this year. Infrastructure sectors have had a positive bias because of strong government thrust and progressive completion of various project milestones. While the government focus on infrastructure spending is indicated by the expected on-year growth of 8.8% in gross fixed capital formation (GFCF) this fiscal, what's interesting is that even private, large global investor funds are vying for equity and debt investment opportunities in this segment by way of private equity or pooled vehicles such as infrastructure investment trusts (InvITs). This favourable environment led to the upgrades in infrastructure sectors, with projects progressively moving from under-construction to completion and finally to an operational asset.

Figure 5: Breakup of top three primary reasons for upgrades in first half of fiscal 2023



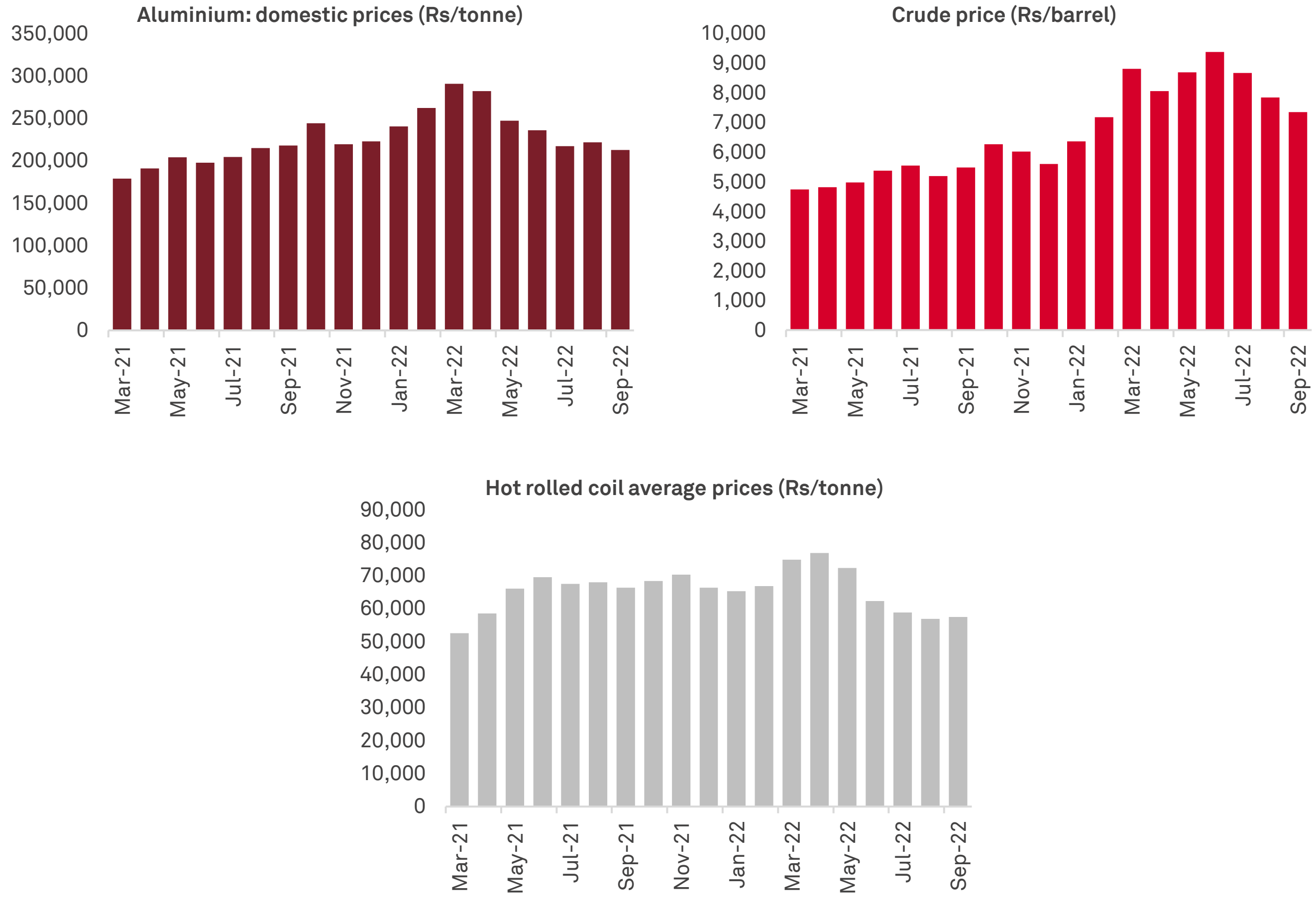
While parental support is also a key reason for upgrades, this is largely on account of improvement in the credit profile of the parent company or track record of equity infusion by the parent.

Let us deep dive into the other key reasons that drove the upgrades in the first half of this fiscal.

I. Healthy operating cash flows, expected to continue improving in fiscal 2023:

- India Inc's recovery last fiscal was sharper and better than expected across most sectors, as reflected in higher-than-expected operating cash flows due to better operating rates or improved pricing. This momentum is expected to continue this fiscal. While the commodity upcycle has spoiled the math for some sectors due to input price increases and limited ability to completely pass on the price rise to end-customers, commodity-linked sectors such as metals (including steel), edible oil and specialty chemicals have reaped in disproportionate benefits, resulting in a significant jump in cash flows. Though most international commodity prices have come off their peaks and weaker global demand indicates the downward trajectory may continue, prices will still be higher on-year.
- Sectors such as textile had an impressive last fiscal on the back of recovery in export demand (elevated by the US ban on products from the Xinjiang region in China) and robust domestic demand. The sharp increase in profitability helped players pare down debt, thus cushioning the sector from expected global headwinds. These trends are substantiated by our analysis of the 10 sectors with the highest number of upgrades, wherein more-than-expected improvement in operating cash flows last fiscal, leading to significant correction in the balance sheets, was one of the primary reasons for upgrades.

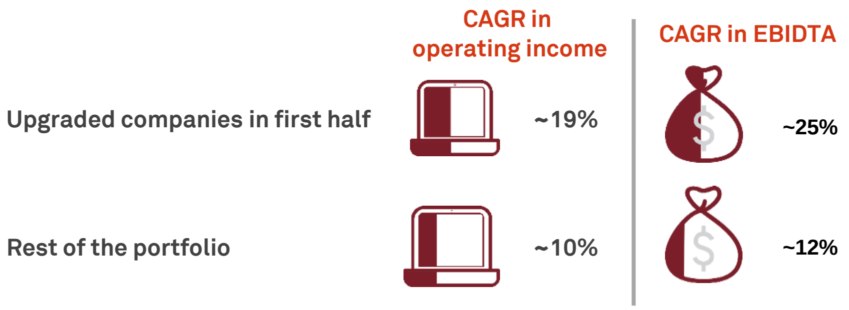
Figure 6: Monthly commodity price trend



Source: CRISIL Research

- The absolute growth in operating profit has been taken as the yardstick to assess the improvement in operating cash flows from fiscal 2020 to fiscal 2023. Our analysis of all rating actions in the first half of this fiscal reveals upgraded companies had median operating profit CAGR of ~25% over the three fiscals through 2023 — this is more than double the rate for the rest of the portfolio.

Figure 7: Analysis of the CRISIL Ratings portfolio over past three fiscals (2023P over 2020)



Note: Above are median computations

II. Trend of deleveraged balance sheets is better in upgraded portfolio:

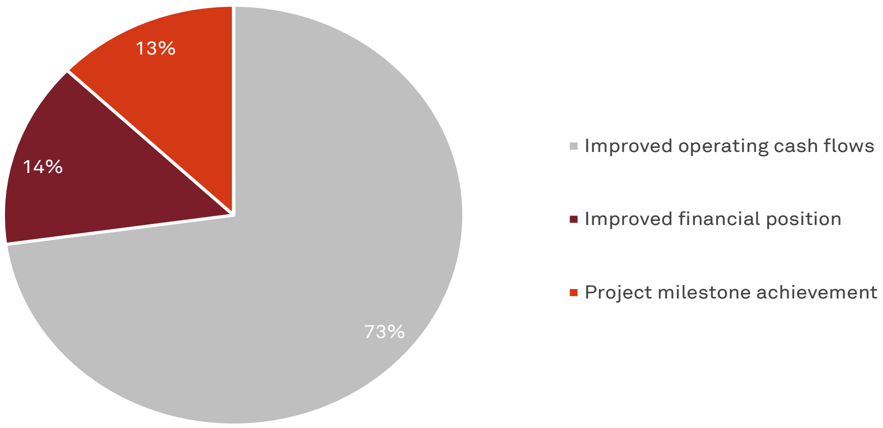
- India Inc continues to showcase secular deleveraging, led by robust accruals, low capex, and equity infusions. Working capital may have increased marginally due to firm commodity prices in the recent past, but the financial risk profiles should remain healthy.
- As India Inc readies itself for yet another global slowdown, lean balance sheets will ensure enough cushion for any credit impact. While the deleveraging trend sustained across the CRISIL Ratings portfolio, upgraded companies continued to outperform the rest of the portfolio. A sharp decline of about 0.4 time in median gearing for companies upgraded in the first half of this fiscal, over the period from fiscal 2020 to fiscal 2023P, is a strong testament to this fact. The rest of the portfolio saw median gearing decline 0.2 time during the period. However higher-than-anticipated capex remains a monitorable.

Significant improvement in infrastructure driving large share of upgrades

Infrastructure sectors had the highest number of upgrades in the first half of this fiscal, driving the overall credit ratio. Around 35% of all upgrades were from the infrastructure and large realty players. The upgrade rate for these sectors, at 21.5%, printed higher that the overall upgrade rate of 16.7%.

Sectors such as renewable power, highway tolling, and industrial machinery have seen the maximum uptick, benefiting largely from being a domestic story and having a limited impact of global headwinds. The improvement is organic as infrastructure projects progresses through crucial stages, such as execution, commissioning and operationalisation. Upgrades for large realtors were driven by healthy demand leading to higher sales.

Figure 8: Three key reasons for upgrades in infrastructure segment



The infrastructure segment is largely decoupled from global headwinds and driven by the government's continued thrust on infra spending, with GFCF expected to grow 8.8% this fiscal. The upgrade rate for the infrastructure segment was 21.5%, compared with the overall upgrade rate of 16.7%. More than 1 out of 3 upgrades accounted from this sector.

Our analysis of infrastructure sectors suggests three primary reasons for upgrades in the first half of this fiscal:

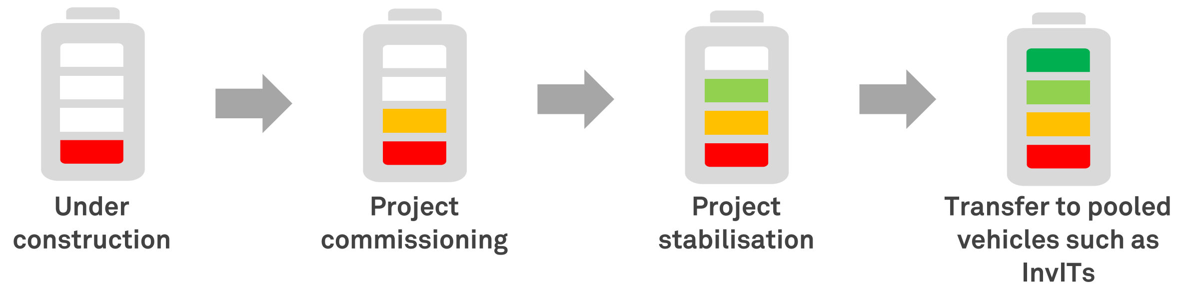
- Improved operating cash flows
- Improved financial position
- Project milestone achievement

Over time, the infrastructure segment has evolved significantly, driven by the following reasons that helped it improve its credit quality:

a. Project milestone achievement/ healthy track record:

Our analysis of upgrades reflects milestone achievement is one of the drivers of upgrades in infrastructure-linked sectors. Successfully completion of key milestones in infrastructure projects takes the assets one step closer to being operational, thereby limiting pre-commissioning risks. Low post-implementation risks imply minimal intervention in operations once projects reach that stage. A significant proportion of upgrades in infrastructure sectors is due to receipt of commercial operation date (COD), stabilisation of the project post commencement, or receipt of annuity payments in case of a hybrid annuity model (HAM) project.

Figure 9: Lifecycle of an infrastructure asset



b. Predictable payment cycles because of strong central counterparties:

In recent years, the role of central agencies as key stakeholders for infrastructure projects has increased. As per the recent report released by CRISIL Ratings on the infrastructure sector, titled 'Building Bonds'[8], the proportion of central counterparties in large renewable players rated by CRISIL Ratings increased from 21% in fiscal 2019 to 40% in fiscal 2022. The number is expected to jump to 57% by the end of fiscal 2024. The presence of central counterparties such as the National Highways Authority of India, Solar Energy Corporation of India (SECI)/NTPC Vidyut Vyapar Nigam Ltd (NVVNL), and Power Grid Corporation of India (PGCIL) in the roads, renewables and transmission sectors, respectively, has ensured timely payments for such projects, resulting in improved operational performance. Moreover, for better risk sharing in the contracts awarded, concession agreements have been revised to address the bottlenecks that hampered the projects. Net-net, active involvement of central agencies in infrastructure projects has brought in greater transparency and equitable risk sharing and streamlined payments from counterparties.

[8] https://www.crisil.com/en/home/our-analysis/reports/2022/09/building-bonds.html

c. Introduction of InvITs resulting in more transparency and inflow of funds:

Traditionally, infrastructure projects were funded either by the government or by large corporations with almost no direct investment from the public. However, with the emergence of InvITs, developers can monetise their revenue-generating assets, helping deleverage balance sheets. Moreover, these structures offer significant value to investors by offering transparency in terms of periodic disclosures. Since its introduction in 2017, there have been over 18 InvITs with debt of ~Rs 1.8 lakh crore[8].

Adjusting for group upgrades

There were 14 group upgrades in the 'homogenous groups' of companies during the first half of this fiscal. These groups are largely homogenous, with significant business, financial and managerial linkages. In such cases, the ratings of individual entities are arrived at by following the homogenous group criteria[9] and the rating actions are usually in tandem.

Considering all the group company upgrades as one, the adjusted credit ratio[10] stands at 4.80 times. There was 1 group downgrade.

[9] https://www.crisil.com/content/dam/crisil/criteria_methodology/criteria-research/criteria-for-rating-entities-belonging-to-homogenous-corporate-groups.pdf

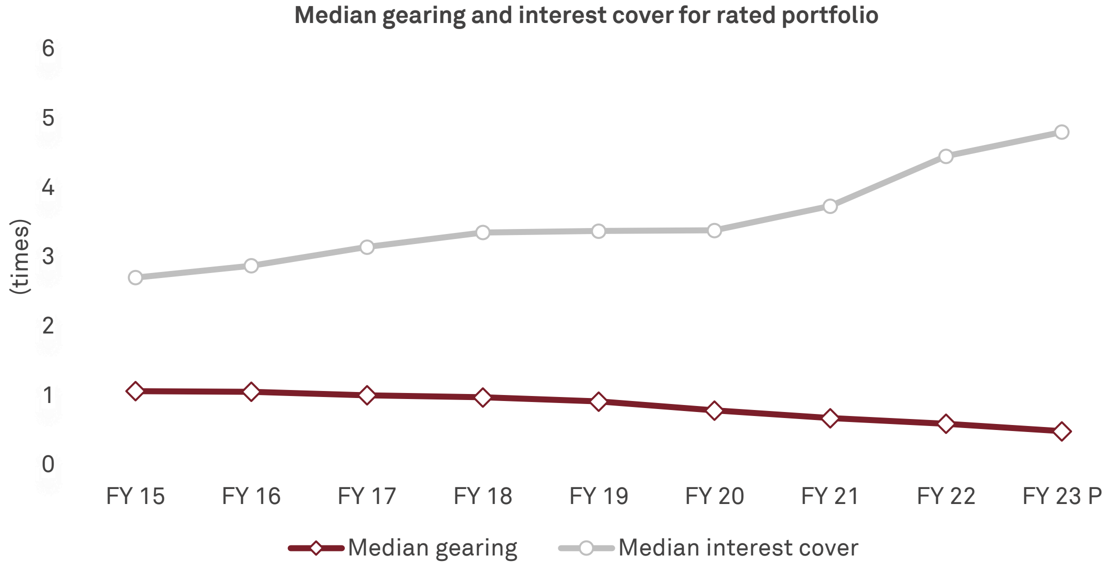
[10] For computing adjusted credit ratio, groups with three or more companies have been treated as one entity.

Credit quality outlook ‘Positive’ for fiscal 2023

The CRISIL Ratings credit quality outlook is ‘Positive’ for this fiscal, and upgrades will continue to outnumber downgrades. The resilience of India Inc to global pressures is driven by its strong domestic demand and strengthened balance sheets. India’s expected GDP growth of 7.3% this fiscal and over 6% next fiscal stands out, especially since key large economies are facing a slowdown and the possibility of recession in the US cannot be ruled out. Another year of normal monsoon, albeit uneven in some regions, supports rural demand, although reined in by persistent inflation. Infrastructure focus should continue as outlined in the Union Budget for the fiscal.

Progressive decline in leverage helps contain the impact of increase in interest rates. One reason for the relatively muted impact is that some proportion of debt is linked to a fixed interest rate, leading to lower weighted average cost. Also, there may be a lag in banks passing on the increased interest rate depending on their marginal cost of debt. For the CRISIL Ratings portfolio, interest coverage is expected to be strong at 4.8 times for this fiscal, against 4.5 times in the previous fiscal.

Figure 10: Secular deleveraging trend supports credit quality of India Inc



Source: CRISIL Ratings

Some key risks to our credit quality outlook could result in moderation of the credit ratio:

- The global slowdown is a key risk to our credit quality outlook. The US and Europe, India's key trading partners, may see slower growth in calendar year 2023. Growth in the US is expected to reduce to 0.2% in 2023 from 1.6% in the previous year, as per S&P Global. A recession in the US could be a bellwether for global factors to worsen. Some export-oriented sectors, such as textiles, are already witnessing a decline in order flow.
- Impact of a prolonged Russia-Ukraine conflict and the ensuing energy crisis in Europe and further tightening of the monetary policy in domestic as well as global markets will affect costs substantially.
- Persistent inflation may impact MSMEs because of their limited ability to fully pass on high costs. However, large and organised players have emerged stronger through the pandemic as reflected in stronger cash flows, even as costs have risen.
- Higher-than-anticipated corporate capex would also remain a key monitorable.

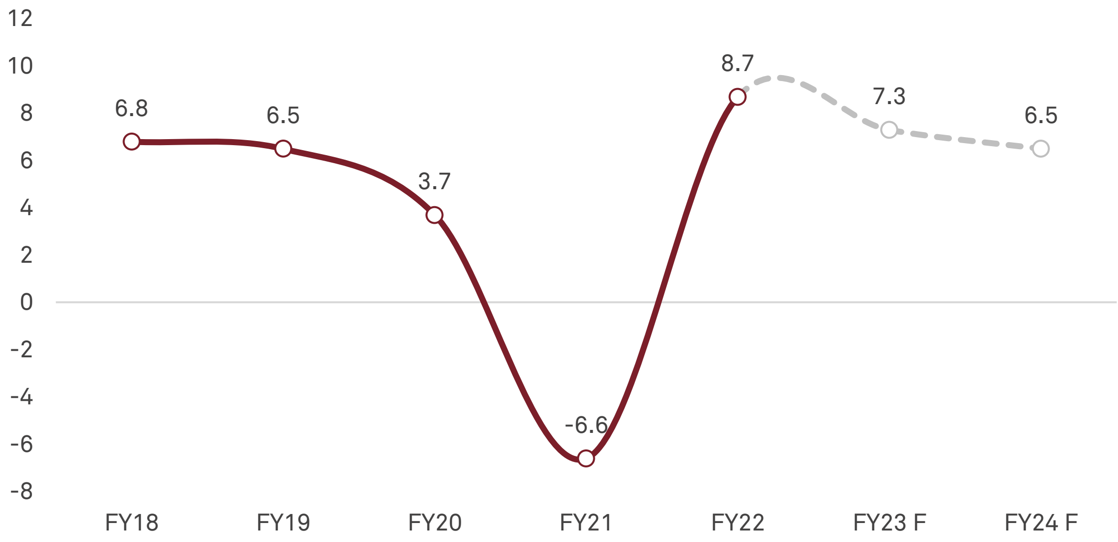
Macroeconomic outlook

CRISIL estimates India's GDP growth at 7.3% in fiscal 2023 and 6.5% in fiscal 2024, compared with 8.7% in fiscal 2022. However, risks are tilted to the downside on account of slowing global growth. Overall, the GDP growth in fiscal 2023 is expected to be supported by a revival in domestic demand, particularly in the services sector. Some support is also expected from enhanced public spending on infrastructure and uptick in private investments.

Investments continued to recover. The Reserve Bank of India (RBI) estimates GFCF, a proxy for fresh investments, will grow 8.8% led by central government capex (which rose 57% on-year during April-June on account of healthy Goods and Services Tax collections) and private investments in infrastructure-linked sectors such as steel and cement. A rise in housing sales, reflected as household investment in the national accounts, also supported overall investments. However, state government capex declined, thereby limiting the upside to investment growth. On the supply side, gross value added is expected to grow 6.7% for fiscal 2023, largely a reflection of the low-base effect. That said, several sub-sectors performed well, registering better sequential momentum.

India recorded a strong GDP rebound in fiscal 2022 but is now challenged by inflationary pressures due to rising global energy and food prices. Inflation does appear to have peaked and there are signs that crude oil and commodity prices are softening, but it is still too early to draw firm conclusions. Global oil and commodity prices, although softer, are still higher than last fiscal and there is pressure to pass it on to end-consumers, which can translate into sticky core inflation.

Figure 11: Real GDP growth (%)



Source: CRISIL Research

On the monetary policy front, central banks across the globe had infused liquidity into the market during the pandemic. They are now trying to put the genie back in the bottle by resorting to monetary tightening to curb inflation. Even the RBI has been tightening its monetary policy by hiking interest rates to absorb the excess liquidity injected in the past two years. Its actions going ahead will be governed by inflation dynamics. Financial conditions have continued to tighten since October 2021 and are stickier than the average of the past decade in India. This is a result of monetary tightening by systemically important central banks, spillover effects of the Russia-Ukraine war, reduction in surplus liquidity, and interest rate hikes by the RBI. At the outset, despite the monetary tightening, bank credit growth has witnessed an upward march, which has picked up in a broad-based manner in response to the growing needs of the recovering economy, increased working capital requirement on account of a sharp rise in input costs, and some intermediation because of a faster rise in bond yields vis-à-vis bank credit. Monetary tightening will constrain economic growth only towards the end of the fiscal as it impacts GDP with a lag of 3-4 quarters.

The catch-up continues

We expect the gathering momentum in private final consumption expenditure and contact-intensive services such as hotels and airlines to be broad-based and support growth, along with continued healthy performance in infrastructure, financial, real estate and professional services, albeit on a low base. While economic recovery continues to gather pace, it faces multiple risks.

Global growth is projected to be slow since central banks in major economies are tightening monetary policies to tackle high inflation. This would imply lower demand for our exports. Along with this, a depreciating rupee indicates a higher imported inflation. While most of the international commodity prices have come off their peaks and the weaker global demand indicates the downward trajectory of prices may continue, they will still be high on-year. The protracted Russia-Ukraine conflict could also put some of the private capex plans on the back burner, curtailing overall investment growth.

While external headwinds persist globally, India remains largely insulated. Recent RBI surveys indicate improving consumer sentiments bode well for consumption demand. However, uneven monsoon progress has impacted sowing of kharif crops such as rice, which may raise food inflation risk.

Rise in capacity utilisation rates in the manufacturing sector is favourable for private capex in pockets, especially for infrastructure-linked industries such as steel and cement and some sectors linked to the Production Linked Incentive (PLI) scheme. Moreover, the advent of the National Logistics Policy will prioritise robust infrastructure, strong exports and logistics efficiency, thereby adding to the growth story. Considering the current global headwinds, India is in a better shape than other economies and is expected to clock the fastest growth.

Update on Corporate Credit Health Framework: Sectoral performance vis-à-vis expectations and the road ahead

In the previous edition of the Ratings Round-Up published on April 1, 2022, CRISIL Ratings had noted a 'Positive' credit quality outlook for fiscal 2023. Secular deleveraging across sectors, demand recovery, nimbleness in supply chains, and tight leash on costs supported the view then, despite the rising uncertainty over the Russia-Ukraine war.

Looking back over the past six months, the war continued to lead to supply-chain challenges and inflation. The hawkish stance by the US on interest rate hikes, the ensuing energy crisis in Europe, and the slowdown in China arising from its zero-tolerance policy towards Covid-19 threaten to derail global growth. That said, the positive upshot for India has been falling global crude oil prices, making imports cheaper. India Inc is currently in a sweet spot led by strong domestic demand, continued focus on infrastructure, and debt-light balance sheets. Nevertheless, sharp interest rate hikes, persistent high inflation and slowing global growth pose downside risks to the outlook.

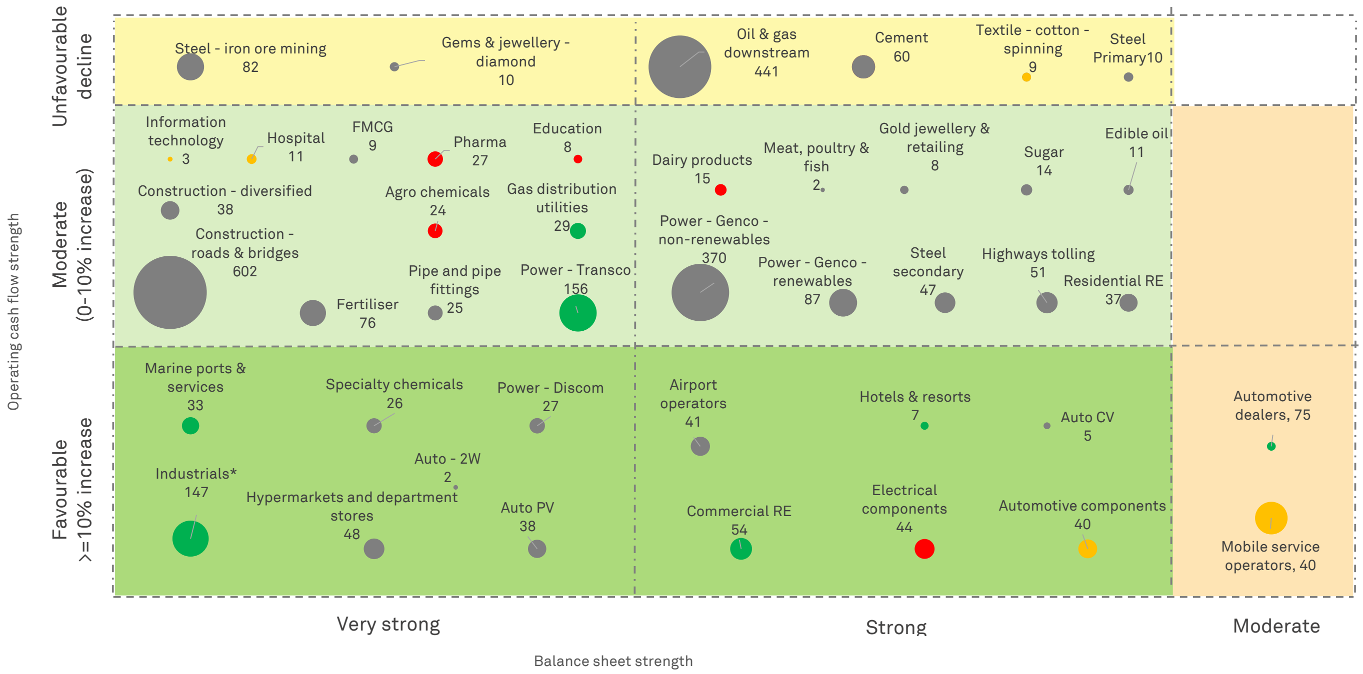
In the following section, CRISIL Ratings presents the second edition of the Corporate Credit Health Framework. It indicates the relative positioning of sectors and their credit quality by relying on two parameters for assessment: operating cash flow strength and balance-sheet strength. This helps identify sectors which may require close monitoring in this rapidly changing environment and differentiate sectors that have maintained very strong buoyancy.

It is noteworthy that sectors that were classified under 'the most buoyant bucket' in the previous edition saw the highest credit ratio in the first half of fiscal 2023. These included pharmaceuticals, specialty chemicals, hospitals, and education services.

Methodology and assumptions

CRISIL Ratings has analysed 43 key sectors, accounting for over 70% of the total debt rated (excluding financial sector entities), on two parameters: operating cash flow strength, which considers absolute growth in Ebitda in fiscal 2023 over fiscal 2022; and balance-sheet strength, which considers expected gearing at the end of fiscal 2023 and the change from a year earlier. This factors in the change in CRISIL Ratings expectation on these parameters based on current trends.

Figure 12: Corporate Credit Health Framework



Bucket 1 | Bucket 2 | Bucket 3 | Bucket 4

1) Industrials comprise engineering and capital goods, industrial machinery and consumables, and heavy electrical equipment
2) Power discoms (distribution companies) largely include private players
3) Size of the bubble indicates rated debt quantum (figures in Rs '000 crore)
4) Colour of the bubble represents movement of sectors from previous expectations set in the Ratings Round-Up for the second half of fiscal 2022

Source: CRISIL Ratings

Terminologies used in the framework:

- The X-axis denotes balance-sheet strength derived using a combination of gearing expected as on March 31, 2023, and the change from a year earlier. Lower gearing reflects deleveraging, seen across companies over the past two fiscals, and cushions the impact of risks.
  - Balance-sheet strength could be 'very strong', 'strong' or 'moderate'.
  - For instance, hypermarkets and department stores show well-managed balance sheets due to low gearing, categorised as 'very strong'.
- The Y-axis denotes expected on-year growth in Ebitda in fiscal 2023 by taking into consideration volume, realisations, increase in commodities prices, and cost optimisation measures undertaken by entities.
  - Cash flow strength will be favourable if Ebitda growth is 10% or above, moderate if Ebitda growth is less than 10%, or unfavourable if there is a decline.
  - For instance, automobiles are expected to display healthy demand growth after the dismal pandemic years since most offices and educational institutes have reopened and vehicle mobility has increased.
- In the second edition of the Corporate Credit Health Framework, we have also analysed the movement of sectors compared with our expectations set in the Ratings Round-Up for the second half of fiscal 2022.

Hence, the placement of a sector has to be read in conjunction with the colour of the bubble representing the sector, as enunciated below:

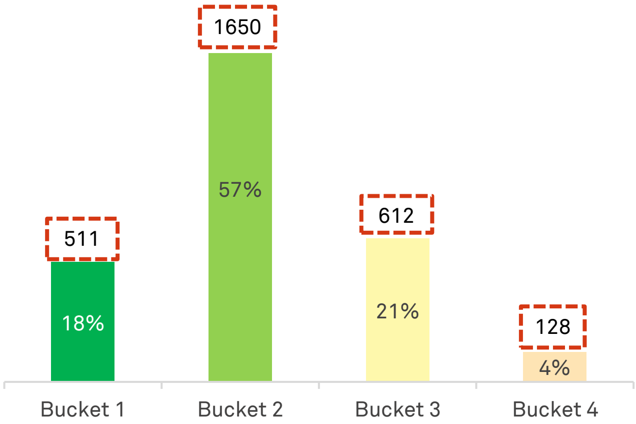
- **Red:** Negative movement in either operating cash flow or balance-sheet strength
  - For instance, the dairy products industry is denoted by a red bubble since change in operating cash flows for fiscal 2023 over the previous fiscal has resulted in moving from the favourable to the moderate bucket, while the expectation of balance-sheet strength remains strong. Players in this sector are facing supply-side challenges, and profitability is expected to slide with increase in procurement prices and transport and packaging costs. This moderation is expected despite the recent hikes in retail milk prices.
- **Amber:** Moderation in fiscal 2023 due to supernormal performance in fiscal 2022, resulting in a high-base effect. However, outlook remains better than the pre-Covid level
  - For instance, textiles had a phenomenal run in fiscal 2022 with decadal high operating profitability, leading to a very high base for fiscal 2023. Recovery in export demand elevated by the US ban on products from the Xinjiang region of China as well as higher domestic demand boosted operating cash flows. Hence, growth in fiscal 2023 over the previous fiscal will optically moderate given the high base. Nevertheless, the outlook continues to be better than the pre-Covid level. Broadly, all such sectors that had an impressive fiscal 2022, leading to moderation in improvement in fiscal 2023, are denoted by an amber bubble.
- **Green:** Positive movement in either operating cash flow or balance-sheet strength
  - Sectors driven by services and logistics, such as hotels and resorts and automotive dealers, have outperformed our previous expectations and hence are coloured green.
- **Grey:** Neutral with no movement in either operating cash flow or balance-sheet strength

In our study, we have categorised the sectors into four buckets as per their placement in the framework.

- **Bucket 1** refers to sectors that are expected to see favourable operating cash flow strength, while having robust balance sheets (very strong or strong)
- **Bucket 2** refers to sectors that are expected to see moderate operating cash flow strength, while having robust balance sheets
- **Bucket 3** refers to sectors that are expected to see unfavourable operating cash flow but will be cushioned by robust balance sheets
- **Bucket 4** refers to sectors that are expected to see favourable or moderate operating cash flows but will have moderate balance sheets

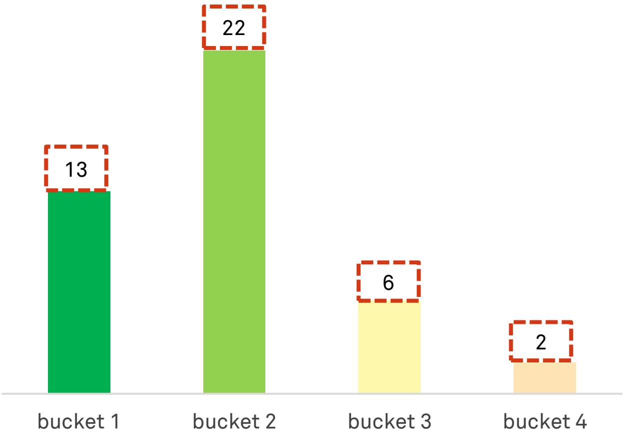
Key conclusions of the study

Figure 13: Rated debt (Rs '000 crore) under analysis



As a percentage of total rated debt under study

Figure 14: Sectors under analysis



The CRISIL Ratings analysis reveals that many sectors will be able to withstand challenges over the medium term, driven by higher operating profits and stronger balance sheets. However, the credit quality of a few sectors will be moderate and may see a lower credit ratio.

- Of the 43 sectors, 13 are in the 'most buoyant' bucket, accounting for 18% of the rated debt, and will likely have favourable operating profit and very strong/strong balance-sheet strength in fiscal 2023 and show buoyancy in credit quality. These include sectors that are expected to turn around after dismal pandemic years, such as hospitality, airport operators, industrials, and marine ports.
- The remaining 30 sectors, accounting for 82% of the total rated debt, will see a favourable trend in one of the two parameters — operating profit or leverage — and will have a positive credit quality outlook. These include some infrastructure sectors, such as highway tolling and renewables, which maintained their position in the framework.
- Export-oriented sectors such as textiles, pharmaceuticals and information technology would see moderation in their position within the framework, as their Ebitda may be lower than anticipated earlier. Sectors such as agrochemicals, dairy and education services would also see moderation in their expected performance due to elevated costs and realisations not keeping pace with cost increases.
- Interestingly, no sector studied seems to be facing an unfavourable trend in terms of operating cash flow and balance-sheet strength in fiscal 2023, in line with the previous expectations of CRISIL Ratings.

The next section touches upon key factors such as revenue and profitability, working capital requirement, leverage, and credit risk profiles across sectors.

Credit quality outlook for key sectors for rest of this fiscal

In this section, we present the credit quality outlook for a few key sectors that fall in the four buckets identified in the Corporate Credit Health Framework. The credit quality outlook for the rest of fiscal 2023 is presented along with changes in the key parameters (revenue visibility, profitability and working capital) versus fiscal 2022. Improvement in performance is represented in green, marginal improvement or no change in amber, and deterioration in red.

Very strong buoyancy in credit quality outlook for 18% of the rated debt analysed

These sectors are estimated to have favourable operating profits and very strong-to-strong balance sheets in fiscal 2023. Sectors such as auto, hotels and resorts will likely report higher profits led by strong recovery.

	Revenue visibility	Profitability	Working capital	Credit quality

Chemicals – specialty

Revenue growth: 2023E: 13-15%, 2024E: 4-6%

Ebitda margin: 2023E: 16-18%, 2024E: 13-15%

Domestic demand led by rising penetration of detergents and home care products, steady demand from downstream industries such as agrochemicals, dyes, foods and fragrances, plastic and plastic products, and the China-plus-one strategy adopted by global players are the major drivers for this sector. However, demand growth from the textiles sector is expected to be muted because of slowdown in end-user markets.

Overall, revenue growth and profitability should be healthy, similar to the levels seen in fiscal 2022.

	Revenue visibility	Profitability	Working capital	Credit quality

Auto components

Revenue growth: 2023E: 14-16%, 2024E: 8-10%

Ebitda margin: 2023E: 12-13%, 2024E: 12-13%

Demand from original equipment manufacturers (OEMs) and aftermarket sales will drive growth, while exports may be affected by the global slowdown.

Operating margin will be stable due to better utilisation and passing on of higher input costs to customers.

Capex is expected to rise on the back of strong demand outlook for electric vehicles, and investments related to the PLI scheme. Higher operating profits and healthy debt metrics will support credit outlook for players.

	Revenue visibility	Profitability	Working capital	Credit quality

Auto –2W/PV/CV

Revenue growth: 2023E: (2W) 8-10%, (PV) 12-15%, (CV) 15-20%; 2024E: (2W) 4-6%, (PV) 8-10%, (CV) 10-12%

Ebitda margin: 2023E: (2W) 13-14%, (PV) 9-10%, (CV) 6-8%; 2024E: (2W) 13.8-14.3%, (PV) 7-9 %, (CV) 9.5-10.5%

For two-wheelers (2Ws), sales are expected to register modest recovery after declining for three successive fiscals. Capacity utilisation is likely to increase in fiscal 2023, driven by both domestic and export growth, but will be lower than the pre-pandemic level. The festive season sales are expected to be strong as most of the offices and educational institutes have reopened and vehicle mobility has increased.

Operating margin may rise 90-130 bps in fiscal 2023, due to improving utilisation and cooling commodity prices.

Passenger vehicle (PV) volume will be driven by easing of chip shortages, particularly in the second half of the fiscal, as capacity addition by chip manufacturers comes onstream, thereby helping clear the sizeable order backlog built over the past six months even as pent-up domestic demand fuels growth.

The commercial vehicle (CVs) segment, particularly medium and heavy CVs, will benefit from replacement demand because of improved utilisation and profitability of fleet operators, and government spending on infrastructure. Light CVs will be propelled by a surge in e-commerce and better last-mile connectivity.

Decline in raw material prices and improved operating leverage will help increase operating margin to 6-8% in fiscal 2023.

Strong balance sheets and modest debt have helped OEMs buttress the impact of profitability pressures and sustain their credit risk profiles in the recent past. Higher accrual driven by better revenue, and a slight improvement in operating profitability will support higher capex by OEMs, including for enhancing electrification.

	Revenue	Profitability	Working capital	Credit quality

Hotels and resorts

Revenue growth: 2023E: 60-65%

Ebitda margin: 2023E: 30%

Strong demand for leisure travel, opening up of international and corporate travel, and wide vaccination coverage should catapult revenue to almost the pre-pandemic (fiscal 2020) level.

For properties in tourist destinations, average room rent and occupancy have surpassed the pre-pandemic levels, and demand for business hotels has picked up due to pent-up domestic business travel.

In fiscal 2023, margin is expected to cross the pre-pandemic level as demand recovers. Some cost-rationalisation measures are being continued, which would support debt protection metrics.

	Revenue visibility	Profitability	Working capital	Credit quality
Commercial real estate				

Revenue growth: 2023E: 5-7%, 2024E: 5-7%

The hybrid model will continue in fiscal 2023 as well, with net leasing growth pegged at 10-15% on-year to 23-28 million square feet for the top six cities: Mumbai Metropolitan Region, National Capital Region, Pune, Hyderabad, Kolkata, and Bengaluru. While IT (information technology) and BFSI (banking, financial services and insurance) hiring may rise gradually, it will not lead to a proportionate increase in net leasing like in the past as employers continue to call employees to work on a rotational basis. Vacancy rates, which shot up 300-400 bps over the past two fiscals due to the pandemic, are likely to improve gradually over the medium term.

Positive to neutral credit quality outlook for 57% of the rated debt analysed

These sectors are expected to have favourable trends in one of the two parameters— operating profit and leverage. Absolute operating profit is expected to improve, or the balance-sheet score is strong or very strong.

	Revenue visibility	Profitability	Working capital	Credit quality
Healthcare				

Revenue growth: 2023E: 14-18%, 2024E: 13-15%

Ebitda margin: 2023E: 14-16%, 2024E: 14-15%

Fiscal 2023 is expected to see stabilisation in demand from traditional drivers such as surgeries, OPD (out-patient department) and other regular treatments as pandemic-related disruptions are expected to be minimal. Average revenue per occupied bed (ARPOB) should increase, driven by both lower share of the low-margin Covid-19 treatments in the overall mix and increase in treatment costs due to inflation.

Margin expansion is likely to be driven by improvement in operating leverage of hospitals with demand growth, ARPOB expansion and pick-up in the high-realisation medical tourism segment that is geared towards larger hospitals.

	Revenue	Profitability	Working capital	Credit quality
Education services				

Revenue growth: 2023E: 10%, 2024E: 8-10%

Ebitda margin: 2023E: 27-29%, 2024E: 27-29%

An uptick in enrolment, especially for higher education, and a modest hike in fees after two years will drive up the revenue of schools and colleges by over 10% in fiscal 2023.

Operating profitability remained steady in the past two fiscals despite muted revenue growth. Though commencement of in-person learning will increase costs, higher revenue and partial passing on of the costs will help players sustain operating profitability at 27-29%.

Negligible capex in the past two fiscals due to uncertainties amid the pandemic helped schools and colleges conserve cash, leading to improved gearing.

	Revenue	Profitability	Working capital	Credit quality

Agrochemicals

Revenue growth: 2023E: 12-14%, 2024E: 10-12%

Ebitda margin: 2023E: 14-16%, 2024E: 14-16%

Fiscal 2023 is expected to see moderate domestic growth following an erratic monsoon, which has led to a slight decline in overall acreage of key crops. Heavy rainfall in the southern and western parts of the country disturbed the pesticide spraying schedule in some geographies for kharif crops. Profitability will moderate this fiscal, given the increase in input prices, and energy and logistics costs.

Export sentiments are, however, positive with growth anticipated at 13-15% on-year riding on demand from top destinations such as the US and Brazil.

	Revenue visibility	Profitability	Working capital	Credit quality

Information technology

Revenue growth: 2023E: 12-13%, 2024E: 9-10%

Ebitda margin: 2023E: 22-23%, 2024E: 21-22%

IT is likely to sustain double-digit revenue growth this fiscal, driven by depreciation in the rupee, continuing core digital transformation services, and strong demand for new-age technologies.

That said, there will be some moderation in revenue growth over the previous fiscal due to expected tightening of discretionary IT expenditure by corporates amid the inflationary headwinds in the US and the EU, which together contribute ~85% to the sector's revenue.

Operating profitability will remain healthy but could fall back a tad to the pre-pandemic low of 22-23% due to rising employee cost amid high attrition rates and increasing travel expenses. Healthy cash generation and large liquid surplus support balance sheets.

	Revenue visibility	Profitability	Working capital	Credit quality

Gold jewellery

Revenue growth 2023E: 1-2%, 2024E: 7-8%

Ebitda margin: 2023E: 6.4-6.8%, 2024E: 6.4-6.8%

The government's move to hike import duty on gold will result in flat revenue growth for gold jewellery retailers in fiscal 2023, compared with the glittering run last fiscal. Retailers will have to pass on the hike to customers, which will curtail demand and wean away discretionary buyers. Demand may pick up in the second half of this fiscal with early onset of the festive season and the recent moderation in prices.

While higher gold prices will compensate for the volume loss and ensure the industry revenue remains flat on-year, operating margin would be impacted by 50 bps to 6.4-6.8% this fiscal.

Due to cautious funding by banks, gold jewellery retailers had reduced their leverage by limiting new store additions.

Ratings

	Revenue visibility	Profitability	Working capital	Credit quality

Pharmaceuticals

Revenue growth: 2023E: 7-9%, 2024E: 8-10%

Ebitda margin: 2023E: 19.5-20%, 2024E: 20%

The Indian pharmaceutical sector will see moderate revenue growth of 7-9% this fiscal due to headwinds in export sales in the regulated markets and a high-base effect in the domestic formulations business. The domestic formulations market is expected to grow 7-9% this fiscal, after a high 15% growth last fiscal, led by price hike for regulated drugs and new product launches.

The margins of formulation players will remain under pressure due to persisting high raw material and freight costs, return of selling expenses, and continued pricing pressure in the US market.

Despite moderation in operating performance and larger working capital needs, credit risk profiles of rated players will remain stable this fiscal, benefitting from low leverage and healthy liquidity.

	Revenue	Profitability	Working capital	Credit quality

FMCG

Revenue growth: 2023E: 10-12%, 2024E: 6-7%

Ebitda margin: 2023E: 24-26%, 2024E: 23-25%

Demand is expected to be tepid during the first half of fiscal 2023, due to high inflation impacting realisable income. Rural demand has slowed down with consumers downtrading to lower value/unbranded products. However, this is expected to recover in the second half on account of a robust monsoon, the festive season, and a low base of the second half of fiscal 2022. However, players are expected to only partially pass on the rise in input cost to customers, which will put pressure on margins, expected at 24-26% in fiscal 2023.

	Revenue visibility	Profitability	Working capital	Credit quality

Construction

Revenue growth: 2023E: 13-15%, 2024E: 9-11%

Ebitda margin: 2023E: 11-12%, 2024E: 12-13%

The balance sheets of road engineering, procurement and construction (EPC) players will remain healthy. Revenue will grow 13-15% this fiscal, backed by robust order books.

Aggressive bidding and high raw material prices will drag down the operating profitability of road EPC contractors by 200-250 bps to a decadal low this fiscal. Limited competition in HAM projects had supported healthy profit margins of road EPC players between fiscals 2018 and 2021. The changes in bid eligibility criteria and smaller package sizes had intensisfied competition last fiscal. This, along with the steep surge in input (steel, bitumen and cement) prices, had shrunk the operating margins of road EPC players.

The credit risk profiles of road EPC players, however, will remain stable on the back of deleveraged balance sheets, prudent working capital management, and steady cash accrual. Interest coverage is likely to remain strong at more than 3x this fiscal.

Highway tolling

	Revenue	Profitability	Working capital	Credit quality

Revenue growth: 2023E: 13-15%

Fiscal 2023 will see healthy toll collection growth of 13-15%, driven by substantial toll rate hikes. The toll rates are typically linked to wholesale price index (WPI), which has seen a significant increase in the recent past.

Traffic growth is correlated with economic growth and will see some moderation this fiscal, in line with GDP growth.

The credit risk profiles of toll road operators are expected to remain stable on the back of strong toll collection and adequate debt coverage metrics.

Edible oil

	Revenue visibility	Profitability	Working capital	Credit quality

Revenue growth: 2023E: 1-2%, 2024E: 7-8%

Ebitda margin: 2023E: 3.6%, 2024E: 4%

After significant growth in fiscal 2022, the edible oil industry is likely to remain flat in fiscal 2023. Edible oil prices may correct over the medium term with expected surplus domestic oil stocks following rise in palm production in Malaysia and Indonesia, while consumption will grow modestly. Operating margins of players are likely to contract 50 bps.

Residential real estate

	Revenue visibility	Profitability	Working capital	Credit quality

The momentum in housing demand across the top six cities is expected to continue, with growth anticipated at 5-10% despite rising property prices, increasing interest rates, and a high-base effect. This is backed by continued demand from the affordable and mid-sized segments, significant improvement in the infrastructure of key cities, rise in new launches by organised players, and consolidation in the industry.

Fiscal 2023 will witness another 5-10% on-year dip in closing inventory with fewer launches as developers focus on completing ongoing projects.

Ratings

	Revenue	Profitability	Working capital	Credit quality
Power (genco) renewables				

Power (genco) renewables

Renewable capacity additions are expected to remain healthy at 35-40 gigawatt (GW) between fiscals 2023 and 2025, compared with 30 GW between fiscals 2020 and 2022. Growth in capacity addition will be driven by the government's focus on clean energy transitions and build-up in pipeline. This will be supported by continued interest from investors aligning towards ESG (environmental, social, and corporate governance) commitments.

Leverage of renewable companies is expected to remain stable despite large capex. This is because equity tie-ups are largely in place for under-implementation capacities, and receivables from state discoms are expected to improve with the implementation of the late payment surcharge (LPS) scheme.

These developments are expected to keep the overall credit quality stable. However, operational performance will remain a monitorable, especially for wind power, which has had a weak output in the past two fiscals.

	Revenue	Operating profit	Working capital	Credit quality
Power (genco) non-renewables				

Power (genco) non-renewables

Growth in base power demand is expected at 6-7% on-year this fiscal, despite the high base of fiscal 2022, and will support volume growth for power generators. Operating profits are expected to remain steady for players having variable cost pass-through mechanism. However, the margins of players with competitively bid tariff and dependence on other than linkage coal may see some moderation due to high coal prices. Working capital intensity may ease with the implementation of the new LPS Electricity (Late Payment Surcharge and Related Matters) Rules, 2022, thereby supporting the credit risk profiles of players.

	Revenue visibility	Profitability	Working capital	Credit quality
Steel				

Steel

Revenue growth: 2023E: 0-(10) %, 2024E: 0-(5) %

Ebitda margin: 2023E: 22-24%, 2024E: 20-21%

The first quarter of the fiscal witnessed significant decline in steel prices with high input costs. Though input prices have corrected since, the impact will be felt only towards the end of the second quarter, leading to a subdued first half. Margins will correct for secondary steel players due to lower input costs. Domestic realisations are likely to be supported by infrastructure, capital goods and automotives, driving domestic steel demand growth to 6-8% this fiscal.

Operating margins of large integrated steel players will be 22-24% this fiscal, down 700-800 bps on-year but still higher than the pre-pandemic average. This should ensure sufficient accrual for continued capex towards capacity expansion. Net debt of primary players will remain flat. There will be lower impact on secondary steel players due to lower input costs.

Stable credit quality outlook for 21% of the rated debt analysed

These sectors are expected to see a decline in operating profit in fiscal 2023, even as the balance sheet remains very strong or strong.

	Order book/ revenue visibility	Profitability	Working capital	Credit quality
Diamond				

2023E: Revenue growth: 15-20%, Ebitda margin: 4-4.25%

Rising inflation and opening up of other avenues of discretionary spending, such as travel and hospitality, will dampen demand growth in the US and Europe in the near term. The US sanctions on Russian diamond mining company Alrosa following the invasion of Ukraine has cut the supply of rough diamonds by almost 30%. Also, key buyers in the US and the EU have been insisting on certificates of origin. As a result, the prices of rough diamonds have shot up almost 30% since the start of fiscal 2023.

Volatility in rough diamond prices could squeeze the operating profitability of Indian diamond polishers by 75-100 bps to 4-4.25% this fiscal. Accordingly, interest coverage may weaken marginally.

On the brighter side, payments from customers have been timely. This, along with reduced inventory, will reduce reliance on external debt. As a result, the total outside liabilities-to-tangible net worth ratio will remain under 1.5 times for the industry, keeping the credit risk profiles of players steady.

	Order book/ revenue visibility	Profitability	Working capital	Credit quality
Cement				

Revenue growth: 2023E: 8-10%, 2024E: 8-9%

Ebitda margin: 2023E: 16-17%, 2024E: 18-19%

Demand is set to rise 8-10% in fiscal 2023, driven by demand from the infrastructure and industrial/commercial segments.

Cost of sales is expected to rise ~9% this fiscal, as average petcoke/imported coal prices will increase over the previous fiscal. Though net realisation is expected to increase with players passing on the rise in the cost of production, this will not match the rise in input costs.

The net debt-to-Ebitda ratio should remain healthy despite increasing capex, as most of the capex will be funded through internal accrual.

Ratings

	Revenue	Profitability	Working capital	Credit quality

Oil and gas downstream

2023E: Revenue growth: 15-20%, Ebitda margin: 5-7%

Demand from the downstream sector is expected to remain subdued on account of high prices in fiscal 2023 amid the Russia-Ukraine conflict and loss of some long-term liquefied natural gas volume. Demand and prices will likely stabilise in fiscal 2024, but revenue and profitability will remain range-bound because of volatility in the commodity market as well as wider fluctuations in forex rates. Any major change by the government in the price determination formula will have a significant impact on the volume and profitability of the industry participants.

Inability of oil marketing companies (OMCs) to increase the retail price of transportation fuels in line with crude oil prices had led to net losses on the retail sale of products in the first quarter of fiscal 2023. However, correction in crude oil prices and 4-6% growth in demand volume will help improve the profitability of OMCs.

	Revenue visibility	Profitability	Working capital	Credit quality

Textiles – cotton

Revenue growth: 2023E: 3-5%, 2024E: 6-8%

Ebitda margin: 2023E: 12-14%, 2024E: 12-13%

After an extraordinary fiscal 2022, in terms of strong revenue growth and decadal high operating profitability, revenue growth for cotton yarn will moderate to 3-5% this fiscal because of lower exports. Higher realisation and domestic demand will provide some relief.

To cope with the shortage of cotton this fiscal, some major players with the capacity to do so have started blending cotton with other fibres, mainly viscose.

Operating margin will moderate this fiscal from the decadal high of 20-23% last fiscal. This is because high cotton prices and the gradual pass-through, along with increased power and fuel expense and employee costs, will partially offset the benefits of operating leverage.

	Order book/ revenue visibility	Profitability	Working capital	Credit quality

Textiles – readymade garments

Revenue growth: 2023E: 16-18%, 2024E: 9-11%

Ebitda margin: 2023E: ~8.5%, 2024E: 8.5-9%

Growth in the readymade garment sector will be driven by the domestic market. Exports, which saw robust demand from the US, the UK and Europe last fiscal, are likely to moderate this fiscal, particularly on subdued demand from Europe as a result of rising inflation.

Margins of readymade garment players will likely moderate by 50 bps to 8.5%% in fiscal 2023, amid increase in raw material prices (gradual pass-through) and other overheads, while rupee depreciation and continuation of export-linked incentive schemes are expected to support demand and protect gross margin. Expected stabilisation of raw material costs and recovery in export demand in fiscal 2024 will help bring the margin back to the fiscal 2022 level.

Despite inflationary pressure, the credit risk profiles are expected to remain stable, supported by low capex intensity and marginal improvement in working capital cycle.

Steady credit quality outlook for 4% of the rated debt analysed

	Revenue visibility	Profitability	Working capital	Credit quality

Auto dealers

Revenue growth: 2023E: 20-25%, 2024E: 11-13%

Ebitda margin: 2023E: 3-5%, 2024E: 4-5%

Auto dealers may clock their fastest revenue growth in three fiscals because of increasing preference for personal mobility, higher economic activity, easing of supply-side constraints, shift in the product mix towards higher priced vehicles, and price hikes of 5-7%.

PV dealers will continue to show robust recovery, and CV and two-wheeler dealers will grow on a lower base given the subdued sales in the past 2-3 fiscals. With strong recovery in sales, the operating profitability of PV and CV dealers will recover to the pre-pandemic level of 4-5%, while the margins of 2W dealers will rise gradually to 3-4% this fiscal.

Credit quality outlook for the financial sector

Improvement in key performance metrics for banks

The banking sector is at an inflection point, slowly putting past vulnerabilities behind and making a comeback after a phase of sharp increase in GNPAs, fall in profits, and subdued credit growth.

Credit growth for the banking sector is expected to pick up to 14-15% in fiscal 2023 from ~12% in the previous fiscal — it has crossed ~15% so far this fiscal. However, growth in deposits has lagged that in credit in recent months, and with the surplus liquidity situation now normalising, ability of banks to garner deposits to meet credit demand will remain a key monitorable.

From a segmental perspective, growth in corporate credit, which constitutes ~45% of the total bank credit, is expected to pick up, driven by demand from the infrastructure sector, additional working capital requirement, and shift from the bond markets given the interest rate movements. The upside impact of private capex on credit growth remains to be seen.

Retail credit, which is ~26% of banking sector advances, is likely to show healthy growth across sub-segments. Home loans, the largest sub-segment, has not felt the impact of rising interest rates on customer demand yet.

With increasing formalisation of the MSME sector and number of MSMEs registered under Udyam, the addressable base for banks is expanding, especially for priority sector loans. The segment is also riding on the benefits of government reforms.

From an asset quality perspective, GNPAs of banks are expected to improve 90 bps on-year to ~5% this fiscal, riding on post-pandemic economic recovery and higher credit growth.

The biggest improvement will be in the corporate segment, where GNPAs are seen falling below 2% next fiscal from a peak of ~16% as on March 31, 2018, as a result of significant clean-up by banks in recent years and strengthened risk management and underwriting.

However, asset quality in the MSME segment, which saw the maximum restructuring (~6% vis-à-vis ~2% for the overall banking sector), remains a key monitorable, with GNPAs expected to rise. GNPAs in the retail and agriculture segments are expected to remain range-bound over the medium term.

The improvement in asset quality and the already high provisioning cover ratio of 73% as on March 31, 2022, should help reduce credit cost, thus improving the sector’s profitability.

Despite lower treasury profit, given the increasing-interest-rate regime, return on assets (RoA) is expected to improve to ~1.0% in fiscal 2023 from 0.9% in fiscal 2022, supported by increasing margins and lower credit cost.

Even from a capitalisation perspective, the banking sector has improved and has adequate buffers. It is, therefore, well placed to support economic growth over the medium term. While most private banks have traditionally maintained comfortable buffers, many of them are also benefiting from the capital raised in the past two years. Public sector banks have seen substantial capital infusion by the government in the past few fiscals and have raised some equity, thereby strengthening balance sheets and improving capital ratios.

Overall, the banking sector is on a strong footing today vis-à-vis the past few years. However, to avoid a repeat of past asset quality challenges, it is important that banks do not relax their credit underwriting standards while focusing on higher growth over the medium term.

Non-banks to see four-year-high growth in AUM; profitability to remain steady despite rising cost of borrowing amid lower credit cost

Non-banks — comprising non-banking financial companies (NBFCs) and housing finance companies (HFCs), excluding government-owned NBFCs — are expected to see their assets under management (AUM) grow 11-12% in fiscal 2023 after three years of single-digit growth. This growth is expected to be relatively broad-based across the retail segments.

Still, growth will be lower than the pre-pandemic level. Intense competition from banks and the rising-interest-rate scenario will limit the competitiveness of non-banks in certain segments, leading them to focus on higher-yield segments for growth. Home loans and vehicle finance, which have the largest share in the non-banks AUM pie, are expected to register double-digit growth this fiscal, which will support growth of the entire sector.

While the home loan segment is likely to grow 13-15% this fiscal, the vehicle finance segment will see growth return to 11-13%. However, competition from banks remains a challenge, and non-banks are expected to continue to lose market share in the home loan and new-vehicle finance segments.

Unsecured loans may be the only segment where NBFCs may touch pre-pandemic growth of 20-22% this fiscal. On the other hand, wholesale finance, which has seen a number of players exit the market over the past few years, will see AUM decline.

The digital lending norms announced by the RBI on August 10, 2022, will impact the way NBFCs operate in the online space. The guidelines aim to usher in orderly growth and financial stability, check malpractices, strengthen transparency, and protect customer interests.

GNPA levels for NBFCs and HFCs were impacted following the announcement of the RBI IRACP[1] Clarifications on NPA recognition as well as upgrade norms in November 2021. After December 2021, the RBI announced deferment of the upgrade criteria to September 30, 2022, providing a reasonable transition time for non-banks to recalibrate the processes, revamp collection infrastructure and teams, and persuade borrowers to align with the new dispensation. GNPAs of NBFCs and HFCs are expected at ~3% as on March 31, 2023, versus 3.5% as on March 31, 2022.

Performance of the restructured portfolio will be a key monitorable for asset quality. Nevertheless, the underlying asset quality should continue to improve as recovery in economic activity provides tailwinds to borrower cash flow.

A key monitorable for the profitability of non-banks this fiscal is the rising-interest-rate environment. A CRISIL Ratings analysis of the non-banks rated by it shows that Rs 15 lakh crore of debt, or ~65% of the outstanding debt as on March 31, 2022, is due for repricing this fiscal because of interest reset or maturity. Incremental debt of ~Rs 3 lakh crore may be raised to cater to the expected growth in lending. The impact of this will vary based on the mix of fixed- and floating-rate borrowings as well as the type of benchmarks these borrowings are linked to, whether external (such as repo) or MCLR (marginal cost of funds-based lending rate). Overall, borrowing cost for non-banks may rise 85-105 bps this fiscal.

The profitability metrics for non-banks are not just contingent on rising rates, but also on the ability to pass on the increase in rates.

This squeeze in lending spreads and interest margin will be offset by lower incremental credit cost on account of the substantial provisioning buffers built over the past two fiscals, which had cranked up credit cost in the past.

Credit cost, which has been rising for the past couple of years, should decline this fiscal with improving asset quality. More importantly, there is still a reasonable amount of cushion available — 0.5-2% of assets — as contingency provisioning, which means incremental provisioning will be lower. This should mitigate the impact of higher interest rates on net interest margin. Consequently, with control over credit cost, overall profitability metrics are expected to hold steady despite the rising-interest-rate environment.

That said, geopolitical issues, sharper-than-expected increase in interest rates, and inflation will bear watching.

Securitisation: Volume picked up in first quarter this fiscal amid stable pool collections

Focus on asset-light growth by non-banks to spur volume

Securitisation volume touched ~Rs 35,000 crore in the first quarter of fiscal 2023, with the number of non-bank originators rising to over 80 from around 50 a year earlier. Superior track record of periodic collections and stable performance have retained investor interest in issuances. That said, rising concerns among investor groups on the repayment ability of borrowers — especially as a result of strong macroeconomic headwinds, such as rising interest rates and inflation — did dampen enthusiasm in the initial months. Mortgage-backed securitisation (MBS) loan pools constituted ~45% of quarterly volume, compared with 53% in the corresponding period of the previous fiscal (see annexure). The asset-backed securitisation (ABS) segment constituted the rest, comprising CV loans (24%), microfinance (10%), gold loans (8%), two-wheeler, education, school finance, and unsecured loans. The proportion of direct assignment (DA) transactions rose to 60% (see annexure), while that of pass-through certificate (PTC) issuances fell to 40% from 48% in April-June 2021.

Stable collections despite macro headwinds

CRISIL Ratings tracks movements in monthly collection ratios (MCR = collections excluding prepayments as a percentage of billing for the month, *see annexure*) for all securitisation transactions rated by it. Median MCRs of rated securitised pools have been stable despite macroeconomic challenges in the form of rise in interest rates, commodity cost and energy prices for retail borrowers. MBS pools, seen as the most reliable asset class, displayed median MCRs (see annexure) of ~100% during the payout months of April-July 2022. CV loan pools saw marginal decline from the peak of 105% during the April 2022 payouts to ~98% in the June-July payouts. Median MCRs of 2W loan pools were 98-99%, while collection ratios of SME loan pools were 95-97% in the April-July 2022 payout period.

Outlook on market activity

Retail loan pools have witnessed lower collections and higher delinquencies amid elevated stress levels since 2020, which led to some instances of utilisation of credit enhancements incorporated as part of the initial transaction structure. Despite their susceptibility to stress, these pools have witnessed sharp, smart and sustainable recoveries, which helped replenish the credit enhancements. Long-standing track record of healthy performance of securitised pools, constant supply of loan assets available for securitisation with non-bank lenders, new structures, and high-yield asset classes could attract more investors over the medium term. With gradual pick-up in economic activity, disbursements are likely to ramp up. Consequently, non-banks may continue to rely on the securitisation route to access incremental liquidity.

However, any ground-level, short-term disruption could impede, and any prolonged displacement could reverse, improvements in the credit quality of the underlying loans in pools. The potential disruptions include rise in interest rates and increasing inflation.

Conclusion

Securitisation, as a legally sound, standardised and reliable route, offers lenders a tried and tested way to access incremental funds, while providing investors with avenues to gain exposure to good-quality, cherry-picked loans across asset classes. These transactions have shown stable credit quality on account of their resilient track record. CRISIL Ratings will continue to monitor the performance of the securitised pools under its surveillance and will take the appropriate rating actions. Fall in collections, rising delinquencies, credit enhancement utilisation, or occurrence of any unforeseen events that amplify risks to future investor payouts will continue to be monitorables.

Epilogue

Even as many large economies are likely to slow down, India is expected to register over 7% GDP growth in fiscal 2023. India Inc is placed well above the rest, led by its buoyant domestic demand, the government's focus on infrastructure, and debt-light balance sheets. The infrastructure segment has a strong momentum, as evident in the budgetary outlay. It is uniquely positioned as largely a domestic story, somewhat shielded from global challenges such as slowdown in developed economies amid tightening monetary policies.

A study of the sectors contributing to over 70% of debt rated by CRISIL Ratings corroborates our expectation of a positive credit quality outlook for India Inc, with almost 75% of the debt being in sectors that are expected to have robust balance sheets and steady cash flow in fiscal 2023.

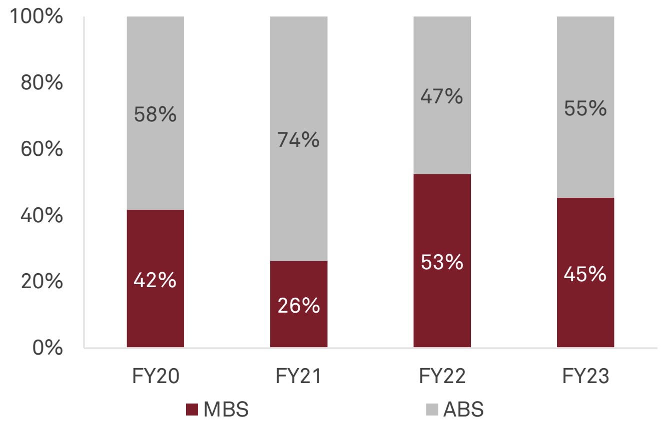
That said, it must be acknowledged that some sectors may bear the brunt of persistent challenges, such as recession in developed markets. S&P Global expects the US to enter shallow recession in the first half of 2023, as sharp rate hikes and elevated inflation erode purchasing power. Sectors dependent on exports will see some moderation amid slowdown in end-user markets. High inflation and subdued consumer sentiment are other risks to our credit quality outlook as they could dampen domestic demand. These factors may result in moderation of our credit ratio.

Even as uncertainties prevail, strong balance sheets and increased profits place India Inc on a strong footing.

Annexure

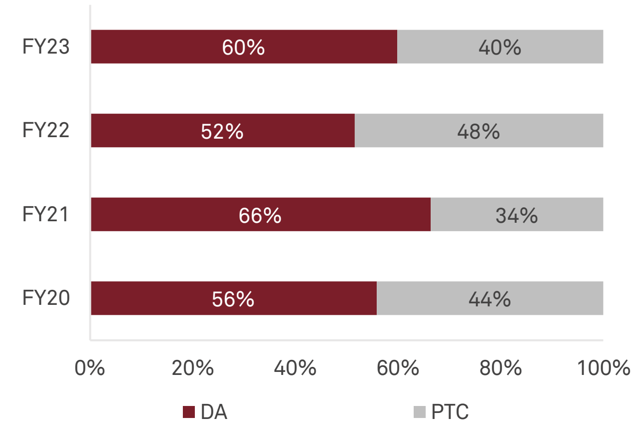
Securitisation market performance over the years

Figure 15: ABS-MBS split of retail securitisation (for the first three months of each fiscal)



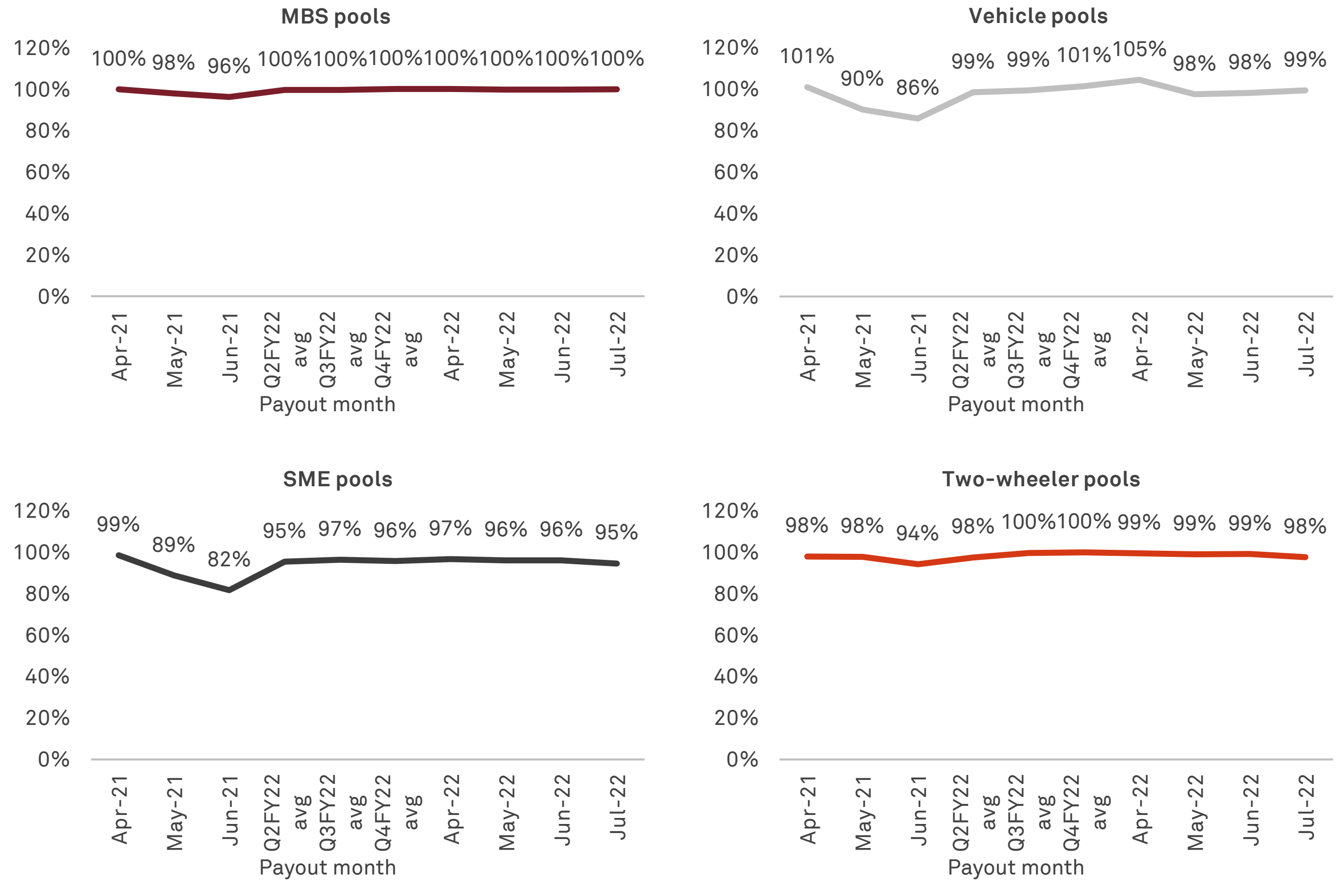
Source: CRISIL Ratings estimates

Figure 16: DA-PTC split of retail securitisation (for the first three months of each fiscal)



Source: CRISIL Ratings estimates

Figure 17: Collection ratios in securitisation transactions rated by CRISIL Ratings



Source: CRISIL Ratings

Notes

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