CRISIL
A STANDARD & POOR'S COMPANY

Year of reckoning beckons

CRISIL's
INDIA OUTLOOK
ECONOMY • INDUSTRIES • MARKETS
2016-17

Contact details

Chief Analytical Officer

Pawan Agrawal
Email: pawan.agrawal@crisil.com

Senior Directors

Sudip Sural
Email: sudip.sural@crisil.com

Krishnan Sitaraman
Email: krishnan.sitaraman@crisil.com

Dharmakirti Joshi
Email: dharmakirti.joshi@crisil.com

Prasad Koparkar
Email: prasad.koparkar@crisil.com

Directors

Anuj Sethi
Email: anuj.sethi@crisil.com

Ajay Srinivasan
Email: ajay.srinivasan@crisil.com

Akshay Chitgopekar
Email: akshay.chitgopekar@crisil.com

Amit Bhave
Email: amit.bhave@crisil.com

Manish Gupta
Email: manish.gupta@crisil.com

Rajat Bahl
Email: rajat.bahl@crisil.com

Ravi Nori
Email: ravi.nori@crisil.com

Sushmita Majumdar
Email: sushmita.majumdar@crisil.com

Sridhar Chandrasekhar
Email: chandrasekhar.sridhar@crisil.com

Suresh Krishnamurthy
Email: suresh.krishnamurthy@crisil.com

Editorial

Raj Nambisan, Director
Email: raj.nambisan@crisil.com

Subrat Mohapatra, Associate Director
Email: subrat.mohapatra@crisil.com

Media contacts

Sunetra Banerjee, Director
Email: sunetra.banerjee@crisil.com
Tel: +91 22 3342 1838

Tanuja Abhinandan, Associate Director
Email: tanuja.abhinandan@crisil.com
Tel: +91 22 3342 1818

Table of contents

EXECUTIVE SUMMARY 5

SECTION ONE: MACRO-ECONOMY 7

Macroeconomy: Recovery needs another dose of good luck 8

SECTION TWO: PROFITABILITY, RATINGS, INVESTMENTS & BANKING 21

Corporate profitability: Topline, net profit growth look set to edge up 22

Rating trends: Divergence in credit quality will continue 24

Investments: Moderate pick-up presaged 27

SECTION THREE: SECTORAL OUTLOOKS 35

Banking: As provisioning eats up profit, 9-10 PSBs to post losses 36

Automobiles: Low rates and fuel prices, and rising income triggers 42

Automotive components: Steady revenue growth, cost gains ahead 48

Capital goods: Fewer orders, compressed margins are hurting 55

Cement: Demand growth, profitability looking up 60

Fertiliser: Rain god benedictions, urea policy can be drivers 67

Metals & mining: Jarring notes will continue for metal makers 74

Pharmaceuticals: On steady growth path; local and US markets key 80

Power: Low PLF pain remains for gencos; UDAY can change game 86

Telecom: Funding needs to soar as data booms, rivalry heats up 93

Textiles/cotton yarn: Demand will stay crimped, cotton stocks reined in 100

Real estate: Plagued by low sales and high inventories 106

Retail: Souped-up brick & mortars will adjust to new realities 114

Roads: On the road to rebound, but potholes abound 120

This page is intentionally left blank

EXECUTIVE SUMMARY

Truly, a year of reckoning beckons.

In fiscal 2017, CRISIL believes India will need relentless implementation of both policy and executive measures already announced, and those that will be. These include progress on UDAY, the power sector reform, clean-up of bad loans and capitalisation of banks, structural reforms for public sector banks (PSBs), and revitalisation of the public-private partnership regime. Any progress on the Goods and Services Tax Bill would be an added bonus.

Then we will need a good monsoon after three consecutive weather shocks (two bad rainy seasons and one spell of unseasonal downpour in early 2015) to mitigate rural distress and stoke demand.

Many of these factors will have a bearing on India's long-term growth story, and that's why we choose to call fiscal 2017 as a make or break year. In the milieu, CRISIL foresees four broad trends influencing the economy next fiscal:

1. A slowing world will keep crude oil and commodity prices soft and therefore the twin deficits – fiscal and current account -- and inflation under control. However, sluggishness in global demand will prolong the agony for exporters.

2. The triggers for next fiscal, therefore, will be domestic. CRISIL's prediction of 7.9% GDP growth next fiscal is predicated on a good monsoon, and hopefully, the global situation will not go out of whack.

3. We expect divergence in credit quality to continue next fiscal driven by leverage levels. While investment-linked sectors will face pressure, consumption-linked sectors -- such as auto original equipment manufacturers and automotive components, textiles, pharma and retail – should be on a stable-to-positive footing next fiscal.

4. Pressure on the asset quality of PSBs will continue through next fiscal because of weakness in investment-linked sectors, highly leveraged companies, and the downturn in commodities. We expect weak assets to rise further to 8.9% by next fiscal end from an estimated 8.5% this fiscal. Provisioning cost could equal or surpass pre-provisioning profit of public sector banks.

Weakening asset quality and falling profit would multiply the woes of PSBs. Their Tier I capital requirement by 2019 will increase further compared with earlier estimates, and the government's commitment under Indradhanush will come up short. Consequently, CRISIL has lowered its rating floor for public sector banks by a notch from the high safety AA- to A+. To be sure, most PSBs continue to be in the high safety category, but here's the perspective: the last time CRISIL rated a PSB at A+ was in 2004.

As for corporate India – excluding financial services and oil companies – we see revenue growth accelerating to 8-9% from ~4% expected this fiscal as domestic demand gathers pace. Ebitda (earnings before interest, tax, depreciation and amortisation) margin should improve 30-40 bps on soft commodity prices, improved capacity utilisation and better revenue growth. Net profit growth could be in the range of 12-15% because of better topline growth, improved Ebitda margin, falling interest rate, and subdued working capital requirement because of cheaper raw materials.

We expect automobile and automotive component makers, cement, fast moving consumer goods, pharmaceutical companies and retailers to do well. The imposition of minimum import price has mildly lifted the sagging spirits of steel manufacturers, but debt servicing ability for most mid-sized and small players is unlikely to improve materially.

On the other hand, capital goods manufacturers, thermal power generation companies and real estate developers are expected to continue to struggle. While data traffic will continue to grow at a feverish pace, telecom companies are likely to witness pressure on margins due to increased network operating and selling costs.

As for investments, we see a moderate pick-up, not a broad-based improvement. CRISIL estimates aggregate investments to grow by 7% in fiscal 2017, driven by infrastructure sectors such as renewable energy, telecom and road. Private sector companies, especially in core sectors, continue to be cautious on committing fresh investments.

SECTION ONE

MACROECONOMY

CRISIL's GDP GROWTH FORECAST
7.9% on adequate monsoon

Recovery needs another dose of good luck

2016 has begun on an ominous note. The International Monetary Fund (IMF), the World Bank and the Organisation for Economic Cooperation and Development (OECD) have pared their global growth outlook for the year amid increasing signs of debility in emerging markets. And the epicentre of global risk and volatility is China.

For India, such a predicament cuts both ways. To wit:

- A slowing world implies prices of crude oil and the commodity complex will remain battered, which will bolster the fiscal math
- But sluggishness in global demand will prolong the agony for exporters
- That means the trigger for growth in fiscal 2017 will come from within, or the domestic economy, and, as in the current fiscal, another dose of good luck through low crude oil prices will be handy.

The Budget preferred fiscal prudence and stability over growth. By maintaining fiscal deficit at the pre-committed level of 3.5% of gross domestic product (GDP), it precluded the possibility of any direct fiscal stimulus. But this focus on fiscal consolidation creates conditions for the Reserve Bank of India (RBI) to cut rates and we expect a 25-50 basis points (bps) reduction in 2016. So, fiscal consolidation will indirectly benefit the economy by bringing down the cost of borrowing for both the government and the private sector.

FAQs

What is the GDP growth expectation for next fiscal?

The economy faced two successive monsoon failures (2014 and 2015) and damage to crops from unseasonal rains in early 2015 with little deleterious rub-off on inflation and growth. Rural incomes and demand, however, suffered. A normal monsoon in fiscal 2017 will give agriculture a one-time growth kicker because of the low-base effect of the two previous years. That should lift sagging rural demand and, by extension, overall GDP growth. The good part is, weather experts presage a La Niña event this year that lavishes rains. The Economic Survey (2015-16) points out that average growth in agricultural GDP was 8.4% in La Niña years in the past.

The Budget, too, has focussed on the rural economy, particularly the farm sector which has seen a 94% increase in allocation, with crop insurance and irrigation the biggest beneficiaries. For the non-farm community, while there are measures to provide a safety net, the increase in allocation is moderate compared with last fiscal. A combination of normal monsoon and rural focus of the Budget can give a

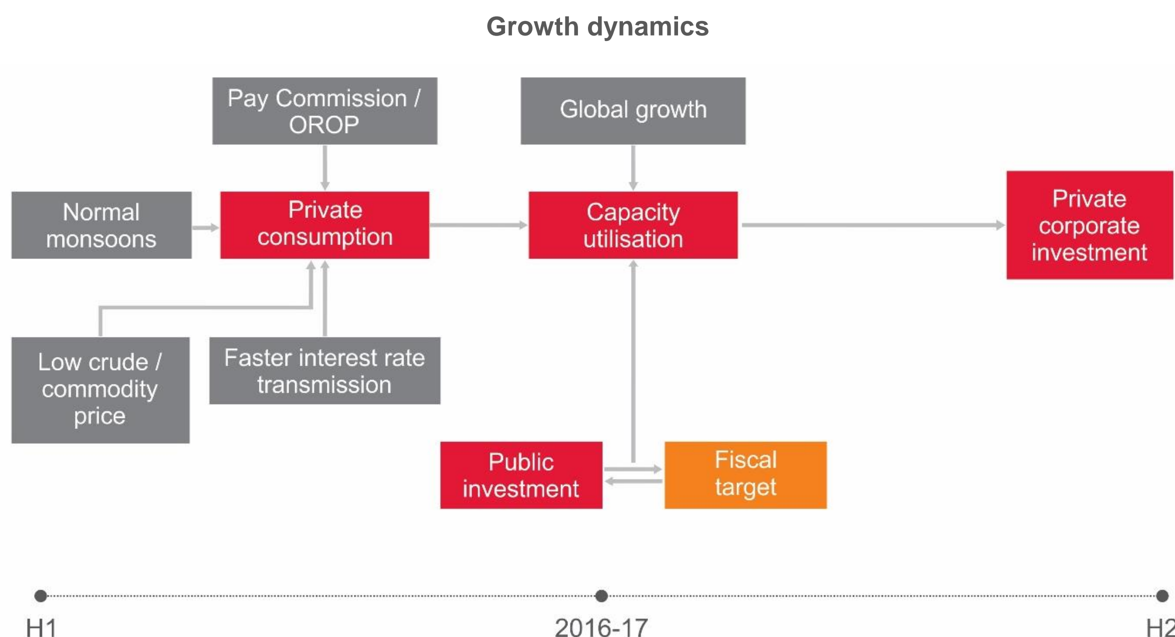
leg-up to rural consumption and the associated sectors such as automobiles, consumer durables and housing.

Growth next fiscal will also find mild support from improved transmission of the RBI's policy-rate cuts and implementation of the salary and pension revisions recommended by the Seventh Pay Commission and the One Rank One Pension, or OROP, scheme.

And despite fiscal consolidation pressure, room has been created for infrastructure spending through the government's own resources and by nudging the public sector undertakings to invest more, specifically on roads and highways (49% on-year increase in investment proposed), railways (up 24%) agriculture and rural development (42% increase in irrigation outlay). These factors will, in turn, raise capacity utilisation and create conditions for new investment by the private sector in the medium-term. But if there is a third consecutive monsoon failure, consumption and private investment recovery will again be delayed.

To slot sustainably into a higher growth trajectory, the country will have to address issues plaguing private investment and a clean-up of bank balance sheets. India's investment-to-GDP ratio has fallen for five straight fiscals. Companies in infrastructure and other asset-heavy sectors will also need to deleverage materially. At the moment, progress on this front is tardy.

Growth dynamics



Source: CRISIL Research

What is CRISIL's macroeconomic outlook for next year?

Our estimates show that India's economy will grow at 7.9% next fiscal from 7.6% expected in the current one if supported by a normal monsoon and if the global situation does not deteriorate from here. So far, the economy's modest recovery has been shaped by good luck on crude oil and commodities, and a supportive policy environment. While this is expected to continue, India cannot afford to be third-time

unlucky with rains. We have revised downwards our growth forecast for next fiscal from 8.1% earlier due to intensifying global headwinds. The International Monetary Fund (IMF), the World Bank and the OECD have already lowered their global growth forecasts for 2016 by 20, 40 and 30 basis points (bps), respectively.

Next fiscal, we expect consumer price inflation (CPI) to stay soft at 5% and unchanged from fiscal 2016. This is assuming a normal monsoon, lower global oil and commodity prices versus this year, and sticky services sector-led components of consumer prices. Weak domestic demand caps the possible upside to inflation from a revision in salaries and pensions, and the expected push to rural incomes.

As for current account deficit (CAD), we expect mild upward pressure because imports are likely to increase on a revival in investments and consumption. Exports, on the other hand, are expected to stay in the bog. The upshot is that we see CAD inching up to 1.4% of GDP next fiscal from an expected 1.3% in the current one.

The rupee will be supported by improving growth-inflation mix, sufficient foreign exchange reserves, and low inflation and CAD. We also expect the government to improve the ease of doing business even more, and take steps to improve investor appetite. We expect the rupee to settle around 65 per dollar by March 31, 2017. But, faster-than-expected pace of hikes by the US Federal Reserve could result in greater capital outflows from emerging markets, including India, and a weaker rupee. As of now, Standard and Poor's expects Fed to make only two rate hikes of 25 bps each in 2016 – that too, not before June. The next fiscal will be closely watched for more reforms and relentless implementation of executive and policy actions already announced. These include progress on banking sector reforms and capitalisation, implementation of the UDAY scheme in the power sector, implementation of the bankruptcy code, progress on the Goods and Services Tax Bill, and revitalising the public-private partnership, or public-private partnership regime. After 2016, the ability of the government to unleash big reforms is likely to diminish due to political compulsions. While the Budget for next fiscal may not be a make or break for the economy, many of the things done beyond it will certainly be.

CRISIL's projections at a glance

	FY14	FY15	FY16F	FY17F
GDP (%)	**6.6**	**7.2**	**7.6***	**7.9**
CPI (%, average)	9.2	6.0	5.0	5.0
CAD (% GDP)	1.7	1.3	1.3	1.4
Fiscal deficit (% GDP)	4.4	4.1	3.9	3.5
Exchange rate (March-end)	60.1	62.6	66.0	65.0
G-sec yield (%, March-end)	8.8	7.7	7.6	7.5

*Source: CEIC, CRISIL Research, Note: * Advance Estimates*

What role will the monsoon play next fiscal?

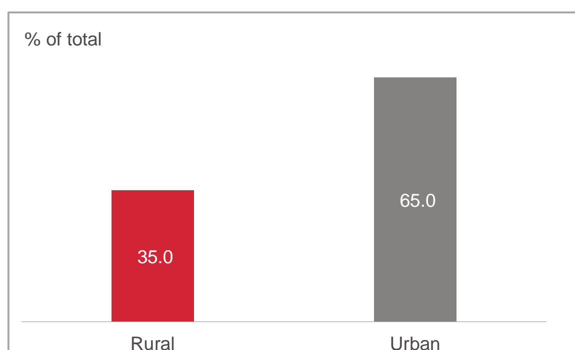
Rains will cast a long shadow, indeed. It will impact:

a. ***The pace and quantum of consumption revival and thereby improvement in capacity utilisation:*** Household consumption data show 35% of the total consumption demand in India is from the hinterland. Also, in the rural areas, 24% of consumption is towards discretionary items. A normal monsoon will mean this part of overall demand will be stoked as incomes rise.

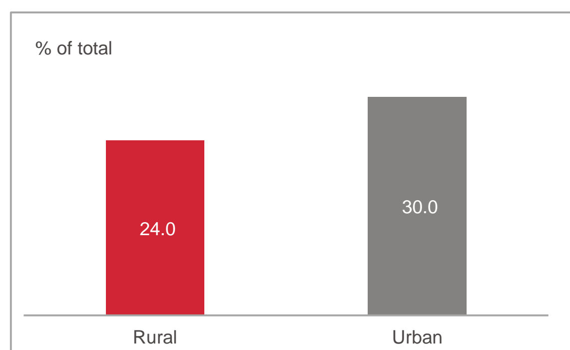
b. ***The performance of non-agriculture sector linked to agriculture:*** Improved outlook for the rural economy will positively impact non-agriculture sectors such as manufacturing and services. The rural economy has a 51% share in manufacturing, and 26% share in services.

c. ***Inflationary pressures in the economy:*** Despite the overall decline, inflation in rural areas has softened to a lesser extent and also remains higher than urban inflation. In the first 10 months of the current fiscal, rural inflation has fallen only by 80 bps compared with a fall of 180 bps in urban inflation. This, coupled with the hit to rural incomes, has eroded purchasing power.

Rural/ urban consumption split

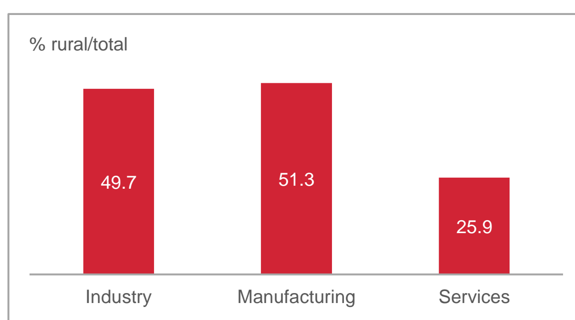


Discretionary spending out of total spending

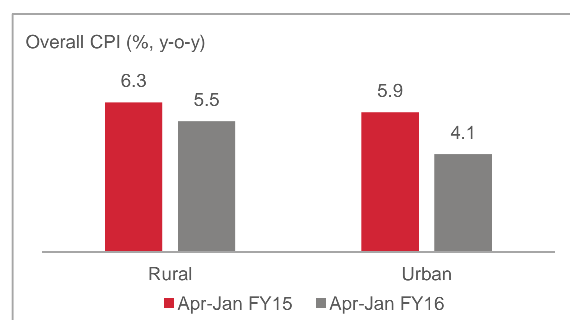


Source: NSSO, CRISIL Research

Share of rural economy in non-farm sectors



Inflationary pressure higher in hinterland



Source: CSO, CEIC, CRISIL Research

What's CRISIL's base-case scenario?

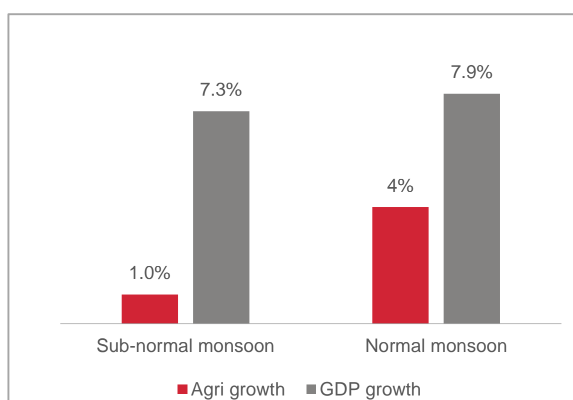
Our base case assumes a normal southwest monsoon accompanied by favourable temporal and regional distribution. Recent weather developments support this assumption. Weather experts have said El Niňo conditions will decline in coming months and things will return to normal by the first quarter of next fiscal. Based on 26 El Niňo events since 1990, half of the incidents have been followed by a neutral year, while 40% have been followed by a La Niña event – where sea-surface temperatures cool and there's higher rainfall. The Australian Metrological Bureau estimates that a neutral or La Niña condition is equally likely in the second half of calendar 2016, while a repeat occurrence of El Niňo is least likely.

Given this, agriculture will grow at an above-trend level of 4% on a weak base caused by two consecutive poor monsoons. Therefore, in the base case, we expect GDP to grow 7.9% in fiscal 2017. The major impetus will come from the farm as non-agriculture growth picks up 10 bps over the previous fiscal to 8.6%.

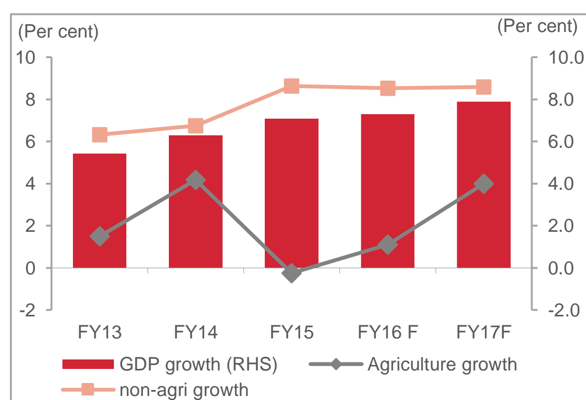
What about the bear-case scenario?

If there is a hat-trick of sub-normal monsoons, agriculture growth will stagnate around 1%, amplify farm stress, crunch rural demand and ultimately drag down non-agriculture growth. In fiscal 2016, a sub-normal monsoon and muted rural demand weighed on industry (e.g. lower sales of tractor and two-wheelers, etc) and pushed back revival in private consumption. Given that the rural economy accounts for 50% of the industrial output and 26% of services sector GDP, a poor monsoon can lower GDP growth to 7.3% next fiscal.

GDP equations, fiscal 2017



Agriculture will provide the impetus



Source: CSO, CEIC, CRISIL Research

What are the growth triggers?

Ground indicators such as credit growth, capacity utilisation and investments indicate the recovery is nascent and this is reflected in low nominal GDP growth. Growth is expected to gain momentum as the government continues to undertake structural reforms, the steps taken in the last 18 months seep through, and the recommendations of the Seventh Pay Commission and OROP are implemented.

That said, the quantum and sustainability of the pick-up in growth will depend a lot on the munificence of the rain god. Private consumption recovery, so critical to stoking private corporate investment, has been firing on one cylinder so far – urban demand – even as rural distress remains at elevated levels. A normal monsoon will thus be critical to the pace of recovery.

Beyond farms, we see the recovery to be moderate, driven mainly by a modest rise in manufacturing growth. Low crude oil prices (assumed at an average of $37-40 per barrel) next fiscal will also help. In addition, the Seventh Pay Commission/ OROP payouts, low inflation and easy monetary conditions will support overall demand.

On its part, the government has tried to frontload productive investments in roads, railways and defence this fiscal – with major success in road building – and we expect this trend to continue in the next. Execution under the National Highways Authority of India has increased 40% on-year in terms of kilometres constructed till January 2016. CRISIL Research expects road investments to double in the next five years compared with the last five years.

These factors will, in turn, raise capacity utilisation rates and pave the path for new investment. We expect the private capex cycle to start picking up gradually by start of fiscal 2018. Among emerging markets, India will continue to remain in a sweet spot given the rise in the number of factors favourable to its growth.

The nuances of GDP growth

At basic prices	FY14	FY15	FY16*	FY17F
Agriculture	4.2	-0.2	1.1	4.0
Industry	5.0	5.9	7.3	7.6
Manufacturing	5.6	5.5	9.5	9.0
Mining & quarrying	3.0	10.8	6.9	7.0
Services	7.8	10.3	9.2	9.1

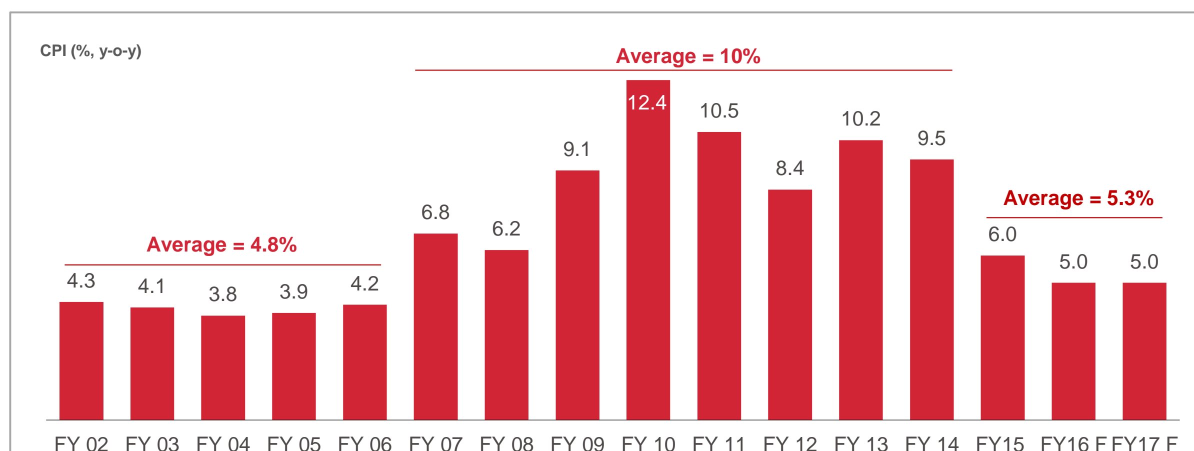
At market prices	FY14	FY15	FY16*	FY17F
GDP	6.6	7.2	7.6	7.9
Private consumption	6.8	6.2	7.6	8.0
Govt consumption	0.4	12.8	3.3	8.2
Fixed investment	3.4	4.9	5.3	8.1
Exports	7.8	1.7	-6.3	5.0
Imports	-8.2	0.8	-6.3	5.2

*Source: CSO, CEIC, CRISIL Research, Note: * Advance estimates, F=CRISIL Forecasts*

Why will inflation remain soft next fiscal?

Next fiscal, we expect consumer price inflation (CPI) to stay soft at 5%, or unchanged from fiscal 2016. This assumes a normal monsoon, impact of lesser decline in global oil and commodity prices, and stickiness in services sector-led inflation. Last fiscal saw the CPI fall 100 bps to an estimated 5% from 6% in fiscal 2015, supported by (i) a sharp decline in food inflation despite the weak impact of monsoon, (ii) depressed global prices of oil and commodities and (iii) slack domestic demand and excess capacities that eroded the pricing power of manufacturers.

Inflation eases after staying elevated for long



Note: F=CRISIL Forecast, Source: CSO, CRISIL Research

If it tamps as presaged, average inflation between fiscals 2015 and 2017 will come down to around 5.3%, nearly halving from the 10% recorded between fiscals 2008 and 2014. But going forward, for inflation to ease further towards 4%, the government will have to undertake structural reforms to fix chronic supply-side constraints. This is especially critical in sectors such as agriculture where weather-related shocks are frequently causing large price spikes, and also in sectors such as healthcare and education where inadequacy of good quality supply has kept inflation high and sticky.

What are the assumptions driving CRISIL's outlook on CPI inflation next fiscal?

There are three we see:

Assumption 1: Food inflation to stay benign

1. **No further weather-related shocks**

   This means we assume a normal southwest monsoon next fiscal, and active food-supply management by the government. The last two years have seen a sharp fall in food stocks, especially rice and wheat, while procurement has been more or less constant. But even at these levels, stocks remain 71% (1.7 times the required norm) and can be used in case of an adverse shock to production.

2. **Only a mild pick-up in global food prices**

   The benefit from falling global food prices could diminish somewhat next fiscal. And for the first time in four years, global food prices are expected to rise in 2016. But this will be a mild 1.5% in 2016 as per World Bank estimates, after the 15% drop seen in 2015. An IMF study (2016) shows a strong correlation between domestic and international cereal prices. So, indications are global factors will not drive up food inflation.

3. **Moderate increases in minimum support price**

   Assuming the monsoon is normal and global food prices remain low, we expect the government to exercise restraint in increasing minimum support price (MSP) next year. In fiscal 2017, the MSP for pulses and oilseeds could see moderate hikes so as to incentivise production, while that for rice and wheat could be much lower.

4. **Better pulses supply management**

   In fiscal 2016, pulses were the only food category where inflation had spiralled due to domestic production shortfall and relatively firm global prices[1]. The government has decided to create a buffer stock of 1.5 lakh tonnes of pulses to control price fluctuation. So far, over 50,000 tonnes of pulses have been procured by procurement agencies. The government can also use the price stabilisation fund to procure stocks that are to be allotted to states based on demand and ensure the rest is sold through designated outlets to consumers within a year of procurement. In the event of any price spike in pulses, the government can liquidate stocks to tame domestic prices.

This fiscal, a mix of factors brought down food inflation, such as better food-supply management by the government, higher production (especially cereals), declining global prices, moderate MSP hikes and utilisation of the price stabilisation fund to subsidise the cost of imported pulses. To top it all, dented rural demand supported lower inflation. Many of these factors are expected to remain supportive next fiscal, too.

Assumption 2: Slow pick-up in domestic demand conditions

We believe overall demand conditions will improve only gradually. Also, given large unutilised capacities, pricing power of manufacturers will remain weak. As a result, the pick-up in inflation will be modest, and may manifest only towards the latter half of next fiscal. The government has stuck to the fiscal consolidation roadmap, while the RBI keeps a hawk's eye on inflation.

Assumption 3: Benign energy driven inflation

Fuel and metal inflation is expected to remain benign. Barring geopolitical risks, global crude oil prices will tend to gravitate lower, albeit less ferociously than in this fiscal. It should an average $37-40 per barrel next fiscal. The government has raised excise duty by a cumulative Rs 4.02 and Rs 7.07 per litre on petrol and diesel, respectively, to offset lower tax collection. Next fiscal, too, and despite a further fall in oil prices, the government can resort to fresh excise duty hikes if the fiscal consolidation goal is stretched. This will mitigate the pushdown to fuel inflation from lower global prices.

[1] *November 2015, CRISIL Opinion: Every third year, pulses catch price-fire*

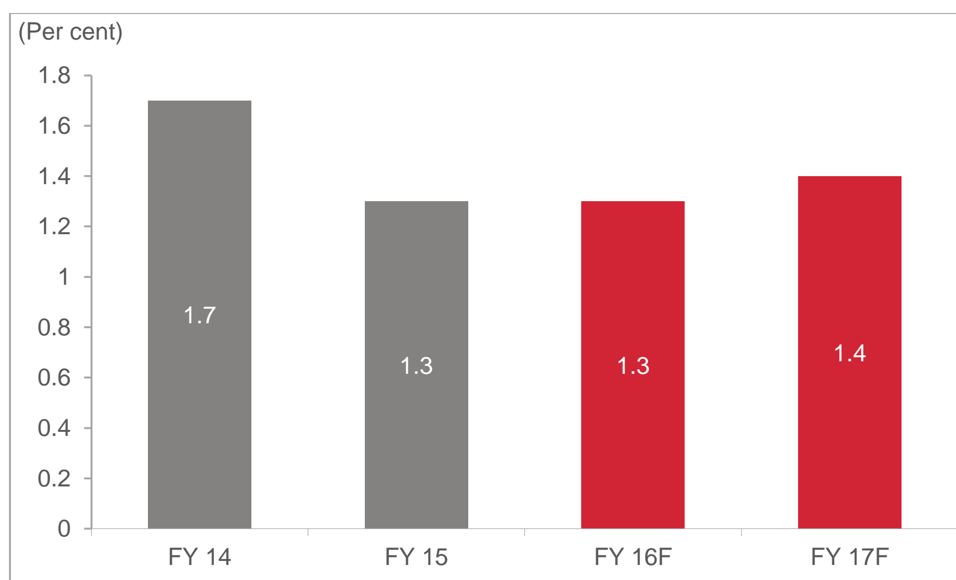
Where does CRISIL foresee CAD?

Even as exports have been declining, the fall in imports on account of weak international commodity prices and subdued domestic demand has kept India's CAD under check. Accordingly, CAD for this fiscal is estimated to be flat at 1.3% of GDP.

Going ahead, however, we expect mild upward pressure on CAD because imports will increase as consumption and investment tick up. While oil imports will remain subdued in value terms owing to benign prices (CRISIL's forecast for Brent crude is $48.5 per barrel average in fiscal 2016 and $37-40 per barrel in fiscal 2017), non-oil imports due to growth in domestic investment and consumption will inflate India's import bill.

Exports, on the other hand, are seen in the rut. Not only petroleum exports, but also non-oil exports are expected to be subdued because of global weakness. On top of it, a sharper-than-expected slowdown in China can accentuate our trade imbalance with the country and also hurt our metal and commodity-based sectors.

CAD as percentage of GDP



Source: RBI, CRISIL Research

Is China's pain India's gain?

This year the source of risk and volatility are the emerging markets – not so much the advanced economies – with China as the epicentre. This is not good news for the world economy, which is yet to show definitive signs of revival. In fact, recovery from the global financial crisis has been patchy, uneven and fraught with risks.

China is the world's largest economy in purchasing power parity terms and the second-largest in dollar terms. Indeed, over the past few years, it has become a dominant consumer and importer of a variety of commodities needed to fire its industry- and investment-led double-digit growth. But it can no longer do that; the risks in the financial sector stemming from overinvestment are forcing a slowdown in the economy. Standard and Poor's expects China's economy to slow to 6.3% in 2016 from 6.9% last year and a scorching double-digit growth that it had maintained since 1990s.

As it slows, China is also rebalancing away from investment to consumption-led growth. After the renminbi was inducted into the special drawing rights, or SDR – the IMF's 'currency' – China is trying its hand at liberalising its forex market.

The consequence of these events has been:

- Slowing growth that has reduced China's voracious appetite for industrial commodities, which is driving down their prices and causing pain in mineral-exporting countries
- Contagion effect in financial markets. The weakening of the renminbi was accompanied by intervention by Chinese authorities in a rather unconventional way, and with little attempt to communicate their actions to market participants. This left markets confused and volatile.

These developments in China cut both ways for India.

First the pain: China is India's largest trading partner. But the trade relationship is quite lopsided – India exports low-value-added goods (3.4% of India's exports are to China) while it imports high-value-added stuff from China (16% of its total imports). China's slowdown has trimmed its imports from India but its exports to India have been growing at a healthy pace. The result is a fast-bloating trade deficit that has now crossed $50 billion. The excess capacity in metals, particularly steel, in China has led to dumping into India, which has directly hit Indian producers. China's slowdown has also slowed growth in many other economies with strong supply chain linkages, and this hurts India's exports to these economies.

Then the gain: India is a net importer of a variety of commodities (including oil). Tumbling prices of these items helps keeps the country's fiscal and current account deficits in check and tamped down inflation. India's relative attractiveness vis-à-vis China has also improved, resulting in increased foreign investment flow from the rest of the world, including China.

But the gains are not guaranteed. The commodity and crude cycle will correct at some point in time and trim India's gains. India will, therefore, have to relentlessly pursue reforms to improve its investment climate, and pass key legislations to make its goods and labour markets efficient.

Fiscal arithmetic and its implications

The call to tighten the fiscal belt despite strong global headwinds and weak domestic demand must have been a tough one. The Finance Minister, by targeting 3.5% fiscal deficit as committed in the Fiscal Responsibility and Budget management (FRBM) Act, resisted the temptation to pump prime the economy.

Interestingly, in the last four years, the gap between budgeted and actual fiscal deficit has closed. This indicates budget-making has become more accurate, in stark contrast to the frequent overshooting seen before.

True, there has been some deviation from the goals envisaged under the FRBM Act to support investment activity. But the overall direction has rightly been one of consolidation: fiscal deficit as a percentage of GDP reduced to 3.9% in 2015-16 from 4.9% in 2012-13, and revenue deficit, as a percentage of GDP has come down to 2.5% from 3.6%.

What's good to see is that unlike between 2012-13 and 2014-15, fiscal consolidation in 2015-16 is not being achieved by paring capital spending but through subsidy reduction made possible by crashing crude oil prices. This has improved the spending mix of the government with a tilt towards infrastructure.

The fiscal math appears credible enough to make us believe this trend will continue in fiscal 2017 as well. The government has projected a realistic nominal GDP growth target of 11% for fiscal 2017. The gross tax-to-GDP ratio for fiscal 2017 has been assumed at 10.8% -- same as that achieved last fiscal. The government has also assumed a modest growth of 11.7% in gross tax revenues. So the overall tax revenue targets appear manageable.

The risk of undershooting on revenue (including non-tax) is contingent on spectrum auctions and divestment, specifically the ambitious target for the latter at Rs 565 billion. Previous experience suggests this would be difficult to achieve as market conditions remain unfavourable and the government doesn't seem to have a clear strategy to execute its divestment plan. For fiscal 2016, compared with a budgeted disinvestment target of Rs 695 billion, only Rs 253 billion has been garnered so far. A similar miss would increase the fiscal deficit by 0.14% next year.

In case there is risk to non-tax revenues, the government may have to axe capital spending to meet the target. In case the scenario of 'sacrificing capital spending at the altar of growth' plays out, the spending mix and India's potential growth rate will be impacted. It is, therefore, important for the government to frontload its divestment programme next year.

Finally, sharp focus on farm

The rural focus of the Budget, along with normal monsoon, is expected to give a leg-up to rural consumption in the coming year. Overall, after years of neglect, some key issues facing rural India have received laudable attention, but there still some missed opportunities.

The impetus to farm sector

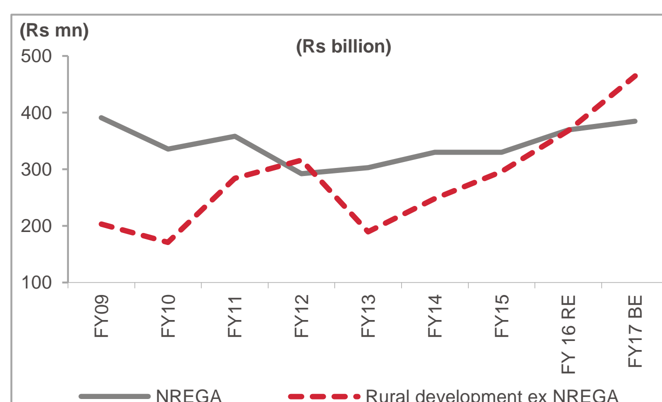
- A 94% on-year increase in spend on agriculture and famers' welfare
- A big push to crop insurance where the spend is budgeted to nearly double under the Pradhan Mantri Fasal Bima Yojana (PMGSY) to Rs 55 billion next fiscal
- Irrigation spend allocated at Rs 77 billion (42% increase on-year) towards fast-tracking and revival of irrigation projects. It also envisages creation of a long-term irrigation fund within Nabard with an initial corpus of Rs 2 billion, in addition to encouraging multilateral funding for groundwater management.
- 100% FDI permitted in food processing

Some other critical issues failed to find adequate policy response in this year's budget. These include steps to encourage private sector investment in agriculture and development of agriculture markets, both of which are crucial to improving profitability of the farm sector.

Non-farm sector impetus

For the non-farm community, while the Budget has announced measures to provide a safety net, the increase in allocation is moderate compared with last fiscal. Within non-farm spend though, there is a clear shift towards non-NREGA spend – while allocation to rural housing and rural roads is up 50% and 25%, respectively, and fast-tracking of project completion has been addressed, NREGA spend is only up 4% on-year.

Shift in rural spending focus



Source: Budget documents, CRISIL Research

This page is intentionally left blank

SECTION TWO

PROFITABILITY, RATINGS, INVESTMENTS & BANKING

Corporate Profitability

No material improvement in debt servicing ability foreseen

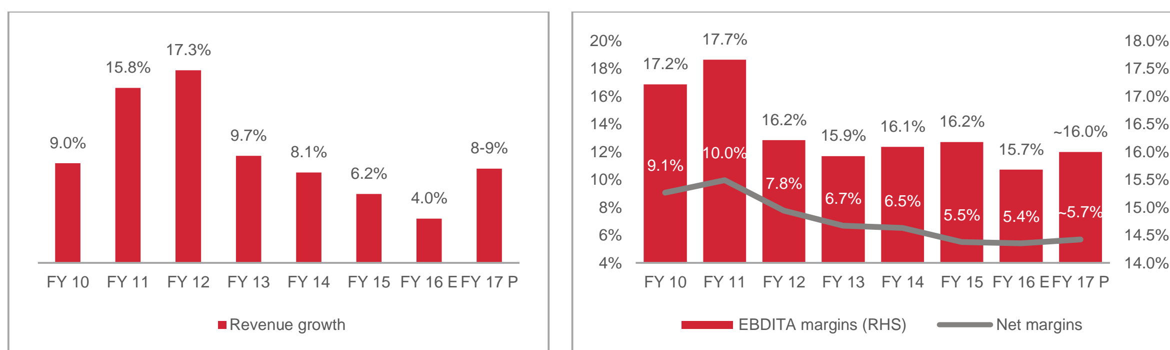
Topline, net profit growth look set to edge up

CRISIL expects the topline performance of India Inc (excluding financial services and oil companies) to have bottomed out this fiscal. Growth next fiscal would be higher as a broad-based demand recovery takes root, but it won't be anywhere near double digits and would likely hover ~8%.

Here's how we see profitability panning out next fiscal:

- Ebitda (earnings before interest tax, depreciation and amortisation) margin to improve 30-40 basis points (bps), driven by weakness in commodity prices, improved capacity utilisation rates, and better revenue growth
- Net profit growth to accelerate and be in the range of 12-15% because of stronger topline growth, improvement in Ebitda margin, lower interest rates as banks shift to a new base rate regime, and subdued working capital requirement because of soft raw material prices

Revenue growth to improve; Ebitda margin to be higher next fiscal

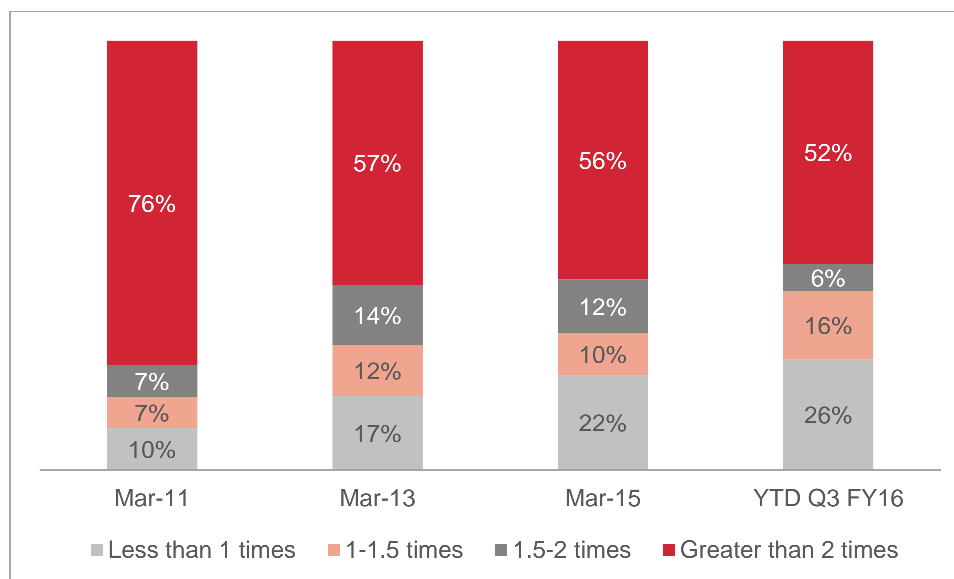


Source: CRISIL Research

Note: Data for NSE listed companies; excludes financials and oil companies

One disconcerting aspect, however, is that better performance may not be sufficient to improve the debt servicing ability (indicated by interest coverage ratio) of companies, which has worsened this fiscal. Close to 40% of the aggregate debt of the National Stock Exchange-listed companies was with companies having interest coverage of less than 1.5 times during April-December 2015, up from 32% in 2014-15. Consequently, corporates, pushed by lenders, will continue to deleverage, especially in the roads, construction, and commodity-linked sectors.

Debt-servicing ability remains a concern



Source: CRISIL Research

Note: Data for NSE listed companies; excludes financials and oil companies

How are key sectors likely to perform next fiscal?

As for individual sectors, we expect automobiles and components manufacturers, cement, fast moving consumer goods, pharmaceuticals and retail companies to outperform next fiscal. The fortunes of steel manufacturers are also looking slightly better as prices are likely to increase and imports come down after the imposition of minimum import price (MIP). This, coupled with increase in capacity utilisation and lower raw material cost, would prop up Ebitda margin of large companies. The improvement would, however, be contingent on MIP continuing beyond the initial six-month period. However, secondary steel manufacturers will remain in the bog as competition from large producers increases. And despite better profitability, debt servicing ability of the industry will not improve materially and debt will remain at elevated levels.

Capital goods manufacturers and thermal power generation companies (currently operating on low plant load factors) are expected to continue to struggle. Real estate developers may witness a slight increase in demand, but cash flows are unlikely to improve significantly, leading to continued dependence on external funding and/or refinancing. While data traffic will continue to grow at a feverish pace, telecom companies are likely to witness pressure on margins due to increased network operating cost, selling & marketing expense and pricing pressure.

Divergence in credit quality will continue

This fiscal, the credit quality of India Inc boiled down to just one factor: leverage. Not surprisingly, credit profiles of highly leveraged firms took a beating while for others it strengthened.

Credit quality deteriorated in commodity and investment-linked sectors such as power, roads, real estate, metals and mining, and capital goods on slow execution, weak demand and a global meltdown in prices. High leverage, coupled with a fall in realisation and profitability, has impacted the debt servicing ability of these entities. The cement and fertiliser sectors sustained their credit quality by continuing to show pricing discipline and stable cash flows, respectively. Telecoms benefited from strong cash flows from data services, partially offsetting the impact of additional debt contracted for spectrum acquisition. By contrast, credit quality improved in consumption-oriented sectors such as pharmaceuticals, auto, retail and textiles due to better demand, prudent working capital management and strong control over debt.

We expect this divergence in credit quality to spill over into the next fiscal, too.

FAQs

What is the impact on credit profiles in investment-linked sectors?

We expect pressure on credit profiles in the investment-linked sectors to continue next fiscal, specifically constraining the infrastructure sector – particularly roads, power and real estate.

Continued weak demand from electricity distribution companies (discoms) will trip the credit profiles of generation companies. Those with cost-reflective tariffs and long-term power purchase agreements (PPAs) will improve their operating performance, driven by lower fuel costs. The recently announced Ujwal Discom Assurance Yojana, or UDAY, scheme is also expected to boost the liquidity of discoms. However, more long-term PPAs are likely to be signed only towards the end of next fiscal.

In roads, several BOT projects awarded between fiscal 2010 and fiscal 2013 will continue to be plagued by time and cost over runs. The credit profile of operational projects is also expected to remain under pressure due to only modest toll rate hikes in an era of low WPI (wholesale price index) and moderate traffic growth. However, the government's current thrust on awarding road projects on EPC (engineering procurement and construction) basis than BOT (build operate transfer) will help developers expand their order book and generate steady cash flows because of better execution. The real estate sector will continue to suffer from inventory pile-up. Developers will face significant refinancing risks as stagnating sales hit cash flows, which, in turn, will hurt their credit profiles.

The credit outlook for metals and mining remains negative next fiscal as a sharp downturn in the commodity cycle, coupled with high leverage, will inhibit the debt-servicing ability of companies.

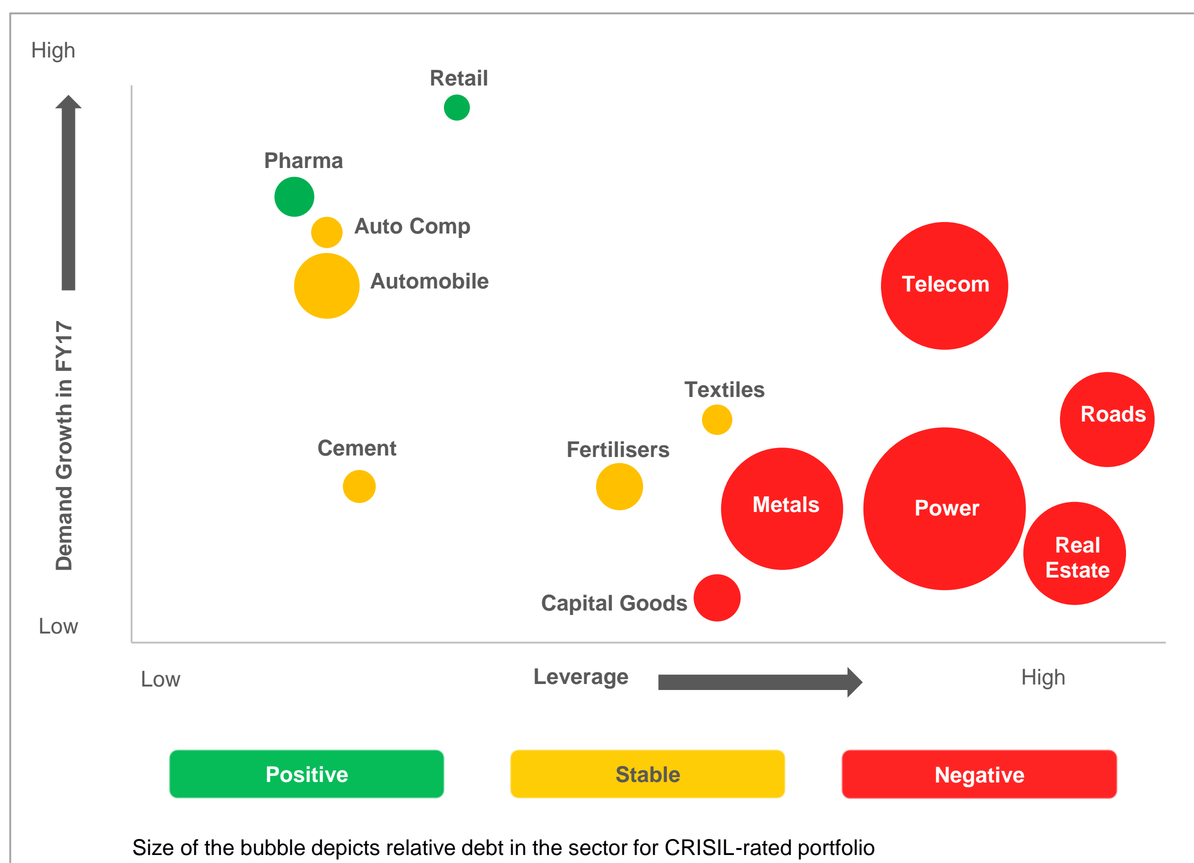
Lower demand from these capital-intensive sectors will translate into slimmer order books for capital goods players. Also, working capital management will remain a key monitorable given the slow project execution in end-user industries.

On the other hand, credit quality is likely to be maintained in both cement and fertilisers. In cement, although there are signs of a demand revival in small pockets, growth will be broad-based only if the real estate sector rebounds and infrastructure spending goes up. Consolidation is likely to deepen in the sector, and possibly trigger rating changes. The fertiliser sector is set to see new investments at a time when corporate capital spending has slowed. Import dependence, enabling investment policy, and availability of pooled gas for new capacities will be key enablers.

What about credit profiles in other sectors?

Unlike investment-linked sectors, the credit outlook of sectors connected to the consumption cycle, and export-oriented ones auto OEMs (original equipment manufacturers), automotive components, textiles, pharma and retail will be stable-to-positive next fiscal. In contrast, we foresee a negative credit outlook for the telecom sector.

Credit quality outlook for fiscal 2017



Source: CRISIL Ratings

In telecom, we expect higher competitive intensity and therefore tariff and margin pressures with the entry of Reliance Jio. Leverage in the sector will increase with accelerating 3G and 4G rollouts by players, and additional spend for acquiring spectrum in the upcoming auctions. While the large incumbents benefit from strong cash flows and high financial flexibility, their strategy towards meeting competitive challenges, and debt contracted for spectrum acquisition will be key monitorables.

Auto OEM players will benefit from improvement in demand and fall in raw material prices; this will also bolster the prospects of automotive components players. However, a broad-based recovery will be contingent upon pick-up in rural demand. Strong balance sheets will support credit profiles despite the sector expected to invest significantly in product development and technology to stay apace with emission and other norms.

Demand in the pharma sector is seen steady. Also, the domestic formulations segment is expected to grow faster than the industry. The impact of regulatory actions by both domestic and overseas regulators will continue to be a key monitorable. Although large players are expected to tap inorganic opportunities, their balance-sheet strength will provide them the flexibility to absorb moderate-sized acquisitions.

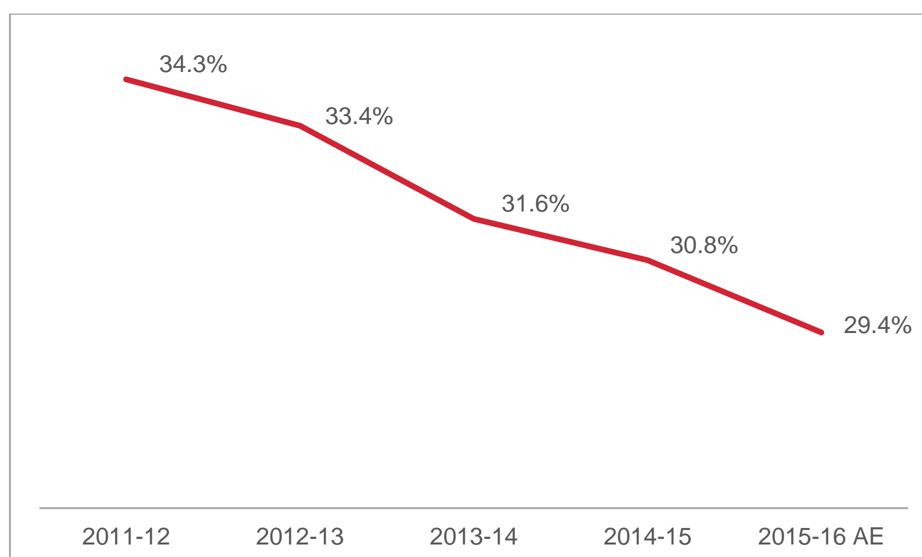
Despite sluggishness in demand, the credit quality of cotton yarn makers is expected to remain largely stable next fiscal. Companies will be able to sustain profitability, which improved in 2015-16 due to greater parity between cotton and yarn prices. Prudent working capital management and muted expansion will support credit profiles.

The organised retail industry will continue to show double-digit growth next fiscal driven by increasing penetration and improving consumer sentiment. Although brick-and-mortar players will keep facing competition online, improving store productivity and proactive adjustment of business models will help them stay in the race. Moreover, strong funding support from deep-pocketed promoters will help players maintain credit quality during the gestation phase.

Moderate pick-up presaged

Weakness in demand and consequent overcapacity across several sectors, high leverage of companies, particularly in the infrastructure and investment-linked sectors, and low efficacy of existing investments have materially impacted the investment climate in India. Not surprisingly, growth in gross fixed capital formation has lagged GDP, declining from 34.3% of GDP in fiscal 2012 to ~29.4% by fiscal 2016.

Gross fixed capital formation as a percentage of GDP has been declining



Source: CSO, CRISIL Research

CRISIL's analysis of capex across key infrastructure[2] and industrial sectors paints a mixed picture of near-term prospects. With continued capacity overhang, lower utilisation rates and inadequate visibility of strong demand pick-up, investments in most industrial sectors will continue to drag. On the other hand, concerted policy push and public spending impetus will to lead to a pick-up in some infrastructure sectors. As a result, we foresee only a moderate pick up in investments overall, with activity limited to a few pockets (roads, telecom, oil refining, renewable energy, power transmission and distribution, fertilisers and coal mining.)

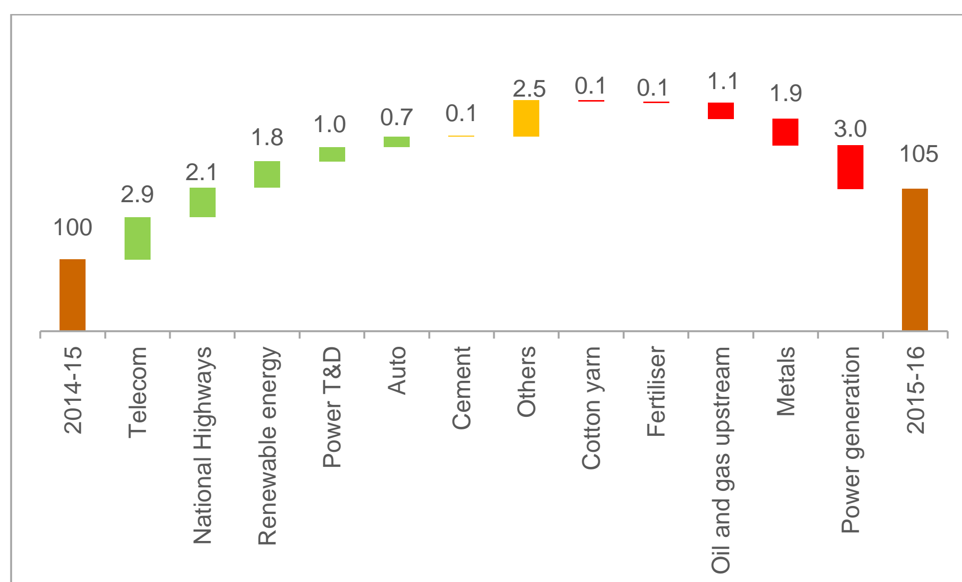
[2] Infrastructure includes airport, power (thermal, renewable, transmission and distribution), urban infrastructure, irrigation, ports, roads, gas pipelines, telecommunications

FAQs

What's the call on investments next fiscal?

CRISIL estimates aggregate investments would grow 5%, driven by infrastructure sectors such as renewable energy, telecom and roads. Excluding these sectors, investments would decline 2%, indicating capex has been fuelled by certain sector-specific drivers rather than a broad-based improvement in sentiment. Companies in the industrial sectors continue to be cautious on committing fresh investments. This is reflected in a 5% decline in overall industrial investments in the current fiscal.

Contribution of various sectors to growth expected this fiscal



Source: CRISIL Research

Note: 2014-15 investment numbers are indexed to 100

Key sectors driving growth in investments this fiscal

Sector	Fiscal year to date trend	Reasons for growth
Renewable energy	▪ Solar: 1.17 GW capacity added in first 9 months; a growth of 178% ▪ Wind: 1.64 GW of capacity added in first 9 months; a growth of 23%	▪ Strong government thrust on renewable energy as indicated by budgetary support, taxation benefits such as accelerated depreciation and state level schemes ▪ Falling capital cost, rising module efficiency, and reduction of constraints in land acquisition and transmission availability for solar power
Roads	▪ Both awarding and execution of national highway projects	▪ Policy reforms such as smoothening of the process for

Sector	Fiscal year to date trend	Reasons for growth
	by has NHAI picked up impressively in fiscal 2016 (46% and 40% year-on-year growth, respectively, in April 2015 - January 2016)	clearances, premium rescheduling, and allowing developers to fully exit their operational road projects two years after commencement of commercial operations ▪ More focus on EPC projects rather than BOT, given leveraged balance sheets of most companies
Telecommunications	▪ Aggregate capex (excluding spectrum) of Bharti, Idea and RCom increased 70% in the 9 months to December 2015	▪ Telecom companies have accelerated investments towards 3G and 4G to attract high-usage data subscribers and tackle imminent competition.

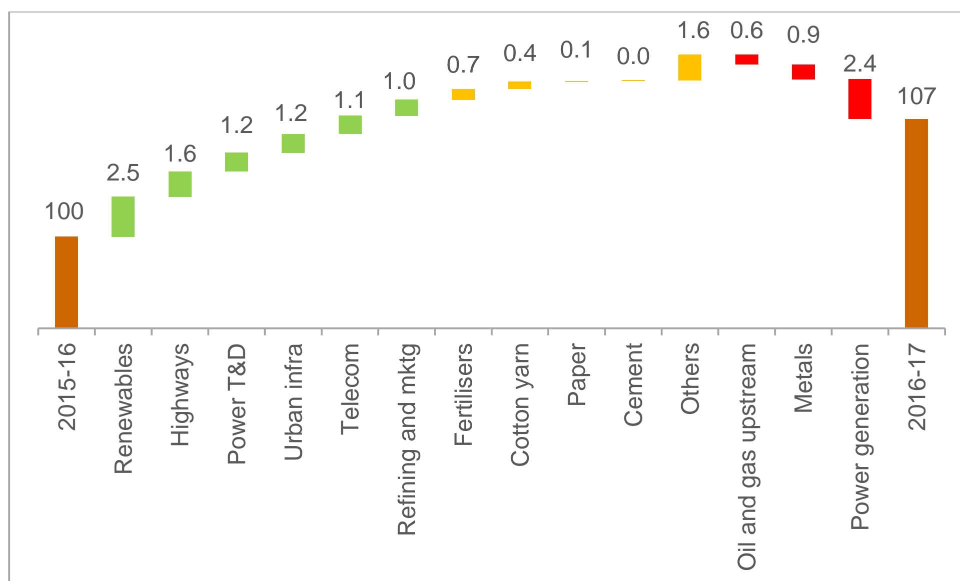
What's CRISIL's forecast on growth in investments next fiscal?

We forecast 7% growth in fixed capital investments, which would be higher than the 5% growth estimated for the current fiscal. Infrastructure investments are expected to lead the way, cranking up 9% growth, compared with a 4% growth projected for industrial investments next fiscal.

Although the picture looks rosy, a closer analysis indicates capex will be limited to a few sectors, just as we have observed in the current fiscal. Industrial investments would decline 3%, if oil refining and marketing and fertiliser-related capital expenditure is excluded. Similarly, without renewable energy and road investments, growth in infrastructure investments would be just 3%.

The muted investment climate is also corroborated by the fact that order flows for construction and capital goods companies (excluding BHEL) have declined 10% year-on-year in the first nine months of this fiscal. Engineering and construction bellwether Larsen & Toubro posted a 13% decline in order inflows for the nine months ended December 2015. While announcing its financial results for the quarter ended December 2015, the company noted that private sector capex is yet to pick up. Other capital goods manufacturers echo this sentiment.

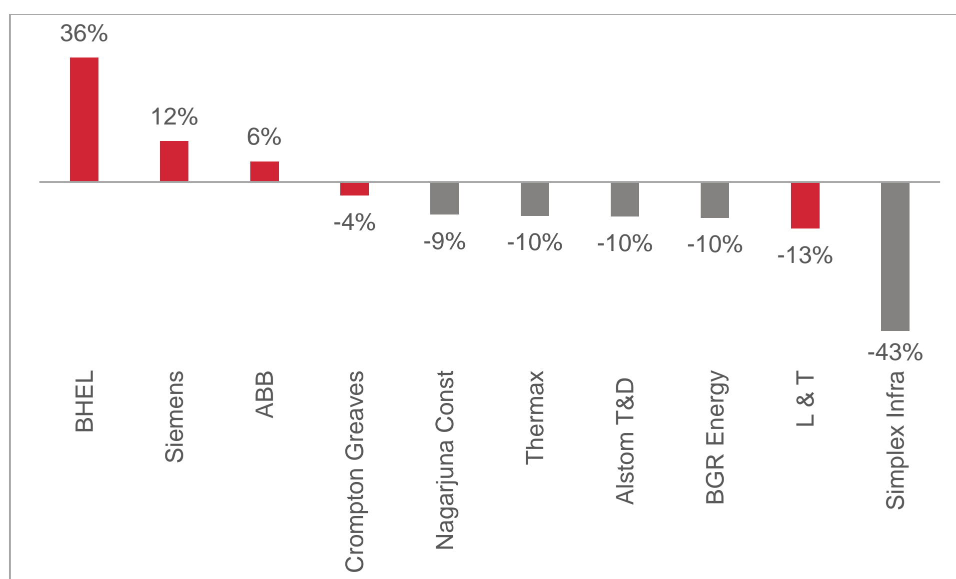
Likely contribution by various sectors to growth next fiscal



Source: CRISIL Research

Note: 2015-16 investment numbers are indexed to 100

Order inflow growth in 9 months of current fiscal still weak for capital goods and construction companies

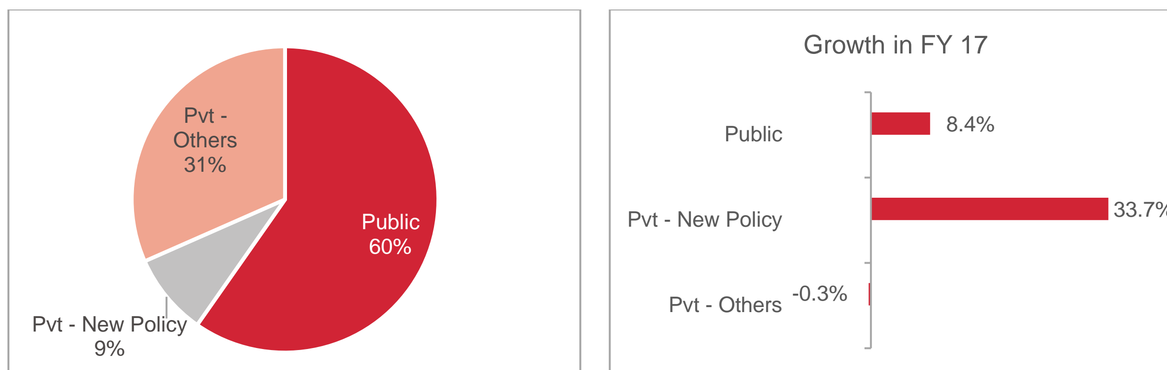


Source: Company reports

What is the trend in private and public investments?

Next fiscal, overall public investment is forecast to grow 8% and private investment by 5%. While the private sector is cautious on industrial sectors, both private and public sector are expected to plonk monies towards infrastructure projects, driven by policy push.

Growth in private sector investments mainly emanating from policy push



Source: CRISIL Research; Note: New policy driven sectors include roads, fertilisers and renewable energy

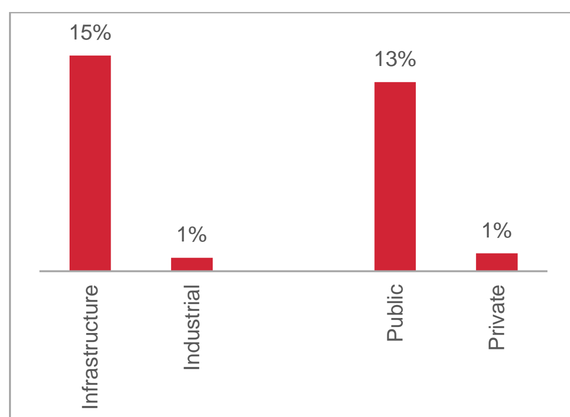
Survey bares surprisingly aggressive investment intention

A CRISIL survey of 61 companies, accounting for about 34% of overall estimated capital expenditure in fiscal 2016, indicates higher optimism on the part of public sector undertakings compared with their private sector counterparts.

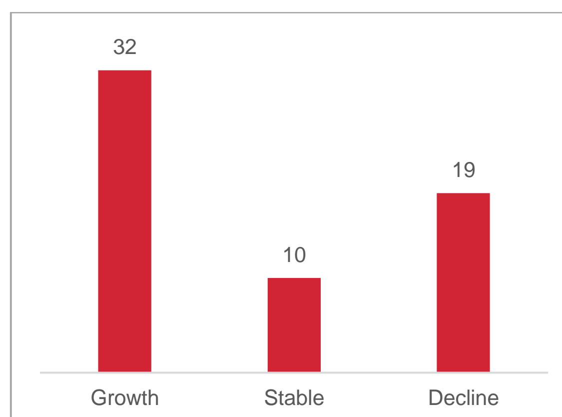
The public sector companies surveyed by CRISIL show they are planning to increase investments by 13% next fiscal. However, given their past track record, we expect actual investment growth to be lower than spelt out at the beginning of the fiscal. Public sector companies with aggressive plans are based in power, refining and marketing, fertiliser and telecom sectors.

In contrast, private sector companies plan to increase capex by a much slower 1% in fiscal 2017. In fact, excluding telecom, private sector companies surveyed by us foresee a 16% decline in capex. These companies do not include road construction and renewable energy players, and therefore the projected capex growth is much lower than our aggregate projections for private sector capex elucidated earlier.

Public companies surveyed foresee strong capex growth



Half of the surveyed companies plan higher capex



Source:CRISIL Research

Note: Survey of 61 companies which contribute to ~35% of capital expenditure in 2016-17

Where are the green shoots in industrial sectors?

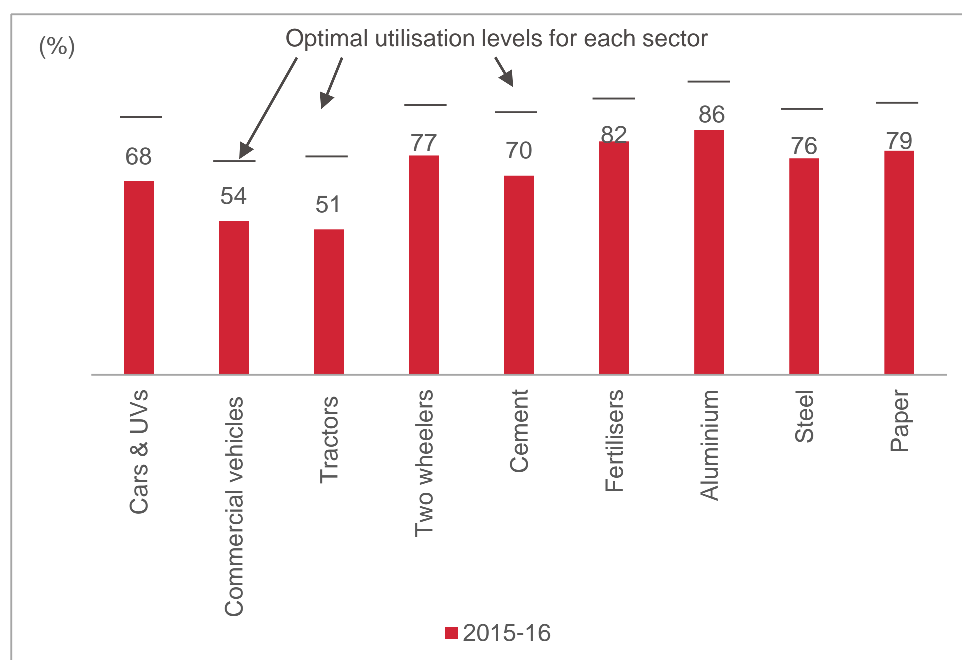
Oil refining is expected to see a sharp spike in investments as public sector companies gear up to meet stricter emission control norms (making BS IV fuel available nationwide by April 2017 and initial investments for BS VI) as well as capacity expansion in their existing refineries.

In the fertiliser sector, Chambal Fertilisers and Rashtriya Chemicals and Fertilisers are setting up new urea capacities because of favourable policy. This is good news for the urea industry, which had been witnessing a rise in imports since no new capacities were added for more than a decade.

In automobiles, though overall capacity utilisation is low, large players in the passenger vehicle and two-wheeler spaces are running at far higher utilisation rates, thus necessitating incremental investments. For example, the utilisation rate of Maruti Suzuki is estimated to be ~96% this fiscal, while for Hero MotoCorp it is at 91%.

Oil and gas exploration companies are, however, likely to pull back because of low oil prices. Overall global exploration and production spending nosedived by 23% in calendar year 2015, and we foresee a further decline in calendar 2016. Global majors such as Chevron, Shell and Petronas have already announced steep cuts, ranging between 15-30%, in their exploration and production budgets for 2016.

Growth to be limited to few sectors given low capacity utilisation levels



Source: CRISIL Research

Which segments in infrastructure will drive investments?

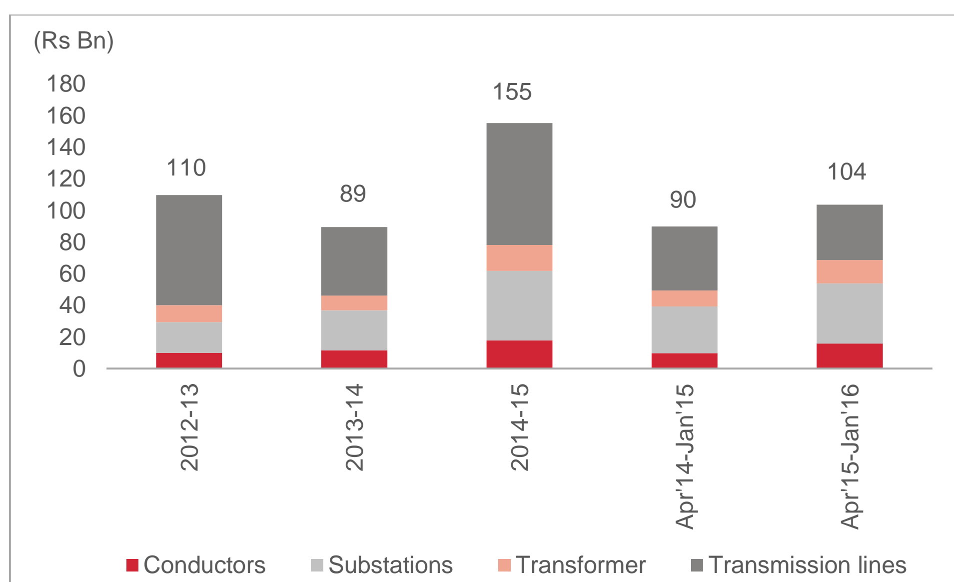
There are essentially three sectoral drivers – power, roads and telecom. Here's a look at them:

1. Power

The power sector alone would account for ~45% of investments in infrastructure, but with a different mix. Investments would be focused on renewable energy and power transmission & distribution rather than thermal power generation. Solar power capacity additions of 5.3 GW are expected next fiscal, which would be double the estimated additions this fiscal. Wind power capacity additions would rise by a relatively modest 16% to 2.9 GW next fiscal. We may also see some advancing of wind power investments because of the proposed halving of accelerated depreciation benefit effective from April 1, 2017, which is expected to impact internal rate of return by 50-100 basis points.

Investments in power transmission and distribution are also expected to grow strongly owing to the government's thrust on improving transmission infrastructure and reducing AT&C (aggregate technical and commercial) losses. Contracts awarded by PowerGrid Corporation of India Ltd (PGCIL) for sub-stations, transformers, conductors, and transmission lines increased by around 15% year-on-year in April-December 2015, indicating momentum in activity.

Increase in PGCIL's tendering activity



Source: Company disclosures

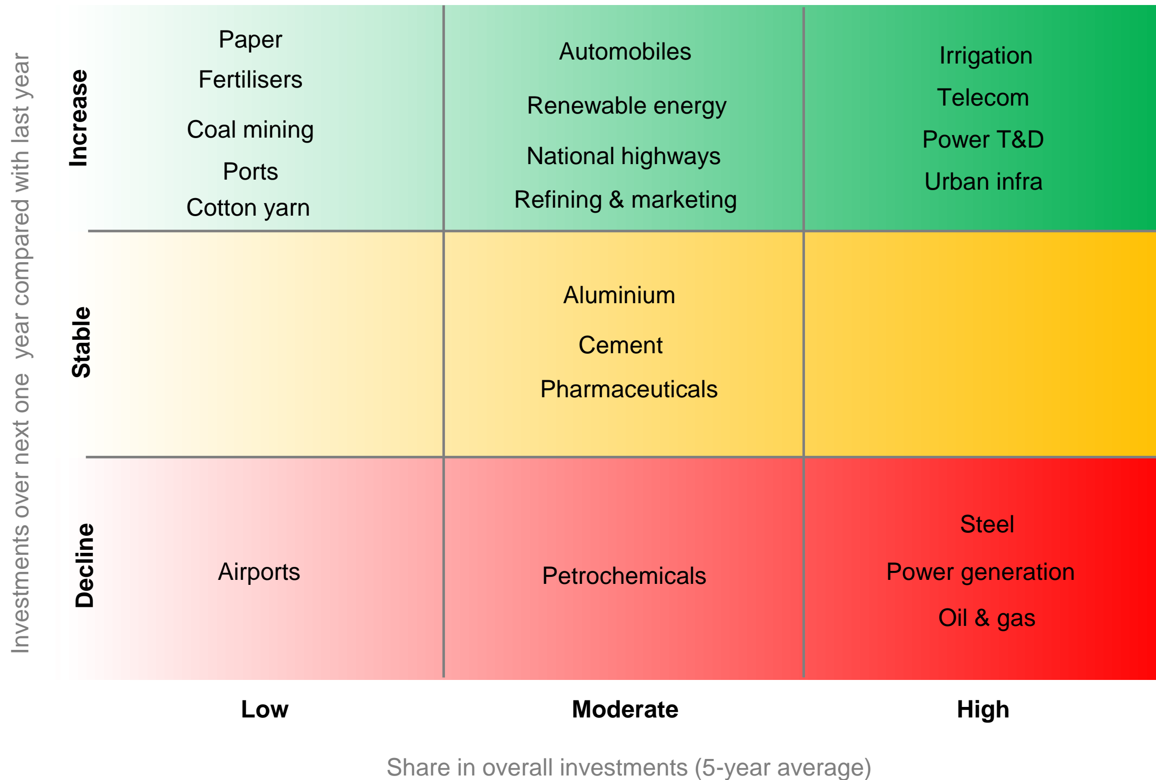
2. Roads

We expect the momentum gained in the current fiscal to sustain next fiscal, too, leading to a 30% growth in investments. Government focus on this space is evident from the 50% increase in total budgetary allocation (including internal and extra-budgetary resources) in fiscal 2017 over the revised estimates for the current fiscal.

3. Telecom

Telecom players are likely to continue to ramp up investments as they scramble to roll out 3G and 4G networks and capture high-usage data subscribers ahead of competition. Regulatory pressures to address call drops would also push players to increase the intensity of investments. We forecast a further 15% rise in investments in fiscal 2017, excluding payment for spectrum acquisition.

Sector-wise investment outlook



Source: CRISIL Research

SECTION THREE

SECTORAL OUTLOOKS

As provisioning eats up profit, 9-10 PSBs to post losses

Of all the sectors of the economy, banking is in the hardest place today, reeling as it is from the blowback of accumulation of bad loans and their inadequate recognition in the past. Stress also multiplies because the credit outlook for investment-led sectors continues to be weak. This is reflected in CRISIL's debt-weighted credit ratio, which fell to a three-year low of about 0.27 in the first half of the current fiscal, implying quantum of debt downgraded in India Inc has exceeded the quantum upgraded in the period. Today, nearly a quarter – 24% to be exact – of the total loans of banks, are exposed to high-risk, or vulnerable, sectors.

Consequently, we expect the following six developments to occur:

- As much as Rs 2.1 trillion of stressed assets in the large corporate portfolio of banks could slip to non-performing assets (NPAs) by the end of next fiscal
- Weak assets in the banking system will rise to 8.9% by end of next fiscal
- Net interest margin, or NIM, to come under pressure and dip by ~10 bps for PSBs
- Provisioning cost of PSBs could equal or surpass their pre-provisioning profits
- Tier I capital raising requirement of PSBs to increase to Rs 1.7 trillion till 2019 from the earlier estimate of Rs 1.3 trillion and therefore the government's commitment under the Indradhanush plan won't be sufficient
- CRISIL rating floor for PSBs has been lowered by a notch to A+ from AA-

FAQs

What is CRISIL's estimate on weak assets by March 2017?

While deterioration into non-performing assets (NPAs) was high over the first half of the current fiscal, the pace increased further because of the asset quality review undertaken by the Reserve Bank of India (RBI) in the third quarter of the year. Stressed accounts to be recognised by banks as NPAs as a result of this review are estimated at ~Rs 1.5 trillion for the third and fourth quarters of the current fiscal.

CRISIL foresees around ~Rs 2.1 trillion of corporate stressed assets (from the top 100 exposures of all banks -- *we will call them the 'Corporate 100' here*) turning NPAs between January 2016 and March 2017. This includes stressed accounts that would be recognised as NPAs in the last quarter of this fiscal as part of RBI's asset quality review.

Here's how we see the stressed asset math for the *Corporate 100*:

- NPA in one bank, but not in others — Rs 1.4 trillion
- Assets identified as stressed but not currently NPA — Rs 400 billion
- Assets identified as stressed among restructured standard assets — Rs 300 billion

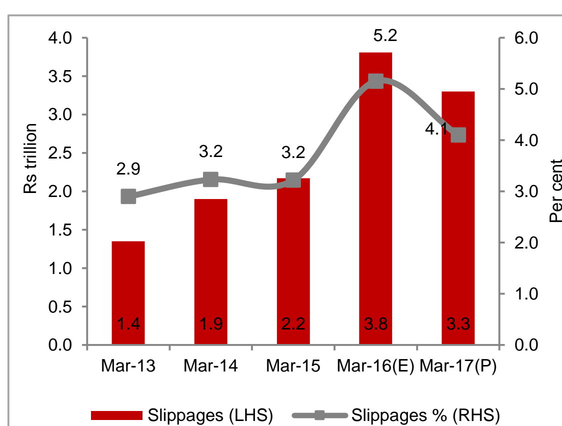
Resulting in

- Total stressed assets that could slip into NPAs from the Corporate 100 — Rs 2.1 trillion

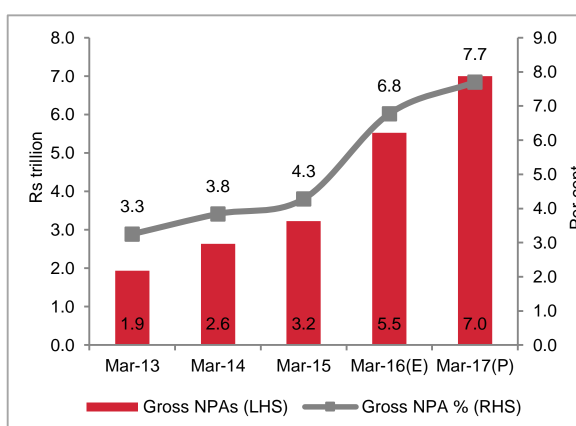
Such assets in the Corporate 100 as a percentage of total corporate advances, therefore, are seen at 5.5%.

Given the increased slippages from large corporate accounts, we expect overall slippages in the banks' portfolio to remain high at 4.1%, or Rs 3.3 trillion, for the next fiscal, and gross NPAs to increase to 7.7%, or Rs 7 trillion. For PSBs, we expect the NPAs to increase to 9.8% or Rs 6.2 trillion.

Slippages to remain high



Gross NPAs to continue to rise

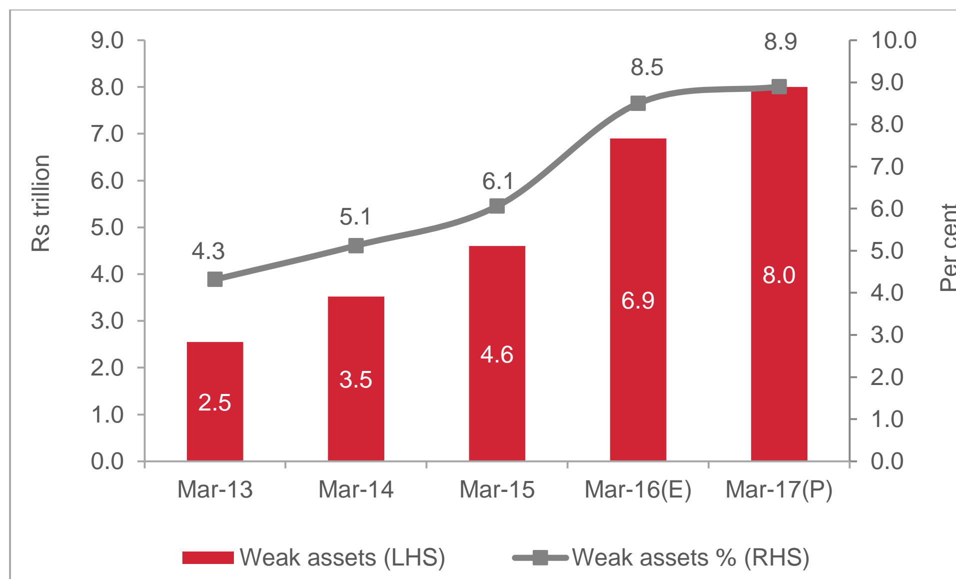


Source: CRISIL Ratings

Overall weak assets of banking system will touch a high of 8.9% or Rs 8 trillion by the end of next fiscal. The PSBs will be worse hit with weak assets increasing to 11.3% or Rs 7.2 trillion.

To calculate weak assets, CRISIL used to add 35% of restructured standard accounts (RSAs), 75% of security receipts invested by banks and 15% of assets structured under 5:25 scheme, to the reported NPAs. Given the weakness we are seeing in the corporate sector, we now estimate that 40% of RSAs could slip into NPAs and hence the weak assets definition is changed to take this into account.

Weak assets to increase further

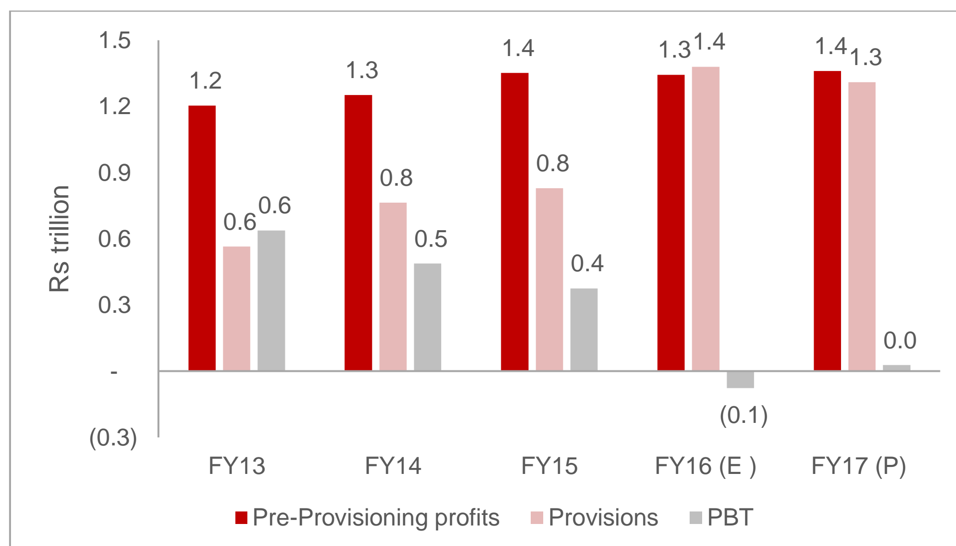


Source: CRISIL Ratings

What's the impact of rising provisioning? Will banks post losses?

The spike in provisioning will neutralise the profits of a number of PSBs – it will equal pre-provisioning profit in both the current and next fiscals for public sector banks as a whole. Close to 7% of the PSB loan book will cease to generate income between fiscals 2015 and 2017 because of slippage to NPAs.

Provisions will surpass pre-provisioning profit of PSBs



Source: CRISIL Ratings

Implementation of the marginal cost lending rate, or MCLR, regime will also impact yields. This, however, could be partially offset by deploying a portion of excess statutory liquidity ratio (SLR) holdings into better-yielding short-term loans (with the revised RBI guidelines permitting use of 3% additional

SLR in liquidity coverage ratio (LCR) computation, reducing the need to maintain higher excess SLR) and lowering of cost of funds as deposits get re-priced lower to factor in the rate cuts done in in the current fiscal.

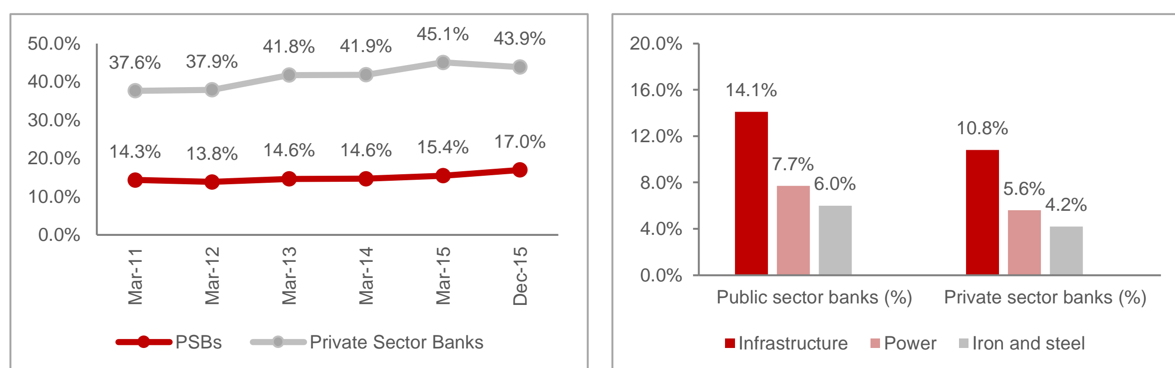
The impact of the UDAY scheme for discoms will be quite neutral next fiscal. While it will lower yields by ~ 3.5% when loans are converted to bonds, this will be pretty much offset by the write-back of provisions for discom loans restructured.

Provisions as a proportion of total assets will touch a high of 1.6% this fiscal, and will remain at elevated levels in the next fiscal because of continued high level of slippages, ageing of NPAs and fresh provisioning towards strategic debt restructuring (SDR) accounts.

As a result, of the 26 PSBs, as many as 9-10 could report losses this fiscal and the next, while others would post low profits.

For private banks, what will save the blushes are revenue diversity, lower exposure to vulnerable sectors and higher proportion of fee income to total income compared with public peers.

Higher share of retail advances in pvt banks… … lower exposure to vulnerable sectors



Source: CRISIL Ratings

What will be the impact on NIM?

We see net interest margin (NIM) declining by around 10 bps for PSBs next fiscal because of the impact of slippages, the new MCLR regime, and the UDAY scheme to revive discoms. The offset will be provided by lower cost of deposits on account of repricing of deposits for rate cuts done this fiscal. Net-net, this will cull NIM by 10 basis points (bps) for PSBs.

Here's how we see the impact on NIMs panning out:

- *Negative impact*
  - Non-recognition of income on incremental NPAs: 6 bps
  - Lower yields on discom loans under UDAY scheme: 5 bps
  - Implementation of MCLR: 10 bps

- *Positive impact*
    - Lower cost of deposits as they get repriced: 11 bps
- *Net impact* on NIM: ~10 bps

How does the terrain look for private banks?

- Private banks will outpace their public peers in terms of growth, and will be relatively unscathed because of strong capitalisation and revenue diversity; they have a much bigger share of the granular retail segment, which formed ~44% of overall advances as on December 2015, compared with ~17% for PSBs.
- Private banks also have lesser exposure to cyclical and vulnerable sectors, and their credit-appraisal practices are far more stringent with focus on strong collaterals. They also prefer taking shorter-term, non-fund-based exposure to the risky sectors.
- Additionally, private banks enjoy relatively higher fee income -- 28% of total income – compared with 18% for PSBs.
- As a result, CRISIL expects the earnings of private banks to remain healthy next fiscal banks will outpace their public peers in terms of growth, and will be relatively unscathed because of strong capitalisation and revenue diversity; they have a much bigger share of the granular retail segment, which formed ~44% of overall advances as on December 2015, compared with ~17% for PSBs.

How much capital will the banking sector need?

Capital-raising will be the biggest challenge for PSBs going forward. Only 10 out of 26 of them may have some capital cushion over the regulatory minimum by end of next fiscal, compared with 25 out of 26 as of end of fiscal 2015.

The banking system will require Rs 3.4 trillion total capital till fiscal 2019 with PSBs requiring a lion's share of Rs 2.6 trillion.

Total capital needed to meet regulatory norms up to 2019 (Rs trillion)	CET 1	AT 1	Total Tier 1	Tier 2	Total Capital
Public sector banks	0.85	0.85	1.7	0.9	2.6
Private sector banks	0.23	0.07	0.3	0.5	0.8
Banking system	**1.08**	**0.92**	**2.0**	**1.4**	**3.4**

Despite PSBs witnessing a sharp fall in profitability, their overall capital requirement has not increased compared with our earlier estimate because of slower-than-expected credit growth. For private banks, overall capital requirement has fallen compared with earlier estimate given the expectation of slower growth while maintaining profitability. *Ceteris paribus*, ~Rs.1.3 trillion additional capital would have been required if credit growth till 2019 was higher at the earlier expectation of 12% for PSBs and 24% for private ones, instead of the present expectation of 9% and 21%, respectively.

So what's the capital math for PSBs?

While the overall capital requirement for PSBs between 2015 and 2019 hasn't changed (~Rs 2.6 trillion), the need for equity capital and overall Tier 1 capital has increased compared with our earlier estimate (*see table below*).

Total capital requirement of PSBs till 2019 to meet regulatory requirements (Rs trillion)	CET 1	AT 1	Total Tier 1	Tier 2	Total Capital
Previous estimate	0.45	0.85	1.3	1.3	2.6
Revised estimate	0.85	0.85	1.7	0.9	2.6

** These estimates factor in the benefits derived from revised regulations that afford the inclusion of Deferred Tax Assets, revaluation reserves and foreign currency translation reserve in Common Equity Tier 1, or CET 1, capital. This adds about ~Rs 370 billion to capital. And release of capital from the implementation of power sector reforms under the UDAY scheme will add another ~Rs 120 billion.*

The government has infused ~Rs 200 billion equity capital and PSBs have raised Rs 60 billion AT 1 capital and Rs 140 billion Tier 2 capital in this fiscal and will require further Rs 1.44 trillion Tier 1 capital and Rs 760 billion Tier 2 capital till end of fiscal 2019.

The regulatory relaxation, allowing a part of revaluation reserves, deferred tax assets and foreign currency translation reserves as CET1 has helped ease the pressure, but equity infusion by the government remains critical.

To be sure, as of now, with credit demand not expected to surge, we see the banking system adequately placed to meet the minimum regulatory capital norms for next fiscal.

Credit growth is likely to see a slight pick-up to 11% next fiscal compared with ~8% this fiscal. Private banks will gain market share by logging faster credit growth of over 20%, while the PSBs continue to grow at a slower pace of ~9%.

In the context, what's CRISIL's rating call?

The ability of PSBs to generate capital from internal accrual has significantly diminished, as also from external sources because of poor valuations and low market appetite as of now for higher-risk Additional Tier 1, or AT1, instruments. So, while capital support from the government is just sufficient to meet the minimum regulatory threshold for next fiscal, the remaining capital promised under the Indradhanush plan till fiscal 2019 won't be.

Overall, the cushion in Tier 1 capital is low for PSBs, which leaves them vulnerable to external shocks.

This has resulted in the lowering of CRISIL's rating threshold of corporate credit rating for PSBs to A+ from the current AA-. The last time CRISIL rated a PSB in A category was in 2003.

Automobiles

RATING OUTLOOK
Stable

Low rates and fuel prices, and rising income triggers

OVERALL DEMAND FORECAST

We expect more broad-based growth in sales volume compared with last year as consumer sentiment improves with faster income growth -- because of the Seventh Pay Commission and One Rank One Pension payouts -- and cost of ownership falls on softening rates and fuel prices.

But monsoon remains the swing factor. The extent of pick up in domestic sales of motorcycles, light commercial vehicles (LCVs) and tractors next fiscal would hinge on the quantum, timing, and distribution of rains.

Adequate rains will mean:

- Around 10% rise in domestic sales of two-wheelers, compared with 2-4% expected this fiscal. Rural areas account for 45% of motorcycle sales.
- 11-13% rise in passenger vehicle (PV – cars and utility vehicles) sales, a touch more than what's forecast for this fiscal
- 7-9% rise in commercial vehicle (CV) sales compared with ~5-7% expected in the current fiscal

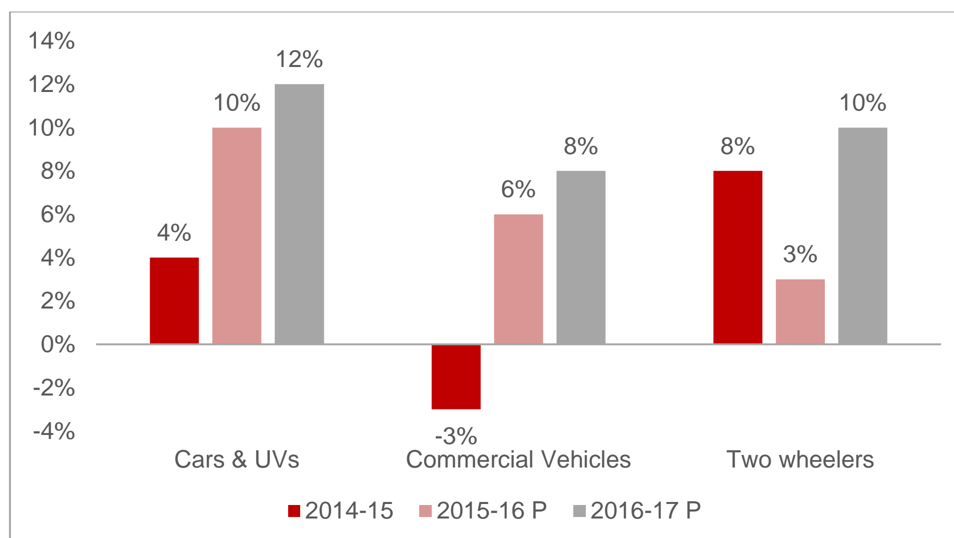
FAQs

What is the sales outlook for different segments?

The compact segment should grow the fastest in the PV segment, with premium hatchbacks (positioned between entry-level hatchbacks and sedans) increasingly catching the fancy of buyers. In CVs, as replacement demand stabilises in medium and heavy commercial vehicles (M&HCVs), growth will moderate to mid-teens from over 20% seen in the past two years. By contrast, LCV sales will grow at 4-6% after three years of decline on growth in private consumption and easier financing availability.

In motorcycles, we expect the premium segment to grow the fastest, while the share of the executive segment (62% of motorcycles sales in fiscal 2015) would continue to shrink due to shift from lower-end executive motorcycles to economy variants, and shift from higher-end executive motorcycles to lower-end premium ones. As for exports of two-wheelers, challenging conditions are expected to persist with muted demand from key importers in Africa and Latin America.

Broad-based growth in domestic automobiles sales volume



P: Projected

Source: Society of Indian Automobile Manufacturers, CRISIL Research

How has the Budget been for the sector?

The Budget's focus on rural income and infrastructure development is structurally positive for the automobiles segment. The levy of infrastructure cess (ranging between 1-4%) on all vehicles and additional 1% luxury tax (on vehicles priced over Rs 1 million) would impact sales a bit, but lower fuel prices and interest rates would soften the impact for consumers.

What is the profitability story?

Ebitda margins of the sector is expected to remain stable as soft raw material prices will offset higher employee cost, promotional and selling costs, product development and technology upgradation cost, and expiry of excise exemption available to original equipment manufacturers (OEMs) in some states. With increasing indigenisation and prudent hedging of foreign exchange exposure, risks associated with currency volatility have been reducing for most large OEMs. However, the profitability of players such as Hyundai Motor India Ltd and Maruti Suzuki India Ltd will remain partly susceptible to currency fluctuations due to their large import content, royalty payments and unhedged forex exposure. In 2015-16, operating profitability of OEMs increased across categories helped by a sharp decline in raw material prices and higher volume in certain segments leading to healthy cash generation.

What about business risk profiles?

Substantial change in market share and sustenance of operating profitability in an increasingly competitive environment would be key to improvement in business risk profiles of OEMs. Support from component-suppliers in the form of product development and cost-effective technology has also increased in the recent past. OEMs will continue to go for new launches at attractive price points next fiscal to capture market share in the fast-growing product categories, though we do not expect significant changes in the overall market share of most OEMs.

What about capital spend and debt metrics?

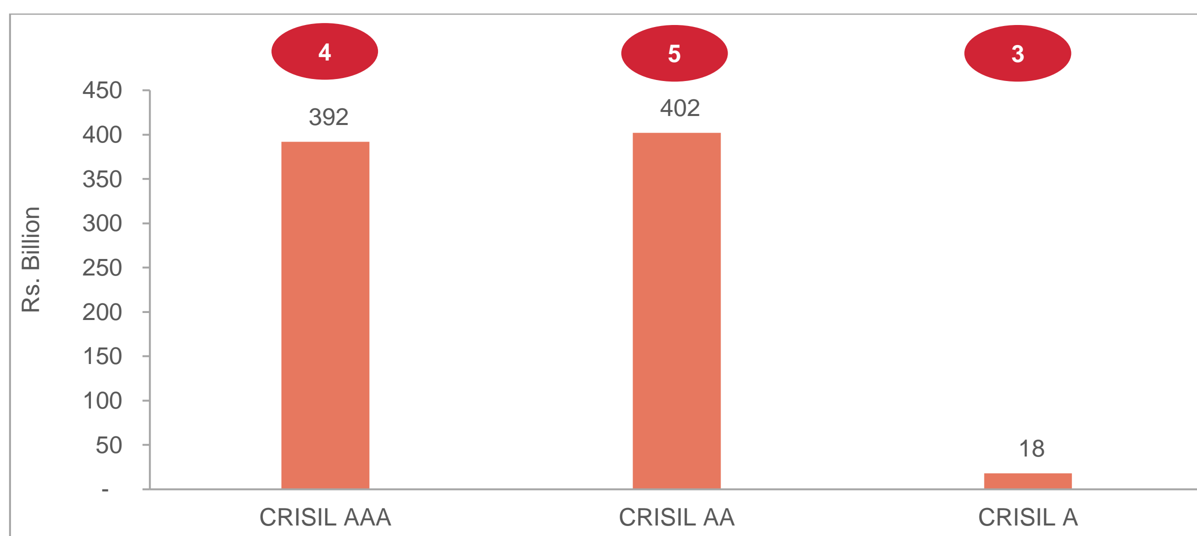
OEMs need to keep updating technology and invest in product development to stay competitive and adhere to emission norms, irrespective of demand cycles. This will mean continuous and sizeable investments over the medium term. For 12 large CRISIL-rated OEMs, we believe capex intensity will increase over next three years with spending of about Rs 450 billion towards product development, research and capacity addition compared to Rs.370 billion over previous three years. Large players, except Tata Motors Ltd, are likely to fund their capex mostly with internal cash generation and surplus cash piles. As a result, debt metrics are expected to remain comfortable. However, for mid-sized OEMs like Fiat India Automobiles Ltd (Fiat) and Daimler India Commercial Vehicles Private Ltd (Daimler), reliance on debt would be relatively higher. Strong parental backing for both Fiat and Daimler, though, will help support their growth plans.

In the context, what's CRISIL's rating call?

Strong balance sheets and large liquid surpluses as well as improving demand scenario have helped OEMs maintain their credit profile in recent times. This is also reflected in the stability of CRISIL-rated OEMs in the past 12 months, except for the Volkswagen Group whose rating was downgraded due to weakening credit profile of its parent. Atul Auto Ltd's rating was upgraded due to sustained improvement in its market position and healthy operating efficiency.

Going forward, CRISIL does not anticipate sharp changes in the ratings of automobile OEMs, owing to better demand, continued new launches to protect and grow market share, and comfortable cash flow positions. OEMs will also benefit from low working capital-intensive operations. Although demand for motorcycles and tractors would be susceptible to the monsoon, credit profiles will remain stable owing to strong financial risk profile of these OEMs. Rating changes for medium-sized players like Piaggio Vehicles Pvt Ltd will be a function of change in their market share, successful ramp up of capacities and impact of sizeable capex on their financial risk profile.

Distribution of aggregate debt in 12 CRISIL-rated automotive OEMs



Source: CRISIL Ratings

How to read the above chart: Bars indicate aggregate debt in a particular rating category for CRISIL-rated automobile companies, while circles show the number of companies in that category.

Ratings outlook distribution	Positive (-)	Stable (12)	Negative (-)

Credit outlook for select CRISIL-rated automobile companies

1. Maruti Suzuki India Ltd (CRISIL AAA/Stable/CRISIL A1+)

Maruti Suzuki is the market leader in the domestic passenger car industry, with a total installed capacity of 1.5 million units per annum. The company currently has 11 models with over 150 variants across segments.

It has effectively leveraged the technological expertise and wide product range of its parent, Suzuki Motor Corporation, to introduce at least one model a year over the past four years, besides several remakes of older models. Given the company's strong product portfolio, distribution network and regular product launches, CRISIL believes the company will maintain its market leadership over the medium term. Maruti Suzuki's operating profitability improved from 7% in 2011-12 to 13.4% in the last fiscal, and is expected to improve further in this fiscal due to higher indigenisation levels and continuous cost-reduction efforts. The company's financial profile will remain strong because of steady cash accrual and large liquid surplus, which will be sufficient to fund its capex and incremental working capital requirement.

CRISIL takes a consolidated approach (Maruti Suzuki and its subsidiaries) to arrive at the rating for Maruti Suzuki.

For the nine months ended December 31, 2015, Maruti Suzuki reported, on a standalone basis, a profit after tax (PAT) of Rs 34.4 billion on an operating income of Rs 424.4 billion.

2. Hero Motocorp Ltd (CRISIL AAA/FAAA/Stable/CRISIL A1+)

Hero Motocorp, India's largest motorcycle manufacturer with a market share of 52.9% in the segment and 40.2% in two-wheelers overall, has a production capacity of 7.65 million units per annum.

A strong product portfolio in the executive segment and a well-entrenched distribution network has helped Hero Motocorp remain market leader over the years. Its financial risk profile is expected to remain strong despite a large capex outlay (Rs 27 billion over next two years) due to healthy cash generation and substantial liquid surplus (Rs 25 billion as on March 31, 2015). However, Hero Motocorp will continue to face intense competition from peers. To sustain its leadership position in the two-wheeler market, we expect the company to launch new models on a steady basis, continuously invest in R&D, and increase its presence in the premium and exports segments.

CRISIL takes a consolidated approach (Hero Motocorp and its subsidiaries) to arrive at the rating for Hero Motocorp.

For the nine months ended December 31, 2015, Hero Motocorp (on standalone basis) reported PAT of Rs 23.2 billion on an operating income of Rs 210.8 billion.

3. Mahindra & Mahindra Ltd (CRISIL AAA/Stable/CRISIL A1+)

Mahindra & Mahindra (M&M) is one of the world's leading tractor manufacturers (capacity of 371,000 units per annum). It also manufactures M&HCVs, LCVs, three-wheelers, two-wheelers and PVs. In India, M&M is a market leader in tractors (market share of 40.3% last fiscal) and utility vehicles (UVs).

The company will be able to maintain its market position on the back of a well-diversified product portfolio, an established network and strong brands. In UVs, M&M's market share declined to about 37% in the last fiscal from 55% in 2011-12 due to the emergence of the UV1 segment (length <4400 mm) that has been driving overall UV sales in the past two years. CRISIL believes M&M will be able to maintain its market share at current levels, driven by a slew of new launches in the UV segment scheduled for the medium term.

Continued positive cash flows should help the company maintain a strong financial risk profile, given its moderate capex (around Rs 75 billion) and investment (around Rs 25 billion) requirements over the medium term. CRISIL believes M&M will maintain adjusted gearing of less than 0.75 times. The company's performance, though, will remain exposed to the cyclicality inherent in the tractor and automobile businesses.

CRISIL takes a consolidated approach (M&M and its core ventures in the automotive, agriculture, tractor and two-wheeler segments) to arrive at the rating for M&M.

For the nine months ended December 31, 2015, M&M reported a PAT of Rs 26.3 billion on an operating income of Rs 286.96 billion.

4. Bajaj Auto Ltd (CRISIL AAA/Stable/CRISIL A1+)

Bajaj Auto is the second-largest player in the Indian motorcycle segment, with a 17.7% share.

The company's position in the domestic motorcycle market is reinforced by a strong brand name, a diversified product portfolio, and leadership in the economy and premium segments. It is also the largest exporter of two-wheelers from India, accounting for nearly 68% of motorcycle exports during April 2015 to December 2015. To sustain its overall business profile, the company will have to increase its share in the high-volume domestic executive segment.

Bajaj Auto will also retain its dominant market share in the high-margin three-wheeler passenger-carrier segment. The company is expected to maintain its robust financial risk profile as well due to

low gearing, healthy cash generation, sizeable investment portfolio (Rs.109.6 billion as on September 30, 2015) and moderate capital spending needs.

CRISIL takes a consolidated approach (Bajaj Auto and its subsidiaries) to arrive at the rating for Bajaj Auto.

For the nine months ended December 31, 2015, Bajaj Auto (on standalone basis) reported a PAT of Rs 28.5 billion on an operating income of Rs 172.76 billion.

5. Tata Motors Ltd (CRISIL AA/ Stable/CRISIL A1+)

Tata Motors, one of India's largest automotive companies, manufactures PVs, multi-utility vehicles and CVs. The company's market position is healthy due to its dominance in M&HCVs and LCVs. Tata Motors acquired Jaguar Land Rover Automotive PLC (JLR) for $2.3 billion in June 2008. In the last fiscal, JLR accounted for 83% and 95% of Tata Motors' consolidated revenue and earnings before interest, tax, depreciation, and amortisation (Ebitda), respectively. CVs comprised 70% of Tata Motors' domestic revenue, and passenger cars the rest.

The company's operating performance is expected to remain comfortable over the medium term, driven by improving demand for CVs in India and the company's globally-diversified footprint. After a compound annual growth rate of 14% over the past three years, JLR's volume grew at 9% for the 10 months ended January 2016. Volume slowdown in China, its major market, has been partially offset by growth in the UK, North American and European markets. CRISIL believes that JLR is likely to sustain its growth momentum over the medium term, driven by its expanded portfolio, track record of successful product launches and diversified geographical footprint.

Despite sizeable capex (Rs 400-500 billion per annum) that will be funded through internal cash generation and debt, the company's capital structure is expected to remain comfortable. The capex, largely in JLR, is modular; in case of volume slowdown due to weak macroeconomic scenario, JLR may prudently defer a part of its capex. The success of this large capex and new product launches will remain a key monitorable for the company's credit profile.

CRISIL takes a consolidated approach (Tata Motors and its subsidiaries) to arrive at the rating for Tata Motors.

For the nine months ended December 31, 2015, Tata Motors reported a PAT of Rs 58.5 billion on an operating income of Rs 1,948.8 billion.

Automotive Components

RATING OUTLOOK
Stable

Steady revenue growth, cost gains ahead

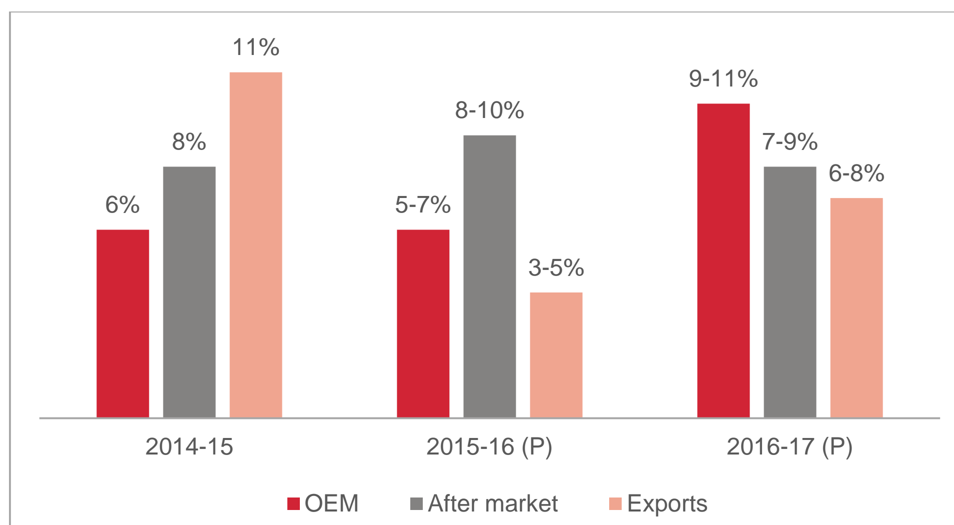
For India's automotive component makers, revenue growth is likely to accelerate to 8-10% in the next fiscal from an expected 5-7% in the current fiscal, driven by higher off-take from original equipment manufacturers (OEMs) and steady replacement (after market) demand, even as exports are expected to pick up only gradually.

Two straight monsoon failures dented rural demand in this fiscal, impacting volume offtake in rural dependent segments such as tractors, motorcycles and light commercial vehicles (LCVs). Exports, too, have witnessed a slowdown in this fiscal due to lower growth in the US and some European markets, including Germany. Nevertheless, strong growth in medium and heavy commercial vehicles (M&HCVs) and healthy recovery in the passenger vehicles (PV) segment will partly offset slowdown in other segments.

Here's how we see the broad trend next fiscal:

- Sales growth to domestic OEMs will be propelled by continued fleet replacement in the M&HCV segment and higher offtake in the PV and scooters segments driven by an improvement in urban consumer sentiment and new model launches. However, the extent of recovery in rural dependent segments like motorcycles, LCVs and tractors would be critically contingent on a conducive monsoon - but the slowdown period has created a significantly low base, paving the way for healthy growth in the near term. Higher volume growth will be partly offset by limited growth in realisations on account of passing of benefits of benign raw material costs to OEM clients.
- Exports will be driven by growth in European PV and commercial vehicle (CV) sales, a slower pace of decline in the US CV production and increasing penetration in south-east Asian markets. Encouragingly, India's exports of technically complex components like engine and drive transmission and steering parts continues to see steady demand despite a slowdown in offtake of other components.
- Replacement demand, too, will continue to rise at a healthy pace of 7-9% y-o-y, amid improving utilisation rates of CVs, which will spur replacement of components by transporters.

OEM segment to drive growth



Source: CRISIL Research

FAQs

Are there any differences in growth outlook by product categories?

Stricter regulatory enforcements in respect of safety and emission standards would give a fillip to the growth rates of players focusing on products catering these requirements. Some noticeable trends include:

- Increasing penetration of anti-lock braking system (ABS) in PVs and M&HCVs and combined braking system (CBS) in two wheelers
- Increasing usage of airbags
- Upgradation in engine components like fuel injection system and exhaust after-treatment systems
- Increasing usage of turbochargers in smaller petrol engines
- Increasing usage of electronic control units/sensors in vehicles

In addition, players catering to convenience driven products such as automatic manual transmissions and navigation systems are also likely to outperform.

What is the forecast on profitability?

Earnings before interest, tax, depreciation and amortisation (Ebitda) margin is expected to improve by almost 100 basis points (bps) in this fiscal, but witness limited improvement next fiscal as steel prices are projected to increase, assuming the minimum import price (MIP) continues beyond the six-month period. Companies with net exports will continue to benefit from the depreciation of the Indian rupee. However, working capital levels for large exporters will continue to remain higher than in the domestic market, due to the larger credit period in the export markets.

How much is riding on the investment cycle?

Automotive component firms improved their financial discipline and balance sheets between 2012-13 and 2014-15 by pruning capital expenditure (capex) and sweating assets. Uptick in domestic OEM demand (which accounts for two-thirds of component demand) and gradual traction in exports should lead to a revival in capex, especially in the second half of 2016-17. We expect suppliers to PVs and two-wheelers, who are operating at high utilisation rates, to lead the capex cycle. Suppliers to the CV segment -- barring those that managed to bag export orders in the recent past -- still have surplus capacity and are most likely to postpone their capex. Post 2016-17, the investment cycle will entail fresh debt addition. While the debt to Ebitda ratio of automotive component suppliers is likely to increase during the capex phase, the same will correct supported by contribution from the added capacity over the next 2-3 years.

What has the Budget done for the sector?

The budget had no specific proposals directly impacting the automotive components sector. However, the focus on rural incomes and infrastructure development is structurally positive for the automobiles sector.

In the context, what is CRISIL's ratings call?

The presence of mainly Tier 1 automotive-component companies leads to a relatively high concentration in 'A' and above rating category (~17% or 60 out of the 363 CRISIL-rated players; *refer to chart*). These companies have a healthy business risk profile that benefits from diversified revenue and customer profiles, strong associations with leading OEMs and well-managed balance sheets. Further, Tier 1 component makers (which supply directly to OEMs) also outsource part of their requirements to Tier 2 component makers; thereby shifting part of the capital spending down the value chain. This to some extent makes up for thinner margins for Tier 1 component players compared with Tier 2 component manufacturers.

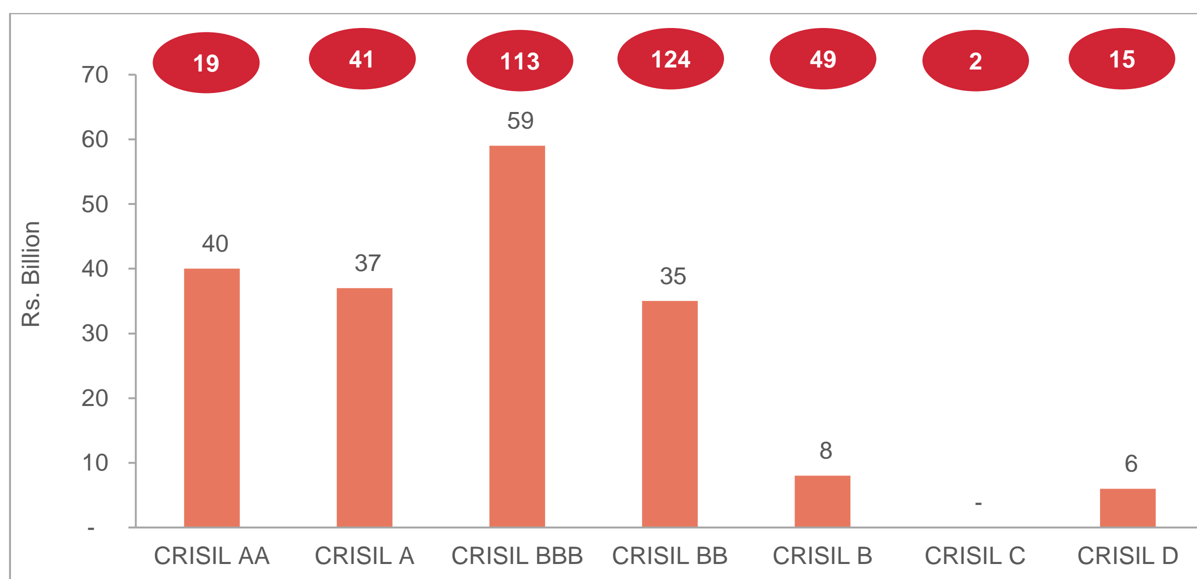
In this fiscal, the sector's credit quality continues to improve with the credit ratio inching close to 2 times from 1.67 times in the last fiscal. Key rating movements (in AA category) include upgrades of Brakes India Pvt Ltd and Gabriel India Ltd, and revision in outlook to 'Positive' for Fleetguard Filters Pvt Ltd.

We believe suppliers to PVs, scooters, M&HCVs, and large exporters are likely to benefit more from the demand uptick in the coming fiscal. Better cash generation will be channelled to support capital investments so as to not significantly stress balance sheets. Hence, despite the improving operating performance, the extent of capex intensity will regulate the pace of upgrades in the near term. On the other hand, players with concentration of revenues to the M&HCV segment are more likely to witness positive rating bias on the back of demand revival and sufficient capacity, obviating capex requirement in 2016-17. Suppliers with segment concentration and exposure to LCVs may face challenges, and continued strain on their credit profiles.

Over the medium term, in view of new regulations being contemplated by the government, we believe automotive component firms will have to make sizeable investments to upgrade plants and technology.

The ability of players to scale up and meet these challenges without materially denting their balance sheets will drive their credit quality.

Distribution of aggregate debt in 363 CRISIL-rated automotive component makers



Source: CRISIL Ratings

<u>How to read the chart above</u>: Bars indicate aggregate debt in a particular rating category for CRISIL-rated auto-component makers, while numbers in circles denote companies in that category.

Rating outlook distribution[3]	**Positive (20)**	**Stable (299)**	**Negative (18)**

Credit outlook for select CRISIL-rated automotive component companies
1. Brakes India Pvt Ltd (CRISIL AA+/Stable/CRISIL A1+)
Brakes India is a dominant player in automotive braking systems with 60% market share in India. Its technological tie-up with US-based TRW Automotive Inc – which holds 49% stake in Brakes India – is an added advantage. The company has a well-diversified product base and strong presence across various auto OEM segments, aftermarket, and exports. Customer diversity is also increasing. Moreover, Brakes India has foundry operations both in the domestic market (part of which is deployed for captive consumption) and in its overseas subsidiary Dunes Oman LLC, FZC. It has strong relationships with leading OEMs such as Maruti Suzuki India Ltd, Tata Motors Ltd, Mahindra & Mahindra Ltd, Ashok Leyland Ltd, Toyota Kirloskar Motors Ltd and Nissan Motors Co Ltd. Key clients abroad include TRW, Arvin Meritor Inc, Renault SA, and Volvo AB.

[3] Excluded 26 companies on rating watch or rated C/D or with only short-term rating

Due to all these factors, the company is more resilient to business slowdowns.

Brakes India's financial risk profile remains healthy (marked by gearing of less than 0.15 time) supported by strong cash generation, and prudence in capex spends even as operations are capital-intensive and working capital management is stable.

CRISIL takes a consolidated approach (Brakes India and its 51% subsidiary Dunes) to arrive at the rating for Brakes India. The company reported a profit after tax (PAT) of Rs 2.5 billion on an operating income of Rs 33.2 billion in 2014-15.

2. Motherson Sumi Systems Ltd (CRISIL AA-/Positive/CRISIL A1+)

Motherson Sumi Systems Ltd (MSSL) is a global automotive-component supplier with operations across Asia, Europe, North America, South America, Australia, and Africa. The company has increased its geographical reach over the years by acquiring assets in new markets, backed by assured business commitments from its customers. An added advantage for MSSL is its diversified product profile – the company's product portfolio comprises wiring harness, rear-view mirrors and polymer based internal and exterior modules, and each segment contributes nearly equally to overall Ebitda.

MSSL has an established relationship with major global OEMs, including the Volkswagen group, Hyundai Motor Co, Renault, Nissan, Ford Motor Co, Daimler AG, General Motors Co, and Maruti Suzuki. MSSL's largest customer is the Volkswagen Group, majorly in Europe. So, any sharp decline in sales to the Volkswagen group will be a credit monitorable.

MSSL's aggressive, debt-funded acquisition intensity, which has been a key growth driver, is expected to continue in future as well and is likely to constrain its financial risk profile (debt to Ebitda has ranged between 2.7 times in 2012-13 to 1 time as on March 31, 2015). However, the acquisitions are backed by assured business from customers. Also, due to the management's sharp focus on profitability, MSSL has, so far, been able to turnaround the performance of the acquired companies.

CRISIL takes a consolidated approach (MSSL and its subsidiaries, including SMRP BV) to arrive at the rating for MSSL. For the nine months ended December 31, 2015, the company on consolidated basis reported a PAT of Rs 11.76 billion on an operating income of Rs 284.4 billion.

3. Gabriel India Ltd (CRISIL AA-/FAA/Stable/CRISIL A1+)

Gabriel India is the second-largest player in the domestic automotive suspension market, so its market position is healthy. Although the OE segment accounts for over 80% of Gabriel's revenues, the company supplies to several other customer sub-segments, which enables it to withstand cyclicality and sustain business during slowdowns.

The company has technical tie-ups with global majors in the segment, which has enhanced its product capability and, in turn, strengthened its customer base. Gabriel's clientele includes leading

OEMs such as TVS Motor Co Ltd, Maruti Suzuki India Ltd, Honda Motorcycle and Scooter India Ltd, Yamaha Motors Ltd, Bajaj Auto Ltd, Ford, Mahindra & Mahindra Ltd, Ashok Leyland Ltd and Tata Motors Ltd.

Gabriel's financial risk profile remains healthy, supported by steady cash generation, almost a debt free balance sheet, moderate capex and prudent working capital management. The company is not expected to undertake significant capex over the medium term, as it is still operating at utilisation levels of around 75%.

For the nine months ended December 31, 2015, the company reported a PAT of Rs 543 million on an operating income of Rs 10.7 billion.

4. Endurance Technologies Pvt Ltd (CRISIL AA-/Stable/CRISIL A1+)

Endurance Technologies is a leading manufacturer and supplier of aluminium die-casting components for automobiles. It also manufactures suspension, transmission, and braking products and is a supplier to two-wheeler and three-wheeler segments in the domestic market.

Endurance benefits from its established relationship with OEMs, both Indian and global. In the domestic market, Endurance is a long-standing supplier to Bajaj Auto Ltd, which is also its largest customer. It also supplies to Honda Motorcycle and Scooter India Ltd, Royal Enfield, Yamaha Motors Ltd and Hero Motocorp Ltd. Major global clients include Fiat, Daimler, Volkswagen, GM and Porsche. The company's business profile is strengthened by its product diversity; aluminium die-casting accounts for 58% of revenues, suspension systems for 29%, and transmission and braking for the rest. Two of its overseas subsidiaries are also suppliers to Daimler and Fiat. As it has a limited presence in the aftermarket segment, Endurance remains moderately exposed to cyclicality in the automotive OEM segment. To counter this, the company is adding more large OEMs as customers.

Endurance's financial risk profile has been improving over time, supported by increasing cash accrual and consistent reduction in debt levels. The turnaround and stabilisation of operations at its overseas subsidiaries led to a significant increase in Ebitda over time. This reduced debt levels and improved credit metrics – its leverage is under 1 time at present, compared with over 4 times in 2011-12. The company is not expected to undertake significant large acquisitions in the medium term, with focus remaining on further improving its credit metrics.

CRISIL takes a consolidated approach (Endurance and its overseas subsidiaries) to determine the rating for Endurance. On a consolidated basis, Endurance reported a PAT of Rs 2.5 billion on an operating income of Rs 49.5 billion for 2014-15.

5. Sundram Fasteners Ltd (CRISIL A1+)

Sundram Fasteners Ltd (SFL) is a leading player in the domestic fasteners industry. Its market position is healthy as it operates across automotive OE segments, the aftermarket segment, and

exports. The company's export operations are buoyed by its overseas subsidiaries in the UK, China, and Germany. SFL makes metal forms, radiator caps, and automotive pumps and assemblies, so the product base is diversified.

SFL's leading OEM clients include Bajaj Auto Ltd, TVS Motor Co Ltd, Tata Motors Ltd, Maruti Suzuki India Ltd, Hyundai Motor India Ltd (rated 'CRISIL A1+'), Ashok Leyland Ltd, Mahindra & Mahindra Ltd and Tractors and Farm Equipment Ltd (TAFE, rated 'CRISIL AA+/FAAA/Stable/CRISIL A1+').

SFL's Indian operations enjoy better stability and margins; challenging market conditions in Europe have impacted the performance of its German subsidiary. Nevertheless, overall cash generation has remained healthy. Further, despite the intensely working capital nature of operations, SFL's credit metrics have improved in the past three years, driven by healthy cash accrual and prudence in capex spend (particularly during the slowdown); consolidated gearing was at 0.99 time as on March 31, 2015.

A revival in domestic demand could increase SFL's capex in 2016-17 but CRISIL believes the company will maintain its credit profile on the back of healthy cash generation.

CRISIL takes a consolidated approach (SFL and its subsidiaries) to arrive at the rating for SFL. For the nine months ended December 31, 2015, on a standalone basis, the company reported PAT of Rs 1.36 billion on operating income of Rs 19.1 billion.

Capital Goods

RATING OUTLOOK
Continuing pressure on profit will be a trigger

Fewer orders, compressed margins are hurting

Capital goods manufacturers have been bearing the brunt of the economic slowdown of the past couple of years. Structural bottlenecks and weak demand have meant slimmer order books, crimped margin and stretched working capital. With capacity utilisation in end-user industries hovering ~70% in the current fiscal, growth in order book and revenue will remain subdued in the next fiscal, too.

FAQs

Are there signs of broad-based revival?

While we expect the pace of decline to decelerate next fiscal, any pick up will be limited to a few segments. For example, manufacturers of earth moving equipment are expected to do better as road construction activity gains further momentum. At an aggregate level, however, private sector investment is expected stay low, while public investment initiatives would help arrest some of the demand slide.

In power, companies with exposure to the generation segment are likely to report flattish order growth compared with those catering to the transmission and distribution (T&D) or renewables segments. Similarly, in infrastructure, suppliers to real estate are likely to be stressed compared with those exposed to the roads sector. Players with exposure to metals and mining are likely to report lower order inflows.

The key rating actions across CRISIL's portfolio also reflect the varied impact. For example, BHEL and L&T MPHS Turbines Generators have witnessed negative rating actions due to their sizable exposure to the power generation segment. Similarly, equipment companies such as Action Construction Equipment and Eimco Elecon have witnessed negative rating actions because of their exposure to the construction and mining segments, respectively. By contrast, Inox Wind and Tata Power Solar have seen positive rating action reflecting their exposure to the fast-growing renewables sector.

What about profitability?

Profitability has been impacted by flattish revenue growth and rising costs. In the last 5 fiscals including the current one, large players have reported an average dip in margin of 200 basis points (bps). Profitability pressure is more pronounced for those with exposure to sectors such as power, where the margin decline has been about 500 bps. With project execution slower, working capital requirement has increased, as reflected in higher average gross current assets (as days of operating income) of over 340 days from ~260 days earlier.

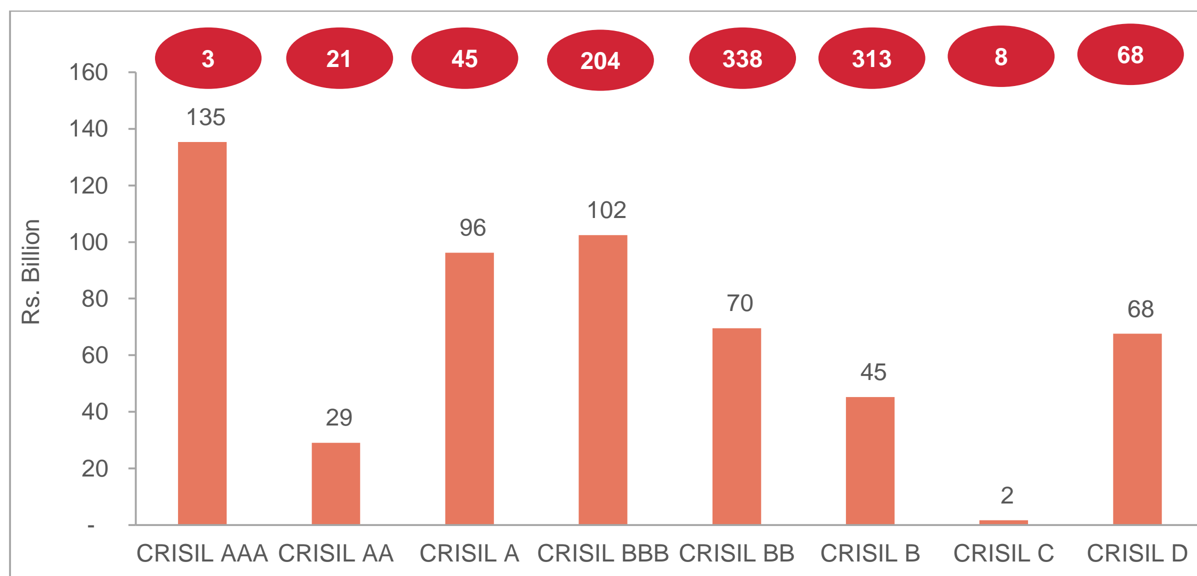
What has the Budget done for the sector?

The budget has provided a thrust to the sector through a sharp rise in investments in sectors such as Railways, Roads and Power transmission and distribution. Cumulatively, investments in these sectors are proposed to be increased by 30% compared to the current fiscal. These investments should boost the declining order book of players in the medium-term. Moreover, through the budget, the government has aimed at improving the competitiveness of the domestic industry through an increase of 250 bps in basic custom duty (on equipment such as motors, generators and measurement instruments) and levy of 12.5% countervailing duty (on specified machineries for construction of roads).

In the context, what's CRISIL's ratings call?

Strong balance sheets have so far cushioned the credit profiles of the bigger companies. However, continued pressure on profitability could lead to downward rating actions. At the same time, large multinationals such as ABB and Siemens have been able to cope with lower growth and arrest profitability pressure (average margin improvement of over 200 bps in the last 5 years) driven by diversified business profiles, strong technology and localisation measures, which is expected to sustain. Rating changes for medium and smaller players will be a function of demand outlook in their specific end-user segments, and its impact on order inflows. Impact of a stretched working capital cycle will be more pronounced given their relatively lower scale of operations, and will be a key monitorable.

Distribution of aggregate debt in CRISIL-rated 1,000 capital goods companies



Source: CRISIL Ratings

How to read the chart above: Bars indicate aggregate debt in a particular rating category for CRISIL-rated capital good players, while numbers in circles denote companies in that category.

Rating outlook distribution[4]	Positive (22)	Stable (855)	Negative (47)

[4] Excludes 76 companies on rating watch or rated C/D, or with only short-term rating

Credit outlook for select CRISIL-rated capital goods companies

1. Larsen and Toubro Ltd (CRISIL AAA/Stable/CRISIL A1+)

Larsen and Toubro (L&T) is one of Asia's largest vertically integrated engineering & construction (E&C) conglomerates. The company's proven track record of timely project execution, ability to cater to a diverse set of sectors, and strong in-house design, engineering and fabrication capabilities, provide it with a competitive advantage. Strong competencies have enabled a robust brand image, as indicated by its healthy and diversified order book of Rs 2,565 billion (at group level) as on December 31, 2015, across sectors and geographies. L&T's business strengths are complemented by its strong financial flexibility. The company has sizeable cash & current investment (Rs 78.71 billion as on September 30, 2015), and has demonstrated ability to raise funds at competitive rates. Driven by steady annual cash accrual, the company's financial risk profile is expected to remain healthy over the medium term.

L&T's credit risk profile is however susceptible to increasing exposure to infrastructure development projects being undertaken by its SPVs, which involve higher operational & financial risks. Also, stretch in working capital cycle in the E&C business owing to slower execution may have an adverse bearing on the company's financial profile.

For arriving at L&T's ratings, CRISIL consolidates L&T and its subsidiaries (including infrastructure holding companies on a standalone basis). CRISIL factors in the capital commitments for L&T's finance subsidiaries. While CRISIL has not consolidated the debt in SPVs held by L&T's infrastructure holding companies, it has factored in L&T's equity commitment, and any cost overruns in these entities.

For the nine months ended December 31, 2015, L&T, on a standalone basis, reported a PAT of Rs 27.72 billion on an operating income of Rs 387.18 billion.

2. Bharat Heavy Electricals Ltd (CRISIL AA+/Negative/CRISIL A1+)

Bharat Heavy Electricals Ltd (BHEL) is a maharatna company and the largest player in India's power and industrial electrical equipment markets. Its equipment accounts for more than 60% of India's total power generation capacity.

BHEL's project execution and profitability are facing challenges due to ongoing structural issues in the power sector. The company witnessed sizeable operating losses in the nine months ended December 31, 2015, on the back of low capacity utilisation, higher material costs, and provisions made towards receivables and inventories. Also, weak financial profile of customers and slow project execution due to delays in obtaining clearances has led to build-up of receivables, resulting in a stretch in working capital.

However, the company benefits from a strong order book of Rs 1,092 billion as on December 31, 2015. Also, its strong financial risk profile marked by low debt, robust liquidity (over Rs 78 billion as on December 31, 2015) and healthy financial flexibility is expected to provide it with adequate cushion to manage operational challenges over the medium term. Continued slowdown in project execution and a delay in receivable collection impacting cash flows will remain a key monitorable.

For arriving at BHEL's ratings, CRISIL consolidates BHEL and its subsidiaries. CRISIL proportionately consolidates BHEL's joint ventures except those set up to execute power projects. That's because of the BHEL management's policy of extending limited support to these projects, and low fungibility of their cash flows.

For the nine months ended December 31, 2015, BHEL, on a standalone basis, reported a net loss of Rs 12.73 billion on an operating income of Rs 156.25 billion.

3. ABB India Ltd (CRISIL AAA/Stable/CRISIL A1+)

ABB India is the market leader in switchgears, power electronics, drive-relays, and several other transmission, distribution, and automation products. The company has a diverse product portfolio, extensive marketing reach and strong cost competitiveness. Its strong market position is complemented by operational and technological support from its ultimate parent ABB Zurich (rated A/Stable/A-1 by S&P); this remains among the key drivers of ABB India's credit profile.

However, ABB India's operating performance is facing headwinds due to structural issues in the power segment leading to slower project execution and increased competitive intensity. The company's order book growth has been modest over the last two years owing to impact of the macroeconomic slowdown on its power and industrial segments. Nevertheless, the company has been able to improve its profitability driven by localisation measures, lower raw material costs and higher efficiencies. The company also benefits from a strong financial risk profile marked by robust capital structure (gearing of around 0.2 time as on December 31, 2015) and low debt levels, which is expected to sustain in the absence of sizeable debt-funded capex plans.

For the year ended December 31, 2015, ABB India reported PAT of Rs 2.99 billion on an operating income of Rs 81.40 billion.

4. Siemens Ltd (CRISIL AAA/Stable/CRISIL A1+)

Siemens is a leading powerhouse in electronics and electrical engineering. The company caters to multiple end-user segments including power, oil & gas, mobility and healthcare. Continued strong linkages with parent Siemens AG (rated 'A+/Stable/A-1' by S&P) in the form of technological and managerial inputs support Siemens' business risk profile. The company also benefits from wide geographical reach and established track record of timely project execution.

Weak investment climate and structural challenges in the power sector have impacted Siemens' revenue growth and order book position. However, the company has been able to improve its profitability over the last 3 years driven by cost and resource management, better realisations and sale of loss making businesses, which is expected to sustain over the medium term. Also, the company's financial risk profile is robust marked by large networth, minimal debt, and sizeable liquid surplus of over Rs 20 billion as on September 30, 2015, providing it with ample cushion to navigate the slowdown. Given the company's healthy market position, it is well positioned to benefit from a sustained pickup in industrial activity.

For the year ended September 30, 2015, Siemens on a consolidated basis reported a PAT of Rs 11.83 billion on an operating income of Rs 105.12 billion.

5. Inox Wind Ltd (CRISIL AA-/Stable/CRISIL A1+)

Inox Wind is a part of the Inox Group. The company manufactures components which are used in the production and assembly of wind turbines, along with providing O&M services for wind turbines, and project execution for wind assets.

Inox Wind has established itself as one of the leading wind energy equipment players in India, and has benefitted from improving demand prospects in the renewable energy sector. The company's market position is supported by its healthy order book, strong technology tie-ups, and robust execution capabilities. The company's technology tie-up with AMSC Austria and its large inventory of wind sites provide it with a competitive advantage in securing and executing large orders. An IPO in March 2015 has led to significant improvement in capital structure (0.6 time as on March 31, 2015) and liquidity profile. While the company has large expansion plans, these will be funded through internal accrual and IPO proceeds. Financial risk profile is therefore expected to improve over the medium term driven by steady cash flows. The company's credit profile also benefits from the strong managerial and financial support it receives from its parent Gujarat Fluorochemicals Ltd (rated 'CRISIL AA/Stable/CRISIL A1+').

However, Inox Wind's operations are working capital intensive marked by large receivables (191 days as on March 31, 2015), and advances to suppliers. Rapid scaling up of operations has also led to higher working capital requirement, which is expected to be partly funded by IPO proceeds. Further, with increasing proportion of equipment supply orders, working capital cycle is likely to shorten, as the intensity is lower compared to turnkey orders. Continued stretch in working capital will remain a key monitorable.

For the nine months ended December 31, 2015, Inox Wind on a consolidated basis reported a PAT of Rs 2.42 billion on an operating income of Rs 25.85 billion.

Cement	RATING OUTLOOK Stable on moderate growth

Demand growth, profitability looking up

Demand forecast

Cement demand growth is seen rising to 5.5-6% next fiscal, led by higher public investments in infrastructure and a pick-up in real estate demand. That compares with ~3-3.5% growth likely this fiscal because of weak monsoon and poor realty demand, and 5.2% in 2014-15.

Split by region, this is what we see:

- East is likely to record the highest demand growth of 10-11%, spurred by state government spending
- Demand in south will grow the slowest at 3-4%; Andhra Pradesh will buck the trend and witness healthy demand growth
- Demand growth in north, west, and central regions would be in the range of 5-6%.

FAQs

What is the outlook on capacity utilisation and prices?

The pan-India utilisation rate will be ~70% this fiscal due to marginal demand growth and addition of new capacities, and is expected to improve to ~72% next fiscal following a pick-up in demand and slow capacity addition. The regional utilisation scenario:

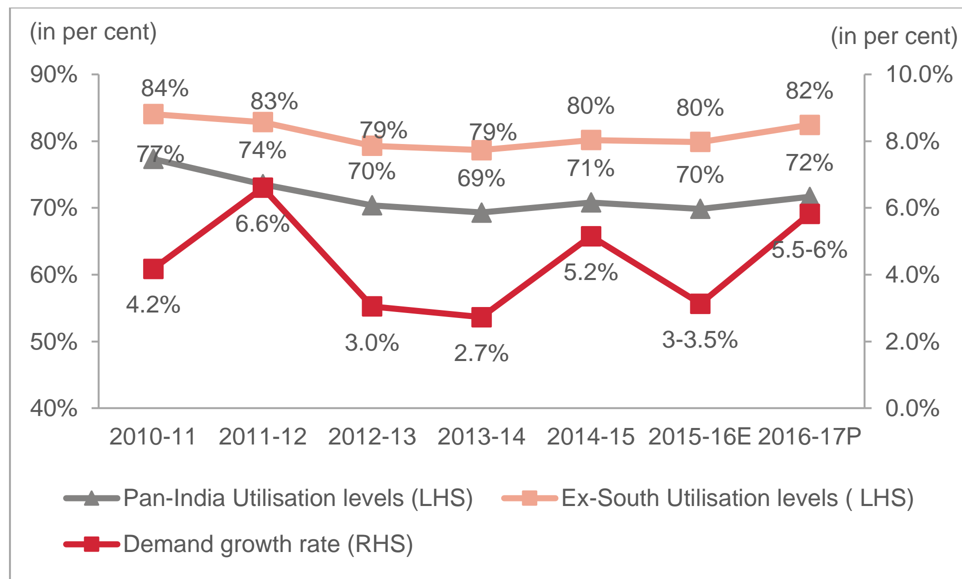
- East has the rosiest outlook because of very favourable demand-supply dynamics, followed by north and west.
- Supply glut in the south will continue to keep utilisation rates subdued ~52%, but realisation will not suffer because of pricing discipline.

Cement prices have remained soft this fiscal, barring in south, where prices have increased 12% year-on-year because of production and pricing discipline. Improvement in demand and higher utilisation would enhance the pricing power of producers next fiscal. We anticipate a ~5% increase in prices on average at the national level. The increase would be the sharpest in east and muted in south.

Will better demand and higher prices prop up profitability?

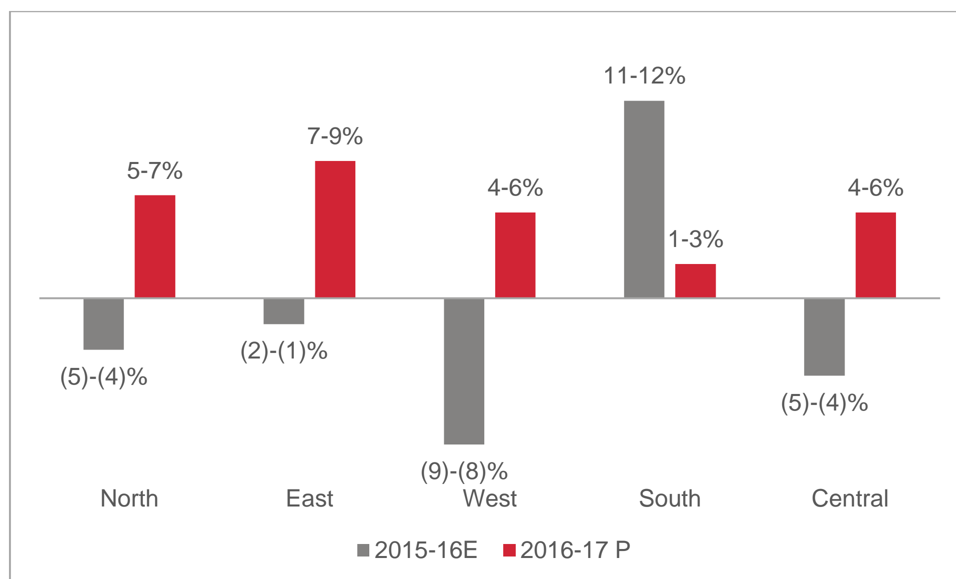
Ebitda margin is expected to improve 70-100 bps next fiscal, driven by a moderate increase in realisation, stability in power and fuel costs, and better freight rates. This follows a flattish trend this fiscal as the benefit of lower power and fuel costs (which account for nearly a quarter of total cost) gets offset by increase in freight rates and raw material prices.

Slight improvement in capacity utilisation



Source: CRISIL Research

Moderate rise in prices anticipated



Source: CRISIL Research

How has the Budget been for the sector?

The government's focus on infrastructure is evident with the total budgetary spending increasing 28% year-on-year next fiscal. This, along with taxation benefits provided on affordable housing, would aid recovery in cement demand.

Would regulation change the path of consolidation?

Overall cement capacity put up for sale is seen at ~40 million tonne per annum (mtpa). This includes the deals already announced, such as Ultratech-Jaypee Cement and Birla Corp-Reliance Cement, subject to approvals.

At present, the Mining Bill does not allow for transfer of limestone mines to new owners of cement companies unless the mines are won through the auction route. This has led to certain large-ticket deals being called off, including Lafarge's divestment of two plants with aggregate capacity of 4.6 mtpa, and Jaypee group's two cement plants with aggregate capacity of 4.9 mtpa. To get around the Bill, companies are opting for stake sale instead of asset sale.

If we look back at the deals since January 2014, there are two clear trends that drove them: 1) Companies with strong balance sheets and healthy liquidity looking to expand, and 2) regional players aspiring to augment capacity/reach. Going forward, too, regional players will have an edge in navigating anti-competition laws. The pace of closure of transactions might just quicken next fiscal if the Mining Bill is amended, which would, hopefully, address the vexed issue of transfer of limestone mines along with cement plants.

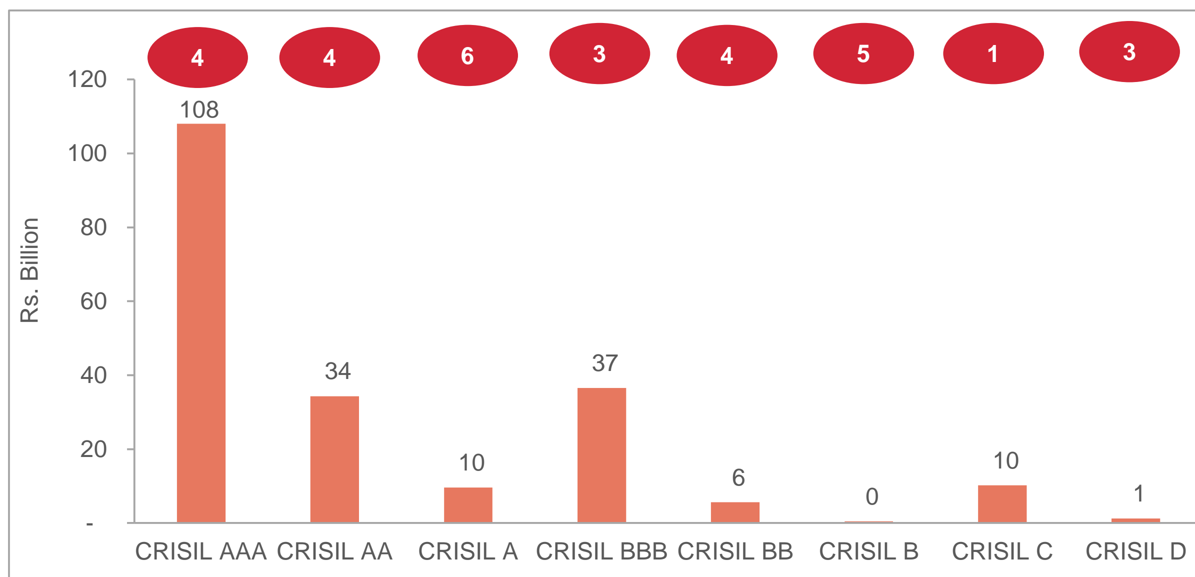
Will M&A activity drive rating changes?

In the current fiscal, we have seen rating actions for two large cement players – Shree Cements (upgrade) and CMCL (positive outlook) – out of the 30 in our portfolio. Both have seen healthy Ebitda/tonne arising from cost leadership and subsidies, respectively. As for the road ahead, we expect improved realisation, healthy liquidity and stronger balance sheet to once again drive positive rating changes. On the other hand, M&As could drive rating downgrades. Although companies do have the appetite to acquire, the funding mix for acquisitions would be a key rating sensitivity factor.

In the context, what's CRISIL's rating outlook?

Going forward, CRISIL presages a stable rating outlook for cement makers, owing to moderate growth in demand. Larger producers are differentiated due to their pan-India presence, diversity, operating efficiencies, strong capital structures and healthy liquidity. Their operating margin is seen improving slightly amid low leverage. Given the localised nature of the industry, mid-sized players will continue to benefit from favourable regional factors such as real estate activity and other competitive advantages such as subsidies for the north-east. On the other hand, ratings on smaller players will continue to be constrained by the absence of a strong brand, low operating efficiencies, leveraged balance sheets and stretched liquidity.

Distribution of aggregate debt in 30 CRISIL-rated cement companies



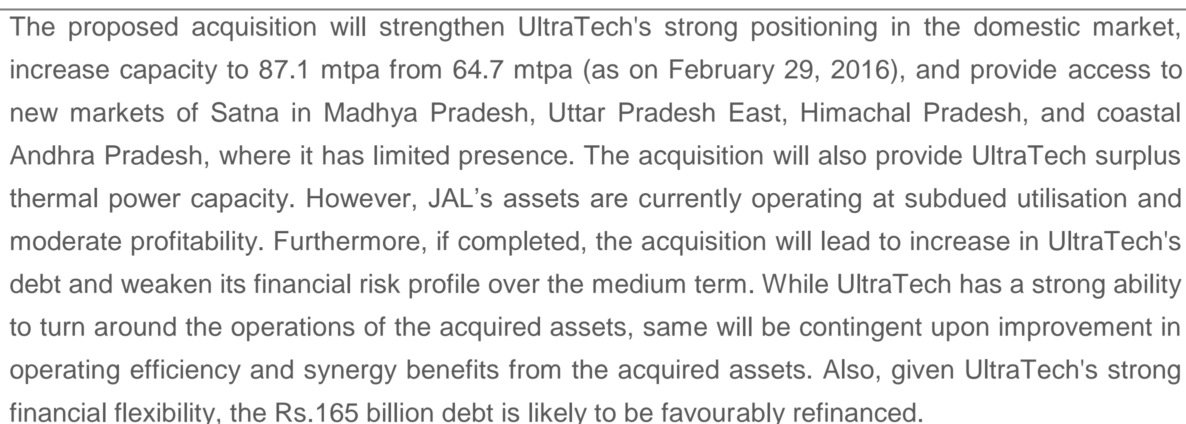
Source: CRISIL Ratings

How to read the chart above: Bars indicate aggregate debt in a particular rating category for CRISIL-rated cement players, while numbers in circles denote companies in that category.

Rating outlook distribution[5]	Positive (4)	Stable (19)	Negative (1)

Credit outlook for select CRISIL-rated cement companies
1. UltraTech Cement Ltd (CRISIL AAA/Watch Developing/CRISIL A1+)
UltraTech, part of the Aditya Birla Group, is India's largest cement manufacturer. It has a pan-India presence with 18% market share across regions, which insulates it from regional risks. UltraTech continues to benefit from its focus on operating efficiencies with an operating margin of over 18% -- among the best in the industry. UltraTech's strong business risk profile is complemented by its robust financial metrics (0.41 times of gearing and ample liquidity of more than Rs 42 billion), which provides it with the flexibility to undertake sizeable capital expenditure and acquisitions. However, as with other players, UltraTech remains exposed to cyclicality in the cement industry. Recently, UltraTech has announced acquisition of 22.4 mtpa cement capacity of Jaiprakash Associates Ltd (JAL) for an enterprise value (EV) of Rs 169 billion, mainly transfer of debt from JAL to UltraTech. The transaction is subject to regulatory and other approvals.

[5] Excludes 6 companies on rating watch or rated C/D, or with only short-term rating; the 4 companies with positive outlook are part of the same group



The proposed acquisition will strengthen UltraTech's strong positioning in the domestic market, increase capacity to 87.1 mtpa from 64.7 mtpa (as on February 29, 2016), and provide access to new markets of Satna in Madhya Pradesh, Uttar Pradesh East, Himachal Pradesh, and coastal Andhra Pradesh, where it has limited presence. The acquisition will also provide UltraTech surplus thermal power capacity. However, JAL's assets are currently operating at subdued utilisation and moderate profitability. Furthermore, if completed, the acquisition will lead to increase in UltraTech's debt and weaken its financial risk profile over the medium term. While UltraTech has a strong ability to turn around the operations of the acquired assets, same will be contingent upon improvement in operating efficiency and synergy benefits from the acquired assets. Also, given UltraTech's strong financial flexibility, the Rs.165 billion debt is likely to be favourably refinanced.

For the nine months ended December 31, 2015, UltraTech reported a PAT of Rs 15.65 billion on an operating income of Rs 186.31 billion.

2. ACC Ltd (CRISIL AAA/Stable/CRISIL A1+) & Ambuja Cements Ltd (CRISIL AAA/Stable/CRISIL A1+)

CRISIL takes a consolidated approach for arriving at the ratings of ACC Ltd and Ambuja Cement Ltd.

The ACC and Ambuja Cements combine has a pan-India presence with an installed capacity of around 60 mtpa, which accounts for over 15% of the domestic market. Robust brand strength and presence of nationwide marketing infrastructure ensure a premium pricing over other brands. However, while Ambuja Cements benefits from operating efficiencies arising out of captive power plants and lower freight costs, ACC's efficiencies lag due to costs associated with older manufacturing units. The anticipated pick-up in demand would benefit the combine's operating rates and profitability margins over the medium term.

Both ACC and Ambuja Cements have a robust financial risk profile as reflected in their large networth of Rs 83 billion and Rs 102 billion, respectively, as on June 30, 2015, besides minimal debt levels and steady cash flows. Moreover, both the entities have sizeable liquid surplus, which benefits their financial flexibility. Despite planned capital expenditure, the combine's financial risk profile will remain robust.

The proposed restructuring of LafargeHolcim Ltd's operations in India will see Ambuja Cements acquiring a majority stake in ACC from LafargeHolcim for Rs 35 billion. This will be a one-time cash outflow and will not impact Ambuja Cements' financial risk profile. The restructuring is subject to receipt of statutory approvals.

For the year ended December 31 2015, ACC reported a PAT of Rs 5.8 billion on an operating income of Rs.118.0 billion; Ambuja Cement reported a PAT of Rs.8 billion on an operating income of Rs.95 billion.

3. Shree Cement Ltd (CRISIL AAA/Stable/CRISIL A1+)

Shree Cement is promoted by the Kolkata based BG Bangur Group. The company would have a cement capacity of ~26 mtpa by March 2016.

Shree Cement has a strong market position in Northern India, with a market share of around 23%. Moreover, with commissioning of additional capacities in Eastern India over the last two years, the company has diversified its presence. Sale of blended cement, proximity to end-user markets and use of split grinding units will enable the company to maintain its cost leadership. The company is among the most efficient players in the cement industry, with robust operating margins of over 20%, which have been maintained notwithstanding the downturn being witnessed.

Given the commoditised nature of cement, Shree Cement will remain vulnerable to cyclicality in the industry. However, the company's strong financial risk profile provides it ample cushion to withstand slowdowns. The company is debt-free on a net basis, and has healthy financial flexibility supported by steady operating cash flows and large liquid surplus of about Rs 20 billion. Any significant organic or inorganic expansion plan and its funding pattern will remain a monitorable for Shree Cement's credit profile.

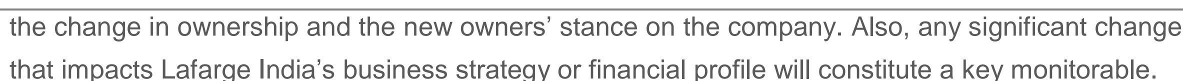
For the six months ended December 31, 2015, Shree Cement reported a PAT of Rs 2.31 billion on an operating income of Rs 35.53 billion.

4. Lafarge India Pvt Ltd (CRISIL AA/Stable/CRISIL A1+)

Lafarge India is held by the LafargeHolcim group and has installed capacity of 11 mtpa in India. The company's major markets are West Bengal, Bihar, Jharkhand, Chhattisgarh and Odisha.

Lafarge India has established itself as a strong market player in eastern India. Its focus on ramping up its capacities in Northern India would benefit the company in medium term. The company generates strong operating efficiencies because of its focus on only blended cements, which leads to lower power, fuel, and raw material consumption per tonne of cement. The company is likely to maintain a strong financial risk profile, marked by low gearing and healthy debt protection metrics. However, it would continue to face margin pressures due to increasing input costs like other cement players and average profitability of the company's ready-mix concrete, or RMC, business.

Recently, the Competition Commission of India (CCI) approves LafargeHolcim's proposal to divest its entire stake (held directly or indirectly) in Lafarge India (involving a total capacity of ~11 mtpa), in relation to the global merger of Lafarge SA and Holcim Ltd (both rated 'BBB/Stable/A2' by S&P). This is against CCI's earlier order in April 2015, to divest a part of Lafarge India's capacities (4.6 mtpa plant in Jojobera and 0.55 mtpa plant in Sonadih). CRISIL will continue to monitor the divestment process of Lafarge India by LafargeHolcim and will reassess Lafarge India's credit profile to factor in



the change in ownership and the new owners' stance on the company. Also, any significant change that impacts Lafarge India's business strategy or financial profile will constitute a key monitorable.

5. Birla Corporation Ltd (CRISIL AA+/ CRISIL A1+/ Watch Negative)

Birla Corporation Ltd (BCL) is the flagship company of the MP Birla group. The cement business is the largest contributor to the company's revenue (over 90%) with the balance coming from jute and other products. BCL has a capacity of 9.5 mtpa with seven cement plants across four states: Rajasthan, Uttar Pradesh, Madhya Pradesh and West Bengal.

BCL will continue to benefit from its established position in North and Central India and a healthy financial risk profile. BCL's flagship cement brands, Chetak, Samrat and Khajuraho are well-known in the market.

Recently, BCL has entered into an agreement with Reliance Infrastructure Ltd (R-Infra) for acquisition of the latter's entire cement business of 5.6 mtpa for an EV of Rs 48 billion. R-Infra has three plants, including an integrated plant at Maihar (Madhya Pradesh), and grinding units at Kundanganj (Uttar Pradesh) and Butibori (Maharashtra). BCL also gets mineral concessions in states of Madhya Pradesh, Maharashtra, Rajasthan, Karnataka, Andhra Pradesh and Himachal Pradesh.

CRISIL believes that the impact on long-term rating could be more than one notch. However, clarity on funding structure for the transition, operating performance of RCPL's assets, potential synergies, and BCL's strategy for the assets being acquired would be required to resolve the watch and take final rating action. The progress of the transaction along with the continuing mining issues at its facilities in Chanderia (Rajasthan) would be key monitorables over the medium term.

For the nine months ended December 31, 2015, BCL reported a PAT of Rs 0.41 billion on an operating income of Rs 24.08 billion.

Fertiliser

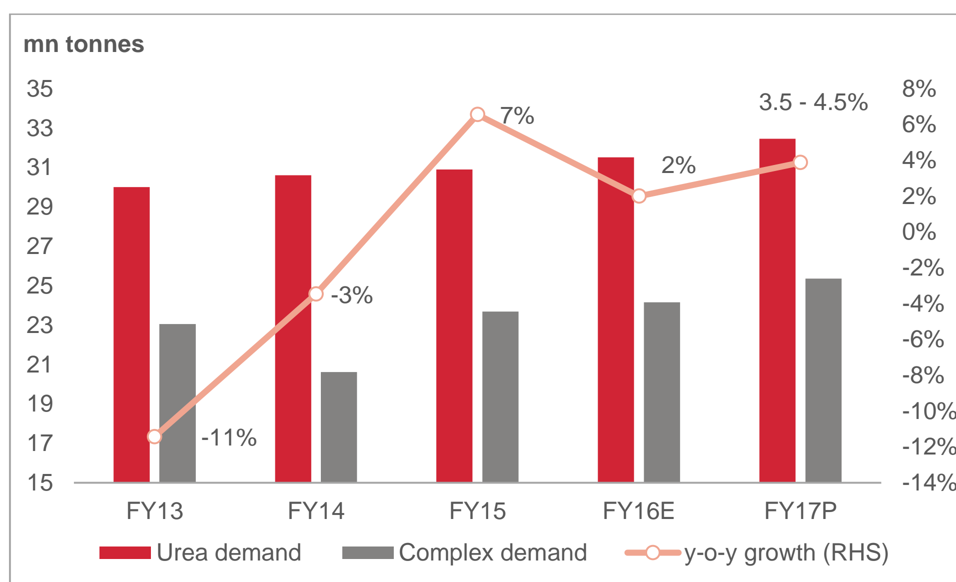
RATING OUTLOOK
Stable, with monsoon a key monitorable

Rain god benedictions, urea policy can be drivers

Demand in the fertiliser industry is expected to grow at 3.5-4% next fiscal assuming a normal monsoon. This follows a relatively slower ~2% growth expected in the current fiscal because of two straight years of deficient rains.

Urea demand is expected to grow at a relatively slower pace of 3% (as against a decadal average growth of 4%) because of neem coating – though it will still be faster than the current fiscal. The governments' mandate of neem-coating 100% of domestic urea production would mean lesser quantities would be required as it releases nitrogen content slowly into the soil and would check diversion of urea for other purposes. In case of complex fertilisers, overall demand is expected to grow at 3.5-4.5% assuming normal monsoon, driven by a skewed soil nutrient mix and only a marginal increase in complex fertiliser prices.

Complex fertilisers to boost overall fertiliser demand



Source: FAI, CRISIL Research

FAQs

What's the forecast on urea production & imports?

Urea production, which is estimated to increase to 23.5-24 million tonne this fiscal from 22.6 million tonne in the last, is expected to stabilise next year. However, consumption will continue to outstrip supply and India will have to import over 8 million tonne over the medium term. Given the implementation of the New Urea Investment Policy 2012, dependence on imports and availability of pooled gas, fresh urea capacities are likely to be set up at a time when corporate capital spending has slowed down. Hence, dependence on imports will continue to increase till fiscal 2019 driven by increased demand, post which imports are expected to decline with commissioning of capacity of close to 4 million tonne in fiscal 2020.

What about profitability of fertiliser companies?

Profits of urea manufacturers is expected to be largely stable next fiscal, after having improved slightly this year after the announcement of the New Urea Policy in May 2015. That's because producers will be able to pass on variable cost on production up to 100% of re-assessed capacity. Variable cost will be based on energy consumption norms, which have been kept unchanged for fiscals 2016 to 2018. In addition, manufacturers are also reimbursed normative fixed costs and capital-related charges. The New Urea Policy and gas pooling policy also encourages urea production beyond 100% capacity by offering players a fixed incentive over variable costs[6], which further stabilises their profits. Under the previous policy, production beyond 100% capacity had become unviable for some players in 2014-15 because of a fall in import parity price of urea and increased dependence on regasified liquefied natural gas.

Ebitda margin of complex fertiliser companies is expected to fall marginally by 30-50 basis points (bps) next fiscal on account of expected rise in raw material prices (phosphoric acid, muriate of potash). Producers are unlikely to fully pass on the price increase to consumers because companies would want to boost demand following the spells of bad monsoon. Moreover, a likely rise in channel inventory by March 2016 — owing to deficient monsoon in 2015 — can not only impact complex fertiliser offtake but also stretch market receivables, in case monsoons fail again this year. The impact of these factors on working capital will be a key rating sensitivity factor.

What is propelling urea investments?

No new urea plant has been set up in India since 1999 for want of assured gas supply. However, with the New Urea Investment Policy 2012 as well as the implementation of gas pooling, we expect another 4 million tonne of urea capacity to be added over the next 4 years, which will bring down imports substantially after fiscal 2019.

Chambal Fertilisers and Rashtriya Chemicals and Fertilisers are setting up brownfield projects. Yet, their credit profiles will not be impacted owing to: a) strong existing cash flows, b) support infrastructure,

[6] Subject to maximum of import parity price of urea plus incidental charges

and c) lump-sum turnkey contract (LSTK), which mitigate project implementation risks. CRISIL will monitor these factors for other players who may invest in similar projects.

What will be the impact of the price cut by RasGas?

Qatar-based RasGas reduced gas prices in December 2015, which will slash the Indian government's fertiliser subsidy bill by almost Rs 50 billion next fiscal. Additionally, lower domestic gas prices will lead to further savings of around Rs 20 billion. Savings on account of these two items form about 10% of the government's overall subsidy bill and may reduce the subsidy receivable for fertiliser manufacturers by ~20 days by March 2017, despite reduction in government's fertiliser subsidy allocation by Rs 30 billion next fiscal. The consequent decline in working capital debt will reduce interest cost and improve debt protection metrics. The government has announced direct benefit transfer on a pilot basis for fertilisers, which augurs well for the players, but implementation is the key.

What has the Budget done for the sector?

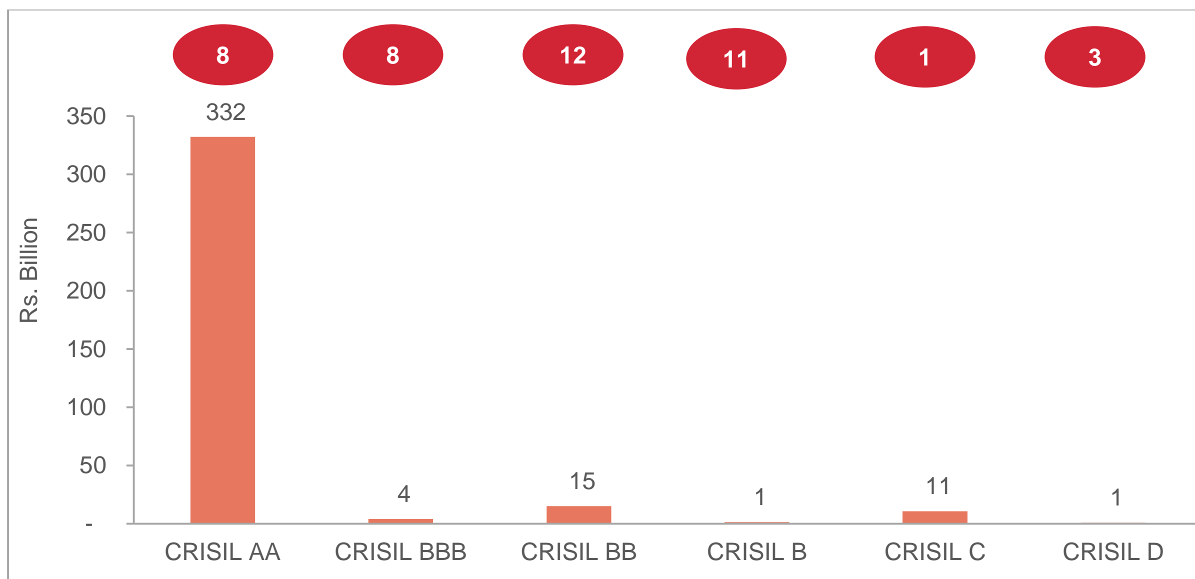
- Subsidy allocation for the fertiliser sector has been kept at Rs 700 billion for the next fiscal as against subsidy allocation of Rs 730 billion for the current fiscal.
- Focus on improving awareness on the importance of quality of the soil through The Soil Health Card scheme would tilt the consumption mix in favour of complex fertilisers; however, this change would be slow and gradual.
- The direct benefit transfer scheme (announced on a pilot basis) is likely to reduce the subsidy leakage in the long run and, thereby, lower the government's subsidy burden over time.

In the context, what's CRISIL's ratings call?

Credit profiles of fertiliser manufacturers largely depend on subsidy policy. For urea manufacturers, most ratings are in the 'high safety' category, given the stable profits expected under the new policy, healthy operating efficiencies and low-term debt. Moreover, large players are continuously improving energy efficiencies and operating within their revised energy norms. The credit profiles of CRISIL-rated large complex fertiliser players will continue to be supported by strong raw material linkages, superior efficiencies and healthy financial risk profile.

With subsidy receivables high at Rs 246 billion (implying a ~126-day cycle) as on March 31, 2015, working capital requirement now accounts for nearly 80% of the total debt of fertiliser makers. A cut in the government's subsidy bill will lower the working capital requirement of manufacturers. However, this benefit will be partly offset by the need to invest capital on improving energy efficiencies (to maintain profitability under the tight energy norms set for fiscal 2019) for urea players, and higher inventory levels for complex fertiliser manufacturers.

Distribution of aggregate debt for CRISIL-rated 43 fertiliser companies



Source: CRISIL Ratings

How to read the chart above: Bars indicate aggregate debt in a particular rating category for CRISIL-rated fertiliser players, while numbers in circles denote companies in that category.

Rating outlook distribution[7]	Positive (1)	Stable (36)	Negative (0)

Credit outlook for select CRISIL-rated fertiliser companies
1. Indian Farmers Fertilisers Co-operative Ltd (CRISIL AA-/Positive/CRISIL A1+)
Indian Farmers Fertilisers Co-operative Ltd (IFFCO), India's largest fertiliser manufacturer, has a capacity of 4.2 million tonne per annum (mtpa) of urea and 4.4 MTPA of phosphatic fertilisers. IFFCO has a market share of ~20% in urea and 30% in phosphatic fertilisers. IFFCO benefits from its diversified business risk profile and strong presence in agrarian belts. Four of its five urea plants are in Uttar Pradesh, the No. 1 consumer of urea among states. Moreover, all five urea plants operate well within the energy consumption norms set up to fiscal 2018. IFFCO's capital expenditure plans for energy-saving projects will also improve operating efficiencies over the medium to long term and boost operating profitability. Further, IFFCO's integrated nature of operations at its Paradip plant, presence of key raw material tie-ups and overseas subsidiaries/joint ventures to manufacture phosphoric acid, provide it with access to adequate raw materials at competitive prices, supporting profitability.

[7] Excludes 6 companies rated C/D or with only short-term rating

IFFCO's financial risk profile is characterised by huge working capital debt to fund subsidy receivables, minimal long-term debt, strong net cash accrual and its healthy financial flexibility.

For the nine months ended December 31, 2015, IFFCO provisionally reported a profit after tax (PAT) of Rs 5.80 billion on an operating income of Rs 227.29 billion.

2. National Fertilisers Ltd (CRISIL AA-/Stable/CRISIL A1+)

National Fertilisers Ltd (NFL) is the second-largest urea manufacturer, with ~16% share in domestic production and a capacity of 3.567 mtpa across five plants. Its Vijaipur-I and II plants in Madhya Pradesh have healthy operating efficiency in terms of energy consumption and have high capacity utilisation. Moreover, the performance of the Nangal, Bathinda and Panipat plants have improved as they significantly reduced energy consumption in fiscal 2016. The new gas pooling policy will help NFL produce beyond 100% capacity at all five plants. These factors will drive up its operating profit over the medium term.

However, NFL has high gearing and modest -- though improving -- debt protection metrics. This is owing to an expected reduction in working capital debt because of faster realisation of capital subsidy receivables (for feedstock conversion projects at Nangal, Bathinda, and Panipat) in fiscal 2016.

For the nine months ended December 31 2015, NFL reported a PAT of Rs 1.66 billion on an operating income of Rs 61.35 billion.

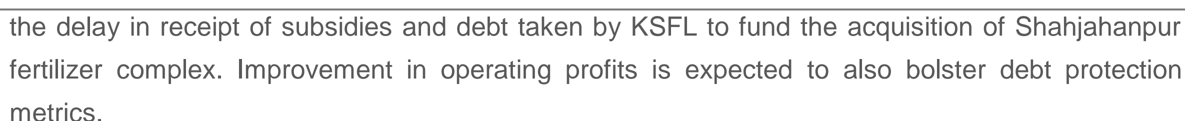
3. Krishak Bharati Co-operative Ltd (CRISIL AA-/Stable/CRISIL A1+)

CRISIL combines the business and financial risk profiles of Krishak Bharati Co-operative Ltd (Kribhco), Kribhco Shyam Fertilisers Ltd (KSFL), and Kribhco Infrastructure Ltd for arriving at the rating for Kribhco.

Kribhco was set up by the government in 1980. The society manufactures fertilisers primarily urea, including bio-fertilisers, and seeds. Kribhco and KSFL combined are the third-largest domestic urea manufacturers with a production capacity of 2.59 million tonne (3.19 million tonne including revamp).

Both Kribhco's and KSFL's business risk profiles are characterised by healthy operating efficiency as reflected in substantial improvement in energy efficiencies at Kribhco's Hazira plant and stable energy consumption at KSFL's Shahjahanpur plant; both plants are expected to operate well within the revised energy norms. Moreover, both plants have capacity utilisation of above 120%, producing 0.7 million tonne of urea, which will be entitled for a fixed incentive under the new policy. Efficient energy consumption at Kribhco's plant and favourable policies will drive up profit in this fiscal, which will be sustained in the next fiscal.

The Kribhco Group, though improving, has an average financial risk profile marked by high gearing and modest debt protection metrics. Gearing is high because of the large working capital debt to fund



the delay in receipt of subsidies and debt taken by KSFL to fund the acquisition of Shahjahanpur fertilizer complex. Improvement in operating profits is expected to also bolster debt protection metrics.

For the six months ended September 30 2015, Kribhco, on a standalone basis, reported a PAT of Rs 0.93 billion on an operating income of Rs 36.94 billion.

4. Chambal Fertilisers and Chemicals Ltd (CRISIL AA-/Stable/CRISIL A1+)

Incorporated in 1985 in Kota, Rajasthan, Chambal has the largest installed urea capacity in the private sector in India with a market share of 8-9%. The company also has significant investments in the shipping and software businesses.

Chambal maintains high operating efficiencies, as both its plants consume energy well within the norm and has high capacity utilisation rate. Chambal's efficiency in terms of employee cost and other overheads is among the best in the industry, which results in healthy operating profit. The company is setting up a 1.34 mtpa brownfield urea plant at the existing site at Gadepan in Rajasthan, which will cost $900 million. The project will be funded in a debt-to-equity ratio of 78:22. The risks associated with the project are largely mitigated by the fixed price nature of a LSTK contract, presence of supporting infrastructure (including gas pipeline connectivity and surplus land) at the site, and strong management capabilities. Further, risks associated with respect to the gas linkage are mitigated, as the gas pooling allows the gas supplies of proposed brownfield units to be met through the gas pool from fiscal 2019 onwards. Chambal's credit risk profile is supported by strong existing cash flows and the management's commitment to sell whole or part of non-fertiliser business to bring in part of the equity contribution for the project.

For the nine months ended December 31 2015, Chambal, on a standalone basis, reported a PAT of Rs 1.15 billion on an operating income of Rs 79.41 billion.

5. Coromandel International Ltd (CRISIL AA+/ Stable/CRISIL A1+)

Coromandel is India's second-largest phosphatic fertiliser manufacturer, with a market share of ~17%. The company's market position is underpinned by its entrenched and leading position in Andhra Pradesh — the country's largest market for complex fertilisers — and its wide product portfolio. Moreover, Coromandel has strong operating efficiencies because of the economies of scale it has in raw material procurement, established relationships with raw material suppliers, captive production of phosphoric acid, superior plant infrastructure and its low handling and transportation costs. This boosts profitability. Its operating efficiencies are also supported by its ability to adjust its product-mix to suit prevailing raw material prices and subsidy regimes. However, Coromandel's profitability was impacted in first nine months of fiscal 2016, as deficient rainfall in most target markets impacted demand for phosphatic fertilisers. This is expected to increase channel inventory by the end of fiscal 2016 and will persuade players to offer discounts in 2016-17, if demand fails to improve.

Coromandel has maintained a strong financial risk profile, as it has minimal debt and large cash and equivalents. Being part of the Murugappa group, the company also enjoys strong financial flexibility.

For the nine months ended December 31, 2015, Coromandel reported a PAT of Rs 2.68 billion on an operating income of Rs 85 billion.

Metals & Mining

RATING OUTLOOK
Negative despite government intervention

Jarring notes will continue for metal makers

Metal prices have plummeted sharply due to global slowdown and massive overcapacity, especially in China. Tailing this, domestic steel and aluminium prices are estimated to decline by 16-19% and 15-17% respectively, this fiscal.

Given the grim scenario, the imposition of a minimum import price (MIP) on 173 iron and steel products for six months in February and increased customs duty on aluminium are expected to provide some succour to manufacturers.

Steel imports are also expected to come down and prices could increase by 5-8% next fiscal, assuming government interventions continue. However, significant capacity addition in the current fiscal and the next (close to 10 million tonne in steel) will limit the headroom to increase prices. And manufacturers of flat steel -- rather than long steel -- will benefit more from MIP, given greater competition and low imports in the latter segment.

FAQs

Is the debt servicing ability of the steel industry expected to improve?

Higher steel prices and softer raw material prices (domestic iron ore and international coking coal) should lift the profitability from current lows. However cash flows will remain under pressure because of mountainous debt – as much as Rs.2.8 trillion for CRISIL-rated players alone. Further, cost of coal for companies whose captive coal blocks were de-allocated will increase. Secondary steel producers will also have to contend with stiffer competition from larger makers of long steel. This would limit profitability gains.

Consequently, we do not foresee a material improvement in debt servicing ability of the industry. CRISIL's analysis of secondary steel makers also shows that every third player is vulnerable to credit risk due to surging imports, falling prices and poor demand.

What about aluminium makers?

The southward trend in aluminium prices is expected to continue, and we see a 3-5% decline next fiscal. Power costs are expected to rise by 6-7%, as smelters begin to run on high-cost captive coal, awarded in the February 2015 auction. This would further squeeze profitability and put continued pressure on credit quality.

What's the outlook for miners?

The outlook for mining companies is also weak because of subdued demand, cheaper imports and weak commodity prices. In 2015, the government passed the Mines and Minerals (Development and Regulation) Act and is in the process of starting auction for mines bearing minerals such as bauxite, iron ore and limestone. Although these regulations would herald long-term transparency in the sector, it may not support near-term profitability. The exception is coal mining --largely monopolised by Coal India -- with significant demand-supply deficit and strong balance sheet. Coal India is expected to continue to maintain its strong credit profile.

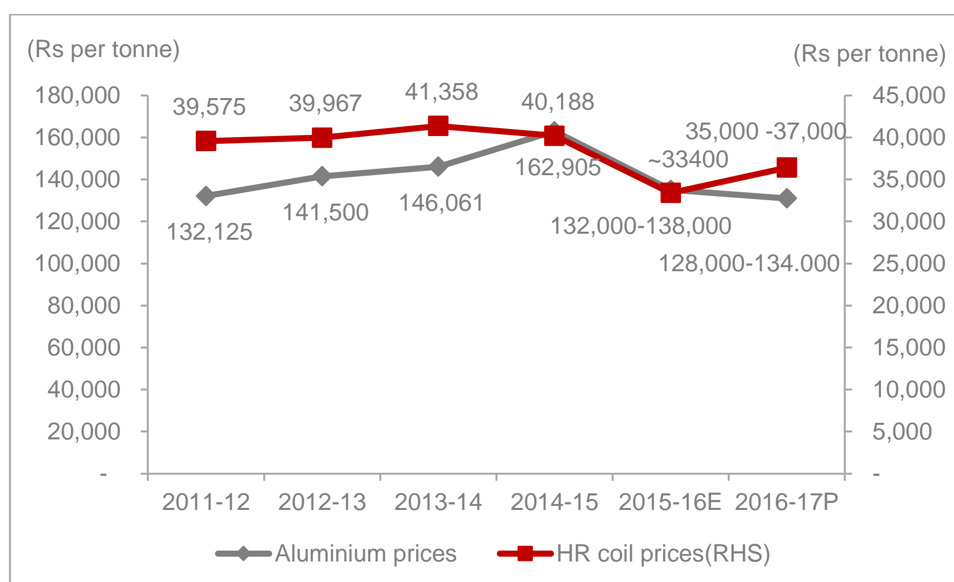
What about cost-efficiency measures being undertaken by metal cos?

Amid a weak operating environment, companies are curtailing output from high-cost smelters and focusing on cost efficiencies at the plant level to lower their cost of production. Players are also looking to deleverage balance sheets through asset monetisation. However, CRISIL believes cost-efficiency measures are unlikely to fully offset the impact of declining realisation and therefore profitability. Further, timely sale of non-core assets, though critical, will also be contingent upon valuations and approvals.

What has the Budget done for the sector?

In the Union Budget 2016-17, the customs duty on aluminium and aluminium products has been hiked to 7.5% from 5%. The hike will benefit the industry marginally as it will halve the gap between landed cost and domestic prices to 3-4% from 6-8% and curb imports.

Domestic aluminium and steel HRC prices to remain soft



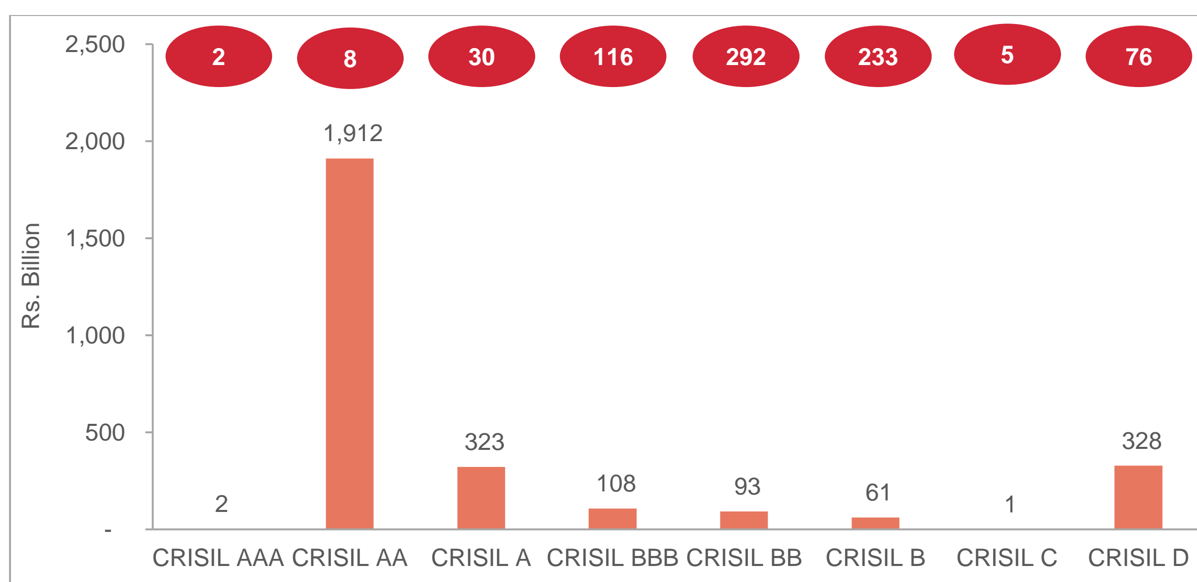
E: Estimated; P: Projected

Source: Industry, CRISIL Research

In the context, what's CRISIL's rating outlook?

Ratings of most companies carry a negative outlook, signalling expected weakening in credit quality. The ratings may be downgraded in the near term, in case of further weakening of operating profitability and continued high debt levels. As much as 80% of CRISIL's rated portfolio – mainly secondary steel players – is in the sub-investment category. Timely liquidity backing from promoters and /or refinancing from banks will, therefore, be the key to credit risk profiles. But a handful of mid-sized players have a positive outlook on the back of strong balance sheets, diversified product profiles and long-standing relationship with customers. Sustained improvement in their business profile could potentially lead to an upgrade.

Distribution of aggregate debt in CRISIL-rated metal & mining companies



Source: CRISIL Ratings

How to read the chart above: Bars indicate aggregate debt in a particular rating category for CRISIL-rated textile – cotton yarn players, while numbers in circles denote companies in that category.

Rating outlook distribution[8]	Positive (10)	Stable (626)	Negative (34)

Credit outlook for select CRISIL-rated metals & mining companies
1. Vedanta Ltd (CRISIL AA-/Negative/CRISIL A1+)
The Vedanta group is majority-owned by Vedanta Resources, a metal, mining, power, and oil-and-gas company, listed on the London Stock Exchange. Vedanta Resources has business interests in aluminium, iron ore, zinc, lead, oil and gas, power and copper in Australia, India, Ireland, Zambia, Namibia and South Africa. Vedanta Resources holds 62.9% stake in Vedanta. The group's copper,

[8] Excludes 92 companies on rating watch or rated C/D or with only short-term rating

iron ore, and power divisions, and its aluminium assets in Jharsuguda and Lanjigarh (Odisha) are in Vedanta. The group also has aluminium operations through Balco and operates its oil and gas business through Cairn India and zinc business in India through Hindustan Zinc Ltd.

CRISIL believes that Vedanta's operating profitability will remain weak in the near term due to moderation in cash flows from the oil and gas, iron ore, and aluminium businesses despite healthy profitability from the zinc business, sound conversion margins in the copper business, and cost rationalisation initiatives. With expectation of subdued oil prices, cash flows from Vedanta's oil and gas business are to remain weak over the medium term.

Although Vedanta has moderated its capex in this business due to decline in oil prices, free cash flows will be lower than earlier expected. In its aluminium business, Vedanta is focused on improving the cost of production. However, realisations have fallen sharper than the improvement in COPs, thus impacting overall cash flows from the business. Weak iron ore prices and transportation issues in Goa have impacted the ramp-up of operations in the iron ore business as well. Also the business risk profile of Vedanta has been moderated by the slow ramp-up of its aluminium smelters and power projects.

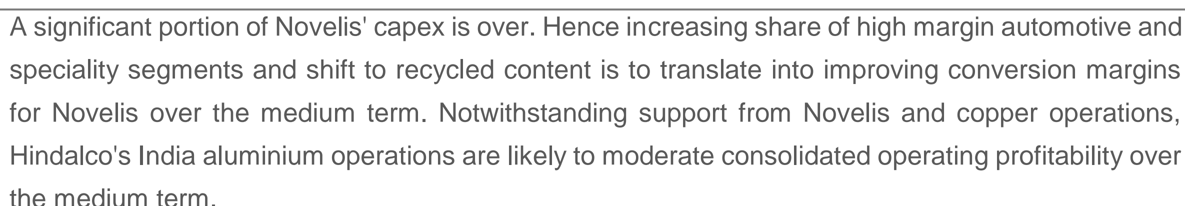
While company has undertaken significant cost efficiency measures to partly offset the impact, CRISIL believes that Vedanta's cash flows will moderate over the medium term. Consequently, Vedanta's net debt to Ebitda ratio is likely to significantly exceed CRISIL's earlier expectations of 3 times and will now take longer to correct. Subdued commodity prices and delayed ramp up across businesses may lead to a further deterioration in Ebitda. This may further delay the correction in net debt/Ebitda ratio and would be a key rating sensitivity factor over the medium term.

For the nine months ended December 31, 2015, Vedanta, on a consolidated basis, reported a PAT of Rs 484.5 billion on an operating income of Rs 41.4 billion.

2. Hindalco Industries Ltd (CRISIL AA-/Negative/CRISIL A1+)

Hindalco is the flagship company of the Aditya Birla Group. Hindalco has a leading market position in the Indian aluminium industry (one-third of the domestic installed capacity for aluminium and around half for copper), with a large proportion of downstream value-added products in its product portfolio. The company also holds 100% stake in Novelis, Inc, whose stable business risk profile and ability to upstream cash flows will support Hindalco's aluminium business in India

Hindalco's consolidated debt/Ebitda ratio remains high at over 7 times because of debt contracted to fund expansion of greenfield smelters and capital expenditure (capex) in Novelis. With weaker-than-expected outlook on profitability in Hindalco's aluminium business, consolidated financial leverage may remain high over the medium term. Hindalco has proactively refinanced its loans in both India operations and Novelis. Refinancing, along with strong liquidity, will support overall financial risk profile amid weak operating environment.



A significant portion of Novelis' capex is over. Hence increasing share of high margin automotive and speciality segments and shift to recycled content is to translate into improving conversion margins for Novelis over the medium term. Notwithstanding support from Novelis and copper operations, Hindalco's India aluminium operations are likely to moderate consolidated operating profitability over the medium term.

For the nine months ended December 31, 2015, Hindalco reported a PAT of Rs 2.5 billion on an operating income of Rs 256.5 billion.

3. Rashtriya Ispat Nigam Ltd (CRISIL A+/Negative)

Rashtriya Ispat Nigam Ltd (RINL) is one of the largest players in the highly fragmented domestic long steel products segment with an installed capacity of 6.3 mtpa (including recently commissioned additional 3.3 mtpa). Furthermore, the company is refurbishing its existing facility to augment its capacity to 7.3 mtpa from 6.3 mtpa, which is likely to be commissioned by March 2018.

The commodity price turmoil has taken a toll on RINL's credit risk profile. RINL’s business risk profile will remain under pressure over the medium term as continued weak demand and fall in steel price realisations will adversely affect profitability. The ongoing pressure on steel price realisations, which is expected to ease only marginally over the medium term, would only be partially offset by the reduction in cost of inputs - mainly iron ore and coal in the near term.

4. Coal India Ltd (CRISIL AAA/Stable/CRISIL A1+)

Coal India plays a strategic role in meeting India's energy requirements. It is the largest coal producing company in the world, with a production of 494 million tonne in 2014-15. It also holds the largest coal reserves in the world with proved reserves of 52.5 billion tonne as of April 1, 2010. In April 2011, the company was awarded the maharatna status, becoming the 5th public sector undertaking with this status.

Coal India possesses around 48% of India’s proven reserves in its command area and accounts for about 81% of India’s domestic coal production and has a near monopoly status. Due to the increasing demand-supply gap and thrust from the government, the company focused on increasing in coal production in 2014-15; thus it witnessed a healthy growth of around 7% compared with 4% between fiscals 2009 and 2014. Coal India has targeted coal production of 615 million tonne by 2016-17. To achieve this, the company plans to take up 126 projects with a cumulative capacity of 438 million tonne during the period.

Coal India’s healthy operating margins are expected to benefit further over the near term driven by higher proportion of e-auction volumes and the auctioning of coal linkages for non-power sector. CRISIL believes that apart from its healthy business risk profile, Coal India will continue to benefit

from its strong financial flexibility with marginal debt and healthy financial flexibility with liquidity of Rs 551 billion as on March 31, 2015.

For the nine months ended December 31, 2015, Coal India produced 373.51 MT of coal and posted a PAT of Rs 23.9 billion on an operating income of Rs 1.2 billion.

Pharmaceuticals

RATING OUTLOOK
Stable

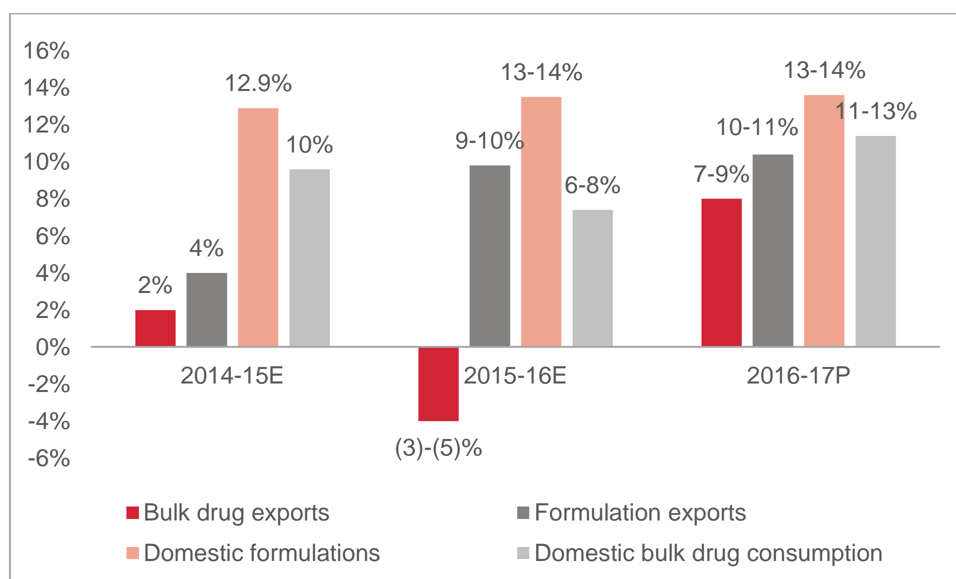
On steady growth path; local and US markets key

India's pharmaceuticals sector is expected to post a growth of 11-12% in the current fiscal led by domestic formulations and a rebound in exports. We expect the growth rate to sustain in the next fiscal as well.

Here's how we see it panning out next fiscal:

- Domestic formulation sales are projected to increase by 13-14%, propelled by continued high demand in chronic-care drugs such as anti-diabetics and cardiovasculars. The government notified the new National List of Essential Medicines 2015, bringing more drugs under price control. However, in value terms, the extent of control increases only from ~17% now to ~18% in terms of market value. Therefore, we believe this will have a negligible impact on growth.
- Growth in formulations exports to the US will remain strong for players not facing regulatory scrutiny currently. Even in Europe and Latin America, high volume growth is likely to offset the impact of currency fluctuations leading to improvement in prospects.
- Bulk drug exports are projected to grow by 7-9%, driven largely by volumes, while domestic consumption of bulk drugs would expand by 11-13%.

Growth outlook for pharmaceutical industry



Note: Growth rate for domestic formulations and domestic bulk drug consumption is in rupee terms

Growth rate for formulation exports and bulk drug exports is in dollar terms

E: Estimated, P: Projected

Source: CRISIL Research

FAQs

What's the call on sector profitability?

Large Indian formulation manufacturers will enjoy an Ebitda margin of 24-25% in the current fiscal, as growth in the US market improves for a few. Further uptick in profitability, though, will be offset by higher US Food and Drug Administration (FDA) compliance costs and R&D expenses. On the other hand, profitability for mid- and small-sized formulation manufacturers is estimated to witness greater improvement in 2015-16, aided by successful launches by a few companies and decline in raw material expenses. For bulk drug companies as well, declining crude oil prices and pricing of linked commodities will aid higher margin growth this fiscal. But margin growth for the industry is likely to remain range-bound in 2016-17 because of higher expenditure on R&D and regulatory compliance.

What will be the impact of regulatory scrutiny and price orders?

The sector witnessed increased scrutiny from the FDA in 2015 with the regulator issuing warning letters and import alerts to several large Indian firms, including Sun Pharmaceutical Industries Ltd, Dr Reddy's Laboratories Ltd and Ipca Laboratories Ltd. This is emerging as one of the key challenges as it can potentially delay approvals and product launches in the US. While this will be a key monitorable, CRISIL believes that any impact on credit profiles will be material primarily for companies with high revenue concentration from specific geographies or plants.

The domestic market will remain exposed to any expansion of the price control regime by the National Pharmaceutical Pricing Authority. The Drug Price Control Order regulates prices of drugs in India in certain key therapeutic areas by fixing an overall ceiling. While such orders amplify the risks posed to specific drugs, they are expected to have minimal impact on the industry as companies have the flexibility to thereafter revise prices in line with changes in the wholesale price index. Further, healthy volume growth, driven by increasing income levels and incidence of lifestyle diseases, will continue to translate in healthy cash flow for India-focused companies.

Will M&A activity find traction?

Large players have been active in the M&A space. While expansion to new geographies and access to the generic pipeline of mid-sized companies are the key drivers for inbound deals, outbound deals are driven by the need to thwart increasing competition, gain access to unpenetrated markets, acquire distribution networks and build a specialty product portfolio. We expect the sector to continue to be in the limelight in the next fiscal. Larger players have the wherewithal to absorb moderate-sized acquisitions given their steady cash flows and strong balance sheets. Multinational players such as Mylan Laboratories Ltd will also have access to funding support from their parent for large acquisitions.

What has the Budget done for the sector?

The budget was largely neutral for the pharmaceutical industry. Reduction in weighted research and development (R&D) deduction to 150% from fiscal 2018 is likely to increase the industry's tax outgo in

the long run but not immediately. Nevertheless, companies will continue to spend on R&D as they focus on tapping lucrative export opportunity in regulated markets such as the US

What about key credit metrics?

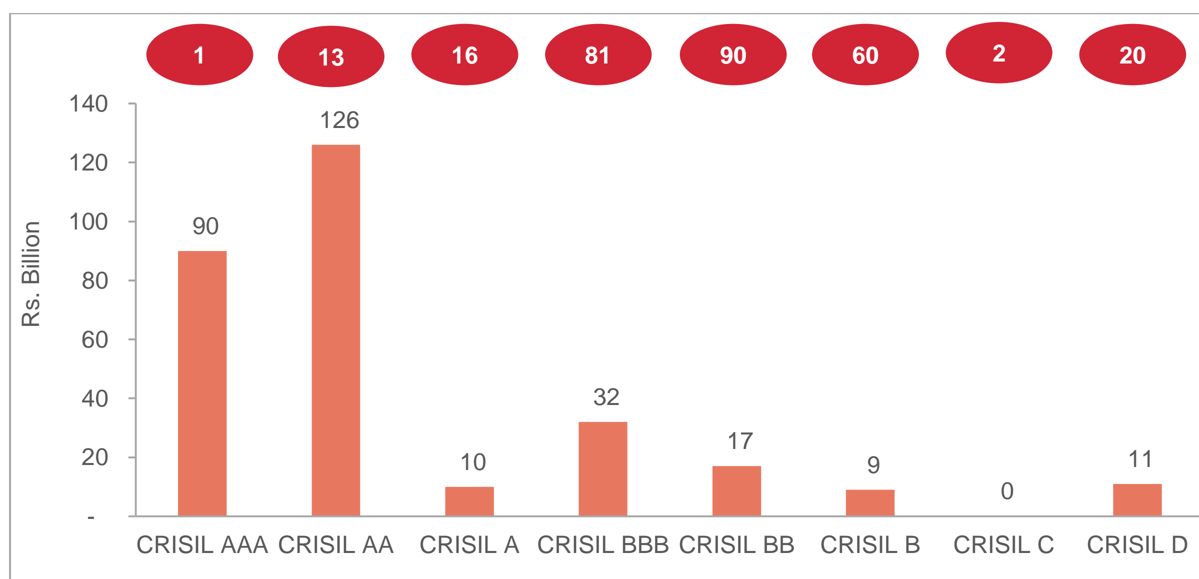
Some of the key credit metrics – such as interest coverage ratios, debt to Ebitda ratio and capital structure -- have remained steady for majority of the players in 2015-16, buoyed by a diverse revenue profile and healthy operating profitability. This is likely to continue in fiscal 2017 as well, except for players with significant exposure to the emerging markets– as stretched working capital cycle could push up debt level and temporarily impact credit metrics. CRISIL, however, believes that the inherent business strength and fundamentals would partly buttress the impact of higher debt levels on credit profiles of these entities.

In the context, what's CRISIL's ratings call?

Strong revenue growth, diversity in revenue profile and steady profitability, apart from robust financial profile, will continue to sustain ratings of large players, despite challenges on the exports front. For mid-sized players, diversification of geographic reach, widening of customer base, while sustaining profitability and reducing working capital intensity, will drive rating upgrades.

On the other hand, performance of companies likely to be materially affected by the actions of the FDA will lead to rating stress, as was seen for Mylan Laboratories and Ipca Laboratories, whose rating outlook was revised to 'Negative' last fiscal. Going forward, we believe timelines and costs involved in remediation measures, and any material impact on revenue and profitability will drive further rating actions.

Distribution of aggregate debt for 283 CRISIL-rated pharma companies



Source: CRISIL Ratings

How to read the chart above: Bars indicate aggregate debt in a particular rating category for CRISIL-rated pharma players, while numbers in circles denote companies in that category.

Rating outlook distribution[9]	Positive (15)	Stable (240)	Negative (6)

Credit outlook for select CRISIL-rated pharmaceutical companies
1. Sun Pharmaceutical Industries Ltd (CRISIL AAA/Stable/CRISIL A1+)
Sun Pharma is the leader in the domestic formulations market with ~8.9% market share. The company has more than 500 brands, with 30 of them featuring in the top 300 pharmaceutical brands in the country. The US is a key market for Sun Pharma, contributing to around half of its revenue. Of late, import alert at one of its plants in Halol, Gujarat, has temporarily impacted revenue and product approvals. The company also continues to sort out the legacy issues inherited after acquiring Ranbaxy Laboratories Ltd and take remedial measures. Revenue growth in the US is expected to remain subdued till this is solved. But with Ranbaxy now in its fold, Sun Pharma's presence across emerging markets and the global consumer healthcare and over–the-counter (OTC) businesses has increased significantly. Operating profitability in 2014-15 moderated to 29% (from around 45% in 2013-14) as the company, in the course of the merger, incurred charges related to policy alignment, closure and impairment; this is expected to improve over the medium term to ~30%, supported by a comprehensive product portfolio and healthy operating efficiencies. Sun Pharma's strong financial risk profile stems from its healthy cash accrual, strong networth, moderate gearing and substantial liquidity, which complements its business risk profile. In the absence of any major debt-funded capex, coupled with progressive debt reduction, gearing is likely to be comfortable. For the nine months ended December 31, 2015, Sun Pharma reported a PAT of Rs 38.68 billion on an operating income of Rs 206.81 billion.
2. Cadila Healthcare Ltd (CRISIL AA+/Stable/CRISIL A1+)
Cadila is one of the top five players in the Indian formulations segment with a market share of ~4%. Cadila has a fairly diversified revenue base with a healthy mix of revenues from different therapeutic segments. It is a market leader in the high-growth lifestyle segments such as gastrointestinal and gynaecology. Domestic business grew at a moderate pace last fiscal due to price controls on its products, but it is expected to grow in line with the market in the near to medium term. The company's global roadmap for the next few years includes filing of generic products in the US and other regulated

[9] Excludes 22 companies on rating watch or rated C/D, or with only short-term rating

markets. The company's Moraiya plant is under regulatory scrutiny, which is expected to impact sales growth. Though site transfers are underway, it will lead to lower revenue in the interim.

The financial risk profile derives strength from Cadila's healthy financial metrics (gearing of 0.73 time and healthy liquidity). The company's financial risk profile will remain strong because of healthy operating margin and cash accrual.

For the nine months ended December 31, 2015, Cadila reported a PAT of Rs 11.61 billion on an operating income of Rs 73.89 billion.

3. Biocon Ltd (CRISIL AA+/Stable/CRISIL A1+)

Biocon is India's leading bio-pharma company with a diversified revenue base, which includes domestic formulations, contract research and sale of active pharmaceutical ingredients (APIs). It is also one of the leading producers of generic insulin in Asia. The company is also developing a range of generic insulin analogs and biosimilars in partnership with Mylan Inc, for worldwide development and commercialisation. Biocon, through its subsidiary Syngene International Ltd, is one of the leading contract research organisations in India and plans to begin manufacturing specialty APIs to diversify its revenue profile.

To de-risk its dependence on the small molecule APIs, Biocon is building a pipeline of new complex new generic products in segments such as oncology, neurology and ophthalmology. With its Malaysian facility being commissioned, the company is on course to make filings, which will eventually help it to cater to the US and European markets.

The company's robust financial risk profile is reflected in its large networth of Rs 36.26 billion as on September 30, 2015, healthy cash accrual and ample liquidity. Despite planned capital expenditure, Biocon's financial risk profile is expected to remain robust.

For the first nine months of 2015-16, Biocon reported a PAT of Rs 6 billion on an operating income of Rs 25.07 billion.

4. Alembic Pharmaceuticals Ltd (CRISIL AA/Positive/CRISIL A1+)

Alembic is among the top 20 domestic formulations players with a market share of ~2%. It has a strong presence in the acute therapeutic areas and an improving market position in the chronic therapeutic areas, with strong brands built over the years. Four of its products feature in the top 300 brands in India. Led by regular product launches, the domestic business is expected to post healthy growth.

We expect that the share of Alembic's international business would increase steadily led by healthy revenue growth from regulated markets, particularly the US. Revenue from the US markets received a leg-up in the first half of the current fiscal with the launch of Ablify (aripiprazole) generic, resulting

in 53% growth. The setting up of its own marketing unit in the US is likely to further provide a fillip to revenue growth. Higher-than-expected profitability led by a healthy growth in the high-margin international segment and chronic segment within the domestic market, while maintaining its financial risk profile, would most likely result in a rating upgrade.

Alembic's healthy business risk profile is also complemented by its comfortable financial risk profile with a sound capital structure (gearing of 0.1 time as on September 30, 2015), strong networth and adequate liquidity. Any substantial debt-funded capex or acquisition will remain a rating sensitivity factor.

For the first nine months of 2015-16, Alembic reported a PAT of Rs 6.28 billion on an operating income of Rs 25.13 billion.

5. Glenmark Pharmaceuticals Ltd (CRISIL AA-/Negative/CRISIL A1+)

Glenmark manufactures and markets pharmaceutical formulations and APIs and undertakes R&D on new chemical and biological entities. The company has a market share of ~2% and is one of the leading players in the domestic formulations market, especially in chronic segments such as dermatology, respiratory and cardiovascular therapies. It has a growing presence in the US and other regulated markets, which account for around 40% of its revenue. Revenue post aggressive filing of abbreviated new drug applications, or ANDAs, with the US FDA is expected to drive growth going forward. Glenmark also has a strong position in the semi-regulated markets, where it is rapidly expanding its presence by launching new products.

Glenmark's moderate financial risk profile is marked by large incremental working capital requirements and capex, and sizable repayments on financial obligations, which would only gradually improve the capital structure going forward. We believe the company's aggressive ANDA filing strategy and capacity expansion at its US facilities are also likely to keep debt levels high. Debt protection metrics will remain moderate with stable cash accrual. The rating may be downgraded if the company's credit metrics weaken due to higher debt levels for capex or incremental working capital requirements. On the other hand, better cash generation or substantial equity infusion resulting in debt reduction, while maintaining operating profitability, would most likely result in a revision in outlook to 'Stable'.

For the first nine months of 2015-16, Glenmark reported a PAT of Rs 5.59 billion on operating income of Rs 53.43 billion.

Power	RATING OUTLOOK Negative on weak demand, capacity additions

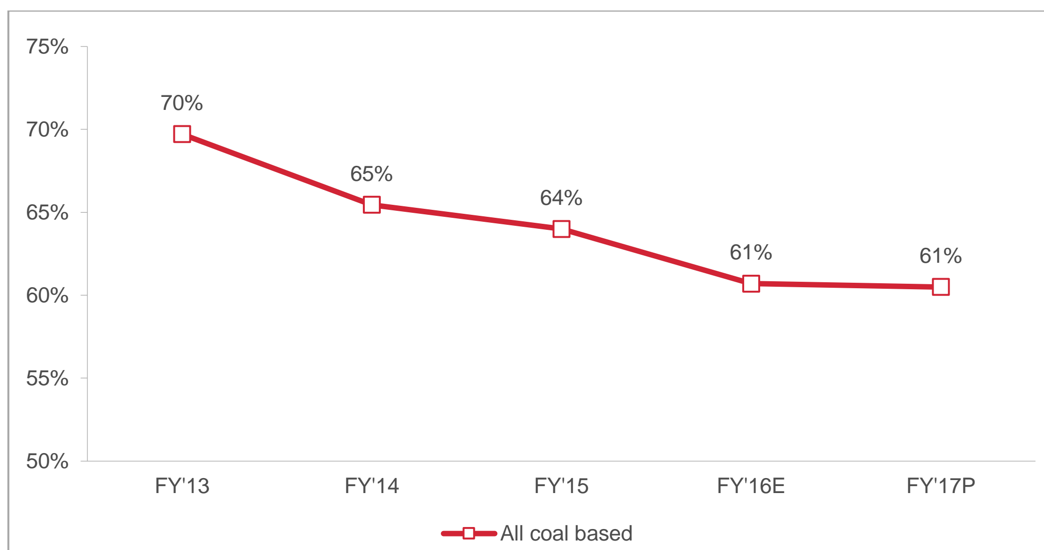
Low PLF pain remains for gencos; UDAY can change game

The outlook for India's power sector remains largely negative next fiscal on the back of continued weak demand from distribution companies (discoms), which hasn't kept pace with GDP growth and capacity addition. Of the total installed coal-based capacities (which contribute over two-thirds of the total power generation) almost 10,000 mw are estimated to be without any long-term power purchase agreements (PPAs). We expect merchant tariff to be subdued and average plant load factor (PLF) of coal-based capacities to remain low next fiscal as well.

What all this will mean for gencos:

- Under-recovery of costs and further stretch in financial profile
- Impact will be maximum on capacities without long-term PPAs
- With supplies high, capacities being commissioned next fiscal will also face high risk of stabilisation, especially sans PPAs and fuel supply arrangements.

PLF of coal-based capacities to remain depressed



Source: CEA, CRISIL Research

Distribution remains the weakest link in India's power sector value chain. Riddled with high losses and debt – stemming from tariffs not reflecting costs and high transmission losses – the sector has often needed a lifeline.

We expect the recently announced UDAY scheme to result in better liquidity and reduction in discom losses. It will improve the ability of discoms to procure power and re-initiate signing of long-term PPAs – or at least medium-term ones. The success of UDAY will depend on the level of adherence to milestones for reduction of aggregate technical & commercial (AT&C) losses, as these would also play a role in reducing costs and hence losses.

FAQs

What will be the trend in the operating performance of gencos?

Generating companies with cost-reflective tariffs and long-term PPAs will see improvement in operating performance because fuel availability – primarily coal – is expected to improve next fiscal. Though not fully adequate, supply improvement will be driven by increased production and availability of railway infrastructure. Imported coal will also be affordable if prices continue at current levels, but any sharp adverse movement in the rupee-dollar exchange rate will be an offset. However, projects that were bid out aggressively will continue to see under-recovery in fixed costs. Also, gas-based capacities will remain under stress because of non-availability of fuel despite the government support in the form of e-auction of regasified liquefied natural gas at subsidised rates.

What's the outlook for transmission companies?

The outlook for operational transmission projects is stable because of low demand risk and also because revenues are linked to line availability. For a majority of them, monthly line availability has been over 99%. However, exposure to weak state discoms would impact the credit risk profile of projects – in case of prolonged delays in payments. For inter-state transmission projects, however, the presence of point of connection, or POC, pool mechanism and strong collection efficiency of Power Grid Corporation of India mitigates such risks to a large extent.

What has the Budget done for the sector?

The outlay for power sector is 84% higher than the current fiscal. The increase in allocation is aimed at improving rural power supply and lowering transmission & distribution losses.

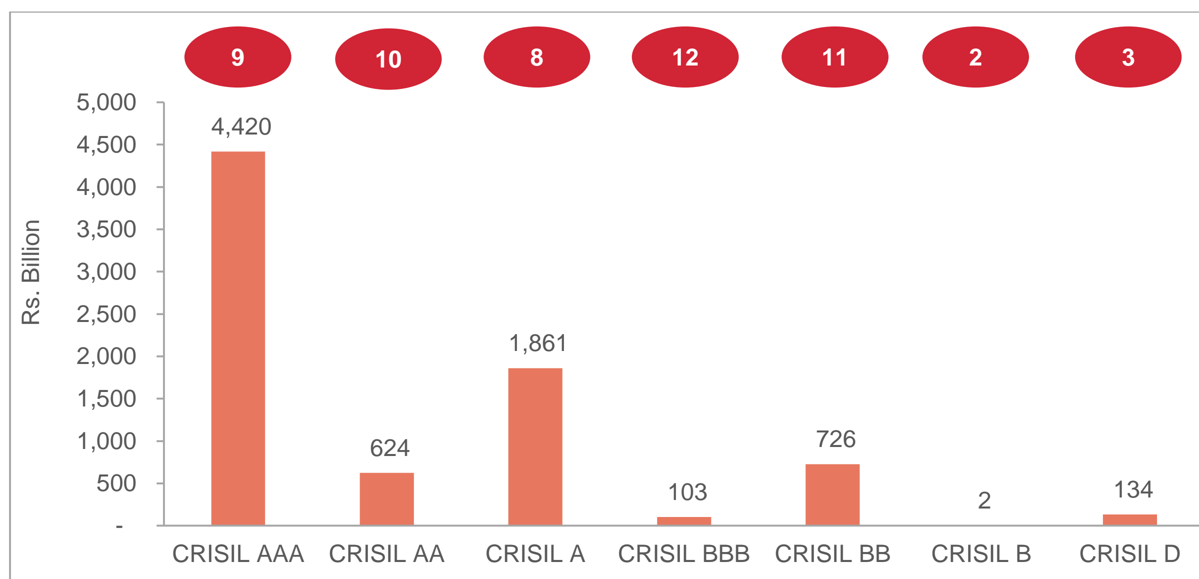
The doubling of clean energy cess levied on coal is expected to increase power generation costs by 10-12 paise per unit. However, this is not expected to impact fixed-return projects as they can pass these costs through. The project returns of competitively bid projects too will not be impacted as amendments (in January 2016) to the National Tariff Policy provide for automatic pass through of revision in such charges.

In the context, what's CRISIL's ratings call?

Companies dependent on the merchant market or those that are seeing under-recovery in their already tied-up tariffs due to competitive bidding will continue to have weak financial risk profiles. Almost 17% of CRISIL-rated power companies have a negative outlook because of these reasons. However, most of the companies rated highly by CRISIL are expected to have a stable outlook next fiscal due to long-term PPAs, cost-reflective tariffs and strong financial risk profiles. Some government companies also

benefit from their strategic importance in India's power sector. Next fiscal, operational transmission projects may refinance their bank loans through longer-tenure capital market instruments at lower interest costs. This, in turn, will improve their debt coverage ratios and will be a credit positive. Further, we believe any merger, acquisition or resolution of compensatory tariff dispute could drive rating changes next fiscal.

Distribution of aggregate debt in 55 CRISIL-rated power companies



Source: CRISIL Ratings

How to read the chart above: Bars indicate aggregate debt in a particular rating category for CRISIL-rated power generation and distribution companies, while the numbers in circles denote companies in that category.

Rating outlook distribution[10]

Credit outlook for select CRISIL-rated power companies
1. NTPC Ltd (CRISIL AAA/FAAA/CRISIL A1+)
We believe NTPC will continue to maintain its dominant position in the Indian power generation sector with new capacity additions and competitive tariff and will thus continue to be of strategic importance to the government. Its financial risk profile will remain strong over the medium term, driven by healthy capital structure and robust liquidity owing to its superior operating and collection efficiencies.

[10] Excludes 8 companies on rating watch or rated C/D, or with only short-term rating

NTPC, already India's largest power generating company with total installed capacity of 45 GW (directly and through its subsidiaries and joint ventures), has another 22 GW of capacities in various stages of implementation. The company maintains market leadership due to its highly competitive tariff and a large, diversified customer base.

NTPC accounts for about 26% of India's total power generation, making it a crucial stakeholder in the government's strategy to expand generation capacity. Consequently, the government has provided need-based financial support in the past to NTPC through guarantees for foreign currency borrowings and by granting it maharatna status. NTPC has also been the beneficiary of one-time settlement scheme promulgated by the government through the Ahluwalia Committee. Its plants are insulated from fuel risk. Any shortfall in its overall coal requirement, which is currently being met by Coal India Ltd (CIL), can be met through imports, as its PPAs allow for pass-through of fuel costs.

NTPC's existing and upcoming capacities (till 2016-17) are under the Central Electricity Regulatory Commission's (CERC) tariff regime, which allows full recovery of all costs provided normative plant availability factors are met. The company, owing to its superior efficiencies, continues to maintain plant availability higher than normative levels. Further, its track record of 100% collection efficiency in the past 12 years has ensured stable cash flows. NTPC's business profile is complemented by its strong financial risk profile, underscored by healthy capital structure and robust liquidity.

For the nine months ended December 31, 2015, NTPC reported a PAT of Rs 75.26 billion on an operating income of Rs 523.94 billion on a standalone basis.

CRISIL takes a consolidated approach for arriving at the ratings of NTPC.

2. NHPC Ltd (CRISIL AAA/Stable)

We believe NHPC will continue to be of strategic importance to the power sector, given its role in harnessing the hydro power potential of India. Its business risk profile will be supported by regulated nature of business and efficient operations leading to nearly full recovery of costs. Its financial risk profile will continue to be supported by strong liquidity and healthy net cash accrual.

NHPC, where the government holds 85.96% stake, is a miniratna and operates 20 hydro power plants with a combined capacity of 6.507 GW.

A large portion of the power it generates is supplied to special category states in the north-east and to Jammu & Kashmir. Moreover, the government has in the past provided support through viability gap funding (loans at subsidised interest rates) and also by initiating central plan action (CPA) in case of delays of payments from discoms.

The company benefits from healthy operating efficiencies arising from higher-than-normative plant availability factor (PAF), which ensures full recovery of costs since its plants operate under the tariff regime regulated by CERC, which leads to stable cash flows.

The company has large ongoing capacity expansion projects in remote locations and challenging terrain, which lead to time and cost-over runs. As a result, NHPC will remain exposed to project implementation risks.

For the nine months ended December 31, 2015, NHPC reported a PAT of Rs 23.36 billion on an operating income of Rs 56.11 billion on a standalone basis.

CRISIL consolidates NHPC with its two subsidiaries – Narmada Hydroelectric Development Corporation Ltd and Loktak Downstream Hydroelectric Power Corporation Ltd – along with proportionate consolidation of the JV National High Power Test Laboratory (P) Ltd for arriving at its ratings.

3. The TATA Power Company Ltd (CRISIL AA-/Stable/CRISIL A1+)

Tata Power's credit risk profile is supported by stable cash accrual from its regulated businesses. The company, along with its various subsidiaries and joint ventures, is present across the entire power value chain i.e., generation, transmission and distribution. The company's 40% generation capacity, distribution businesses in Delhi and Mumbai, and its transmission businesses are under regulated tariff regime, thereby ensuring stable cash accrual and contributing to around half of its consolidated revenues. Also, Tata Power has a strong management with extensive domain expertise. The company has robust financial flexibility owing to its healthy liquidity and stable cash accrual, which is further enhanced on it being a part of the Tata Group. CRISIL expects the company's credit risk profile to continue to benefit from the regulated nature of its businesses, strong management, and association with the Tata Group.

Tata Power's credit risk profile, however, has weakened over the past on account of around 25% of its capital employed being in the economically unviable Mundra UMPP, which requires support from Tata Power for debt servicing. With the recent refinancing of Mundra UMPP's long-term rupee debt, the support requirement from Tata Power has significantly reduced. Final outcome on Mundra UMPP's compensatory tariff will remain a key monitorable. Also, recent decline in coal prices has significantly reduced the dividend income from Tata Power's coal investments.

For the nine months ended December 31, 2015, Tata Power, on a consolidated basis, reported a PAT of Rs 6.1 billion on an operating income of Rs 281.1 billion

CRISIL consolidates Tata Power and its group companies, including Tata Power Delhi Distribution Ltd, Coastal Gujarat Pvt Ltd, Maithon Power Ltd, Tata Power Trading Company Ltd, Powerlinks Transmission Ltd, Tata Power Solar Systems Ltd and SPVs formed for the acquisition of coal entities

in Indonesia, along with proportionate consolidation of Tata Power's coal operating entities in Indonesia, for arriving at its ratings.

4. Torrent Power Ltd (CRISIL AA-/Stable/ CRISIL A1+)

Torrent Power handles the power business of the Torrent Group (with presence in pharmaceuticals through Torrent Pharma) and is engaged in generation and distribution businesses mainly in Ahmedabad, Gandhinagar and Surat, with distribution franchisee in Bhiwandi and Agra. Its distribution business in Ahmedabad, Surat and Gandhinagar enjoys a natural monopoly as it is the sole distribution licensee in these areas. Further, its strong operational and commercial efficiency, with low AT&C losses, has ensured stable cash flows. The company’s generation capacities of AMGEN (422 mw; coal based) and SUGEN (1,147.5 mw; gas based), too, derive benefits from stable cash flows owing to their strong operational performance and regulated tariff. However, its DGEN (1,197 mw; gas based) and SUGEN-40 (382.5 mw; gas based) were stranded till March 2015 for want of gas and face offtake and fuel availability risks.

In the current fiscal, Torrent Power's cash flows are estimated to be higher than in previous years driven by tariff hikes in its Ahmedabad and Surat distribution businesses, which has enabled partial recovery of past regulatory gap. Also, improved cash flows from SUGEN-40 and DGEN under the e-bid RLNG scheme, leading to a PLF of 25-30%. In the near term, the company will continue to benefit from strong cash flows from the distribution business and recovery of past regulatory gap based on approvals. Further, SUGEN-40 and DGEN are expected to continue to participate in the e-bid RLNG scheme and benefit from improved cash flows to meet debt service obligations next fiscal.

Over the medium term, CRISIL will monitor the approval of PPAs of SUGEN-40 and DGEN by the relevant regulators, which will play a key role in improving the viability of these projects. To support long-term fuel requirements, Torrent Power has signed an agreement with Petronet LNG for one million tonne per annum regasification arrangement for 20 years starting 2017. Favourable outlook for RLNG prices and an expected gradual increase in natural gas production could enable these plants to produce cost competitive power that would offset off-take risks and would improve the long-term viability of the project.

For the nine months ended December 31, 2015, Torrent Power on a consolidated basis reported a PAT of Rs 8.41 billion on an operating income of Rs 92.06 billion.

5. Power Grid Corporation of India Ltd (CRISIL AAA/Stable/CRISIL A1+)

We believe Power Grid will continue to be strategically important to the government given the importance of its transmission network in meeting power generation targets. The company will continue to have a robust financial risk and stability in cash flows backed by efficient operations and regulated tariff structure over the medium term. The company has been consistently maintaining line availability, on which recovery of tariff depends, well above the normative availability of 98%.

A central transmission utility and a navratna, Power Grid is under the administrative control of the Ministry of Power. It owns and operates transmission network of 115,637 circuit km (mostly 400 KV transmission lines) and 192 sub-stations. The company is responsible for national grid management, planning transmission systems and for collection of transmission charges from all interstate transmission service (ISTS) customers on behalf of ISTS licensees.

The company benefits from healthy operating efficiencies arising from higher than normative system availability, which ensures full recovery of its costs and stability to its cash flows. Further, the company's track record of completing new projects within stipulated time have also help it in generating steady revenues for debt servicing.

Power Grid is well insulated from threat of new competition as it has already locked in Rs 1 trillion of capex for the Twelfth Five Year Plan. The company has also started participating in competitively bid out projects, the returns from which will remain a key monitorable.

While Power Grid derives its entire revenue from the financially weak discoms, its strong collection efficiency largely mitigates this risk. Moreover, Power Grid's authority to regulate power to defaulting customers lends additional comfort.

For the nine months ended December 31, 2015, Power Grid reported a PAT of Rs. 44.28 billion on an operating income of Rs. 150.42 billion on a consolidated basis.

Telecom

RATING OUTLOOK
Negative

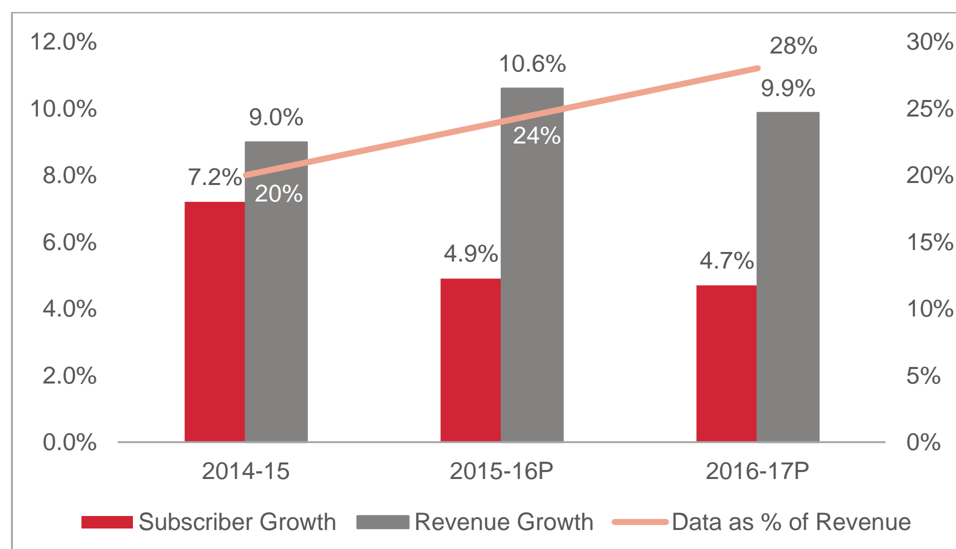
Funding needs to soar as data booms, rivalry heats up

Telecom industry revenue is foreseen growing 10% next fiscal, propelled by rapid increase in data subscribers and traffic as 3G and 4G services proliferate, driven by cheap handsets. Capex outlay is likely to increase further as players scramble to roll out network upgrades ahead of the impending launch by Reliance Jio Infocomm (Jio). We expect to witness a high-intensity battle for grabbing high-usage, service-focused data subscribers once Jio enters the fray, which will also spawn a shift in focus from pure-play services to content differentiation.

Here's how we see things panning out next fiscal:

- Chances of tariffs falling beyond 20% look remote despite Jio's imminent entry.
- Data revenue expected to grow 30-35% from levels seen in current fiscal, while voice revenue would likely stay flat.
- Rise in network opex amid regulatory push on quality of services, pricing pressure, marketing expenditure and rollout of 4G services will lead to a decline in Ebitda margin by up to 400 bps.
- Drop in profitability, capex needs, payout for spectrum acquired at the previous auctions and another round of spectrum auction will increase the funding needs of operators.
- The dip in margins and higher investments will put pressure on the already stretched debt protection metrics of players, the average debt to Ebitda for incumbents was high at over 4 times as of March 31, 2015.

Domestic revenues and subscriber growth



Source: CRISIL Research

What about debt levels?

Leverage in most telcos has increased significantly following the 2014 and 2015 telecom auctions – total debt in CRISIL-rated entities (including deferred spectrum payment liabilities) doubled to Rs 3,077 billion as of March 2015 from Rs 1,450 billion as of March 2012. Majority of the debt added has been towards reacquisition of expiring spectrum and acquisition of additional bands for 3G and 4G rollout. Debt levels are forecast to increase further with 3G and 4G network rollouts accelerating and spectrum auctions scheduled to take place in fiscal 2017. Further, any debt-funded acquisition will place more strain on their already stretched balance sheets.

Will we see further consolidation?

After the March 2015 spectrum auctions, the top three operators – Bharti Airtel, Vodafone, and Idea – which together account for more than 70% of industry revenue, have further consolidated their position. In the last two rounds of spectrum auctions, these operators, along with Jio, obtained about 85% of the spectrum sold. Their sheer dominance, in terms of both revenue and spectrum share, makes further consolidation inevitable.

Recent deals such as Reliance Communications' spectrum-sharing agreement with Jio and its acquisition of the telecom business of Sistema Shyam, and Idea Cellular's acquisition of Videocon's spectrum in two key markets indicate the pressure being faced by smaller players.

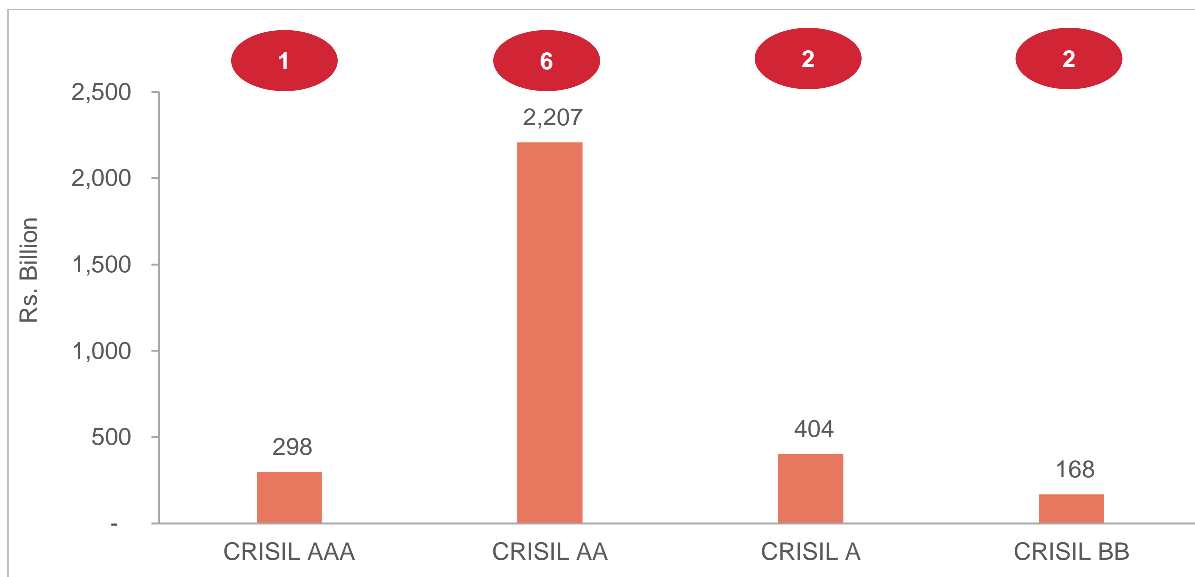
What has the Budget done for the sector?

The levy of 0.5% Krishi Kalyan cess will marginally increase telephone bills. Mobile phones are likely to become more expensive in the short term with withdrawal of exemption from basic customs duty and countervailing duty on import of mobile components and increase in special additional duty from 2% to 4%. These changes, we believe, will not have a material impact on the sector.

In the context, what's CRISIL's ratings call?

The top three telcos – Bharti Airtel, Vodafone India and Idea Cellular – have a strong market position, accounting for nearly 70% of the total industry revenue, and have robust cash flows, which afford them significant financial flexibility. Some of the CRISIL-rated telcos such as Vodafone, Tata Teleservices and Jio also benefit from strong parentage, and their standalone ratings are notched up based on parental support. CRISIL's ratings on these telcos also take cognisance of ongoing steps to reduce debt through asset sales and capital infusion by promoters. However, any significant debt contracted towards spectrum acquisition combined with the effect of the competitive strategy adopted by the telcos on profitability, will determine rating changes, if any, next fiscal.

Distribution of aggregate debt in 11 CRISIL-rated telecom companies



Source: CRISIL Ratings

How to read the chart above: Bars indicate aggregate debt in a particular rating category for CRISIL-rated telecom players, while numbers in circles denote companies in that category.

Rating outlook distribution[11]	Positive (0)	Stable (8)	Negative (2)

Credit outlook for select CRISIL-rated telecom companies
1. Bharti Airtel Ltd (CRISIL AA+/Stable/CRISIL A1+)
Bharti Airtel is currently the largest mobile operator in India with a subscriber base of over 200 million. It had a subscriber market share of over 23% and a revenue market share of over 31% as of September 2015. It was the first private player to operate in all 22 telecom circles. Besides India, the company operates in 19 countries across Asia and Africa. Bharti Airtel is the best-positioned among the top three telcos, in terms of spectrum holding, with the ability to offer 3G services in all circles except Kerala, besides having a pan-India 2G and 4G footprint. This has been augmented in the March 2015 auctions, wherein Bharti Airtel was not only able to renew its expiring spectrum but also acquire additional spectrum across 900 MHz, 1800 MHz and 2100 MHz bands. Moreover, the company has already launched 4G in over 300 towns, thereby acquiring the first-mover advantage over Jio and other rivals – this expanding 3G/4G footprint is expected to strengthen

[11] Excludes one company on rating watch

its business risk profile. Bharti Airtel continues to report strong growth in data revenues, with the share in total revenues increasing to 14% in 2014-15 from 9% in 2013-14. Bharti Airtel's operating margins are expected to remain stable over the short term as the increase in revenues from higher data usage will offset any additional costs incurred.

The company's strong business risk profile is complemented by its strong financial flexibility due to its access to both domestic and international capital markets. Further, the company's financial profile will remain strong because of robust cash accrual. Bharti Airtel's return on capital continues to remain moderate on account of the debt incurred for purchase of African assets. However, to reduce debt, the company has taken strategic initiatives such as selling overseas tower assets as well as operations in some African countries.

For the nine months ended December 31, 2015, Bharti Airtel reported a PAT of Rs 46.4 billion on an operating income of Rs 716.3 billion.

2. Vodafone India Ltd (CRISIL AA/Stable/CRISIL A1+)

Vodafone is the second-largest mobile operator in India with a subscriber market share of 19% and revenue market share of around 23% as of September 2015.

Vodafone, too, won spectrum in February 2014 as well as in the March 2015 auctions; apart from renewing its expiring licences, it acquired additional spectrum in 900 MHz, 1800 MHz, and 2100 MHz bands, which could be used to provide 3G services.

Vodafone's data strategy consists of a strong focus on its core markets – it has 4G spectrum availability in only five circles, but these circles constitute more than 50% of its total data revenues. The company, however, does hold 3G spectrum in 16 circles and 2G spectrum in all 22 circles. Similar to Bharti Airtel, Vodafone's share of total revenue from data has increased to 15% in 2014-15 from 9% in 2013-14.

Although Vodafone has funded a large part of its capex and spectrum acquisition through debt, it derives significant financial flexibility from being a 100% subsidiary of the Vodafone Group (Vodafone Group; rated 'BBB+/Stable/A-2' by Standard & Poor's [S&P]) and receives strong financial support from the parent company. The Vodafone Group has extended shareholder loans of around Rs 90 billion to Vodafone and infused Rs 60 billion in March 2015 to partly fund its upfront auction payment requirements. Further, the group has also invested Rs 75 billion in the Indian business by way of subordinated bonds. The financial profile is also supported by steady cash accrual. However, the company's operating profits have been under pressure in 2015-16, partly on account of higher-than-expected network operation expenses.

For the six months ended September 30, 2015, Vodafone reported a net loss of Rs 25 billion on an operating income of Rs 214 billion.

3. Idea Cellular Ltd (CRISIL A1+)
Idea Cellular, a part of the Aditya Birla Group, is the third-largest mobile operator with a subscriber market share of around 17% and revenue market share of around 19%. Like the other two top players, in the spectrum auction held in March 2015, Idea Cellular was not only able to renew its expiring spectrum but was also able to acquire spectrum across 900 MHz, 1800 MHz and 2100 MHz bands. Idea's focus has traditionally been on providing voice services and deepening its penetration among voice users. Nonetheless, it has also tried to keep pace with the evolving data market. Idea launched 3G services at the end of March 2011 and at present offers 3G services in 21 service areas. The company has also advanced its date for 4G data launch, from calendar year 2017 to the current year. It has already launched 4G services in a few cities. Idea's share of total revenue from data has risen to around 15% in 2014-15 from 9% in 2013-14. Increasing data revenues have helped improve the company's operating margins to 34% in 2014-15 from ~27% in 2012-13. Idea's financial risk profile continues to be marked by strong interest coverage and net cash accrual to total debt. Further, robust cash accrual backed by rising data uptake provide a cushion for the high debt. Idea also continues to be strategically important to the Aditya Birla group; the group's stake in the company allows it adequate financial flexibility. For the nine months ended December 31, 2015, Idea reported a PAT of Rs 25.04 billion on an operating income of Rs 264.97 billion.
4. Tata Teleservices Ltd (CRISIL A/Negative/CRISIL A1)
Tata Teleservices Ltd (TTSL) and its listed subsidiary Tata Teleservices (Maharashtra) Ltd (TTML) – together referred to as Tata Tele – provide telecom services under the Tata DoCoMo brand. The Tata group, through Tata Sons and other entities, holds over 60% equity stake in TTSL and 48% stake in TTML. Tata Tele's all-India subscriber market share was 6.2% as on September 30, 2015, while revenue market share was 6.8% for the quarter ended September 30, 2015. Tata Tele provides GSM (global system for mobile) services in 18 circles and CDMA (code division multiple access) services in 19 circles, and 3G services in nine circles, for which it has 3G spectrum. In the 2015 auction, the company acquired spectrum in 800 MHz and 1800 MHz for Rs 78.5 billion. Tata Tele continues to be among the weaker players in the telecom sector in India. Although its operating performance has improved over the last 12-18 months, backed by reduction in termination charges, scaling down of operations in loss-making circles, network optimisation through

redeployment of cell sites from loss-making circles, and stringent cost control measures, its market position continues to remain weak because of its late entry into the GSM space.

Tata Tele's capital structure remains highly leveraged with net debt of Rs 324 billion as on March 31, 2015. Tata Tele receives significant financial and management support from the Tata group, which has infused Rs 61 billion into the company over the past five years to support operations. Tata Tele has entered into agreement with American Tower Corp to reduce its stake in Viom Networks Ltd, a passive telecom infrastructure company, from 53% to 33% and is expected to receive Rs 28 billion by first quarter of 2016-17. The proceeds from the transaction are expected to be utilised to fund capex and debt repayment. Tata Tele also has an option to monetise its balance stake over the medium term, which adds to its financial flexibility.

For the six months ended September 30, 2015, TTSL reported a net loss of Rs 14.2 billion on a revenue of Rs 53.9 billion, against a net loss of Rs 19.6 billion on a revenue of Rs 54.3 billion for the corresponding period the previous year.

5. Reliance Jio Infocomm Ltd (Jio, CRISIL AAA/Stable/CRISIL AAA(SO))

Jio, incorporated in 2007, is a subsidiary of Reliance Industries Ltd (RIL). RIL holds around 99% of its subscribed equity shares. The company was a successful bidder in all 22 circles in the broadband wireless access (BWA) spectrum auction conducted by Department of Technology in June 2010. In October 2013, the company received the unified licence for all 22 service areas across India and became the first telecom operator in the country to get a pan-India unified licence, which allows it to offer all telecom services, including voice telephony, under a single licence.

Jio has been active in most spectrum auctions since 2010. In February 2014, it acquired the right to use spectrum in 14 circles. Further, in March 2015, it acquired the right to use spectrum in six circles in the 1,800 MHz band and 10 circles in the 800 MHz band. The company plans to use this spectrum holding in conjunction with its pan-India 2300 MHz spectrum to provide seamless 4G services.

Jio has a large liberalised spectrum holding of 751 megahertz (MHz), which includes 440 MHz in the 2,300 MHz band, 214 MHz in the 1,800 MHz band and 97 MHz in the 800 MHz band. This large spectrum holding will benefit the company, given the scarcity of spectrum in the country and the residual life of this spectrum being the longest across all telecom operators. Additionally, the LTE (long term evolution) technology has significantly evolved in the last few years, with increased efficiency of network equipment, availability of device eco-systems, and compatibility across bands.

Jio is strategically very important to RIL; it is RIL’s highly anticipated vehicle for re-entry into the telecom services industry. So, it will continue to get strong management and financial support from RIL. As on March 31, 2015, RIL had invested Rs 300 billion in Jio in the form of equity and also provided guarantee to the subsidiary’s debt obligations of around Rs 120 billion. RIL is expected to

fund a significantly large portion of Jio's total project cost as equity since most of the equity is likely to be invested before it ties up its debt.

However, Jio will be entering the sector at a time when there are well-entrenched and equally capable players such as Bharti Airtel, Vodafone and Idea Cellular, which command sizeable revenue market share and have been in operation for more than a decade. The amount of differentiation that Jio brings and the value proposition that it offers to users of incumbent players services will be critical in determining its success.

Textiles - Cotton Yarn

RATING OUTLOOK
Largely stable

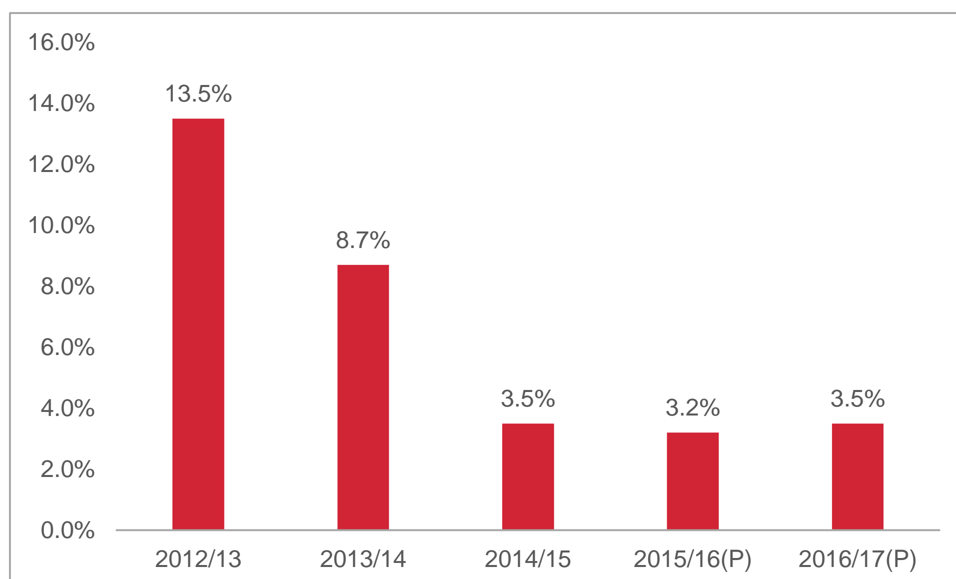
Demand will stay crimped, cotton stocks reined in

Demand for cotton yarn is expected to remain sluggish, growing 3-4% in fiscal 2017, because of expected moderation in exports and derived demand from export of garments and fabrics. Hence, consumption will be driven primarily by the relatively stable domestic demand.

Profitability of yarn manufacturers has improved in the current fiscal by 50-100 bps because of greater parity between cotton and yarn prices, after a significant decline in the last fiscal due to a sharp decline in yarn prices amid stable cotton prices.

Next fiscal, cotton prices are expected to get a lift from marginal increase in minimum support price and relatively lower yields. Yarn prices generally mirror this trend, but demand pressures and surplus capacity will prevent any material increase in prices. Consequently, profitability of yarn manufacturers is expected to remain largely stable in the coming fiscal.

Decline in exports growth has impacted cotton yarn demand



Source: Textile Commissioner's Office, Commerce Ministry, CRISIL Research

FAQs

What is the story on inventories?

Being a seasonal commodity, cotton is purchased in bulk during the cotton season and used through the year. Earlier, companies used to hold between 4-6 months of inventory. However, after fiscals 2011

and 2012, a period which witnessed a sharp decline in cotton prices resulting in large inventory losses, average cotton holding period has reduced from about 113 days in 2010-11 to about 84 days in 2014-15. This has continued in the current fiscal, and prudence in inventory is likely next year, too, unless cotton production witnesses a significant reduction. Historically, receivable management for this sector has been under control, characterised by tight credit terms and adequate consumers in the market. This is not expected to change despite muted demand as also evidenced in previous down cycles.

What is the trend in capacity addition?

Capacity additions over the next 2-3 years will be muted despite the recent modification to Technology Upgradation Fund Scheme (TUFS), where allocation for fresh investments for the entire textile value chain has nearly doubled to Rs 52 billion from Rs 27 billion. To boot, the 26% cap on the spinning sector has also been removed. Policy measures being implemented by various state governments also provide a positive investment climate for capacity expansion. However, the government doing away with interest subsidy and capping the capital subsidy under TUFS means smaller and modular projects of Rs 2 billion or below will be preferred over large projects. Capacity additions by standalone yarn manufacturers would be muted due to sluggish demand and capacity overhang. On the other hand, apparel or home-textile manufacturers that are partly backward-integrated into cotton yarn will continue to add spinning capacity to achieve higher integration.

What about debt levels of yarn makers?

Overall debt levels of yarn manufacturers are expected to remain under control driven by prudent capacity additions and working capital management.

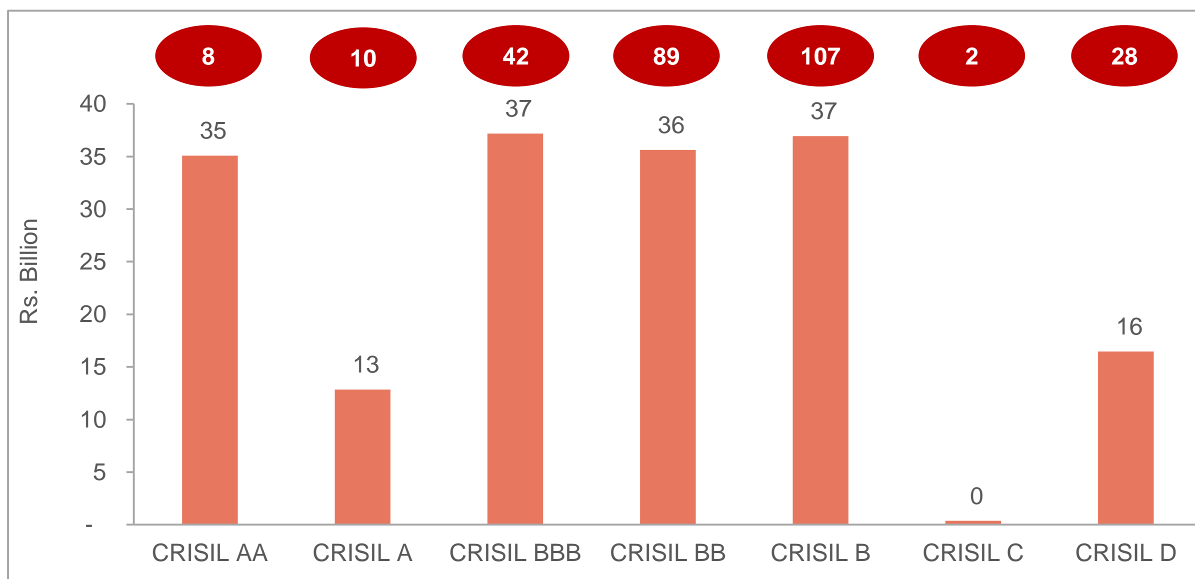
In the context, what's CRISIL's ratings call?

The rating outlook for yarn manufacturers is expected to remain stable next fiscal, underpinned by steady business outlook and gradual improvement in their financial metrics. In the last fiscal, there was acute pressure on ratings because of margin contraction, while this year, credit quality benefitted as pressure on margins eased and manufacturers exhibited prudence in working capital management and capacity addition. Consequently, key debt protection metrics such as gearing and interest coverage benefited during the year. Ratings for two large entities have already witnessed a change – Thiagarajar Mills Pvt Ltd (upgraded) and Ambika Cotton Mills (Outlook revised to Positive). Both exhibited resilience in margins in the last fiscal and also sustained their healthy financial metrics.

Also, about 10% of the rated portfolio is in default category (CRISIL D). This is largely due to peak repayment obligations for capex term loans coinciding with periods of distress (2014-15 and, to an extent, 2015-16) resulting in liquidity tightness and delays in meeting obligations.

Any upward rating actions next fiscal will most likely be driven by better profitability due to change in product mix in favour of higher value counts or value added products, as well as continued improvement in financial metrics. Management of working capital levels will remain a key monitorable.

Distribution of aggregate debt in 286 CRISIL-rated textile – cotton yarn companies



Source: CRISIL Ratings

How to read the chart above: Bars indicate aggregate debt in a particular rating category for CRISIL-rated textile – cotton yarn players, while numbers in circles denote companies in that category.

Rating outlook distribution[12]	Positive (9)[13]	Stable (243)	Negative (3)

Credit outlook for select CRISIL-rated cotton yarn/ integrated textile companies
1. Vardhman Textiles Ltd (CRISIL AA/Stable/ FAA+/ Stable/ CRISIL A1+)
Vardhman Textiles is part of the Vardhman group, one of India's leading textile groups, with operations across the yarn, fabric, sewing threads, fibre, special alloys, and garment sectors. CRISIL has combined the business and financial risk profiles all the companies to arrive at ratings for the entire group. The group has a strong market position in textiles marked by large capacities, spinning capacities accounting for ~2% of the total installed capacity in India, and diversified product portfolio that includes yarn, fabric, thread and steel. Vardhman group's operating efficiencies also benefit from economies of scale, especially in raw material procurement and integration in operations. It has a healthy financial risk profile marked by healthy networth and capital structure and strong debt coverage metrics.

[12] Excludes 32 companies on rating watch or rated C/D, or with only short-term rating
[13] Out of 9 companies, 6 companies are part of same group, on which a consolidated view is taken

Vardhman group's profitability is susceptible to the inherent volatility in cotton and yarn prices as ~50% of revenues are derived from cotton yarn, and large stocking requirements due to the seasonal nature of cotton, which further exposes it to the price volatility and adds to the working capital intensity.

Vardhman group's business metrics will remain healthy, driven by its diversified revenue profile. The group's healthy cash accrual and moderate capex plans will help it maintain its financial risk profile over the medium term.

For the nine months ended December 31, 2015, Vardhman group reported a PAT of Rs 4.56 billion on an operating income of Rs 50.29 billion.

2. Premier Weaving and Spinning Mills Pvt Ltd (CRISIL AA-/Positive/ CRISIL A1+)

Premier Weaving is part of the Premier group, which also has seven other companies. CRISIL has combined the financial and business risk profiles to arrive at ratings for the entire group. The group derives revenue from yarn, grey fabric and home furnishings (made-ups)

Premier group's business risk profile benefits from highly integrated operations, significant capacities in weaving and spinning. Operating efficiencies also benefit from economies of scale, especially during raw material procurement, and presence of captive windmills, which results in cost savings. Premier group's credit profile also benefits from continuous improvement in financial risk profile over the past five years supported by prudent funding of capex.

Premier group's profitability is susceptible to the inherent volatility in cotton and yarn prices. In the past four years, operating margins have fluctuated between 13% and 25%. Additionally, the group stock raw materials for up to 4 months, down from ~7 months in 2010-11, which has to some extent lowered its exposure to volatility in cotton prices besides moderating working capital intensity from earlier high levels.

We believe the group will not undertake any significant capex in the medium term thereby ensuring its financial risk profile strengthens further. Operating performance is expected to remain stable in the absence of any capacity addition.

3. Nahar Spinning Mills Ltd (CRISIL A/Stable/CRISIL A1)

Nahar Spinning is the flagship company of the Nahar group. It derives around 85% of its revenues from manufacture of cotton yarn and the remaining from garments and hosiery

Nahar Spinning has an established market position in cotton yarn and knitted garments, underlined by its strong relationship with its prominent domestic and international clients and healthy geographical diversity. However, its profitability remains susceptible to volatility in cotton and yarn

prices due to large dependence on cotton yarn for revenues. Between 2010-11 and 2014-15, operating margins ranged between 1% and 21.6%.

Nahar Spinning's financial risk profile is somewhat constrained by large inventory stocking policies during the cotton season, resulting in spiking of debt levels. Besides, the company has been actively enhancing its capacities, using debt, leading to modest credit metrics. Its return on capital employed is also sub-par due to volatile profitability and modest asset turnover.

Going forward, working capital intensity is likely to reduce owing to reduced cotton stocking, which will also benefit the financial risk profile. Nahar Spinning will also maintain its established market position and stable profitability, which would result in steady cash flows.

For the nine months ended December 31, 2015, Nahar Spinning reported a PAT of Rs 421 million on operating income of Rs 14.84 billion.

4. Ambika Cotton Mills Ltd (CRISIL A-/Positive/ CRISIL A2+)

Ambika, promoted by Mr P V Chandran, is a manufacturer and exporter of primarily finer count yarn ranging between 60s and 100s. The company specialises in manufacturing premium quality compact yarn, by optimal blending of imported and indigenous cotton.

Ambika benefits from healthy operational efficiencies, supported by premium quality yarn leading to better price realisation, flexibility to pass on any increase in raw material prices to its customers, and captive power generation resulting in reduced power costs. This is also reflected in its stable operating profitability, ranging between 19% and 21% over 2012-13 to 2014-15. Ambika's financial risk profile also benefits from absence of large debt-funded capex over the past five years and stable working capital management. This, along with healthy cash generation, has consistently improved its financial risk profile.

However, Ambika's business risk profile is marked by moderate revenue diversity -- with entire revenues derived from cotton yarn -- and limited customer diversity.

The company has no major capex plans, which will ensure its financial risk profile continues to strengthen while sustaining its healthy operating performance supported by steady offtake from end customers.

For the nine months ended December 31, 2015, Ambika reported a PAT of Rs 339.3 million on an operating income of Rs 3.72 billion.

5. Trident Ltd (CRISIL A-/Stable/ CRISIL A2+)

Trident, promoted by Mr Rajinder Gupta, manufactures cotton yarn and terry towels, and is one of the leading exporters of terry towels in India. It also manufactures writing and printing paper for the domestic market.

Trident has a strong market position in the textiles industry, with substantial capacity additions made over the past five years taking advantage of TUFS and available state government incentives. Its profitability benefits from the highly integrated manufacturing process for the textile division. Over the past three years, captive consumption of yarn for towels production has increased, which has helped mitigate against dwindling yarn realisations. High reliance on debt to fund its capacity expansions and working capital intensive operations has resulted in a moderate financial risk profile.

Trident's business risk profile will improve, driven by gradual ramp-up of operations in the recently expanded capacities and continuing healthy operating efficiencies. Its financial risk profile is also expected to improve, driven by moderate capex plans and healthy cash generation. Improving asset utilisation in recently added capacities will be a credit monitorable as the company has sizeable repayment obligations, mainly due to debt-funded capital spending.

For the nine months ended December 31, 2015, Trident has reported a PAT of Rs 1.73 billion on an operating income of Rs 27.19 billion.

Real Estate

RATING OUTLOOK
Continues to be negative

Plagued by low sales and high inventories

After declining continuously between 2012 and 2015, demand for residential units is expected to recover slightly and grow by 2% in calendar year 2016, driven largely by upcoming infrastructure projects or commercial drivers.

Here are the key trends that we see:

- New launches have slowed down, and developers are focusing on completion of existing projects instead. Even then, nearly 60% of the under construction residential real estate supply across top ten cities tracked by CRISIL is expected to be ready for possession only by calendar year 2018 because of project delays and postponements.
- Average residential capital values remained largely stagnant in 2015 in 10 major cities as demand for residential real estate continued to decline. Prices in NCR, Kochi, and Chandigarh fell 3-6% as sentiment turned bearish. Even though demand is expected to pick up marginally, we expect capital values to remain range-bound in 2016, given the high supplies.

Demand across top 10 cities in India: Trend and forecast

Source: CRISIL Research

FAQs

Are there any variations by region?

In addition to lower sales, approval delays in the west and lower collections in the north have heightened the woes of real estate players. In both these regions, developers who have stuck to construction schedules have benefitted from the timely receipt of customer advances linked to progress of construction. By contrast, developers in the South have done well due to stable sales and steady progress in construction.

Due to weak sales in the north and west, inventories continue to pile up with sustained construction activity. A CRISIL analysis of India's top 25 realtors in November 2015 showed high inventory levels in both regions; 58 months in the north and 48 months in the west.

What about commercial realty?

Vacancy levels have reduced on the back of limited additional supply and increasing absorption over the last couple of years. This trend is expected to continue on the back of healthy demand from IT/ITES and growth of e-commerce in the year ahead.

In the past, developers have borrowed in the form of lease rental discounting against their operational commercial assets to meet the funding gap in residential segment partially. A CRISIL analysis showed debt against commercial properties increased by Rs 50 billion over the last two years. While the developers can still leverage their commercial assets to raise funds, the cushion available will not be adequate to meet the large funding requirement in the residential segment, limiting the financial flexibility offered by this avenue in the year ahead.

Can developers get out of the vortex of debt?

In the past two years, due to lower collections, developers have taken on more debt to fund construction. In cases where banks have curtailed their exposure to the sector, developers have resorted to expensive sources of alternate funding such as non-convertible debentures. As a result, realtors remain highly indebted, and face increasing debt-servicing obligations in future. The only way out for them is to refinance the existing debt for which they will again have to rely on external borrowings. Apart from few developers who have projects with good sales potential and unencumbered operational commercial assets, the refinancing risk looms large for several others, stretching their credit profile. In an earlier report titled The Realty Reality, CRISIL estimated the total refinancing risk at Rs 300 billion over 2015-16 and 2016-17.

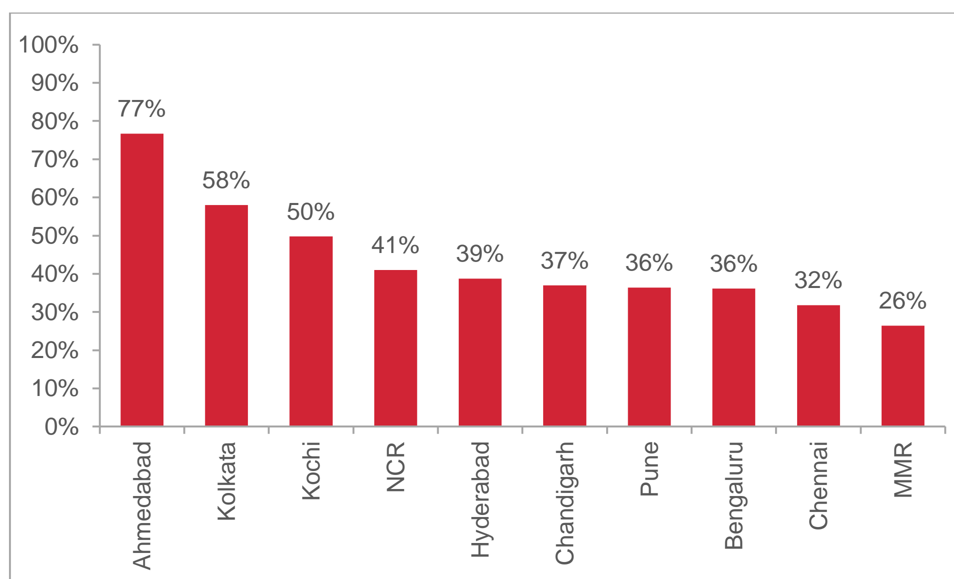
What has the Budget done for the sector?

It has provided some positives, especially in the affordable housing segment. The additional Rs 50,000 interest deduction provided to first time home buyers (applicable only on loans not exceeding Rs 3.5 million for houses costing below Rs 5 million and sanctioned between April 1, 2016 and to March 31, 2017) and tax benefits provided to developers constructing affordable houses meeting certain criteria should provide a fillip to this segment. Developers in Tier II and III cities (where an average residential

unit is priced below Rs 5 million) will be the prime beneficiaries, but in the top ten cities, too, nearly 40% of the upcoming supply is prices at less than Rs 5 million.

For developers, the abolition of dividend distribution tax means real estate investment trust (REIT) has become an attractive avenue to raise funds. CRISIL's analysis estimates that the large developers can potentially raise a total of Rs 0.36 trillion through REITs.

Percentage of upcoming supply priced below Rs 5 million



Source: CRISIL Research

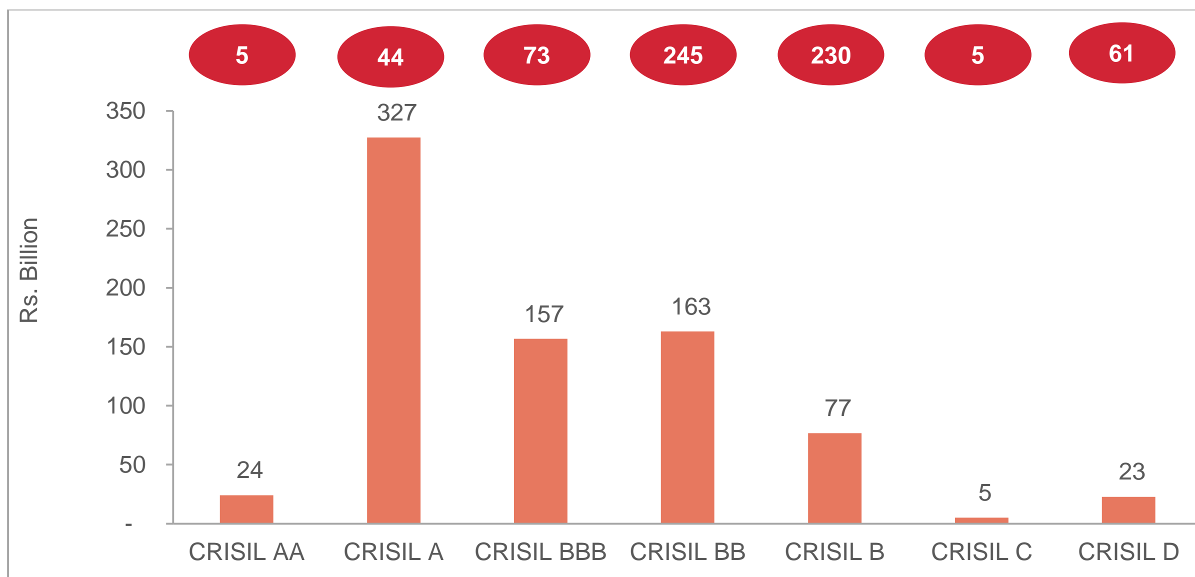
In the context, what's CRISIL's rating call?

As seen in the CRISIL-rated portfolio, most downgrade actions have been led by sustained low demand over the last three years. However, no substantial pick-up in sales is expected in this fiscal to generate the cash flows needed for both construction activity and debt-servicing obligations.

In this scenario, improving liquidity by refinancing the debt on conducive terms, making equity investments or selling land or other non-core assets will help sustain the credit profile of real estate developers. Banks are still wary of further exposure to the sector, so developers will continue to rely on alternate sources of funding.

Going forward, consumer sentiment is expected to improve with a gradual turnaround in the economy and payouts linked to the Seventh Pay Commission recommendations, but it is the actual pick-up in sales or even inquiries that will draw investor attention. CRISIL had earlier estimated the payout for private equity players in the next five years at Rs 0.85 trillion. This will only increase with more equity infusion. Hence, the ability of realtors to arrange funds to meet their business and financial requirements will play a key role in sustaining their credit profile.

Distribution of aggregate debt for 663 CRISIL-rated real estate companies



Source: CRISIL Ratings

How to read the chart above: Bars indicate aggregate debt in a particular rating category for CRISIL-rated real estate players, while numbers in circles denote companies in that category.

Rating outlook distribution[14]	Positive (2)	Stable (577)	Negative (18)

2016-17 credit outlook for Top-5 CRISIL rated real estate developers
1. Kolte-Patil Developers Ltd (CRISIL A+/FAA-/ Stable)
Kolte-Patil, incorporated in 1989, is promoted by Mr Rajesh Patil, his brother Mr Naresh Patil and his brother-in-law Mr Milind Kolte. The company is one of Pune's largest residential real estate developers. Since inception, it has developed 10 million sq. ft (msf). The company is now expanding operations into Bengaluru and Mumbai. Kolte-Patil has a strong market position in Pune with 19.6 msf of residential real estate projects under construction. The company has a large number of projects across segments, which has helped it to maintain healthy bookings, as reflected in sales of 3.2 msf of residential space in the five quarters ended September 2015. The company is also expanding its geographical reach; it has 1.6 msf of projects in Bengaluru and nine society redevelopment projects in Mumbai.

[14] Excludes 66 companies on rating watch or rated C/D, or with only short-term rating

Kolte-Patil's financial risk profile is comfortable with low gearing of 0.25 times as on March 31, 2015, as its projects are primarily supported by the steady flow of customer advances. The company is expected to maintain a gearing below 0.5 time over the medium term.

Kolte-Patil has been hit by the slowdown in the real estate industry; its sales growth has declined over the past two quarters. However, the company's reputation in Pune, and its healthy cash flow position give it a cushion to withstand such downturns. But Kolte-Patil's current project portfolio is almost twice the area developed and delivered till date, which poses significant execution and delivery risks. However, a major portion of the portfolio is at an advanced stage of construction, mitigating these risks.

For the nine months ended December 31, 2015, Kolte-Patil, on a consolidated basis, reported a net profit of Rs.0.6 billion on net sales of Rs.5.0 billion, against a net profit of Rs.0.8 billion on net sales of Rs.5.4 billion for the corresponding period of the previous year.

CRISIL takes a consolidated approach (Kolte-Patil and all its subsidiaries and associate companies) to determine Kolte-Patil's rating.

2. Hiranandani Group (CRISIL A+/Negative)

The Hiranandani Group was established in the late 1970s by Mr Niranjan Hiranandani and Mr Surendra Hiranandani. The group focuses on developing large, mixed-use, township projects in Mumbai and its suburbs.

CRISIL follows a consolidation approach for rating the Hiranandani group. Only those entities that have high business and financial linkages are consolidated in our analysis. CRISIL does not consolidate the business and financial risk profiles of other entities/groups associated with the Hiranandani family – EVITA Construction Pvt Ltd, Persipina Developers Pvt Ltd, Hircon International LLC, and Hiranandani Upscale – as these are managed separately.

The Hiranandani group has built a strong brand name in the Mumbai Metropolitan Region (MMR) over the past three decades. It has developed 14 msf of residential area and 7 msf of commercial area, which bolsters its business profile. Moreover, the group earns stable lease income of Rs 5.9 billion per annum from its large portfolio of leased assets (about 4.6 msf as on March 31, 2015) which supports its residential business in case of any cash flow mismatches.

However, the group's financial risk profile has moderated significantly in recent years. In 2014-15, the promoters withdrew Rs 13 billion, far higher than Rs 2-4 billion in previous years; this had to be funded by additional borrowing in the core group. Moreover, in the current year, the group has contracted a new LRD (lease rental discounting) facility of Rs 14.75 billion of which about Rs 10 billion will be passed on to the promoters. This is contrary to CRISIL's earlier expectations of no

withdrawal in 2015-16 and 2016-17. With this, the total external debt is expected to increase to around Rs 36 billion by March 31, 2016, from Rs 10.55 billion as on March 31, 2014.

CRISIL believes that the core group's leverage may increase further over the medium term to up-stream funds to the promoters, as the promoters have large development plans outside the core group, necessitating funding support. The financial risk profile may be impacted by how much capital the promoters withdraw and any further debt that the core group may raise to fund it; these are, therefore, key rating sensitivity factors.

3. Salarpuria-Sattva Group (CRISIL A/Stable/CRISIL A1)

The Salarpuria-Sattva Group was founded by the late Mr G D Salarpuria in 1986 in Kolkata. Currently, the group is managed by its managing director Mr Bijay Agarwal. It has developed 17 msf since inception, of which around 60% is commercial development (mostly in Bengaluru). The group has so far been a predominantly commercial real estate player but is now shifting its focus to residential real estate.

CRISIL takes a consolidated approach (the group's subsidiaries and joint ventures in the real estate business) to arrive at the rating for the group. However, the group's non-core businesses such as aerospace and technology have not been consolidated as they are unrelated to the core business and their operations are small vis-à-vis the group's networth.

The Salarpuria-Sattva Group has two core revenue streams, ensuring healthy, consistent cash flows. The group has a good residential portfolio of around 10 msf of which 50% is already sold; this ensures smooth cash flows from its residential business as projects progress. The group also earns lease income of Rs 1.8 billion per annum, providing it with a steady stream of cash flows and giving it the financial flexibility to raise debt.

The group's financial risk profile is expected to remain comfortable on account of its comfortable capital structure of 0.4 time as on March 31, 2015, and its ability to raise debt by leveraging lease rentals. The group also has unutilised bank lines of Rs 3 billion, which gives it adequate financial flexibility.

Although the real estate industry is in the midst of a slowdown, the group's healthy financial flexibility and its diversified business profile give it the wherewithal to withstand such downturns. However, the group is expanding its activities for growth, which exposes it to completion, market and risks related to cash flow management in projects.

4. Brigade Enterprises Ltd (CRISIL A/Stable)

Brigade Enterprises Ltd is the flagship company of the Brigade Group. The group, established in 1986, is one of the largest real estate players in southern India. Till date, it has developed around 26

msf, around 90% of it in the residential segment. The company's activities are concentrated in Bengaluru, although it has developed projects in Mysuru, Cochin, and Chennai too.

CRISIL consolidates Brigade Enterprises and its subsidiaries, together known as the Brigade Group, to arrive at the company's final rating.

The Brigade Group's strong track record and its diversified revenue profile support its business risk profile. The group generated Rs 1.1 billion in sales in 2014-15, backed by good saleability in the Bengaluru real estate market. Its residential business is complimented by steady cash flows (around 2.2 billion per annum) from the lease and hospitality segments. Healthy occupancy in its lease and hospitality businesses mitigates any fluctuation in cash flows, reinforcing its business risk profile.

The group has healthy financial flexibility, which is reflected in unutilised bank lines of Rs 3 billion and its ability to raise debt by leveraging lease rentals. It also had healthy cash and equivalents of around Rs 2 billion as on December 31, 2015, strengthening its liquidity profile.

The group has aggressive development and land acquisition plans, which has increased debt to Rs 14.7 billion as on December 31, 2015 compared with Rs 8.7 billion as on March 31, 2014. Given the slowdown in real estate, the Brigade group is vulnerable to demand- and project-related risks although its adequate financial flexibility and diversified sources of cash flows will mitigate these risks to some extent.

5. DLF Ltd (CRISIL A/Negative/CRISIL A2+)

DLF is one of India's oldest and largest real estate companies with experience in developing real estate projects across business and customer segments.

DLF has a strong business risk profile driven by a large portfolio of rental assets, strong market position in northern India, and a low-cost land bank. As on December 31, 2015, it has 37 msf of residential and commercial properties under construction, and a total leased asset portfolio of around 29 msf.

Given the subdued demand outlook for the residential segment, DLF's operating cash flows will continue to remain weak and its large debt will constrain its debt-protection metrics over the medium term. However, steady lease rental income provides stability to its otherwise cyclical business. The company has raised/re-financed debt at competitive rates, which reflects high financial flexibility. DLF follows a policy of maintaining liquidity equivalent to debt obligations over the next six months.

DLF has been actively pursuing a debt-reduction plan that includes disposal of non-core assets, induction of strategic investors, and fundraising through fresh equity issuance. In 2015-16, the company raised Rs 19.9 billion by selling stake in a residential project in Delhi to GIC Pvt Ltd, the

sovereign wealth fund established by the Singapore government. It also entered into an agreement to sell its movie exhibition business to PVR Ltd.

In 2016-17, the progress on debt reduction plan and its impact on financial risk profile will be a key monitorable.

For the nine months ended December 31, 2015, DLF, on a consolidated basis, reported a net profit of Rs.3.5 billion on net sales of Rs.69.2 billion, against a net profit of Rs.3.7 billion on net sales of Rs.57.0 billion for the corresponding period of the previous year.

Retail	RATING OUTLOOK Stable

Souped-up brick & mortars will adjust to new realities

Organised brick and mortar (B&M) retailers' (excluding jewellers) revenue growth will moderate to 13-15% next fiscal, compared with compounded annual growth rate of 24% over the last five years aided primarily by moderate growth in store space, increasing penetration across product categories and rising incomes. These retailers are positioned to benefit from increasing penetration of organised retail in India, which still remains low at 8.6%. This is despite the strong growth of e-retail, driven by aggressive discounting and increasing convenience.

The resilience of large B&M retailers will, however, vary across product categories. Those that are standardised in nature – books, music and consumer durables – will witness significant moderation in like-to-like growth, due to aggressive push by e-retailers. As a result, CRISIL expects B&M retailers to realign their business models and increasingly shift focus to apparels, food and groceries.

How are B&M retailers changing strategy?

Even as the pace of revenue growth is slowing down, B&M retailers have sharpened their focus on profitability across segments, and enhancing share of the more profitable private labels to improve margins. Besides, they are taking initiatives such as focusing on the omni-channel model, rightsizing their stores, expanding through a cluster-based model and to Tier II and III cities, as well as exiting from unviable product categories.

For instance, Aditya Birla Retail Ltd is adding stores in geographies where it already has a presence in order to spread supply chain costs, while Hypercity Retail Pvt Ltd (Hypercity; a 51% subsidiary of Shoppers Stop Ltd) has been resizing stores and stepping back on consumer durables to improve profitability.

In the current fiscal so far, profitability of large retailers has been in the range of 5-8%. This is expected to be the case in the next fiscal, too.

What is the picture on the debt side?

The intensity of store additions by large players has moderated over the past couple of years, which means gestation losses could be minimal. CRISIL expects new store openings to moderate to 10-15% of existing space in 2016-17 (16-18% in earlier years) due to limited availability of quality space in key metros, thereby leading to lower capex intensity. Players such as Avenue Supermarts Ltd (Avenue) and Reliance Retail Ltd though, may expand store capacities faster as they venture into newer cities, supported by profitable operations and strong balance sheets.

As for most large B&M retailers, continued promoter support, improving scale and cash generation because of a greater proportion of stores having broken even will limit reliance on external debt for expansions.

What has the Budget done for the sector?

Excise duty has been levied on branded garments (~30% of organised retail) at 2% (without CENVAT credit) or 12.5% (with CENVAT credit) for items retailing at Rs 1,000 and above. We expect the impact on retailers to be neutral as they are likely to pass on the cost increase to consumers.

Also, 100% foreign direct investment through approval route in marketing of food products produced and manufactured in India has been permitted. This may lead to higher investment by global players in food retail.

In the context, what's CRISIL's call on ratings?

Food retailing will continue to be more challenging compared with apparel because of lower gross margins and continuing losses. Avenue is the only pure-play CRISIL-rated food retailer with profitable operations that emanate from high productivity of its stores. Reliance Retail turned profitable due to the diversity of its product portfolio – including apparel and jewellery – despite the drag in food.

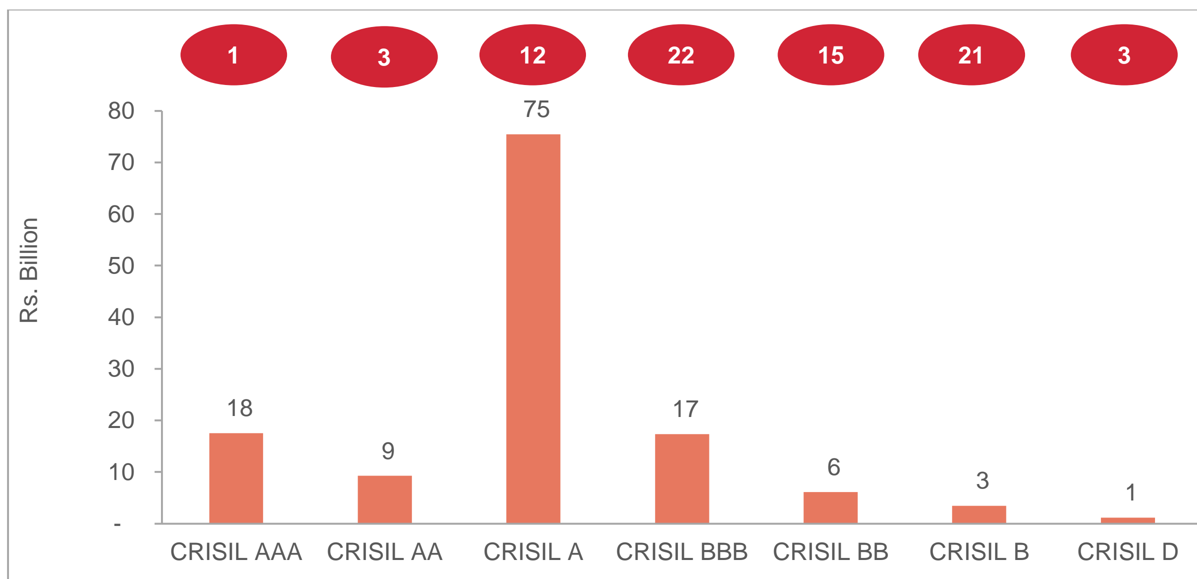
Nevertheless, the ratings of food retailers have been largely stable driven by the ability of promoters to fund extensive gestation losses and scale up business. Rating changes in this segment would be a function of higher number of broken-even stores and prudent working capital management.

As for apparel retail, higher growth and better profitability have always attracted investments. FabIndia Overseas Pvt Ltd and Lifestyle International Pvt Ltd continue to report healthy profitability in the range of 7.5-10%. Lifestyle International and Numero Uno Clothing Ltd have seen positive rating actions during 2015-16 on expectation of improved cash generation and credit metrics.

In contrast, the rating on Aero Club was downgraded due to margin erosion and stretch in working capital cycle. Rating upgrades will be driven by continued good operating performance of existing stores, quick turnaround of new stores and maintenance of key credit metrics at prudent levels, even as players pursue growth strategies.

The credit metrics of small and mid-size retailers (almost half of CRISIL's rated portfolio) – or debt/Ebitda and leverage -- is weaker than that of large retailers (which have higher working capital intensity and more external debt), due to limited capability of promoters to support operations and capex. Significant deterioration in key credit metrics due to large debt-funded capex or stretched working capital cycle will be key monitorables for small and mid-size retailers.

Distribution of aggregate debt of 77 CRISIL-rated B&M retailers



Source: CRISIL Ratings

How to read the chart above: Bars indicate aggregate debt in a particular rating category for CRISIL-rated B&M retailers, while numbers in circles denote companies in that category.

Rating outlook distribution[15]

Credit outlook for select CRISIL-rated B&M retailers
1. Reliance Retail Ltd (CRISIL AAA/Stable/ CRISIL A1+)
A step-down subsidiary of Reliance Industries Ltd (RIL), Reliance Retail (including Reliance Retail Ventures Ltd, or RRVL) has a total of 2,514 stores (as on March 31, 2015) across 200 cities in the country with an area of ~12 million square feet across the value, digital, fashion and lifestyle, jewellery and brands (brands are held through RRVL) formats. Reliance Retail is India's largest retailer by revenue with leadership position across several formats and has witnessed consistent same-store sales growth. The value format, which contributed over 50% to revenue in 2014-15, is expected to be one of the key drivers of growth in 2016-17. The company has a healthy financial risk profile, marked by low gearing as well as low debt to Ebitda ratio. Furthermore, Reliance Retail benefits from strong management and financial support from RIL for which, Reliance Retail will remain a strategically important investment.

[15] Excludes 5 companies on rating watch rated C/D or with only short term rating

CRISIL takes a consolidated approach Reliance Retail and its holding company RRVL.

For 2014-15, Reliance Retail, at a consolidated level, reported a profit after tax (PAT) of Rs 2.23 billion on net sales of Rs 172 billion.

2. Avenue Supermarts Ltd (CRISIL AA-/Stable/CRISIL A1+)

Avenue operates the D-Mart-branded chain of stores and currently has 92 hypermarket stores (3.5 million square feet) in Maharashtra, Gujarat, Karnataka, Andhra Pradesh, and Madhya Pradesh as of November 30, 2015.

By focusing on productivity and a low-cost business model, Avenue has established itself as one of top 3 food retailers in India. D-Mart's strong brand also helps new stores ramp-up faster and break-even within six months on an average as compared to the industry benchmark of 12-18 months. As a result, it has consistently reported higher same-store sales growth than its peers in food and grocery retail.

Avenue has a large an expansion plan of around Rs 20 billion, to increase its retail space by about 90% by fiscal 2018. This would result in the company's gearing peaking at around 0.85 time in the near-term before correcting to comfortable levels supported by healthy cash accrual. Higher-than-expected debt funding for the proposed expansion or weaker-than-expected operating performance of Avenue would be key monitorables.

For the six months ended September 30, 2015, Avenue reported a net revenue of Rs 40.2 billion.

3. FabIndia Overseas Pvt Ltd (CRISIL AA-/Stable/CRISIL A1+)

FabIndia is a leading player in the ethnic apparel, home products, personal care products and organic foods segment, which are sold under the 'FabIndia' brand. The company also has a step-down subsidiary, East Lifestyle Ltd (East), based out of the United Kingdom, which is into apparel in the same market.

The company's 50-year old brand has created a loyal customer base and has created a niche market for itself in the ethnic wear segment, where its competitors are small and unorganised. This has helped FabIndia register healthy growth in the apparel segment. It sources products from small units engaged in traditional handicrafts and garment manufacturing using its efficient supply chain. However, its product profile is concentrated towards the highly competitive apparel segment, which contributes 75% of its revenues. Ramping up of revenues at East, would help FabIndia register better growth over the medium term.

FabIndia has a healthy financial risk profile due to its near debt-free balance sheet. The company is expected to maintain a healthy financial risk profile over the medium term given that its store additions will be funded through internal accrual.

For arriving at the ratings, CRISIL consolidates FabIndia and its subsidiaries.

FabIndia reported a PAT of Rs 391.5 million on an operating income of Rs 9.9 billion for 2013-14.

4. Lifestyle International Pvt Ltd (CRISIL A+/Positive/CRISIL A1+)

Lifestyle is a part of the Landmark group promoted by Mr Mukesh Jagtiani. Its ‘Lifestyle’ departmental stores, ‘Home Centre’ outlets, and ‘Max’ stores have combined retail space of 4.68 million square feet as on September 30, 2015.

A diversified presence across apparel price points and in the home furnishing segment aids LIPL’s business risk profile. The Lifestyle format operates in the premium apparel segment, while Max operates in the value apparel segment. The Home Centre format operates in furniture and home furnishings retail segment.

Lifestyle has demonstrated steady improvement in its business performance driven by healthy scaling up of its operations, sustained strong like-to-like growth and faster ramp-up of new stores. Increasing number of broken even stores and focus on higher margin offering private labels will benefit the company’s profitability.

Consistent equity infusion by the promoter during Lifestyle’s gestation phase supports its financial risk profile. Subsequently, strong scaling up of operations driven by phased expansion, better-than-industry productivity at vintage stores and faster ramp-up of new stores have led to strong improvement in Lifestyle’s cash accrual over time. Its debt, which reduced substantially in the current fiscal, is now expected to increase moderately due to part debt-funding of its proposed expansion plans.

Nevertheless, the company’s key credit metrics are likely to be maintained at comfortable levels due to continued healthy profitability from own stores.

In fiscal 2015, Lifestyle reported a PAT of Rs 1.6 billion on a net revenue of Rs 43.3 billion.

5. Shoppers Stop Ltd (CRISIL A1)

Shoppers Stop is a K Raheja Corp group company promoted by Mr Chandru L Raheja and is one of the largest departmental store chains in India, with 76 stores and retail space of 4.3 million square feet as on December 31, 2015. The company also has presence in the hypermarket segment through ‘Hypercity’ (17 stores with retail space of 1.3 million square feet). The company also operates ‘Crossword’ and ‘Home Stop’ which are into retailing of books and home décor, respectively.

With a diverse product range that targets the relatively less price-sensitive, upper and upper-middle class consumers and through regular store additions, Shoppers Stop has successfully scaled up this franchise.

Despite the adequate performance of the departmental store format, consolidated debt metrics are constrained by continuing losses at Hypercity; gearing and interest coverage, have moderated significantly in recent years. Shoppers Stop has initiated several initiatives such as rightsizing of stores, closing of unviable stores/loss making product categories and change in product mix, to reduce losses at Hypercity, and breakeven at operating level is expected by 2016-17.

Shoppers Stop's credit profile nevertheless is also supported by periodic equity infusions to ramp-up retail space, and funding of operational requirements at Hypercity. Higher-than-expected debt due to large capex, lower traction at Hypercity and change in stance of support from promoters would be key rating monitorables.

CRISIL takes a consolidated approach (Shoppers Stop and its subsidiaries including Hypercity) to arrive at the rating for Shoppers Stop

For the nine months ended December 31, 2015, Shoppers Stop, on consolidated basis, reported a PAT of Rs 120 million on an operating income of Rs 36.94 billion.

Roads	**RATING OUTLOOK** **Negative; execution, refinancing key**

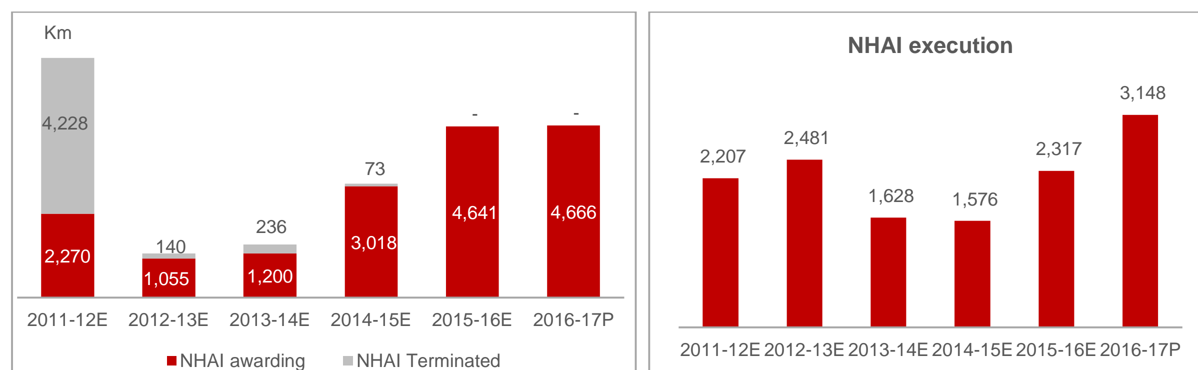
On the road to rebound, but potholes abound

A slew of policy reforms such as easing the clearances process, ensuring 80% land acquisition before project awarding, premium rescheduling, and allowing developers to fully exit their operational road projects two years after commencement of commercial operations have reinvigorated interest in the road sector.

Project awarding by the National Highways Authority of India (NHAI) has increased ~45% year-on-year, while execution has picked up 40% between April 2015 and January 2016. Moreover, for projects awarded after fiscal 2014, delays have come down significantly.

We expect the momentum to sustain in the next fiscal as well. NHAI awarding may not pick up significantly compared with fiscal 2016 levels, but with projects being mainly awarded on engineering, procurement, construction – or EPC -- basis, execution is expected to increase by 40% next year. However, competition, as reflected in the difference between L1 and L2 bids, continues to remain high.

NHAI awarding and execution to pick up



Source: NHAI, CRISIL Research

FAQs

What has the Budget done for the road sector?

The Union Budget has proposed a 49% on-year rise in investments for development of national highways to Rs 1.03 trillion. This would support continued rise in public investments for highway execution. Investments in rural roads through the Pradhan Mantri Gram Sadak Yojana (PMGSY), which have seen significant increase over the last two years, received another boost through a 26% increase in budgetary allocation for next fiscal. The proposal for putting in place a framework for disputes resolution and renegotiation of private-public partnership contracts are also long-term positives.

What is the magnitude of stuck projects?

A CRISIL analysis of NHAI's under-construction BOT (build operate transfer) projects in October 2015 showed that half of them, spanning 5,100 km, are at risk of not being completed because of cost over-runs and weak financial health of sponsors. Out of total 80 operational BOT projects, 26 spanning 2,400 km are in no position to service their debt because of lower-than-expected traffic volume and interest rates that were rising till 2014. A number of projects awarded between fiscals 2010 and 2013 were stuck due to land acquisition issues.

Will stuck BOT projects stress financial profiles?

The financial profile of under-construction BOT projects awarded between 2009-10 and 2012-13 is expected to remain stressed due to implementation delays leading to cost overruns and increase in debt. Aggravating the situation is the sponsor's inability to bring in funds to support the project cost overruns or cash flow mismatches.

The standalone credit profile of operational projects is also expected to remain under pressure due to modest toll rate hikes in an era of low WPI (wholesale price index), inflation and moderate traffic growth. The upshot is that the financial position of developers is expected to ease only marginally, if at all, next fiscal driven by timely asset sales in the current subdued environment.

What about credit profiles of road developers?

For a few, credit profiles remain healthy because of prudent project selection, robust order book, sustained pace of project execution, and sound financial risk profile notwithstanding the subdued external environment. These players have been cautious about taking up new orders and maintaining operating margin, and have been restrained while bidding for BOT projects. We expect these developers to maintain their healthy credit profile and continue with a cautious growth strategy next fiscal.

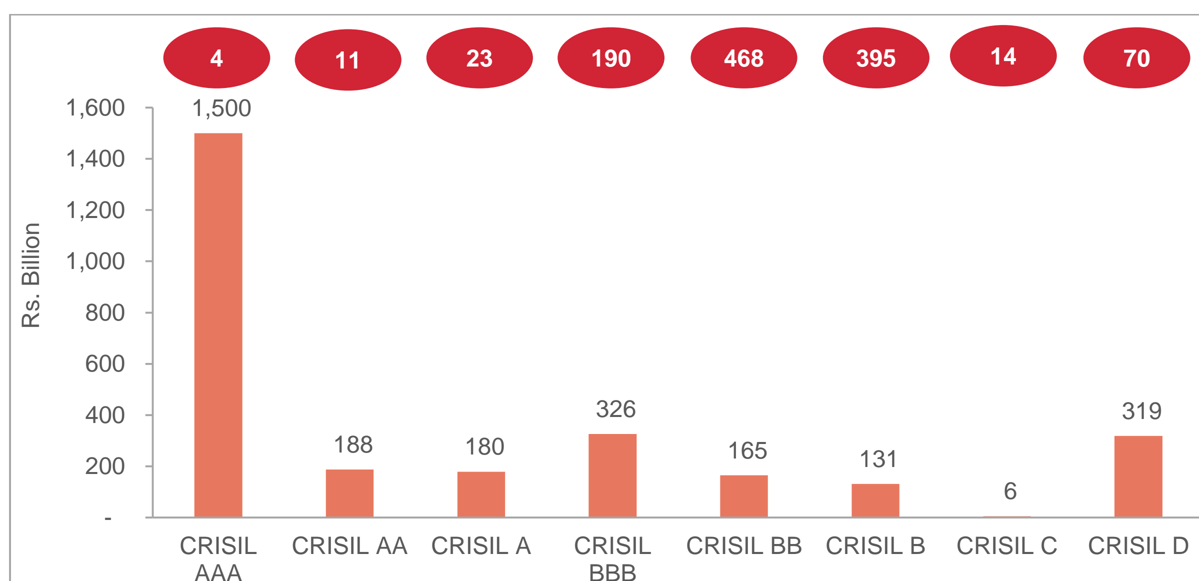
However, a majority of developers are under pressure due to their stressed financial position in view of the large debt required to fund their equity contribution, and the financial support needed for their BOT projects. Many have a gearing of over 2 times, and more debt is likely to be taken. But with the removal of the 'restriction on exit' clause in operational BOT projects, developers can now raise funds through stake sale in these projects, which could improve their financial position and, hence, their credit profile marginally in the near term. However, the timeliness of asset sale in the current environment will remain a key monitorable next fiscal.

In the context, what is CRISIL's ratings call?

Although traffic growth has picked up marginally this fiscal, the credit profiles of operational projects is expected to remain under pressure due to lower toll rate hikes in an era of low WPI. Traffic would need to grow by over 30% to meet debt-servicing requirements next fiscal – an unlikely scenario as of today. Timely support from sponsors to bridge cash flow mismatches will be critical because debt in these projects is with limited or no recourse to the sponsor. Moreover, in certain projects, a change of promoter could open up access to better refinancing terms and further financial support.

Credit profiles of operational road projects with stable operations can further improve if their debt can be refinanced through the capital market and IDF-NBFCs (infrastructure debt funds-non banking finance companies). These projects can leverage on the existing tail period in the concession agreement and refinance existing debt with long-term, low-cost funds. With refinancing, the cash flow cushion available to meet the debt-servicing obligations improves, thereby enhancing the projects' credit profile. The refinancing strategy is expected to gather momentum next fiscal, as it has done in the past couple of years.

Distribution of aggregate debt of 1,175 CRISIL-rated EPC contractors and road SPVs



Source: CRISIL Ratings

How to read the chart above: Bars indicate aggregate debt in a particular rating category for CRISIL-rated EPC contractors and road SPVs, while numbers in circles denote companies in that category.

Rating outlook distribution[16]

Credit outlook for select CRISIL-rated companies
1. Ashoka Buildcon Ltd (CRISIL AA-/Stable/CRISIL A1+)
Established in 1993, Ashoka Buildcon's business comprises build-operate-own, or BOT, road projects, engineering, procurement and construction, or EPC, divisions, collection of tolls on roads and bridges owned and constructed by third parties, and manufacture of ready-mix concrete. In the EPC division, the company constructs roads and bridges for its own BOT projects as well as for third parties; it also executes EPC projects in the power distribution space. Ashoka Concessions Ltd was

[16] Excludes 107 companies on rating watch or rated C/D, or with only short-term rating

set up in November 2011 as a subsidiary of Ashoka Buildcon to which four operational and three under construction projects were transferred. SBI Macquarie was to infuse Rs 8 billion through a stake dilution of 34% in Ashoka Concessions. As on date, SBI Macquarie has infused Rs 7.84 billion into the company which acts as an exclusive BOT project developer for both Ashoka Buildcon and SBI Macquarie.

CRISIL combines the business and financial risk profiles of the two companies to determine Ashoka Buildcon's rating. CRISIL has not combined the business and financial risk profiles of the special purpose vehicles of Ashoka Buildcon and Ashoka Concessions as they are moderately integrated.

The Ashoka Group's business risk profile is expected to remain strong due to its proven track record in executing EPC contracts, a healthy order book, and its cautious approach in bidding for BOT projects. The Ashoka group has experience of over two decades in the EPC segment and has one of the largest portfolios of BOT projects in India; of 19 BOT projects, 15 are currently operational, two are in the final stage of completion, and two are in the nascent stage of construction. The group's competitive advantage arises from its strong experience in constructing and managing BOT projects and the caution it exercises while taking up EPC orders as well as BOT projects. In addition, the group has extended operational and financial support to its group companies, which is expected to continue in the near term.

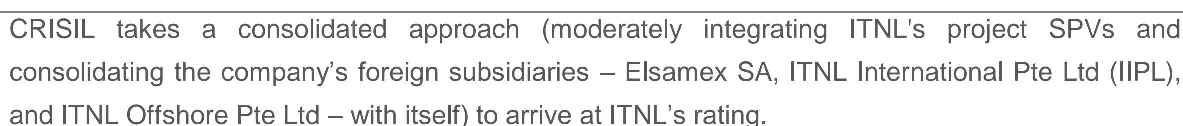
Ashoka Buildcon's strong business risk profile is complemented by its robust financial metrics marked by strong net worth (including QIP of Rs 5 billion in 2015-16) and low gearing. This, coupled with the group's continued caution in bidding in the past one year is expected to keep the company's capital structure robust in the next fiscal as well.

For the nine months ended December 31, 2015, ABL, on a standalone basis, reported a net profit of Rs.1.0 billion on net sales of Rs.13.9 billion, against a net profit of Rs.0.7 billion on net sales of Rs.12.9 billion for the corresponding period of the previous year.

2. IL&FS Transportation Networks Ltd (CRISIL A/Stable/CRISIL A1)

IL&FS Transportation Networks Ltd (ITNL) was set up in 2000 by Infrastructure Leasing & Financial Services Ltd (IL&FS) to consolidate its road infrastructure projects and pursue new projects in surface transportation infrastructure through the public private partnership route. The company develops, operates, and maintains national and state highways. It has diversified into other segments of transportation such as metro rail and bus services.

It is a market leader in the road sector and has a fairly diversified portfolio of 30 annuity and toll road projects in over 16 states. Operational projects account for nearly 50% of ITNL's portfolio and add to its financial flexibility, which is also supported by its strong parentage and a high promoter stake (more than 70%). IL&FS and its group companies have extended support to ITNL in the past and will continue to provide need-based support.



CRISIL takes a consolidated approach (moderately integrating ITNL's project SPVs and consolidating the company's foreign subsidiaries – Elsamex SA, ITNL International Pte Ltd (IIPL), and ITNL Offshore Pte Ltd – with itself) to arrive at ITNL's rating.

Given the issues in the sector, ITNL's revenues and profitability have also declined. High equity commitments and support for cost overruns and revenue shortfall in the SPVs continue to put pressure on ITNL's cash flows and liquidity. With an estimated gearing of 3 times as on March 31, 2016, ITNL's financial risk profile will remain stressed.

ITNL has a healthy portfolio of operational projects, so it could raise funds either by stake sales or by securitising their cash flows. However, valuations and timelines remain key monitorables.

For the nine months ended December 31, 2015, ITNL, on a standalone basis, reported a net profit of Rs.1.4 billion on net sales of Rs.32.5 billion, against a net profit of Rs.3.2 billion on net sales of Rs.27.2 billion for the corresponding period of the previous year.

3. Second Vivekananda Bridge Tollway Company Pvt Ltd (CRISIL AA (SO)/Stable)

Second Vivekananda Bridge Tollway Company Pvt Ltd (SVBTCL) is an SPV set up to implement the 6.1 km, six-lane Second Vivekananda Bridge (SVB) tollway across the Hooghly river in Kolkata. The company is promoted by Pacific Alliance Stradec Group Infrastructure Company LLC, which holds 99.99% equity; L&T Infrastructure Development Projects Ltd holds the rest.

SVB is the largest BOT tollway bridge project constructed in India till date. It is about 50 m downstream from the existing Vivekananda Bridge (Bally bridge). The bridge is being managed on a BOT basis, with NHAI (rated 'CRISIL AAA/Stable') as the concessioning authority. The construction of the bridge was completed in June 2007 in a record time of 39 months and it was opened to the public in July 2007. The concession period is 30 years (up to 2033).

SVB provides a connecting link for national highways (NH) on either side of the Hooghly River for traffic going from NH-6 (connecting Mumbai and Chennai) and NH-2 (connecting Delhi to West Bengal) towards NH-34 (which connects India to Bangladesh and the north-eastern regions of India). Additionally, due to the ban on freight vehicles on the existing Bally and Howrah bridges, SVB is the preferred option for commercial traffic. As a result, the bridge has healthy traffic flow and toll collections, so it has strong debt-protection metrics.

Moreover, build-up of a debt service reserve account (DSRA) of Rs 105 million and a major-maintenance reserve account (MMR) of around Rs 45 million to cover the next major maintenance in 2018-19 provides a cushion against any sudden movement in traffic volumes or toll rates. Unencumbered cash balance of around Rs 1.5 billion as on March 31, 2015, also bolsters the company's liquidity.

The 'SO' (structured obligation) suffix for the rating on SVBTCL reflect the escrow mechanism through which toll collections are routed and payments are made as per the defined payment waterfall; it also factors in the maintenance of a DSRA and an MMR.

4. Western MP Infrastructure and Toll Roads Pvt Ltd (CRISIL A-/Stable)

Western MP Infrastructure and Toll Roads Pvt Ltd (WMP) is an SPV promoted by the Essel group, a prominent business house in India. The group's publicly listed companies include Zee Entertainment Enterprises Ltd, Zee News Ltd, Wire & Wireless India Ltd, Dish TV India Ltd, Essel Propack Ltd, and ETC Networks Ltd.

WMP was appointed by the Madhya Pradesh Road Development Corporation to construct, design, engineer, operate, and maintain the 125 km Lebad-Jaora stretch on state highway (SH) 31 on BOT basis. The company commenced tolling for the first stretch of the 67 km, 4-lane highway on the Lebad-Jaora stretch in November 2009, five months ahead of schedule. Tolling on the second toll plaza commenced from June 4, 2011, a delay of over than 12 months on account of the change in scope and design by the Ministry of Railways.

WMP operates on SH-31, which is a segment of the 500 km Ajmer-Naisirabad–Neemuch-Mandsaur-Indore road. SH-31 is a major road connecting NH-8 and NH-3. As a result, the project generates moderate toll collection from commercial vehicles, which account for 90% of toll collections and 60% of traffic volumes. In addition, the toll rates for all vehicle categories are revised by a fixed rate of 7% annually throughout the concession period, partly shielding WMP from fluctuations in WPI. Consequently, the project has an adequate average DSCR (debt service coverage ratio) of 1.4 times over the tenure of debt.

Toll revenue is WMP's only major source of revenue and any fluctuation in toll revenue may impact the company's ability to meet its debt obligations on time. For instance, despite a fixed toll rate revision of 7%, toll revenue grew only 3.5% in 2014-15 because traffic volume shrank. However, the company's cash flows are supported by liquidity (in the form of DSRA of Rs 190 million maintained in the form of fixed deposits) as well as unencumbered cash balance of Rs 100 million as on September 30, 2015, which could be utilised for major maintenance purpose if required.

5. North Karnataka Expressway Ltd (CRISIL AAA(SO)/Stable/CRISIL A1+(SO))

North Karnataka Expressway Ltd (NKEL) is an SPV promoted by IL&FS, ITNL, and Punj Lloyd Ltd to design, develop, construct, operate, and maintain a 77-km stretch of the Belgaum-Maharashtra border road on NH-4 on annuity basis.

NHAI has signed a 17.5-year concession agreement, including a 2.5-year construction period, with NKEL; thus, the effective operating period for the concession is 15 years. The project became operational in July 2004; NKEL has successfully operated and maintained the road so far. The company has been receiving semi-annual annuity payments of Rs 505.1 million as per the agreement

schedule from NHAI. Annuities are secured by a letter of credit equivalent to one semi-annual annuity payment during the concession period, which takes care of procedural delays, if any, in annuity payments.

Although NKEL is immune to traffic risk, timely and full release of annuity from NHAI depends on proper maintenance of the road. NKEL has successfully maintained the road for seven years. If there is a delay in release of annuity, the trustee makes the payment to the investors from the DSRA. NKEL is currently also contesting a claim by income tax authorities for assessment years 2006 and 2007, resulting in the creation of a contingent liability. NKEL has adequate liquidity to meet the liability should it materialise.

The 'SO' suffix for the rating on NKEL reflects the payment mechanism and the legal structure of the transaction. As per the structure, the annuity from NHAI, which will be received semi-annually by NKEL, will be used to make investor payouts. Any excess cash in the transaction after meeting the investor payouts and other expenses (including apportioning for the MMR) will be first used to top-up the DSRA (equivalent to one instalment of maximum principal and interest payment), if required, before being taken out of the company.

CRISIL A STANDARD & POOR'S COMPANY

About CRISIL Limited

CRISIL is a global analytical company providing ratings, research, and risk and policy advisory services.

We are India's leading ratings agency. We are also the foremost provider of high-end research to the world's largest banks and leading corporations. With sustainable competitive advantage arising from our strong brand, unmatched credibility, market leadership across businesses, and large customer base, we deliver analysis, opinions, and solutions that make markets function better.

Our defining trait is our ability to convert data and information into expert judgements and forecasts across a wide range of domains, with deep expertise and complete objectivity.

At the core of our credibility, built up assiduously over the years, are our values: Integrity, Independence, Analytical Rigour, Commitment and Innovation.

CRISIL's majority shareholder is Standard and Poor's(S&P). Standard & Poor's, a part of McGraw Hill Financial, is the world's foremost provider of credit ratings.

CRISIL Privacy Notice

CRISIL respects your privacy. We use your contact information, such as your name, address, and email id, to fulfil your request and service your account and to provide you with additional information from CRISIL and other parts of McGraw Hill Financial you may find of interest.

For further information, or to let us know your preferences with respect to receiving marketing materials, please visit http://www.crisil.com/privacy. You can view McGraw Hill Financial's Customer Privacy Policy at http://www.mhfi.com/privacy.

Last updated: August 2014

Our Office

Ahmedabad
Unit No. 706, 7th Floor,
Venus Atlantis, Prahladnagar,
Satellite, Ahmedabad - 380015,
India
Phone : +91 79 4024 4500
Fax : +91 79 4024 4520

Bengaluru
W - 101, 1st floor, Sunrise Chambers,
22, Ulsoor Road, Bengaluru - 560042,
India
Phone : +91 80 4244 5399
Fax : +91 80 4244 5300

Chennai
Thapar House, Mezzanine Floor,
No. 37 Montieth Road, Egmore,
Chennai - 600 008,
India
Phone : +91 44 2854 6205 - 06 /
+91 44 2854 6093
Fax : +91 44 2854 7531

Gurgaon
CRISIL House
Plot No. 46, Sector 44,
Opp PF Office, Gurgaon, Haryana,
India
Phone : +91 0124 672 2000

Hyderabad
Uma Chambers, 3rd Floor,
Plot No. 9&10, Nagarjuna Hills,
Near Punjagutta Cross Road
Hyderabad - 500 082,
India
Phone : +91 40 2335 8103/05
Fax : +91 40 2335 7507

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

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

Stay Connected | CRISIL Website | Twitter | LinkedIn | YouTube | Facebook

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