Credit Metrics Remains Subdued for the Indian Corporate Sector

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Aggregate credit metrics for corporate sectors remain subdued even as profitability improved

With challenges both on the domestic front and globally remaining unabated, the Indian Corporate Sector ended FY 2016 with another year of subdued performance. Slow pace of improvement in structural challenges grappling the infrastructure sectors, global commodity meltdown and anemic trends across domestic consumption-driven sectors continued be the highlights of corporate performance during FY 2016. Sectors like Metals, especially Iron & Steel in fact witnessed sharp contraction in coverage indicators during the year as earnings were adversely impacted by decline in steel prices as well as competition from cheaper imports. The pressure on debt servicing indicators in Infrastructure & Construction sectors (i.e. Average interest coverage for last 4 quarters stood at 1.0x) also remained unabated owing to continuation of structural challenges (slow pace of project execution, delays in land acquisition and other allied issues) and limited improvement in balance sheet strength.

Exhibit 1: Trend in Interest Coverage Ration for sample & stretched sectors

	Quarterly				Annual	
	Q1 FY16	Q2 FY16	Q3 FY16	Q4 FY16	FY 2015	FY 2016
For Sample	4.3	4.0	4.1	4.1	4.3	4.1
For Sample^	3.5	3.2	3.3	3.3	3.6	3.3
For Sample ^^	**3.1**	**2.9**	**2.9**	**2.9**	**2.9**	**2.8**
Iron & Steel	1.3	0.9	0.3	0.9	2.1	0.9
Construction	0.8	1.1	1.0	1.2	1.0	1.0
Sugar	(0.1)	0.7	1.6	3.8	0.6	1.4
Real Estate	1.4	1.4	1.8	1.3	1.9	1.5
Gems & Jewellery	1.6	1.9	2.8	0.4	1.8	1.6
Capital Goods	1.9	2.1	0.4	4.5	2.6	2.2
Shipping	3.0	2.9	1.0	0.2	2.0	1.8
Power	2.3	2.4	2.5	2.5	2.3	2.4
Airlines	1.8	1.5	4.1	2.5	(1.1)	2.5

Source: ICRA research; ^ Excludes IT, Pharma & FMCG;
^^ Sample represents Top-80% percentile of the portfolio (in terms of debt)
The above table includes interest coverage for key stress sectors

Over 50% of debt lies in sectors with leverage indicators weaker than sample aggregate

Exhibit 2: Trend in Debt/EBITDA indicator across Sectors

	Debt (Rs. Billion)	Debt (%)^	Debt/EBITDA				
Sectors	In FY 2016e	In FY 2016e	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016e
List of Sectors with TD/EBITDA higher than sample aggregate							
Power	5,898	22.1%	6.7	6.8	6.5	6.6	6.8
Construction	3,435	12.9%	8.2	8.4	10.1	10.0	13.3
Iron & Steel	2,968	11.1%	4.3	5.5	6.1	7.2	15.7
Real Estate	856	3.2%	5.5	6.2	6.6	6.2	9.3
Textile	443	1.7%	4.9	4.8	4.1	3.9	7.3
Fertilizers	362	1.4%	3.4	5.3	5.4	4.9	5.5
Capital Goods	274	1.0%	1.2	2.0	3.1	3.6	4.1
Shipping	262	1.0%	8.9	9.1	7.1	8.7	10.2
Sugar	235	0.9%	5.8	6.4	10.4	15.0	7.0
Port	184	0.7%	9.4	4.4	4.2	4.0	3.7
Gems & Jewellery	137	0.5%	2.7	2.3	6.6	4.0	5.0
Hotels	68	0.3%	8.1	8.2	7.9	9.4	4.6
Sample Aggregate*	**26,716**	**100%**	**3.0**	**3.3**	**3.5**	**3.6**	**3.7**

Source: ACE Equity; ICRA research; ^ as proportion of overall estimated debt levels for FY 2016e

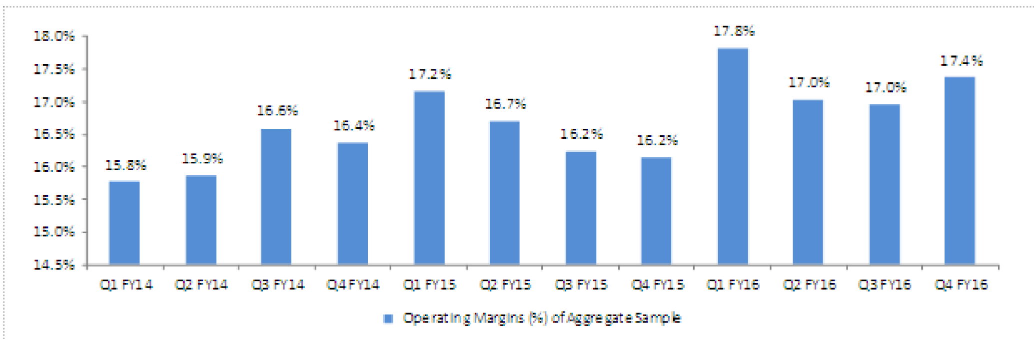
^ The financials of Automobile OEMs have been adjusted for their financial services subsidiaries

As can be seen from the above table, bulk of the stretched leverage resides in three sectors, namely Power, Construction, and Steel.

Softening commodity prices supported marginal improvement in EBITDA margins in FY 2016

From profitability perspective, the fiscal 2016 was relatively better for the Indian Corporate Sector as many of the sectors benefitted from benign commodity prices even as earnings of metal companies, especially steel manufacturers contracted sharply during the year. As a result, the EBITDA margins for our aggregate sample of 507 companies improved by 70 bps to 17.3% in FY 2016. Margin expansion was more visible in H2 FY 2016 as earnings of consumption driven sectors benefitted from the volume uptick during the festive season, while those of commodity-driven sectors also stabilized with recovery in international commodity prices and imposition of Minimum Import Price (in case of Steel). Accordingly, EBITDA margins for our sample of 507 companies expanded by 120 bps on YoY basis in Q4 FY 2016.

Exhibit: Trend in EBITDA Margins



Benign input material cost was the key factor supporting margin expansion

While host of factors supported improvement in EBITDA margins during the year, the decline in raw material cost in wake of weak commodity prices have had the most pronounced impact. Some of the key sectors which witnessed improvement in EBITDA margins on account of lower input cost during the year included – Airlines, Automobile OEMs, Power, FMCG, and Tyres. In addition to these sectors, entities in the Oil & Gas sector also witnessed margin expansion during FY 2016 driven by better realization for upstream companies (after incorporating the impact of lower subsidies) and higher gross refining margins (GRMs) for downstream/refining entities. Despite challenges in EMs on account of currency depreciation and higher R&D expenditure, the margins of pharmaceutical companies also expanding in FY 2016 on account of favorable impact of generic opportunities on certain high-value drugs in the U.S. In addition, the sugar sector saw improvement in financial performance as correction in international demand-supply environment and expectation of lower production in India led to sharp recovery in sugar prices in the last 4-6 months.

Sectors where margins were Stable	Sectors where margins Improved	Sectors where margins Declined
Auto Components	Airlines	Iron & Steel
Cement	Oil & Gas	Metals & Mining
Construction	Sugar	Real Estate
Fertilizers	Chemicals	Capital Goods
IT – Software	Auto OEMs	Consumer Foods
Media	Tyres	
Organized Retail	Pharmaceuticals	
	Power	
	Hotels	
	FMCG	
	Telecom	

Source: ICRA research

Margin contraction was most prominent in the metals space
While on one hand many of the sectors benefitted from lower commodity cost, companies in the metal space, especially steel sector reported one of their weakest performances as operating margins for an aggregate of 17 entities shrunk to 6.9% in FY 2016 vis-à-vis 12.2% in the same period of the previous year. As a result, steel companies reported a loss of Rs. 168 billion in FY 2016. Apart from Metals, Real Estate, Capital Goods, Consumer Foods were the other key sectors where margins contracted during FY 2016 in comparison to the same period in the prior year. Amongst the key sectors, while the performance of capital goods manufacturers continued to be influenced by weak order inflows, delays in execution of existing orders and associated cost overruns, in the Real Estate, the profitability pressures came largely on account of subdued off take.

Systemic credit quality pressures persist
The Credit Ratio of ICRA-assigned ratings stood at 1.3 times in FY 2016, lower than the level of 1.9 times witnessed in FY 2015. During the year, ICRA upgraded the ratings of 785 issuers and downgraded the ratings of 553 issuers, in relation to a total of 7,371 issuers whose rating was outstanding at the beginning of the year. While a Credit Ratio of more than 1.0 time prima facie points to a likely improvement in the credit quality of India's corporate and financial sector entities, the rating actions when seen in conjunction with the value of debt upgraded or downgraded, suggest that systemic credit quality remains under strain. This is reflected in the debt value-weighted Credit Ratio of ICRA-assigned ratings, which stood significantly depressed at 0.6 time in FY2016, in relation to the more sanguine looking volume-weighted Credit Ratio of 1.3 times. The rise in the financial sector's non-performing assets (NPAs), the large volume of corporate debt restructured or refinanced, the still-high leveraging levels of a large number of corporate entities, and the large count and proportion of rating downgrades in the investment-heavy sectors underscore the existence of systemic credit-quality pressures.

Exhibit 63: Trend in ICRA's Adjusted Credit Ratio^

	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Number of Issuers Upgraded	287	223	560	913	785
Number of Issuers Downgraded	734	757	603	472	552
Credit Ratio	0.4	0.3	0.9	1.9	1.3

Source: ICRA research

Credit trends in sectors to which banking sector has large exposure have also been mixed
Of the total banking credit deployed in industries, around 50% is contributed by four sectors viz., **Power, Metals & Mining, Textiles** and **Roads**. In the last few years, the credit quality of issuers in these sectors has been influenced more by exogenous factors rather than issuer-specific ones. In FY 2016, while external variables, generally had a negative influence on the credit quality of issuers in the Power, Metals & Mining and Roads sectors, they supported the credit profiles of entities in sectors like Textiles to some extent.