Pick-up in Government Spending and Consumption-led Demand supports Corporate Credit Outlook

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Pick-up in Government spending on infrastructure, consumption-led demand and low base to support corporate sector earnings in FY 2019

The non-infra corporate sector has seen some revival in growth and profitability indicators over last 2-3 quarters of FY 2018. The consumer-oriented sectors, namely Automobiles, FMCG, Consumer Durables and Retail witnessed pick-up in demand aided by low demonetisation base and improved consumer demand on back of the benefits of seventh pay commission, rural recovery and GST rate cuts. One of the key trends that stood out from management commentary of various companies across sectors during FY 2018 was the gradual recovery in rural demand. Right from Automobile OEMs to FMCG companies, rural sales appear to be on an improving trend and the outlook remains benign driven by expectations of normal monsoons, hike in MSPs and overall thrust on agri-economy ahead of elections.

Besides favourable outlook for consumer-oriented sectors, ICRA believes that pick-up in the affordable housing segments and infrastructure, primarily road and irrigation projects, is likely to support demand growth going forward in core sectors like cement and steel. After being influenced by demonetisation, GST-led disruption and lack of sand availability in various parts of the country, cement production has been on an improving trend over the past few quarters. Likewise, steel consumption, grew by approximately 6% during FY 2018 and is likely to grow between 5-6% in FY 2019 aided by Government's infrastructure push.

However, sharp rise in commodity prices and rupee depreciation pose some challenge

Over the past couple of years, corporate earnings have improved on back of benign commodity prices and improving consumption demand. This trend continued to an extent in FY 2018 as healthy volume growth helped offset the impact of rising commodity prices. However, select sectors such as Telecom, Pharmaceuticals, IT, Airlines, Tyres, and Sugar witnessed earnings contractions in FY 2018. Going forward, sharp rise in commodity prices and rupee depreciation post challenge for earnings across many sectors. This coupled with rising inflation and interest rates remain a potential challenge to the credit outlook. Earnings of Airlines, Automobile, Consumer Durables, FMCG, Chemicals, Paints etc. will be impacted by rising costs. However, companies in the oil exploration and metals will be the key contributors to improvement in EBITDA margins owing to steadily rising commodity prices. Accordingly, ICRA estimates that EBITDA of Corporate sector to grow at a faster pace in FY 2019 (13%) vis-a-vis turnover (8%).

Capital expenditure cycle unlikely to revive in the near-term

The capital expenditure requirements, which has been modest over last several quarters, considering unutilised capacity across segments and debt burden, may gradually pick-up as the slack gets fully absorbed. Among the key investment driving sectors, ICRA expects only modest capacity addition of 17-18 GW p.a. (21 GW in PY) in the Power sector over the next two years. Steel and Cement will also witness only brownfield addition as companies opt for M&A opportunities in the stressed asset space.

However, investments in automobile sector will continue to augment capacity as well as product development requirements to meet upcoming emission norms and safety regulations.

Deterioration in credit metrics expected to have bottomed out in FY 2018

Over the years, the deterioration in credit metrics of Indian Corporate sector has been driven by sectors like Construction, Metals, Power and Real Estates. With improvement in commodity prices and overall demand, the financial performance of Metal companies has improved substantially during FY 2018 and is likely to improve further, which will ease pressure on overall corporate sector's credit metrics. In the construction sector as well, stress appears to have bottomed out aided by divestments, fund-raising initiatives and overall improvement in execution and order inflows. While outlook remains Negative for Real Estate, in the power sector, deleveraging and refinancing of SEBs under UDAY scheme and improvement in energy demand is likely to support credit metrics.

ICRA has a 'Negative' outlook on Telecom, Airlines and Real Estate

ICRA has a 'Negative' outlook on Airlines, Telecom and Real Estate sectors. The airline industry faces significant headwinds from increasing fuel prices and weak pricing power, despite healthy traction on demand. The telecom sector continues to suffer from weak ARPUs in both voice and data segment due to competitive pressures and high debt burden. The real estate sector continues to witness a phase of stabilisation and consolidation and implementation of the Real Estate Regulation and Development (RERA) Act and GST. ICRA expects consolidation in the sector, wherein customers are likely to gravitate towards reputed brands, in the process, benefiting large pan-India players over the longer term.

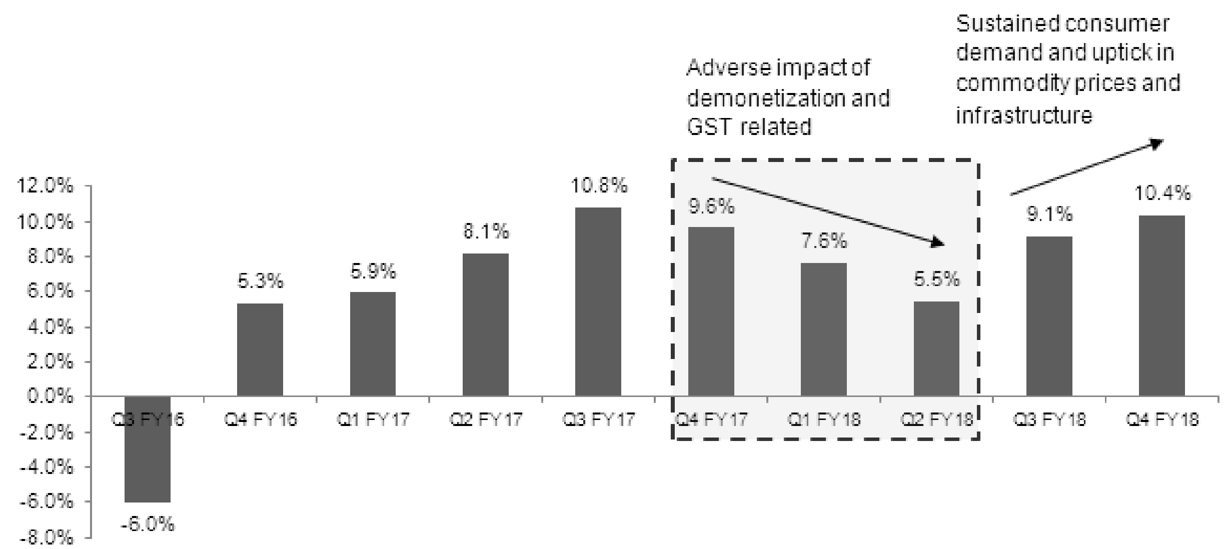
Apart from aforementioned sectors, ICRA expects earnings to remain under pressure in Pharmaceuticals, IT Services and Sugar sector as well. Earnings pressure in the Pharmaceutical sector stem from pricing pressure in the U.S. generics market, limited new product launches in the generics space and higher costs associated with regulatory compliance. Although credit metrics of pharmaceutical companies will remain comfortable, industry's leverage has increased in recent years because of reduced cash accruals and large ticket debt-funded acquisitions.

The operating margins of IT companies have been on a declining trend reflecting the challenging operating environment characterised by continued pressure on commoditized IT services, wage inflation, higher onsite costs necessitated by visa curbs as well as lower discretionary spend by corporate. While companies are implementing various initiatives such as introducing more variable portion in salaries, automation, lesser idle resources etc. but these steps provide limited cushion.

The domestic sugar industry is currently going through a period of over-capacity with sugar production growth ~45-50% during SY 2018 driven by recovery in sugar production from key sugar-producing states viz. Maharashtra and Karnataka where relatively better monsoon over the past couple of years leading to improved cane availability. This has resulted in sharp drop in realization and in turn earnings and credit metrics of sugar companies during H2 FY 2018 and is likely to exert pressure going ahead.

Revenue growth started improving in H2 FY 2018 on back of sustained consumer demand, uptick in commodity prices and low-base effect. Select sectors such as Telecom pulled down revenue growth because of pressure on ARPUs

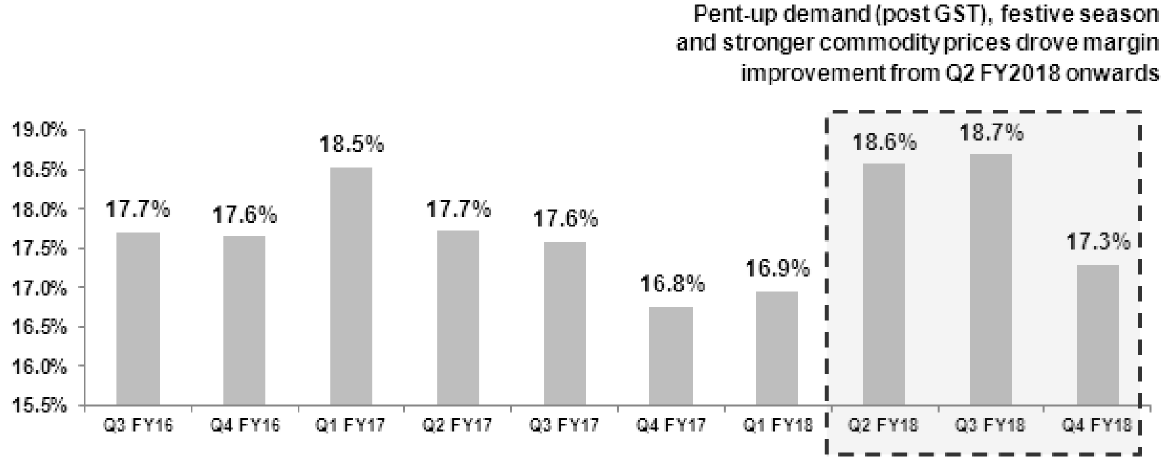
Exhibit 1: Trend in Aggregate Revenue Growth of 428 Companies



Source: ACE Equity, ICRA research

EBITDA margins expanded on YoY basis but some pressure was visible sequentially; Margin expansion was driven by sectors such as Automobiles, Cement, Steel, FMCG and Consumer Durables. However, sectors like Telecom, Sugar, Airlines, Ports and Shipping reported contraction in margins

Exhibit 2: Trend in EBITDA margins (%) of 428 Companies



Source: ACE Equity, ICRA research