Corporate Sector Performance Remains Subdued in 2015

Subrata Ray
Sr.Group Vice President
ICRA Ltd.

Shamsher Dewan
Asst.Vice President
ICRA Ltd.

Confluence of factors influenced weak corporate sector performance in FY 2015

In contrast to expectations, the financial performance of Indian corporate sector failed to improve meaningfully in the recently concluded fiscal year FY 2015. While whole host of factors were at play, the impact relatively muted pick-up in consumption demand, continuation of challenges on the execution front in the infrastructure space and absence of meaningful recovery in capex cycle had the most pronounced impact. The fiscal 2015 was also characterized by slowing rural economy as factors including weak monsoon followed by untimely rains, lower than expected agriculture output and modest increase in minimum support prices (MSP) for key crops impacted incomes of rural households.

The year 2015 was also marked by sharp correction in global commodity prices, especially for crude oil, whose prices have corrected by almost 42% since July 2014 before touching a low of US$ 45/barrel in January 2015. Although lower crude oil prices are a positive for oil marketing in India as it helps in bringing down their subsidy burden, the sudden fall led to inventory losses (for refineries and oil marketing companies) and lower realizations (for oil marketing companies) during the second-half of the fiscal. Consequently, most of the oil producing companies (including ONGC, Cairn India etc) and refineries like MRPL etc. reported sharp drop in their earnings during the year. That apart, softening demand for steel globally also impacted the prospects of the domestic steel companies as decline in steel prices in the international market exerted pressure on realizations of Indian steel producers, particularly from H2 FY 2015 onwards. The sector, which was already facing the burden of rising operating costs due to shortage of domestically mined iron ore and firm coal prices, now had to face stiff competition from cheaper imports. With concerns on slowdown in China rising, the possibility of further correction in commodity prices has only risen.

While operating environment in some of the core industries remained challenging, some of the domestic-oriented sectors like automobiles; cement and consumer durables did see uptick in demand. For instance, despite rural slowdown, the automobile production (in volume terms) in India grew by 8.7% during FY 2015 compared to 4.0% in FY 2014. The improvement was particularly driven by recovery in Medium & Heavy Duty Truck segment as well as Passenger Vehicles, which benefited from replacement of ageing fleet and improving cost of ownership (in the backdrop of lower fuel prices), respectively.

Apart from automobiles, some of the other sectors that witnessed improvement in operating metrics included – Telecom, FMCG, Auto Components, Tyres and Cement. While improved operating performance of telecom companies reflected the industry-wide trend towards better pricing power and strong growth in under-penetrated data services segment, industries like Auto Components benefited from pick-up in domestic demand and favorable exports prospects.

Aggregate margins remained stable but more industries witnessed contraction sequentially

From profitability perspective, the aggregate EBITDA margins of 515 companies in our sample remained relatively stable during FY 2015. However, entities in sectors like Metals, Capital Goods, Refineries and Oil (Upstream) continued to witness pressure on margins on account of industry specific issues. Additionally, the trend in EBITDA margins on a sequential basis also showed some signs of weakness with number of sectors that witnessed margins contraction increasing from just one (in Q2 FY2015) to six (in Q3 FY 2015) and eight (in Q4 FY 2015). This trend largely correlates with the trend of macro-economic indicators, which also reflected relatively weak pace of improvement in H2 FY 2015 vis-à-vis H1 FY 2015. While consumption trends remained subdued, companies in sectors like FMCG, Consumer durables, Auto Components etc. reported improved margins, benefitting from lower commodity prices.

Net earnings impacted by industry-specific issues and one-time impairment charges

In FY 2015, net earnings of 515 companies (in our sample) declined by 12% to Rs. 2,707 billion with entities in the Oil & Gas space, Iron & Steel, Construction and Telecom being the key contributor. Apart from industry specific issues, the decline in net earnings of entities in some of the key sectors, especially Iron & Steel and Capital Goods was also accentuated by one-time impairment/write-off on certain investments. For instance, while Vedanta took an impairment of Rs. 192 billion on its investment in Cairn India (following sharp drop in crude oil prices), Suzlon (in the Capital Goods space) made a provision for Rs. 5.9 billion following stake sale in Senvion SE (its key overseas investment).

Apart from Iron & Steel and Capital Goods, some of the other sectors that incurred losses (at an aggregate level[1]) during FY 2015 were - Airlines, Construction/Infrastructure, Sugar, Hotels and IT-Hardware. However, unlike Iron & Steel and Capital Goods (where aggregate losses were influenced by select entities), the proportion of multiple entities incurring losses was higher. For instance, in the Construction space seven out of a sample of 20 companies reported losses during the financial year. Likewise, the two listed airlines in India (i.e. Jet Airways and SpiceJet) continued to report losses albeit at a considerably lower level than the previous year. The scenario was fairly similar for companies in Sugar and Hotel sector as well as they continued to suffer from surplus capacity.

Weak earnings growth continued to defer improvement in credit metrics in FY 2015

The fiscal 2015 also began with optimism that entities with high debt burden especially in sectors like Power, Iron & Steel, Construction and Metals & Mining will be able to improve their credit metrics. While many of large corporate groups did initiate efforts to improve their balance sheets by hiving-off non-core assets, raising equity as well as limiting capex plans, the overall impact on credit metrics was fairly muted as earnings didn't improve dramatically. Accordingly, credit ratios like TD/EBITDA for sectors like Power, Construction and Iron & Steel remained in the range of 4.8x-15.0x during FY 2015 while Interest Coverage ratio also didn't show signs of improvement.

We expect this trend to continue in the near-term as many of the core sectors continue to face structural issues. For instance, power sector, which accounts for majority (21%) of the debt in our sample continues to face challenges in form inadequate feedstock availability (especially natural gas), weak financial profile of state power distribution companies and uncertainty related to timeline for implementation of tariff compensation for affected IPPs. Similarly, most of the key entities in the Iron & Steel continue to have high leverage, which is unlikely to reduce as weakening steel prices would continue to exert pressure on earnings.

Some of the key sectors that witnessed improvement in credit ratios during the year included Telecom, Automobile OEMs, and Tyres. In addition, some of the less capital intensive sectors like IT, FMCG, and Pharmaceuticals also continued to either improve or maintain their strong credit metrics.

Improved macro Conditions bolster Indian economy's ability to withstand global volatility

Despite the headwinds posed by muted global growth and an unfavorable agricultural outlook, Indian economic growth is expected to improve to 7.4-7.6% in 2015-16 from 7.3% in 2014-15 and outpace the expansion recorded by most countries with a comparable size.

Higher government spending on infrastructure, simplification of clearances, easing of norms for foreign direct investment, continued reform momentum and transmission of monetary easing are expected to support a revival in investment activity in FY16, led by sectors such as roads, urban infrastructure and freight corridors.

Moreover, moderating inflation is expected to boost urban consumer demand. Taking into account the drag related to the weak rabi harvest in Q1FY16, as well as the lingering uncertainty regarding the ultimate turnout of the kharif harvest, ICRA expects the agricultural sector to record a marginal growth in 2015-16, with improvement in rural sentiments and consumption activity unlikely to set in until H2FY16. Moreover, the pace of fresh investment in some sectors is likely to remain sluggish on account of the continuing constraints posed by the lingering sector-specific issues, high indebtedness of some Corporate groups, weak asset quality of the Banking system, muted demand for exports and availability of cheaper imports, as evidenced by the sluggish revival of projects despite the intervention of the Cabinet Committee on Investments (CCI). Notwithstanding the uncertainty related to the impact of the monsoon and kharif harvest on food prices, factors such as a modest rise in support prices for various crops, adequate stocks of cereals, low growth of rural wages and the moderation in crude oil prices are expected to dampen average CPI below 5.5% in 2015 from 6.6% in 2014.

The vulnerability of India's external account have declined meaningfully over the last two years, with a 21% rise in India's foreign exchange reserves and reduction in the current account deficit from above 4% of GDP in 2011-12 and 2012-13 to 1.3% of GDP in FY15. While the magnitude of external debt has risen since March 2013, its vulnerability has eased on parameters such as the proportion of short term debt and the coverage provided by forex reserves.

Corporate sector performance to improve going forward; Pro-cyclical industries to benefit

While fiscal FY 2015 was a mixed year for corporate sector in India, we expect the outlook to gradually improve over the coming 12 to 18 months, supported by improving demand environment, weakness in international commodity prices and pass through (albeit limited) of interest rate cuts and the Government's pro-growth policy initiatives. We expect credit profile in industries that are most directly correlated to India's domestic economic cycle such as cement, automobiles, metals and infrastructure to improve. A likely rebound in earnings coupled with recovering margins, will help shore up credit metrics on an average.

On the flip side, the outlook is less sanguine for industries whose revenues are susceptible to the low oil price environment, especially in the upstream oil & gas sectors. Further, owing to structural issues and high indebtedness in sectors like Power, Infrastructure/Construction and Steel, the outlook remains subdued.

---

[1] Based on combined performance of companies in our sample