ICRA

SECTOR OUTLOOK DESIGNATIONS

A revised approach

AUGUST 2021

Agenda

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Revised Definition | Sector Outlook

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What is the revised definition of ICRA's sectoral outlooks?

ICRA has reviewed and revised its approach for assigning the outlook on various sectors. The sector outlook now reflects ICRA's view on the state and the direction in which the **business fundamentals** of the sector participants are expected to evolve over the next 12-18 months starting from 'today' or whenever the outlook is assigned/ changed. This is different from our earlier approach where the outlook reflected our forward-looking view on the credit profiles of the sector participants.

Business fundamentals are one of the essential components of credit quality and we believe that the revised approach would provide the lenders, investors, and other market participants a useful compass to understand more clearly - which way the business profiles of the sector participants is headed.

- In sectors that are reasonably concentrated such that the top few players account for a majority market share, our outlook would reflect a forward-looking view on the *median performance* of the sector participants.
- In sectors that are fragmented in terms of market share, our outlook would reflect a forward-looking view on the *aggregate performance* of the sector participants.

What would be the linkage between the outlook on the sector and the movement of ratings in the sector?

As per ICRA's revised approach, the sector outlook would now have the nature of a business outlook, as opposed to a credit outlook. The two types of outlook definitions – business outlook and credit outlook – carry different information content.

An outlook definition that hinges on business fundamentals does not take into account factors like financial leverage, or the parentage (say, sovereign ownership) of the sector participants. At a broad level, a positive (negative) business outlook would tend to imply that positive (negative) rating actions are more likely in the sector, in the near term. However, the sector outlook should not be construed as the net instances of upgrades, downgrades or an average of the rating outlooks on the entities in the sector. The sector outlook is only intended to convey ICRA's assessment of the state and direction of business fundamentals within the overall sector, and does not count the other risk mitigating or risk enhancing drivers of credit ratings in the sector.

The revised definition is simpler in construct and sharply focused on one of the key components of credit risk viz., business fundamentals – that are more homogeneous in scope in a given sector, unlike credit quality.

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What is ICRA's analytical approach to decide the sector outlook?

Decision criteria: The view on the business fundamentals of a sector is formed in relation to an appropriate baseline performance level of the sector participants.

- If the performance is expected to remain below the lower threshold of the baseline performance over the next 12-18 months, the sector outlook would be **Negative**.
- If the performance of the sector is expected to remain within the tolerance band of the baseline performance over the next 12-18 months, the sector outlook would be **Stable**.
- If the performance of the sector is expected to progress past the upper threshold of the baseline performance over the next 12-18 months, the sector outlook would be **Positive.**

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Is the baseline performance level going to be a static benchmark?

The baseline performance metrics for the various sectors are going to be reviewed and updated with time.

Consider an example of a sector where there are unfavourable and structural shifts in the business fundamentals, such as those caused by an increase in the competitive intensity or adverse changes in the regulatory environment or consumer behavior.

This would likely first induce ICRA to change the sector outlook to Negative from Stable.

Once the sector reset is complete and the sector participants are understood to have adjusted to the new normal, it would likely prompt ICRA to change the outlook back to Stable (*ceteris paribus*). The latter decision would be accompanied by a downward shift in the baseline performance level/ range for the sector such that the sector outlook decisions in the future would be anchored around the revised performance metrics.

In cases where the structural shifts may render the business model of the sector participants as obsolete, then the outlook could remain as Negative, until the distant future.

What could drive a change in a sector's outlook?

The outlook on a sector may be revised upon a review of the risk factors mentioned below. The list of factors mentioned below is only indicative and is not intended to be an exhaustive representation of all the business drivers for a sector.

Volume growth

Business growth or lack of it thereof is a well-known channel of credit risk transmission. If ICRA expects volume growth in a sector to be such that it could enhance (or weigh on) the business fundamentals of the sector, assessed in reference to a baseline level/ range of performance, the sector outlook could change to Positive (or Negative).

Regulatory landscape

If there are positive or negative developments on the regulatory front that are expected to have a structural bearing on the sector's risk profile over the medium-term, the sector outlook may be revised. *Example*: A sector where regulatory support was high in the past but now there is evidence that suggests a shift in favour of a free market approach, or vice versa, it may induce a review of the sector outlook.

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What could drive a change in a sector's outlook?

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Competitive intensity

The outlook on a sector could be reviewed if there is an expectation of a rise in the competitive intensity in the sector that could have a bearing on the pricing power of the market participants. Competitive intensity could change not just because of the influx of new players but also because of the injection of large new capacity (resulting in over-capacity), a change in the players' stance favouring market share over profitability etc.

Funding conditions

There may be situations where funding conditions for a sector undergo a change that impacts the financial flexibility of the sector participants. This could constrain the availability of funding for the sector participants or increase the cost of funding. *Example*: Investor risk aversion towards the NBFC sector/ Gems & Jewellery sector in recent periods following reports of fraudulent accounting practices and unreliable financial statements of select entities. While management & governance issues are firm-specific rating drivers, these could snowball into broader sector-wide funding challenges, inducing a review of the sector outlook. In a strict sense, funding conditions are a matter of financial risk assessment but investor perception towards a sector could have a strong bearing on the business fundamentals as well, thus triggering a change in the sector outlook.

Sector Outlooks | Current Outlook and Benchmarks

Presented below and in the subsequent slides is ICRA's outlook on select sectors based on the revised definition. Also presented are the broad indicative thresholds that we would consider for revising the outlook in future.

Sectors	Outlook	Indicative Thresholds for Revision in Outlook		
		Positive	Stable	Negative
Airlines	**Negative**	Domestic passenger traffic growth >12% (vis-à-vis the pre-Covid period) Brent Crude Oil Price < US$ 45/bbl	Domestic passenger traffic growth: 0%-12% (vis-a-vis the pre-Covid period) Brent Crude Oil Price: US$ 45-75/bbl	Domestic passenger traffic growth < 0% (vis-à-vis the pre-Covid period) Brent Crude Oil Price > US$ 75/bbl
Auto Components (Excl. Tyres)	**Stable**	Revenue growth > 12% (vis-a-vis the past four quarters) OPBIT margins > 10%	Revenue growth: -5% to +12% (vis-a-vis the past four quarters) OPBIT margins: 7% to 10%	Revenue growth < -5% (vis-a-vis the past four quarters) OPBIT margins < 7%
Auto Components (Tyres)	**Stable**	Volume growth > 10% (vis-a-vis the past four quarters) OPBITDA margins > 16%	Volume growth: -5% to +10% (vis-a-vis the past four quarters) OPBITDA margins: 12% to 16%	Volume growth < -5% (vis-a-vis the past four quarters) OPBITDA margins < 12%
Automobile Dealerships	**Stable**	Aligned with the outlook on the underlying automobile OEM segments, besides being influenced by unusual movement in the inventory levels		

Sector Outlooks | Current Outlook and Benchmarks

Sectors	Outlook	Indicative Thresholds for Revision in Outlook		
		Positive	Stable	Negative
Automobile OEMs (Commercial Vehicles)	**Stable**	Volumes > 10 lakh units (over the next four quarters) OPBITDA margins > 9%	Volumes: 7-10 lakh units (over the next four quarters) OPBITDA margins: 6% to 9%	Volumes < 7 lakh units (over the next four quarters) OPBITDA margins < 6%
Automobile OEMs (Passenger Vehicles)	**Stable**	Volume growth > 12% (vis-a-vis the past four quarters) PBIT margins > 8%	Volume growth: -5% to +12% (vis-a-vis the past four quarters) PBIT margins: 4% to 8%	Volume growth < -5% (vis-a-vis the past four quarters) PBIT margins < 4%
Automobile OEMs (Tractors)	**Stable**	Volumes > 11 lakh units (over the next four quarters) PBIT margins > 15%	Volumes: 8-11 lakh units (over the next four quarters) PBIT margins: 8% to 15%	Volumes < 8 lakh units (over the next four quarters) PBIT margins < 8%
Automobile OEMs (Two Wheelers)	**Stable**	Volumes > 24 million units (over the next four quarters) OPBITDA margins > 15%	Volumes: 20-24 million units (over the next four quarters) OPBITDA margins: 11% to 15%	Volumes < 20 million units (over the next four quarters) OPBITDA margins < 11%

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Sectors	Outlook	Indicative Thresholds for Revision in Outlook		
		Positive	Stable	Negative
Cement	**Stable**	Volume growth > 14% (vis-a-vis the past four quarters) OPBITDA/ tonne > Rs. 1,100/ MT	Volume growth: 5%-14% (vis-a-vis the past four quarters) OPBITDA/ tonne: Rs. 900-1,100/ MT	Volume growth < 5% (vis-a-vis the past four quarters) OPBITDA/ tonne < Rs. 900/ MT
Construction	**Stable**	Revenue growth > 15% (vis-a-vis the past four quarters)	Revenue growth: 5%-15% (vis-a-vis the past four quarters)	Revenue growth < 5% (vis-a-vis the past four quarters) Receivables > 120 days
Construction Equipment	**Stable**	Sales volumes > 95,000 units (over the next four quarters)	Sales volumes: 70,000- 95,000 units (over the next four quarters)	Sales volumes < 70,000 units (over the next four quarters)
Ferrous Metals	**Positive**	Volume growth > 7% (vis-a-vis the past four quarters) OPBITDA/ tonne > USD 150/ MT	Volume growth: 0%-7% (vis-a-vis the past four quarters) OPBITDA/ tonne: USD 100-150/ MT	Volume growth < 0% (vis-a-vis the past four quarters) OPBITDA/ tonne < USD 100/ MT

Sector Outlooks | Current Outlook and Benchmarks

Sectors	Outlook	Indicative Thresholds for Revision in Outlook		
		Positive	Stable	Negative
Hospitals	**Stable**	Occupancy > 63% OPBITDA margins > 16%	Occupancy: 55%-63% OPBITDA margins: 12%-16%	Occupancy < 55% OPBITDA margins < 12%
Jewellery Retail	**Stable**	Revenue growth > 20% (vis-a-vis the past four quarters) OPBITDA margins > 8%	Revenue growth: 5%-20% (vis-a-vis the past four quarters) OPBITDA margins: 6%-8%	Revenue growth < 5% (vis-a-vis the past four quarters) OPBITDA margins < 6%
Logistics (Roads)	**Stable**	Revenue growth > 10% (vis-a-vis the past four quarters) OPBITDA margins > 10%	Revenue growth: 0%-10% (vis-a-vis the past four quarters) OPBITDA margins: 6%-10%	Revenue growth < 0% (vis-a-vis the past four quarters) OPBITDA margins < 6%
Media (Broadcasting)	**Negative**	Advertisement revenue growth > 12% (vis-a-vis the pre-Covid period)	Advertisement revenue growth: 0%-12% (vis-a-vis the pre-Covid period)	Advertisement revenue growth < 0% (vis-a-vis the pre-Covid period)

Sector Outlooks | Current Outlook and Benchmarks

Sectors	Outlook	Indicative Thresholds for Revision in Outlook		
		Positive	Stable	Negative
Media (Exhibitors)	**Negative**	Occupancy > 33% OPBITDA margins > 20%	Occupancy: 27%-33% OPBITDA margins: 10%-20%	Occupancy < 27% OPBITDA margins < 10%
Media (Print)	**Negative**	Advertisement revenue growth > 8% (vis-a-vis the pre-Covid period) OPBITDA margins > 20%	Advertisement revenue growth: 0%-8% (vis-a-vis the pre-Covid period) OPBITDA margins: 10%-20%	Advertisement revenue growth < 0% (vis-a-vis the pre-Covid period) OPBITDA margins < 10%
Oil & Gas (Downstream)	**Stable**	Refining only: Singapore Gross Refining Margins (GRMs) > USD 6/bbl Refining and Marketing: Singapore GRMs > USD 6/bbl and marketing margins > Rs 3/litre on sale of MS and HSD	Refining only: Singapore GRMs: USD 1.5-6.0/bbl Refining and Marketing: Singapore GRMs: USD 1.5-6.0/bbl and marketing margins: Rs. 1-3/litre on sale of MS and HSD	Refining only: Singapore GRMs < USD 1.5/bbl Refining and Marketing: Singapore GRMs < USD1.5/bbl and marketing margins < Rs 1/litre on sale of MS and HSD
Oil & Gas (Upstream)	**Stable**	Brent Crude Oil Price > USD 75/bbl	Brent Crude Oil Price: USD 45-75/bbl	Brent Crude Oil Price < USD 45/bbl

Sector Outlooks | Current Outlook and Benchmarks

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Sectors	Outlook	Indicative Thresholds for Revision in Outlook		
		Positive	Stable	Negative
Pharmaceuticals	**Stable**	Revenue growth > 10% (vis-a-vis the past four quarters) OPBITDA margins > 22%	Revenue growth: 4%-10% (vis-a-vis the past four quarters) OPBITDA margins: 18%-22%	Revenue growth < 4% (vis-a-vis the past four quarters) OPBITDA margins < 18%
Ports	**Stable**	Cargo volume growth > 10% (vis-a-vis the pre-Covid period)	Cargo volume growth: 0%-10% (vis-a-vis the pre-Covid period)	Cargo volume growth < 0% (vis-a-vis the pre-Covid period)
Real Estate (Commercial)	**Stable**	Vacancy (top six markets) < 10%	Vacancy (top six markets): 10%-20%	Vacancy (top six markets) > 20%
Real Estate (Residential)	**Negative**	Years to sell (top eight cities) < 2.25	Years to sell (top eight cities): 2.25-3.25	Years to sell (top eight cities) > 3.25

Sector Outlooks | Current Outlook and Benchmarks

Sectors	Outlook	Indicative Thresholds for Revision in Outlook		
		Positive	Stable	Negative
Real Estate (Retail)	**Negative**	Rental income growth > 20% (vis-a-vis the pre-Covid period)	Rental income growth: 0%-20% (vis-a-vis the pre-Covid period)	Rental income growth < 0% (vis-a-vis the pre-Covid period)
Retail (Fashion)	**Negative**	Revenue growth > 15% (vis-a-vis the pre-Covid period)	Revenue growth: -5% to +15% (vis-a-vis the pre-Covid period)	Revenue growth < -5% (vis-a-vis the pre-Covid period)
Retail (Consumer Durables & Electronics)	**Stable**	Revenue growth > 15% (vis-a-vis the pre-Covid period)	Revenue growth: -5% to +15% (vis-a-vis the pre-Covid period)	Revenue growth < -5% (vis-a-vis the pre-Covid period)
Roads (Toll)	**Stable**	Toll collection growth > 12% (vis-a-vis the pre-Covid period)	Toll collection growth: 6% to 12% (vis-a-vis the pre-Covid period)	Toll collection growth < 6% (vis-a-vis the pre-Covid period)

Sector Outlooks | Current Outlook and Benchmarks

Sectors	Outlook	Indicative Thresholds for Revision in Outlook		
		Positive	Stable	Negative
Banks	**Stable**	Gross NPAs < 4.0% Return on Assets > 1.0%	Gross NPAs: 4.0%-7.0% Return on Assets: 0.5%-1.0% Credit growth < 15%	Gross NPAs > 7.0% Return on Assets < 0.5% Credit growth < 0%
Small Finance Banks	**Negative**	Gross NPAs < 1.2%/ Improving Return on Managed Assets > 1.7% Growth in assets under management (AUM) < 30%	Gross NPAs: 1.2%-2.0%/ Stable Return on Managed Assets: 1.3%-1.7% AUM growth: 10%-30%	Gross NPAs > 2.0%/ Weakening Return on Managed Assets < 1.3% AUM growth < 10%
Brokerages	**Stable**	Trading volume growth > 40% PAT/ Net Operating Income > 30%	Trading volume growth: -10% to +40% PAT/ Net Operating Income: 10%-30%	Trading volume growth < -10% PAT/ Net Operating Income < 10%; losses in margin funding book

Sector Outlooks | Current Outlook and Benchmarks

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Sectors	Outlook	Indicative Thresholds for Revision in Outlook		
		Positive	Stable	Negative
Housing Finance Companies	**Negative**	Asset quality trend (GNPA/ Stage 3) < 1.5%/ Improving Return on Managed Assets > 2.2% Growth in assets under management (AUM) < 25%	Asset quality trend (GNPA/ Stage 3): 1.5%-2.5%/ Stable Return on Managed Assets: 1.8%-2.2% AUM growth: 10%-25%	Asset quality trend (GNPA/ Stage 3) > 2.5%/ Weakening Return on Managed Assets < 1.8% AUM growth < 10%
Insurance (General)	**Stable**	Growth in Gross direct premium income (GDPI) > 12% Combined ratio < 115% PAT/ Adjusted networth > 7%	GDPI growth: 5%-12% Combined ratio < 115%-125% PAT/ Adjusted networth: 3%-7%	GDPI growth < 5% Combined ratio > 125% PAT/ Adjusted networth < 3%
Insurance (Life)	**Stable**	Growth in new business premium > 12% PAT/ Adjusted networth > 7%	Growth in new business premium: 5%-12% PAT/ Adjusted networth: 3%-7%	Growth in new business premium < 5% PAT/ Adjusted networth < 3%

Sector Outlooks | Current Outlook and Benchmarks

Sectors	Outlook	Indicative Thresholds for Revision in Outlook		
		Positive	Stable	Negative
NBFCs (Infrastructure Financing)	Stable	Asset quality trend (Gross Stage 3) < 4.0% Return on Managed Assets > 2.0%	Asset quality trend (Gross Stage 3): 4.0%-7.0% Return on Managed Assets: 1.5%-2.0% AUM growth: 10%-15%	Asset quality trend (Gross Stage 3) > 7.0% Return on Managed Assets < 1.5% AUM growth < 10%
NBFCs (Microfinance)	Negative	Asset quality trend (90+ dpd) < 1.0%/ Improving Return on Managed Assets > 2.7% Growth in assets under management (AUM) < 30%	Asset quality trend (90+ dpd): 1.0%-2.0%/ Stable Return on Managed Assets: 2.1%-2.7% AUM growth: 10%-30%	Asset quality trend (90+ dpd) > 2.0%/ Weakening Return on Managed Assets < 2.1% AUM growth < 10%
NBFCs (Retail)	Negative	Asset quality trend: Improving Return on Managed Assets > 2.7% Growth in assets under management (AUM) < 20%	Asset quality trend: Stable Return on Managed Assets: 2.1%-2.7% AUM growth: 10%-20%	Asset quality trend: Weakening Return on Managed Assets < 2.1% AUM growth < 10%

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Thank You!