ICRA

PERFORMANCE OF ICRA-ASSIGNED RATINGS IN FY2023

Rebound in credit quality perseveres through operating environment headwinds

APRIL 2023

Highlights

ICRA

- **India Inc.'s credit quality continued its strong rebound in FY2023, sustaining the positive momentum initiated in FY2022, post the pandemic's adverse impact on businesses seen in the earlier year**. Although rating reaffirmations largely returned to the 10-year average of 80% in FY2023 (compared to 77% in FY2022), the ratings that underwent a change remained skewed towards upgrades. As in the previous fiscal, FY2023 saw almost three upgrades for every downgrade.
- **As credit quality improved, the occurrence of defaults was also seen to be much lower in FY2023**. There were only 22 defaults in ICRA's portfolio in FY2023, compared with 42 in FY2022 and 44 in FY2021. This trend is seen to be consistent with the general improvement being witnessed in the asset quality indicators of banks and non-banking finance companies.
- **Real estate, Financials, and Textiles were the top three sectors in terms of rating upgrades**. Upgrades in the real estate sector were led by the warehousing and the office segments. In the financial sector, several small to mid-sized NBFCs and Housing Finance Companies (HFCs) were upgraded showing a track record of consistent business growth while maintaining/ improving asset quality and capitalization metrics. In the textiles sector, ICRA upgraded the ratings of several branded apparel manufacturers and retailers with their business volumes benefitting from the tailwinds of formalization, including the shift in customer preferences towards branded wear.
- The **hospitality sector** was among the most severely affected sectors because of the pandemic. However, the rebound over the past one year has been equally strong. With both revenues as well as profitability expected to exceed the pre-Covid levels in FY2024, credit quality is set to improve, which has been driving upgrades since the second half of FY2023. **ICRA has a Positive outlook on the sector**.
- **Inflationary concern amid weak pricing power** was one prominent credit theme that prompted downgrades in FY2023. The debilitating effect of cost inflation was seen across multiple sectors, including building materials, food products, pharmaceuticals, gas-based power plants etc. Rupee depreciation against the US Dollar provided another inflationary prop to the commodity prices that weighed on profits.
- **With economic growth in the advanced economies expected to falter in FY2024, the export-oriented sectors like Textiles and Gems & Jewellery will likely face demand headwinds in the near term, a phenomenon already on witness since H2 FY2023**. The **IT Services sector** too could face demand challenges depending on the extent to which discretionary IT spending slows following the global macro-economic headwinds, setbacks seen in the financial services sector in the USA (marked by recent regional bank failures), and the adverse impact on the technology sector caused by the retraction of easy money policies and its manifestation in employee layoffs.
- **Another risk to watch out for is the interest rate risk**. While the asset quality of banks and financial institutions has been improving steadily, the key downside risk stems from the possibility of an unexpected rise in bad loans when the full impact of the rise in interest rates in FY2023 starts reflecting in the P&L of borrowers in FY2024. A further rise in interest rates (*beyond the 250-bps hike in repo rates in FY2023*) will test the resilience of the asset quality improvement trends.

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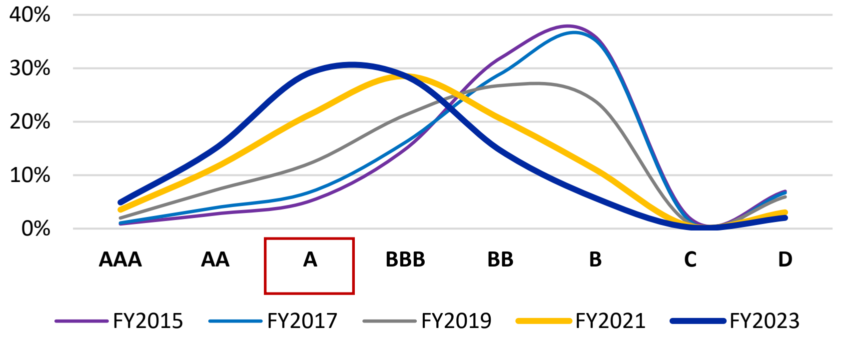
ICRA PORTFOLIO ATTRIBUTES

Median credit rating in ICRA's portfolio stands in the [ICRA]A category

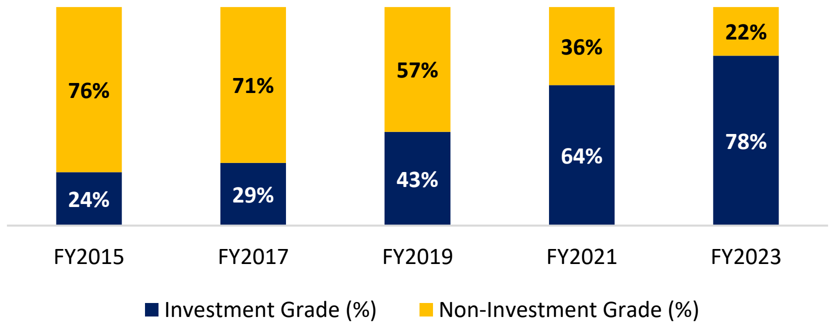
ICRA

Trend in the Category-wise Distribution of ICRA-assigned Ratings



Source: ICRA

Investment Grade versus Non-Investment Grade Entities in ICRA's Rated Portfolio



Source: ICRA

- After having remained in the [ICRA]BB category for several years until the beginning of FY2019, the **median** credit rating of ICRA's rated universe had shifted upwards to the [ICRA]BBB category at the beginning of FY2020 and has been in the [ICRA]A category over the past three years. Also, the **mode** of the rating distribution is currently in the [ICRA]A category.

- The composition of ICRA's rated universe has been undergoing a change over the years with the percentage of investment grade entities rising to 78% at the beginning of FY2023 from 24% at the beginning of FY2015.

- The above is attributable not to the general improvement in the credit quality of the rated entities, but to the discontinuation of ICRA's rating coverage on many lower rated entities owing to such entities' lack of cooperation in terms of sharing information with ICRA.

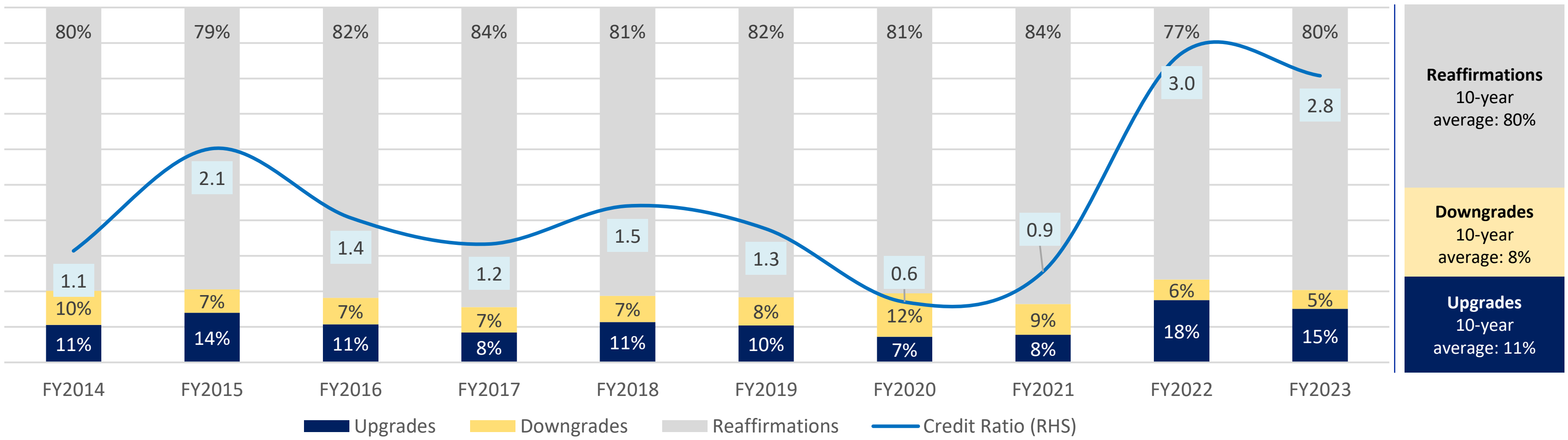
NOTE: The data in the above charts reflects the rating distribution as at the beginning of the various years mentioned

ICRA

RATING MOVEMENTS

Rating reaffirmations normalized, while the pie of rating changes remained tilted towards upgrades in FY2023

Trend in Rating Reaffirmations and Rating Changes



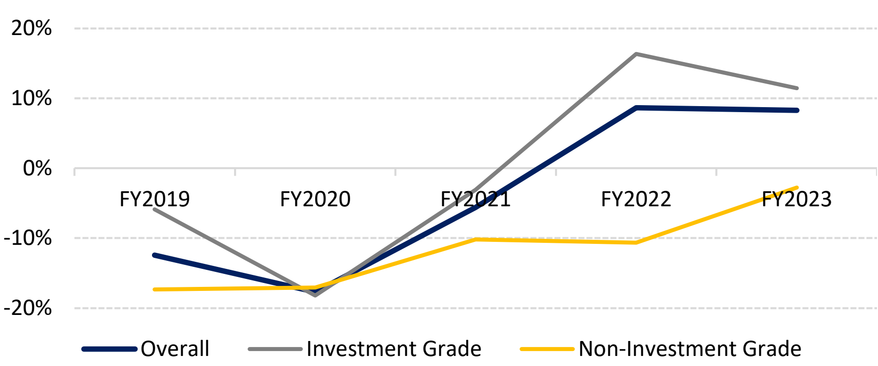
Source: ICRA

- In FY2023, the proportion of entities whose ratings were reaffirmed or remained unchanged normalized to 80%, aligned with the long-period average.
- However, as in FY2022, the proportion of entities whose ratings were upgraded in FY2023 remained elevated at 15% in relation to the long-period average of 11%.
- The proportion of rating downgrades had already reduced to 6% in FY2022 as business fundamentals rebounded post the economic growth slowdown and the Covid-induced credit pressures seen in FY2020 and FY2021. The proportion of rating downgrades remained low at 5% in FY2023 as the recovery momentum continued to hold steady overall, even as supply chain concerns, cost inflation, interest rate hardening, and currency depreciation posed challenges.

Ratings maintained their upward drift in FY2023

ICRA

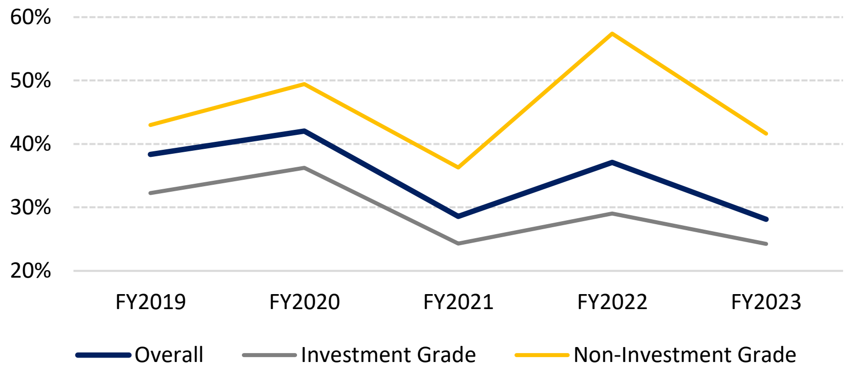
Rating Drift = (Notches Upgrades - Notches Downgrades)/ Rated Entities



Source: ICRA

- The ‘drift’ of ICRA-assigned ratings remained in the positive territory at 8% in FY2023, similar to the levels seen in FY2022. The rating trends over the past two consecutive years clearly standout from the perspective that the corresponding figure was negative in 9 out of the 10 years until FY2021.
- In FY2023, the ‘drift’ for the non-investment grade ratings also improved to minus (-) 3%, the highest it has been over the past decade.
- For two consecutive years, a strong upgrade momentum, and substantially lesser number of downgrades, including defaults, has supported the upward drift in the ratings.

Rating Volatility = (Notches Upgrades + Notches Downgrades)/ Rated Entities

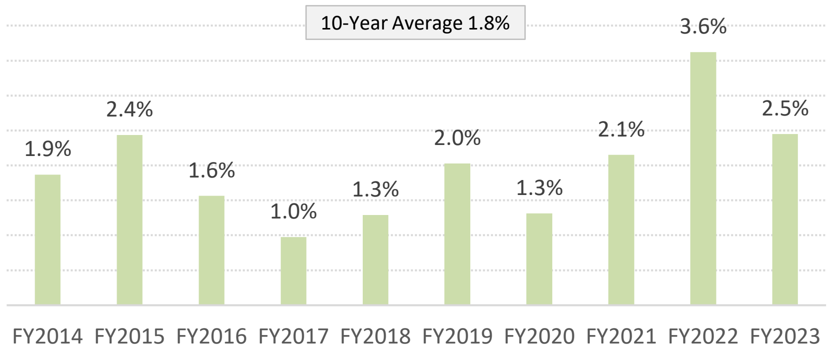


Source: ICRA

- While the upgrade momentum of FY2022 for the most part continued into FY2023, downgrade pressures were lesser in FY2023 resulting in a softening of the ‘rating volatility’ to 28% in FY2023. This was substantially lower than the volatility figure of 37% seen in FY2022, and the preceding five-year average of 35%.
- The relatively lesser instances of downgrades in general and downgrades to the default category in particular—contributed to the reduction in the overall rating volatility in FY2023.

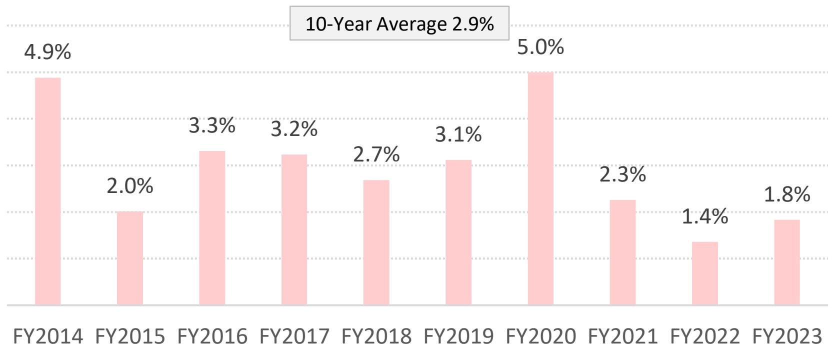
Rating traffic across the investment grade/ non-investment grade divide remained favourable compared with the historical averages

Percentage of Non-Investment Grade Entities Upgraded to the Investment Grade – Rising Stars



Source: ICRA

Percentage of Investment Grade Entities Downgraded to the Non-Investment Grade – Fallen Angels



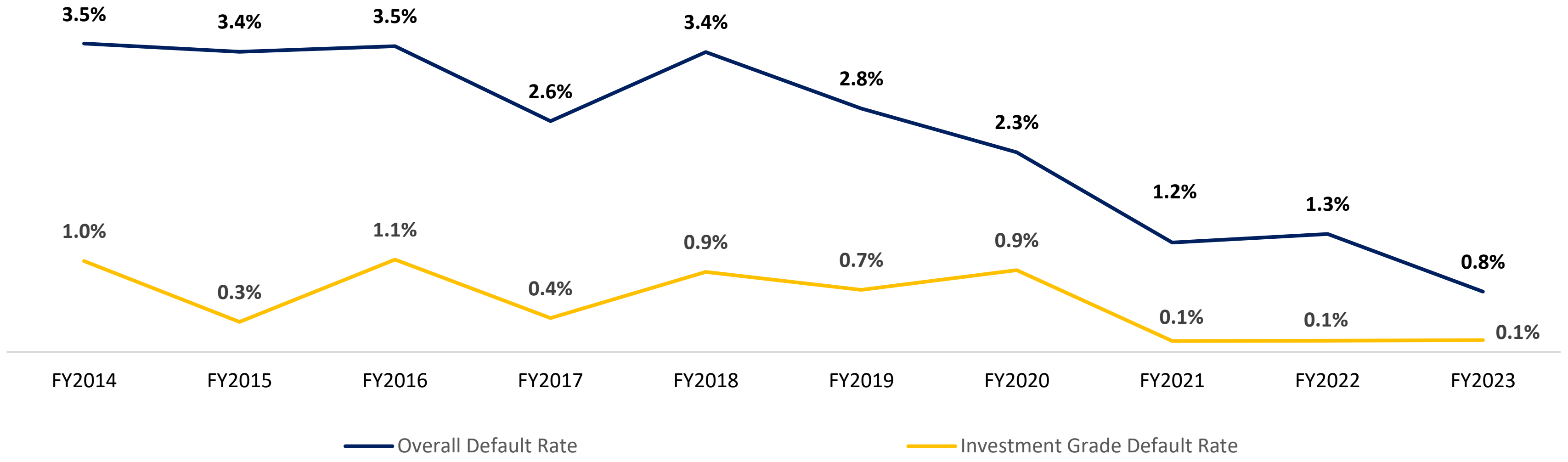
Source: ICRA

- In FY2023, 2.5% of the non-investment grade entities graduated to the investment grade categories (3.6% in FY2022) [*termed as Rising Stars by ICRA*]. Thus, even as the Credit Ratio of ICRA-assigned ratings in FY2023 was similar to that recorded in the previous year, post the upgrade, more ratings remained within the non-investment grade in FY2023 vis-à-vis the previous fiscal. Nevertheless, the proportion of rising stars in FY2023 remained higher than the past 10-year average of 1.8%.

- In FY2023, the percentage of *Fallen Angels* i.e., the number of entities whose ratings were downgraded from the investment grade to the non-investment grade as a proportion of the total entities in the investment grade at the beginning of the year was 1.8%. While this was higher than the proportion of 1.4% seen in FY2022, it remained lower than the past 10-year average of 2.9%. All the fallen angels were rated in the [ICRA]BBB category prior to the downgrade in FY2023.

Defaults have been on a leash over the past three years

Trend in the One-Year Default Rate



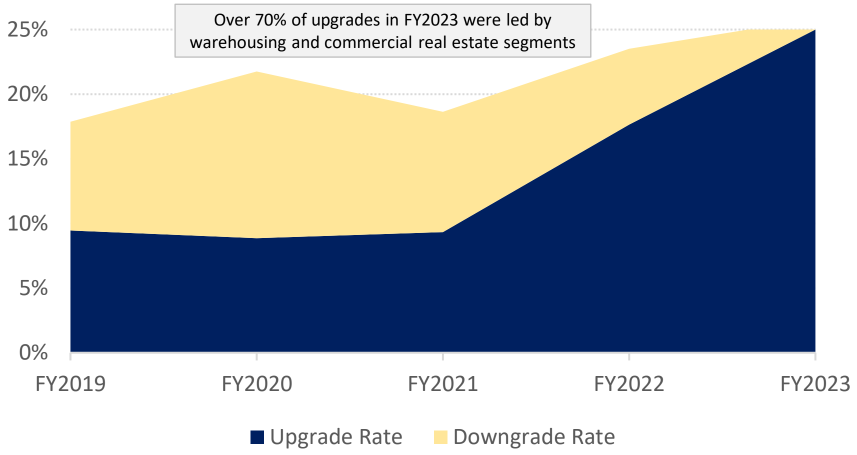
Source: ICRA

- If the instances of downgrades in FY2023 were low, occurrence of defaults was seen to be even lower. There were only 22 defaults in ICRA's portfolio in FY2023, compared with 42 in FY2022 and 44 in FY2021, with 19 out of the 22 defaults being from the non-investment grade.
- These trends are consistent with the general improvement seen in the asset quality indicators of banks and non-banking finance companies.

SPOTLIGHT: SECTORS WITH HIGH RATING ACTIVITY

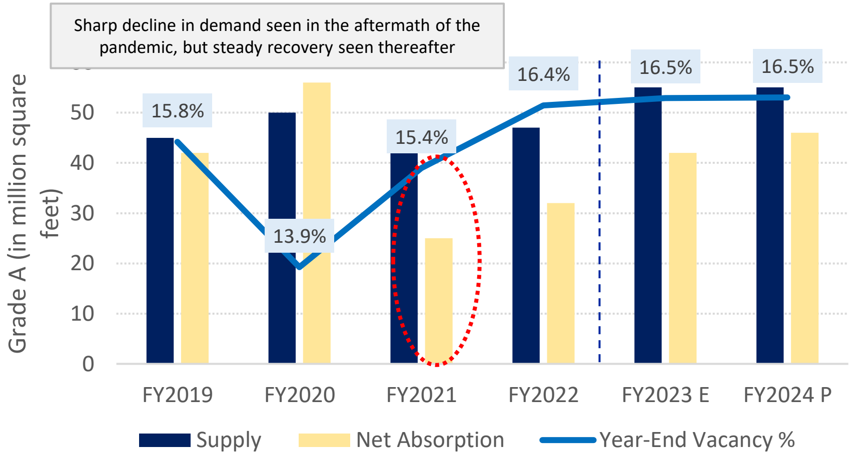
Real Estate Sector | Upgrades led by warehousing and commercial real estate segments

Trend in the Upgrade Rate and the Downgrade Rate in the Real Estate Sector



Source: ICRA

Incremental Supply, Absorption and Vacancy in the Top Six Office Markets

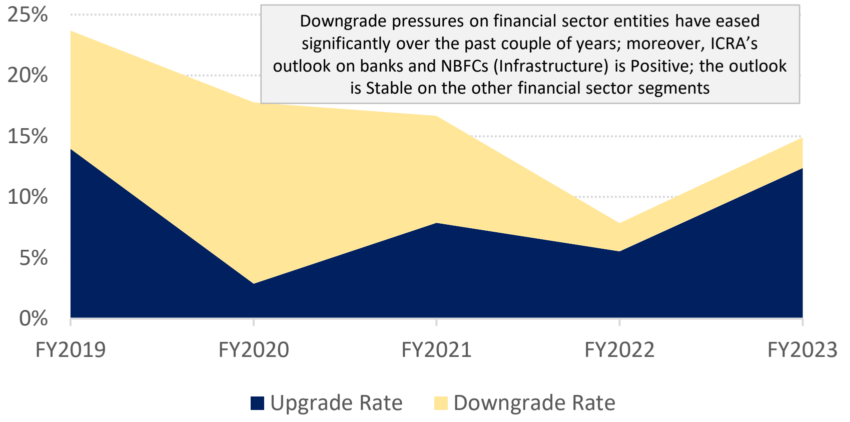


Source: Propequity, ICRA Research; E: Estimated; P: Projected

- The **real estate sector** witnessed 61 upgrades and 3 downgrades in FY2023. Adjusted for upgrades of entities belonging to the same corporate group, there were 20 upgrades in FY2023. Among the corporate groups that had multiple entities upgraded during the year include Indospace (*21 entities*), Blackstone (*8*), Salarpuria-Sattva (*6*), TVS/ CDS Group (*4*), Manglam (*3*), Bestech (*2*), ESR (*2*), Hiranandani (*2*), and RMZ (*2*). The warehousing and the commercial real estate segments were the primary contributors to the upgrade count led by improved leasing activity and rising occupancy levels of the assets.
- While ICRA expects that incremental supply in the top six office markets (*Bengaluru, Delhi NCR, Hyderabad, Pune, Mumbai, and Chennai*) to outpace net absorptions in FY2024 for the fourth year in a row, the competitive pressures will be manageable, and the credit metrics should generally remain steady with increase in leasing income alongside scheduled debt repayments.

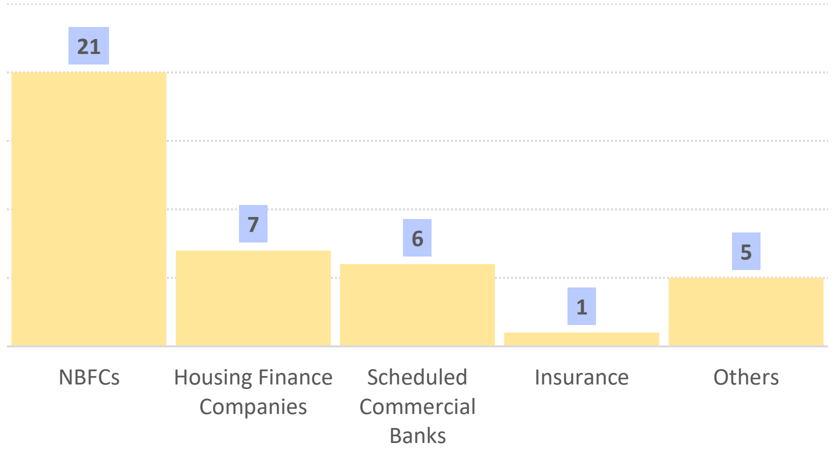
Financial Sector | Healthy credit growth, improving asset quality and capitalization support rating upgrades

Trend in the Upgrade Rate and the Downgrade Rate in the Financial Sector



Source: ICRA

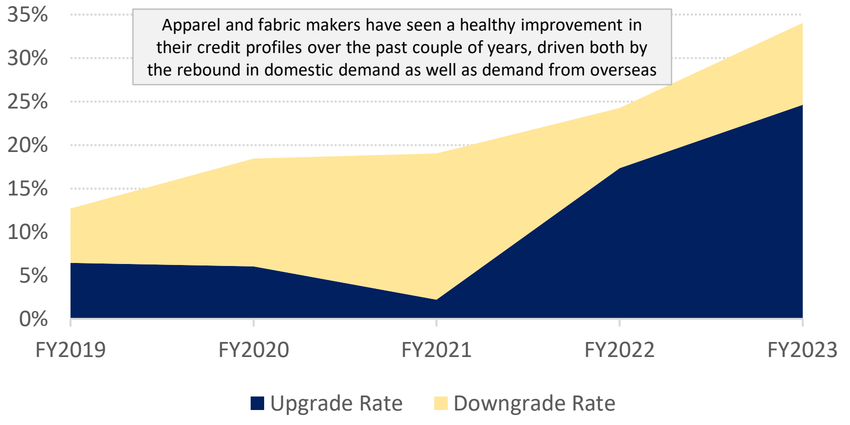
Mix of Financial Sector Entities Upgraded in FY2023



Source: ICRA

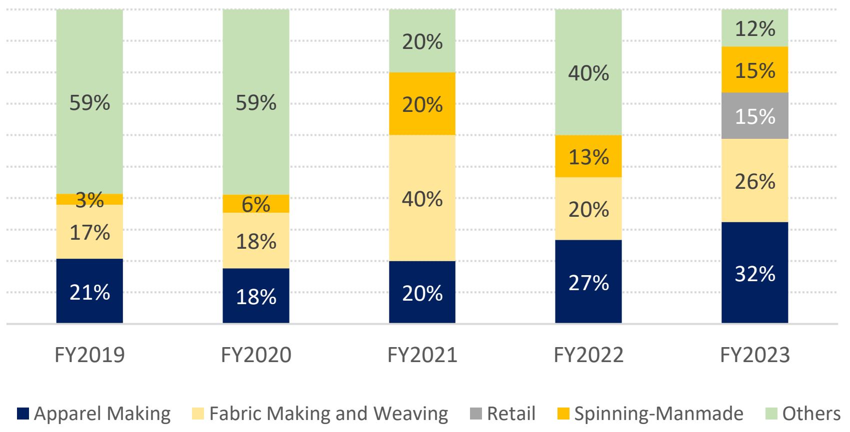
- With 40 upgrades, the **financial sector** was the second largest contributor to the upgrade pie in FY2023. The NBFCs and the HFCs upgraded in FY2023 were mostly small to mid-sized with a loan book ranging between Rs. 500 Crore to Rs. 10,000 Crore, showing a track record of consistent business growth while maintaining/ improving asset quality and capitalization metrics. The ratings of select banks were upgraded as their earnings profile was expected to sustain their improving trend with further improvement in their solvency/ capitalization metrics seen through fresh equity capital mobilization.
- Overall, in 10 out of 40 upgrades, fresh equity capital infusion was one of the triggers for an upgrade. The stabilizing asset quality indicators and their expected sustenance is expected to continue to support ratings in the sector over the near term.

Trend in the Upgrade Rate and the Downgrade Rate in the Textiles Sector



Source: ICRA

Segment-Wise Contribution to Upgrades in the Textiles Sector

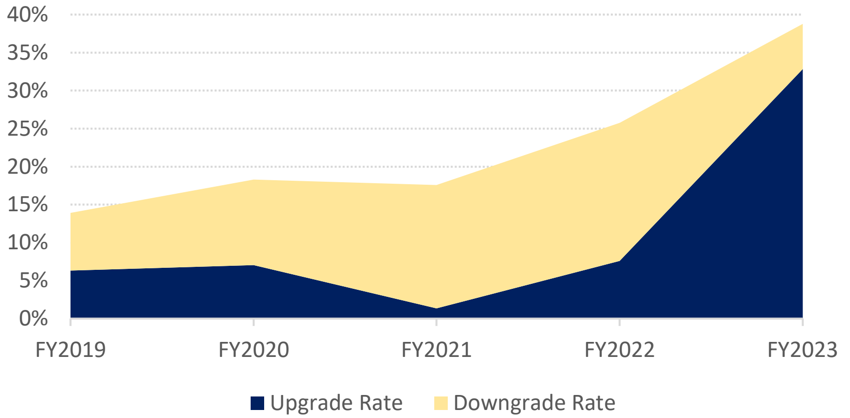


Source: ICRA

- In the **textiles sector**, ICRA upgraded the ratings of several branded apparel manufacturers and retailers in FY2023 as their business swelled on the back of the tailwinds of formalization, including the shift in customer preferences towards branded wear [*Go Fashion, Cantabil, Page Industries, Kalyan Silks*]. Also, select entities that are engaged in leather garment, infantwear, and woven apparel exports were upgraded as they experienced a strong overseas demand post the pandemic.
- However, there are risks looming on the horizon for the apparel exporters in terms of the possibility of a demand slowdown in the advanced economies of USA and Europe. More on this later in this report.

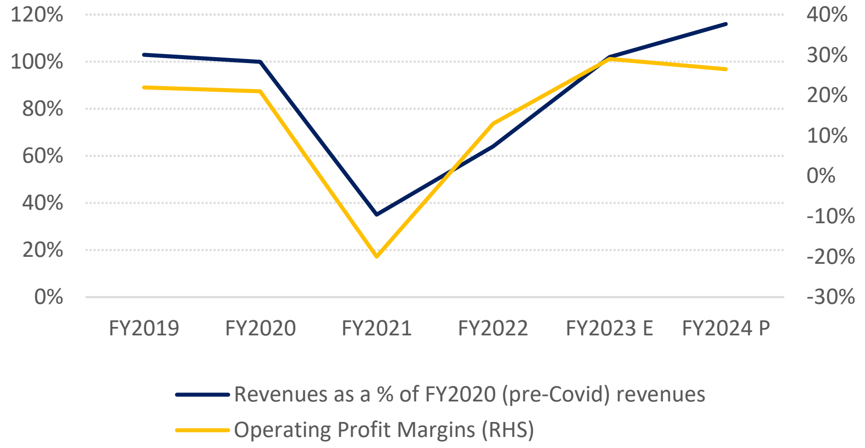
Hospitality Sector | Strong recovery in revenues and profitability

Trend in the Upgrade Rate and the Downgrade Rate in the Hospitality Sector



Source: ICRA

Trend in Revenues and Margins



Source: ICRA Research; Above data reflects a sample comprising of 12 large hotel companies in India; E: Estimated; P: Projected

- The **hospitality sector** was among the most severely affected sectors because of the pandemic. For two consecutive years—FY2021 and FY2022—ICRA's downgrade rate in the sector had touched a high of 17%. On top of this, as of Mar 2021, around 70% of ICRA's portfolio in the sector was on a Negative outlook. However, following the strong recovery seen thereafter in terms of occupancies and average room rates, besides the achievement of more cost-efficient operations, a large number of entities in the sector were upgraded by ICRA in FY2023. Currently, none of the hospitality entities in ICRA's portfolio is on a Negative outlook.

- Even as the rebound in the foreign tourist arrivals to the pre-Covid levels is yet to be attained, the overall recovery in the sector has been better than expected, aided by recovery in leisure demand, pent-up demand from MICE (including weddings), and a gradual pick-up in business travel. ICRA currently has a Positive outlook on the sector.

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RATING ACTIONS

ICRA-Rated Entity	Description	Rating Action
Jodas ExpoIM	**A pharmaceuticals-formulations player that derives over 80% of its revenues from exports to Russia**. Ratings downgraded by ICRA in view of the expected adverse impact on demand, logistics challenges, and the elongated receivables cycle that was likely to create cash flow pressures following the removal of select Russian banks from the SWIFT network.	[ICRA]BB+ (Negative)/ [ICRA]A4+ Ratings downgraded/ subsequently withdrawn
Girnar Food & Beverages	**Tea producer in ICRA's portfolio that derives around half of its revenues from exports to Ukraine and Russia**. The company did face business disruptions because of container shortages but only for a short period; also, the company continued to receive payments from customers without delays. Ratings derive comfort from the comfortable credit profile with limited dependence on external debt and a strong liquidity position. The company does not have any external repayment obligations and has no major capital expenditure plans.	[ICRA]A- (Stable)/ [ICRA]A2+ Ratings unchanged
Dr. Reddy's Laboratories	**While the company has very limited presence in Ukraine, Russia is a reasonably-sized market accounting for 8-10% of revenues**. No material adverse impact seen on the company's performance, except for a brief period, post which the sales rebounded, and the channel stock normalized. The ratings were reaffirmed by ICRA.	[ICRA]AA+ (Stable) Rating reaffirmed
AVI Oil India	**A manufacturer of synthetic esters and lubricants whose French parent (Nyco, 50% stake) is a major supplier to the Russian military.** No operational disruption faced by the company in terms of know-how support from the parent.	[ICRA]A+ (Stable)/ [ICRA]A1 Ratings reaffirmed
Banks	**Select banks in ICRA's rated portfolio have an exposure on Nayara Energy (an entity 49% owned by the Rosneft Group of Russia) and Vadinar Oil Terminal, the captive port facility of Nayara Energy**. As per ICRA's estimates, only 4% of the core capital of these banks was exposed to the above entity. In any case, the entity is so far not seen to have faced any material operational or financial impact because of the Russia-Ukraine conflict.	**No rating actions because of such exposure**
Fertiliser Entities	The global developments had a material impact on **fertilizer prices** and **supplies**. This was credit negative for the fertiliser entities, looked at in isolation. However, ICRA took comfort from the expected support from the Government of India (GoI) by way of additional subsidy allocation, which indeed fructified subsequently.	**No rating actions**

Cost inflation amid relatively weaker pricing power | Rating Actions

Select entities whose ratings were downgraded in view of inflationary pressures amid limited pricing power:

Entity	*Sector*	Which input?	Finished product	Earlier Long-Term Rating	Revised Long-term Rating
Anugraha Valve Castings	*Engineering*	Ferrous scrap	Valve castings - mostly exported	[ICRA]A- (Stable)	[ICRA]BBB+ (Stable)
Asian Granito	*Ceramic Tiles*	Natural gas	Ceramic tiles	[ICRA]A+ (Negative)	[ICRA]A- (Negative)
Everest Ply & Veneers	*Plywood Boards*	Core veneer, urea formaldehide resin	Plywood	[ICRA]BB (Stable)	[ICRA]BB- (Stable)
Nilons Enterprises	*Food Products*	Various associated inputs	Pickles, sauces, vermicelli, macaroni, and jams etc.	[ICRA]BBB (Stable)	[ICRA]BB+ (Stable)
Kesoram Industries	*Building Materials*	Coal	*Cement*	[ICRA]BBB- (Negative)	[ICRA]BB+ (Stable)
OPG Energy	*Power*	Natural gas	Thermal power	[ICRA]BBB (Watch Developing)	[ICRA]BB (Negative)
Parakh Agro Industries	*Agricultural Food & Other Products*	Wheat	Wheat flour	[ICRA]A- (Stable)	[ICRA]BBB+ (Stable)
Raj Industries	*Diversified FMCG*	Palm fatty acid distillate and lauric acid	Soap	[ICRA]A (Stable)	[ICRA]A- (Negative)
Sany Heavy Industry	*Construction Equipment*	Steel and others	Mining and concrete equipment	[ICRA]A- (Negative)	[ICRA]BBB+ (Negative)
Sri Krishna Pharmaceuticals	*Pharmaceuticals*	Para-amino phenol	Paracetamol	[ICRA]A- (Stable)	[ICRA]BBB+ (Stable)
Srinivasa Farms	*Poultry*	Poultry feed	*Poultry*	[ICRA]BBB- (Negative)	[ICRA]BB+ (Stable)
The Indian Wood Products Company	*Food Products*	Imports the raw material viz., gambier	*Kattha*	[ICRA]BBB- (Negative)	[ICRA]BB+ (Stable)

For the above entities, increase in costs was not compensated by a commensurate increase in realisations. This created profitability pressures and, alongside other secondary reasons, resulted in rating downgrades in FY2023.

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LOOKING AHEAD | KEY WATCHOUTS

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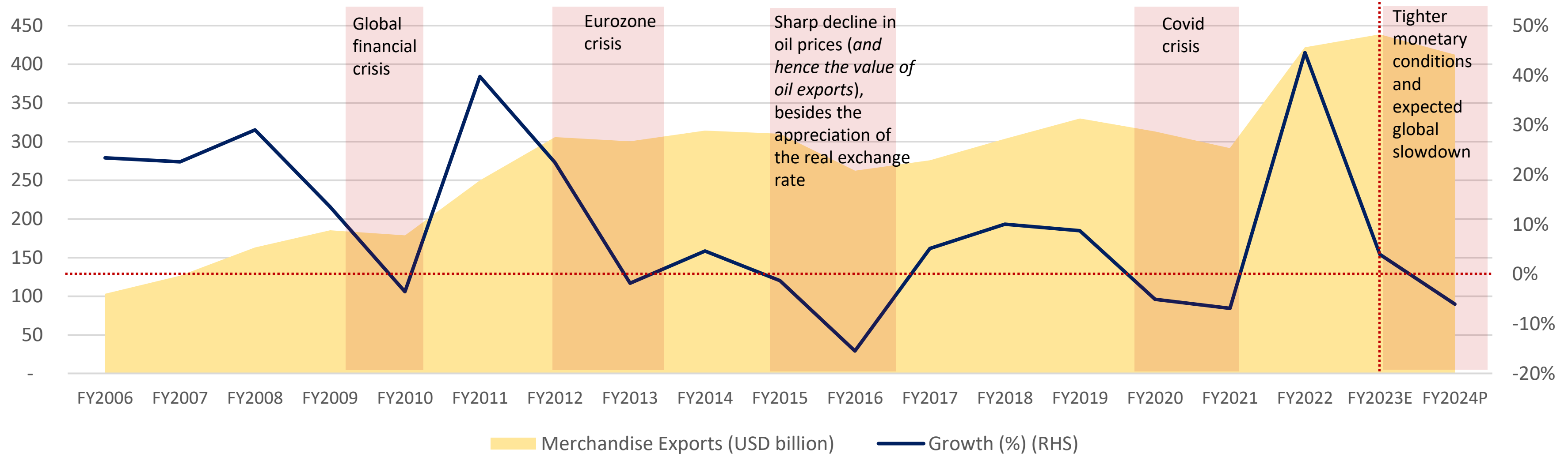
1. RISK OF A SLOWDOWN IN EXPORTS

Merchandise exports from India expected to contract by around 6% in FY2024

Trend in Merchandise Exports from India



Source: Ministry of Commerce and Industry, ICRA Research; E: Estimates; P: Projections

- The latest World Economic Outlook update published by the International Monetary Fund (IMF) projects that **global economic growth will fall to 2.9% in CY2023** (3.4% in CY2022), below the historical average of 3.8%. Rising interest rates to combat inflation, and the war in Ukraine would weigh on economic activity in CY2023, even as China's reopening will provide a counterbalance.
- Merchandise exports from India have been slackening already, slipping into a YoY contraction of 2.8% during Oct-Feb FY2023 compared with an expansion of 16.9% seen during H1 FY2023. **ICRA projects merchandise exports to contract by around 6% in FY2024 amid slowing external demand and relatively lower commodity prices**, after rising by an estimated 4% in FY2023.

Economic slowdown in Europe and the USA to weigh on India's export growth

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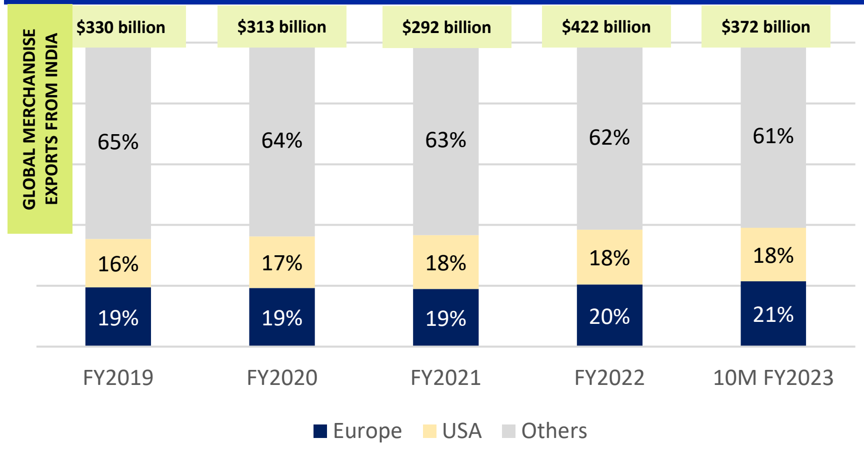
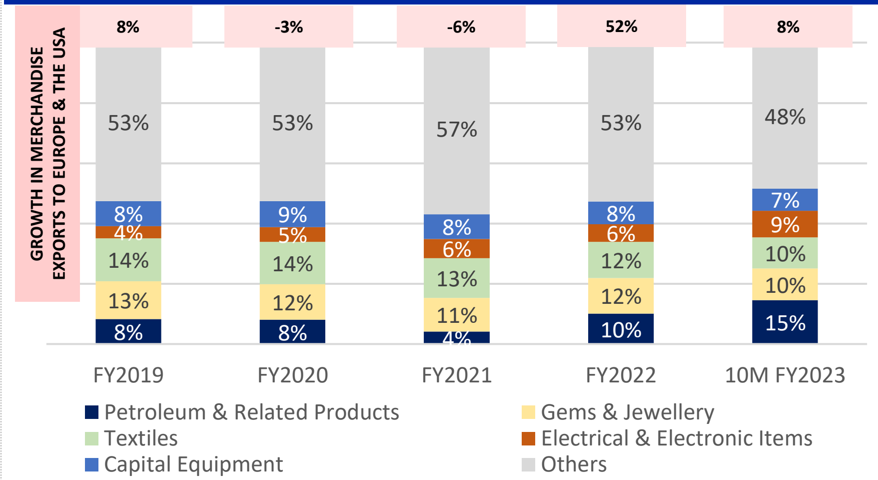
Contribution of Europe and USA to India's Merchandise Exports



Source: Ministry of Commerce and Industry, ICRA Research

Category-wise Proportion of India's Merchandise Exports to Europe & the USA



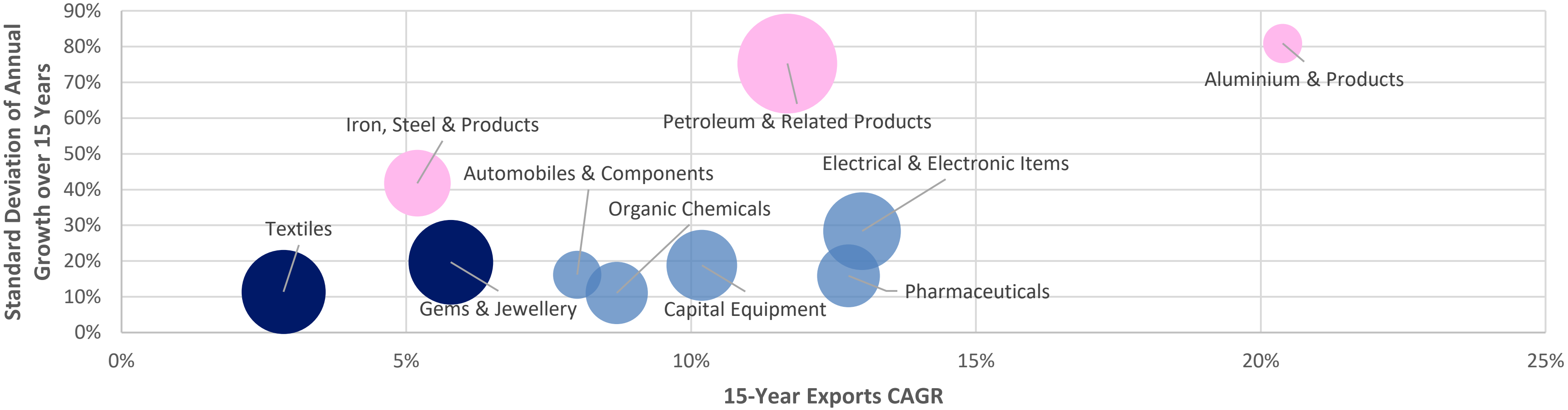
Source: Ministry of Commerce and Industry, ICRA Research

- **The expected slowdown in global economic growth in FY2024 will be largely attributable to slowing economic activity in Europe and the USA**. These geographies collectively accounted for 39% of India's global merchandise exports in 10M FY2023.
- While India's merchandise exports to Europe and the USA expanded by 8% YoY in 10M FY2023, a potential contraction in FY2024 is imminent as economic activity in both these geographies is expected to gear down. The IMF projects GDP growth in the Euro area to fall to 0.7% in CY2023 (3.5% in CY2022), and that in the USA to fall to 1.4% in CY2023 (2.0% in CY2022). That being the baseline, several downside risks to these estimates exist, arising most notably from an **unstable geopolitical environment** and the **not-so-steady financial conditions**.

NOTE: Data for Europe includes that for the EU27 countries, European FTA, and other European countries; Textiles segment includes apparels, cotton, cotton yarn, carpets, and special woven fabrics.

Receding commodity prices and slowdown in global discretionary spending will pull down export growth

Historical Growth and Volatility in the Top 10 Merchandise Categories of Exports from India to Europe & the USA



Source: Ministry of Commerce and Industry, ICRA Research; Data for Europe includes that for the EU27 countries, European FTA, and other European countries; Textiles segment includes apparels, cotton, cotton yarn, carpets, and special woven fabrics; Size of the bubble reflects the relative quantum of exports from India

- The **top 10 merchandise categories**, as depicted in the Exhibit above, account for around 75% of India's aggregate merchandise exports to Europe and the USA.
- The commodity segments viz., **Petroleum, Iron & Steel,** and **Aluminium**, accounting for around 20% of India's aggregate merchandise exports to Europe and the USA have shown the highest volatility over the years, in large measure because of the pricing volatility associated with commodity prices.
- The demand for **Textiles** and **Gems & Jewellery** also faces swings given their discretionary consumption character; however, the amplitude of the swings is historically seen to be milder compared with the other merchandise segments. These are among the top few non-petroleum segments in terms of merchandise exports from India to Europe and the USA.

Export growth prospects

- **Textiles:** Within the Textiles sector, **cotton yarn exports** will face cyclical as well as structural headwinds in the near term caused by price competitiveness concerns. As for **apparel exports**, the experience of the past global demand troughs caused by the global financial crisis of 2009 and the Eurozone crisis of 2011/ 2012 indicates that while demand would face pressures in FY2024, the severity would likely be manageable.

- **Gems & Jewellery:** After a strong rebound in the demand for **cut & polished diamonds** (CPD) seen in FY2022 post the pandemic-induced sharp decline seen in the preceding year, exports moderated in FY2023 because of inflationary pressures. Demand moderation was more pronounced in higher-sized diamonds (50 cents and above) compared with smaller-sized diamonds (30 cents and below). Demand growth is expected to remain subdued in FY2024 in view of continued inflationary pressures and competition from other spending avenues.

- **Electrical & Electronics:** This is the third largest category of merchandise exports from India and recorded almost 40% export growth both in FY2022 as well as in FY2023. Over one-third of this category is constituted by smartphones. Export growth in this category in FY2023 as well as FY2024 is slated to be led by the sharp rise in **smartphone exports** from India *($ 8.3 billion smartphone exports recorded in 10M FY2023*). The production-linked incentive (PLI) scheme of the Government of India is going to be the key catalyst to exports growth in this category.

- **Information Technology Services:** The USA and Europe contribute 80%-90% to the revenues of the major Indian IT services companies. The order book of large IT companies remains strong which will support revenue growth over the near term. However, the evolving macro-economic headwinds, setbacks seen in the financial services sector in the USA (marked by recent regional bank failures), and the adverse impact on the technology sector caused by the retraction of easy money policies and its manifestation in employee layoffs would have an **adverse impact on incremental discretionary IT spending.** That said, the cost optimization deals should continue to generate healthy demand. Notwithstanding the above, the strong balance sheets of the major IT sector entities will continue to support their credit profiles.

Credit Negative | Credit Neutral | Credit Positive

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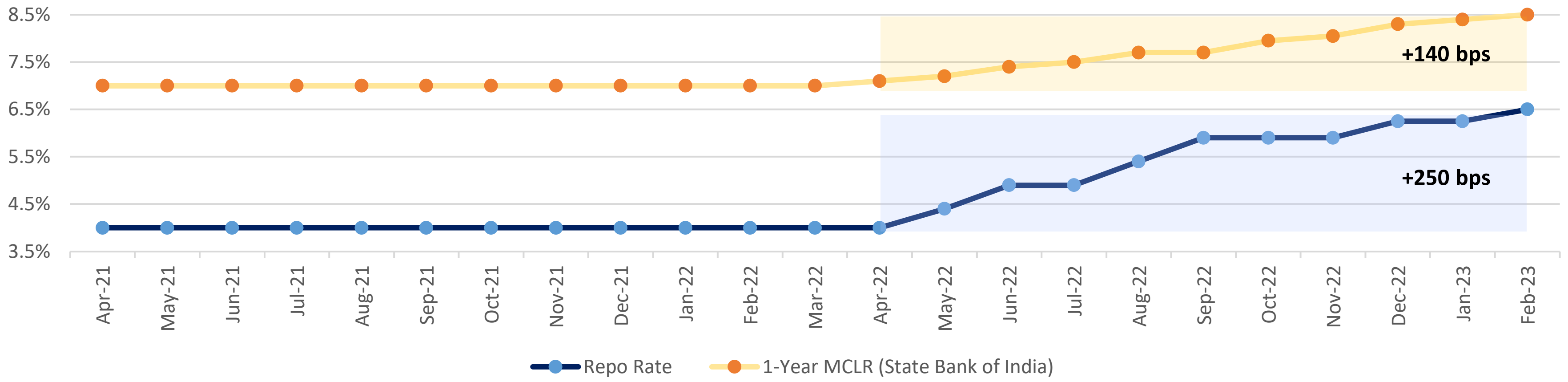
2. INTEREST RATE RISK

MCLR-linked loans have seen a relatively milder rise in rates compared with the repo rate

Trend in movement in the repo rate and the one-year marginal cost of lending rate (MCLR) of the State Bank of India



Source: Reserve Bank of India (RBI), State Bank of India (SBI), ICRA Research; NOTE: As of Jun 30, 2022, the share of External Benchmark based Lending Rate (EBLR)-linked loans in total outstanding floating rate rupee loans of scheduled commercial banks was 46.9% while that of MCLR-linked loans was 46.5%.

- Between May 2020 and May 2022, the repo rate had remained at 4.00% while the State Bank of India's (SBI's) 1-year MCLR had remained at 7.00%.
- As global inflation climbed and remained persistently sticky, the US Fed began its rate hike cycle in Mar 2022. As a reaction to the global developments, besides a consideration of the local factors, the RBI began its rate hike cycle in May 2022. Over the past 12 months, the repo rate in India has seen an aggregate increase of 250 basis points (bps) in comparison with the US Fed hiking rates over the same period by 475 bps.
- In comparison, SBI's 1-year MCLR has increased by only 140 bps, implying that for the entities whose floating rate loans are linked to their lending bank's MCLR, the year FY2023 was not as unsettling in terms of the rise in interest costs as for the entities whose loans are linked to an external benchmark like the repo rate.

A further 100 bps increase in interest rates will be credit negative for leveraged entities/ sectors

Roads (Toll)

Toll rate hike in assets that became operational over the past decade (awarded post 2008) is linked with the December wholesale price index (WPI). Accordingly, based on the specified formula, the toll rate hike in FY2024 will be about 5%. With steady traffic growth, ICRA expects toll collections in FY2024 to grow by 6-9% (*around 18% growth estimated for FY2023*). While the adverse impact of rising interest rates is seen to have been largely mitigated so far because of the healthy growth in toll collections, a further 100 bps increase in interest rates would be a credit negative, more so for entities without the backing of a strong promoter group.

Roads (Annuity)

All AAA rated road annuity assets in ICRA's portfolio have fixed rate borrowings. As for others that have floating rate borrowings, their existing ratings have the tolerance to withstand the impact of a certain level of interest rate hikes. Over the past 12 months, the impact of a 150-200 bps increase in interest rates on the cumulative debt service coverage ratio (DSCR) was estimated to be around 5-bps, low enough not to trigger a rating change. While a further increase in interest rates would be a credit negative, the 'restrictive payment clause' in the loan terms of most of the road assets, that kicks-in when the debt coverage metrics fall below a pre-defined threshold, would be a mitigant.

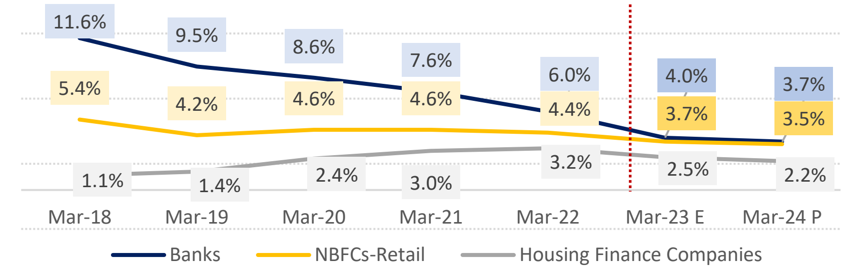
Power

Most thermal power entities in ICRA's portfolio have a cost-plus mechanism wherein an escalation in costs including interest costs is pass-through in nature. For entities without the cost-plus arrangement *(thermal and renewable)*, a 150-200 bps increase in interest rates causes an impact of 8-12 bps on the cumulative DSCR. While the existing ratings have had the tolerance levels to bear the above impact on the coverage ratios, a further 100 bps increase in interest rates could pressure their unsupported credit profiles. However, the risk is somewhat mitigated as the ratings of many entities in ICRA's portfolio draw support from the backing of strong sponsors.

- More broadly, sectors or entities that face demand pressures, have limited pricing power, and are high on financial leverage are likely to face greater pressure on their credit profiles in FY2024 when the impact of the higher interest rates gets further transmitted to the MCLR-linked/ base rate-linked loans.

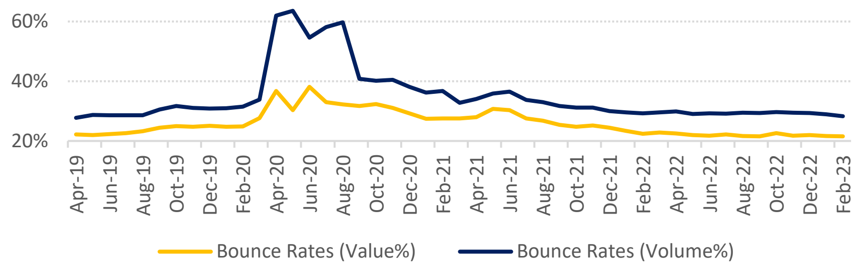
Asset quality of banks and financial institutions has been improving but rising interest rates could impact asset quality in unexpected ways

Asset Quality of Banks, NBFCs (Retail) & HFCs has been Improving



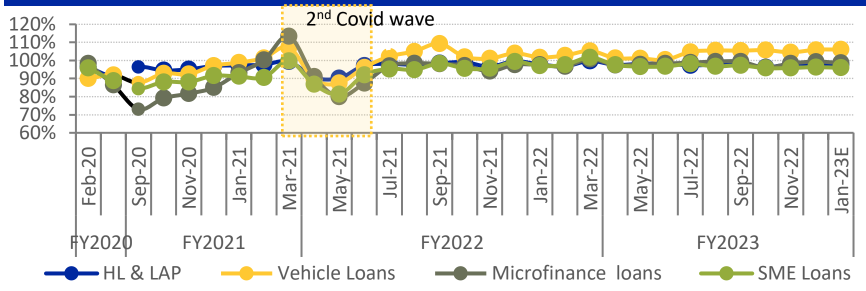
Source: Company Results, ICRA Research; Gross NPAs (%) for banks, Gross Stage-3 (%) for NBFCs (Retail) and HFCs; Data for NBFCs-Retail & HFCs represents 85%-95% of the industry's AUM

NACH Debit Bounce Rates are at Four-Year Lows



Source: NPCI

Monthly Collection Efficiency of ICRA-Rated Pools has been Steady



Source: ICRA Research; HL & LAP: Home Loans & Loans Against Property

- In the base case scenario, ICRA expects the earnings profile of banks to improve in the near-term drawing support from a healthy credit growth and potentially better loan pricing power driven by expectations of an increase in credit spreads for corporate bonds.
- The three Exhibits alongside suggest that asset quality pressures on banks and financial institutions have been consistently receding. Our base case expectations are that the Gross NPAs/ Gross Stage-3 assets of banks and financial institutions will maintain their improvement trajectory in the near term. That said, the downside risk to our estimates stems from the possibility of an unexpected rise in bad loans when the full impact of the rise in interest rates in FY2023 starts reflecting in the P&L of borrowers in FY2024. A further rise in interest rates (*beyond the 250-bps hike in repo rates in FY2023*) will additionally test the resilience of the asset quality improvement trends.

SECTOR OUTLOOK SNAPSHOT

Sector Outlook

STABLE

- Airlines
- Airport Infrastructure
- Auto OEMs
- Auto Comp
- Automobile Dealerships
- Bulk Tea
- Cement
- Chemicals
- Construction
- Construction Equipment
- Dairy
- Ferrous Metals
- Hospitals
- IT Services
- Jewellery-Retail
- Logistics (Road/ Ports)
- Media (Broadcasting)
- Media (Exhibitors)
- Non-Ferrous Metals
- Oil & Gas (Downstream)
- Pharma
- Ports
- Power (Renewables)
- Power (Thermal)
- Power (Transmission)
- Real Estate (Residential)
- Real Estate (Malls)
- Real Estate (Commercial)
- Retail – Fashion
- Roads (Toll)
- Sugar
- Telecom (Services)
- Telecom Towers
- Textiles (Cotton Spinning)
- Brokerages
- Housing Fin Cos
- Insurance
- NBFCs (Retail)
- NBFCs (Microfinance)
- Small Finance Banks

POSITIVE

- Banks
- NBFCs (Infra)
- Hospitality
- Oil & Gas (Upstream)

NEGATIVE

- Media & Entertainment – Print
- Power – Distribution

Progression to Stable outlook from Positive outlook in FY2023

Progression to Stable outlook from Negative outlook in FY2023

Progression to Positive outlook from Stable outlook in FY2023

For details regarding the meaning of sector outlook designations, please see this link

Endnotes

Credit Ratio: This is defined as the ratio of the number of entities upgraded to that downgraded during the year. The rating downgrades considered for analysis exclude the entities whose ratings were downgraded because of their non-cooperation with ICRA unless it was a case of a downgrade to the [ICRA]D category. Also, the analysis does not capture the ratings that were in the Issuer Not Cooperating (INC) category at the beginning of the year.

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