

Measuring the Contingencies

How contingent liabilities affect credit quality

AUGUST 2024

One prominent credit theme characterising the performance of India Inc. over the past few years has been that of corporate deleveraging. The mid to large-sized entities across most sectors have seen their ratio of debt-to-profits improve, driven by substantial profit growth coupled with moderate debt-funded capital expenditures. The following data points corroborate the foregoing. Between March 2018 and March 2023, the *Debt/ OPBITDA* ratio for a sample of 3,300 publicly-listed non-financial sector entities analysed by ICRA improved to 2.5x from 3.3x. Likewise, the *Debt to GDP ratio* for these sample entities moderated by a substantial 400 basis points (bps) to 14%¹. The *Total Outside Liabilities (TOL) to GDP ratio* too moderated by 500 bps to 32%². In comparison, the *Shareholders' Funds to GDP ratio* remained largely stable at 16% during this period. It is no surprise then that credit rating upgrades have outnumbered downgrades by an order of magnitude of 2-3 times in the past three years³.

While both the on-balance sheet debt as well as the TOL have reduced materially in comparison to the nominal GDP over a period of five years ending in March 2023, the contingent liabilities—that are by definition off-balance sheet—have recorded a reduction of only 160 bps to around 4%. In macro terms, the contingent liabilities in the non-financial sector are far from being disconcertingly large in aggregate amount to create systemic credit quality issues. However, in micro terms, on many occasions, the large contingent liabilities turn out to be among the key constraining factors for an entity's credit rating. It is also observed that when large contingent liabilities suddenly crystallise, they exert substantial pressure on the affected entity's liquidity position, which could even result in multi-notch rating downgrades.

Data shows that litigations account for the biggest share in the total pie of contingent liabilities, touching almost 80%. Their proportion has only increased in the past few years. Claims raised by counterparties because of contracting disputes and those raised by tax authorities are the salient contributors to the litigations. The credit risks posed by litigations are hard to capture in the credit ratings precisely given the uncertainties involved in the outcome of the litigations and the time horizon over which these might materialise or be fully redressed. This report provides a perspective on how the contingent liabilities, including the litigation-related risks, are analysed by ICRA in credit assessments. The report also includes data on the trend in the overall contingent liabilities, while presenting a sectoral picture as well.

¹ This sample is estimated to account for around half of the total debt of the listed plus unlisted companies in the non-financial sector. Note: The updated data as of March 2024 is not available for most of the sample entities and, hence, the period of analysis is restricted till March 2023.

² TOL is defined as Total Liabilities minus Shareholders' Funds. Therefore, TOL is inclusive of Debt.

³ It is the mid to large-sized entities (as opposed to the MSMEs) that constitute the universe of entities with a credit rating. These entities substantially overlap with ICRA's sample set.

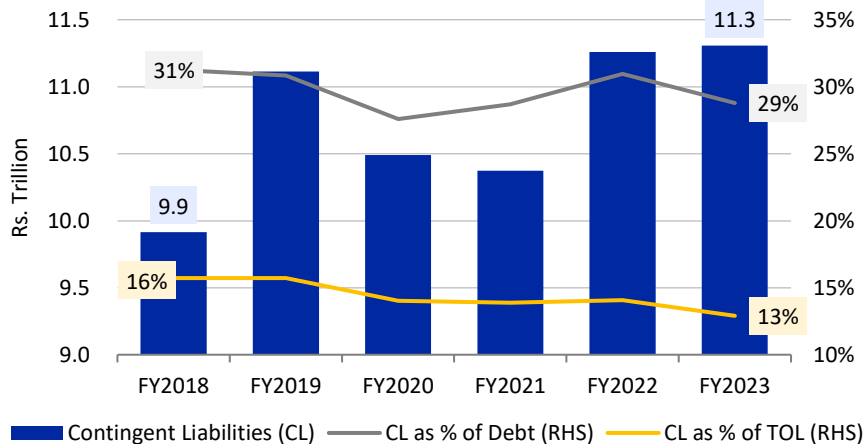


Contingent Liabilities

Trends and proportions

Contingent liabilities have grown only modestly over the years

Trend in total contingent liabilities and their share in debt and TOL

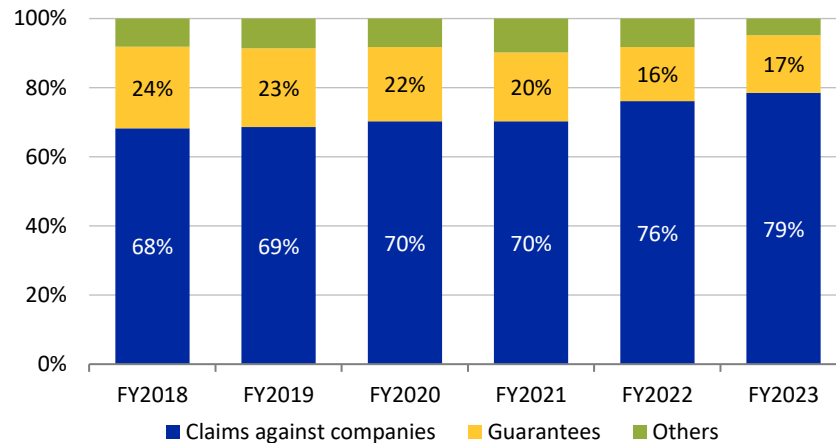


- In the five-year period ending Mar 31, 2023, the total contingent liabilities have grown at a CAGR of 3% to Rs. 11.3 trillion, slower than the pace at which the TOL have grown (7%) in ICRA's sample. Accordingly, the proportion of the total contingent liabilities vis-à-vis the TOL has moderated during this period.

Source: Ace Equity, ICRA Research

Note: The analysis is based on the data of around 3,300 publicly-listed non-financial sector entities

Trend in break-up of contingent liabilities by type

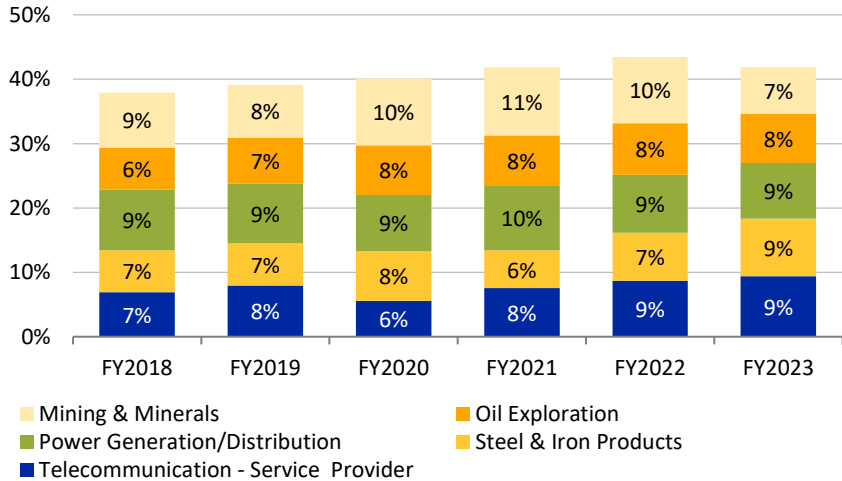


*Guarantees includes both corporate guarantees extended to group companies as well as bank guarantees issued by banks on behalf of companies (such as performance guarantees)

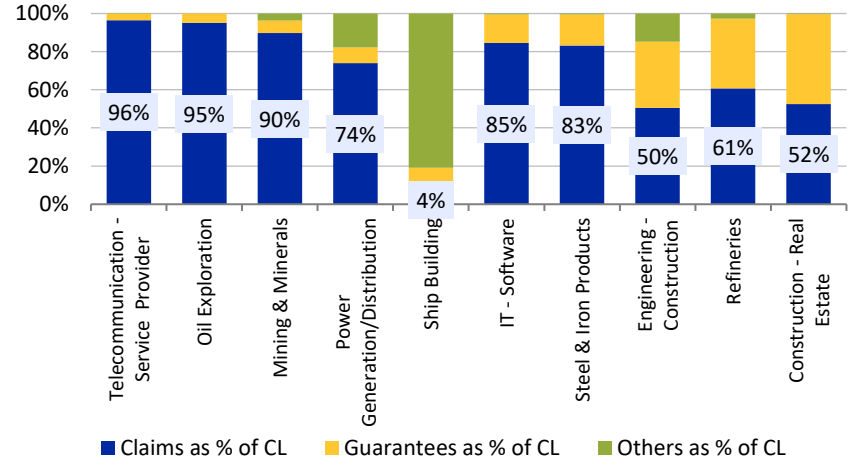
- Claims against companies, pertaining to disputed demands from counterparties and claims raised by tax authorities for corporation tax, GST, excise, customs duties, etc., are the most prominent type of contingent liabilities. Their share has increased, driven both by increase in the absolute amount of claims as well as decline in amount of guarantees.

Disputed claims account for majority of contingent liabilities across most sectors

Top five sectors account for over 40% of contingent liabilities



Disputed claims account for lion's share of contingent liabilities across most sectors



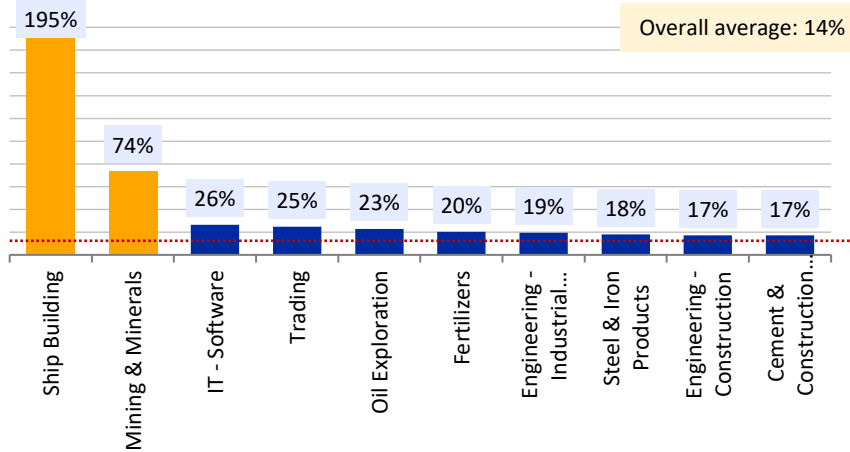
Note: Data reflects average of 3 years ending in March 2023

- The **top 10 sectors** account for over **60%** of the total contingent liabilities with the share of **top five sectors** being **42%**.
- In the **telecommunications** sector, the disputed claims include not only those from tax authorities but also from the Department of Telecom.
- The **'Others'** sub-head of contingent liabilities in the **shipbuilding** sector stands out in the second graph above, being skewed by the indemnity bonds issued by Mazagon Dock Shipbuilders Limited to its customers for its various contracts.
- The business model of **construction** companies involves the issuance of performance bank guarantees (BGs), which reflects in the higher share of the **'Guarantees'** sub-head in the second graph above—for the Engineering-Construction and the Construction-Real Estate sectors.

Source: Ace Equity, ICRA Research; Note: The analysis is based on the data of around 3,300 publicly-listed non-financial sector entities

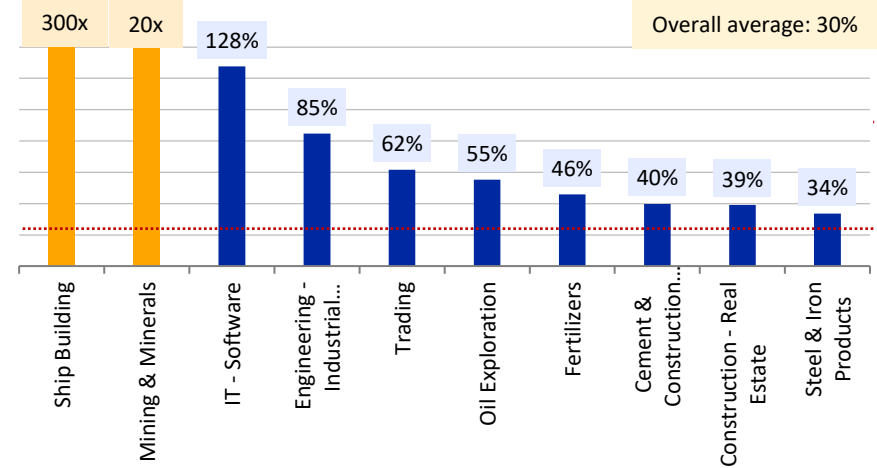
Shipbuilding and mining carry highest share of off-balance sheet risks, although not entirely unmitigated

Top 10 sectors – Share of contingent liabilities in relation to TOL



Note: The red horizontal line in both graphs represents the average for the sample; data in both graphs reflects average of 3 years ending in March 2023

Top 10 sectors – Share of contingent liabilities in relation to debt



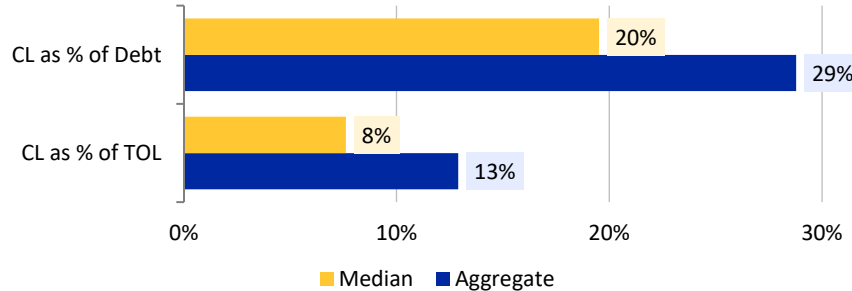
Note: Not drawn to scale for shipbuilding and mining & minerals

- The **Shipbuilding** and the **Mining** sectors are seen to have the **highest proportion of contingent liabilities** in relation to both TOL as well as debt. Being concentrated sectors, the data in these two sectors largely reflects the statistics of select large, publicly-listed entities. Mazagon Dock Shipbuilders and Coal India have large contingent liabilities vis-à-vis their TOL and debt, yet this risk is mitigated for various factors, most notably their sovereign ownership.
- For the **IT-Services** sector, while the proportion of contingent liabilities vis-à-vis TOL and debt appears to be relatively higher, it **does not imply a high risk**, as entities in the sector have a low financial leverage with high cash and liquid investments. Accordingly, the sector participants' contingent liabilities as a percentage of cash stand comfortable at 60%, much lower than the sample average of over 160%.

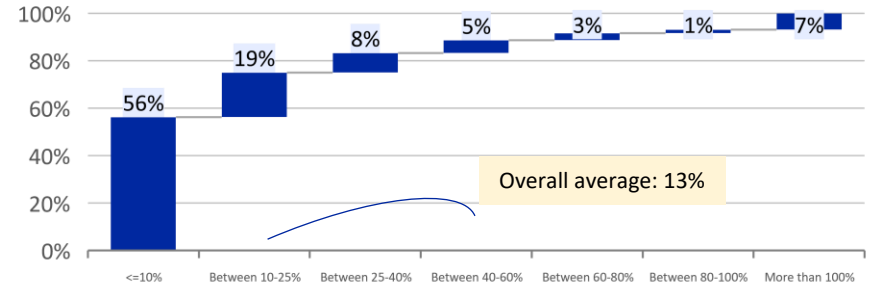
Source: Ace Equity, ICRA Research; Note: The analysis is based on the data of around 3,300 publicly-listed non-financial sector entities

Off-balance sheet risk build-up not to the extent that is suggestive of systemic blind spots

Median values are at some distance from the sample aggregate (or average)

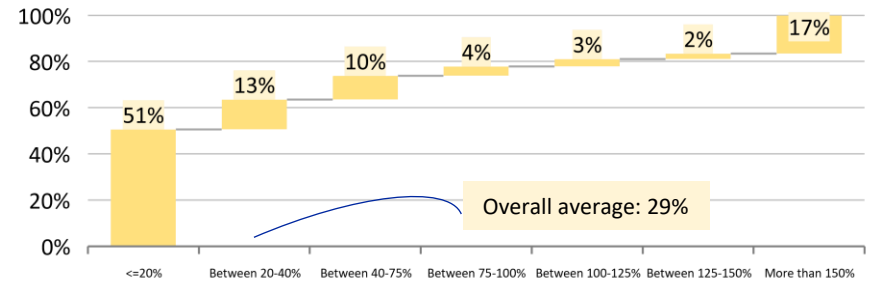


Distribution of the sample entities' contingent liabilities as % of TOL



- Roughly 60% of entities in the sample report *contingent liabilities as % of TOL* and *contingent liabilities as % of Debt* at levels below the overall average. This explains why the sample's median values are at some distance away from the sample's average values.
- Even among 40% of entities whose off-balance sheet liabilities are higher than the overall average, it is the entities dotting the longer tail that push up the overall average.
- The inference that could be drawn here is that the contingent liabilities in the non-financial sector are not uncomfortably large across the board. Therefore, the attendant risks are not widespread among entities and systemic credit risks are accordingly less of a concern.

Distribution of the sample entities' contingent liabilities as % of debt



Source: Ace Equity, ICRA Research; Note: The analysis is based on the data of around 3,300 publicly-listed non-financial sector entities; data in the three graphs is as per the FY2023 financials.

Small proportion of debt corresponds to entities whose contingent liabilities as a share of TOL are higher than the sample average

Rating-wise distribution of entities

	Rating category-wise volume of debt (Rs. crore) [A]	Debt where CL as % of TOL > 13%* (Rs. crore) [B]	Debt where CL as % of TOL > 13%* (proportion) [B]/ [A]
AAA	1,603,925	246,758	15%
AA	887,763	76,325	9%
A	133,313	29,176	22%
BBB	57,092	11,305	20%
Non-Investment Grade	300,716	54,918	18%
TOTAL	2,982,809	418,482	14%

NOTE: The significance of the figure of 13% flows from the previous slide where this figure represents the average contingent liabilities as a % of TOL for the sample of entities analysed.

The data presented on this slide probes into the question—from among the sample entities, what proportion of entities’ total debt in the various rating categories breaches the average mark of 13%—and, hence, veers into a riskier terrain? The answer to this question, as the above table shows, is 14%.

Tying together the insight gathered from the previous slide and that gained from this one: While 40% of the sample entities’ contingent liabilities as a % of TOL is higher than the average mark (13%), on a volume of debt basis, this figure is much lower at only 14%. Moreover, as one goes down the rating scale, the proportion is seen to increase, which is consistent with what one would have expected intuitively.

Source: Ace Equity, ICRA Research; Note: The numerical figures are as per the FY2023 financials, while the ratings considered are as of July 1, 2024.



ICRA's Approach

Analysing contingent liabilities

The fact that the contingent liabilities are not materially large at a system level does not detract from the risks that they pose at the entity level. The analytical challenge is about how to account for the associated uncertainties into credit assessments. The description below captures ICRA's broad approach towards this end.

Assess the nature of the contingent liability

Contingent liabilities are typically in the nature of:

1. Claims against the company from counterparties
2. Litigation on account of direct and indirect tax demand
3. BGs that are issued on behalf of the company
4. Corporate guarantees extended by the company for debt of other group companies

Evaluate the stage of dispute/ business profile

For claims raised against the company and litigations, the stage of the dispute matters:

1. Is it the stage of initial demand notice?
2. Was the initial verdict in favour of the company and the other party has now filed an appeal?
3. Was the initial verdict against the company and the company has now filed an appeal?

For Bank Guarantees: Track record of the company in terms of invocation of BGs and the share of BGs at the risk of invocation based on the progress of the underlying deliverable, as assessed by ICRA.

For Corporate Guarantees: Credit profile of the principal obligor/ borrower.

Estimate the likelihood of materialisation

Depending upon the stage of the dispute, the business profile, the company management's perspective, and legal opinions taken from reputed third-parties, the likelihood of materialisation of the contingent liabilities is estimated, subject to a "floor".

The "floor" for the likelihood of materialisation of CLs is as follows:

1. Initial demand notice: 10%
2. Appeal by other party: 5%
3. Appeal by company: 50%
4. Bank Guarantee: 5% to 20%
5. Corporate Guarantee: Historical 1-year default rate based on the credit rating of borrower

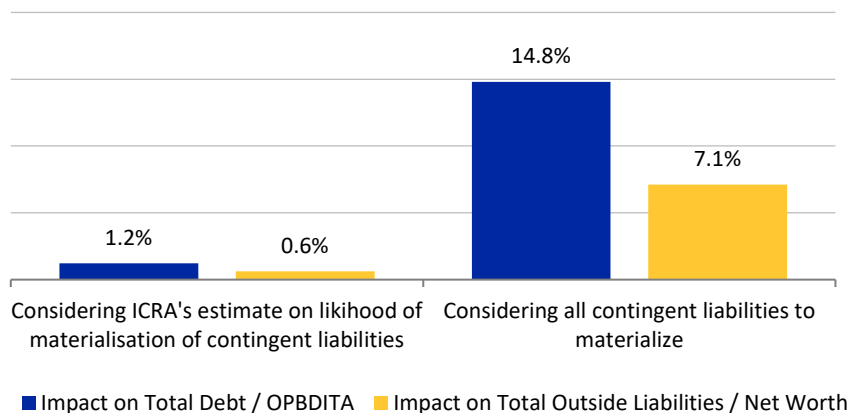
Illustration | Assessing the impact of materialisation of contingent liabilities on financial metrics

Contingent liabilities	Details considered by ICRA for estimating the likelihood of materialisation	Rs. crore	ICRA estimated likelihood of materialisation (%)	ICRA estimated amount that can materialise
Income tax claim against the company	Initial demand notice served to the company	150.0	10%	15.0
Income tax demand under appeal	Appeal filed by the company against the demand notice; earlier verdict was against the company	50.0	50%	25.0
Bank Guarantee	Company has a good track record of no BG invocation; also, given the low complexity of projects being undertaken, ICRA estimates only a small proportion of the BGs to be at a risk of devolvement	75.0	5%	3.8
Total Contingent Liabilities		275.0		43.8

Snapshot of key financials		Rs. crore	Key financial metrics					
			As per reported financials	Adding to total debt, ICRA's estimated contingent liabilities that could turn into actual liabilities (I)	[Hypothetical] Adding the entire contingent liabilities to Total Debt (II)	% increase (I)	% increase (II)	
OPBDITA		625						
Net Worth (A)		1,000						
Total Debt (B)		1,500						
Other Liabilities (current and non-current) (C)		750						
Total Outside Liabilities (B+C)		2,250						
			Total Debt/ OPBDITA	2.40	2.47	2.84	2.9%	18.3%
			Total Outside Liabilities/ Net Worth	2.25	2.29	2.53	1.9%	12.2%

Simulation | Assessing impact of materialisation of contingent liabilities on reported financial metrics of ICRA-rated sample entities

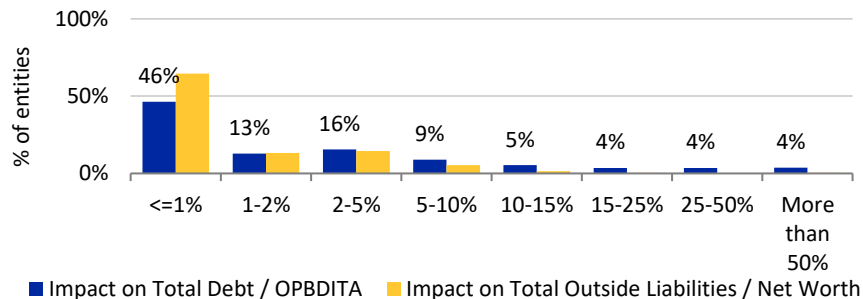
Median impact on select key financial indicators (KFI) – simulating the extent of worsening



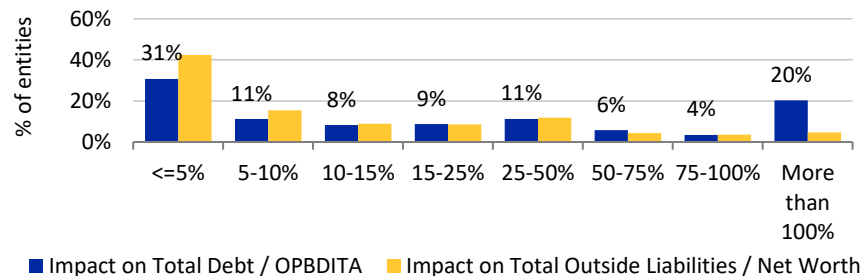
The materialization of the contingent liabilities is assumed to be funded by incremental debt.

The median impact on the financial profile of the entities is estimated to be limited in both the base case scenario wherein the likelihood of devolvement is as per ICRA's estimates (on an average 8-10% of the total contingent liabilities are assumed to materialise) as well as in a worst-case scenario wherein all the contingent liabilities are assumed to materialise.

Distribution of the impact on select KFI when contingent liabilities materialise based on ICRA's assessment of their likelihood of materialisation



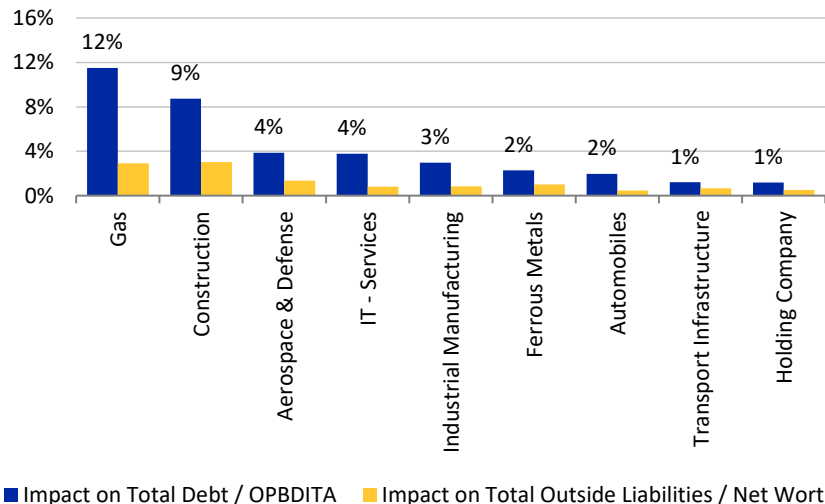
Distribution of the impact on select KFI when all the contingent liabilities are assumed to materialise



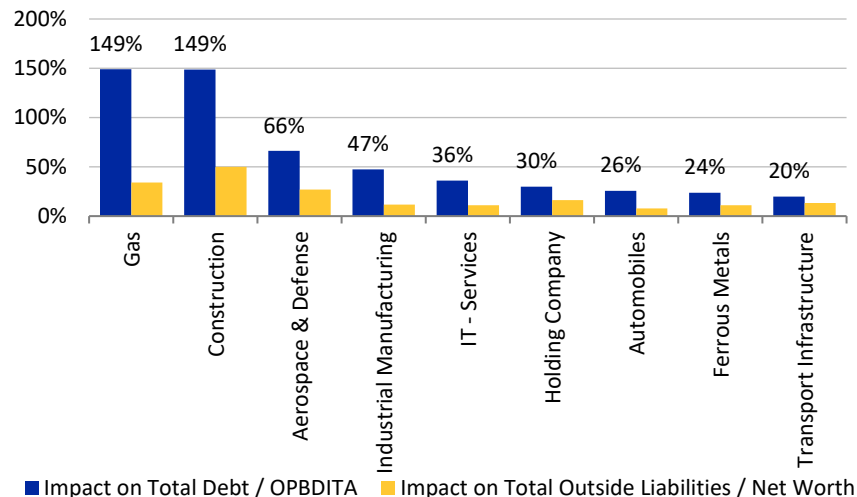
Note: The analysis pertains to a sample of around 1,400 ICRA-rated entities in the non-financial sector (as on July 1, 2024) with cumulative contingent liabilities of Rs. 9 trillion. The analysed financials are for FY2024 (estimated financials are used if audited financials are not available).

Gas utilities and construction sector entities would be more at risk if the stress scenarios play out

Median impact based on ICRA's assessment of the likelihood of materialisation of contingent liabilities



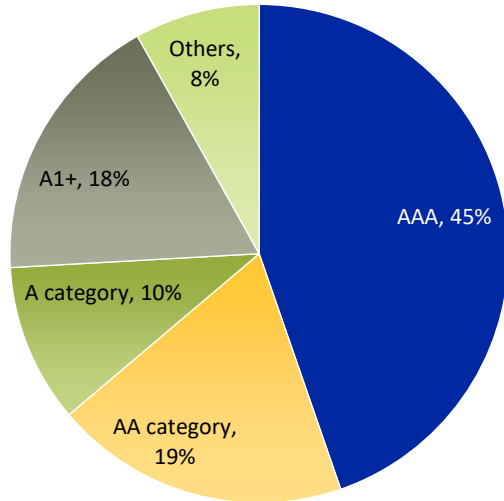
Median impact assuming all contingent liabilities are to materialise



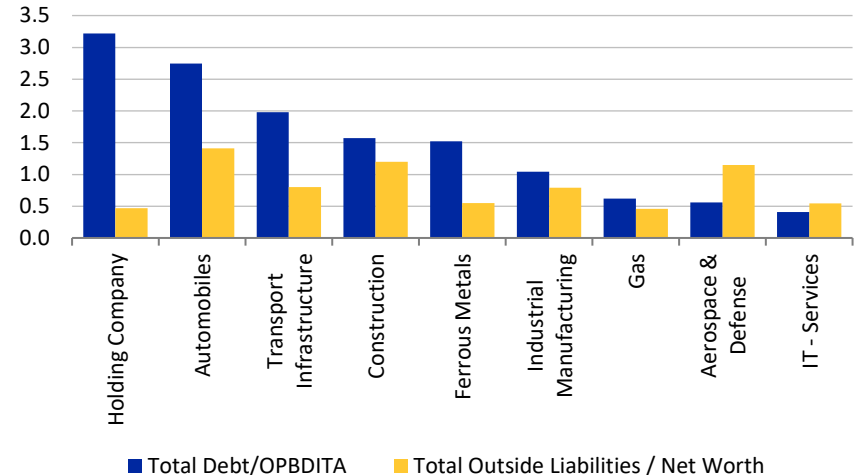
- Across most sectors, a limited impact is expected on the financial metrics in the base case scenario, wherein all the contingent liabilities do not materialise at once (on an average 8-10% of the total contingent liabilities are assumed to materialise). However, in an extreme stress scenario, the impact could be material for some of the sectors with a higher share of contingent liabilities.

Higher rating categories account for most contingent liabilities

Rating category-wise distribution of contingent liabilities



Sector-wise median financial metrics for top sectors with high share of CL as % of TOL



- About 92% of the contingent liabilities are attributable to entities that are rated in higher rating categories.
- Given the stronger financials of such entities, they have sufficient cushion to absorb the impact of increase in borrowings to fund the outflows on account of materialisation of contingent liabilities. Many entities also have comfortable liquidity to meet the outflow without any reliance on external borrowings.
- Moreover, the entities in higher rating categories typically have strong financial flexibility, which allows them to access additional funding (from banks/ capital markets) at short notice in case of any exigency, mitigating the impact of any sudden materialisation of the contingent liabilities.

Source: ICRA Research; Note: Analysis is based on the ICRA-rated sample of 1,400 entities

Construction entity: Invocation of BG impaired liquidity

- More than three decades of experience in construction business with reputed clientele
- A customer invoked the Performance Guarantee (BG) provided in favour of the company due to non-performance
- Sudden crystallisation of the BG strained the cash flows of the company, resulting in multi-notch rating downgrade

Jewellery entity: Income Tax raid followed by substantial demand notice

- IT raid conducted across the company's corporate office and various retail stores
- Subsequently, large IT demand raised against the company for the previous years. Company filed for appeal against the demand notice
- The IT demand significantly increased the contingent liability for the company, which increased to 40% of total debt and 35% of TOL of the company, from less than 5% earlier
- The ratings are currently on Watch with Negative Implications

Real estate entity: Reduction in guarantees & commitments improved the financial profile

- Holding company for a large Bengaluru-based real estate group
- The company had guaranteed significant amount of loans and extended shortfall undertaking for various SPVs and JVs executing various real estate projects
- A high share of contingent liabilities had been a constraining factor for the company's rating
- The company subsequently diluted its stake in the various SPVs and JVs, which resulted in ~40% reduction in the outstanding guarantees and commitments. This supported the rating upgrade of the entity

Beverage entity: Significant decline in litigations, triggered multi-notch rating upgrade

- One of the largest companies in the domestic spirit industry
- Despite the takeover of management control by one of the largest global spirit producers, the ratings were constrained by ongoing litigations faced by the erstwhile promoter and the impact of the same on the company
- Subsequently, with termination of historical contracts with the erstwhile promoter group companies, the uncertainties pertaining to any potential / contingent liability arising from the same was removed, which resulted in multi-notch rating upgrade for the company



Annexures

What are contingent liabilities?

As per IND AS 37, a contingent liability is:

- (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- (b) a present obligation that arises from past events but is not recognized because: (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or (ii) the amount of the obligation cannot be measured with sufficient reliability.

How are contingent liabilities presented in the financial statements?

As the existence of the contingent liabilities will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity, these are not recognized as liabilities in the financial statements. Unless the possibility of any outflow in settlement is remote, a disclosure is however required to be made with a brief description of the nature of the contingent liability and, where practicable: (a) an estimate of its financial effect (b) an indication of the uncertainties relating to the amount or timing of any outflow; and (c) the possibility of any reimbursement.

- Slide 10 cites that ICRA assumes a likelihood of 10% for direct tax demand-related cases to go against the company. This draws from the data published in one of the tax administration reports of the OECD (Page 138) ([available here](#)). Data suggests that in 2020, only 7.9% of tax-related cases in India were resolved in favour of the administration (i.e., against the taxpayer). That said, the Government of India has taken remedial actions to address this, including by way of 'The Direct Tax Vivad se Vishwas Act, 2020'.
- A taxpayer company, after receiving an assessment order from the tax authorities can file for appeals via four fora—CIT (Appeals), ITAT, High Courts, and the Supreme Court. The litigation period could run into more than a decade if the appeals are to be proffered all the way to the Supreme Court. The long process stems from the capacity constraints in the Courts, lack of a fast-track dispute resolution mechanism, and no timelines specified for the conclusion of proceedings. The latest report of the Comptroller and Auditor General of India (for the year ended March 2021) covering the affairs of the Department of Revenue-Direct Taxes presents a somber picture of the pendency of tax-related cases in India (Page 21) ([available here](#)). The search and seizure operations conducted by the income tax department—under Section 132 of the Income Tax Act to unearth any undisclosed income or valuables—are also an event risk that creates credit uncertainties.
- India stands quite low in the Ease of Doing Business rankings of the World Bank, particularly on parameters like enforcing contracts and paying taxes. A weak dispute resolution track record in these two areas pushes up the litigation intensity while prolonging the period of resolution. Because of this, the contingent liabilities of India Inc., especially relating to claims raised by counterparties and tax authorities, remain a time bomb but one with a very long fuse.



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