India Credit Spotlight 2018

Growth Prospects Amid Macro Risks

S&P Global Ratings

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Guest Opinion:

Will External Brakes Slow The Indian Growth Train?

*(**Editor's Note:** The author of this article is Dharmakirti Joshi, Chief Economist of CRISIL Ltd., the India-based subsidiary of S&P Global. The thoughts expressed in this Guest Opinion article are those of the author and do not necessarily reflect the views of S&P Global Ratings.)*

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Key Takeaways

- India's GDP growth should rebound to 7.5% in fiscal 2019, supported by the third straight year of normal monsoons, reductions in GST-related problems, budgetary support to the rural economy, and a low-base effect.
- Sustaining GDP growth at 8% over the next few years would require a material lift through private investments and relentless implementation of reforms.
- Investments are looking up, but a broad-based investment recovery led by the private sector is constrained by capacity overhang, high leverage, and political uncertainty.
- At the same time, the volume and complexity of global shocks has been rising.
- Compared with 2013, India is way more resilient and continues to stand tall among emerging markets.

India is still chasing the global recovery bus. Fiscal 2018 (April 1, 2017, to March 31, 2018) was one of those rare years when domestic GDP slowed even as the world economy accelerated. During that time, India's real GDP growth dropped to 6.7% from 7.1% a year earlier, mainly due to the twin shocks of demonetization and destocking of inventories before the advent of a goods and services tax (GST) regime. Glitches in the tax's implementation exacerbated the situation. But in the last year of the Modi government's five-year term, there's room for cautious optimism.

CRISIL Ltd. expects India's GDP growth to rebound from its low base to reach 7.5% in fiscal 2019. That's thanks to the third straight year of normal monsoons, an ironing-out of GST-related creases, and budgetary support for the rural economy. Yet signs of fragility persist.

Inflation, current account deficits, and interest rates are growing pressure points. Rising exogenous risks include rising crude oil prices, U.S. interest rates, and trade wars. At the same time, huge nonperforming assets limit the ability of public sector banks to finance growth. Consequently, we expect India's current account deficit to expand to 2.6% of GDP fiscal 2019 from 1.9% in fiscal 2018 and 0.7% in fiscal 2017. Not surprisingly, for the first time in four years, India's

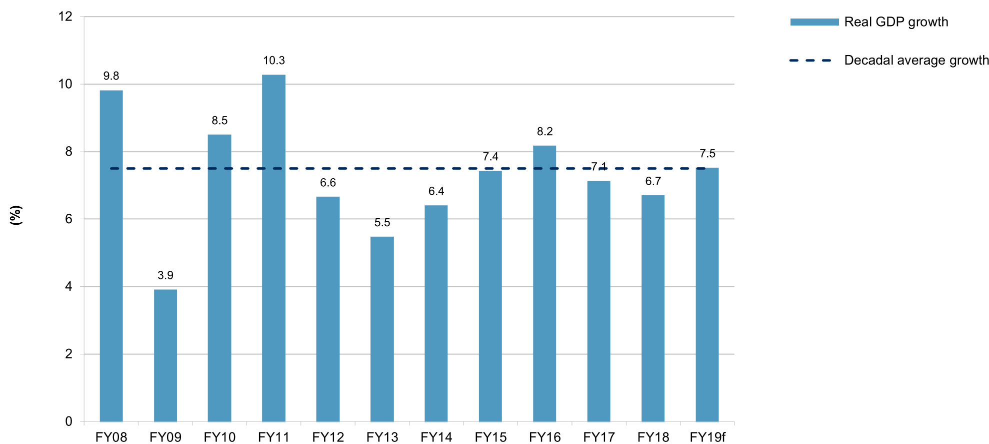
fiscal deficit slipped 30 basis points (bps) from its budget target of 3.2% of GDP for fiscal 2017.

Despite the slowdown, fiscal 2018 may prove a watershed year for India's reforms. We believe the implementation of GST and the Insolvency and Bankruptcy Code (IBC) will be game changers over the next few years. The tax is helping create a common national market, and improving logistics efficiencies and formalization of the economy. And the IBC is speeding up resolution of bad loans, which should improve the corporate credit culture.

The Drags On The Economy

Chart 1

India's Growth In Perspective



FY--Financial year (ending March 31). f--Forecast. Data from FY13 is on the new base (2011-12 as the base year). Source: Central Statistics Office, India.

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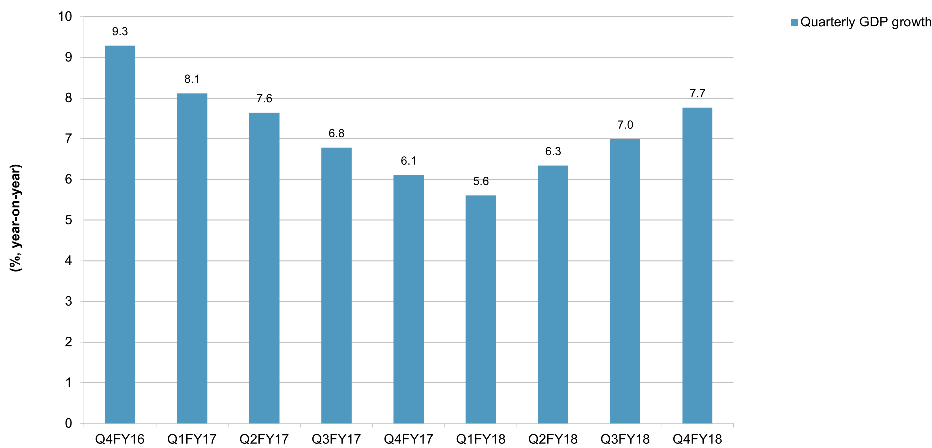
India's real GDP growth averaged 7.3% in fiscal 2015-2018, a tad lower than 7.5% in the preceding five years. That came despite demonetization and the introduction of GST, amid an environment of monetary and fiscal restraint.

Chart 2

Upward Momentum In Growth



Q--Quarter. FY--Financial year (ending March 31). Source: Central Statistics Office, India.
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Declining GDP growth reversed course in the second quarter of fiscal 2018 to reach 6.5%, and then climbed further to 7.2% in the third and 7.7% in the fourth. The sharp recovery in the fourth quarter was driven by government spending, higher manufacturing output, above-trend growth in agriculture, and strong construction activity. There was some uptick in investments, too.

Trade was a drag, with exports growing 3.6% and imports 11%.

The services sector was pulled down by the financial (read banking), real estate, and professional services sectors, which decelerated to 5% growth in the fourth quarter from 6.9% in the third.

Growth in trade, hotels, transport, communications, and services related to the broadcasting sector also slowed to 6.8% from 8.5%, seemingly on account of GST-related glitches. Government services offset this by growing 13.3% from 7.7%.

Table 1

The Two Sides Of GDP (%)

	2016-17				2017-18			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Supply-side classification								
Agriculture, forestry and fishing	4.3	5.5	7.5	7.1	3.0	2.6	3.1	4.5
Mining and quarrying	10.5	9.1	12.1	18.8	1.7	6.9	1.4	2.7
Manufacturing	9.9	7.7	8.1	6.1	(1.8)	7.1	8.5	9.1
Electricity, gas, utilities	12.4	7.1	9.5	8.1	7.1	7.7	6.1	7.7
Construction	3.0	3.8	2.8	(3.9)	1.8	3.1	6.6	11.5
Trade, hotels, transport, communication etc	8.9	7.2	7.5	5.5	8.4	8.5	8.5	6.8
Financial, real estate and professional services	10.5	8.3	2.8	1.0	8.4	6.1	6.9	5.0
Public administration, defence and other services	7.7	8.0	10.6	16.4	13.5	6.1	7.7	13.3

Table 1

The Two Sides Of GDP (%) (cont.)

	2016-17				2017-18			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Expenditure/demand-side classification								
Private consumption	8.3	7.5	9.3	4.2	6.9	6.8	5.9	6.7
Government consumption	8.3	8.2	12.3	22.5	17.6	3.8	6.8	16.8
Fixed investment (GFCF)	15.9	10.5	8.7	6.0	0.8	6.1	9.1	14.4
Exports	3.6	2.4	6.7	7.0	5.9	6.8	6.2	3.6
Imports	0.1	(0.4)	10.1	6.6	18.5	10.0	10.5	10.9

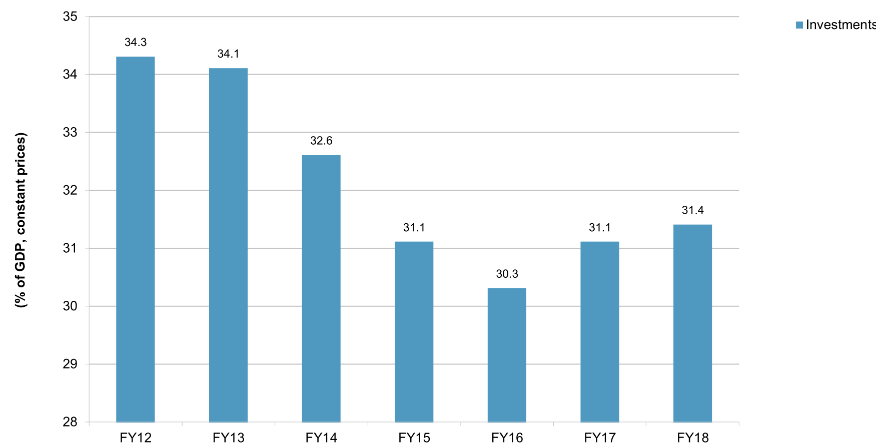
Source: Central Statistics Office, India.

Investments Edge Up

The good news on investment is that its share of GDP (or the investment ratio) has started to pick up after declining since fiscal 2012. But this is largely government-led. A broad-based, decisive pick-up in the investment cycle led by the private sector is clearly some way off.

Chart 3

Investments Have Mildly Picked Up



FY--Financial year (ending March 31). Source: Central Statistics Office, India.
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We believe the nascent recovery in investments will persist, led by the government's efforts in the roads and housing sectors. Conditions are becoming favorable for the revival of private corporate investments, such as improvement in capacity utilization. But the pivotal movement will take time for the following reasons:

- Capacity utilization: While we expect capacity utilization to improve in this fiscal year, it will still be below the thresholds that induce private investments. The utilization will be strongest in sectors such as cement, commercial vehicles, steel, aluminium, and tractors; these typically

have a share of 15%-20% of private investments.

- Focus on improving capital structure: Companies in the debt-heavy infrastructure space are likely to continue to deleverage and improve their capital structure.
- The political cycle: The election season is generally marked by uncertainties, both regarding change in regime and policy focus. Large investment commitments, especially by the private corporate sector, are therefore unlikely.

RBI Is Raising Rates As Inflation Picks Up

The central bank's accommodative stance of more than four years has ended. The Reserve Bank of India (RBI) raised its repo rate by 25 bps on June 6, 2018, as some risks to inflation that it had flagged previously started to materialize. Core inflation, too, picked up and touched 5.9% in May.

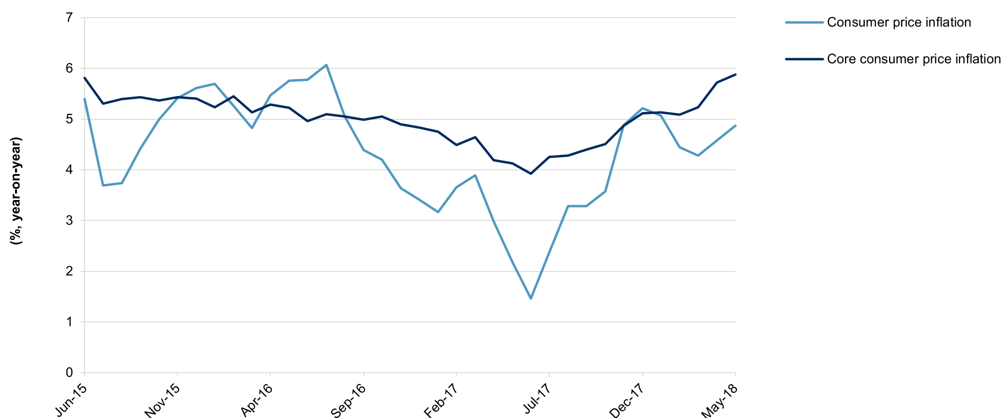
In the last fiscal year, the RBI shifted to a neutral stance, but even then interest rates on a number of instruments started to harden. Since January 2018, yields on 10-year benchmark government bonds have risen almost 100 bps. Corporate bond yields are also up, and a number of banks have raised their deposit rates and marginal cost of funds-based lending rate.

A neutral stance implies the RBI wants to keep its options open in the wake of domestic and global uncertainty.

Inflation based on the Consumer Price Index (CPI) rose to 4.9% in May 2018, from 4.6% in April and 4.3% in March, reversing a three-month trend. Although food inflation was marginally down, fuel inflation rose with petrol and diesel prices. Core inflation, too, firmed up. Core inflation (CPI excluding food, fuel and light, petrol and diesel) was the primary driver of overall inflation in May, as it rose to 5.9% from 5.7% in April.

Chart 4

Consumer Price Inflation
Headline and core change course



Note: Core consumer price inflation excludes food, fuel, light, petrol, and diesel categories. Source: Ministry of Industry and Commerce.
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The first risk to inflation that is playing out is the spike in crude oil prices. These prices rose 18% in fiscal 2017, and we expect another 23% growth in this fiscal year. With domestic fuel prices linked to global prices, the first-round effects will be felt immediately. What amplifies that is capricious

administrative action: excise duty was raised when crude oil prices were falling, and are not being cut when they are rising. Second-round effects will depend on continuation of the growth momentum.

Another key risk is from food inflation, which has a much higher weight in the CPI but is currently benign. There could also be pressure on food inflation if the recently announced hike in minimum support prices (MSP) is effectively implemented, i.e., the government succeeds in ensuring that farmers get these prices.

MSPs have been set at 1.5x the cost of production, which translates to a weighted average hike of 13% over last year's MSP. A depreciating rupee and elevated prices of metals add to the inflationary strain.

With GDP growth picking up and core inflation rising, the output gap is narrowing according to the RBI.

Inflationary expectations have also started lifting. The RBI's household inflation expectation survey for May 2018 reports a rise in "year ahead" inflation expectations by 130 bps. We expect CPI inflation to rise to 4.7% for fiscal 2019, from 3.5% in the preceding fiscal year.

India Is Less Vulnerable Today

The impact of external shocks on the economy depends on the quantum of shocks as well as India's vulnerability. Compared with 2013, India is way more resilient and continues to stand tall among emerging markets. But the quantum and complexity of global shocks have been rising.

Over the past few months, emerging markets have seen capital outflows, and India was no exception with the rupee depreciating sharply amid outflows from debt and equities.

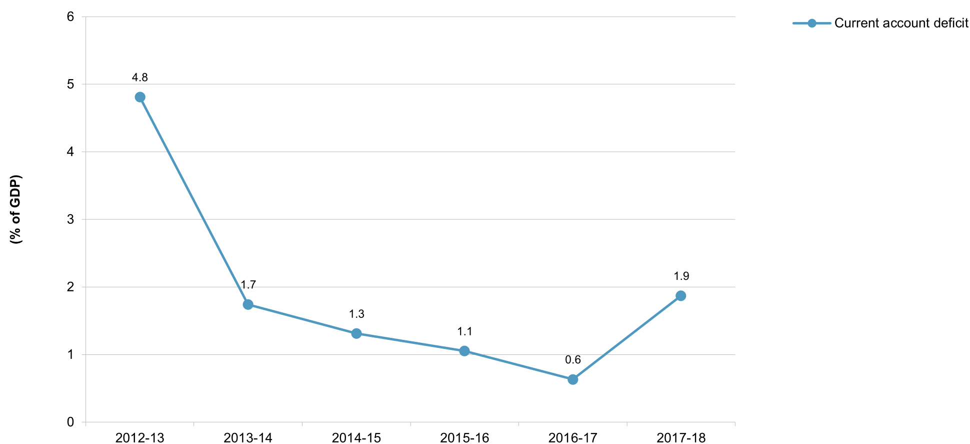
The cause is external shocks such as rising oil prices, tightening by the U.S. Federal Reserve, and geopolitical uncertainties--coupled with weakening of some domestic macro indicators.

Oil was the first risk to surface, followed by rising asymmetry in the monetary policies of advanced economies, widening interest-rate differentials between India and the U.S., and trade wars moving from rhetoric to tariff action.

High oil prices have begun to pinch by manifesting in a widening current account deficit, which raises India's vulnerability to capital flows. The deficit for the fourth quarter of fiscal 2018 was 1.9% of GDP, compared with 0.7% in fiscal 2017.

Chart 5

Current Account Deficit Is Rising



Source: Reserve Bank of India.

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There is policy stance asymmetry among the four major central banks of advanced economies: the Fed, the Bank of England (BoE), the European Central Bank (ECB), and the Bank of Japan (BoJ).

While the ECB and BoJ are still practicing qualitative and quantitative easing, the Fed and the BoE have to roll back the easing and are raising their policy rates. The Fed has already raised rates twice this year (of 25 bps each) and is widely expected do so twice more this year and three more times in 2019. Such differences in stance and the consequent widening of the interest rate differential between these economies will lead to capital outflows from emerging market economies, including India.

The International Monetary Fund flagged inward-looking trade policies as a major downside risk to a global economic revival.

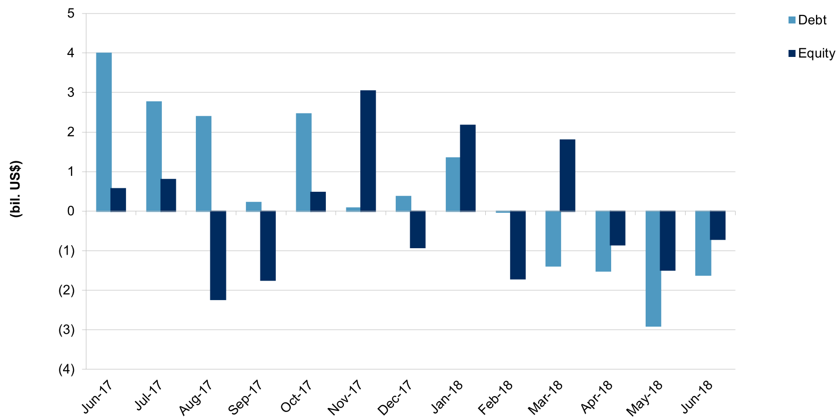
Trade tensions between the U.S., China, and Eurozone have remained high during the past few months. The first salvo in the U.S.-China trade war was fired when import tariffs on Chinese exports to the U.S. worth US$38 billion came into effect on July 6, 2018, and were met by similar tariffs on U.S. exports.

The situation promises to intensify since the U.S. has threatened to expand the ambit of tariffs to more goods. This could push back the nascent recovery in global trade growth, adversely affect global supply chains and investment decisions, and undermine India's trade prospects.

With rising risks, global capital has been leaving emerging markets, and India has also been experiencing debt and equity outflows. Consequently, the rupee has depreciated 6.9% against the greenback since January 2018--way sharper than the 1.7% per year seen between fiscals 2015 and 2018.

Chart 6

Debt And Equity Inflows Turn Into Outflows
Net FPI outflows



FPI--Foreign portfolio investment. bil--Billion. Source: National Securities Depository Ltd. (India).
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Chart 7

The Rupee Is Sliding

INR--Indian rupee. Source: Reserve Bank of India.
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Received wisdom says that although all emerging markets are affected by a general aversion to risky investments, the ones with poor macroeconomic fundamentals will be hit the most. In 2013, with high fiscal and trade deficits, India was part of the infamous "Fragile Five" (Turkey, Brazil, India, South Africa, and Indonesia) and was hit by capital outflows after the Fed announced culling of asset purchases.

With a significant improvement in its macro parameters since fiscal 2015 and foreign exchange reserves of $412 billion, India is today outside that group.

Maintaining GDP growth at 8% plus over the next few years from our projection of 7.5% for fiscal

2018 would require a big lift through private investments and relentless implementation of reforms.

Table 2

Macroeconomic Outlook

	2013-2014	2014-15	2015-16	2016-17	2017-18	2018-19f
GDP growth (%)	6.6	7.2	8.2	7.1	6.7	7.5
Inflation (%)	9.5	6.0	5.0	4.5	3.6	4.7
CAD/GDP	1.7	1.3	1.1	0.7	1.9	2.6
Fiscal deficit/GDP	4.6	4.0	3.9	3.5	3.5	3.3
Exchange rate (INR:US$, March)	61.0	62.4	67.0	65.9	65.0	67.0
10-year yield (March-end)	8.8	7.7	7.5	6.8	7.6	7.7

INR--Indian rupee. CAD--Current account deficit. f--Forecast. Source: Central Statistical Office, RBI, CRISIL.

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Sector Review:

India's Infrastructure Marathon: Why Steady Growth Can't Close The Supply Gap

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Key Takeaways

- India is making progress at bridging the gap between infrastructure supply and demand, but still has a long way to go.
- The Indian government estimates infrastructure investment of US$4.5 trillion will be needed through 2040, which is substantially more than India's GDP of US$2.6 trillion in 2017.
- We believe private investor demand for Indian infrastructure assets remains strong for projects with good viability, backed by the country's economic growth prospects.
- Macroeconomic risks from currency weakness, global trade protectionism, rising inflation, and policy uncertainty ahead of upcoming elections may create more roadblocks.
- Regulated utilities will be the most resilient to external shocks, while ports and renewables are more exposed.

India's infrastructure sector is at an inflection point. S&P Global Ratings believes the country's economic growth opportunities and the viability of projects should continue to attract capital. However, we still expect the sizable deficit in infrastructure supply and demand to persist, with growing macroeconomic risks threatening to slow investments.

India's progress at scaling up its infrastructure is shown in its decreasing power deficits, high passenger growth for airports, rising renewable capacity, and large metro train projects in progress. The government is leading the buildup in view of growing urbanization.

Nevertheless, India's infrastructure deficit is simply too large to eliminate any time soon. The government estimates infrastructure investment of US$4.5 trillion will be needed through 2040. That's substantially more than India's GDP 2017 of US$2.6 trillion.

Macro roadblocks that could strain the government's budget or reduce project returns for the private sector include currency weakness and global trade protectionism. Rising inflationary

strains can push up interest rates, while elections scheduled for 2019 could fuel political and policy uncertainty.

We've received many investor queries as to whether India can bridge the infrastructure deficit, and to examine the diverse regulations and peculiarities of different sectors. We address these and other related issues in this article.

Frequently Asked Questions

Why does India still have an infrastructure deficit? Is funding the key issue?

Infrastructure takes time to build, and perhaps more so in India than for many other countries. Projects suffer delays and cost overruns due to complex land acquisitions and environmental issues. And in all democracies, societal considerations play a part, too. But the need for better infrastructure isn't disputed. The World Economic Forum's 2017-2018 Global Competitiveness Report ranked India 66th in terms of infrastructure, marginally up from 68th place in 2016-2017. We expect this ranking to improve noticeably over the next five years.

The Indian government believes ample infrastructure funding is available. But some leading financiers consider otherwise, as suggested at Asian Infrastructure Investment Bank's 2018 summit. Many domestic banks saddled with bad assets (including from infrastructure and power sectors) will lend only selectively, constraining available capital.

We believe private investor demand for Indian infrastructure assets is significant--for specific sectors and the right assets. In particular, private investments lead the way in renewables and airports because of favorable economics. Investors generally prefer sectors where regulations or growth prospects provide greater visibility on cash flows. For other sectors such as railways (including bullet trains), government spending and government-to-government loans may remain the key source of funding.

How do regulatory conditions vary for key infrastructure sectors?

Regulations are diverse (see table 1). Regulated utilities and airports face heavy regulations, while independent power producers, renewables, and ports largely operate based on competitive market forces. Utilities benefit from a regulatory framework that has been stable for two decades; other sectors lack long track records or a framework (see table 1).

Table 1

Regulatory Trends For India's Infrastructure Sectors

Sector	Current regulatory status	Future regulatory trend
Conventional power -Regulated	Supportive: Stable, timely tariff changes with full cost pass-through	Stable: Review due in 2019--continuity will be key
Airports	Mixed: Regulations could support stable earnings, but delays and disputes are leading to volatility	Marginally improving: Some disputes are getting resolved, but timeliness is a question mark
Ports	Largely unregulated for private ports	Stable: Private ports likely to remain unregulated
Independent power producers	Limited impact of regulations	Stable: Unlikely to face significant regulatory interventions
Renewables	Supportive: Grid priority and long-term purchase power agreements	Stable: But largely moving into competitive bids, rather than regulated returns

Table 1

Regulatory Trends For India's Infrastructure Sectors (cont.)

Sector	Current regulatory status	Future regulatory trend
Roads	Mixed: Changes to land acquisition and hybrid annuity model are positive, but past unresolved disputes still weigh on the sector	Stable to improving: Largely govt.-led spending; private sector is slowly returning through Hybrid Annuity model (where govt. shares part of the project cost) or as EPC contractor.
Railways	Unclear: Very limited projects with private sector, some with significant tariff disputes	Stable: Most projects remain govt. funded, limited private presence
Water	Unclear: Practically no material private sector water utilities in play	Stable: No clear plans or efforts to support industrial scale water utilities

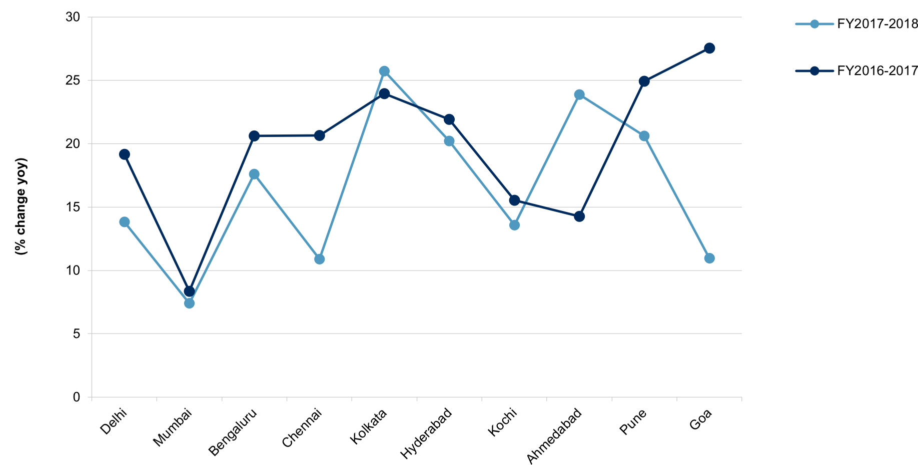
Source: S&P Global Ratings.

What's the impact of regulatory differences among sectors?

High. The regulatory mechanism for utilities and airports is technically based on similar grounds, i.e., assured returns on equity. However, because of differences in the maturity of regulations and timeliness of implementation, the cash flow trends for companies in the two sectors vary sharply. Under their long-established framework, utilities have full pass-through of costs. In contrast, airports face long delays in implementation of tariffs and ambiguity in tariff components. However, if regulatory resets become timely, airports in India could also benefit from assured returns.

Chart 1

Airport Passenger Traffic Has Grown Robustly



FY--Fiscal year ending March. Source: IATA.

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We expect earnings growth to remain protected for utilities at about 9% annually from fiscal 2018 (ending March 2018) to fiscal 2020 due to full cost pass-through. Revenue growth was weak from 2015-2017 due to lower coal prices, but earnings remained solid, driven by capacity growth.

On the other hand, we expect a sharp drop in revenue and earnings for airports from 2018-2020, even though passenger traffic is likely to grow by a strong double digit. Regulations seek to provide

stable target returns over the five-year regulatory period. Strong growth in 2015-2017 led to over-collection of revenues, a situation that persisted due to delayed tariff resets. Tariffs in 2018-2020 will therefore fall sharply to offset the over-collection in previous years.

What's your expectation for capex and leverage for rated infrastructure companies?

We expect capital expenditure (capex) to remain high for Indian infrastructure players across sectors. However, leverage trends vary.

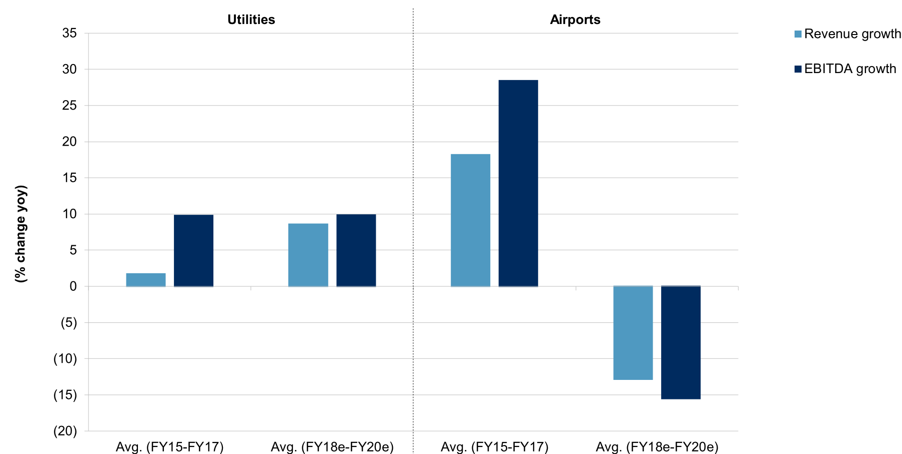
Rated utilities will likely maintain elevated capex of about US$8 billion annually, but the commissioning of new capacities and regulated returns on investment should increase earnings. As a result, we expect the segment to deleverage. The group's average ratio of funds from operations (FFO) to debt should strengthen to about 12% in 2018-2020 from 10% in 2015-2017. Renewables will likely continue to incur significant growth capex and maintain weaker credit metrics, with an average ratio of FFO to debt of below 9% over the same period.

We anticipate higher leverage for rated airports in 2018-2020. We estimate the FFO-to-debt ratio to weaken to around 15% from above 20% in 2015-2017. Delhi Airport is set to incur significant expansion capex of more than Indian rupee (INR) 80 billion (US$1.16 billion) and Hyderabad INR20 billion, spread over the next few years. At the same time, delays in implementation of tariff adjustments will result in lower tariff rates. Without timely recovery of future capex costs through tariff adjustments, credit metrics may come under pressure.

Airports have seen very strong growth in the past three years, achieving passenger traffic targets three to five years ahead of their planned initial estimates. Rising income levels, competitive airfares compared to rail, and growing connectivity support the growth in domestic and international travel.

Chart 2

Stable Growth For Rated Utilities, Likely Sharp Fall For Airports



e--S&P Global Ratings estimate. FY--Fiscal year ending March. Source: S&P Global Ratings.
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How do macroeconomic factors affect the infrastructure sector?

The infrastructure sector has a high correlation with the overall economic environment. Apart from regulations, economic activity, interest rates and demand growth can significantly influence cash flows and in some cases even project viability. Regulated utilities are the most resilient; while renewables, ports, and airports will be most at risk to unexpected macro shocks (see table 2). The intensity and duration of shocks will be the key determinant of the overall impact.

Table 2

Macro Risks That Can Affect The Infrastructure Sector

Macro risk	Impact on rated issuers	Least exposed rated issuers	Most exposed rated issuers
Economic slowdown	Moderate: Current infrastructure deficit, regulated returns on investment for regulated utilities and airports and long-term contractual cash flows for renewables will mitigate the impact. Lower than 6% GDP can result in weaker-than-expected demand.	Regulated utilities: Cushioned by assured returns	Ports: Exposed to lower trade activities and lack of assured returns
Rising interest rates	Medium: Some infrastructure companies with floating rate loans are exposed. Others have fixed rate loans or benefit from interest cost pass-through. More than 100bps increase in interest rates can bite.	Regulated utilities: Interest cost is a pass through	Renewables with high leverage of above 8x debt-to-EBITDA and floating rate loans
Funding environment	Medium: Limited refinancing risk but continuing growth capex requires funding support. Sharp domestic and international funding constraint together can create pressure.	Regulated utilities: Stable cash flows and stronger credit profile	Airports: Large capex requires debt-raising amid sharp fall in tariffs
Weaker rupee	Low: Airports and ports benefit from significant foreign currency earnings while utilities and renewables exposed on borrowing and capex. Impact will depend on pace and extent of depreciation, though up to 10% rupee depreciation can be largely absorbed.	Regulated Utilities: Hedging costs/forex loss are a pass-through	Renewables: Active hedging can mitigate risk
Higher inflation	Low: Higher working capital requirement for utilities, operational cost inflation for ports, airports.	Renewables and utilities: Low operating costs for renewables and cost pass-through for regulated utilities	Ports and airports: Lower margins may compress cash flows
Global trade war	Low to moderate: Domestic-focused sectors like utilities will be less impacted, but export-focused sectors like ports/airports can be affected.	Utilities: Domestic demand likely to be the key driver	Ports: Fall in trade volumes will lead to weaker cash flows
Political uncertainty	Low to moderate: Limited policy changes expected in pre-election period of 2019, and policy continuity is likely under most political combinations.	Utilities: Strong independent regulator	Renewables: Sharp reversal in renewable push (though not expected) can change growth prospects

Source: S&P Global Ratings.

What's your expectation for the thermal power and renewables sector?

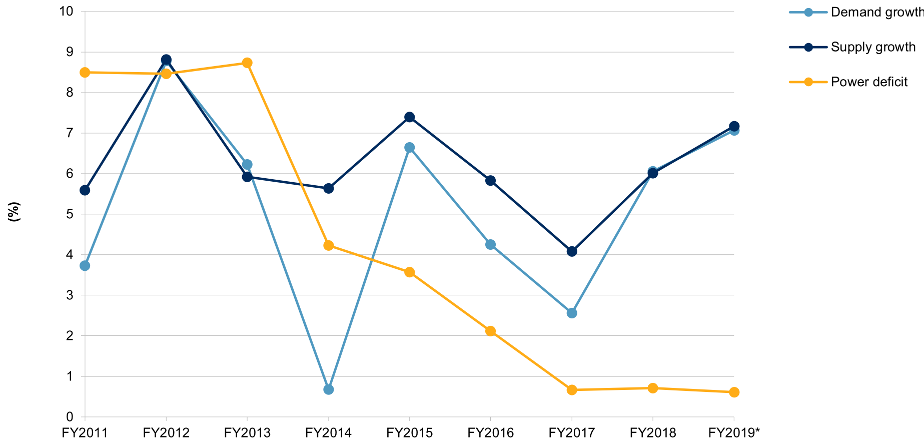
We believe the power sector is moving towards equilibrium in demand and supply from a deficit situation. However, the fortunes will vary for thermal and renewables. Under the National Electricity Plan 2018, India projects that power demand will grow at compounded annual growth rate of over 6% until 2022. Planned coal capacity additions are likely to exceed retirement and new addition requirements, even up to 2027. As a result, overall system plant load factors (PLF) will decline. Weaker demand and healthy capacity additions in the past few years has helped bridge the power deficit gap. PLFs are a measure of a plant's generation vs. the potential capacity.

PLFs for coal power plants on the other hand have fallen due to three main issues: weaker demand, rising share of renewables, and fuel supply issues. A regulatory review is due in 2019 and

any significant unexpected variations to the current strong framework could be negative.

Chart 3

Falling Deficit Driven By Weaker Demand And Growing Supply



*Up to May 2018 (provisional). MU--Million unit. Source: CEA.

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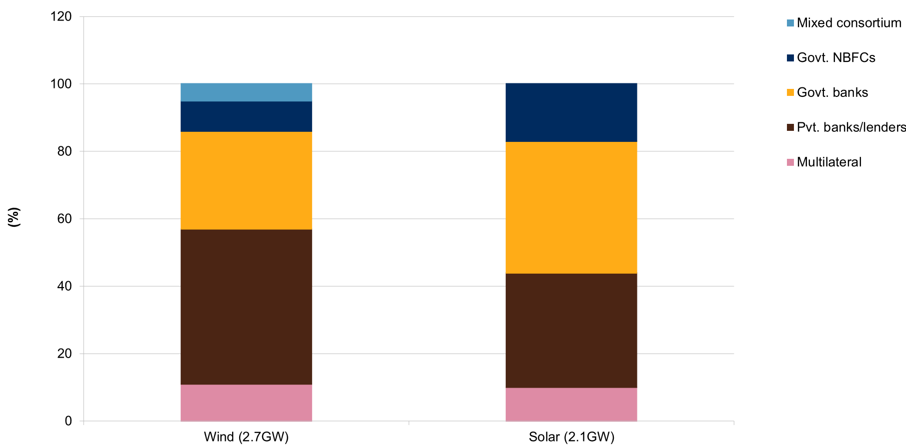
Favorable regulations with grid priority and long-term contractual power purchase agreements together create the right setting for large institutional investors. High investment needs to support growth have been largely met by major international investors and debt. Lower returns due to falling tariffs, weak operating performance, and high leverage remain the key challenge, in our view.

Chart 4

Renewables Funding: The Growing Role Of Private Players (FY2013-2016)



GW--GigaWatts. NBFCs--Nonbank financial companies. Source: Bloomberg New Energy Finance.

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Related Research

- Guest Opinion: Will External Brakes Slow The Indian Growth Train?, July 18, 2018
- Bridging Infrastructure Gaps In India And ASEAN Could Create Credit Divides, Jan. 16, 2018
- India Corporate Outlook 2018: Recovering Credit Profiles Could Drive Acquisitions And Consolidation, Jan. 18, 2018
- Indian Corporates: Leverage Will Decline As Companies Reap Rather Than Sow

This report does not constitute a rating action.

Indian Corporates: Leverage Will Decline As Companies Reap Rather Than Sow

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Key Takeaways

- We expect corporate revenues to grow by a strong 12%-14% over the next 12-24 months, on the back robust domestic demand.
- Earnings in manufacturing will likely grow faster than revenues over the next 12-24 months, driven by the benefits of operating leverage.
- Some sectors will buck the deleveraging trend amid a scramble to acquire steel and power assets on the block under the new bankruptcy regime.
- Macro uncertainties pose a risk to India's otherwise strong growth picture. These include potential external shocks and potential surprises ahead of the 2019 elections.

Indian companies are known to prioritize growth over financial health. S&P Global Ratings expects this to change--at least for the next two years. We foresee a profit upcycle, as revenues expand but capital expenditure stays flat. Thanks to slack utilization rates, many companies can accommodate higher demand without further investments: they can reap without sowing.

We estimate median Indian corporate revenues will increase by 12%-14% a year over the next 24 months, or about 500 basis points higher than the past three years' average. Earnings should rise even faster, helping Indian corporates continue a deleveraging trend seen over the last two years. These growth expectations are anchored in continuing strong domestic demand and are lower than peak growth rates seen in the previous cycle.

In the long term, however, we do not anticipate that Indian corporates will keep the gains from deleveraging. They are more likely to revert to chasing growth while testing financial discipline, given business conditions and habits in India.

We analyzed 250 listed companies for this report, examining factors such as sales, spending, and profit in aggregate and by sector. A small set of these corporates are highly indebted and account for one-third to half of forecast aggregate corporate debt, creating systemic risk for lenders. We believe our rated Indian companies should broadly perform in line with broader corporate trends.

Finally, we note that external risks could result in intensifying currency volatility or higher interest rates. Other significant risks are looming global trade wars and uncertainty ahead of the 2019 general elections.

Fast Growth, Slow Spending--With Some Exceptions

Indian corporate leverage is set to decline as companies earn more than they spend over the next two years. Median corporate revenues should speed up as manufacturers build on the green shoots planted over the past two years, while the services sector will stage a mixed recovery from a slow growth period. EBITDA growth will be driven by factors such as better utilization rates rather than buildouts of new capacity.

Structural drivers of earnings include Indian companies' low-cost operations, low per capita usage in a number of goods and services, and (to the benefit of large corporates) continuing migration from informal to formal consumption. India's GDP growth rate is picking up, with demand bottlenecks clearing after difficult structural reforms, including demonetization and the introduction of a goods and services tax (GST).

Some structural reforms will have a counter-impact on deleveraging trends. The Insolvency and Bankruptcy Code, implemented in 2016, will give large corporates the opportunity to acquire stressed assets in steel and power, among other sectors. Participating in bankruptcy auctions will require heavy borrowing; however, industry consolidation should increase efficiencies and earnings over the long term.

Within the overall growth story, certain sectors will lag, due to lower access to funding, or exposure to specific export markets that are seeing uneven growth prospects.

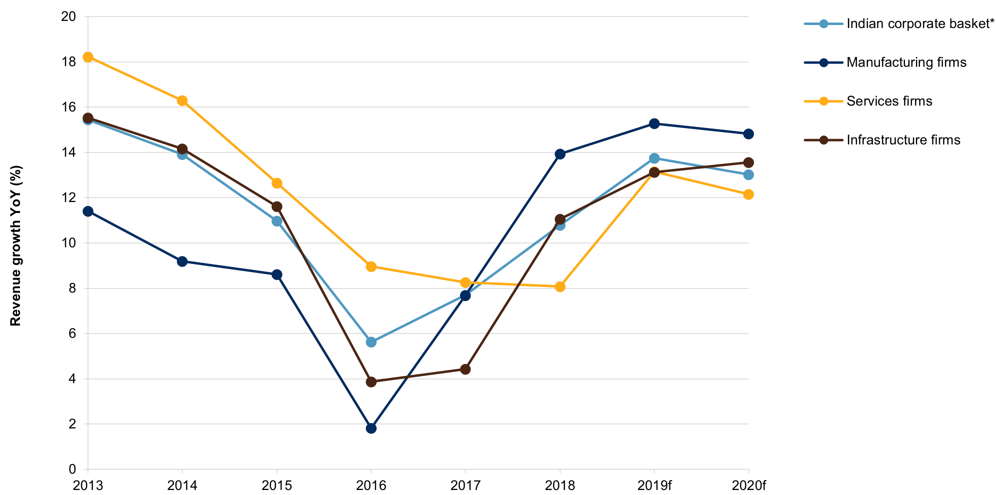
We base our analysis on aggregate (consensus) earnings quality and debt protection metrics for 250 corporates. In terms of the S&P BSE 500 Index, these companies represent Indian rupee (INR) 19.6 trillion (US$288 billion) of debt and INR6.4 trillion of EBITDA, or 70% of the debt and 75% of EBITDA, respectively.

Revenues Are On A Strong Growth Trajectory

We expect the median Indian corporate to increase revenues at 12%-14% a year over the next 24 months. Revenues for the manufacturing sector will run higher at 14%-15% annually over the period, and the services sector slower at 11%-12%. The key pillars of demand are retail consumption and government spending on infrastructure, both of which remain firmly in place. We foresee additional tailwinds from high commodity prices and the continued reduction of China's excessive output in a number of manufacturing sectors. India's double-digit revenue growth is a reversal from a "hard landing" in demand seen in in fiscal 2016 (year ended March 31, 2016).

Chart 1

Corporate Revenue Growth Is Strong, Led By The Manufacturers



*Our basket is made up of 250 listed Indian companies. f--Forecast. YoY--Year on year. Data are for the fiscal years ending March 31.
Source: S&P Capital IQ estimates.
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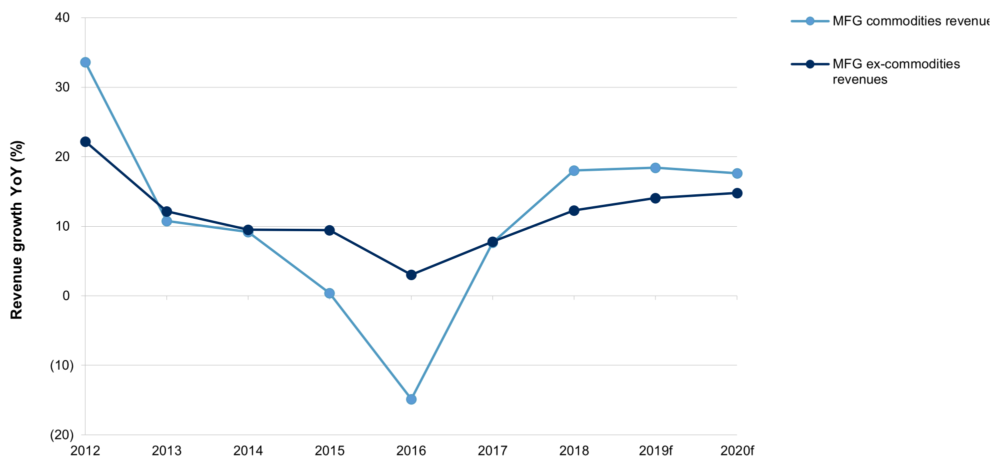
While big-ticket reforms could stall in the run-up to the elections, we do not see this affecting the profitability of domestic consumption-oriented businesses. We expect the top manufacturers to get closer to long-term trend growth of a multiple to GDP. Our assumptions also factor in a moderation in commodities prices over the next two years, following the strong bounce-back in the past two.

Chart 2

Manufacturing Revenue Growth Is Broad-Based
Revenue growth for our basket* of Indian manufacturers, commodities versus non-commodities



*Carved from our basket of 250 listed Indian companies. MFG--Manufacturing Sector. f--Forecast. YoY--Year on year. Data are for the fiscal years ending March 31.
Source: S&P Capital IQ estimates.
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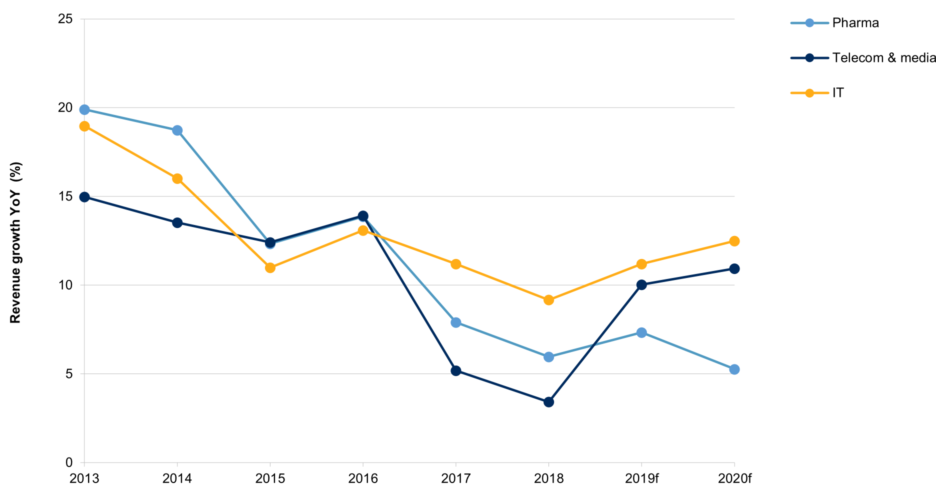
We anticipate a mixed recovery in the services sector. The pharmaceutical sector, for example, continues to grapple with price erosion in the key U.S. export market.

The telecom sector is emerging from an intensive price war over the past two years. We expect operating performance to stabilize and gradually recover as compression in key measures such as average revenue per user (ARPU) bottoms out in the wireless space over the next couple of quarters. However, we do expect higher competition in the fiber-to-home space.

A pivot toward the digital frontier should provide further positive growth momentum in the Indian IT sector. This comes as major listed companies drive growth by expanding their digital business. At the same time, mid-tier IT continues to grow faster than industry average.

Chart 3

A Mixed Recovery Is Expected In The Services Sector



Note: Carved from our basket of 250 listed Indian companies. Pharma--Pharmaceutical sector. Telecom--Telecommunications sector. IT--Information Technology sector. f--Forecast. Data are for the fiscal years ending March 31. Source: S&P Capital IQ estimates.
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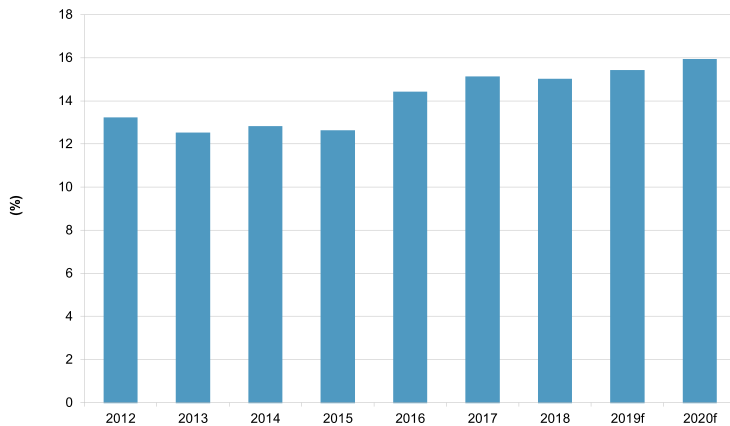
The Good Side Of Operating Leverage

Excess capacity will essentially create high operating leverage in the next two years, with companies utilizing spare capacity rather than investing in new facilities to meet incremental demand. As a result, we expect profitability of manufacturers to improve over the next two years. EBITDA margins are set to expand by 100 basis points on average, against a median EBITDA margin of 15% in fiscal 2018.

Chart 4

EBITDA Expected To Grow Faster Than Revenues For Manufacturing Sector
Median EBITDA margins for the manufacturing sector



*Note: Carved from our basket of 250 listed Indian companies. f--Forecast. Data are for the fiscal years ending March 31.
Source: S&P Capital IQ estimates.
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This story goes back to 2009, when India's industrial sectors--including commodity-based manufacturing, automobiles, capital goods and power--began investing heavily in new capacity. When this industrial supply hit the market starting 2014-2015, conditions had changed. Slower China growth and stimulus-spending, falling commodity prices, and consecutive droughts in India had dented demand across a variety of sectors.

To their credit, top India corporates managed reasonable growth in 2017-2018 notwithstanding demonetization and GST. We believe the temporary disruptions will give way to a clearer growth runway helped (not least) by the reduction in import substitution seen in commodity sectors.

Commodity inflation (including oil) and hyper-competition in a few sectors remain key risks to this view. However, we believe low labor costs will be a valuable buffer for Indian corporates along with longer-term enablers for domestic demand such as reducing regulatory complexity, expanding coverage of electricity and roads, and other government spending.

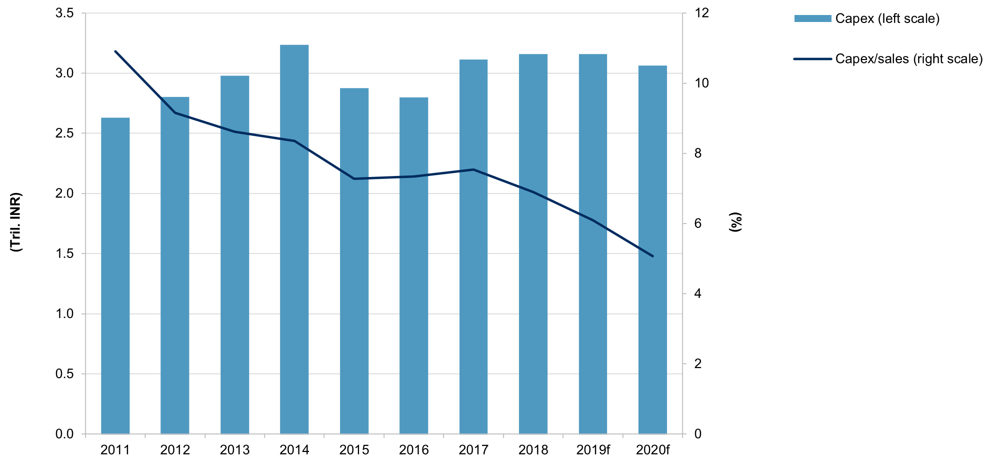
Capital Spending To Lag Well Behind Earnings Growth

We expect capital expenditure (capex) to remain flat compared with growth in earnings over the next two years, as companies target efficiencies and better utilization rather than capacity additions. Pre-election uncertainty and other macro clouds may further contribute to spending caution.

We note that consensus spending expectations within the sample show a much greater variation than earnings expectations. In particular, only about half of the corporates in our sample are expected to materially increase annual capex spending over the next two years whereas virtually the entire sample is likely to show some level of earnings growth. In effect, absolute capex for the entire set of corporates should remain broadly in line with the levels seen in past two years (around INR3 trillion) but revenues and earnings should grow significantly

Chart 5

Capital Expenditure Expected To Decline Significantly As A Proportion Of Sales
Spending and spending ratios for our India corporate basket*



*Our basket is made up of 250 listed Indian companies. Capex--Capital expenditure. Capex/sales--Capex as a percentage of total revenue. INR--Indian rupee. tril.--Trillion. f--Forecast. Data are for the fiscal years ending March 31. Source: S&P Capital IQ estimates.

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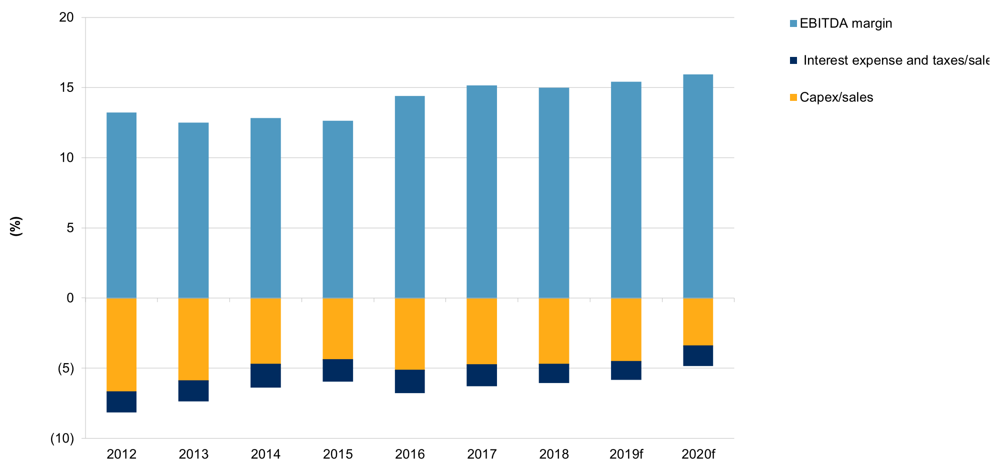
As a consequence, capex as a percentage of sales is likely to fall steeply over the next two years. A portion of this trend will be corrected by a handful of large corporates spending to acquire stressed assets such as in steel and power (not factored into these estimates). Notwithstanding, Indian corporates in aggregate should stay convincingly free cash flow positive over the next two years.

Chart 6

Indian Manufacturers' Margins Will Rise On Tame Spending
Breakdown of margins across the years for Indian corporates



Note: Carved from our basket of 250 listed Indian companies. Capex--Capital expenditure. Capex/sales--Capital expenditure as a percentage of total revenue. Same for interest and taxes. f--Forecast. Data are for the fiscal years ending March 31. Source: S&P Capital IQ estimates.

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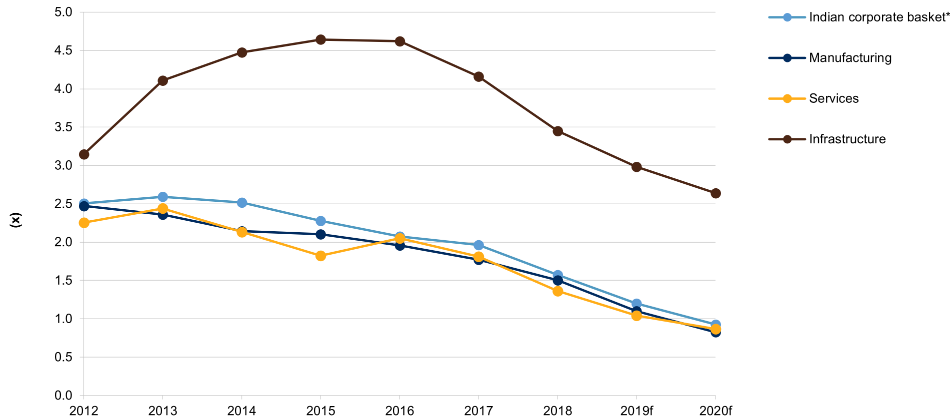
Financial Leverage Remains On An Improving Trend

We anticipate headline leverage, as measured by the ratio of debt to EBITDA, will improve across all sectors over the next 12-18 months. Leverage is expected to reduce by about one half-turn of EBITDA for the median corporate from 2018-2020.

Chart 7

Earnings Growth Will Drive Improving Leverage
Adjusted debt-to-EBITDA ratio for our Indian basket and select sectors



*Our basket is made up of 250 listed Indian companies. f--Forecast. Definition of adjusted debt: Reported debt adjusted for operating leases less 75% of reported cash and cash equivalents. Definition of adjusted EBITDA: Reported EBITDA + operating lease rentals. Data are for the fiscal years ending March 31.
Source: S&P Capital IQ Estimates. Copyright © 2018 by Standard & Poor's Financial Services LLC. All rights reserved.

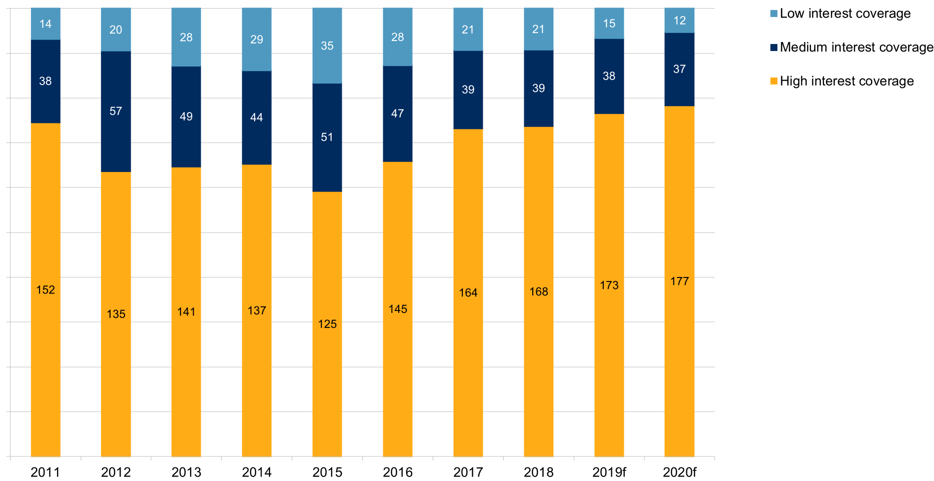
We note that higher leverage in infrastructure has been partly supported by regulated return utilities or government offtake which has allowed greater earnings visibility to lenders in the past.

While Indian corporates have a historical inclination to chase growth by sacrificing financial headroom, we don't foresee a systemic increase in leverage anytime soon. That's because we expect availability of credit to be prudent and rationed, and spending tendency is unlikely to step up in a pre-election year. At the margin, we expect companies to either retain increased cash as a war chest for future spending or buffer for downcyle--rather than pre-pay term debt. To that extent , the deleveraging could be more in terms of financial ratios rather than reduction in gross debt in the system.

We expect similar improving trends in interest coverage ratios notwithstanding the possibility of rate hikes this year. While corporate interest rate coverage unsurprisingly dropped in the interest rate-hike cycles in fiscal years 2010 and 2014, we nevertheless foresee an improvement in interest coverage ratios. This is because we anticipate that for most companies, the rate of earnings growth will more than offset any increase in corporate borrowing costs on account of higher funding costs for banks.

Chart 8

Number Of Low Interest Cover Corporates Is Marginal



Note: Carved from our basket of 250 listed Indian companies. High interest coverage: Adj EBITDA/Interest >4x; Low interest Cover: Adj EBITDA/Interest <2x; Medium interest coverage: Adj EBITDA/Interest 2<x<4. f--Forecast. Data are for the fiscal years ending March 31. Source: S&P Capital IQ Estimates.

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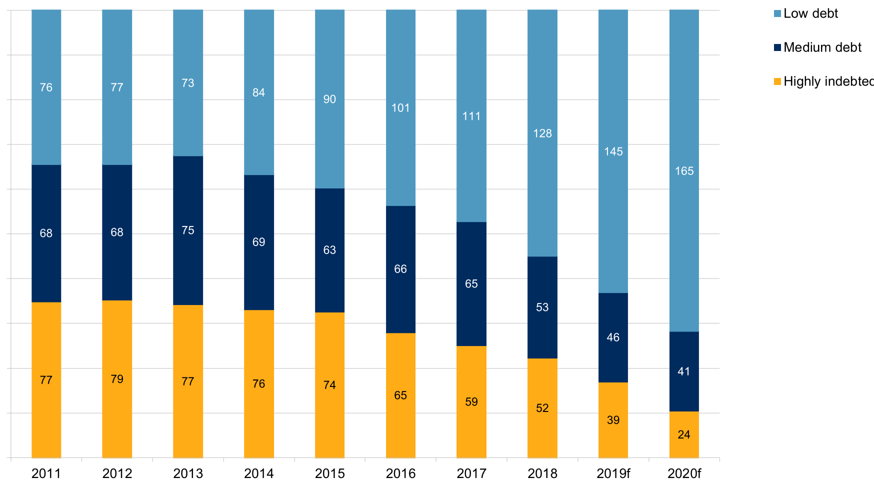
We believe the polarization and rationing of bank credit by sector will have a greater impact than the overall rise in interest rates. We expect discrimination of credit availability to intensify over the next 12-24 months as banks place greater emphasis on project viability, shorter loan tenors and cross collateralization.

We believe a select set of highly indebted companies (assessed as having adjusted debt to EBITDA greater than 4x) will increasingly find themselves at the unfavorable end of credit rationing and polarization. The number of companies in this category (among the 250) is likely to fall to about 10% over the next couple of years although they would still account for between half to one-third of total corporate debt across the forecast years.

Chart 9

Number Of Highly Indebted Corporates To Reduce Over Time...



Note: Carved from our basket of 250 listed Indian companies. Highly indebted: Adj debt/EBITDA >4x; Low debt: Adj debt/EBITDA <2x; Medium debt: Adj/EBITDA 2<x<4. f--Forecast. Data are for the fiscal years ending March 31. Source: S&P Capital IQ Estimates.
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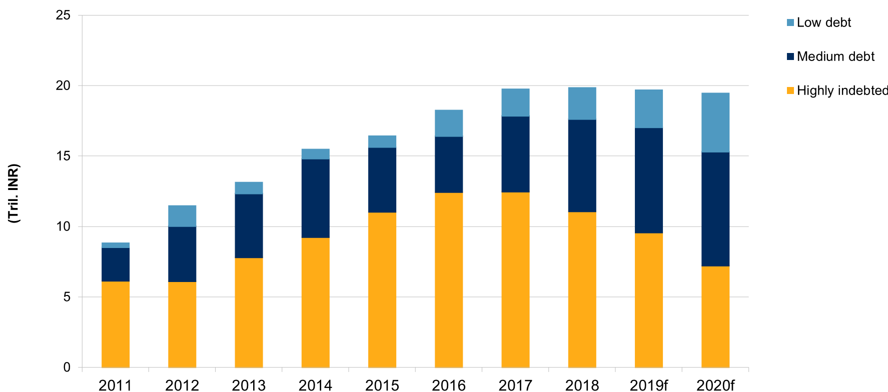
Chart 10

...But Highly Leveraged Companies Will Still Comprise A Substantial Portion Of Outstanding Debt
Cumulative adjusted debt split by type of corporate



Note: Carved from our basket of 250 listed Indian companies. tril.--Trillion. INR--Indian rupee.Highly indebted: Adj debt/EBITDA >4x; Low debt: Adj debt/EBITDA <2x; Medium debt: Adj/EBITDA 2<x<4. f--Forecast. Data are for the fiscal years ending March 31. Source: S&P Capital IQ Estimates.
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Lenders Still Face Risks

The proportion of debt concentrated among select highly leveraged companies and the likely high share of short-term borrowings among these corporates is a continuing risk for lenders headed over the next two years.

We also note that certain highly leveraged companies, notably in power generation, retail, real

estate and airlines, will remain so. These perennially indebted companies will contribute the bulk of the systemic risk, rather than other (new) corporates moving into highly leveraged territory. Engineering and construction, and small metals and mining, are other sectors carrying high debt which are not well represented in the listed companies' sample.

One systemic risk we haven't captured in this analysis is the potential share of unhedged foreign currency exposure relative to the sector's foreign currency revenues and this mismatch may strain cash flows in a currency depreciation scenario.

Macro Settings Support A Stable Growth Picture, Despite Uncertainties

We believe large Indian corporates retain their inherent ability to grow at a long-term rate faster than GDP, driven by continued retail demand and government enablement such as infrastructure spending and reforms to ease doing business. While policy decision-making may slow down in the months leading up to elections in 2019, we believe the drivers underpinning retail demand stay firmly in place. These are low per capita usage of several commodities and manufactured products; a gradual shift from the informal to the formal sector; and a step-up in consumption driven by enhanced access to electricity, mobile phones, housing, and roads.

Rising interest rates may dampen underlying demand in certain sectors that depend on retail financing (auto, real estate, and consumer goods) and may cause rollover issues for a small set of corporates. However, we expect the growth and deleveraging story of corporate India to stay intact.

We also believe external macro-risks remain contained, at least at this juncture. Despite tariff-related punches and counter-punches in the global trade arena, escalating tensions are unlikely to dramatically affect Indian corporate earnings in the next year. Indian companies have relatively low sales to the U.S. in areas where tariffs are rising, and limited exposure to the fallout from a potential U.S.-China or U.S.-Europe trade war. However, a major multilateral rise in protectionism could affect export-oriented sectors such as pharmaceuticals and IT, and have a negative impact on global business and consumer confidence.

While higher international oil prices are negative overall, we note that the translation to transport costs and corporate fuel costs is muddled by India's tax buffers. State and central taxes make up a material proportion of fuel costs. Changing these taxes or introducing subsidies on upstream companies are levers available to the government to smooth potential volatility in retail fuel prices. That said, the government has not used these options so far.

As with other emerging markets, a sustained pace of reforms and predictable regulatory regime are necessary to attract the investment (both private domestic and foreign) needed to reinforce India's stable outlook on growth. The upcoming general elections should provide more clarity on whether India's reforms can persist through the political cycle.

Table 1

Ratings And Outlooks For Our Indian Corporate Portfolio

Entity	Issuer cedit rating	Outlook
Adani Ports and Special Economic Zone Ltd.	BBB-	Stable
Adani Transmissions Ltd.	BBB-	Negative
Bharti Airtel Ltd.	BBB-	Negative
Delhi International Airport Ltd.	BB	Stable
Genpact Ltd.	BBB-	Stable

Table 1

Ratings And Outlooks For Our Indian Corporate Portfolio (cont.)

Entity	Issuer cedit rating	Outlook
Glenmark Pharmaceuticals Ltd.	BB-	Stable
GMR Hyderabad International Airport Ltd.	BB+	Positive
Greenko Energy Holdings	B+	Stable
HT Global IT Solutions Holdings Ltd.	BB-	Stable
iEnergizer Ltd.	B+	Stable
Infosys Ltd.	A-	Stable
Jain Irrigation Systems Ltd.	B+	Stable
Jubilant Pharma Ltd.	BB-	Stable
NHPC Ltd.	BBB-	Stable
NTPC Ltd.	BBB-	Stable
Oil and Natural Gas Corp. Ltd.	BBB-	Stable
Power Grid Corporation of India Ltd.	BBB-	Stable
Reliance Industries Ltd.	BBB+	Stable
SKI Carbon Black (Mauritius) Ltd. (Birla Carbon)	BB	Stable
Tata Consultancy Services Ltd.	A	Stable
Tata Motors Ltd.	BB+	Stable
Tata Steel Ltd.	BB-	Stable
UPL Corp. Ltd.	BBB-	Stable
Vedanta Resources PLC	B+	Stable
Wipro Ltd.	A-	Stable

Note: As of July 25, 2018.

This report does not constitute a rating action.

The Worst Is Almost Over For India's Banks

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Key Takeaways

- S&P Global believes India is at the tail end of its bad-loan recognition problem.
- We expect underlying profitability to remain weak as banks make provisions on stressed assets up to their economic value.
- Large losses have dented public sector banks capital but government capital infusions are providing reprieve.
- Our stable outlook on banks is underpinned by our expectations of a very high likelihood of government support.

India's weakened banking system is set to strengthen over the next couple of years. Banks have stepped up nonperforming loan (NPL) recognition amid tighter regulations, with the consequent provisioning leading to a record loss of more than US$9 billion for public-sector banks in the quarter ending March 31, 2018. S&P Global Ratings believes more stringent recognition, coupled with faster resolution under the country's new bankruptcy law, is helping to clear legacy bad loans. Weak risk management and internal controls, however, limit the potential for considerable upside.

Our stable outlook on banks is underpinned by our expectations of a very high likelihood of government support. The government's ongoing recapitalization program of Indian rupee (INR) 2.1 trillion (US$32 billion) will help shore up depleted capital positions. While we no longer think this program is sufficient to meet the sector's capital needs, we believe the government could arrange additional support as needed.

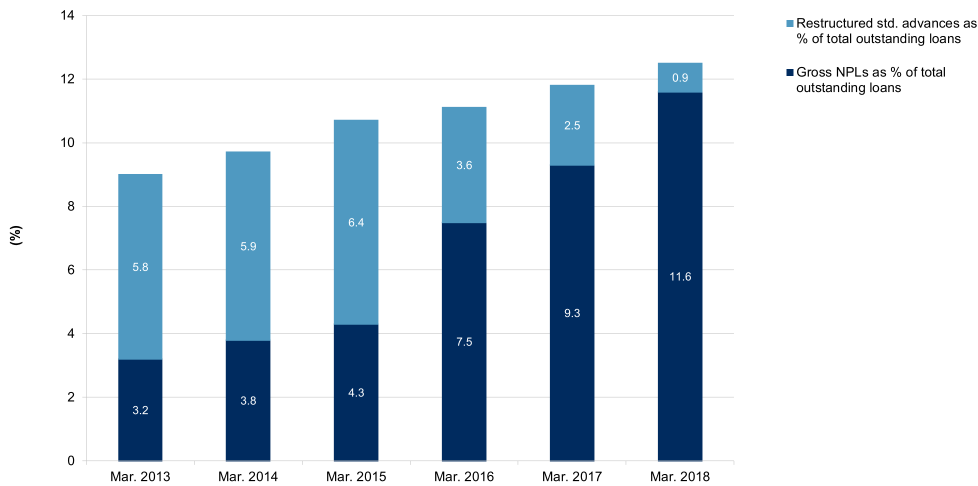
Tail-End Of NPL Recognition

We estimate that Indian banks' recognized NPLs now cover a substantial part of weak loans in the system, which comprise about 13%-15% of total loans. This more realistic recognition, coupled with rebounding corporate profits, and quicker resolution of nonperforming assets (NPA) under the new bankruptcy law, will help banks gradually recover from a protracted bad-debt cycle.

The Reserve Bank of India (RBI) has significantly tightened the recognition norms in the past three years. In February 2018, the RBI withdrew its previous forbearance on restructured loans, requiring banks to classify the bulk of restructured loan as NPLs. This contributed to a sharp uptick in reported NPLs, which spiraled to 11.6% as of March 31, 2018 (see chart 1).

Chart 1

NPLs Recognition Is Improving For Indian Banks



NPLs--Nonperforming loans. Std--Standard. Note: The stressed-asset ratio in India is defined as gross NPLs + standard restructured advances as a percentage of gross advances. Source: Reserve Bank of India.

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Banks are trying to resolve overdue loans before August 2018, which is the RBI's next deadline for completing resolution of stressed loans larger than INR20 billion, or else these cases will also be pushed to bankruptcy and would entail a minimum 50% regulatory provision. However, the government may extend the timeline for overdue power -sector loans to provide a reprieve to power -sector companies and the banks.

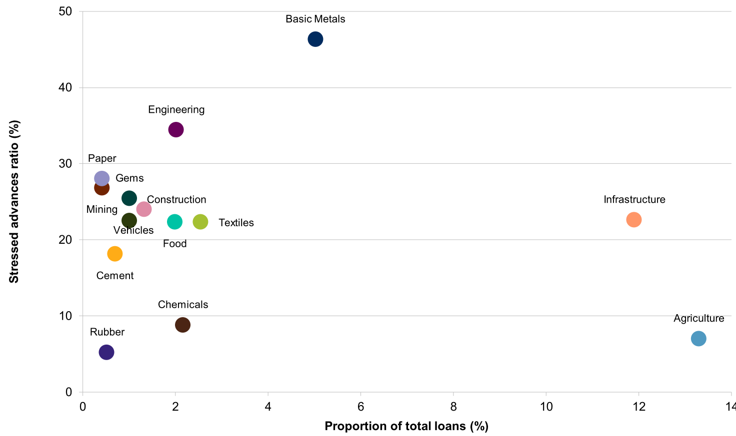
If banks fail to meet the RBI's deadline, then stressed assets could expand more than we expect. Nevertheless, many banks and large government-owned finance companies, such as Power Finance Corp. Ltd. and Rural Electrification Corp. Ltd., have signed inter-creditor agreements empowering the lead bank to sign off on resolutions as long as 66% of affected lenders agree (Project Sashakt, meaning empowerment, allows banks to resolve while owners remain in control, unlike the bankruptcy law). This should help speed the resolution process.

We believe the RBI's strengthening norms and more stringent timelines mean that banks will increasingly find it more difficult to window-dress accounts to hide the true level of weak assets. The central bank is reportedly conducting another asset quality review, which is said to be focusing on 240 corporate loans. Many of which are already classified as NPLs, but the RBI is investigating whether they are under-provisioned.

A recovering corporate performance should also lower nonpayment pressure (see "Indian Corporates: Leverage Is Declining As Companies Reap Rather Than Sow," published on RatingsDirect on July 26, 2018.) We expect spending to be tame for many corporate sectors, and revenues to rise on stronger demand. That said, corporates will continue to be the main source of weak loans, in our view. Their financial health remains hobbled by debt-funded expansions, weak demand, and uncertainty over policies and regulations over the past few years. Infrastructure and metals and mining have contributed the most to stressed assets among corporates, due to weak fundamentals and high banking exposure to the segment (see chart 2).

Chart 2

Infrastructure And Metals Are The Most Stressed Corporate Sectors



Note: The stressed-asset ratio in India is defined as gross NPLs + standard restructured advances as a percentage of gross advances. This data is from March 2018. Source: Indian Financial Stability Report, June 2018.

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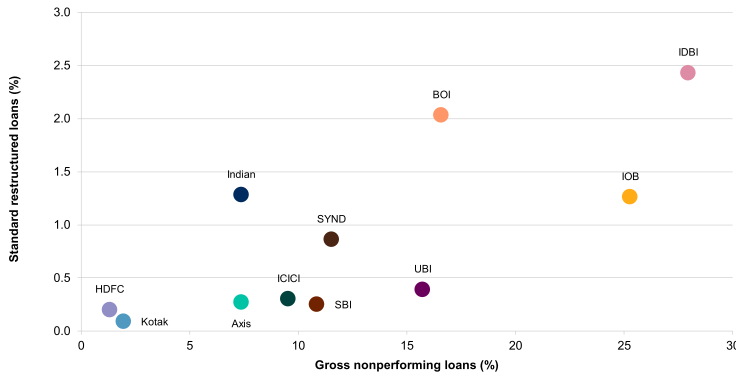
Public sector banks have a mammoth share of these weak loans given their focus on the corporate sector (see chart 3). These banks also tend to have weak risk management and internal controls.

Chart 3

Stressed Assets Are Highest At India's Public Sector Banks



Note: The stressed-asset ratio in India is defined as gross NPLs + standard restructured advances as a percentage of gross advances. For private banks the data is standalone and advances are on net basis. NPLs --Nonperforming loans. Data as of March 31, 2018. Kotak--Kotak Mahindra Bank, Indian--Indian Bank, IOB--Indian Overseas Bank, SYND--Syndicate Bank, IDBI--IDBI Bank, UBI--Union Bank of India, Axis--Axis Bank, ICICI--ICICI Bank, BOI--Bank of India, SBI--State Bank of India.

Source: Banks' financial reports.

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NPL resolution is gaining momentum but recovery rates will remain low

The resolution of these NPLs will gain momentum in fiscal 2019 (ending March 31, 2019) under the new bankruptcy code. The new code has tilted the balance of power in favor of lenders, yet we expect recoveries to remain low. "Haircuts" will become a reality and banks will have to make higher provisions to provide for true economic losses. Exceptions include the steel sector and some cement companies that are in recovery mode, bolstered by hard assets and a favorable commodity cycle. For many other NPLs, recovery is likely to be low.

In our opinion, the recovery rate in this cycle will remain close to the previous 26%. The real benefit of the new bankruptcy code will be in the next credit cycle. Nevertheless, the resolution of NPLs should help reduce overall NPLs in the system in this year.

Reform: The Missing R Of The "4Rs"

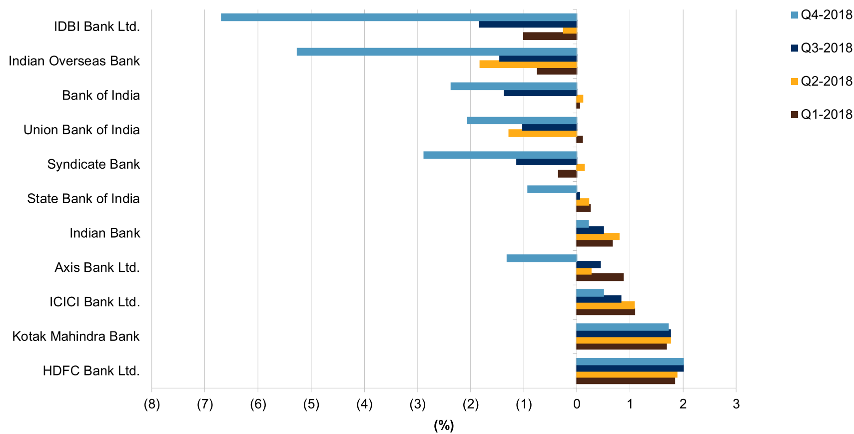
We believe that India has not done enough to reform its banks. The government is working on a four-pronged strategy to improve the health of the banking sector: recognition, recapitalization, resolution, and reform. The first three of the "4Rs" has progressed significantly, but in our view, India hasn't done enough with respect to reform. Signs of inherent weakness in governance and transparency standards include the recent allegations of US$2 billion fraud at Punjab National Bank (PNB; unrated), NPL divergences in many banks, and governance allegations against senior banks (see "ICICI, Axis Bank Troubles Highlight Risk Management, Governance Issues In Indian Banks," April 11, 2018).

Look To Fiscal 2020 For The Turnaround

We expect another year of high provisioning as public sector banks clean up their balance sheets and provide for losses on their stressed assets. Other drags on earnings include lower treasury income amid rising interest rates. Most rated banks reported losses in the fourth quarter of fiscal 2018, with the exception of the three private sector banks and Indian Bank (see chart 3). Axis Bank Ltd. also reported its first ever quarterly loss. Among the unrated public sector banks, only Vijaya Bank reported a profit.

Chart 4

Reported Losses Jumped In First Three Months Of 2018 (Q4-2018)
Reported return on average assets



Q--quarter. All data is based on stand-alone numbers and annualized. Source: Banks' financial reports.
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We expect a turnaround in the earning performance of India's banks in fiscal 2020. In our view, NPLs will start to decline, after banks complete substantial provisioning in fiscal 2019. This turnaround could be delayed if large unexpected NPLs materialize in the agriculture sector, where for example government-granted loan repayment waivers could hurt credit discipline. Small- to mid-size enterprise (SME) loans could face pressure because entities with business models based on tax arbitrage could struggle in the post-goods-and-services-tax era. The loan-against-property segment may also be vulnerable.

Capital Has Eroded But Government Support Is Providing Reprieve

Infusions from the Indian government are helping replenish India's depleted capital bases. A few government-owned institutions such as Indian Overseas Bank and IDBI Bank Ltd. have dipped into their capital conservation buffers to meet shortfall (see chart 4). Allahabad Bank, an unrated public sector bank, was even in breach of the minimum capital adequacy requirement number as of March 2018.

The RBI projects that public sector banks that are under prompt corrective action (or RBI monitoring to prevent further capital erosion) could see sharp declines in their capital-to-risk-weighted assets ratio (CRAR) to 6.5% by March 2019 from 10.8%, in the absence of any capital infusion. Besides writing off weak loans, banks also need capital to meet their Basel III requirements, which will increase further in March 2019.

We are no longer certain that the government's INR2.1 trillion recapitalization program will be sufficient to restore capital bases, however. The government has already pumped in about INR880 million in the quarter ending March 2018 and the rest of funds will be injected this year. The US$2 billion fraud at PNB and the recall of additional tier-1 (AT1) capital instruments by weak banks has led us to believe that more capital infusions may be necessary.

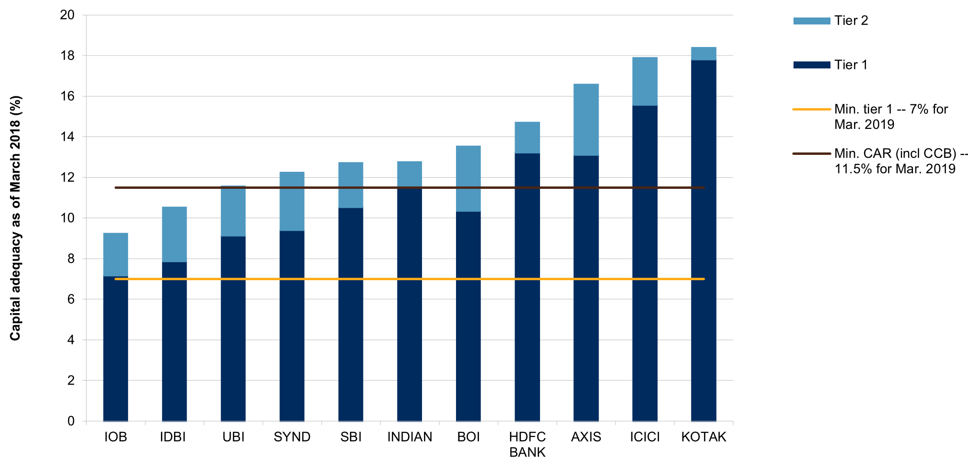
Additionally, the original INR2.1 trillion plan envisaged that INR570 billion would be provided from the capital markets, including instruments like AT1. But we don't expect weaker banks to tap the AT1 market in the next year or so, thus limiting this option (see "The Indian Exception: How

Government Support Changes The AT1 Market For Banks," March 16, 2018).

Having said that, capital support for other banks could also come in the form of capital infusion by other Indian public sector entities, such as Life Insurance Corp. of India (LIC), General Insurance Corp. of India, Power Finance Corp. Ltd., and Rural Electrification Corp. Ltd. For example, LIC is seeking approval to increase its holdings in IDBI Bank to a majority stake. If LIC provides capital to IDBI Bank as part of the transaction, then the government will accordingly be able to provide proportionately higher capital to other public sector banks that are stressed for capital.

Chart 5

Bank Capital Is Getting Scarce



Min. tier 1--Minimum tier 1 capital requirements. Min. CAR--Minimum capital adequacy ratio (including the capital conservation buffer).

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Banks could also manage capital shortfalls with further sales of non-core sale assets and by shrinking their balance sheet. In fact, some public sector banks, such Bank of India, IDBI Bank, and Indian Overseas Bank have seen negative loan growth in the last few years. Public sector banks have been consistently ceding market share to private sector banks over a longer period, and this trend has accelerated in the past three to four years due to concerns on capital. A notable exception to this trend is State Bank of India.

Government Support Underpins Stable Outlooks

Our stable outlooks on the banks reflect our view that the "4Rs" and other initiatives taken by the government and the central bank will strengthen the banking system over the next one to two years. We believe the risk to our view is on the upside: ratings are more likely to be raised than lowered in the next two years. That said, weak risk management and internal-control practices limit the potential for considerable upside.

Support from the Indian government protects most public sector banks from downgrades. We lowered our stand-alone credit profiles on Indian public sector banks between one and five notches during this downcycle. But the issuer credit ratings changed one to two notches, reflecting a very high likelihood of ongoing government support. Should recognition and reform initiatives uncover further problem assets than first envisaged, the significant pressure on the industry's asset quality and capital would increase further. This in turn would further strain ratings. Additionally, in the near term, there is a risk that a bank may breach its minimum

regulatory capital requirement if there is a timing mismatch between clean-up of the balance sheet and government capital infusion.

Meanwhile, government has withdrawn the Financial Resolution and Deposit Insurance (FRDI) bill, or India's version of a resolution framework for its banks. The FRDI bill included a bail-in of deposits, in dramatic contrast to other Asian markets. Such a lack of protection for depositors as envisaged in the original FRDI bill sharply contrasted with India's moves to support public-sector banks' AT1 instruments despite reported losses. The government helped the banks call the instruments rather than allowing them to be "loss-absorbing" as designed in the event of losses. India remains highly supportive of its banking sector.

What Are The Downside Risks?

A sharper-than-expected rise in crude oil prices would adversely affect India's current account deficit. Higher oil could also push up inflation and the fiscal deficit. Another pressure on the current account could come from foreign portfolio withdrawals, due to concerns related to the upcoming elections, or negative sentiment for emerging markets. Such adverse macro factors could cause: (1) larger and faster-than-expected hikes in interest rates in India; and (2) currency depreciation which could hurt unhedged corporate borrowers. These scenarios could undermine asset quality and delay recovery in Indian banks.

Appendix: State Of Play For Top Indian Banks

State Bank of India (BBB-/Stable/A-3)

We expect State Bank of India (SBI) to continue to grow its loan exposure to micro, small and midsize enterprises (MSMEs). Slippages should reduce, given we believe most stressed assets are already recognized as nonperforming. As of March 31, 2018, the bank has aggregate exposure of Indian rupee (INR) 776 billion referred for resolution to insolvency courts. Resolution of accounts in National Company Law Tribunal (NCLT) List 1 and NCLT List 2 are likely to materialize over the next 12-18 months. SBI anticipates recoveries from these large accounts to be higher than provisions held (the bank's provisions for NCLT accounts are 63% of the exposure).

Subdued credit growth, higher provisions, and considerable mark-to-market (MTM) losses in the government bond portfolio contributed to a net loss of INR65 billion for SBI for the fiscal year ended March 31, 2018. The bank's reported gross NPL ratio rose to 10.91% from 9.11% after the central bank reclassified restructured loans as nonperforming in February 2018.

HDFC Bank Ltd. (BBB-/Stable/A-3)

HDFC Bank Ltd.'s prudent lending and favorable retail-wholesale loan mix should continue to fuel top-line growth, in our view. The bank's deposit base has steadily increased although the current account and savings account (CASA) ratio has fallen year over year (YoY) due to a high base following the demonetization exercise in India. HDFC Bank has gained market share over the past few years from its public sector peers, many of which have been placed under the central bank's prompt corrective action framework.

We anticipate that HDFC's interest margins will remain stable with limited room for expansion. The bank's asset quality remains one of the best among its domestic peers, with a reported gross

NPL ratio of 1.30% as of March 31, 2018. Good risk monitoring and management systems and avoidance of stressed sectors have contained asset quality risks. While the bank's above-average loan growth could raise asset-quality risks, we believe management can contain the risk.

HDFC Bank's reported net profit rose 20.2% YoY in the fiscal year ended March 31, 2018. The rise in wholesale lending slowed down during the last quarter of the year, but retail growth remained strong.

ICICI Bank Ltd. (BBB-/Stable/A-3)

Asset quality issues have undermined ICICI's performance, as reflected in the recent quarterly loss. In our opinion, ICICI's financial performance should improve over the next 12-24 months since we believe it has recognized most of its stressed assets as nonperforming. We expect asset quality pressures to ease in the latter half of fiscal 2019, owing to the resolution of bad loans and improvement in the corporate portfolio. The bank has tightened underwriting standards for corporate loans, including by reducing limits on new exposures. Its reported gross NPL increased considerably in the fourth quarter of fiscal 2018 following the central bank's revised recognition norms for stressed assets.

Rising interest rates in India and ICICI's large low-cost CASA deposit base should support interest margins over the next 12-24 months. The bank's increasing retail share will likely reduce the high concentration in its top 20 accounts. ICICI's reported net profit for fiscal 2018 fell 31% YoY due to a sharp increase in provisions and lower treasury income.

The Central Bureau of Investigation is investigating alleged conflicts of interest involving the bank's managing director and CEO, Chanda Kochhar. The accusations relate to loan disbursals, and we will continue to monitor developments regarding governance at the bank. ICICI's board of directors has also initiated an independent inquiry into this and other potential governance issues (e.g. recognition of NPLs).

Axis Bank Ltd. (BBB-/Stable/A-3)

We believe steps to recognize and resolve problem loans, improve provisioning levels, and raise capital are key for Axis Bank Ltd. to improve its financial performance. The bank's strategy to enhance risk management and compliance is also likely to enhance asset quality. A smooth transition in leadership when the CEO steps down later in 2018, and continuity in management, will also be key credit factors for the bank.

Axis' results for the year ended March 31, 2018, underscore high stress levels in the corporate loan portfolio and the impact of the central bank's reclassification of restructured loans as nonperforming. Axis classified most of its stressed assets as nonperforming and set aside appropriate provisions, leading to a jump in gross NPLs and a 92% decline in profit to Indian rupee (INR) 3 billion. Strong loan growth across segments countered downside pressure on net interest income from NPLs. Axis' gross NPLs rose to 6.77% of total loans, from 5.04% in the previous year.

Bank of India (BB+/Stable/B)

Bank of India's (BOI) increasing exposure to retail, agricultural, and MSME segments should benefit its long-term business franchise. The bank's share of corporate loans fell to 48% in fiscal 2018, from 51% in the previous year. BOI has also considerably lowered exposure to its lower-yielding international loan book.

We expect BOI's gross NPL ratio and slippages to remain elevated although provisioning has improved. We believe asset quality will remain stressed owing to the increasingly high exposure to the infrastructure sector and the historically drawn-out recovery process. In December 2017, the central bank placed BOI under prompt corrective action citing high net NPL, insufficient common equity tier-1 (CET1) capital, and negative return on assets for two consecutive years. BOI's reported net loss widened to INR60 billion in fiscal 2018 due to contraction in interest margins, significant MTM losses, and higher loan loss provisions. The cost to income ratio increased by 834 bps to 56%.

IDBI Bank Ltd. (BB/Stable/B)

The potential takeover of IDBI Bank Ltd. by Life Insurance Corp. of India (LIC, unrated) has no immediate impact on the ratings on the bank. We continue to see a very high likelihood of government support for the state-owned bank. While the government's direct stake in IDBI could decline below 51% post this deal, we believe the government will continue to strongly support the bank whether the majority holding is held by government or by LIC (a 100% government-owned entity). Nonetheless, we would continue to monitor the developments around this transaction. We would revisit our assessment of government support for IDBI Bank if at any point, we believe that IDBI's link with the government has weakened or if LIC looks to sell substantial stake in IDBI to strategic investors to pave the way for privatization.

IDBI Bank has a weak stand-alone credit profile of 'b-' and has been subject to the central bank's prompt corrective action since May 2017. The bank's ratio of nonperforming loans, at 28% of outstanding loans, is the highest in our rated portfolio. IDBI reported a loss of about INR81 billion in fiscal 2018 and it again dipped into its capital conservation buffer (CCB) in March 2018, with a consolidated total capital ratio of 10.5% as opposed to the regulatory requirement (including CCB) of 10.875%.

Union Bank of India (BB+/Stable/B)

We expect Union Bank's earnings to remain muted as provisioning costs will likely remain high in fiscal 2019. The bank's provision coverage ratio at 50.7% as of March 31, 2018, remains low. High credit costs, compressed margins, and lower treasury income resulted in a full-year loss of INR52.2 billion compared with INR5.7 billion profit after tax for fiscal 2017. The bank's gross NPA (including nonperforming loans and restructured loans classified as performing) were about 17% highlighting its weak asset quality. We believe the power sector could contribute to slippages in the coming quarters.

In our view, the bank is dependent on capital infusions from the government, as muted earnings will continue to pressure the bank's capital (CET1 ratio of 7.6% versus minimum requirement of 7.375% including capital conservation buffer). During fiscal 2018, the bank received INR45.2 billion from the government and raised another INR20 billion via qualified institutional placement.

Union Bank continues to focus on SME, retail and agriculture segments in order to achieve lower risk-weighted assets growth while overseas operations have shrunk. CASA share of deposits has broadly remained stable at 33% as of March 31, 2018.

Indian Overseas Bank (BB/Stable/B)

IOB's performance is likely to remain weak in the current fiscal year as it is still saddled with huge stock of stressed assets, which requires clean-up. The bank's NPL provision coverage at 61.1% as on June 30, 2018 remains low, though improving. As such, we expect the bank's credit costs to remain high and margins to remain relatively low due to non-accrual drag. This will likely lead to a loss in fiscal 2019 (fifth consecutive year of loss). IOB's pretax loss widened to INR86.3 billion compared with INR33.8 billion a year earlier as a jump in credit costs and non-interest expenses offset any improvement in margins. It made further loss of INR9.1 billion in the first quarter fiscal year 2019.

The bank's gross NPA (including NPLs, and performing restructured and foreclosed assets) at 26.5% as of March 31, 2018, remains one of the highest among the Indian banks that we rate, next only to IDBI's gross NPA of close to 35%. IOB's weak operating performance and negative retained earnings have lowered the bank's capital ratios. And, it further exercised the call option on its outstanding additional Tier 1 instruments of INR10 billion in June 2018. As such, its capital ratio dipped sharply in the first quarter of fiscal 2019. That said, the recent (July 18, 2018) announcement of capital infusion of INR21.5 billion from the government of India should provide some support and help bank meet its minimum capital requirement, which as per the bank would go up to 7.5% (tier 1) and 9.7% (total capital) post this infusion. In our view, IOB will remain dependent on regular capital infusions, mainly by the government, to meet its capital needs both for clean-up and for meeting its regulatory requirement.

In line with the bank's strategy, its ratio of low-cost CASA improved to 36.9% as of June 30, 2018 (in the past two years). However, such improvement typically happens when a bank is consolidating its loan book. It remains to be seen if IOB can sustain the improvement in its funding profile while growing.

Syndicate Bank (BB+/Stable/B)

We expect Syndicate's core earnings to likely remain under pressure over the next 12 months, with additional provisions, given the ongoing stress in asset quality. In fiscal 2018, Syndicate too slipped into the red with a pre-tax loss of INR42.8 billion, after narrowly escaping it in the previous year. The loss was mainly attributed to the sharp rise in provision for NPLs, which more than doubled to INR76 billion compared with INR35 billion in the previous year. The bank's reported gross NPA is still high at 12.4% as on March 31, 2018, but it is next only to Indian Bank and State Bank of India amongst the rated public sector banks.

While the NPL provision coverage has improved to 60.7% as on March 31, 2018, it remains low. As such, we will continue to see elevated provision levels, at least in the current fiscal year. Syndicate's capital ratios with CET1% of 7.56% are close to the minimum regulatory capital requirement (including capital conservation buffer) of 7.375%. But we expect the bank to continue to meet the capital requirements in the current fiscal year, too, with the help of external capital infusion.

In terms of credit growth, the bank's domestic book grew at 6% for the year, similar to YoY growth of the public sector banks (at 6.3%), driven by growth in housing loans and loans to nonbank financial companies (NBFC). The bank continues to increase its exposure to NBFC, which is already higher (at 11% of total loan book) than the industry. This portfolio has been performing well for the bank, and it had no NPLs as on March 31, 2018. Unlike other public sector banks that are reducing their overseas exposure, Syndicate grew aggressively in this space, with overseas

advances growing by 17% in fiscal 2018, and now forming 18.7% of the total loan book. Over 75% of the bank's overseas book is due from banks.

Indian Bank (BBB-/Stable/A-3)

We expect Indian Bank's core earnings to be under pressure over the next 12 months as the bank will have to step up its provision coverage ratio from the current level of about 50%. The bank's performance remains better than rated public-sector peers; it continues to be profitable and non-performing loans ratio was relatively low at 7.4% as of March 31, 2018. Restructured loans classified as standard were 1.3% as of March 2018 and could contribute to slippages in coming quarters, in particular those pertaining to the power sector, which in turn could keep credit costs elevated. The bank's capital ratios have sufficient buffers over the regulatory minimum with tier 1 ratio of 11.3% and a total CAR of 12.6%. The bank's 23% credit growth for fiscal 2018 was notably higher than the industry and driven by retail, agriculture, plus micro and SME segments.

Kotak Mahindra Bank (BBB-/Stable/A-3)

We believe Kotak Mahindra Bank is well positioned to increase its market share in the Indian banking industry. The bank's credit profile is characterized by superior risk management, above-average profitability and capitalization, an improving funding profile, and diversified business model. We expect Kotak Mahindra Bank's asset quality and credit costs to remain better than the industry average owing to the bank's high exposure to retail loans and its low proportion of project finance loans. The bank's asset quality has been better than peers' in this credit downcycle, which was triggered by corporate loans from capital-intensive sectors such as iron and steel and infrastructure.

Kotak's results for the quarter ended June 2018 underscores healthy loan growth (22% on a year-on-year basis), a gross non-performing loan ratio of 1.9%, and an improved consolidated tier-1 capital ratio of 17.4% (due to fresh fundraising in the past fiscal year). The bank launched "811," a digital banking account, last year to increase its customer base. We believe this digital strategy will benefit the bank's franchise and business position.

This report does not constitute a rating action.

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