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Performance of ICRA-Assigned Ratings in H1 FY2023

Rating upgrades maintain their pace

The credit quality of India Inc. continued to strengthen in H1 FY2023, carrying on with the momentum set in motion since the beginning of FY2022. In H1 FY2023, as also in FY2022, instances of rating upgrades by ICRA were over three times that of downgrades. With ICRA upgrading the ratings of 18% of its portfolio entities in H1 FY2023 on an annualised basis (and prior to that an equally high 19% in FY2022), the upgrade rate[1] reflected a significant mark-up over the past 5-year and the past 10-year average of 11%.

The upgrades in the just-concluded half-fiscal were concentrated in a few sectors. **Real estate, textiles, financials, engineering, construction,** and **roads** sectors constituted the upgrade leaderboard for H1 FY2023. These six sectors accounted for almost half of the total upgrades by ICRA in H1 FY2023, while constituting one-third of ICRA's rated portfolio.

- A predominant majority of upgrades in the **real estate sector** were those of entities that are engaged in the leasing of commercial office space or warehousing assets wherein project completions, healthy leasing activity, and/ or loan refinancing at more favourable terms improved their credit profiles. Also, many entities upgraded were backed by relatively stronger sponsors.

- In the **textiles sector**, ICRA upgraded the ratings of several branded apparel manufacturers/ retailers as their business swelled on the back of the tailwinds of formalization, including the shift in customer preferences towards branded wear. Also, select entities that are engaged in leather garment and woven apparel exports were upgraded as they experienced a strong overseas demand post the pandemic.

- In the **financial sector**, several small to mid-sized NBFCs with a loan book ranging between Rs. 500 Crore to Rs. 10,000 Crore, showing a track record of consistent business growth while maintaining/ improving asset quality and capitalization metrics witnessed upgrades. The ratings of three banks were also upgraded as their earning profile were expected to sustain their improving trend with further improvement in their solvency/ capitalization metrics seen through fresh equity capital mobilization.

- The credit profile of several **engineering** and **construction** sectors entities is seen to be benefiting from their healthy order books and steady execution pace, supporting upgrades. The order books of construction entities are benefitting from the public investment projects in irrigation, roads, water supply, underground tunnelling, and metro works. These apart, the ratings of select construction entities were upgraded based on the increasing diversification of their order book, including orders for the construction of data centers, a sub-segment with a relatively lesser competitive intensity. Likewise, several entities were upgraded—that manufacture engineering items straddling across transformers, smart meters, solar modules, elevator guide rails, material handling systems, and non-automotive forgings—in view of their growing order book and manageable working capital intensity.

- In the **Roads** sector, several annuity-based and hybrid annuity-based projects were upgraded driven by reasons including reduction in execution and funding risks following project completions, and timely commencement of the semi-annual annuity payments from the concession authority, assuaging revenue risks.

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[1] Upgrade Rate is defined as the number of entities upgraded in the period of analysis as a percentage of the total number of rated entities as of the beginning of the period. The calculation of the upgrade rate excludes the [ICRA]AAA and the [ICRA]A1+ rated entities.

The rating downgrade rate[2] at 5% remained on a leash in H1 FY2023 (6% in FY2022) in comparison with the past 5-year average of 12% and the past 10-year average of 9%. The business rebound post the pandemic, limited capital expenditures and hence restrained fresh term borrowings, and organic reduction in the existing balance sheet debt kept the incremental downside credit risks low. The reasons for downgrades were entity-specific, including delays faced in realising receivables, instances of inter-group transactions posing governance concerns, rising input costs with limited pricing power, besides the rise in project implementation risks for some. If the instances of downgrades in H1 FY2023 were low, occurrence of defaults was seen to be even lower. There were only five defaults in ICRA's portfolio in the recent half-fiscal, compared with 42 in FY2022 and 44 in FY2021, with four out of the five defaults being from the non-investment grade.

The above trends indicate that India Inc. has shown notable resilience in terms of maintaining and even strengthening its credit quality, against the backdrop of multiple exogenous factors in the form of geopolitical conflicts, supply chain disturbances, volatile energy prices, and the actions and reactions of monetary policy interventions across the world. These developments have manifested in inflationary pressures, interest rate hardening, and the weakening of the Indian currency against the US Dollar. When ICRA reviewed its portfolio of ratings in H1 FY2023 to assess its vulnerability to interest rate and currency risks, the following was observed for select sectors:

- For toll roads, the adverse impact of rising interest rates was expected to be largely mitigated by the sharp increase in toll rates in view of their formula-based linkage with the wholesale price index that has been ruling at multi-year highs. Further, the credit profiles of several toll road entities in ICRA's portfolio draw support from strong promoter groups, with a demonstrated track record of extending financial support.

- The road annuity assets in ICRA's portfolio either have fixed rate borrowings or their existing ratings have the tolerance to withstand the impact of a certain level of interest rate hikes. The overall impact of a 200-basis points (bps) increase in interest rates on the cumulative debt service coverage ratio (DSCR) was estimated to be around 8-14-bps for toll road assets and about 5-bps for annuity assets, which is unlikely to cause a rating change. Moreover, the restrictive payment clause in the loan terms of most of the road assets, that kicks-in when the debt coverage metrics fall below a pre-defined threshold, acts as an additional mitigant. However, a material rise in borrowing costs beyond the above could trigger rating reviews in future.

- For thermal power entities in ICRA's portfolio, a majority have a cost-plus mechanism wherein an escalation in costs including interest costs is pass-through in nature. For entities without the cost-plus arrangement, a 200-bps increase in interest rates could pressure their unsupported credit profiles; however, the overall risk is largely mitigated as these entities in ICRA's portfolio draw support from the backing of strong sponsors. In the renewable energy segment in ICRA's portfolio, there is a mix of entities with fixed and variable rate borrowings, but the existing ratings of most entities can accommodate some hardening of interest rates. In any case, the 'elephant in the room' for the power generation entities is the risk of delays in the receipt of payments from the distribution companies (discoms), a risk that may get exacerbated in an inflationary environment even if the costs might be pass-through. In H1 FY2023, the ratings of six power sector entities were downgraded by ICRA because of payment delays from the discoms.

- As for currency risk, ICRA reviewed around 130 entities in its portfolio in H1 FY2023 whose net unhedged foreign currency exposure on account of export/ import or foreign currency borrowings was more than their operating profits, implying a reasonably high exposure to currency risks. However, a large majority of these entities were seen to have the supporting levers in the form of adequate liquidity buffers, parent-support, or the ability to pass on cost increase to their customers—to negotiate the currency risk pressures. Around 10 entities, however, were seen not to possess the currency risk mitigation levers and faced credit pressures on other counts as well, that led to rating actions on them in H1 FY2023.

[2] Downgrade Rate is defined as the number of entities downgraded in the period of analysis as a percentage of the total number of rated entities as of the beginning of the period. The calculation of the downgrade rate excludes the [ICRA]D rated entities.

With commodity prices receding from their recent peaks and with trends in softening export demand, ICRA revised its outlook on the **Ferrous Metals, Non-Ferrous Metals,** and **Textiles (Cotton Spinning)** sectors to **Stable** from Positive in H1 FY2023. This implies that the realisation growth-led upward rating inducements in these sectors that were strongly at display in FY2022, are unlikely to drive rating actions in these sectors in the near term. ICRA also revised its outlook on the **Retail (Fashion)** and the **Airport Infrastructure** sectors to **Stable** from Negative in recent months as the operating metrics in these sectors are on their path to rebounding to their pre-Covid levels. The sectors that continue to remain on a **Negative** outlook include **Airlines, Media and Entertainment (Exhibitors and Print),** and **Power (Thermal and Distribution)**. In comparison, two sectors are currently on a **Positive** outlook viz., **Oil and Gas (Upstream)** and **Roads (Toll)**.

Commenting on the overall developments, **Mr. K. Ravichandran, Chief Rating Officer, ICRA**, said, "*We forecast India's GDP to grow by 7.2% in FY2023 as against 8.7% in FY2022 and -6.6% in FY2021 as the demand for contact-intensive services remains buoyant and a pick-up in private and government capital expenditure looks on the anvil. A significant hardening of interest rates, however, is a risk factor that would impact discretionary spending, make debt less affordable, and restrain capex. Further, an escalation in geopolitical conflicts, a global recession, and global fund flows (inter-related, not distinct factors) would challenge India's macroeconomic fundamentals, even if not as much in relation to the other economies. These factors, directly or indirectly, would have a bearing on the credit quality trendlines, looking ahead*."

ANNEXURE

The sectors that witnessed a relatively high rating activity in H1 FY2023 are tabulated below:

H1 FY2023	Upgrade Rate (%)	Downgrade Rate (%)	Credit Ratio (x)
Real Estate	15%	1%	17.5
Textiles	14%	2%	6.7
Financial Sector	6%	1%	6.3
Engineering	12%	2%	5.3
Roads	19%	5%	3.8
Construction	10%	6%	1.9
Others	7%	3%	2.4
Overall ICRA Portfolio	**9%**	**3%**	**3.3**

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About ICRA Limited:

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