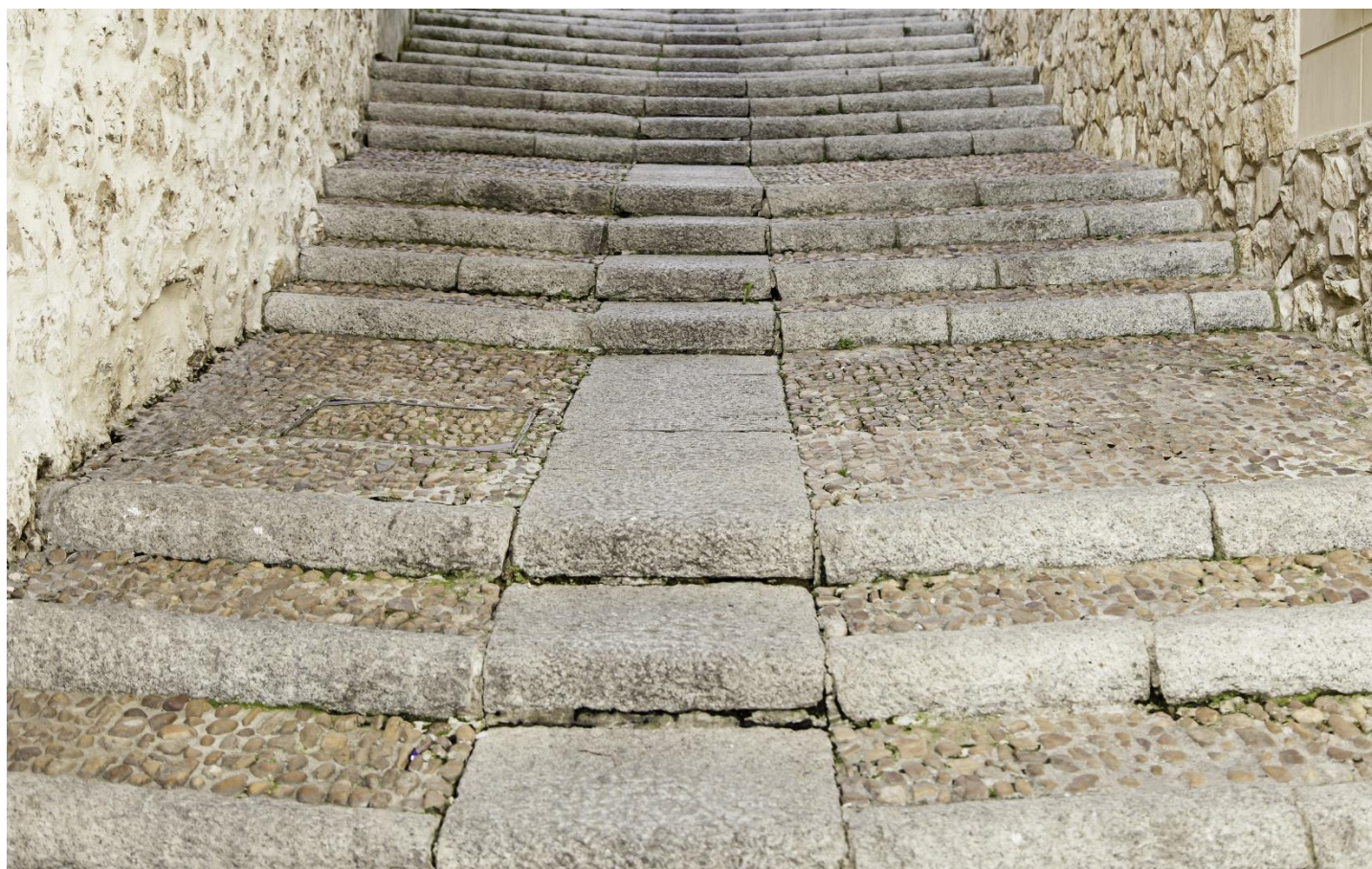


**Ratings  
Round-Up**

Fiscal 2017

**Credit quality improves,  
but remains fragile**



## Analytical contacts

**Pawan Agrawal**  
Chief Analytical Officer  
[pawan.agrawal@crisil.com](mailto:pawan.agrawal@crisil.com)

**Arun Vasu**  
Associate Director  
[arun.vasu@crisil.com](mailto:arun.vasu@crisil.com)

**Viren Shah**  
Manager  
[viren.shah@crisil.com](mailto:viren.shah@crisil.com)

**Gurninder Kaur Aurora**  
Senior Executive  
[gurninder.aurora@crisil.com](mailto:gurninder.aurora@crisil.com)

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# Ratings

## Executive summary

CRISIL's rating actions during fiscal 2017 underscore credit quality of India Inc is gradually recovering. However, the underpinning remains fragile as some sectors continue to struggle and several large companies remain highly indebted. As a result, the gross non-performing assets (GNPAs) in the banking sector are expected to remain at elevated levels.

CRISIL's credit ratio for fiscal 2017 was 1.22 times, similar to the 1.29 times seen for fiscal 2016, while debt<sup>1</sup>-weighted credit ratio improved to a 5-year high of 0.88 time compared with 0.31 time.

The improvement was driven by firm commodity prices, stable macros, improving capital structure and lower interest costs.

Going forward, we expect the gradual improvement in credit quality to sustain.

In all, there were 1,335 upgrades and 1,092 downgrades, during the year. Like last fiscal, upgrades were driven by consumption-linked sectors, while downgrades were led by investment-linked sectors. The impact of demonetisation on credit quality is expected to be transient.

We expect upgrades to outnumber downgrades in the near term driven by improving domestic consumption demand after demonetisation. Further, several debt-intensive sectors such as metals (especially non-ferrous) and sugar are expected to see improvement in credit quality in fiscal 2018 because of rising prices.

These trends would also reduce slippages to non-performing assets (NPAs) in the banking sector in fiscal 2018. Yet the stock of gross NPAs will rise and remain at elevated levels. Recoveries would continue to be subdued given that sizeable NPAs are in highly leveraged companies with stretched cash flows.

Several investment-linked sectors such as real estate and capital goods continue to face headwinds. Stress is also building in some microfinance institutions (MFIs). And major corporate houses with high indebtedness will continue to struggle.

While CRISIL expects credit quality to improve in fiscal 2018, the pace will hinge on progress in balance sheet deleveraging through asset sales, another normal monsoon, no further slowdown in India's major trade destinations, pick-up in investment cycle, effective implementation of reforms (especially GST), the ability of MSMEs to withstand the increasing trend towards formalisation, and absence of any sharp swings in the rupee versus the dollar.

CRISIL remains focussed on the quality of its ratings and strives to minimise sudden and sharp rating actions (upgrades as well as downgrades). Investors expect rating categories, especially in the higher rating categories ('A' and above) to display high degree of stability. CRISIL's portfolio witnessed 172<sup>2</sup> rating actions in the 'A' and above categories during 2016-17, out of a portfolio of 1,074 in these rating categories. Only 9<sup>3</sup> of these were multi-notch changes.

<sup>1</sup> Debt outstanding in the books of the firms, excludes financial sector players

<sup>2</sup> This is based on number of rating actions and could include multiple ratings actions of the same company during the year.

<sup>3</sup> Excludes ratings placed on 'Rating Watch', which is used to convey to investors that the rating is being monitored for certain critical events and that additional information is awaited. This helps reduce the possibility of any surprise for the investors.

## About CRISIL's Ratings Round-up

CRISIL's Ratings Round-Up is a semi-annual publication that analyses CRISIL's rating actions and traces the linkages between such actions and the underlying economic trends and business factors.

A credit rating is an opinion on the likelihood of timely repayment of debt. Therefore, an analysis of rating actions in a large and diverse portfolio of rated firms is an apt indicator of economic prospects.

This edition analyses CRISIL's rating actions in the fiscal year ended March 31, 2017.

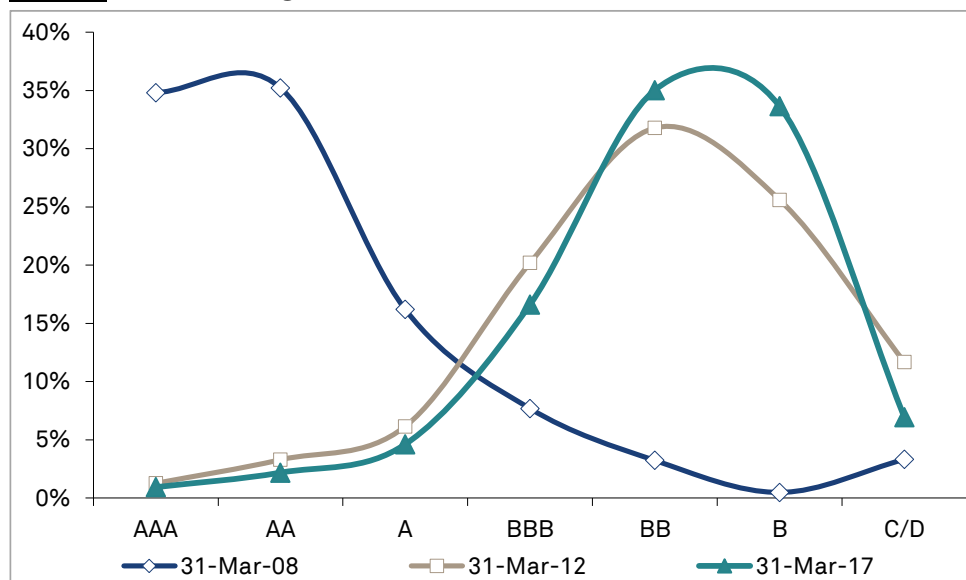
## CRISIL's portfolio, median ratings unchanged

Ratings outstanding on **~14,000** issuers

Median rating remains **CRISIL BB** category

Over the past three years, CRISIL's rated portfolio of outstanding ratings has stabilised – with around 14,000 ratings. Almost three-fourths of the outstanding ratings are in the 'CRISIL BB' or lower categories. Consequently, the median rating stayed put at 'CRISIL BB' category, lower than the 'CRISIL AA' category median as on March 31, 2008 (*Chart 1*).

**Chart 1:** CRISIL's rating distribution



Source: CRISIL

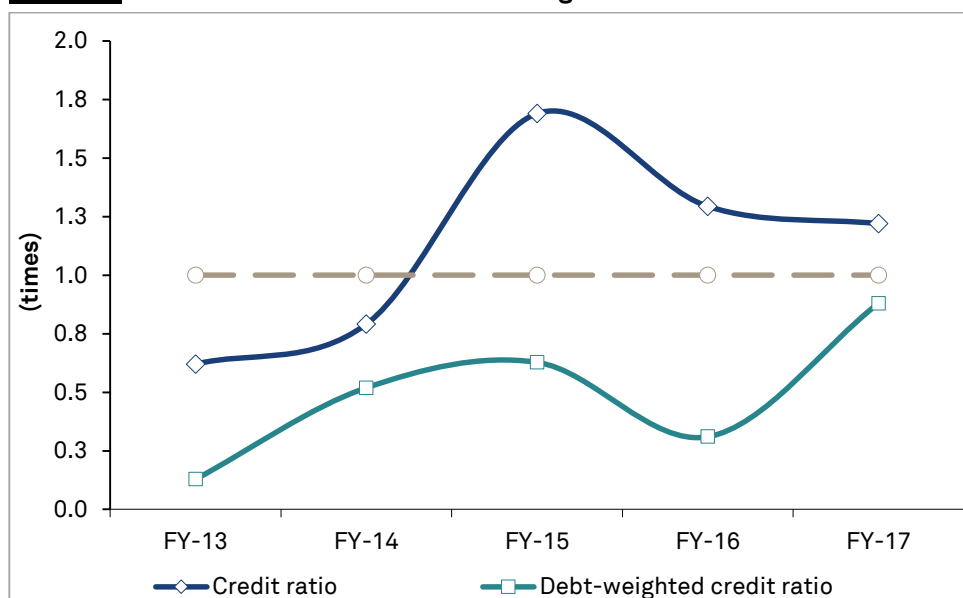
**Credit ratio flat,  
debt-weighted  
credit ratio at a  
5-year high**

**At 1.22 times, credit  
ratio little changed**

**Debt-weighted credit  
ratio at 0.88 time**

CRISIL's credit ratio for fiscal 2017 at 1.22 times was similar to the 1.29 times seen in fiscal 2016, while debt-weighted credit ratio improved to 0.88 time compared with 0.31 time (*Chart 2a*).

**Chart 2a:** Trends in credit ratio and debt-weighted credit ratio

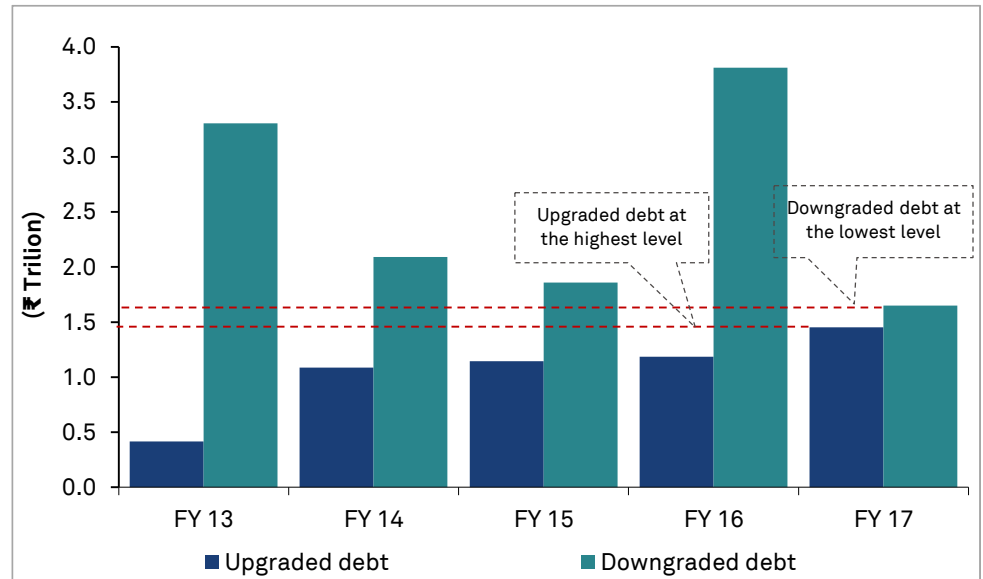


Source: CRISIL

Debt-weighted credit ratio touched a five-year high in fiscal 2017 (CRISIL's rated portfolio has been stable in these years with ratings outstanding at around 12,000-14,000).

Total debt upgraded and total debt downgraded reached their respective five-year highs and lows in fiscal 2017. These indicates a gradual improvement in credit quality of India Inc (*Chart 2b*).

**Chart 2b: Debt upgrades and downgrades**



Source: CRISIL

This improvement in credit quality was driven by firm commodity prices, stable macros, impact of sustained structural reforms, improving capital structure and lower interest costs. Though demonetisation was disruptive for demand and liquidity, we expect its impact to be transient.

## Demonetisation a short-term blip

The government's move on November 8, 2016, to demonetise bank notes of Rs 500 and Rs 1,000 impacted demand, operations and liquidity of companies across sectors in CRISIL's rated portfolio.

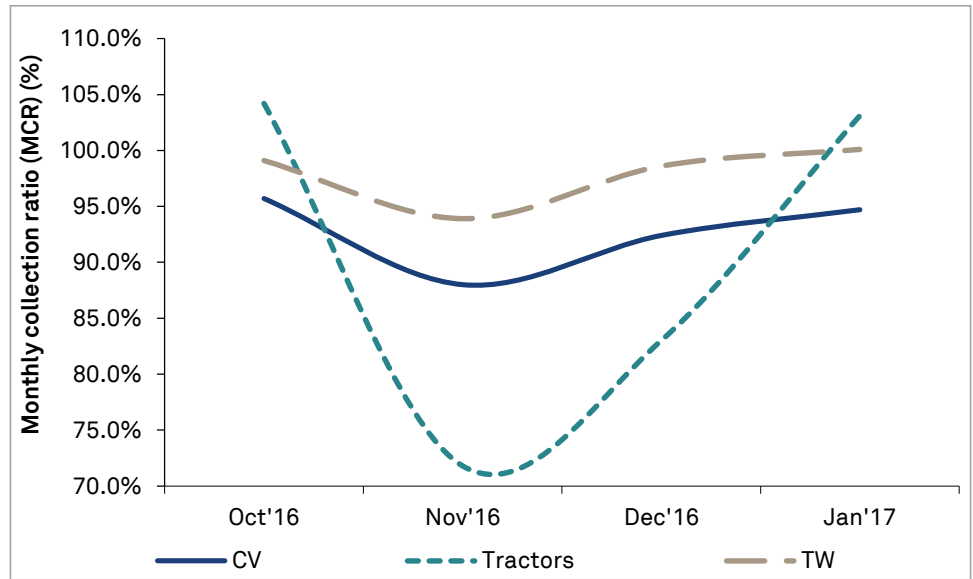
The impact has been severe in sectors which had higher proportion of cash-based transactions (real estate and gold and jewellery). On the other hand, automotive manufacturers/ component makers have seen moderation in demand growth momentum. Organised retailers, after the initial blip in sales, have seen a gradual improvement with mix of consumer spending shifting to electronic mode from cash. Strong financial flexibility and parent support helped maintain the credit profiles of CRISIL-rated toll road operators.

The liquidity position of companies was adversely impacted by demonetisation. However, we have witnessed companies conserving liquidity by efficient inventory management and support from creditors. Large companies, which have had otherwise very stringent collection policies, eased the pressure by supporting smaller companies/distributors. With lower activity due to decline in demand and operations, the need for funds was also lower, which offset some stretch in working capital. Bank lines, though, were used in times of need. In addition, discretionary capital spending was deferred which made the outlook on capital structure relatively better.

An analysis of the rating actions after demonetisation shows that the credit ratio was 1.29 times for the period between November 9, 2016, and March 31, 2017, whereas it was 1.16 times between April 1, 2016, and November 8, 2017, indicating virtually no impact of demonetisation.

That it was a blip was reflected in the collections of securitised pools of vehicle loans rated by CRISIL. These pools saw a V-shaped recovery in January 2017 collections, rebounding to around 95% from around 85% in November 2016, virtually shrugging off demonetisation (*Chart 3*).

**Chart 3: Vehicle loan collections looking good again**



CRISIL estimates based on collection efficiency across CRISIL rated securitization pools

Source: CRISIL

Firms within consumption-linked sectors continue to show better credit quality despite moderation in demand due to demonetisation. This was supported by a favourable monsoon and implementation of the Seventh Pay Commission and One Rank One Pension (OROP) recommendations. However, investment-linked sectors such as real estate, construction and industrial machinery continue to be under pressure.

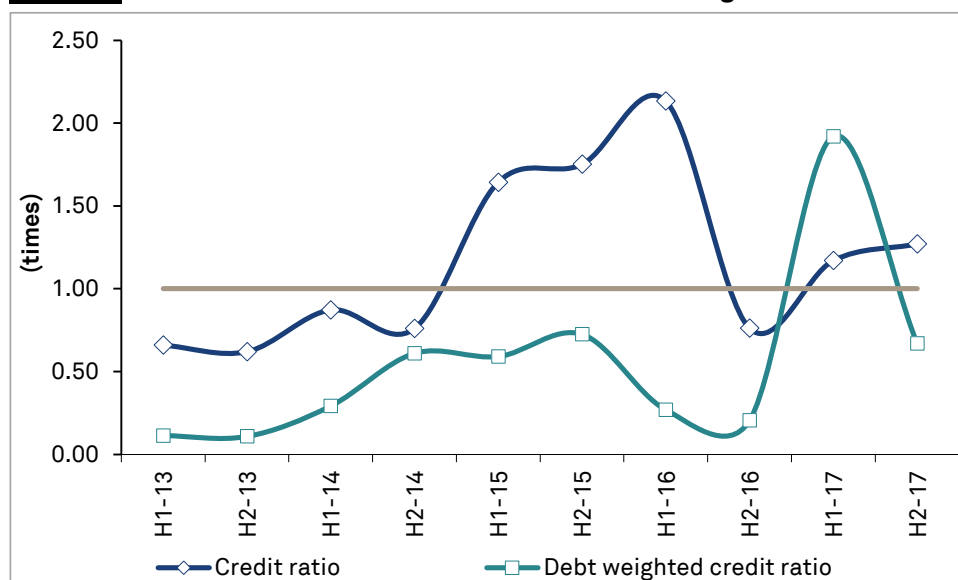
Here, it is imperative to note that these figures may not be reflective of the entire banking system since it does not include some major corporate houses with high indebtedness such as Essar, GVK, Jaypee and Videocon. CRISIL does not have ratings on most of them and hence, our analysis does not incorporate that.

## Credit trends on expected lines in the second half

In CRISIL's October 2016 Ratings Round-Up titled '*Credit quality recovers, sustainability key*', we had expected the overall credit ratio to stay above 1 in the near term led by a rural leg-up to private consumption following a normal monsoon. But debt downgrades by value was expected to be more in the second half because of continuing pressure on the investment-linked sectors.

Though we had not at the time foreseen demonetisation, our expectations have held true for the second half of fiscal 2017 since impact of demonetisation seems mostly transient. The credit ratio for the second half of fiscal 2017 was around 1.27 times compared with 1.17 times in the first half of fiscal 2017. Debt-weighted credit ratio for the second half of fiscal 2017 was 0.67 time as against 1.92 times in the first half of fiscal 2017 (*Chart 4a*).

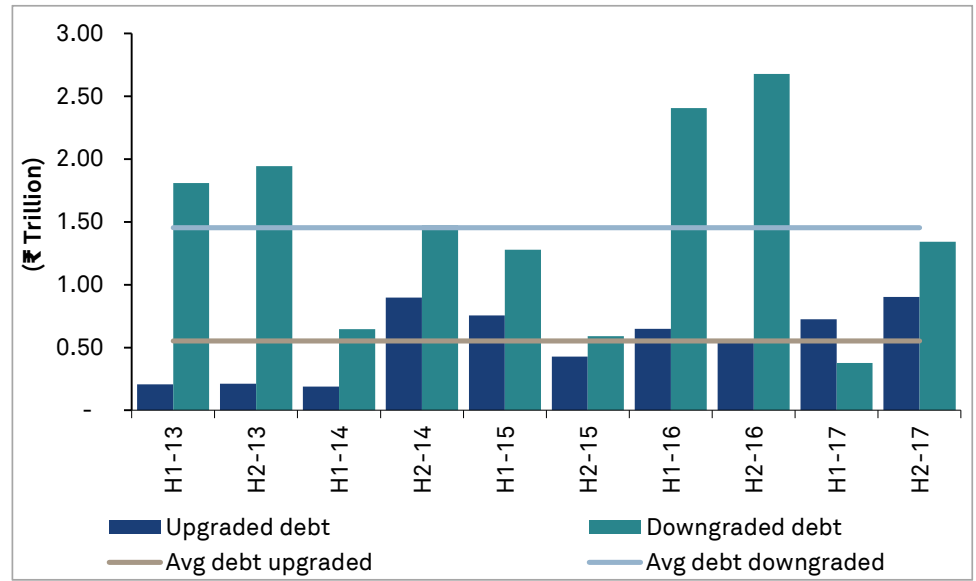
**Chart 4a: Semi-annual trends in credit ratio and debt-weighted credit ratio**



Source: CRISIL

Value of debt downgraded increased from around Rs 0.4 trillion in the first half of fiscal 2017 to Rs 1.3 trillion in the second half of fiscal 2017 – lower than the average debt downgraded in the last 10 semi-annual periods of about Rs 1.5 trillion. On the other hand, value of debt upgraded increased from around Rs 0.7 trillion in the first half of fiscal 2017 to Rs 0.9 trillion in the second half of fiscal 2017 – higher than the average debt upgraded in the last 10 semi-annual periods of about Rs 0.6 trillion (*Chart 4b*).

**Chart 4b: Semi-annual trends in debt upgrades and downgrades**



Source: CRISIL

## Upgrade and downgrade rates moderated

**9.4%**  
upgrade rate

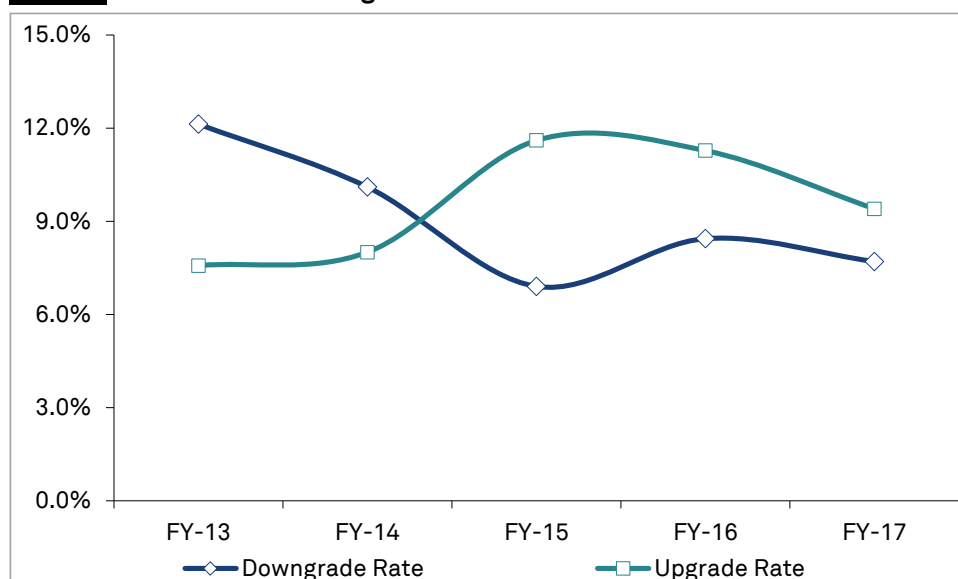
**7.7%**  
downgrade rate

CRISIL's rating portfolio for fiscal 2017 witnessed 1,335 upgrades compared with 1,092 downgrades. The upgrade rate moderated from 11.3% in fiscal 2016 to 9.4% in fiscal 2017, whereas the downgrade rate declined from 8.4% to 7.7% (*Chart 5*). This helped the credit ratio hold above 1 time in fiscal 2017 at 1.22 times – or quite similar to 1.29 times in fiscal 2016.

Consumption-linked sectors such as auto ancillaries, packaging and agricultural products continued to drive upgrades, whereas downgrades continued to be dominated in investment-linked sectors such as real-estate, metals and construction and industrial machinery.

While the pace of upgrades moderated in consumption-linked sectors after demonetisation, the pace of downgrades declined in the metals sector due to stabilisation in prices, policy support in the form of anti-dumping duty and minimum import price, and a gradual improvement in demand from affordable housing, urban infrastructure and railways.

**Chart 5: The swerves in rating action**



Source: CRISIL

## Financial profile was the catalyst

**50%** rating actions financial profile driven

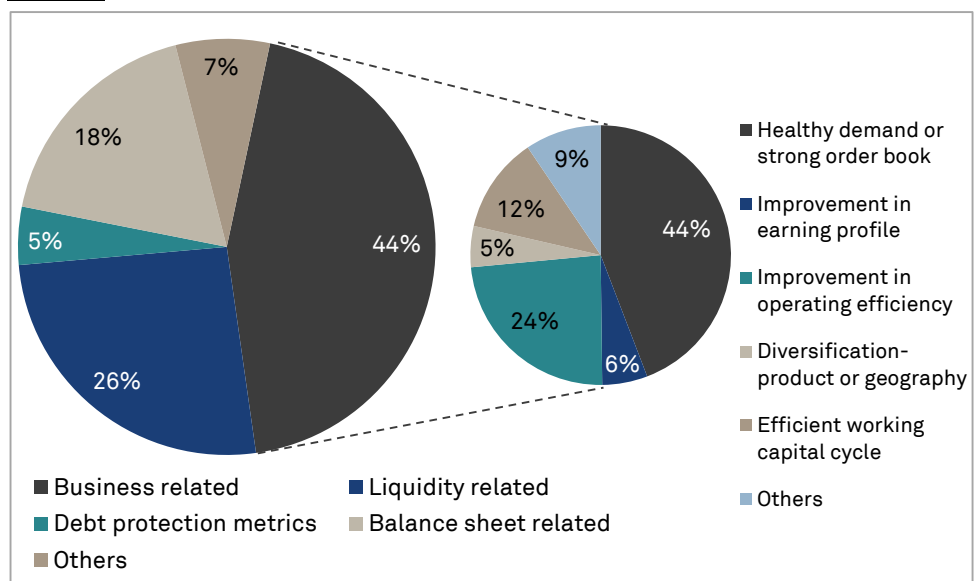
**75%** rating actions in BB or lower categories

Almost half of the rating actions were because of financial profile reasons. Almost three-fourth of the rating actions in fiscal 2017 was in the sub-investment grade ('BB' or lower category).

The financial reasons for upgrade were better liquidity and improvement in capital structure, while the business reasons were mainly robust demand growth and improvement in operating margins (*Chart 6*).

Consumption-linked sectors saw maximum upgrades led by sectors such as auto ancillaries, agricultural products and packaging.

**Chart 6: Reasons for upgrade**

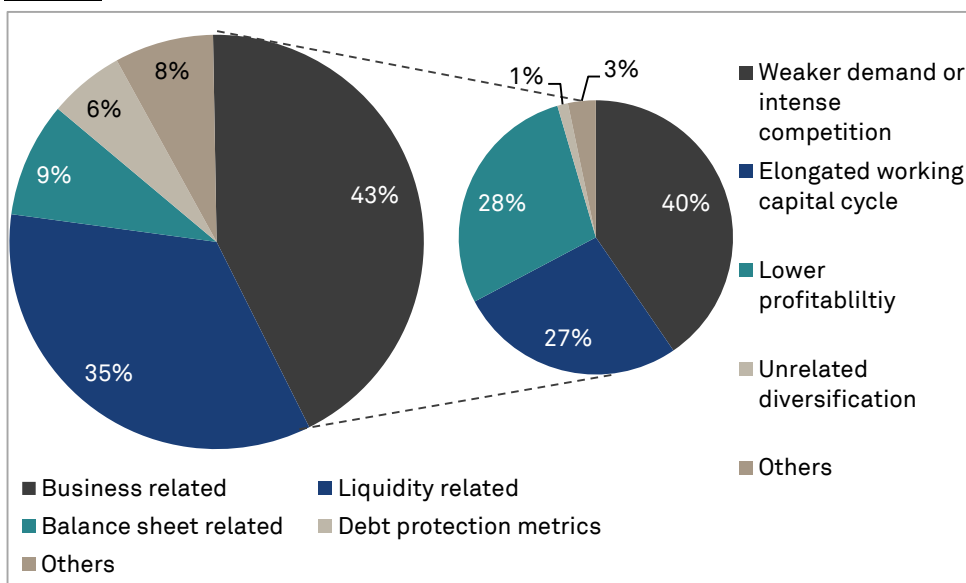


Source: CRISIL

On the other hand, liquidity was the key financial reason for more than a third of the downgrades, stemming from lower cash accrual and higher bank limit utilisation.

Weak demand, pressures on operating profitability, and elongated working capital cycle were the main business reasons for downgrades (*Chart 7*). Investment-linked sectors such as real estate, construction and industrial machinery accounted for most of the downgrades.

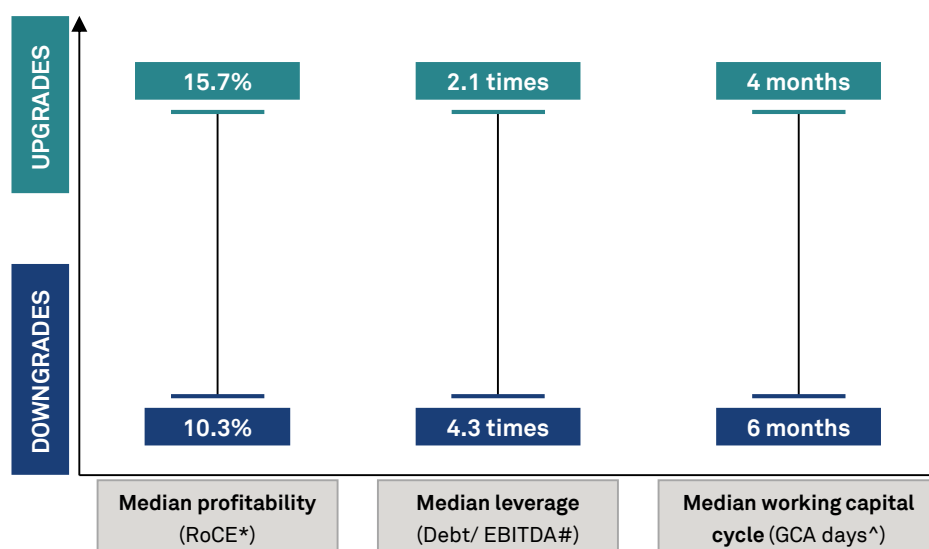
**Chart 7: Reasons for downgrades**



Source: CRISIL

Firms upgraded in fiscal 2017 continued to display distinctly better profile compared with those downgraded. Upgraded firms in general had higher profitability, lower indebtedness and better working capital management. This is reflected in the wide gap between the median of these parameters for upgraded and downgraded firms (Chart 8).

**Chart 8: Median financials of firms that witnessed rating actions**



\*RoCE: Return on capital employed

#EBITDA: Earnings before interest, depreciation and amortisation

^GCA: Gross current assets

Source: CRISIL

## Changes mostly of one notch

**~95% of rating actions were of low intensity**

**Only 9 actions were multi-notch**

Sharp and sudden rating actions (upgrades and downgrades) from higher rating categories ('A-' and above) are not desirable; investors expect them to have a high degree of stability. Sharp changes lead to huge cliffs (in terms of returns) for investors, leaving them with little scope to manage their exposure.

CRISIL's portfolio witnessed 172<sup>4</sup> rating actions in the 'A' and above categories out of a portfolio of 1,074 in these rating categories. Only 9<sup>5</sup> of these were multi-notch changes (high intensity), while the rest were all single notch (low intensity).

## Consumption sectors do well

**Apparel and luxury goods laggard among consumption-linked sectors**

**Construction and engg bucks trend in investment-linked sectors**

Despite demonetisation, consumption-linked sectors continued to witness more upgrades than downgrades. Favourable and well-spread monsoon, and the implementation of the Seventh Pay Commission and the One Rank One Pension (OROP) recommendations augured well. However, demonetisation did act as a dampener towards the end of calendar 2016, especially for rural consumption. Among the consumption-linked sectors, apparel & luxury goods was an exception with more downgrades than upgrades largely because of gold and jewellery retailers. These players, who were reeling under weak demand amid increased regulatory compliance, received another blow in the form of demonetisation, which led to deferral of discretionary purchases.

Downgrades continued to be driven by companies from investment-linked sectors. However, the pace of downgrades declined over fiscal 2016, especially compared with the second half of fiscal 2016 due to less intense pressure on commodity-linked sectors, particularly metals, following stabilisation in prices and policy support (anti-dumping duty and minimum import price were levied).

Sectors such as construction, industrial machinery, and real estate, which were already stressed, continued to witness sluggish demand, stretch in working capital cycle, weak liquidity and pressure on profitability. The real estate sector,

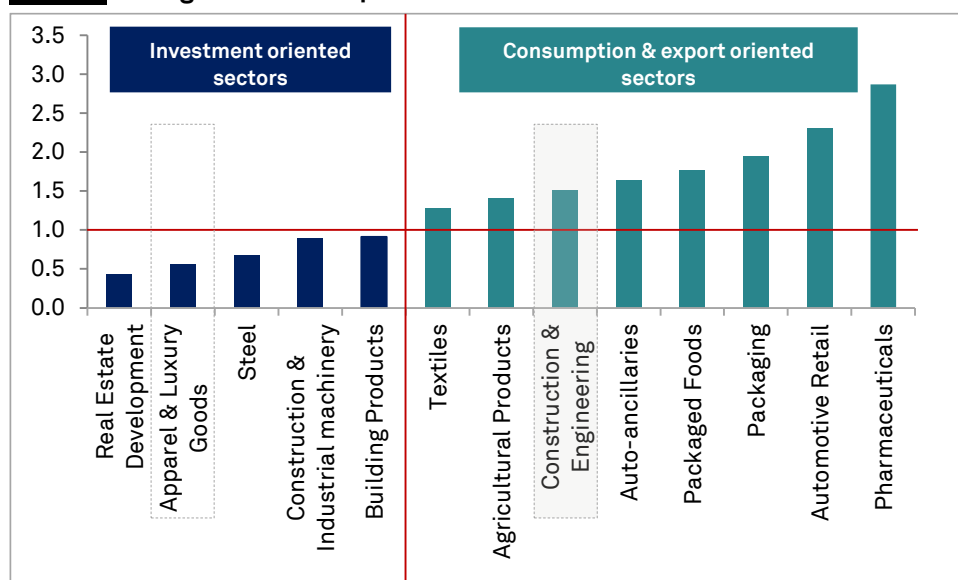
<sup>4</sup> This is based on number of instances of rating actions and could include multiple ratings actions of the same company

<sup>5</sup> Excludes ratings placed on 'Rating Watch', which is used to convey to investors that the rating is being monitored for certain critical events and that additional information is awaited. This helps reduce the possibility of any surprise for the investors.

mainly the residential segment, was among the most impacted by demonetisation because of the higher cash-based transactions in the sector. Among investment-linked sectors, construction & engineering was an exception, logging more upgrades than downgrades due to strong order book growth (particularly among the EPC, or engineering, construction and procurement, players catering to the roads and affordable housing sectors) because of government push.

India’s major trade destinations – the US and Europe – struggled through the first half of calendar 2016 showing signs of recovery only towards the end. Nevertheless, exports of engineering goods, gems & jewellery, and organic and inorganic chemicals grew. Companies in the pharmaceutical and auto ancillaries segments also saw better exports.

**Chart 9: Rating actions on top industries**



Source: CRISIL

Auto ancillaries and automotive retail had seen almost two upgrades for every downgrade because of healthy demand, new product launches and diversification – both by customer and geography. Auto ancillaries saw more orders from the two-wheeler and heavy commercial vehicle segments.

The pharmaceuticals sector continued to witness more upgrades than downgrades driven by robust demand both in domestic and export markets. Companies have been able to increase their presence in the regulated markets, especially the US, and continued to diversify by adding new molecules.

The textiles sector had a mixed bag with majority of the upgrades seen among cotton ginning players driven by better cotton prices. Readymade garment makers, largely catering to the domestic market, also saw improvement in credit

profiles on better demand. However, cotton spinners saw more downgrades driven by lower increase in yarn realisation compared with the cost of cotton.

The construction and industrial machinery sector continued to witness more downgrades driven by sluggish demand in end-use industries, which continued to delay capex spends resulting in lower-than-expected revenue growth and decline in profitability. Upgrades were mainly driven by better liquidity and improvement in capital structure, which was mainly on account of infusion of funds from promoters.

The real estate sector witnessed maximum defaults. Credit quality remained under pressure with the sector witnessing more than 2 downgrades for every upgrade. Upgrades were limited to firms that had projects nearing completion and had seen traction in sales, or where there was equity infusion or unsecured loans that improved liquidity. Weak demand, especially in the residential segment, project delays, and slippages in existing collections drove downgrades.

The steel sector witnessed more downgrades than upgrades driven by lower-than-expected revenue growth and high indebtedness. However, the pace of upgrades improved through fiscal 2017 as prices stabilised and gradually started to recover. Policy support in the form of minimum import price and anti-dumping duty also helped.

## India Inc performance

**8% revenue  
growth foreseen**

**Profitability seen  
rangebound**

CRISIL's analysis of the financial performance of 355<sup>6</sup> firms in the CNX 500 index for the third quarter of fiscal 2017 indicates that demonetisation had constrained revenue growth and moderated profitability. Revenue growth was flat at 1.6% on a sequential basis, while net profit margin (NPM) moderated to 9% against 10% in the second quarter.

In the third quarter of fiscal 2017,

- Consumption-linked sectors such as automobile manufacturers and ancillaries, consumer durables saw moderation in demand. Additionally, telecom companies saw pressure on profitability because of intense competition.
- Investment-linked sectors such as real estate, which was already facing stress due to weak demand, also felt the pain of demonetisation.
- Export-linked sectors such as pharmaceuticals and IT services witnessed stability in revenues, though profitability had slightly moderated.
- Lastly, stabilisation in commodity prices aided the improvement in top-line and profitability of primary producers of metal and energy commodities.

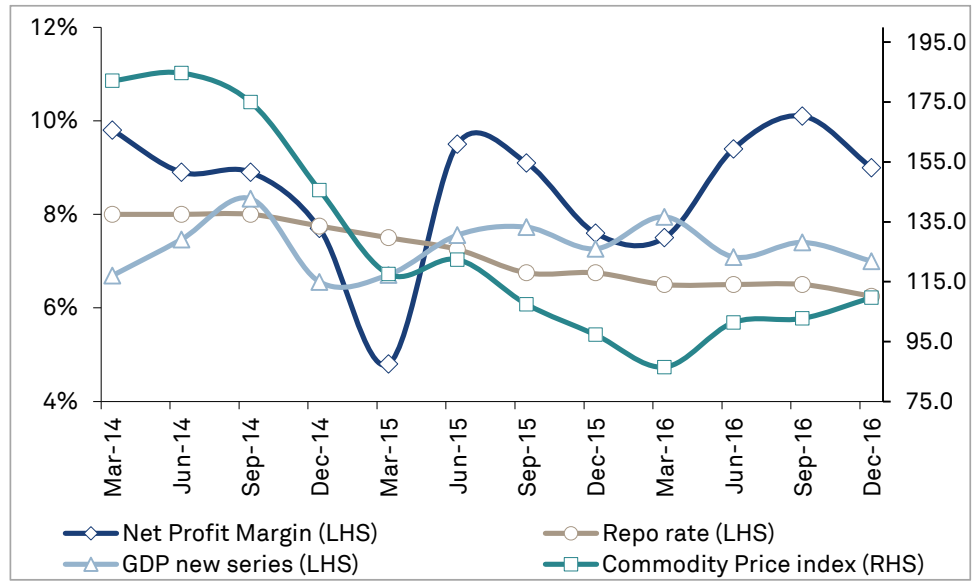
CRISIL expects corporate revenue to grow at around 8% in fiscal 2018 on a year-on-year basis. Revival in sectors such as construction equipment, EPC (on improving order book); metals (especially non-ferrous) and sugar - on better prices, are expected to aid the improvement.

Corporate profitability is seen range-bound in fiscal 2018 after some improvement in fiscal 2017 as commodity prices are expected to increase, albeit gradually, increasing input costs.

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<sup>6</sup> These listed companies have reported results for the quarter ended Dec 31 2016, and have remained in the S&P CNX 500 for the past 12 quarters. Oil refining and marketing companies have been excluded because their reported numbers would have skewed the sample. Companies from the financial sector have also been excluded.

**Chart 10: Net profit margin and commodity prices**



Source: CRISIL

## Exports improve, but risks persist

### 3.4% IMF forecast on global growth in 2017

### 3.6% IMF forecast on global growth 2018

On January 16, 2016, the International Money Fund (IMF) estimated world trade volume to grow just 1.9% for the calendar year due to weak global growth and low commodity prices. These factors impacted the first half of 2016, but the second half, especially towards the end, saw an improvement in global demand, with economic conditions in the US and Europe showing signs of improvement.

After a lacklustre 2016, IMF expects the world to grow at a modest pace of 3.4% and 3.6% in 2017 and 2018, respectively, with world trade volume seen up 3.8% and 4.1%, respectively.

S&P Global Ratings expects India's largest export markets – the US, the UK and the Eurozone (ex-UK) to grow at 2.3%, 1.7% and 1.6%, respectively, in 2017, and 2.4%, 1.6% and 1.5%, respectively, in 2018. The figure for the UK and Eurozone has been revised upwards by 70 and 20 basis points, respectively, since our last publication.

Policy uncertainties and protectionist moves will be the risks to these estimates.

**Table 1: GDP growth rates**

Countries	2014	2015	2016(f)	2017(f)	2018 (f)
Eurozone (ex-UK)	1.2	1.9	1.7	1.6	1.5
UK	3.1	2.2	1.8	1.7	1.6
US	2.4	2.6	1.6	2.3	2.4
China	7.3	6.9	6.7*	6.4	6.1

\*Actual

Source: S&P Global Ratings

India's exports (based on data till February 2017) in fiscal 2017 has returned to low single-digit growth, after witnessing high double-digit decline in fiscal 2016.

Oil exports, which had declined by almost 50% in fiscal 2016, fell around 4% in fiscal 2017. The decline in non-oil exports was almost across the board in fiscal 2016. In fiscal 2017, engineering goods, gems & jewellery, and organic and inorganic chemicals sectors bettered themselves.

CRISIL expects non-oil exports to continue to do well in fiscal 2018 based on improving outlook in its major export markets.

**Credit growth to remain muted**

**Fiscal 2017 credit growth estimated at 5%-8%**

**Fiscal 2018 credit growth expected at 8%-10%**

Bank credit growth in the first half of fiscal 2017 was in line with fiscal 2016 at 9%-10%. Our expectations of a better second half was dented by the government's demonetisation move as it severely hurt retail credit demand. In addition, weak working capital demand (as companies adjusted operations to face the impact of demonetisation) and the continuing delay in pick-up of investment cycle further lowered credit demand. Bank credit growth slowed sharply to around 4%-5% in the second half fiscal 2017.

Money raised through commercial paper (CP), which had increased by about 43% in the first half of fiscal 2017, slowed to ~4% in the second half (Feb-end 2017) on lower demand for funds and narrowing differential between bank and capital market rates. That's because of transmission of past rate cuts and the shift to the marginal cost of funds-based lending rate (MCLR).

Since January 2015, the RBI has reduced its policy (repo) rate by 175 bps. This fiscal, transmission has improved a touch because of demonetisation-driven liquidity, and successive reduction in small savings interest rates by the government. So far during the fiscal, MCLR has fallen by 107 bps.

The Monetary Policy Committee (MPC) of the RBI, at its review meeting on February 8, 2017, kept the policy repo rate unchanged at 6.25%, and moved its stance from 'accommodative' to 'neutral'. That could very well mark the end of the current rate cut cycle – at least in the near term.

A 'neutral' stance gives the RBI the flexibility to move in any direction as macro conditions permit. The shift reflects the central bank's decision to exert caution on inflation given the medium-term inflation target of 4%.

CRISIL expects bank credit growth to remain muted at 8-10% in fiscal 2018 (estimated at 5%-8% in fiscal 2017), led by low industrial capital expenditure and continued refinancing through bond markets. Retail sector growth will continue to show higher growth as consumption demand gradually picks up and cost of borrowing falls.

**Table 2: Trends in industrial activity and fund mobilisation**

Quarter ended	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Bank credit growth (%)	13.1	9.7	10.5	9.5	9.3	9.6	11.1	11.3	9.4	10.4	5.1 <sup>@</sup>	4.4 <sup>*</sup>
Repo rate (%)	8.00	8.00	8.00	7.50	7.25	6.75	6.75	6.75	6.50	6.50	6.25	6.25
Credit spreads (%) #	0.4	0.4	0.4	0.4	0.5	0.4	0.4	0.6	0.6	0.4	0.7	0.7 <sup>**</sup>
ECB mobilised (\$ billion)	6.5	4.2	6.9	7.5	6.3	5.5	8.3	4.3	2.7	6.0	4.2	2.8 <sup>^^</sup>
Equity mobilised (Rs billion) <sup>β</sup>	197.1	238.0	89.1	164.4	304.9	157.1	317.9	112.7	247.6	220.3	259.7	124.0 <sup>^^</sup>
IIP growth (% YoY)	4.5	1.3	2.0	3.3	3.3	4.8	1.7	0.2	0.7	-0.9	1.1	0.8 <sup>@@</sup>
GDP growth (% YoY) <sup>^</sup>	7.5	8.3	6.6	6.7	7.6	7.7	7.3	7.7	7.1	7.5	7.4	6.9 <sup>^</sup>

<sup>@</sup>Updated as on Jan. 6, 2017; <sup>\*</sup>Updated as on Mar 17, 2017; <sup>\*\*</sup>Updated as on Feb 2017; #AAA spread over 10 year G-sec; <sup>^</sup> As per new GDP series; <sup>^^</sup> Updated till Feb 2017; <sup>@@</sup> Updated till Jan 2017

Source: CRISIL

## Profit pressure in banking

## Slippages to decline in fiscal 2018

## GNPAs to remain at elevated levels

Indian banks, with sizeable exposure to corporates and MSMEs, will continue to be impacted by the weak credit quality of borrowers from investment-linked sectors in the near term. However, the pace of fresh addition to NPAs will reduce in fiscal 2018. The various structuring tools (mainly 5:25, SDR and S4A) provided by the RBI for banks to manage their asset quality should help progressively reduce slippages.

However, recoveries and upgrades will continue to lag as concerns on the pace of recoveries from large corporate accounts remain, with reduction in NPAs largely supported by high write-offs. In fiscal 2016 and for the nine months ended December 31, 2016, share of write-offs in overall reductions for public sector banks increased to 45% against 37% in the previous 5 years. NPAs from top 3 vulnerable sectors constitute close to 25% of total banking sector NPAs.

Absolute gross NPAs and weak assets<sup>7</sup> for the sector are expected to touch about Rs 7.8 lakh crore and Rs 8.7 lakh crore, respectively by March 31, 2017. Further, with credit growth expected to be around 5%-8% for fiscal 2017, gross NPAs and weak asset ratios could hover ~9.5% and 10.5%, respectively, by March 31, 2017. With the rise in gross NPAs, as more of stressed and restructured assets slip to NPAs, gross NPA ratio is expected to rise to 10.6%, or about Rs 9.5 lakh crore, by March 31, 2018. With private investments not

<sup>7</sup> Weak assets is CRISIL's measure for assessing banks' asset quality. Weak assets = Gross NPAs + 40% of outstanding restructured standard advances (excluding state power utilities) + 75% of security receipts + 15% of loans structured under 5:25 (flexible structuring of long-term project loans).

expected to pick up momentum, credit growth in fiscal 2018 is expected to be not greater than 10%. Asset quality will also be driven by implications of demonetisation, if any, on the MSME and agriculture sectors, which will be visible in the first half of the fiscal 2018.

With the ageing of NPAs, the provisioning requirements of banks is expected to increase gradually over the medium term. Provisioning cover for NPAs is expected to rise to around 46-47% by March 2018 from 41% as of June 2016.

As provisioning requirements increase, weak public sector banks will continue to report losses next fiscal. Also, with interest rates not expected to soften materially going forward, treasury profits seen in fiscal 2017 may not be available to bolster profitability of these banks. In CRISIL's opinion, with pressure on net interest margins and low credit growth, provisioning costs for PSBs could exceed pre-provisioning profits in fiscals 2017 and 2018. However, private sector banks, especially the retail focused ones, have been able to weather the asset quality storm well with gross NPAs below 3%. Overall private sector banks should register gross NPAs of 4-5% at the end of fiscal 2017 compared with 12%-13% for public sector banks.

Moderation in credit growth, however, has helped improve capital ratios of banks and partly offset the impact of weak profitability. Also, banks have been able to raise non-equity Tier I capital over the past 2 years, which has helped them meet Basel III capital norms. Banks have raised around Rs 49,000 crore of Tier I bonds till date under Basel III. CRISIL believes that with lower-than-expected growth over the medium term and improved market acceptance for non-equity Tier I bonds (where coupon payment norms have been recently eased), the capital raising challenge for public sector banks should be smaller than that envisaged earlier.

**Table 3: The weak assets matrix**

	Mar-14	Mar-15	Mar-16	Mar-17 (P)	Mar-18 (P)
Gross NPAs (as a percentage of gross advances)	3.8%	4.3%	7.5%	9.5%	10.6%
RSA (as a percentage of gross advances)	5.3%	5.7%	3.5%	2.5%	1.8%
Weak assets (as a percentage of gross advances)	5.1%	6.2%	9.1%	10.5%	11.6%
Gross advances (Rs trillion)	68.7	75.3	81.1	84.3	90.2

Source: CRISIL

## Outlook

CRISIL expects upgrades to outnumber downgrades in the near term driven by improving domestic consumption demand, firm commodity prices, increased government spending –especially in segments such as roads, affordable housing, urban infrastructure, railways – stable macros, impact of sustained structural reforms, improving capital structure, and lower interest costs.

Several debt-intensive sectors such as metals (especially non-ferrous) and sugar are expected to see improvement in their credit quality because of better prices. That should bolster the value of debt likely to be upgraded.

While these trends is expected to lead to lower slippages to NPAs in fiscal 2018, the underpinnings in the banking sector remain fragile. CRISIL expects the stock of gross NPAs to continue to rise and remain at elevated levels. Recoveries are seen subdued given that sizeable NPAs are in highly leveraged companies with stretched cash flows. Further, several investment-linked sectors such as real estate and capital goods continue to see headwinds. Microfinance institutions (MFIs) are also seeing a build-up in stress. Additionally, many major corporate houses with high indebtedness would remain stressed.

Finally, while credit quality is expected to improve in fiscal 2018, its pace will hinge on:

- Firmness and stability in commodity prices, especially metals
- Progress on deleveraging corporate balance sheets through asset sales
- Another spell of normal monsoon and no further slowdown in India's major trade destinations
- Pick-up in investment cycle, especially for investment-linked sectors
- Effective implementation of reforms, especially GST
- Ability of SMEs to scale up and formalise
- Absence of any sharp swings in the rupee versus the dollar

## Key reasons for rating actions, and sectoral credit quality outlook

### Automotive components



#### Upgrades

Upgrades were mainly due to improved volume growth – specifically in the passenger vehicle (PV), two-wheeler and tractor segments – additions of new products/customers, efficient working capital management and prudent spending. This improved profitability and financial risk profile.

#### Downgrades

Downgrades were largely because of delay in successful ramp-up of operations/additional capacities, slowdown in commercial vehicle (CV) sales and exports, coupled with weak liquidity. Liquidity was under pressure because of stretch in working capital, lower-than-expected cash accrual and high debt repayments over the near term for some of companies.

### Drive turning smoother for automotive component suppliers

Domestic automotive components industry is expected to grow at 8-10% in fiscal 2018 compared with 7-8% estimated in fiscal 2017 driven by steady demand from original equipment manufacturers (OEMs) and the aftermarket segment, and gradual recovery in export demand.

Growth in fiscal 2017 was impacted by demonetisation-driven demand contraction. However, the impact was short-lived with demand gradually recovering from January 2017.

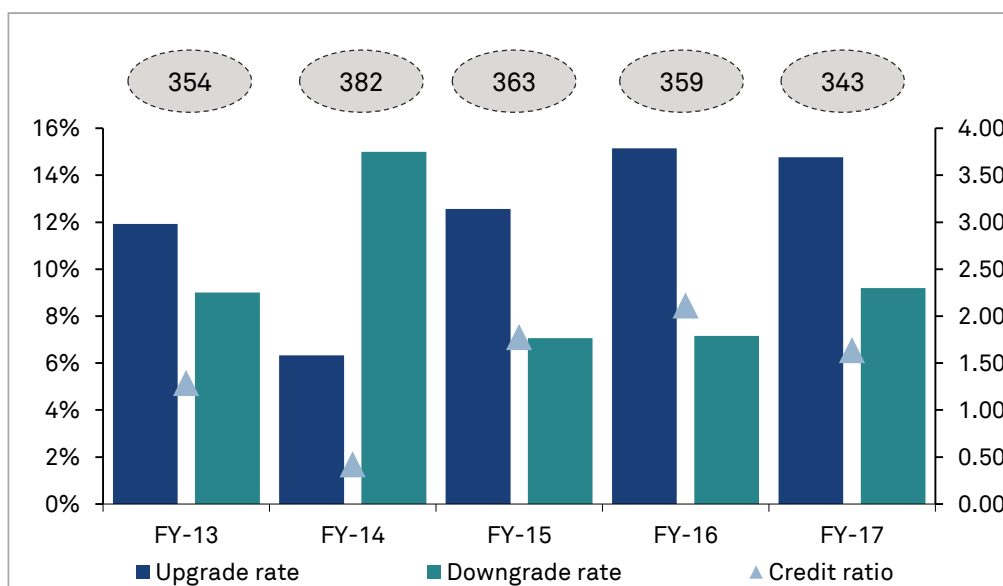
The growth in domestic OEM demand, which contributes to almost two-third of total revenue in this sector, will be steady at 9-11% in fiscal 2018 on the back of improving sales from PVs and two-wheelers. Lower interest rate and new model launches in addition to some pent-up demand will drive this growth even as we expect some increase in vehicle prices and fuel cost. CV sales, however, will be sluggish owing to waning replacement demand and slower growth in industrial production. Further, tractor sales will be dependent on favourable monsoon.

On the exports front, demand is expected to recover but will remain low at 0-3% in fiscal 2018, due to plateauing car sales in the US, moderate recovery in heavy duty trucks in the US, and slower growth in Europe and China (US and Europe account for about 50% of auto component exports from India).

Profitability of component manufacturers is expected to remain stable despite 2-4% rise in raw material prices expected in fiscal 2018. That's because the sector is fairly mature and the component manufacturers have strong relationship with the original equipment manufacturers (OEM) enabling them to pass on volatility in input prices to the OEMs.

Further, the component manufacturers have demonstrated financial prudence over the years by deferring capital expenditure (capex) plans and efficiently managing working capital requirements. As a result, credit profiles have remained stable.

Over the medium term, with new emerging technologies and increasing regulations on emission norms and safety systems, demand for complex automotive component will increase. That will lead to sizeable capex to upgrade capacities. But despite a restart in capital investments, we expect the credit risk profiles to remain fairly stable owing to the cushion available in balance sheets. Nevertheless, the funding mix of increasing capex and exposure to vulnerable demand segments such as CVs will be the key monitorables.



\*Number inside bubble is the outstanding ratings for the sector for the respective period.

Source: CRISIL

## Basmati rice



### Upgrades

The upgrades were mainly of companies that expanded capacity and diversified into new geographies and added customers. Higher capacity utilisation led to better operating margins. That, coupled with efficient working capital management, improved financial risk profiles.

### Downgrades

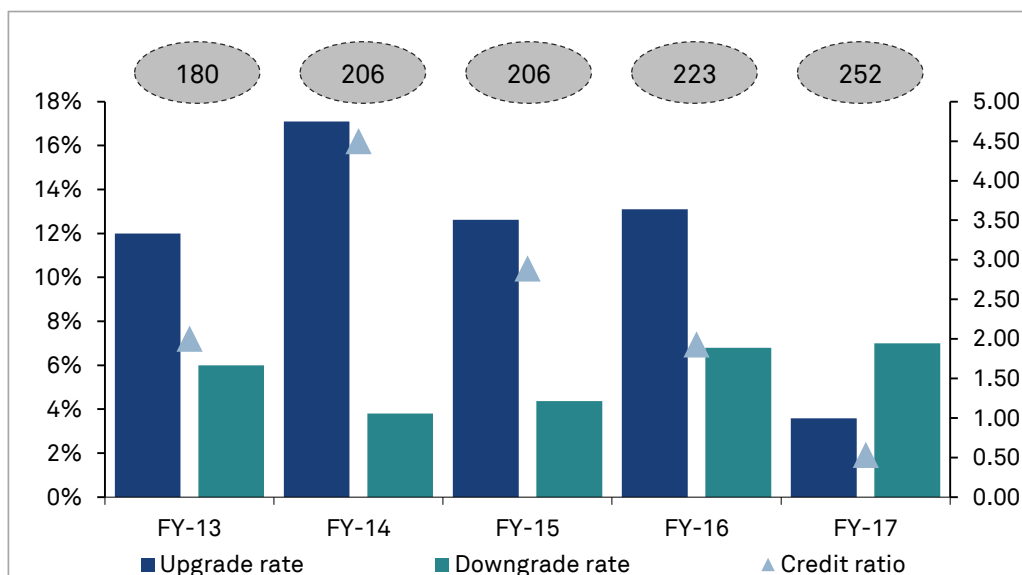
Downgrades were mainly attributable to decline in revenue and realisations and also due to large inventory holdings leading to elongated working capital management. Furthermore, around two-third of the downgrades were to the default category.

### **Weak export demand and lower realisations to keep basmati rice players under pressure**

India exported 4.04 million tonne (MT) of basmati rice (valued at Rs 22,714 crore) in fiscal 2016, which was an increase of 9.1% by volume and a decline of 17.7% by value (3.7 MT and Rs 27,500 crore in fiscal 2015). Clearly, the decline in sales realisations had hit basmati rice exporters hard during fiscal 2016. These challenges continued in April 2016–January 2017 as India exported basmati rice valued at Rs 17,200 crore during the period. The reasons for continuing challenges in rice exports are suppressed sales realisations and lower exports (by volume) to major importing countries.

While lower paddy prices have helped exporters in lowering their purchase price, it also accelerated the deterioration in credit risk profiles of highly leveraged exporters of basmati rice which were carrying high-cost inventory from the previous season. CRISIL expects credit risk profiles of basmati rice exporters to continue to show moderate-to-high stress. Export volumes to Iran also reduced in fiscal 2017 for the second straight year. Exports of Indian basmati variety to China are insignificant in fiscal 2017 and will not influence the credit profiles of Indian basmati rice exporters in the near term.

CRISIL expects that India's overall rice production to be higher, but realisations from basmati rice exports and export volume will remain marginally weaker because of sluggish demand abroad.



\*Number inside bubble is the outstanding ratings for the sector for the respective period.

Source: CRISIL

## Construction & engineering



### Upgrades

CRISIL witnessed a spate of upgrades in the construction and engineering space, mainly EPC players, due to healthy order book growth on increased government spending on roads and power transmission. This increased cash accruals and improved gearing ratios.

### Downgrades

Downgrades were mainly driven by lower-than-expected revenue growth and weak liquidity. Intense competition and project delays had mainly caused the revenue decline, whereas stretch in receivables had led to weak liquidity. The median working capital cycle for downgraded firms was 9 months compared with 5 months for upgraded firms. Almost one-fourth of the downgrades were to the default category.

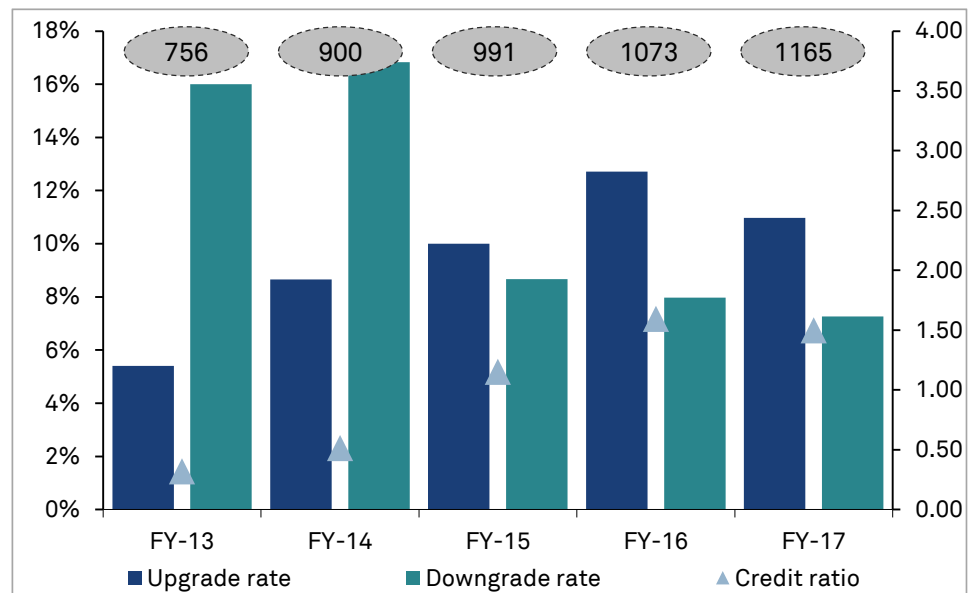
### EPC players gain from rising government spending

Increased government spending and slew of reforms to improve financial flexibility led to turnaround in performance in the EPC segment. Despite large companies remaining stressed because of past aggression and leveraged balance sheets, those with relatively better working capital management and capital structure have been scaling-up businesses over the past three years. These companies, which are primarily mid-sized, are expected to sustain healthy revenue-growth momentum over the medium term supported by large unexecuted order book. The strong growth in their revenue is complemented by steady profitability given their conservative bidding for projects and sharp focus on order execution.

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Order execution is spread across key infrastructure sectors such as project management consultancy (primarily for housing sector), construction of roads and railways, implementation of power transmission and distribution projects and civil construction of buildings and factories. Budgetary allocation to construction activities such as roads (highways and rural roads), bridges, ports and affordable housing has increased for fiscal 2018 over last year. That, in turn, is expected to result in continued order inflow to EPC companies over the medium term.

Along with healthy revenue growth, these players have sustained their comfortable capital structure because of efficient working capital management, lower capex as well as support for BOT projects, which has resulted in lower dependence on external borrowings. This has translated into gradual improvement in their key credit metrics, including leverage and debt coverage indicators.



\*Number inside bubble is the outstanding ratings for the sector for the respective period.

Source: CRISIL

## Packaging



### Upgrades

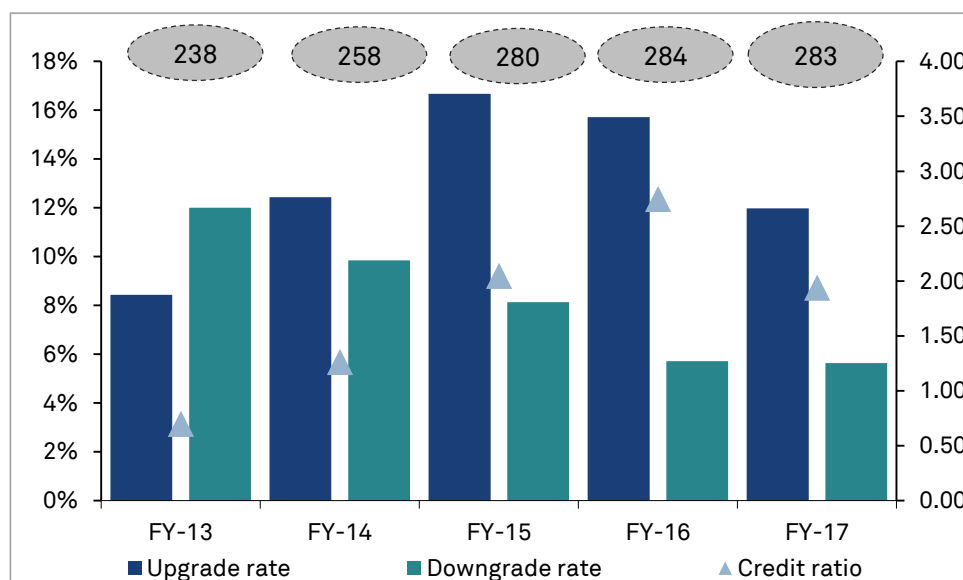
Around 60% of the upgrades were because of improvement in business risk: rising demand, increased capacity utilisation, and diverse customer profile, along with improving mix of high-margin product leading to better operating margins. Controlled working capital management and capital expenditure ensured that financial risk profile was sustained.

### Downgrades

More than 50% of the downgrades were because of a decline in realisations due to a fall in the prices of polymers, small order book, or un-anticipated deterioration in counter-party risk in the form of stretched receivables from specific end-user industries, ultimately impacting the overall liquidity profile.

Though average realisation has not seen any upside amid flattish polymer prices, steadily growing demand, especially for flexible packaging, will continue to drive overall growth of the Indian packaging industry to ~12-15% average over the medium term. Increasing demand in FMCG, pharmaceuticals, processed foods, beverages, personal healthcare, and beauty products, will bolster growth of the flexible packaging segment, outpacing rigid packaging. Rising disposable incomes, urbanisation, changing tastes and preferences, and favourable demographics will remain the key demand drivers.

Profitability, which took a hit last fiscal amid high volatility in crude prices and foreign exchange rates, is expected to remain steady this fiscal with polymer prices stable tangoing crude prices. With large capacities being added, capacity utilisation and receivables management with exposure to sectors such as construction will remain the key monitorable. Companies with diversified customer base will be better placed.



\*Number inside bubble is the outstanding ratings for the sector for the respective period.

Source: CRISIL

## Packaged foods



### Upgrades

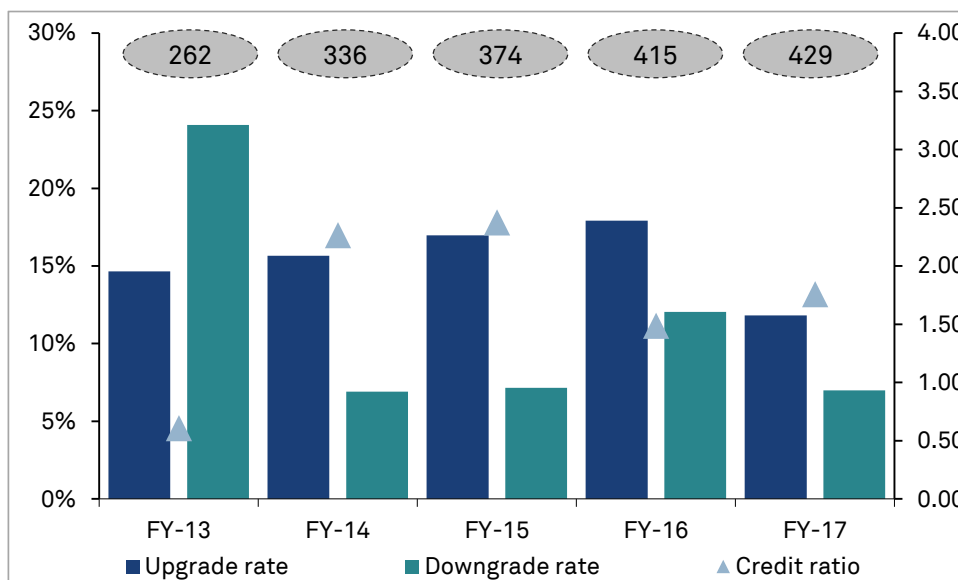
More than 60% of the upgrades were attributable to improvement in business risk profiles. This was driven by volume growth as companies expanded to new geographies, added customers, improved utilisation and operating margins. This also led to higher cash accruals.

### Downgrades

More than half of the downgrades were driven by lower-than-expected revenue growth and weak liquidity. Furthermore, more than one-third of the downgrades were to default category.

### Policies remain the key monitorable for credit outlook

India's buffalo meat export revenues saw de-growth of 8.9% in fiscal 2016, in line with CRISIL's expectations. That came after two consecutive years of good growth (52% in fiscal 2014 and 10.7% in 2015), and was driven by a sharp fall in the Brazilian real against the US dollar, which made India's exports uncompetitive. India had overtaken Brazil as the largest exporter of beef in the world in calendar 2014. Between April 2016 and January 2017, buffalo meat exports degrew 2.4% in volume terms because of competition and the impact of demonetisation on meat procurement. Uttar Pradesh contributes to about half of India's buffalo meat exports and the state government is in the process of framing its policy on continuation of illegal slaughter houses and mechanised abattoirs. The policy will have a decisive impact on the sector's outlook and growth prospects. The credit risk profiles of players in the sector will depend on their ability to manage the working capital cycle through better operating efficiencies and market expansion initiatives. Russia and China are two important destinations having the potential for consumption of Indian buffalo meat. However, the government's focus on promoting this category of exports remains to be seen.



\*Number inside bubble is the outstanding ratings for the sector for the respective period.

Source: CRISIL

## Pharmaceuticals



### Upgrades

Upgrades were driven by steady demand – both domestic and exports – and profitability, resulting in improvement in the financial risk profiles. Around half of the upgrades was in the bulk drugs segment, which saw companies adding new molecules and increasing share in regulated markets.

### Downgrades

Most of the downgrades were in the non-investment grade category mainly attributable to weak liquidity and stretch in working capital cycle.

### Pharmaceuticals to see modest growth in fiscal 2018

The Indian pharmaceuticals sector is expected to grow at around 10-11.5% over the medium term backed by gradual but steady recovery in growth both in the domestic and export segments. The drivers of growth in the domestic market continue to be rising healthcare demand (especially for chronic care drugs), and increasing market penetration. That, coupled with base effect of lower realisations after high price interventions in recent years by the government, will also drive the growth. The risk of further pricing interventions remains, and the impact would vary across companies.

Recovery in export growth will be driven by higher ANDA<sup>8</sup> approvals and new product launches in regulated markets. While there has been increasing scrutiny by the US Food and Drug Administration (FDA), several players have been

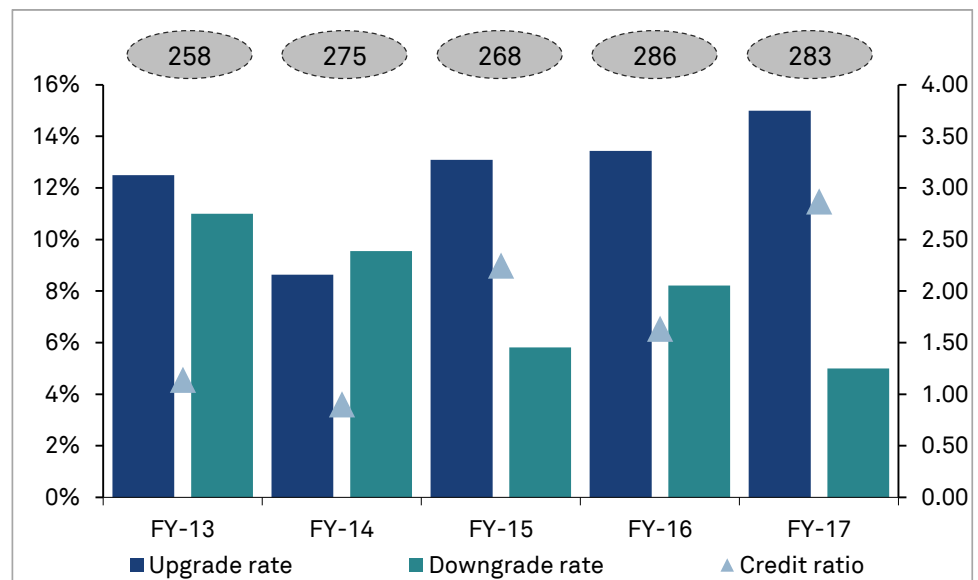
<sup>8</sup> ANDA: Abbreviated New Drug Application

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carrying out remediation measures. Thus, we expect that those receiving regulatory clearances will see accelerating sales growth in the US over the medium term. However, this will be offset by pricing pressure due to supply chain consolidation, relatively fewer drugs going off patent, and increasing competition resulting in price erosion in the US. Overall, both exports and domestic formulations businesses are expected to recover from the setbacks of fiscal 2017.

The profitability of large formulators is likely to be healthy, though not at the high levels of the past, despite pricing interventions in the domestic market, increasing pricing pressures in the US and the EU, and rising compliance costs. Moreover, their research and development (R&D) expenses have also increased due to growing focus on differentiated generics and biosimilars. Conversely, the profitability of small and mid-sized formulators may witness improvement on the back of increased product and geographic diversification.

On the other hand for bulk drug manufacturers, we see growth at low double digits driven by increasing exports, especially in low-competition specialty products segment. But profitability expansion will be limited because of pricing pressure in the commoditised bulk drug categories given high Chinese competition and recovery of crude oil prices that could push up inputs cost.



\*Number inside bubble is the outstanding ratings for the sector for the respective period.

Source: CRISIL

## Real estate



### Upgrades

Upgrades were mainly driven by timely completion of projects and infusion of equity or unsecured funds from promoters, thereby improving liquidity and better debt service coverage metrics.

### Downgrades

Downgrades were mainly on account of sluggish demand, specifically in residential sector, project delays, slippages in existing collections, which also resulted in weak liquidity. Half of the total downgrades were to the default category.

### A hard reality check

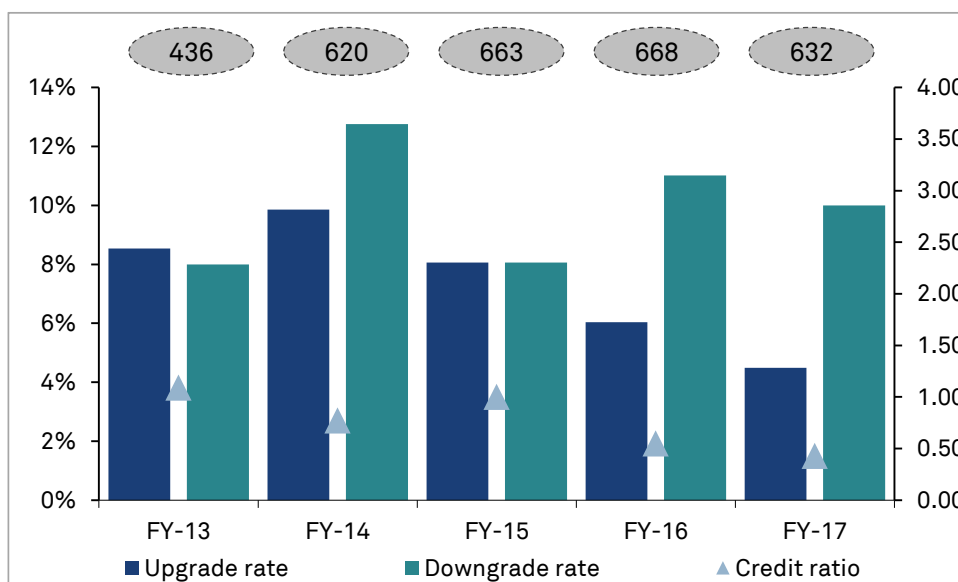
The residential real estate sector has been facing headwinds for the past few years, primarily due to weak demand. This is reflected in declining sales velocity and subdued cash collections (both in fiscal 2016 and in the first half of fiscal 2017), fewer project launches, and large unsold inventories. Demonetisation has further impacted demand, especially in secondary market transactions and in micro markets with high investor concentration. Demand remains muted as buyers adopt a 'wait and watch' mode. Developers are likely to face funding challenges in the short-to-medium term, which could further delay ongoing projects. In addition to high reliance on non-bank funding, developers with a diversified portfolio are further leveraging commercial assets and resorting to sale of assets to tide over funds crunch. Over the long term, however, demonetisation, along with the implementation of The Real Estate (Regulation and Development) Act, 2016, should improve transparency and support the industry's growth and end users' confidence.

Demand is expected to remain muted in the near term and recover gradually over the medium term, with sustained improvement in macroeconomic conditions. In the affordable housing segment, demand is expected to stay strong given the relatively low ticket sizes and impetus from the government's 'Housing for All' programme. The allocation under the Pradhan Mantri Awas Yojana received a special allocation of Rs 29,000 crore for fiscal 2018, an increase of 38.7% over previous fiscal.

In commercial real estate, vacancies have reduced steadily on the back of increasing absorption over the last couple of years and limited additional supplies. Rentals have also been rising steadily. Occupancy is expected to stay healthy driven by improving business conditions.

The retail sector continues to witness strong traction given the healthy performance of large and established retail malls across the country. Large foreign institutional investors have been scouting for good properties across metros, and large and small cities, given the strong growth potential over the medium term.

Real estate investment trusts (REITs) are emerging as an attractive avenue for large developers and investors with income-generating commercial and retail assets, especially after recent clarifications and amendments. This will enable them to monetise assets, while lowering their cost of capital and also diversify their funding source.



\*Number inside bubble is the outstanding ratings for the sector for the respective period.

Source: CRISIL

## Steel



### Upgrades

Around half of the upgrades were driven by business reasons: higher revenues following better domestic demand and realisations; diversification into new geographies and products; and, improvement in operating margins on increased capacity utilisation. This also led to higher cash accrual and better gearing ratios.

### Downgrades

Downgrades were driven by lower-than-expected revenue growth and declining operating margins due to increasing competition and lower cost efficiencies. Furthermore, stretch in working capital cycle and weak operating performance led to lower-than-expected cash accrual against debt obligations. More than one-fourth of the downgrades were to the default category.

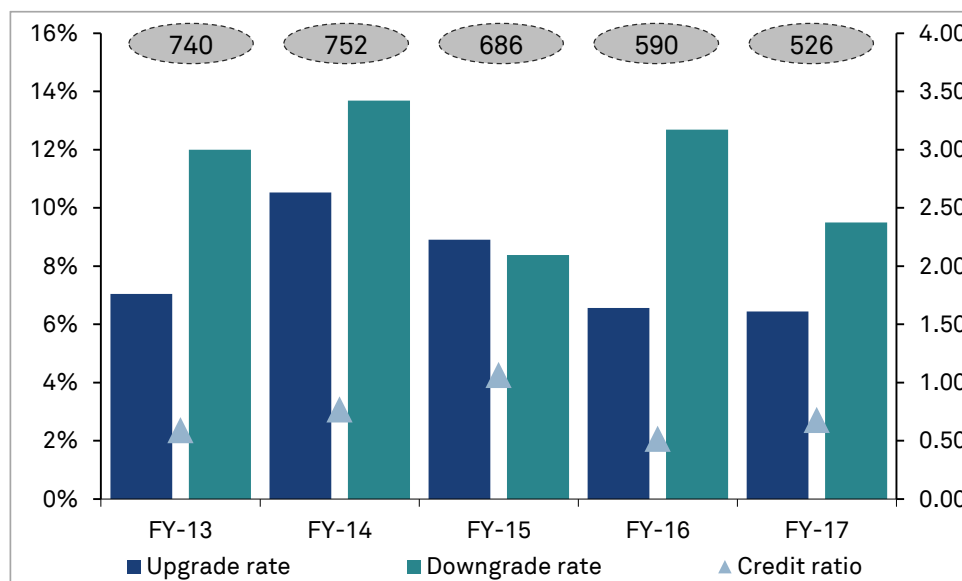
### Improvement in prices augurs well

Demand for steel globally is expected to remain stable at lower levels in fiscal 2018. That's because of subdued demand from China, which accounts for almost half of world consumption. A structural shift from investment-driven growth to consumption-driven growth in China precludes significant growth in steel demand, despite a lower base and incentives to the automobile and real estate sectors. Overall global demand will, however, be supported by steady growth

from the US automobile, energy, and construction sectors. Thus, we expect global demand to grow at a subdued pace of 0-2% over the medium term.

Domestic demand is expected to increase at 4.5-5.5% in fiscal 2018 driven by the government's push to infrastructure development and affordable housing. Furthermore, import curbs and the recent spike in coking coal prices have improved realisations. Domestic steel prices are expected to increase another 2-4% in fiscal 2018 on account of demand and elevated coking coal prices.

Profitability of steel players is expected to improve marginally in fiscal 2018, after witnessing a healthy improvement in fiscal 2017, driven by better capacity utilisation. That's because of a gradual pick-up in demand, decline in imports due to recent increase in global steel prices, and fewer capacity addition. The credit quality of players will, however, remain constrained because of elevated debt levels.



\*Number inside bubble is the outstanding ratings for the sector for the respective period.

Source: CRISIL

## Textiles



### Upgrades

Upgrades were mainly witnessed among cotton ginners due to higher cotton prices and readymade garments makers due to better demand and higher operating margins.

### Downgrades

Most of the downgrades were driven by lower-than-expected cash accrual and weak liquidity. More than a third of the downgrades were to the default category.

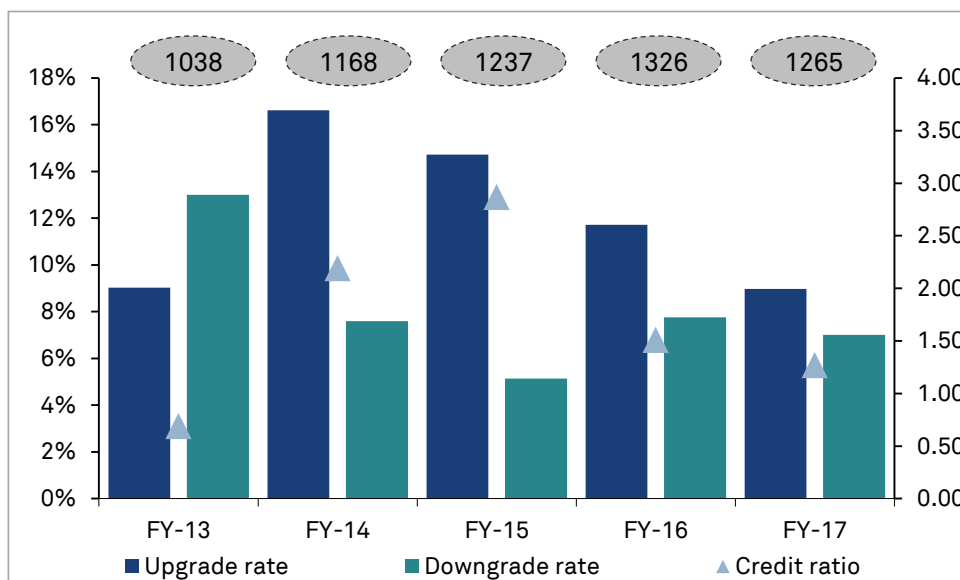
### **RMG credit profiles to be better than cotton spinning**

Readymade garment (RMG) exports are projected to grow at a moderate 5-7% compounded annual growth rate (CAGR) in dollar terms over the medium term. The outlook for RMG exporters look marginally better for fiscal 2018 compared with fiscal 2017 as proportion of exports to non-traditional market continue to improve and clothing consumption in US market recovers. However, lower cost competitiveness compared with Bangladesh and Vietnam, and the absence of any free trade agreement, continue to limit the long-term export growth potential of Indian players.

Profitability for exporters is expected to improve marginally in 2018 supported by way of enhanced duty drawback coverage and employee provident fund scheme reforms extended under the new textile policy even as raw material prices remain flat.

As the domestic markets rebound from demonetisation, revenues for domestic garment manufacturers are expected to grow in fiscal 2018 as against fiscal 2017. Rising income levels and increasing retail penetration in India augurs well for long-term growth potential of domestic manufacturers. But, profitability expansion will be limited, given the intense competition and the expected discounting on inventory built-up following lower sales in the second half of fiscal 2017.

Demand for cotton yarn is expected to remain sluggish on the back of weak yarn exports driven by declining demand from China, partially offset by an anticipated improvement in derived demand. While cotton prices are likely to be stable in fiscal 2018 given the normal production in cotton season 2017, weak demand and excess yarn capacities would result in subdued capacity utilisation for spinners thereby exerting pressure on profitability. Further, the proposed GST regime will have a marginally negative impact on the sector as the tax rates for spinners are expected to be higher than the current effective indirect tax rates. Sluggish yarn demand coupled with withdrawal of TUFs (Technology Upgradation Fund Scheme) incentive for spinners will restrict capacity additions over the medium term.



\*Number inside bubble is the outstanding ratings for the sector for the respective period.

Source: CRISIL

## Non-banking financial companies



### Upgrades

Most of the upgrades were driven by relatively better asset quality and capitalisation.

### Downgrades

Downgrades in this sector were mainly on account of deterioration in earnings profile. There was one downgrade due to downgrade of the parent firm.

### Market share to continue to expand, capital position healthy

Non-banking finance companies (NBFCs) have steadily grown over the past few years and increased their share in the Indian financial services market. They are expected to continue to strengthen their market position supported by continued product diversification and improved funding ecosystem. New businesses are expected to constitute 40% of NBFC advances by fiscal 2019 compared with 16% in fiscal 2016.

Vehicle loans and gold loans are expected to pick up in the coming years after witnessing a period of low growth during fiscal 2012-2016. However, there is a very stiff competition that the segment faces, particularly in retail asset classes, from banks. Subdued demand for corporate credit has led banks to focus on the retail segment.

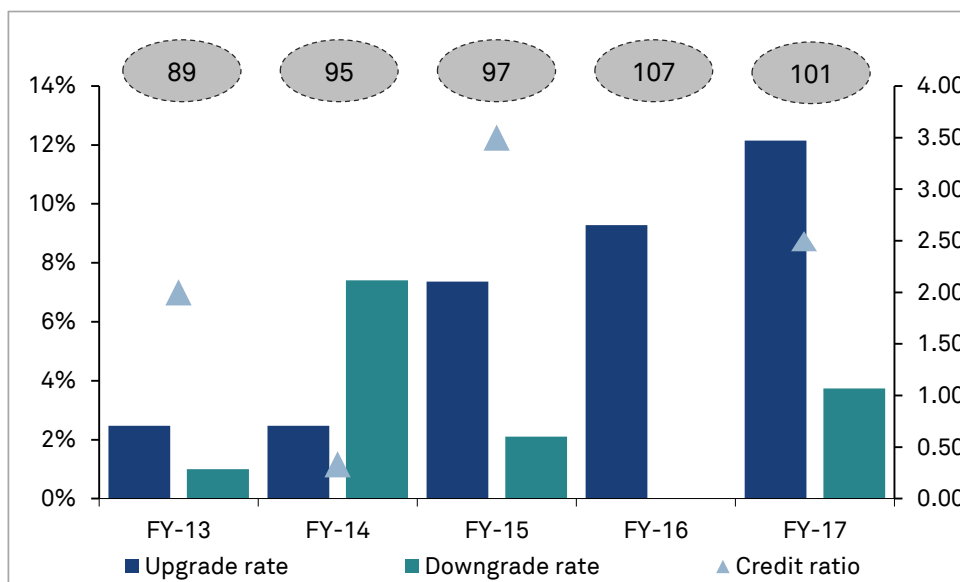
Demonetisation, however, has led to new set of challenges for the sector. While business has been impacted across the board, financing of certain asset classes which have higher dependence on cash such as tractors, two-wheelers, commercial vehicles and MSMEs, have been relatively more affected.

While collection efficiencies are showing a V-shaped recovery, around 1.5 months of overdues (November and December 2016) are expected to drag for another 9-12 months, which may lead to additional credit costs.

Overall, the underlying asset quality performance of NBFCs is expected to remain stable and improve gradually over the next few quarters. However, reported gross non-performing assets (NPAs) will increase on account of transition to more stringent asset classification norms.

Nevertheless, the comfortable capital position coupled with increased investor interest in NBFCs provides respite. NBFCs have raised around Rs 26,000 crore of equity capital over the past five years. Further, newer instruments like masala bonds and pick up in securitisation transactions are expected to strengthen the funding profile, reducing the gap between banks and NBFCs.

CRISIL believes that technology and operational innovations will be the next game changers in the financing space. Early adoption of best practices in this space will enable NBFCs deal with rising competition from banks which are increasingly looking closely at the retail financing space to grow in light of the dormant corporate credit market.



\*Number inside bubble is the outstanding ratings for the sector for the respective period.

Note: There were no downgrades in fiscal 2016

Source: CRISIL

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We are India's foremost provider of ratings, data, research, analytics and solutions. A strong track record of growth, culture of innovation and global footprint sets us apart. We have delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers. CRISIL's businesses operate from India, the US, the UK, Argentina, Poland, China, Hong Kong and Singapore.

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**Last updated: April 2016**

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