Research

CRISIL Q4 FY17 Results Outlook

April 2017

Corporate profitability: Review and Outlook

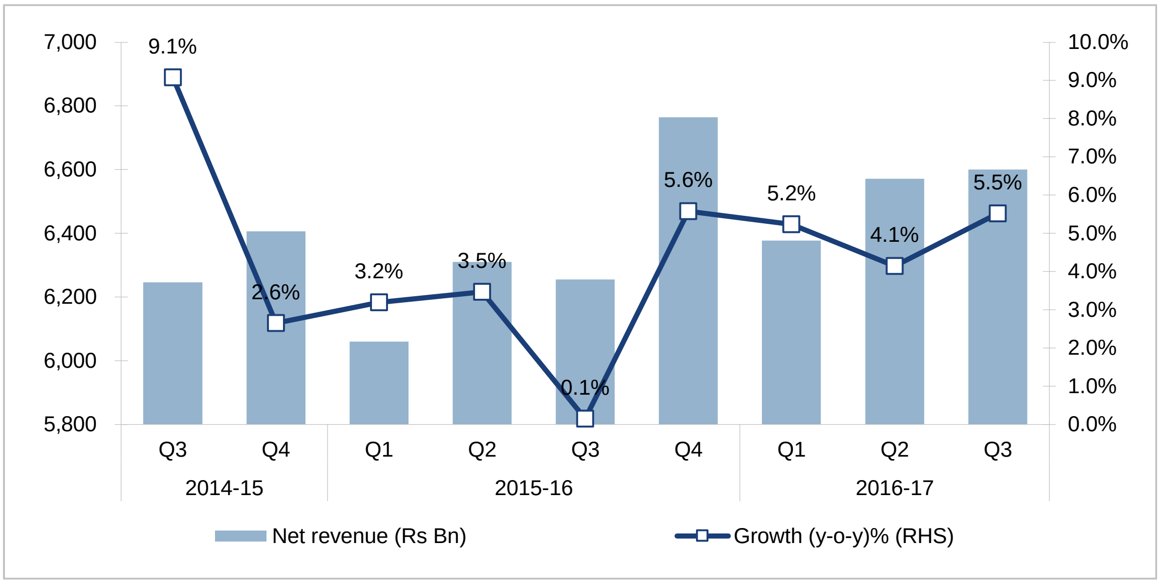
Results review (October – December 2016)

Growth remained tepid, but revived in Q3 2016-17 despite demonetisation

Revenue growth continued to remain tepid at 5.5% in Q3 2016-17, but was higher than that witnessed in the first two quarters of this fiscal. This was despite impact of demonetisation playing out during the quarter. An analysis of the performance of 390 companies across 50 sectors (excluding financial services and oil) shows that growth in Q3 2016-17 was primarily driven by healthy performance of export-linked sectors – IT services and pharma, in particular – which grew at 9.7%. Moreover, continued government spending led to investment-linked sectors including capital goods, steel and aluminium witnessing robust growth of 11.5%. However, other investment-linked sectors such as construction and cement, fared poorly due to liquidity crunch on account of demonetisation and high inventory.

Government stimulus in the form of 7th Pay Commission and one rank one pension (OROP) payout as well as a favourable monsoon were expected to turn the consumption tide, post a tepid H1 2016-17. Robust festive season offtake across companies fairly established this trend. However, demonetisation limited volume growth, leading to moderate growth in the quarter. Consumer discretionary and consumer staples sectors particularly felt the pinch of demonetisation, growing at a tepid 1.6% and 3.9% respectively in Q3 2016-17.

Industry's revenue, year-on-year basis



Source: CRISIL Research

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A snapshot of key sectors

Revenue Growth (y-o-y)	Q3FY15	Q4FY15	Q1FY16	Q2FY16	Q3FY16	Q4FY16	Q1FY17	Q2FY17	Q3FY17
Overall Industry	**9.1%**	**2.6%**	**3.2%**	**3.5%**	**0.1%**	**5.6%**	**5.2%**	**4.1%**	**5.5%**
Key sectors	**9.0%**	**2.6%**	**3.6%**	**5.1%**	**0.8%**	**7.7%**	**6.3%**	**5.5%**	**6.6%**
Automobiles	9.9%	8.6%	11.2%	10.6%	12.5%	15.3%	9.8%	11.0%	2.0%
IT services	11.4%	9.4%	14.6%	15.2%	13.0%	17.1%	15.1%	9.7%	9.3%
Power	8.7%	-2.8%	2.8%	13.9%	2.3%	9.8%	4.5%	0.8%	1.7%
Steel products	1.2%	-7.2%	-8.2%	-11.3%	-17.5%	-4.2%	-2.6%	6.6%	27.4%
Telecom services	8.7%	7.1%	5.8%	6.0%	4.9%	7.7%	6.0%	3.1%	-4.5%
Pharmaceuticals	22.1%	18.4%	24.3%	10.2%	7.0%	15.6%	8.7%	8.2%	10.3%
FMCG	23.3%	15.7%	10.5%	8.2%	-1.9%	3.3%	7.0%	7.9%	1.9%

Note: **Key sectors** include Airline services, Aluminium, Automobiles, Auto components, Capital Goods, Cement, Chemicals, Construction, FMCG, Housing, IT services, Media & Entertainment, Natural gas, Pharmaceuticals, Power, Retail, Steel products, Sugar, Telecom services, Textiles and Tyres; **Overall industry** covers key sectors and other sectors (Automotive castings, Ceramic Tiles, Chlor Alkalies, Coal, Coffee, Distillers and breweries, Edible oil, Educational services, Ferro Alloys, Fertilisers, Gems and jewellery, Hotels, Hospitals, ITeS, Material handling, Oilfield equipment, Paper, Ports, Power cables and conductors, Power transformers, Roads and highway, Shipping, Steel Intermediates, Steel pipes, Tea, Transmission towers and Telecom towers)

Source: CRISIL Research

Key segments that supported revenue growth in Q3 2016-17 were:

- **Steel products:** In Q3 2016-17, revenue of companies in this sector grew 27.4% on-year, propelled by moderate growth in domestic steel demand and spike in exports. This revenue growth was also aided by rise in steel prices, which recovered by over 21% in domestic market.
- **IT services:** IT services sector continued surging at 9.3%, driven by volume growth. Rupee depreciation of 2.5% y-o-y against USD during the quarter also supported revenue growth. However, continued pressure on billing rates in traditional services slightly subdued blended billing rate.
- **Pharma:** The sector recorded 10.3% revenue growth on-year, driven by large formulation players who grew robustly at 11.6%. Cipla, Lupin and Glenmark registered strong growth in US markets. Demonetisation did not impact domestic market, with several companies like Lupin, Cipla and Torrent Pharma recording double-digit growth.
- **FMCG:** Fast-moving consumer goods sector bore the brunt of the demonetization move by the government with volumes of most players falling. However, rise in both realisations and exports cushioned players and the sector witnessed on-year revenue growth of 1.9%.
- **Power–** Power sector recorded lower growth than the industry average. Revenue of power generation companies remained flat due to lower generation amidst feeble demand. Higher revenue growth from the power transmission business led to overall rise in revenues from power business.
- **Automobile**: The automobile sector posted 2% on-year growth, mainly because of surge in cars and utility vehicles (UV) segment (12.3% on-year growth led by robust volume growth). However, two-wheelers' net revenues dropped 8% on-year, mainly due to ~9% fall in total sales volumes owing to demonetisation. Revenue of domestic commercial vehicle (CV) manufacturers stepped up 3.5% on-year, mainly owing to 7.5% growth in sales volume, which was partially offset by 4% fall in realisation.
- **Telecom:** The sector witnessed 4.5% fall in total revenue, with drop in revenues of Idea Cellular and Bharti Airtel. Entry of Reliance JIO in the market exerted pricing pressure on players across the board.

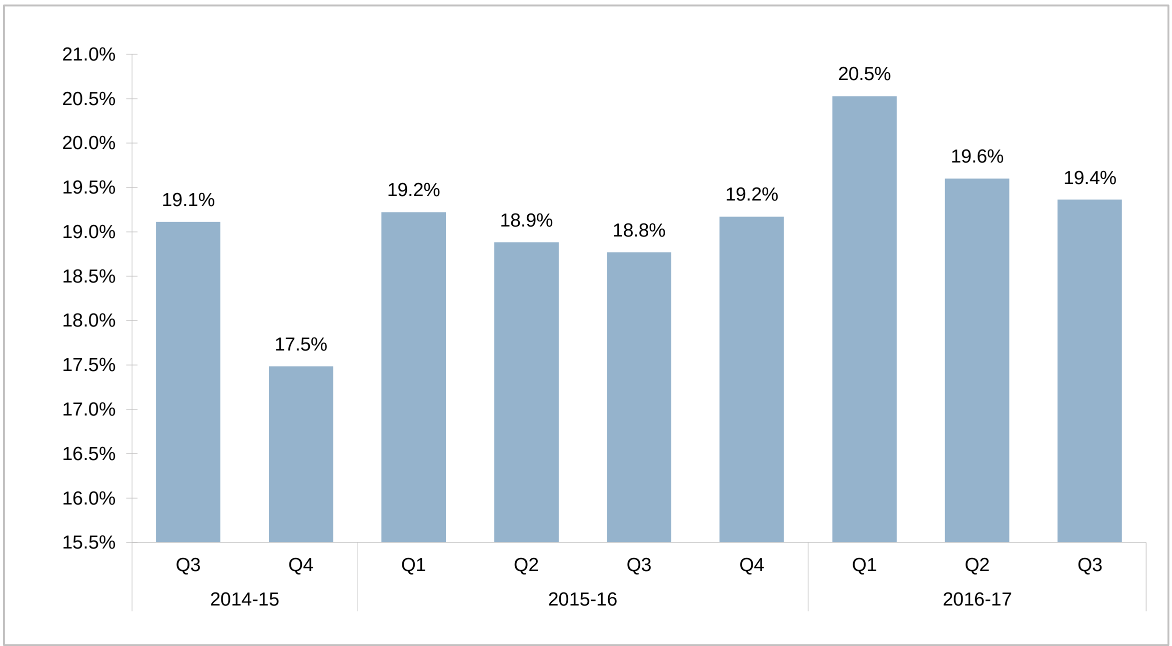
Improving realisations, higher volumes lead to operating margin expansion in Q3 2016-17

Demonetisation did not dent overall profitability of Indian industries; EBITDA margin expanded to 19.4% in Q3 2016-17, rising 60 bps on-year. Commodity-linked sectors – steel products and aluminium – chiefly drove profitability, as rising metal prices along with volume growth expanded operating margins by 1083 bps, on-year to 15.9%. In fact, excluding these sectors, operating margins would have declined marginally by 25 bps on-year.

On the other hand, margins of auto and FMCG sectors marginally contracted owing to fall in discretionary spending, because of liquidity issues. Rise in raw material costs coupled with fall in sales in the two-wheeler segment adversely impacted margins of the automobile industry. Even though raw material prices were higher across FMCG and fast-moving consumer durable (FMCD) companies, in comparison to H1 2016-17 as well as Q3 2015-16, several of the companies have managed to keep margin contraction under check by reducing overhead costs. Cut-throat competition precipitated price wars and margin contraction of the telecom sector.

In the same period, export-linked sectors as a whole witnessed margin contraction owing to pricing pressure.

Industry's EBITDA margin



Source: CRISIL Research

A snapshot of key sectors

EBITDA Margins	Q3FY15	Q4FY15	Q1FY16	Q2FY16	Q3FY16	Q4FY16	Q1FY17	Q2FY17	Q3FY17
Overall Industry	**19.1%**	**17.5%**	**19.2%**	**18.9%**	**18.8%**	**19.2%**	**20.5%**	**19.6%**	**19.4%**
Key sectors	**20.4%**	**18.3%**	**20.1%**	**20.1%**	**19.7%**	**20.4%**	**21.7%**	**21.2%**	**20.4%**
Automobiles	25.8%	12.4%	15.4%	13.4%	12.2%	12.6%	12.6%	13.2%	11.7%
IT services	25.3%	20.3%	23.7%	25.3%	24.9%	24.2%	23.8%	24.2%	24.5%
Power	29.3%	30.6%	31.1%	32.9%	34.0%	34.1%	33.3%	33.9%	32.7%
Steel products	15.9%	12.0%	12.4%	10.4%	5.2%	9.5%	17.4%	13.4%	15.9%
Telecom services	33.4%	35.1%	34.3%	33.7%	34.3%	35.8%	34.9%	35.1%	31.9%
Pharmaceuticals	22.5%	17.5%	24.9%	24.6%	23.4%	22.1%	24.2%	24.2%	24.0%
FMCG	23.1%	23.0%	23.1%	23.8%	24.9%	24.5%	24.0%	24.4%	24.6%

Source: CRISIL Research

On-year increase in EBITDA margin was driven by:

- **Steel products**: EBIDTA margins of these companies improved by 1,062 bps on-year, due to increased realisation (because of imposition of safeguards by government). Also, higher inventory of lower-cost coking coal (prices suddenly spiked in Q3 2016-17) aided margin expansion.
- **Pharmaceuticals**: The sector witnessed tepid margin expansion of 52 bps, driven by new launches from large formulation players like Cipla, Lupin and Glenmark Pharma. However, this was partially offset by remediation expenses and continued pricing pressure in the US and Europe. Moreover, weak performance by mid-sized and small-sized formulation players, owing to expiry of exclusivity period, shrank the segment's margin by 240 bps on-year.
- Other than these key segments, a marginal decline in operating margin was witnessed in sectors such as **automobiles** (due to increase in raw material cost), **IT services** (due to pressure on billing rates) and **FMCG** (due to fall in volume growth and rise in advertising expenses**).**

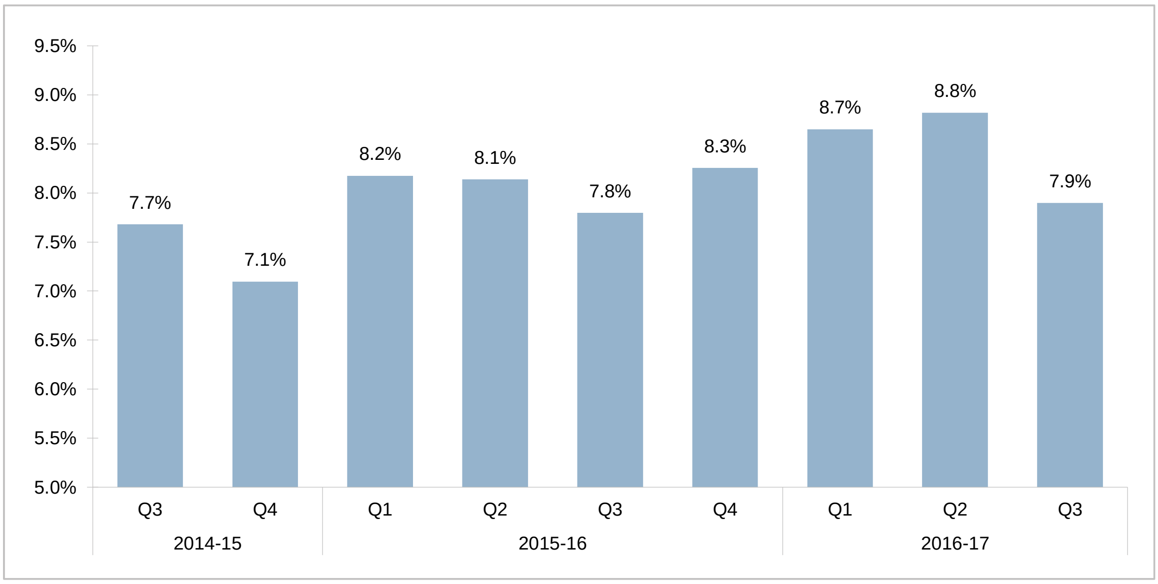
Higher interest expenses restrict net margin expansion in Q3 2016-17

Despite improving operating profitability, net profit margin of Indian industries remained stable at 7.9% as rising interest expenses and extraordinary losses limited net margin expansion.

In fact, margin pressure at the net level was witnessed across sectors. 70% of the sectors, which accounted for ~85% of total net profits, either saw contraction or flat margins.

Net profit margin of consumer discretionary sector narrowed significantly (213 bps) owing to decline in profitability of telecom, airline and automobile sectors. In fact, export-oriented sectors also experienced squeeze in net margins. On the other hand, margins of investment-linked sectors – capital goods and steel products – expanded substantially in line with their operating profitability.

Industry's net margin



Source: CRISIL Research

A snapshot of key sectors

Net Margins	Q3FY15	Q4FY15	Q1FY16	Q2FY16	Q3FY16	Q4FY16	Q1FY17	Q2FY17	Q3FY17
Overall Industry	**7.7%**	**7.1%**	**8.2%**	**8.1%**	**7.8%**	**8.3%**	**8.7%**	**8.8%**	**7.9%**
Key sectors	**8.0%**	**7.7%**	**8.5%**	**8.5%**	**8.0%**	**8.9%**	**9.0%**	**9.5%**	**8.1%**
Automobiles	5.9%	4.0%	8.4%	7.8%	7.1%	7.0%	8.4%	9.1%	6.6%
IT services	20.0%	16.9%	18.9%	19.0%	19.0%	19.0%	18.0%	18.1%	18.6%
Power	7.8%	11.1%	8.8%	10.6%	9.2%	10.1%	8.4%	10.2%	7.3%
Steel products	-1.3%	-0.9%	-3.2%	-6.5%	-10.1%	-5.4%	-3.4%	-4.8%	-2.3%
Telecom services	6.2%	5.5%	8.5%	6.3%	5.5%	5.1%	4.1%	3.3%	-1.6%
Pharmaceuticals	12.0%	12.3%	14.9%	16.0%	15.8%	13.3%	15.9%	15.7%	14.6%
FMCG	17.8%	16.5%	14.9%	16.1%	17.5%	16.3%	16.3%	17.1%	17.6%

Source: CRISIL Research

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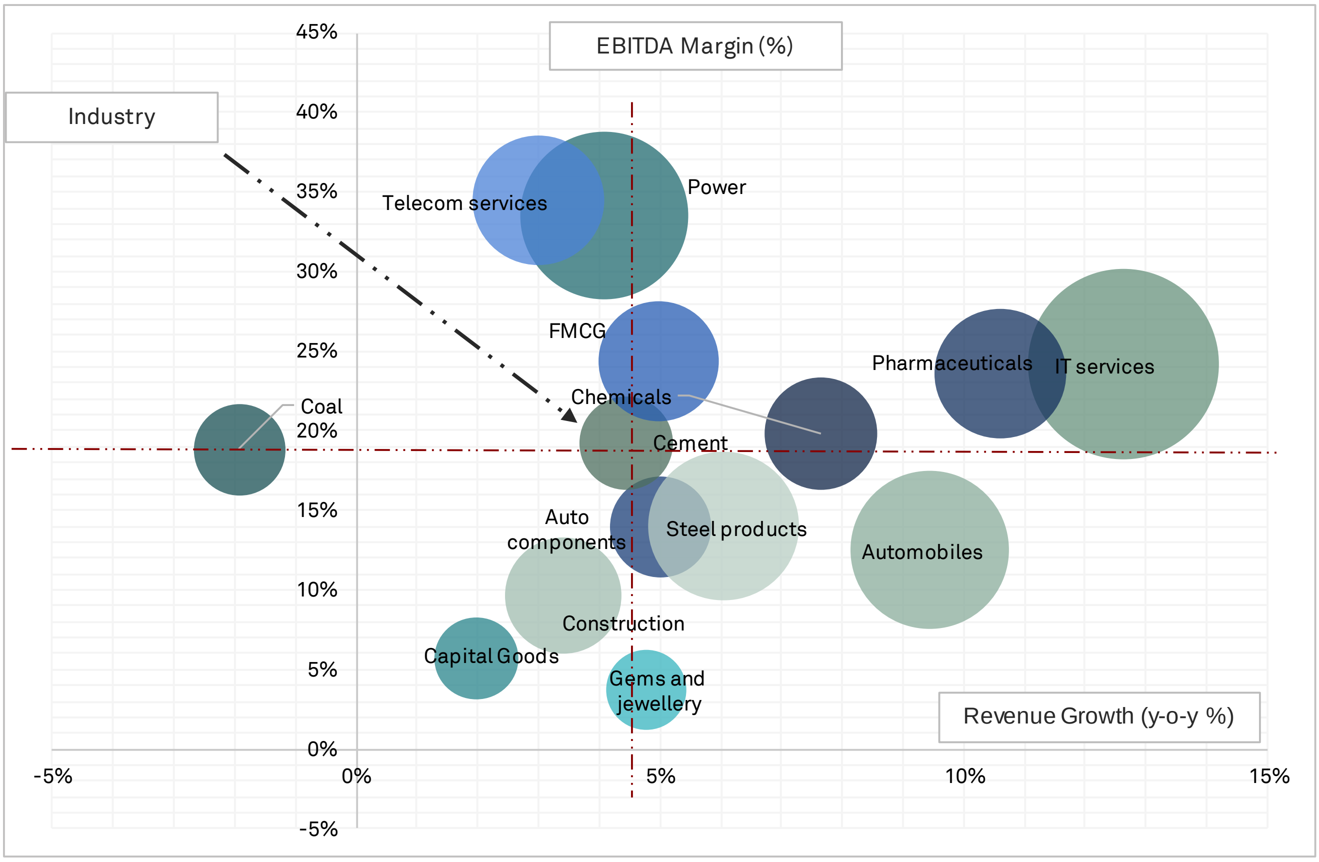
Performance metrics of major sectors

Revenue growth versus EBITDA margin across key sectors (past four quarters)



Source: CRISIL Research

Note: Data represents aggregate performance of the mentioned sectors for the *past four quarters (Q4 2015-16 to Q3 2016-17)*; size of the bubble indicates sector's share in overall industry's revenue

Revenue outlook (January - March 2017)

CRISIL Research, India's largest independent and integrated research house, expects revenues of companies in key sectors - excluding banking, financial services and insurance, and oil – to rise by 8.5% (on-year) in the fourth quarter of current fiscal. Growth is expected to be driven by rise in commodity prices along with pickup in demand on the back of continued government investments in infrastructure space. However, export-linked sectors are expected to witness the slowest growth in the last 12 quarters owing to pricing pressure and marginal rupee appreciation.

Snapshot of key sectors

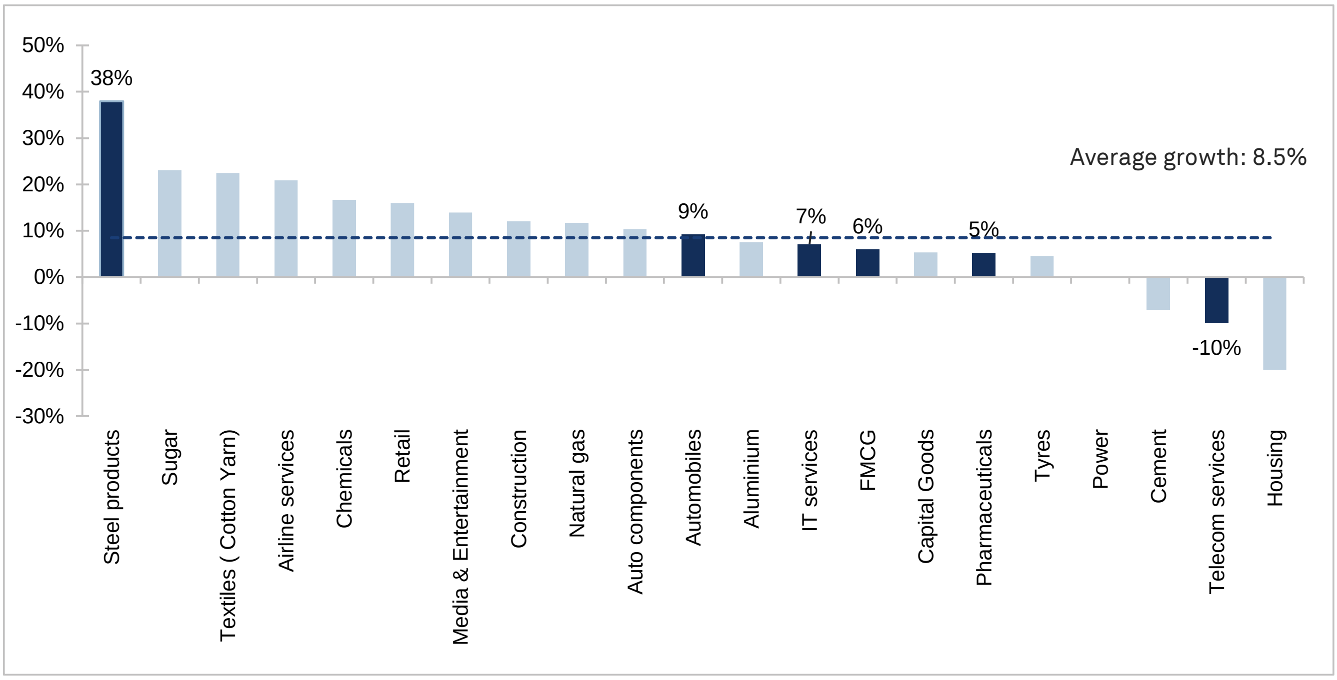
Revenue Growth (y-o-y)	Q4FY15	Q1FY16	Q2FY16	Q3FY16	Q4FY16	Q1FY17	Q2FY17	Q3FY17	Q4FY17E
Key sectors	2.6%	3.6%	5.1%	0.8%	7.7%	6.3%	5.5%	6.6%	8.5%
Automobiles	8.6%	11.2%	10.6%	12.5%	15.3%	9.8%	11.0%	2.0%	9.2%
IT services	9.4%	14.6%	15.2%	13.0%	17.1%	15.1%	9.7%	9.3%	7.1%
Power	-2.8%	2.8%	13.9%	2.3%	9.8%	4.5%	0.8%	1.7%	-0.4%
Steel products	-7.2%	-8.2%	-11.3%	-17.5%	-4.2%	-2.6%	6.6%	27.4%	38.0%
Telecom services	7.1%	5.8%	6.0%	4.9%	7.7%	6.0%	3.1%	-4.5%	-9.8%
Pharmaceuticals	18.4%	24.3%	10.2%	7.0%	15.6%	8.7%	8.2%	10.3%	5.3%
FMCG	15.7%	10.5%	8.2%	-1.9%	3.3%	7.0%	7.9%	1.9%	6.0%

Source: CRISIL Research

- **Steel products:** Revenue is projected to grow ~38% on-year, led by strong volume growth, backed by exports, pickup in domestic demand and rise in realisations. Overall demand is expected to rise 11% with domestic demand increasing moderately (6%) and exports robustly (January-February exports rose 202% on-year). Realisations are expected to witness strong growth, to the tune of 22-27%, with players passing on the rise in coking coal prices.
- **Pharmaceuticals:** Aggregate revenue of large formulation firms is pegged to rise 5-5.5%, with new product launches by Natco Pharma. Revenue of large formulation players is expected to grow 1-3%, propelled by healthy exports. However, pricing pressure as well as strengthening rupee is expected to put pressure on revenue growth.
- **FMCG:** Aggregate revenue is slated to improve 5-7% on-year, led by volume growth to the tune of 3-5% and marginal improvement in realisations. Improving consumer sentiments with easing of the cash crunch is expected to drive volume growth in this quarter.
- **IT services:** Revenue in rupee terms is projected to increase at a slower pace of 7-7.5% on-year, because of Brexit (UK's exit from Eurozone) and external uncertainty with regards to policies of the new American government. Economic uncertainty in the European Union (EU) and consequent impact on export-dependent sectors such as IT, would also hurt domestic software companies.
- **Automobiles:** Revenue of the automobile sector is estimated to grow healthily at 9-9.5% (on-year) in Q4 2016-17. Cars and UVs segment, which is expected to grow at a robust 20%, would drive growth for the automobiles sector. Commercial vehicles' revenue is expected to rise ~9% on-year for the last quarter of 2016-17, owing to ~5% expected jump in volumes and ~4% in average realisations. Net revenue of two-wheeler players is expected to increase 1-3% on-year with higher realisation. However, further rise in this segment will be arrested by 1-2% dip in total sales volume.

- **Telecom and power sector** are expected to de-grow in this quarter, power sector marginally, owing to tepid generation, and telecom sector majorly, with revenue cascading to the tune of 9-11%. Reliance Jio extended its services for free till 30 March, 2017. This is calculated to negatively impact data and voice realisations of incumbent operators. Revenues in metros are expected to be affected more as compared to Circle B and C service areas, as 4G adoption is higher in urban areas.

Revenue growth outlook across key sectors in the March quarter on-year:



Note: Major sectors are highlighted above

Source: CRISIL Research

Other sectors that are expected to drive revenue growth are:

- **Airline services:** Aggregate revenue is estimated to increase 20-22% upon strong growth in passenger traffic, primarily in the domestic sector. Domestic passenger traffic is pegged to increase 20-22% on-year, due to lower fares.
- **Chemicals**: Aggregate revenue of companies in the petrochemical segment is slated to rise 20-22% on-year in Q4 2016-17, because of improvement in realisation. Despite healthy demand growth, domestic players' sales volume growth will be marginal, as they are operating at high utilisation rates.
- **Construction:** Revenue is projected to rise ~12% in the fourth quarter of 2016-17, mainly on account of strong order book and faster execution of projects by key players L&T and Simplex Infrastructures.

EBITDA margin outlook

High input costs to lead to margin contraction for key industries

Despite healthy revenue growth in Q4 FY17, EBITDA margins are expected to decline by 100-150 bps to 19.3%. Price war owing to intense competition will lead to significant margin erosion of 1000 bps in the telecom sector. Higher raw material prices are expected to put downward pressure on automobiles, FMCG, airlines, petrochemicals and tyres.

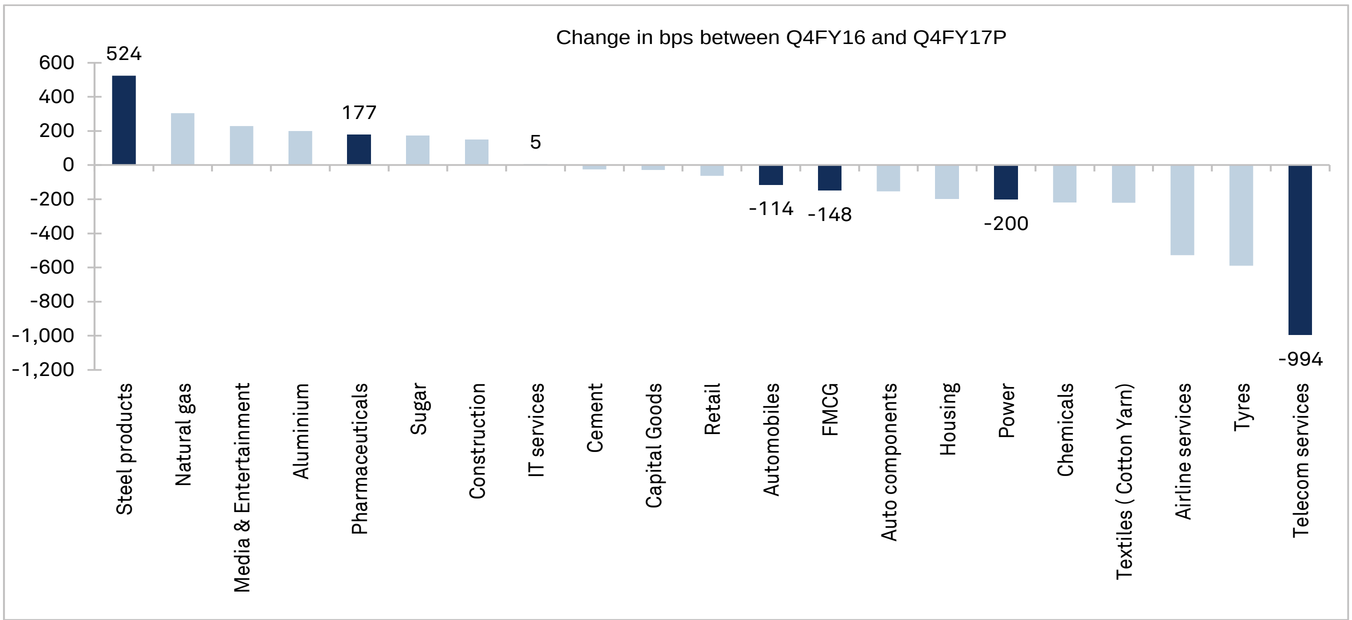
On the other hand, sharp rise in realizations of steel and aluminium would result in healthy margin expansion of 500 bps and 300 bps respectively.

Snapshot of key sectors

EBITDA margin (%)	Q4FY15	Q1FY16	Q2FY16	Q3FY16	Q4FY16	Q1FY17	Q2FY17	Q3FY17	Q4FY17E
Key sectors	18.3%	20.1%	20.1%	19.7%	20.4%	21.7%	21.2%	20.4%	19.3%
Automobiles	12.4%	15.4%	13.4%	12.2%	12.6%	12.6%	13.2%	11.7%	11.4%
IT services	20.3%	23.7%	25.3%	24.9%	24.2%	23.8%	24.2%	24.5%	24.2%
Pow er	30.6%	31.1%	32.9%	34.0%	34.1%	33.3%	33.9%	32.7%	32.1%
Steel products	12.0%	12.4%	10.4%	5.2%	9.5%	17.4%	13.4%	15.9%	14.7%
Telecom services	35.1%	34.3%	33.7%	34.3%	35.8%	34.9%	35.1%	31.9%	25.8%
Pharmaceuticals	17.5%	24.9%	24.6%	23.4%	22.1%	24.2%	24.2%	24.0%	23.9%
FMCG	23.0%	23.1%	23.8%	24.9%	24.5%	24.0%	24.4%	24.6%	23.0%

Source: CRISIL Research

Change in EBITDA margins (outlook) across key sectors in the December quarter, on-year:



Note: Major sectors are highlighted above

Source: CRISIL Research

- **Steel products**: With continued government support, domestic steel prices are expected to increase 22-27% on-year. However, improvement in EBITDA margin for companies in steel products is expected to be restricted to 525 bps as escalation in coking coal prices in Q3 2016-17 is pegged to spill over into Q4 2016-17.
- **Pharmaceuticals:** For large formulation players, EBITDA margin is estimated to expand 220-270 bps on-year, driven by spike in prices of Glenmark Pharmaceuticals and Dr Reddy's products during the quarter. On the other hand, EBITDA margin is expected to remain flat on-year for mid-sized players, because of pricing pressures faced by them in Europe and the US. Also, lower new product launches will put more pressure on margins. Thus, margin of overall pharmaceuticals industry is expected to expand by 170-190 bps.
- **Power:** Margins of power generation companies are expected to contract by 320-370 bps on-year to 27-29% owing to increase in fuel costs mainly due to hike in fuel price by Coal India ltd, increase in railway freight rates, and coal cess. Moreover, imported coal prices which are still at an elevated level, would further drag down margins. However, steady margins in transmission and distribution business are expected to result in overall margin contraction of 200 bps on-year.
- **FMCG:** EBITDA margin is likely to decline by 130-150 bps, owing to a rise in cost of raw materials such as crude oil, copra and palm fatty acid distillate. Heavy investments in advertisement and brand building to boost demand, is also expected to affect margins.
- **IT services:** EBITDA margin is forecast to expand 0-20 bps on-year, aided by rupee depreciation (vis-à-vis Q4 2015-16) and increased share of digital services. Downward pressure on realisation and investments in digital capability will curtail margin expansion. Limited scope for improvement in utilisation rates will further affect profitability. Also, reforms such as H1-B visa fee (post-Donald Trump's election), would hurt margins.
- **Automobile sector:** EBITDA margin is expected to shrink 110-150 bps as CV manufacturers' margins are expected to fall sharply by ~530 bps, mainly on account of ~23% expected increase in basic raw material prices in Q3 2016-17 (input prices are passed on with a quarter lag).
- **Telecom services:** EBITDA margin is estimated to fall by ~1,000 bps in Q4 as industry's revenues come under pressure (due to RJio). Launch of new networks on spectrum acquired during the October 2016 auctions will also add to network operating expenses of the operators. Marketing costs are also expected to rise as operators roll out 4G networks, leading to fall in margins.

Other sectors that are expected to report improvement in margins are:

- **Natural gas:** EBITDA margin of the regasification segment is forecast to expand by over 220-270 bps. Healthy demand growth for LNG is likely to translate into higher third-party and spot sales, aiding profitability during the quarter. On the other hand, EBITDA margin is projected to rise ~250-300 bps, on account of higher realisation for the transmission segment. EBITDA margins of distribution players are expected to rise 300-350 bps, given sharp decline in gas costs. Thus overall margins are expected to expand by 280-310 bps on-year in Q4 2016-17.
- **Aluminium:** EBITDA margin is expected to expand 280-320 bps on-year, largely on account of reduced input cost and improved realisation
- **Sugar:** Operating margin is estimated to expand by 170-200 basis points (bps) on-year to 31-32%, owing to higher increase in sugar realisations in comparison with cane costs, on account of lower recovery rates and fall in distillery and power realisations on-year.

About CRISIL

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