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Does Covid – 19 pose a credit risk for India Inc..?

The situation on Covid-19 is an emerging one and as of now there are close to 300 confirmed cases of Covid-19 in India. Let's look at the magnitude of this attack against the other such recent pandemics

	Impact on world GDP	Mortality (Nos and %) *	Impact on India GDP	Mortality (Nos and %)
SARS coronavirus (2003)	0.1% to 0.4%	800 (10%)	Not significant	
Ebola (2013-2016)	#	11315 (59%)		
Covid-19 (2020)	0.5% **	11822(3.4%) *	0.5%	4 (1%)^

**as on March 21, 2020 **as per OECD # Impact was largely restricted to three countries in Western Africa. ^ as per www.covidout.in*

While the last Ebola outbreak was largely restricted to western Africa, SARS and Covid-19, both originating from China seem to have a geographically widespread coverage. SARS was reported in 26 countries around the globe including countries in Europe, South America, North America and Asia. As per www.Worldometers.com as on March 20, 2020, Covid-19 has already spread to 182 countries in Asia, America and Europe and Africa with 11822 deaths of which 3255 were in China.

As can be seen, the impact of Covid--19 on the world economy is certainly going to be larger than the earlier two pandemics. As per ADB study, Covid-19 is expected to have an impact between 0.1 to 0.4 percent on world GDP,however it cautions that the situation is emerging and an accurate estimate would be difficult to make. China itself would be impacted to the extent of 0.8 percent of its GDP and the rest of the developing Asia would have an impact to the extent of 0.2%. As per a recent survey by Factset of 364 S&P 500 companies, 138 companies belonging to 11 sectors (38%) citied "Coronavirus" during the call. At the sector level the most concerned were the Industrial companies followed by Information Technology and healthcare sectors.

Closer home in India as per data dated March 21, 2020, there are close to 300 confirmed cases of Covid-19 of which 53% are imported cases and 47% are local transmission. There have been 4 deaths (mortality rate of 1%) (www.covidout.in)

The impact on the Indian Industry is no longer limited to the extent of trade and dependence on China by the various sectors, but will also have effects of shutdowns announced across Europe, Americas and Australia. In this article we try to focus on the impact that this pandemic can have on 6 major sectors viz. Metals and Mining, Pharmaceuticals, Chemical & Agrochemicals, Textiles, Gems & Jewellery and Hotels.

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1. Metals & Mining Sector

The Covid-19 outbreak has especially hit Central province of Hubei region and its capital city Wuhan, which is also one of the largest steel manufacturing hubs in China. China is the largest supplier, consumer and exporter of commodities like steel, aluminium, copper and zinc as well as of steel making raw materials and additives. The Virus outbreak had significantly affected Chinese demand, but the situation seems to have bottomed out in China. However, the spread of the virus outside China appears to have worsened especially in Europe, USA, Middle East and other Asian economies which are severely impacting the global demand-supply balance for ferrous and non-ferrous metals. While demand has ebbed, supply has also been curtained with extending shut down of furnaces. Global prices across commodities have also seen significant price correction as under:

Steel HRB - (US$/Tonne)	USA	China	World Export	Iron ore
FY17	640	389	441	68
FY18	717	495	551	69
FY19	907	510	566	72
FY20 till date	643	458	489	96
Mar-20	651	424	466	87

(US$/Tonne)	Aluminium	Copper	Zinc	Nickel
FY17	1688	5159	2365	10037
FY18	2043	6449	3050	11162
FY19	2036	6347	2746	12896
FY20 till date	1764	5923	2449	14177
Mar-20	1602	4860	1820	11420

Source: World Bank, Steel Benchmarker, London Metal Exchange (LME)

Global demand from the European, Middle East and the US markets is likely to remain muted for the next one quarter and prices for most of the base-metals are likely to remain subdued, owing to significant demand-supply disruptions. Global steel prices are expected to hover around US$ 400-450 per tonne, aluminium prices hovering around US$ 1,500-1,800 per tonne, while that of copper and zinc being range bout around US$ 4,500-4,900 per tonne and US$ 1,700-1,900 per tonne respectively.

Impact on Indian Steel industry:

Domestic steel demand is likely to get impacted during the current and the next quarter owing to the loss of manufacturing output on account of the expected shut-downs to contain the spread of the virus. While the demand is likely to get impacted, steel production output is likely to remain constant as India has sufficient raw material security for steel production and most of the steel plants maintain inventory levels for the next 2 months.

CARE does not expect significant dumping of the Chinese inventory into the Indian markets, owing to the several protectionist measures adopted by the government. While the domestic steel prices are expected to remain subdued, the same is also likely to get insulated from the landed cost parity of the global steel prices, owing to the continuation of MIP at around US$ 479 per tonne. Profitability of most of the steel players is likely to remain under pressure owing to volatility in raw material prices and falling global prices, which mean the steel prices in the domestic markets, are likely to hover around the MIP. Credit profile of Indian steel industry is likely to deteriorate if the duration to contain the virus spread extends beyond a month or two from now. India exports around 10% of its total production and the same is also likely to get impacted.

If we look at CARE's rating distribution of Metal companies, almost 60% of the players in the industry are in speculative grade, while the rest are in investment grade as per table below.

	Total Ratings	Investment grade (IG)	Higher IG (A- and above)	BBB	Below IG
Iron and Steel	285	118	40	78	167
Mineral Mining	29	17	11	6	12
Non-Ferrous Metals	51	23	6	17	28
Coal Mining	4	3	1	2	1

The cases in the higher IG categories encompassing all the integrated players would be more resilient, whereas the converters/ downstream players who are mostly in lower credit categories are likely to face liquidity problems.

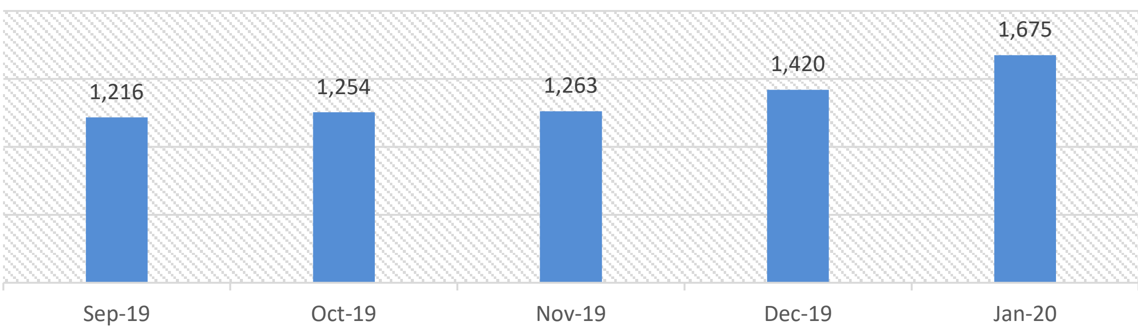
2. Pharmaceutical Industry

The total Indian pharmaceutical industry is estimated to be around US$ 38 Bn. of which almost 50% is exports. India derives about 40% of its export revenue from regulated markets, some of which are experiencing lockdowns with import restrictions on various goods. However, there have not been any restrictions on importing of healthcare products and drugs and we do not expect that to happen. CARE Ratings has 3 entities in AAA rating category and 9 entities in AA rating category whose financial risk profiles remains robust with very low debt levels, strong liquidity position and considerable unutilized credit lines which provides necessary cushion to meet any kind of exigency.

Further, CARE Ratings has 24 and 48 entities in A and BBB rating category. The impact on these companies depends on their sourcing mix and product mix.

Indian bulk drug and formulations companies are heavily dependent on import of key starting material (KSM) and Active Pharmaceutical Ingredient (API) particularly from China. However, considering the holiday period of Chinese New Year, most of the Indian pharma players had by January 2020, stocked additional inventory (see graph below) for production up to Q4FY20. Also, due to supply disruption faced during the pollution control issue in China in 2018, most large Indian formulation companies have backward integrated for APIs whereas the bulk drug companies have backward integrated for KSM.

The following table illustrates the import trend of bulk drugs from China (Rs. cr)



At present, the industry is receiving supply from the Chinese market with a delay of about 10-15 days. However, this supply gap has resulted in increase in raw material prices especially for paracetamol, ibuprofen and vitamins. With fewer number of new cases being registered (March 18, 2020 being nil) at China, it is understood that Chinese bulk drug manufacturers will soon commence operations at optimal capacity. Till such time, it is expected the price escalations would continue. If this situation persists for the next 3-6 months, then CARE Ratings expects credit pressure on companies rated BBB and below unless the players are able to pass on the increased costs to customers. While price increase in the domestic market for all affected products may not be feasible due to DPCO regulations, pharma companies may look to increase prices in the export markets to recover increased cost of raw materials. India has restricted export of 26 APIs and formulations in the face of the COVID-19 outbreak and companies having large reliance on such single product may face challenge. Companies in the lower rating categories are also expected to be significantly impacted if lock-down kind of situation arises because most of these entities have one to two manufacturing facilities and inhibition of operations at these facilities would entirely arrest their cash flow from operations thus leading to cash flow mismatch. CARE Ratings is watching the situation and undertaking reviews of cases on selective basis.

3. Chemicals and Agro Chemicals:

Agrochemicals

China accounts for over 50% of total agrochemical imports of India. As per the latest available import data the proportion continues to remain at similar level with some moderation. The decline in imports from China has been made good from other locations.

Imports (Rs. Cr)	2018-2019	2019-2020 (Apr-Jan (P))	Pro-rata Change YoY (%)
China	4,904.28	3,997.19	-2
Top 10 Import destinations	8,552.37	7,292.99	2
Total AgroChem Imports in to India	9,266.84	7,915.40	2
Proportion of Imports from China (%)	53	50	

Source: DGCI&S; Pro-rata change is calculated by adjusting the FY19 figures for 10 months.

The procurement of agrochemicals for the Rabi season has already ended and kharif season procurement normally commences in March-April every year. Given the fact that domestic manufacturers already knew the Covid--19 situation of China, most of the manufacturers had sufficient time to make alternative arrangements for short term. Further, the imports from China are intermediates and not the final product, thus same can be procured from other destinations. The situation is still evolving with capacity utilization in Chinese factories at around 30% and other major importing destinations facing the Covid--19 closure. This may adversely impact the procurement for upcoming Kharif season.

Other Chemicals – Dyes & Intermediates and Rubber Chemicals

CARE Ratings believes supply of some of the dye intermediates is likely to be disturbed owing to COVID-19. Although, Indian dyestuff companies manufacture large part of chemical intermediates in domestic market, they are still dependent on China for some specific dye intermediates like K-Acid, J-Acid, Bromamine Acid, Sulpho Tobias Acid and Cyanuric Chloride. Manufacturing these intermediates in domestic market is costly in the long-run as compared to procuring it from China. Most of the key intermediates for the segment were manufactured in Hubei province and Henan province, which are adjacent to Covid--19 epicenter and thus, the manufacturing plants are closed there. All the large domestic dye manufacturing companies have adequate stock of these intermediates, which would last them another 45-60 days. So, if situation does not improve in this period, the cost of production of domestic dye manufacturers is expected to move up. Further, in contrast, demand for dyes from developed countries (which are now facing COVID-19) is likely to remain subdued leading to lower sales volume and consequent impact on operating profit margin for these players. However, the integrated dye manufacturing players would be in a better position to meet this challenge.

The dye Intermediate sellers/exporters may see short-term boost in their profitability as supply disruption has already elevated prices for some of the intermediates by 30-40% in recent past.

Rubber chemical companies in domestic market were protected with Anti-Dumping Duty which was abolished during FY20. This led to higher influx of Chinese/Korean made chemicals in domestic market. However, with COVID-19 impacting production in China, the supply surplus issues would resolve. However, the challenge for rubber chemical companies is now on demand side, as the key end-user industry i.e. Tyre manufacturers are facing weak demand from OEM’s amidst automobile sector slowdown.

Would this be a favourable opportunity for the Chemical sector?

China has been the largest chemical exporter globally with total exports amounting to US$ 80 Bn. (industry estimates ended 2018), while India with its ~US$ 19 Bn. (for FY18) exports stands 10th in global chemical exports. The chemical exports from India reported staggering growth during last two years as can be seen in the below table. This growth was attributed to stricter clampdown on chemical companies by the Chinese government for achieving greater environmental compliance.

Export Growth Y-o-Y (%)	FY16	FY17	FY18	FY19
Organic Chemicals	3	4	22	34
Dyes & Pigments	-6	6	10	22
Miscellaneous Chemical Products.	3	9	15	29
Total Chemical Exports	2	5	19	31

In this backdrop, COVID-19 provides Indian chemical manufacturers a unique opportunity to grab market share and establish relationship with the customers that were until now largely catered by China. China has been one of the key manufacturing destinations for some of the large global chemical companies. The Covid-19 outbreak in China has highlighted the risk of overdependence on single country for supply-chain. Large organizations are looking to geographically diversify their sourcing plans. India with favorable tax structure and potent chemical clusters (clusters having common effluent treatment capacities) becomes one of the key destinations for new investments / tie-ups with existing industry players.

Sharp decline in Crude Oil prices would augur well for chemical companies having B2C business model (largely adhesive and paint companies). These entities are expected to report expansion in operating profit margin with decline in key raw material prices (as prices of most of the raw materials are correlated to Crude Oil prices). For B2B companies, the benefits derived from lower raw material cost are generally pass-through in the medium term.

4. Textiles

The textile and clothing industry employs over 105 million people and also earn around US$ 40 Bn. forex, apart from substantial revenue under GST and other taxes.

The outbreak of Covid-19 is expected to impact the segment of the Indian textile sector which is significantly dependent on exports. In 2018-19, North America was the largest contributor to Indian Cotton Textile exports with a share of 24% followed by SAARC at 17% and EU at 14%. Several countries in EU have reported a complete lockdown post outbreak of Covid-19. Further, even in USA as per the news reports retail sales have also fallen significantly.

The major impact would be felt by exporters of Ready Made Garments, Made-ups and home textiles. As per our understanding, the companies are reporting order cancellations/deferrals by 2-3 months. This could lead to inventory build-up. Further, for the orders already shipped there could be a possibility of stretch in receivables resulting in delay in settling post-shipment credit.

Domestic situation also is not favourable with malls in many states being closed and retail sales showing significant decline. CARE rates around 540 companies in textile industry of which 144 companies are in investment grade category. CARE expects moderation in credit profile of textile companies, which would be more pronounced in case of companies with high leverage/ SMEs which have limited bargaining power and modest liquidity backup.

5. Hotel Industry

Perhaps the most visible and immediate impact of Covid-19 is seen in the hotel and tourism sector in all its geographical segments - inbound, outbound and domestic and almost all verticals - leisure, adventure, heritage, MICE, cruise and corporate. Given various travel restrictions imposed by the Indian Government as well as Governments across the globe, forward bookings for various conferences and leisure travel bookings to foreign destinations have already been cancelled. In India, most of the summer holiday bookings have been cancelled (about 40-50% most of which was to states of Kerala, Rajasthan and Goa) impacting the domestic tourism.The impact on the inbound and outbound passengers is expected to be most severe in the next couple of quarters.

COVID-19 has already impacted the Jan-March 2020 and as the lean season seeps in for both business and leisure segments from April, the hotel players will have some time to realign themselves (cost rationalization, process improvement measures) before the next peak season. The operational parameters (Occupancy rates & Average room rates) of the hotel players are expected to get adversely impacted for next couple of quarters. Though a medium term impact, this may lead to lower cash flows for the hotel entities and thus exert pressure on their profitability and liquidity.

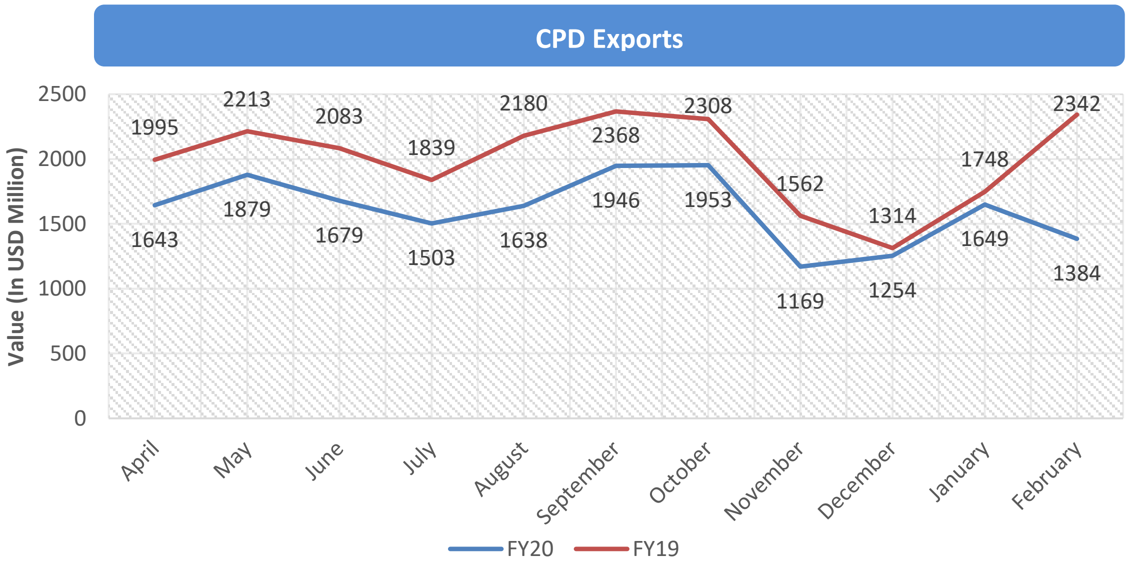
Hotels which derives higher share of revenue from foreign passengers and food & beverages segment will be the worst affected. Cost-cutting measures are the need of hour. Hotel entities which will be quick in trimming down the unnecessary costs and implement various efficiency improvement measures will be able to cut down the damage better.

Hotel sector is characterized by long gestation period. Hotel entities with recent expansions or groups with a higher portfolio of new assets compared to mature assets will face additional heat on their already weak financials. With high debt repayments and squeezed profitability, these entities may witness tightening in their liquidity and credit profile. Furthermore, hotels need to revisit their capex plans as the Covid-19 impact is expected to derail the future growth.

CARE Ratings rates 83 entities in the hotel industry of which 6 are rated in the higher rating categories of A & above, 36 in the BBB category and 41 are rated below investment grade. CARE Ratings expect that hotels in the higher rated category which are backed by strong groups and have better liquidity and lower leverage will be able to withstand the current situation. However, most others in the sector might witness moderation in their credit profile on account of increase in the leverage levels in medium term to manage the cash flow mismatches.

6. Indian Cut and Polished Diamond (CPD) industry

Two major markets, Hong Kong and USA, contributed around 73% of total exports of CPD during 10MFY20. Exports of CPD to China are largely routed through Hong Kong, a major diamond trading hub along with Belgium and the UAE. The overall export of CPD in 9MFY20 (refers to the period April 01 to December 31) was already lower by 17.14%, as compared to 9MFY19. The Indian diamond industry, which was expected to recover in Q4FY20, owing to reduction in inventory levels in the midstream segment, the trade treaty between USA–China and a recovery in exports during January 2020 (growth of around 31%), has, however, been adversely affected due to Covid -19 outbreak. The outbreak, which, initially brought China and Hong Kong to a standstill, led to decline in jewellery manufacturing operations and has caused a 40% drop in the overall exports of CPD from India to $ 1.38 billion in February 2020.



According to the provisional data released by the Gems & Jewellery Export Promotion Council (GJEPC), import of rough diamonds during the last 4 months ending February 2020 aggregated to US$ 5.1 Bn. as compared to USD$ 4.95 Bn. in corresponding 4 months of the previous year. Considering a processing time of 3-4 months, the inventory in midstream segment has already increased. With the sudden outbreak and rapid spread of COVID-19 across Europe and USA in March 2020, travel restrictions have been placed and all trade shows have either been cancelled or postponed and almost all major cities are under a lockdown siege. The entire value chain starting from supply centres (India and China/Hong Kong), to the trading hubs (Belgium & Dubai) and diamond jewellery manufacturers and retailers (Europe and USA), has been impacted. Retail stores are either closed or operating for limited time periods and lockdowns announced by various governments is impacting demand.

The CPD industry in India is now caught between increasing inventory and reducing exports due to reasons cited above. CARE Ratings expects overall exports of CPD to reduce further in the near term thus causing stress on liquidity profile of these players. Moreover, uncertainty over timely receipt of receivables from customers and reduction in prices of polished diamond remain key concerns. CARE Ratings has rated 226 entities in the GJ sector of which 23 cases are in higher rating categories of A & above and 158 are below investment grade. Entity wise impact will depend on its exposure to China, Hong Kong and USA, its ability to adjust with the current environment, reliance on bank borrowings to fund export orders, liquidity cushion available with the company to meet its obligations in case of delay in receivables. CARE is reviewing the companies in its portfolio for all the above factors

Conclusion

Covid-19 is an emerging situation and the final impact on each of the above sectors would only be known after the severity and duration of the present virus attack dies down. However, each of the above major sectors are likely to face headwinds in terms of demand and profitability. CARE Ratings is closely looking at portfolio companies to examine the impact on credit quality on the various factors mentioned above. Apart from these sectors, many others like real estate, media and entertainment , construction etc would be impacted. The fallout and resultant impact on other sectors is still an emerging situation which would be studied in detail.

In order to cushion the economic fallout of Covid-19 and to enable the revival of business activity, a large number of global central banks have announced emergency rate cuts and monetary policy measures since February'20. National governments too have announced a raft of measures to soften the impact of the disruptions caused by the pandemic.

Visit http://www.careratings.com/upload/NewsFiles/SplAnalysis/Policy%20response%20to%20the%20corona%20virus%20pandemic.pdf for an article on Policy Response to the Corona Virus Pandemic.

In line with these, CARE Rating believes that the Indian government along with the Central bank would announce fiscal measures to support the economy.

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