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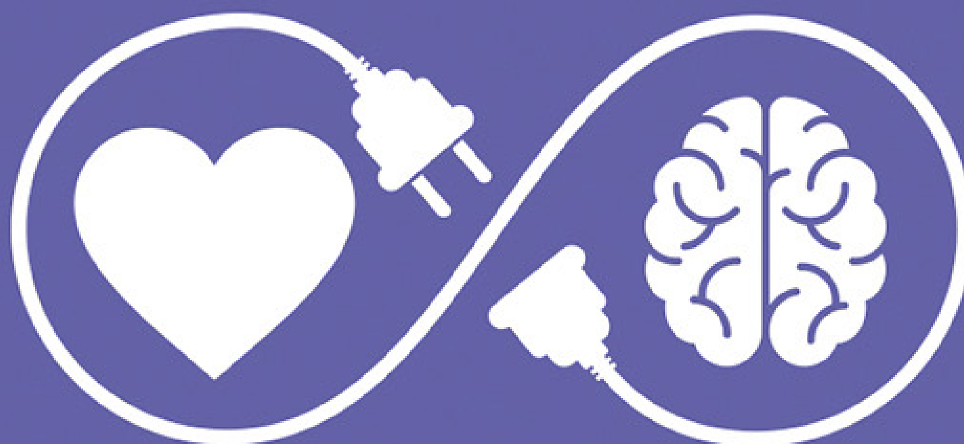
FORUM VIEWS



It's Called Investment.

Conscious Conversations

A BOMBAY STOCK EXCHANGE BROKERS' FORUM (BBF) ORIGINAL YEARLY SPECIAL

DOES FY'23 HOLD OUT A STRONG PROMISE FOR RATING COMPANIES?

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After an extended and uncertain pandemic, business prospects for the credit ratings industry are finally looking up. However, a lot still depends upon advances in domestic consumption and investment environment.

Given the uncertain times the world has witnessed over the past two years, it would not be a stretch to say the pre-pandemic course of world economies has suffered a major speedbump. Almost every sector has faced an impact strong enough to push them into understanding and exploring ways to get back on track and prepare better for emergencies. Credit rating industry is no different.

The business prospects in this sector are broadly underpinned by the performance of the economy and the credit markets. On both fronts, challenges have presented themselves in abundance. Businesses -- small or large - have been operating under stress. Some even have had to shut shop. And though the numbers frequently point to recovery, multiple waves of the virus kept growth and sentiment on the edge.

There has been a fair degree of adaptation to the upheavals caused by the pandemic and the economy has come off its lows even though activity levels for many sectors are yet to return to pre-Covid era. Muted demand due to reasons ranging from a savings-driven approach to closure of services to contain the virus has hampered the pace of recovery, but also kept private investment at bay.

The growth in the credit markets i.e., the fresh fund raising by businesses is inextricably linked to investments and economic activity. The low fund raising by the commercial sector in the country has impacted the business volumes of the domestic rating agencies in recent times. The slowdown in consumption, subdued investments and apprehensions over the future has hurt demand for funds by businesses and in turn the business volumes of the rating agencies.

Having said that, the Indian economy is still amongst the fastest-growing economies in the world. Propelled by public spending and aided by proactive reform measures of the government, the country has done a laudable job at ensuring the economy does not slip into a state of hopelessness. As per the first advance estimates of

the national income released by the National Statistical Office, the Indian economy is projected to grow at 9.2% in 2021-22, surpassing pre-Covid level in actual terms, mainly on account of improved performance, especially in farm, mining and manufacturing sectors. The government's thrust on capital expenditure and infrastructure building that has been reinforced in the FY23 Union Budget is expected to stimulate demand and progressively bring in private investments.

The business prospects for the rating industry in FY23 are brighter given that the domestic economy is in the recovery and revival mode. The central government's budget focus and allocations for infrastructure building is expected to facilitate a rather broad-based upswing in activity. This, in turn, would provide the impetus for a revival in private investment and consequently fundraising by the commercial sector. Overall, it is good news for the rating industry.

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Lacklustre FY22

The state of the domestic credit markets is gauged from the fundraising from the various sources and the participation in terms of sectors and entities.

The picture so far in FY22 has been rather mixed and is seen to be concentrated in certain segments. While fundraising from the corporate bond markets was tempered, it has been higher in case of commercial papers. Bank credit demand by corporates, although restrained, has improved from a year ago.

Corporate bond issuances during the first nine months of FY22 was 26% lower than a year ago. Besides that, the issuances were restricted to the higher-rated corporates and the finance sector. Over 90% of the issuances have been restricted to entities rated AA - (high credit worthiness) and above and around three quarters of the issuances have been by entities from the finance sector.

Commercial paper issuances during the first nine months of FY22 have seen a 36% increase from the corresponding period of FY21. The finance sector accounted for 60% of the issuances and sizable issuances have been for short tenure of 7-10 days directed towards IPO funding.

Bank credit offtake has progressively picked up pace in FY22. In the first 10 months of FY22, the demand was 8.2% higher than a year ago, which is a significant improvement from the growth of 5.9% in the same period last financial year. The demand for bank credit, however, has not been broad-based across segments as of end-December 2021.

The annual growth in credit demand by the retail and agriculture sector at 8.1% and 10.8%, respectively, has been higher than that of industry (3%) and services (6.5%). The lower credit offtake by the commercial sector is partly due to the deleveraging by borrowers as well as their low appetite from fresh investments. The selectiveness of banks to lend to only certain segments is also a contributing factor.

Bank loan ratings are an important business segment of rating agencies and the sustained weakness in bank credit offtake by industry and services has been pressuring business volumes of rating agencies.

Credit Quality on the Mend

In an encouraging sign, the credit quality of rated entities has seen a steady improvement. This can potentially stimulate fundraising by them and thereby the business of the rating industry.

The credit quality of the rated entities as measured by CareEdge credit ratio (ratio of upgrades to downgrades) in H1 FY22 has been the strongest in three and half years and the robust credit quality is expected to be sustained in H2 FY22.

Good Tidings in FY23

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All facts and figures in place, the business prospects for rating industry in FY23 as of date appears to be moving the right direction, but a lot would be conditional on the extent of advances in the domestic consumption and investment environment and the resultant demand for funds from the credit markets.

It nevertheless needs to be mentioned that the anticipated revival in the investment climate would be gradual and would be contingent on the resurgence and sustainability of demand in the economy.

We foresee a further strengthening in bank credit demand with higher activity levels and easing concerns over the pandemic as the vaccination drive becomes more widespread. The supportive or easy monetary policy of the Reserve Bank of India that keeps interest rates low would also aid credit offtake from banks.

Contrary to the policy actions of its counterparts in advanced economies who are in the process of withdrawing the emergency monetary policy support extended at the onset of the pandemic have begun (or will soon begin) raising interest rates, the RBI has indicated it would continue with its accommodative monetary policy well into FY23. In doing so, they are seeking comfort from their inflation projections that are expected to be moderate and well within their target range of 4% to 6%. (average of 4.5% for FY23). The growth in bank credit would necessarily increase the volume of bank loans that need to be credit rated.

In case of corporate bonds, the cost of funds could be higher in FY23 and this could have a bearing on funds raised. Given the higher quantum of borrowings by the government in FY23, yields are likely to be pressured.

Higher GSec yields would raise the yields of corporate bonds, too. This could increase the cost of borrowings for companies from the debt-capital markets. That said, the higher rated companies would continue to tap the corporate bond markets as the spread between GSec and corporate bonds has been range-bound and even narrowed despite the sharp rise in GSec yields in recent months.

The improvements in the credit quality has improved the risk perception of corporate bonds viz. of the higher rated entities. If the hoped for rebound in economic activity and investments materialises, corporate fundraising from the debt markets especially by the higher rated entities could be higher in FY23. The volume of corporate debt ratings then would see a commensurate increase in the coming financial year.

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With over 30 years of experience in the financial services sector, **Ajay Mahajan** heads the ship at CareEdge (CARE Ratings Ltd.) as its Managing Director and Chief Executive Officer. An alumni of BITS Pilani and a gold medallist from the prestigious Faculty of Management Studies, New Delhi, he has served as a banking and capital markets expert at top corporations. He began his career at Bank of America and rose the ladder to become the MD & Country Head of Global Markets Group. Deeply committed to his craft, he has also donned top management roles at YES Bank and UBS. His last assignment before joining CareEdge was a seven-year stint at IDFC Group where he played a crucial role in transforming the company from just an infrastructure-financing business to a multi-product wholesale banking business comprising corporate credit, SME credit, government banking, and financial markets among others.