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ASSESSING THE QUALITY OF CREDIT IN FY17

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Credit ratings are a very useful indicator of the health of the corporate sector and provide signals for the formulation of perspectives in credit quality. All credit ratings assignments involve an initial rating followed up by a surveillance exercise till the loan is repaid and hence would track the quality of the asset over time. Broadly speaking the ratings would move along with the state of the economy though specifically the industry related issues would define the same for the company besides micro factors that are specific to its functioning. In a way the credit rating becomes a leading indicator for the credit profile of a company which can be aggregated over sectors and overall industry.

Against this backdrop, an examination of the movement in credit ratings of the rated entitiesi.e. the rating surveillance exercise,can serve as an early indicator of the credit quality in the system. It needs to be noted here that credit rating agencies approach to recognizing defaults helps capture deterioration in credit quality significantly ahead of banks. The changes or movements in credit ratings of the rated entities reflect the improvements, stability or weakness in the financial health of the rated entities. Given the large quantum and diverse set of entities rated by CARE Ratings, the cumulative findings can be treated as being representative of the overall system.

CARE's latest assessment of the movement in credit rating of entities rated by it for the 9 months of 2016-17 (Apr-Dec'16) reveals that the credit quality has recorded some moderation in the current fiscal i.e. there has been an increase in downgrades and a tempering in the number of upgrades, indicative of the pressures on credit quality faced by certain segments. At the same time, interestingly, there is a high degree of sustained stability in the financial position of the rated entities. 73% of the entities that were rated during this period had their ratings being reaffirmed or not undergoing any change, reflecting also the overall stability in their financial position. Further, there was nearly 20% increase in the number of reaffirmation in the 9M 2016-17 compared with corresponding period last year.

To measure the mobility in ratings and thereby the credit quality in the system, CARE uses the Modified Credit Ratio (MCR). The MCR is the ratio of (upgrades and reaffirmations) to (downgrades and reaffirmations). An increase in the MCR implies an improving credit quality of the rated entities. An

MCR closer to one / unity indicates higher stability in ratings, with larger proportion of reaffirmations and higher number of upgrades than downgrades. While the ratio of upgrades to downgrades is also often used, it is bifocal in nature and does not take into account the retention of ratings, which as mentioned earlier is the largest part of the sample that is rated and buttresses stability in the overall credit quality of companies. Curiously, more reaffirmations are an indicator of the degree of accuracy of credit ratings as when an opinion is formed it should not be changing too often. However in turbulent times there would be a tendency for these changes to take place.

The MCR of the rated entities in the first 9 months of the current fiscal has touched a 2 year low. However, the credit quality of the rated entities has been exhibiting sustained stability since mid-2013-14in terms of the ratio being above 1. The MCR for the 9M 2016-17 dropped to 1.08 compared with the corresponding period in the 2015-16 (1.15) and 2014-15 (1.18). The MCR was below 1 (0.82) in 9M 2012-13.

The evaluation of the rating action over the last 6 years shows that

- The number of reaffirmationshas been steadily increasing during this period, with this fiscal recording the highest number of reaffirmation.About 73% of the rating surveillance exercises undertaken by CARE resulted in reaffirmation of ratings during 9MFY17, higher than the 68% and 65% of surveillance cases reaffirmed in corresponding period of the previous 2 financial years, indicative of the improved stability in credit quality of the rated entities.
- There has been a moderation in the number of upgrades this year. About 17% of the surveillance cases were upgrades during 9MFY17 compared with the 22% and 24% in the corresponding period in the previous 2 years.
- Downgrades have been accounting for nearly 10% of the surveillance cases since the last 3 years.

The segments that witnessed an improvement in credit quality (higher number of upgrades and reaffirmations) in 9MFY17 compared to previous periods belong to both manufacturing as well as services sectors. They included sectors such as construction, textiles, wholesale and retail trade, electricity (generation), electrical equipment, rubber and plastic products, auto, chemicals, non-banking financial institutions, sugar, hospitality, real estate activities, food & food products, paper, cement, health related activities, fabricated metal products and information & communication. These sectors also saw a high proportion of reaffirmations in ratings i.e. stability in financial health and performance.

The factors that have aided upgrades across sectors can be broadly classified as being on account of improvements in liquidity position, operating performance, execution & timely completion of projects. Healthy order book, favorable demand prospects, improvements in profitability, capital structure and debt coverage indicators were also factors that aided the ratings assigned.

Higher number of downgrades was recorded largely in sector such as Iron &Steel, transport & storage, agriculture, pharmaceuticals, non-ferrous metals, beverages, mineral mining, crude & natural gas extraction, computer hardware, electronic and optical products, coke & refined products, professional and technical activities.

Decline in sales & scale of operations, cancellation of projects, moderation in profitability margins, stressed liquidity position, operating losses and stretched working capital position, delay in debt servicing were some of the factors that have prompted downgrades in these sectors.

The economicslowdown in relative terms that is expected this year,based on both CSO has projected as well as CARE's in-house research suggests, and the resultant pressures on the already stressed corporate financials could impact sustainability of credit rating for companies going forward till the time economic conditions normalize and move towards the earlier expected growth trajectory. The change in status of ratings would hence have to be monitored closely as specific developments in industries on account of the recent demonetization move could be affecting the financials of companies. In this context the Q3 and Q4 results of companies would provide valuable clues on these changing perspectives.

On the other hand it must be pointed out that the banks have started lowering their interest rates which will help in improving the overall debt conditions as servicing ability improves. This is a big positive for companies which will reflect positively in the coming months. Therefore, the overall credit profile will be driven by different forces in the coming months and it is hoped that with the economy likely to pick up soon, the direction would be favourable.

Mokashi is currently the Managing Director & CEO of Credit Analysis & Research Ltd. (CARE Ratings), a premier credit rating agency in India and also Director in CARE's subsidiary companies viz. CARE Ratings (Africa) Pvt. Ltd. And CARE Kalypto Risk Technologies and Advisory Services Pvt. Ltd.

He has over 30 years' experience and worked with Otis Elevator Company India Ltd, DSP Financial Consultants Ltd. and Kotak Mahindra Finance Ltd before joining CARE. He has worked in diverse areas in ratings such as rating operations, criteria development, business development, disinvestment advisory services, international ventures, regulatory compliance, human resources management, information technology etc. He was involved in several strategic initiatives including the IPO of CARE.

He was earlier elevated to the Board of CARE on August 22, 2009 as a Deputy Managing Director and has served on the Board for nearly seven years. Mr. Mokashi also serves on the Board of CARE's subsidiary companies viz. CARE Kalypto Risk Technologies and Advisory Services Pvt. Ltd and CARE Ratings (Africa) Pvt. Ltd.

He was a member of the Working Group formed by National Housing Bank (NHB) for promoting RMBS and other Alternate Capital Market Instruments - covered Bonds [October 2012].

He is a member of the Committee on Differential Premium for Banks set up by the Deposit Insurance and Credit Guarantee Corporation (DICGC) [May 2015]

He has a Masters Degree in Management from NMIMS. Mr Mokashi is a Graduate in Mechanical engineering from VJTI, Mumbai University.

He has also completed CFA programme both from the CFA Institute, USA and ICFAI Hyderabad.

He has also attended specialized course in Risk Management from the Stern School of Business, New York University, USA.

He is an avid reader and has been a guest faculty at several national level institutions on topics related to risk management.