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Assessment of Credit Quality of Rated Entities: Q1 2020-21

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There has been a notable decline in the credit quality of Indian companies in recent times which attests to the weakness in the domestic economy and the constrained financing conditions. The credit profile of entities rated by CARE Ratings has witnessed a perceptible moderation in the current financial year triggered mainly by COVID-19 and the consequent lockdown announced affecting the operations of most entities.

The assessment of the credit quality of entities rated by CARE Ratings in Q1 2020-21 shows that

- The credit quality of the rated entities as measured by CARE Rating's 'modified credit ratio' (MCR) declined to a 26 quarter low in Q1 2020-21.
- Despite a moderation from year ago, the credit quality of entities with 'investment grade' rating was better than that of entities with 'below investment grade' ratings.
- Although there has been a decline in the proportion of upgrades and increase in downgrades, the majority of entities (79%) saw their credit ratings being reaffirmed in Q1 2020-21.
- The credit rating downgrades in 2019-20 has been largely on account of impact on operations and credit quality of entities due to the pandemic, decline in scale of operations, deterioration in asset quality, delays in debt servicing and weakened - capital structure, debt service coverage ratios and liquidity position.
- The reaffirmation and upgrade of ratings of entities has been influenced by the entities with favourable financial position with respect to profitability, increase in scale of operations, comfortable debt servicing parameters, liquidity position and capital structure. Company and industry specific factors too have influenced the rating changes.
- The MCR for 22 of the 31 key sectors was below 1, indicating credit quality pressures across sectors.

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Modified Credit Ratio (MCR) – Concept and Trend

(i) Concept

The Modified Credit Ratio (MCR) is defined as the ratio of (upgrades and reaffirmations) to (downgrades and reaffirmations).

An increase in MCR denotes an increase in proportion of upgrades vis-à-vis downgrades, whereas a decrease in MCR shows the reverse. In other words, an increase in the MCR implies an improving credit quality of the rated entities while a decline in the same signals a deterioration in credit quality of the rated entities. An MCR closer to one indicates higher stability in the ratings, with a larger proportion of reaffirmations. The MCR is calculated on a 4 quarter rolling basis.

The movement of the MCR consequent to the periodic review of the credit rating of the rated entities (which point out the improvement, stability or weakness in the financial profile of these entities over time) not only helps measure mobility in ratings but is also seen as being reflective of the changes in credit quality in the system given the large quantum and diverse set of entities rated by CARE Ratings.

(ii) Trend in MCR

Exhibit 1 captures the movement in MCR on a 4 quarter rolling basis. Excluded here are cases in the category of "Issuers Not Co-operating".

The MCR for the four quarters including Q1 2020-21 declined to a 26 quarter low and was below one, denoting higher number of rating downgrades of the entities whose ratings were reviewed.

Exhibit 1: Movement in Modified Credit Ratio

Period	MCR
Q12012-2013	0.98
Q12013-2014	0.83
Q12014-2015	1.05
Q12015-2016	1.17
Q12016-2017	1.10
Q12017-2018	1.07
Q12018-2019	1.09
Q12019-2020	1.04
Q12020-2021	0.94

Source: CARE Ratings

(iii) Segment and Category wise trend in MCR

There has been a broad-based decline in credit quality across segments in Q1 2020-21. However, the moderation in credit quality has been higher in case of the large enterprises (LE) segment than in the SME[1] (small and medium enterprises) segment. The MCR for the LE segment at 0.91 in Q1 2020-21 was the lowest since Q2 2013-14 and was 11 bps lower than that in the comparable period of a year ago (Q1 2019-20).

[1] Total revenues not exceeding Rs.100 crs.

Given the higher share of the large enterprises (84%) in the total portfolio of entities whose ratings and financial position were reviewed in Q1 2020-21, the credit quality pressures of this segment weighed down the overall credit quality. Disruption in operations and the credit profile due to the pandemic, stretched liquidity position, decline in the scale of operations, fall in profitability margins, weakened capital structure and deterioration in debt coverage indicators have been the some of the main factors that have led to the decline in the credit risk profile of the rated entities of the LE segment.

Table 1 : MCR- Large Enterprise (LE) and Small and Medium Enterprises (SME)

	LME	SME
Q12012-2013	0.99	0.95
Q12013-2014	0.81	0.87
Q12014-2015	1.05	1.08
Q12015-2016	1.18	1.15
Q12016-2017	1.09	1.15
Q12017-2018	1.07	1.05
Q12018-2019	1.10	1.08
Q12019-2020	1.02	1.10
Q12020-2021	0.91	1.01

Source: CARE Ratings

Table 2 : MCR- Investment Grade and Below Investment Grade Companies

	Below Investment Grade	Investment Grade
Q12012-2013	0.79	1.07
Q12013-2014	0.75	0.89
Q12014-2015	0.98	1.12
Q12015-2016	1.06	1.27
Q12016-2017	1.01	1.18
Q12017-2018	0.98	1.14
Q12018-2019	1.02	1.15
Q12019-2020	1.00	1.07
Q12020-2021	0.92	0.95

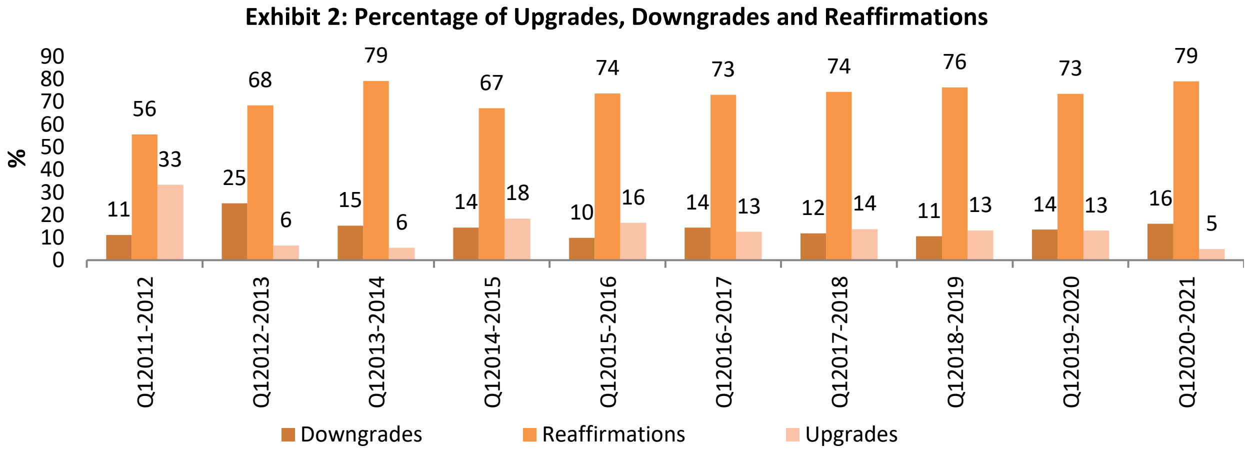
Source: CARE Ratings

The credit quality of entities with both investment grade' (BBB- and above) and 'below investment grade' ratings (BB+ and below) moderated in Q1 2020-21 with their MCR falling below 1, underscoring the higher proportion of downgrades to upgrades. Even though the MCR of 'investment grade' entities in Q1 2020-21 at 0.95 was 12 bps lower than year ago it was higher than that of 'below investment grade' entities (0.92).

Proportion of Upgrades, Downgrades and Reaffirmations

The majority of entities saw their credit ratings being reaffirmed in Q1 2020-21. 79% of the entities whose ratings were reviewed in Q1 2020-21 saw their ratings being reaffirmed, 6% higher than that in the same period a year ago. There has however been a notable decline in the proportion of upgrades and an increase in downgrades in Q1 2020-21 when compared with the Q1 2019-20. Only 5% of the entities reviewed in Q1 2020-21 witnessed a rating upgrades v/s 13% a year ago while 16% of the entities saw a rating downgrade from 14% in Q1 2019-20.

Exhibit 2: Percentage of Upgrades, Downgrades and Reaffirmations



Industry-wise Rating Movements

The MCR across key industries on a 4 quarter rolling basis is highlighted in Table 3 below.

Table 4: Industry-wise MCR

Sectors	Q12018-2019	Q12019-2020	Q12020-2021
Agriculture, forestry and fishing	1.09	1.07	1.00
Auto	1.21	1.15	0.85
Banks	0.90	0.96	0.94
Beverages	1.31	1.21	1.09
Cement and related products	1.34	1.03	1.00
Ceramics	1.26	1.14	0.97
Chemicals and chemical products	1.13	1.09	1.01
Construction	1.10	0.96	0.89
Education	1.03	0.94	1.11
Electrical Equipment	1.08	1.12	0.96
Electricity - Generation	1.29	1.11	0.99
Electricity - Transmission and distribution	1.00	0.96	0.97
Fabricated metal products	1.08	1.07	0.92
Financial Institutions	1.00	0.96	0.94
Food and food products	1.15	1.10	0.96
Hospitality	1.10	1.09	0.97
Hospitals	0.93	0.94	0.96
Information and communication	1.09	0.79	0.69
Information Technology & ITES (IT Enabled Services)	1.13	1.00	1.03
Iron and Steel	1.18	1.34	1.02
NBFC	1.12	1.05	0.89
Other manufacturing	1.04	1.03	0.96
Paper and paper products	1.42	1.24	1.10
Pharmaceuticals	1.15	0.98	0.96
Real Estate activities	0.92	0.93	0.82
Rubber and plastics Products	1.00	1.09	1.05
Sugar	1.04	0.96	0.97
Telecom	0.81	0.94	0.75
Textiles	1.18	1.02	0.98
Transportation and storage	1.01	1.00	0.90
Wholesale and retail trade	0.96	1.07	0.94

- Of the 31 key sectors, the credit quality as measured by the MCR in Q1 2020-21 was above unity (1) for entities belonging to 9 sectors, reflective of the stability/improvement in their credit ratings. These sectors comprised of education, paper and paper products, beverages, rubber and plastic products, IT, iron and steel, chemicals, agriculture and cement. Of these sectors, only education and IT registered an improvement in credit quality from year ago.

- The credit quality of 22 key sectors was pressured with their MCR being below 1 and nearly all these sectors witnessed a deterioration in credit quality from year ago.

- 5 sectors witnessed an improvement in credit quality in Q1 2020-21 from year ago. These include education, hospitals, IT & ITES, electricity (transmission and distribution) and sugar.

- Information and communication, telecom, real estate activities, auto, construction and NBFCs were the sectors that recorded the lowest MCRs (below 0.9) in Q1 2020-21.

- The iron and steel and auto sectors witnessed the sharpest moderation in credit quality in Q1 2020-21 from a year ago.

- Telecom, ceramics, NBFCs, electrical equipment and fabricated metal products, food products, electricity generation and wholesale and retail trade were the other sectors that witnessed a significant deterioration in their credit profile from year ago.

- The auto sector was already grappling under weak demand conditions in FY20 and the lockdown due to COVID 19 further worsened the off-take affecting the credit profile of the auto sector. Credit profile of auto players was also affected by working capital stuck in inventory and debt funded capex.

- Iron and steel sector's credit quality has been impacted by lower demand (domestic and exports), delays in (debt funded) project executions, high levels of receivables and long working capital cycles and high leverage. The restrictions on the use of LOU based LCs by the RBI has also had a bearing on the moderation in credit quality of entities of the sector.

- The credit profile of the construction sector was mainly impacted by stressed liquidity position, cost over-runs, delays in project execution, high receivables, order book being impacted due to company being debarred from participating in certain projects and high leverage and delay in asset monetization and debt reduction plans.

- Hospitality was also one of the worst hit sectors due to the pandemic and saw a large number of downgrades.

- The NBFC sector was already facing headwinds due to the liquidity crisis it faced earlier. Further, moratorium allowed to borrowers in March 2020 is also causing cash flow disruptions with liquidity buffers depleting. The deterioration in the credit quality of the NBFC sector was also on account of weak asset quality, deterioration in capitalization levels, slower than planned liquidation of non-core investments, negative net interest income and de-growth in loan portfolio. Deterioration in credit profile of parent/group companies, high leverage and delay in asset monetization and debt reduction plans were also factors that led to a moderation in credit quality of the sector.

- The weakness in the credit profile of the telecom sector has been on account of reduced scale of operations, changes in capital structure, loss of customers and losses incurred by certain entities due to increased intensity of competition.

- Electrical equipment sector has been impacted by liquidity constraints, difficulty in handling working capital requirement after discontinuation of LOUs by RBI and volatile raw material prices that affected profitability.

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