CARE Ratings
Professional Risk Opinion

Assessment of Credit Quality of Rated Entities: Q2 2020-21

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The pandemic-led lockdown and restrictions on conduct of normal business activity for over 6 months has severely affected operations and thereby the financial profile of a vast majority of entities. As this comes on top of the slowdown in the domestic economy of the last 3 financial years, the weakness in the credit quality of businesses has been aggravated. There has been notable decline in the credit quality of Indian companies across sectors in the current financial year.

The credit quality of entities rated by CARE Ratings has moderated to over 6 year lows in the current financial year. At the same time, despite the unprecedented nature of the disruptions, the overall credit quality of the domestic entities has been better than that in 2012-13. This can largely be attributed to the measures undertaken by RBI and the government to mitigate the impact of the Covid-19 led disruptions. RBI allowed lenders to offer a 6 months moratorium on loan repayment (till end Aug'20) and the emergency credit lines scheme of the government made available bank funds to firms to take care of their cash flow requirements.

The assessment of the entities rated by CARE Ratings in Q2 2020-21 shows that

- The credit quality of the rated entities as measured by CARE Rating's 'modified credit ratio' (MCR) although still at the lowest levels since the Q4 2013-14, has not seen a further deterioration from that in Q1 2020-21. There has been a marginal improvement on a quarterly basis.

- The majority of entities (73%) saw their credit ratings being reaffirmed in Q2 2020-21, even as the proportion of upgrades saw a decline (y-o-y basis).

- Entities with 'below investment grade' ratings saw a higher deterioration in their credit profile than the entities with 'investment grade' ratings.

- The credit rating downgrades in Q2 2020-21 have been largely on account of Covid-19 led disruptions. The pandemic and the resultant lockdown has reduced the scale of operations impacting sales, collections, liquidity and overall profitability of businesses, all of which have adversely impacted the financial profile of these entities. Additionally, delay in debt servicing, deterioration in credit profile of the guarantor, increased operations and maintenance risk, weakened capital structure and delay in envisaged capital infusion have been some other factors that have prompted rating downgrades.

- The rating reaffirmations and upgrades during Q2 2020-21 factored in the favourable financial position of the entities in terms of scale of operations, liquidity situation, capital structure, debt servicing parameters along with company and industry specify factors.
- Although credit quality has been under pressure across sectors, the sharpest deterioration in credit quality has been in the case of telecom, real estate, construction, auto, wholesale and retail trade, textiles and food & food products.
- Sectors that saw improved credit quality include education, sugar, hospitals & healthcare, pharmaceuticals and IT.

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.**

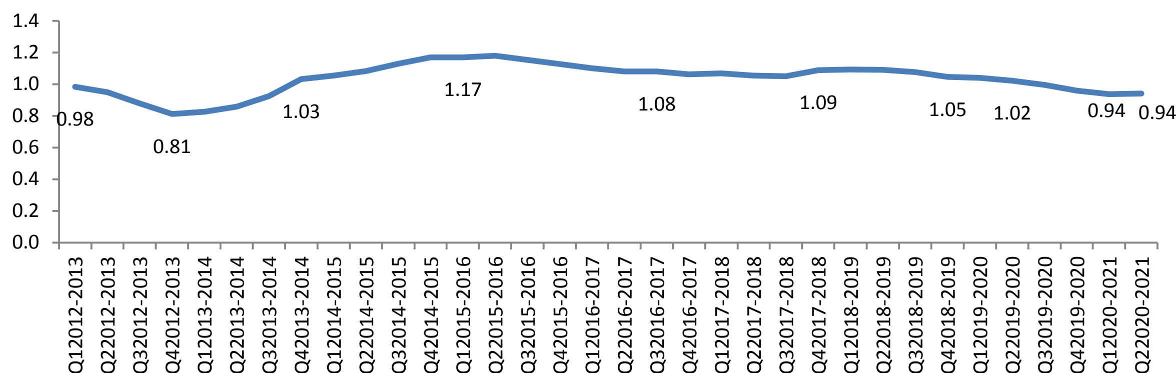
The movement of the MCR consequent to the periodic review of the credit rating of the rated entities (which point out the improvement, stability or weakness in the financial profile of these entities over time) not only helps measure mobility in ratings but is also seen as being reflective of the changes 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 Q2 2020-21 was stable at 0.94. The MCR in the first 2 quarters of 2020-21 (at 0.94) is at the lowest level since Q3 2013-14 (0.92). The ratio has been below unity (1) from Q4 2019-20 denoting higher number of rating downgrades and lower number of rating upgrades of the entities whose ratings were reviewed during this period.

Exhibit 1: Modified Credit Ratio (4 quarter rolling basis)



Source: CARE Ratings

(iii) Segment and Category wise trend in MCR

There has been a broad-based decline in credit quality across segments in Q2 2020-21. While the MCR for the SME segment at 1 indicated stability in credit profile of entities of the segment, the MCR for the LE segment at 0.92 was 7 bps lower than that in the comparable period of a year ago (Q2 2019-20).

Given the higher share of the large enterprises (75%) in the total portfolio of entities whose ratings and financial position were reviewed in Q2 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
Q22012-2013	0.95	0.94
Q22013-2014	0.85	0.88
Q22014-2015	1.08	1.09
Q22015-2016	1.18	1.18
Q22016-2017	1.07	1.12
Q22017-2018	1.06	1.04
Q22018-2019	1.09	1.10
Q22019-2020	0.99	1.10
Q22020-2021	0.92	1.00

Source: CARE Ratings

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

	Below Investment Grade	Investment Grade
Q22012-2013	0.76	1.04
Q22013-2014	0.78	0.93
Q22014-2015	0.99	1.17
Q22015-2016	1.08	1.28
Q22016-2017	0.99	1.16
Q22017-2018	0.96	1.14
Q22018-2019	1.03	1.14
Q22019-2020	1.00	1.04
Q22020-2021	0.91	0.96

Source: CARE Ratings

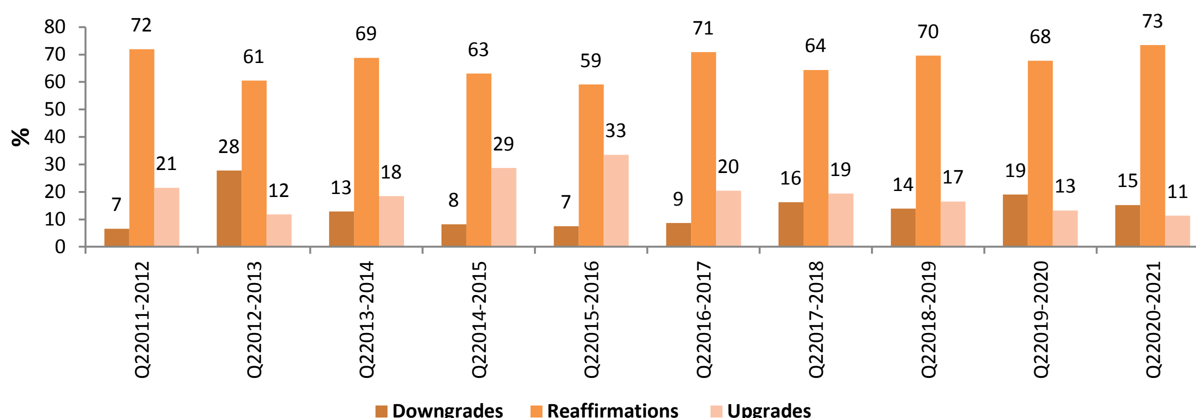
The credit quality of entities with both investment grade' (BBB- and above) and 'below investment grade' ratings (BB+ and below) moderated in Q2 2020-21 with their MCR falling below 1, underscoring the higher proportion of downgrades to upgrades. Even though the MCR of 'investment grade' entities in Q2 2020-21 at 0.95 was 8 bps lower than year ago it was higher than that of 'below investment grade' entities (0.91).

Proportion of Upgrades, Downgrades and Reaffirmations

The majority of entities saw their credit ratings being reaffirmed in Q2 2020-21. 73% of the entities whose ratings were reviewed in Q2 2020-21 saw their ratings being reaffirmed, 6% higher than that in the same period a year ago.

11% of the entities reviewed in Q2 2020-21 witnessed rating upgrades v/s 13% a year ago while 15% of the entities saw a rating downgrade from 19% in Q2 2019-20.

Exhibit 2: Proportion of Ratings Upgrades, Downgrades and Reaffirmations



Industry-wise Rating Movements

Of the 31 key sectors, MCR in Q2 2020-21 was above unity (1) for entities belonging to 9 sectors, reflective of the stability/improvement in their credit ratings. These sectors included cement, education, healthcare, IT, paper and paper products, pharmaceuticals, rubber and plastic products, iron and steel, and sugar. Of these 9 sectors, only 5 sectors viz. cement, education, healthcare, pharmaceuticals and sugar witnessed an improvement in credit quality from year ago.

The credit quality of 22 key sectors was under pressure with their MCR being below 1 and nearly all these sectors witnessed a deterioration in credit quality from year ago. The sharpest deterioration in credit quality has been in the case of telecom, real estate, construction, auto, wholesale and retail trade, textiles, hospitality and food and food products.

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

Table 3 : Industries whose credit quality deteriorated

	Q22018-2019	Q22019-2020	Q22020-2021
Agriculture and allied	1.10	1.09	0.96
Auto	1.25	1.10	0.87
Banks	0.93	0.96	0.89
Beverages	1.19	1.39	0.94
Ceramics	1.23	1.14	0.90
Chemicals	1.10	1.10	0.98
Construction	1.04	0.97	0.91
Electrical Equipment	1.14	1.04	0.97
Electricity - Generation	1.27	1.10	0.99
Electricity - Transmission and distribution	0.95	0.98	0.95
Fabricated metal products	1.08	1.09	0.86
Financial Institution	1.00	0.94	0.98
Food and food products	1.16	1.07	0.92
Hospitality	1.03	1.09	0.95
Information and communication	1.08	0.72	0.91
NBFC	1.13	0.94	0.96
Other manufacturing	1.06	1.02	0.98
Real Estate activities	0.92	0.91	0.86
Telecom	0.90	0.86	0.78
Textiles	1.12	1.03	0.95
Transportation and storage	1.03	0.96	0.90
Wholesale and retail trade	1.00	1.05	0.91

Table 4: Industries whose credit quality was stable/ improved

	Q22018-2019	Q22019-2020	Q22020-2021
Cement and related products	1.14	1.07	1.08
Education	1.03	0.96	1.13
Hospitals and health care	0.91	0.92	1.02
Information Technology Enabled Services)	1.06	1.03	1.00
Iron and Steel	1.27	1.27	0.99
Paper and paper products	1.24	1.35	1.10
Pharmaceuticals	1.05	0.96	1.02
Rubber and plastics Products	1.07	1.07	1.04
Sugar	1.00	1.00	1.08

- 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 sector. Credit profile of auto players was also affected by working capital stuck in inventory and debt funded capex as well as the decline in scale of operations that had led to a lower absorption of fixed and semi variable overhead costs. The deterioration in capital structure and weak liquidity position has also exerted pressure on the financial profile of the entities in 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 the restriction imposed on its operations and saw a large number of downgrades.

- The real estate sector has been faced with high inventory levels amid weak demand, labour shortage, disrupted supply chains and growing risk aversion among lenders. All these factors have stressed the liquidity position and increased cost of funding for entities in the sector adversely impacting their financial profile.

- The textile sector has been facing headwinds for the last few years due to higher raw material prices, stiff competition and low value addition, all of which have affected profitability. The outbreak of Covid 19 has adversely impacted both domestic and export demand for textiles. All this prompted downward rating revision for entities of the sector.

- The NBFC sector was already facing tight market conditions due to the liquidity crisis it faced earlier in the previous 2 financial years. The pandemic/lockdown led low collections and moratorium allowed to borrowers in March 2020 has led to cash flow disruptions and has constrained liquidity. 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, delays and difficulty in raising funds, 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 entities 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.