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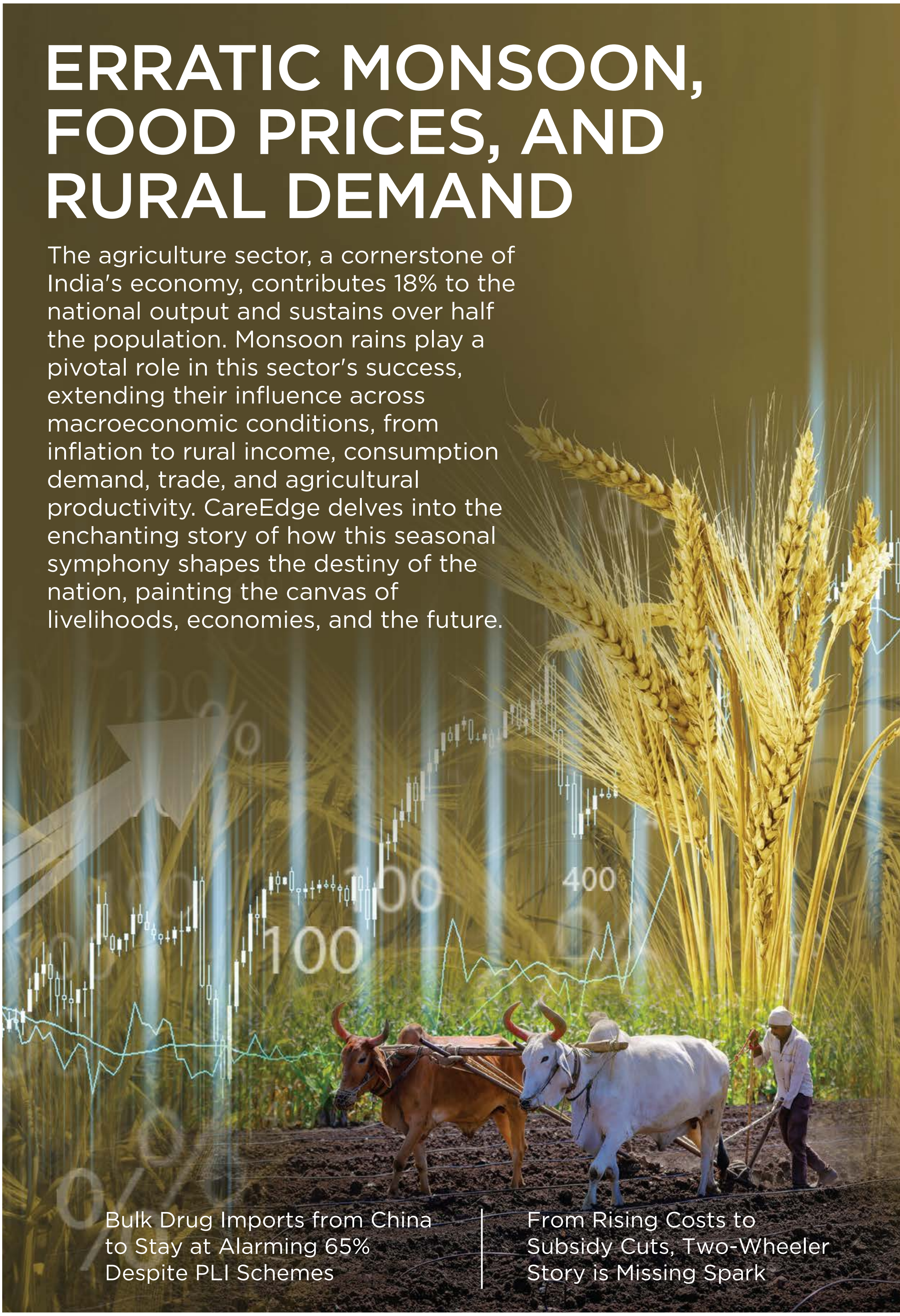


## ERRATIC MONSOON, FOOD PRICES, AND RURAL DEMAND

The agriculture sector, a cornerstone of India's economy, contributes 18% to the national output and sustains over half the population. Monsoon rains play a pivotal role in this sector's success, extending their influence across macroeconomic conditions, from inflation to rural income, consumption demand, trade, and agricultural productivity. CareEdge delves into the enchanting story of how this seasonal symphony shapes the destiny of the nation, painting the canvas of livelihoods, economies, and the future.

Bulk Drug Imports from China to Stay at Alarming 65% Despite PLI Schemes

From Rising Costs to Subsidy Cuts, Two-Wheeler Story is Missing Spark

# NOTE FROM

# SACHIN GUPTA

Chief Rating Officer & Executive Director

## G20 Summit: Transforming the Landscape for Corporate India

In the current landscape, the cover story revolves around the encouraging profitability of Corporate India, a development that was anticipated. In the preceding year during this quarter, the global economy was grappling with the repercussions of the Ukraine-Russia conflict, leading to a significant surge in commodity prices. Subsequently, the moderation of these commodity prices has fostered improved profit margins. However, it's worth noting that this upturn in profitability is juxtaposed with tepid sales growth, primarily attributed to the impact of lower commodity prices on the sales value of industries reliant on commodities, such as Steel, Chemicals, and Oil and Gas.

Nonetheless, the headline-grabbing story of the month is the G20 Summit and its profound implications for India's role on the global economic and political stage. Never before have we witnessed such a gathering of world leaders convening in India, a testament to the nation's ascending influence. Remarkably, amidst a backdrop of increasing global polarization, this summit yielded noteworthy announcements and decisions.

From the perspective of Corporate India, the G20 Summit has unveiled three pivotal long-term growth drivers:

**Expanding Trade Horizons:** Historically, India has maintained a relatively inward-focused approach, particularly concerning manufactured goods. However, the summit spotlighted India's potential to become a global manufacturing powerhouse. As the Western world endeavours to diversify its sources away from China, India's low-cost labour force, improving infrastructure, and robust financial system position it as a compelling alternative - a “China+1.” This newfound stature can potentially enhance India's negotiating power in Free Trade Agreements (FTAs) and deepen its ties with rapidly growing economies like Saudi Arabia, Brazil, and Indonesia, which could become significant trading partners.

**The India–Middle East–Europe Economic Corridor:** Among the ambitious announcements at the G20 Summit, the IMEC stands out as a game-changer with direct economic implications. Indian corporations stand to gain substantial opportunities in constructing extensive infrastructure projects, including roads and ports. Furthermore, as the world accelerates its shift towards decarbonization, Middle Eastern nations are expected to transition away from traditional oil and gas sectors, potentially paving the way for Indian companies to participate in emerging industries. IMEC serves as a conduit for capitalizing on these transformative developments.

**Deepening Ties with Africa:** The inclusion of the African Union, representing 55 African nations, within the expanded G20 framework marks a significant symbolic achievement for the Indian government. Africa boasts vast mineral reserves and represents a burgeoning potential market, with a current GDP nearing USD 3 trillion. Historically, China has been a dominant player in the African continent, with substantial investments and strong political connections. Now, India is poised to emerge as a credible alternative to China. The focus will be on infrastructure development and ensuring mineral security in this partnership.

In conclusion, the G20 Summit has brought about a profound transformation in India's standing on the global platform, elevating it to a position of greater prominence and influence. However, the implications of this summit extend far beyond the nation's diplomatic successes. For Corporate India, this event has opened up a wealth of strategic opportunities that have the potential to reshape the landscape of its operations.

# NOTE FROM RAJANI SINHA

Chief Economist

## India's GDP data shows cautious optimism

India's GDP growth has continued to show momentum recording a growth of 7.8% in Q1 FY24, improving from 6.1% growth recorded in the previous quarter. While the GDP growth number is broadly in line with our expectations, it is lower than RBI's projection of 8%. A sector wise analysis shows that the GDP growth has been led by services sector that has recorded a strong growth of 10.3%, with very good performance specifically by Financial, Real Estate and Professional services. With raw material prices reducing, manufacturing sector has continued to show improved momentum recording a growth of 4.7%.

On the expenditure basis, the heartening aspect is that the consumption momentum has shown an improvement, with private final consumption expenditure recording a growth of 4.9% compared to 2.7% in the previous quarter. There has been some moderation in investment expenditure that has grown by 8% in Q1 FY24 (8.9% in previous quarter) and that can be partially attributed to the base effect. The capital expenditure is so far being mainly led by the Government sector. In Apr-June quarter we have seen the centre capex increasing by 59% (YoY), while state capex has grown by 76% (as per our aggregate analysis for 19 states).

Weak external demand has continued to cast a shadow on India's GDP numbers. While exports of goods and services have fallen by 7.7% in Q1 FY24, surprisingly imports of goods and services have increased. This has resulted in sharp widening of the trade deficit and has eaten into the GDP number.

We expect the GDP growth to moderate in subsequent quarters. For FY24, GDP growth is likely to be around 6.5%. There is likely to be some moderation in services sector growth as some of the pent-up demand wanes. Manufacturing sector is expected to see continued gradual improvement as the sector reaps benefits of lower raw material prices. Agriculture sector fate remains uncertain given the skewed progress of monsoon so far. In fact, the 10% deficient rainfall so far and the skewed temporal and spatial distribution has already resulted in sowing of some of the kharif crops like pulses and oilseeds adversely impacted. Unfortunately, this comes at a time when some of global agriculture commodity prices (specifically edible oil) are also showing increasing trend. The concerning aspect is that poor agri performance will also dent rural demand that had just about started showing signs of improvement. Moreover, this could also put upward pressure on food inflation. The threat is that sustained high food inflation could dent the overall consumption recovery, specifically for the lower income category.

The other very critical aspect would be for the private investment to pick up in the months to come. As per CMIE data, investment projects completed, is so far clearly being led by the Government sector. Moreover, it is limited to construction and road sector, with manufacturing sector still looking weak. However, the private sector has been showing strong intent to invest, as per the Investment Projects announced data. Hopefully this should result in private investment picking up in the coming quarters. Given the lurking weather related and geo-political concerns, if India manages to achieve 6.5% growth in FY24, it would be something to cheer about.

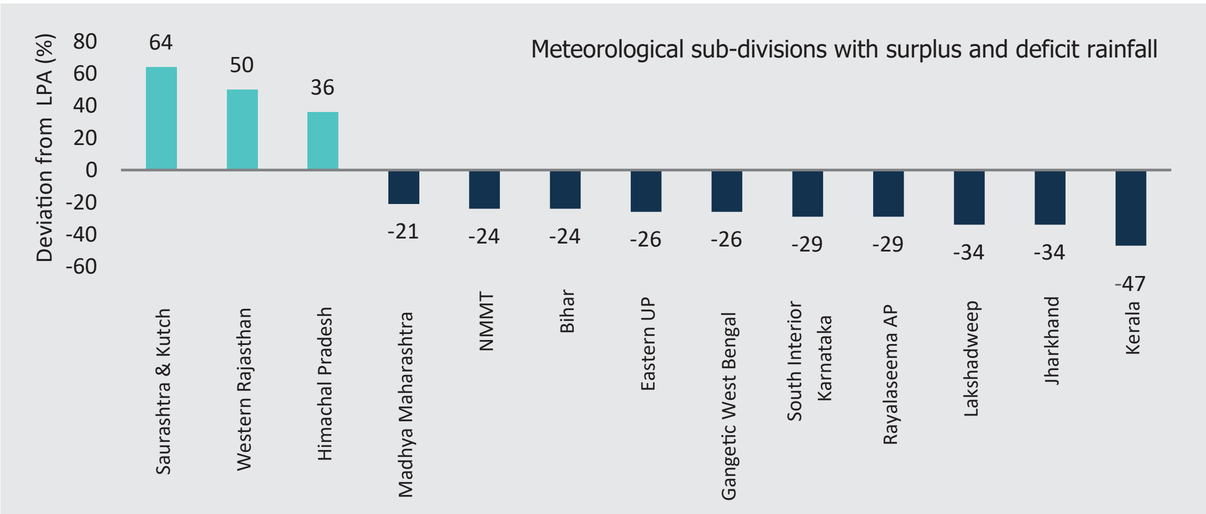
# ERRATIC MONSOON, FOOD PRICES, **AND RURAL DEMAND**

Agriculture and allied sector, which contributes around 18% to the national output and provides livelihood to more than half of India's population, is heavily dependent on the monsoon. The monsoon has a far-reaching effect on domestic macroeconomic conditions and directly or indirectly impacts domestic inflation, rural income, consumption demand, trade, and agricultural productivity. The dependency on the monsoon is further underlined by the fact that only about 57% of the farm area is covered by irrigation, with large states like Maharashtra, Karnataka, Odisha, West Bengal, and Tamil Nadu having coverage below the national average. Since over 75% of India's annual rainfall occurs between June and September, these four months are crucial for Kharif output and can impact domestic reservoir levels, affecting irrigation-dependent rabi output.

While an uneven monsoon increases the risk to domestic food prices, global developments don't support domestic inflationary conditions either. The risk to global food prices remains elevated with recent weather-related disruptions in South Asian countries and geopolitical developments. The evolving geopolitical situation warrants close monitoring amid recent reports of Russian warships firing warning shots aimed at cargo heading for ports in the Black Sea coasts. The collapse of the Black Sea grain deal will adversely affect global wheat, corn and oil edible prices. Further, due to El Nino, there is the expectation of subdued production growth of palm oil in Malaysia and Indonesia and that has resulted in a spike in global edible oil prices. FAO Vegetable Oil Price Index rose sequentially in July, marked by a rise in sunflower, palm, soy, and rapeseed oil prices. Higher global food prices can pass through to domestic consumption baskets as import dependency remains high on some items like edible oil and pulses. India's import dependency of pulses and edible oil for domestic consumption currently stands at around 55% and 9%, respectively.

Amid these evolving global developments and weather-related vagaries, rural demand remains most vulnerable and can be hit by a dual blow of higher food inflation and lower income. The government's budgeted cuts on subsidies introduced during the pandemic can further weaken rural demand.

**Southwest Monsoon has Both Spatial and Temporal Variations**




Source: CEIC; Data as on August 25, 2023. NMMT: Nagaland, Manipur, Mizoram and Tripura.

The erratic progress of the southwest monsoon has resulted in a spike in the prices of the domestic food basket, which has a weight of about 40% in the CPI inflation basket. On the one hand, excess rainfall over a short period has resulted in flooding in certain parts of India, adversely impacting the production of certain crops; on the other hand, significant deficit rainfall in certain pockets has adversely affected the sowing activity. Among the major agricultural regions, eastern Gangetic plains (ranging from eastern UP, Bihar, Jharkhand, and Southern West Bengal) and Southern Karnataka, Madhya Maharashtra, Rayalaseema in Andhra Pradesh, and Kerala continue to witness a significant deficit in the cumulative rainfall. At the same time, certain western regions like Saurashtra and Kutch, Western Rajasthan, and Himachal Pradesh continue to witness surplus rain.

Apart from the spatial distribution, the temporal distribution of rainfall has been skewed across the country. After a cumulative deficit rainfall in June (10% below normal), July witnessed a rebound with cumulative rainfall 5% above normal. In line with the India Meteorological Department's (IMD) and Skymet's projection, the rainfall activity has been muted in August to date, with cumulative rainfall falling back to an 8% deficit. Weak to moderate El Nino conditions are expected to lead to a prolonged dry spell.

**Monsoon Dependency Increases Risk to Agricultural Output**

A deficit monsoon has adversely affected kharif sowing with a decline in the sowing of pulses (-8.3% y-o-y), oilseeds (-0.9% y-o-y), and cotton (-1.8% y-o-y). As kharif sowing activity is expected to be over by the end of August, the sowing of these crops is unlikely to improve drastically. A drop in yield due to irregular monsoon and a lower acreage can lead to a demand-supply mismatch, further increasing inflationary pressures in the food basket. Pulses and cereals are already witnessing double-digit inflation.

Lower rainfall and the resultant lower reservoir levels will have implications for the rabi crops that have a higher dependency on irrigation. The cumulative water levels in 146 key reservoirs across India have dipped below the 10-year average as a result of slow monsoon progress over the past week. As per the weekly data published by the Central Water Commission (CWC), the water storage in the 146 monitored reservoirs as of 24th August was at 64 % of their total capacity which is six percentage points below their 10-year average. The reservoir levels mirrored the spatial distribution of monsoon, with Eastern and Southern regions witnessing a significant deficit in comparison to the 10-year average.

Pulses, coarse grains, and oil seeds remain India's most rain-dependent food crops, with a higher proportion of unirrigated areas. A deficit in the sowing of these crops can further add to the inflationary pressures. Given the current status of the reservoir level, six states - Maharashtra, Jharkhand, Karnataka, Odisha, West Bengal, and Tamil Nadu remain the most vulnerable states. The risk to agricultural output is very high in these six states as they have current reservoir levels below their 10-year average and an area under irrigation below the national average. Together, these most vulnerable states contribute nearly a third of India's agriculture GVA.

Despite having an area under irrigation above the national average, crop output in states like Kerala, Uttar Pradesh, Andhra Pradesh, and Bihar also faces significant risk due to a deficit in their reservoir level.

**Monsoon and Macro Impact**

Monsoon increases macroeconomic risks on two fronts:

**Food inflation can stay higher over the next few months:** Irregular rainfall patterns have had a notable impact on crop production, manifesting in two distinct ways. Firstly, an intensified and condensed period of heavy rainfall in north-western India has inflicted damage upon vegetables and fruits, disrupted already planted crops, and hindered the timely commencement of sowing, as farmers awaited the dissipation of excess water. Secondly, a deficiency in rainfall in the eastern and southern regions is also anticipated to have adverse effects on crop yields.

Among the crops in jeopardy due to the erratic monsoon progression, oilseeds and pulses stand out as the most vulnerable. Given their relatively high reliance on imports, any decrease in domestic production could potentially expose domestic consumers to fluctuations in the global prices of agricultural products.

The upside risk to food inflation also stems from a risk of higher pass-through of the recent sequential uptick in global vegetable oil prices (12.1% m-o-m) into the domestic consumption basket, thereby adding to imported inflation. Vegetable oil accounts for ~40% of the annual agriculture import bill and almost 55% of the domestic consumption demand is met via import. Over the past few months, the contraction in the domestic price of oils and fats has cushioned the spike in food inflation. Any reversal in the deflationary trend in edible oil will be detrimental to domestic inflationary conditions.

Retail food inflation surged from 4.7 % in June to 10.6% in July. Apart from a 37.3% (y-o-y) surge in vegetable prices, other subcomponents like cereals (13%), milk (8.3%), pulses (13.3%) and spices (21.6%) also showed a significant rise. The uptick in vegetable prices in July was primarily led by certain vegetables in the food basket and is expected to be transient. However, the rise in prices of wheat, rice, and coarse cereals tends to be stickier as compared to vegetable prices. Cereals have sustained double-digit inflation over the past six months, and domestic prices of pulses have seen a sharp uptick recently. Thus, a poor harvest of these agricultural products can keep their costs elevated for longer.

Given the direct influence of food inflation on household inflationary expectations, the government would be wary of building inflationary pressures. The Centre has already introduced pre-emptive measures to keep a lid on food inflation through supply-side interventions to boost domestic availability. The recent restrictions on the export of non-basmati rice, imposing 40% export duty on onion exports, monitoring of stock limits on pulses to prevent hoarding and continuing ban on wheat export imposed in May last year are some of the measures undertaken by the government. Comfortable buffer stock position in wheat and rice will provide some firepower to the government to fight a rise in cereals inflation. The Centre may also look to cut import duties of certain essential food items and put restrictions on the export of sugar to tame domestic inflationary pressures.

The RBI is expected to remain cautious and, employ a 'wait and watch' approach. While there is an anticipated moderation in vegetable inflation, the potential for persistent price pressures on cereals, pulses, and spices remains evident. Furthermore, it's worth noting that the risk of food inflation being influenced by global factors has also heightened. Nonetheless, the presence of more subdued core inflation, declining Wholesale Price Index (WPI) inflation, and a dip in global commodity prices, particularly in the industrial metals sector, will serve to mitigate the impact on Consumer Price Index inflation, albeit with a certain time lag.

Our projection anticipates that food inflation will maintain an elevated trajectory in the coming months, gradually receding by October in conjunction with the influx of fresh harvest into the market. Our analysis indicates that food and beverage inflation is projected to peak, reaching an average of 9.4% in the second quarter of FY24. Subsequently, we expect a gradual cooling, with an estimated 6.9% in the third quarter of FY24, followed by a further decline to 5.9% in the fourth quarter of FY24.

**Rural demand outlook weakens on account of lower agricultural output:** The rising cost of living led by high food inflation and expected hit to agriculture due to an erratic monsoon has put the spotlight back on the stress in rural demand. Risk to farm income remains high as uneven distribution of monsoon has affected the sowing of certain crops and can adversely affect crop yields. Risk to rabi sowing also remains elevated as reservoir levels remain significantly below the 10-year average in Eastern and Southern India. The 77th round of the National Statistical Office (NSO) survey on 'Land and Livestock Holdings of Households and Situation Assessment of Agricultural Households' shows that about 37% of rural household income comes from crop production, about 49% of income comes from wages and remaining 14% comes from non-farm business, livestock and rent.

While there are risks arising from monsoon-related vagaries to income from crop production, a deeper look into the data reveals a growing risk to the rural income coming from wages as well. There are visible signs of distress in the rural labour market. The rural unemployment rate continues to hover around 8%, and demand for work under the rural employment guarantee scheme (MNREGA), often seen as a sign of distress in the rural labour market, has increased by 15.2% in July compared to last year. One plausible explanation for such a jump in demand for MNREGA jobs is the delayed sowing of the kharif harvest, which has softened rural demand for agricultural workers.

Budgeted withdrawal of pandemic-era revenue expenditure led by a steep reduction in the subsidy bills will further squeeze rural consumers' wallets. Real rural wage (adjusted for inflation) has remained mostly stagnant with marginal growth of 0.4% in March 2023. Subdued rural consumption is also indicated by falling 2-3-wheeler sales, muted tractor sales, and slowing non-durable goods production. The weakness in rural demand is also being corroborated by corporate quarterly results of FMCG companies. Our analysis of quarterly performance of the domestic FMCG companies in Q1 FY24 shows that gross sales have

recorded a muted growth of 2.2%, even while their operating profit growth has improved to 12% due to lower raw material prices. As pressures on volume continue to persist, FMCG companies have specifically highlighted that rural demand remains weak, even though it is showing signs of improvement. A rise in food inflation could further destabilise the feeble rural demand recovery.

Going ahead, we expect consumption demand to pick up during the festive season, but the quantum of rise in demand will be dependent on the extent of the hit due to the vagaries of the monsoon. On the positive side, expected slowing inflation in the coming quarters (Q3 and Q4) will boost disposable income in the hands of consumers. Both the Centre and State's capex continue to stay strong, which will 'crowd in' private investments and boost job creation, adding further impetus to consumption demand.

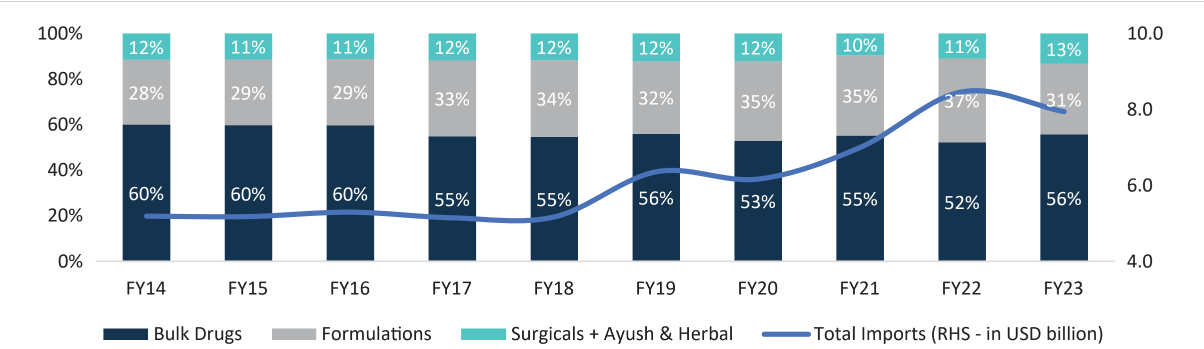
While some recovery in rural demand was witnessed, the re-surfacing of inflationary concerns poses a threat to the feeble rural demand recovery. However, overall inflation including food inflation likely to moderate from Q3 onwards and we expect rural demand to improve, but we need to be watchful of the further progress of monsoon and global developments and the impact of the same on domestic food inflation.

# BULK DRUG IMPORTS FROM CHINA TO STAY **AT ALARMING 65% DESPITE PLI SCHEMES**

- **The contribution of bulk drug imports from China has increased in terms of value and volume from 64% and 62% during FY14 to 71% and 75% during FY23, respectively.**
- **India continues to rely heavily on some of the critical Key Starting Materials from China.**
- **CareEdge Ratings believes that despite the envisaged commissioning of various projects under the PLI scheme, the dependency on the import of bulk drugs from China would remain high at about 65% going forward.**

The Indian pharmaceutical industry has demonstrated impressive growth over the years, achieving a Compound Annual Growth Rate (CAGR) of approximately 7% during FY14-FY23. As of FY23, the industry's market size has soared to approximately $49.78 billion. Concurrently, the total pharma imports have also exhibited a similar CAGR of about 7%, reaching $7.9 billion during FY23. When we delve into the specifics of pharma imports, it is evident that bulk drugs hold a significant share, accounting for approximately 55% of the total imports. Formulations follow closely, contributing around 30% to 35%, while the rest comprises Ayush & Herbal and Surgical products. Interestingly, of the total bulk drugs manufactured, almost one-third are exported, and the remaining two-thirds are domestically consumed. India's contribution to the global supply of generic drugs is noteworthy, as it constitutes about 20% of the global supply. The country's prowess in the pharmaceutical domain is further solidified by its rankings – third largest in terms of volume and 14th largest in terms of value. However, this position as a prominent supplier of generic drugs also entails a substantial demand for bulk drugs.

**Indian Pharma Imports across Segments during FY14-FY23**




Source: CMIE

India has over 3000 bulk drug manufacturers but most of them are small unorganised players and they contribute about 50% to 60% of the total share.

Bulk drugs have emerged as a dominant component, contributing 55% to 60% of the total pharma imports over the last decade. Simultaneously, bulk drug imports have witnessed a steady Compound Annual Growth Rate (CAGR) of about 7%, reflecting the industry's growing reliance on these essential components. Geographically, a significant portion of India's pharma imports, including certain formulations, Ayush & Herbal, and Surgical products, are sourced from various countries. However, the scenario is notably different when it comes to bulk drugs, with a substantial dependency on a single country - China, which raises concerns due to existing geopolitical tensions.

China accounts for approximately 43% of the total pharma imports in India, making it the primary source of bulk drugs for the country's pharmaceutical industry. While imports of other pharmaceutical products are diversified across multiple countries, the reliance on China for bulk drugs stands out as a critical point of vulnerability. The contribution of bulk drug imports from China has exhibited significant growth in both value and volume terms, increasing from 64% and 62% during FY14 to 71% and 75% during FY23, respectively. Notably, the total bulk drug imports have grown at a CAGR of about 7% in terms of value from FY14 to FY23, compared to a higher CAGR of 9% from China over the same period. The implications of such reliance on China for bulk drugs are far-reaching, particularly for life-saving drugs, where the dependency on Key Starting Materials (KSM) from China exceeds 50%. This situation raises legitimate concerns about the availability, cost, and uninterrupted supply of crucial medicines in India's healthcare landscape.

**Project Completions Strike a Decade High but Dependency on China Continues**

During FY24, the total project completions in the drugs and pharmaceuticals industry are expected to be around $516 million which is the highest registered during the last decade. One of the prime reasons for such a high run rate of project completions during FY24 is due to the production-linked incentive (PLI) scheme introduced by the government along with an overall increase in demand for drugs and pharmaceuticals. Further, amongst the project completions, one specific project - the Penicillin G manufacturing plant located at Kakinada, Andhra Pradesh alone contributes $244 million which is almost half of the total project completions envisaged during FY24.

According to a comprehensive analysis by CareEdge Ratings of companies operating in the active pharmaceutical industry (API) segment, the Net Asset Turnover stands at 2.5x to 3x times. This metric reflects the efficiency with which these companies are utilizing their assets to generate revenue. In light of the projects completed during FY23 and the estimated projects to be completed during FY24 and FY25 under the Production-Linked Incentive (PLI) scheme, CareEdge Ratings anticipates a positive impact on the industry's reliance on imports from China. By the end of FY24, it is estimated that the dependency on Chinese imports is expected to decrease to 69%. Furthermore, as major projects become operational during Q4FY24 and additional projects are set to commence during FY25, this reliance is projected to reduce further to around 65%. Although a positive development, it is worth noting that the dependency will still remain at a relatively high level.

During the next two years, FY24 and FY25, the Indian Pharma Industry is expected to grow by approximately 7%-9%. This growth will lead to incremental requirements for APIs (Active Pharmaceutical Ingredients), which are expected to be met through enhanced capacity additions under the PLI schemes. As a result, the overall dependency on the import of bulk drugs from China is likely to continue to be high.

### CareEdge Ratings View

"Over the last decade owing to unattractive business prospects and lower returns on investment for key KSMs and APIs, the investments in these segments were weak. Simultaneously, on account of the availability of the said raw materials at lower prices from China, the Indian pharma players have relied heavily on its import of bulk drugs from China which has reached a whopping 71% and 75% in terms of value and volume respectively during FY23. The PLI scheme 1 & 2 although supposed to play a critical role in developing the KSMs and APIs at competitive prices and reduce dependency, the results of the same have not been very encouraging.

As per the industry, combating the pricing war with Chinese players would be extremely challenging. India currently needs an entire ecosystem beginning with dedicated universities, R&D driven by cutting-edge technology, large bulk drug parks (focused exclusively on lifesaving KSMs) with common infrastructure and substantial support from the government. Nevertheless, deriving the existing benefits from PLI schemes, CareEdge Ratings expects the import dependency to taper marginally and the same is expected to be about 69% and 65% by the end of FY24 and FY25, respectively. However, with the amelioration of raw material prices, along with deriving benefits from enhancing manufacturing capabilities for high-value drugs, speciality chemicals etc., it is expected that the operating margins of bulk drug entities to improve from 18% during FY23 to about 20% by FY25," said D. Naveen Kumar, Associate Director at CareEdge Ratings.

# C&I SEGMENT: GROUP CAPTIVE MODE TO **DRIVE INSTALLATIONS IN FY24-FY25**

- **Annual open-access installations are projected to remain within the range of 4 to 5 GW for the next two years.**
- **This necessitates debt financing of more than Rs. 30,000 crore.**
- **ESG thrust along with the favourable economic viability, to drive demand prospects for this segment.**

Commercial & Industrial (C&I) consumers in India have the option to purchase power either through a third-party power plant or through a captive/group captive power plant besides procuring power from the designated utility in their region. Availment through the third-party open access route does not warrant any capital investments from the procurer but necessitates the procurer to pay all the open access charges applicable in the state. On the other hand, in the captive/group captive route, C&I consumer owns at least 26% stake in the plant, while exempt from paying two major types of open access charges i.e., cross subsidy surcharge (CSS) and additional surcharge (AS) which approximately account to Rs. 2.5-3.0 per unit in the key RE states.

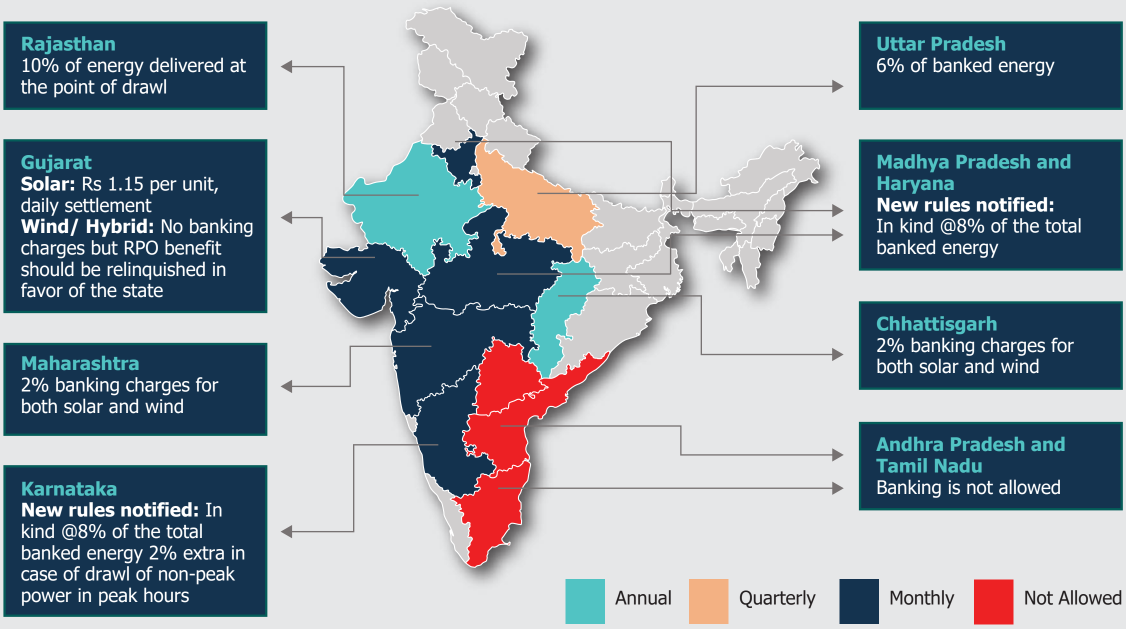
Till FY17, the open access RE market was a fledgling market and capacity installations surged on the back of a favourable state policy promulgated in the state of Karnataka. As per this policy, solar plants commissioned prior to 31st March 2018, would be exempt from paying open access charges for a period of 10 years. Karnataka witnessed open access RE installations of over 2 GW in FY18, kickstarting the growth of this segment. Apprehending the migration of premium customers to private players leading to potential revenue loss, few state discoms withdrew open access benefits during FY18 to FY21. Consequently, the installations which suffered due to the spread of the virus remained subdued during this period. However, the open access market has grown over the last two years with installations of 2.6 GW and 3.2 GW in FY22 and FY23, respectively, driven by supportive policies in some of the key states and improvement in the competitiveness of renewable tariffs against the grid tariffs. The latest growth wave has also been brought by a conducive wind-solar hybrid policy in the state of Gujarat.

According to CareEdge Ratings, annual open access installations in India have remained below 3.5 GW thus far, with cumulative installations at approximately 13.6 GW, which account for between 9 to 10% of the overall installed capacity of renewable energy. The C&I market presents significant growth opportunities for the renewable sector and is expected to attract substantial private investments. In CareEdge Ratings view, annual open-access installations are projected to remain within the range of 4 to 5 GW for the next two years i.e., till FY25 thereby necessitating debt financing of at least Rs. 30,000 crore.

### Green Energy Open Access Rules to be a Key Enabler for C&I Sector

The government has introduced various green energy open access rules to accelerate the transition towards renewable energy rendering the market attractive for both power producers and consumers in the C&I sector. Initiatives include (i) reducing the eligible load to 100 kW from 1 MW for consumers to procure power through the open access route, (ii) defining the modalities of open access charges that can be applied by state distribution companies (discoms), and (iii) stipulating a minimum banking period of 30 days for consumers among others. Discoms are also obligated to supply green energy at an additional cost upon consumer request. While the government aims to harmonize open access rules nationwide, individual states have the jurisdictional powers to determine open access charges for their customers through their electricity commissions.

**Banking Provisions across Key RE States**




Source: Industry Sources, CareEdge Ratings

Thus far, a few states such as Karnataka, Madhya Pradesh and Haryana have come up with a final order for the adoption of green energy open access rules and CareEdge Ratings has analysed the same. While few suggestions primarily pertain to reducing the minimum load requirement, the applicability of a minimum banking period of 30 days has also been accommodated. On the other hand, suggestion related to the adjustment of energy banked in the off-peak period against drawl in the peak period has been disallowed in the states of MP and Haryana.

In the other key states, which are yet to adopt the green energy open access rules, Tamil Nadu and Andhra Pradesh continue to refrain from offering banking to the C&I customers which poses a hurdle for the segment's development. While Gujarat has a conducive banking policy for wind and hybrid plants with nil banking charges, it has very high banking charges for solar units @ Rs. 1.15 per unit, which discourages the installation of solar plants through open access routes.

CareEdge Ratings in its analysis has compared the landed cost from a wind-solar hybrid open-access project, both captive as well as third-party open-access project against the prevailing grid tariffs for industrial consumers at 33 kV voltage level. For this evaluation, the PPA tariff for the wind-solar hybrid project has been assumed at Rs. 4 per unit. Owing to the exemption of CSS and AS, the group-captive model is by far the most preferred OA business model. The margin of safety i.e., the discount a RE C&I project offers on the grid tariff ranges between 20-40% under the group captive mode with the viability being the best in Gujarat, Karnataka, and Uttar Pradesh. The third-party OA model, wherein all open access charges apply with almost no exemptions, is the least attractive and currently unviable across many states. Interestingly, the Margin of Safety in the case of Gujarat lies in double digits primarily on account of prevailing high grid tariffs.

### CareEdge Ratings' View

"The introduction and successful adaptation of green energy open access rules are expected to support future capacity additions through the open access route. Moreover, the inclination and commitment of corporates towards decarbonising their supply chains along with the strong economic incentive due to procuring green power, especially through the captive route would continue to act as an enabler for this segment. The presence of strong counterparties in this segment has also resulted in adequate availability of debt financing. However, impediments in the form of regulatory risks about lack of uniform open access policies across states and increase in competitive intensity is expected to pressurize returns," stated Jatin Arya, Associate Director, CareEdge Ratings.

CareEdge RATINGS

# FROM RISING COSTS TO SUBSIDY CUTS, **TWO-WHEELER STORY IS MISSING SPARK**

- **The core segments of two-wheelers, specifically the 75cc-110cc range in motorcycles and the 75cc-125cc range in scooters, exhibited a sharp sales volume decline from FY19 to FY22, with a slight recovery noted in FY23.**
- **Motorcycles have witnessed a partial offset of this decline through relatively lower drops or quicker recoveries in the higher engine capacity segments.**
- **This decline in sales volumes of the mainstay models can be attributed to an overall higher cost of ownership of two-wheelers.**

The mainstay segment of motorcycles, specifically the 75cc-110cc category, witnessed a notable contraction in domestic sales volumes over the period spanning FY19 to FY22. However, a modest resurgence was evidenced in FY23. Conversely, segments with higher engine capacities displayed comparatively lower volatility. In FY19, domestic motorcycle volumes reached a pinnacle at 1,35,98,190 units, with the 75cc-110cc segment constituting 62% of the industry's sales volumes. While the share of this pivotal segment has progressively diminished, accounting for 51% in FY23, the industry's overall volumes have not rebounded to their FY19 levels. This dynamic indicates that the incremental volumes generated in the higher capacity (and consequently higher-priced) segments have not successfully counterbalanced the decline experienced in the foundational segment.

In the realm of scooters, a similar trajectory was observed in the primary 75cc-125cc segment, resembling the trends seen in the core motorcycle segment. However, the 125cc-250cc scooter segment experienced a more pronounced volume correction, and sales in the sub-75cc category have consistently remained low.

The downturn in sales within the core segments of both motorcycles and scooters can be attributed to escalated acquisition and operational costs over the past three to four years. In the case of the 125cc-250cc scooter segment, the decline can be partly attributed to the impact of electric scooters cannibalizing sales. Notably, incentives such as road tax exemptions and subsidies under the government's FAME (Faster Adoption for Manufacturing of Electric Vehicles) scheme have catalysed a surge in electric scooter sales over the preceding four years.

### Increased Cost of Ownership of Two-wheelers

During the FY20-FY23 period, the price of two-wheelers has increased by at least 35%, driven by commodity price increases as well as government regulations that mandated the incorporation of additional safety features as well as adherence to more stringent emission norms. The transition from BS-IV to BS-VI emission standards was made effective from 1 April 2020. Safety features such as Anti-Lock Braking Systems (ABS, for two-wheelers 125cc and above) and Combined Braking Systems (CBS, for less than 125cc) became mandatory exactly a year earlier. CareEdge Ratings believes that while the revised insurance norms introduced effective from September 1, 2018, (mandating the purchase of five-year third-party insurance policies while purchasing a two-wheeler) had increased overall acquisition costs only marginally, it has also contributed to the rise in the cost of acquisition and has impacted the sales of the entry-level models of motorcycles and scooters along with the other factors mentioned earlier. The over 50% surge in steel prices during FY21-FY22 had a larger impact on the prices of two-wheelers than the regulation-driven price increases of previous years.

The increase in prices of two-wheelers witnessed in the past four years has led to a weakening in rural demand and deferment of buying decisions, despite four continuous years of normal monsoon over FY20-FY23. Any disruption to agricultural output in FY24 due to the El Nino impact, which reduces the disposable income of the rural populace can further subdue two-wheeler sales in the current year. Q1FY24 has witnessed an overall 31% decline in export volumes of two-wheelers, driven by a 37% decline in motorcycle sales volumes, which was partly offset by a 30% rise in scooter volumes. India's two-wheeler exports are primarily to developing nations in Africa, Latin America and Asia. Many of these nations are currently facing monetary challenges and have devalued their currencies, making imports more expensive. The decline in motorcycle exports does not exhibit any definitive pattern across the various engine capacities, indicating that the overall demand has weakened from importing countries.

### Sharp Reduction in FAME Subsidy Slowing Down Electric Two-wheeler Demand

In order to boost the sales of electric vehicles, the Central Government vide the Ministry of Heavy Industries had introduced the FAME subsidy scheme effective from 1 April 2015 with a small budget of Rs. 75 crores. The scheme entailed cash subsidy being credited to dealers of EVs to bring down the acquisition cost for vehicle buyers. The budgetary allocation was increased on an annual basis along with the extension of the scheme, till FY19 when the budget stood at Rs. 145 crores. Post this, it was replaced by the FAME II scheme, which entailed a massive increase in budget, to Rs. 10,000 crores and was initially applicable for three years (till 31 March 2022), but was extended in June 2021 for another two years, till 31 March 2024. In the same month the Central Government increased the subsidy on two-wheelers from Rs. 10,000/kWh to Rs. 15,000/kWh with the maximum cap increased from 20% to 40% of the ex-factory price of the vehicle. Apart from the subsidies available under the FAME scheme, various state governments also introduced their own incentives such as a subsidy amount per kWh of battery capacity, and discounts (or complete exemption) on payment of road tax.

Sales of two-wheelers peaked in FY19, before declining over the next three years. While the Covid impact was clearly visible in FY20 and FY21, the rise in commodity prices in FY22 constrained rural sales. CareEdge Ratings is of the opinion that given the challenges explained above and the already high base of 1.9 crore vehicles sold in FY23 (with 1.5 crore vehicles sold domestically in the year), achieving a significant growth rate above this number would be a challenge.

### CareEdge Ratings' View

CareEdge Ratings posits that although commodity prices have softened in FY23, the ongoing need for additional technological advancements to adhere to E20 ethanol blending standards (introduced in stages since April 1, 2023) will sustain elevated prices for internal combustion engine (ICE) based two-wheelers. Presently, E20 blended petrol is retailing at around Rs. 60 per litre in select cities as per the government's phased rollout. This seemingly reduces the operating cost for buyers, potentially bolstering sales. However, a substantial track record for E20-compliant vehicles, encompassing fuel efficiency, power, and maintenance costs, is yet to be established. Furthermore, the existing retail price is largely influenced by government subsidies on E20 petrol, which may eventually be withdrawn akin to regular petrol and diesel. Due to the current high operational and ownership costs of internal combustion-based two-wheelers, buyers had been gravitating towards electric two-wheelers, backed by substantial subsidies from both Central and State governments. Initially, CareEdge Ratings anticipated that growth in the two-wheeler segment would be driven by electric vehicles, albeit from a smaller base compared to ICE-based vehicles. However, the reduction in FAME subsidy effective from June 1, 2023 has curtailed the previous robust growth in this category.

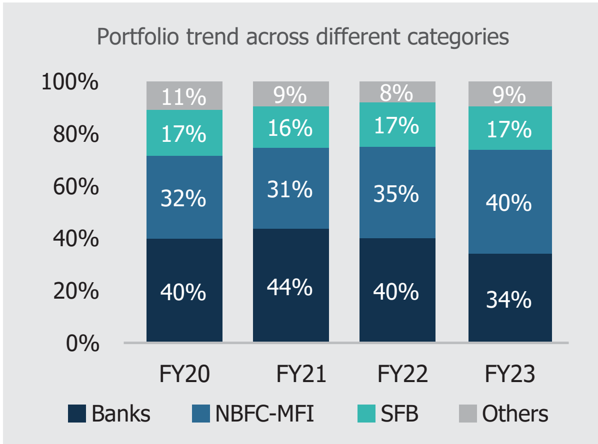
According to Sudarshan Shreenivas, Director, CareEdge Ratings, "Over the long-term, technological developments leading to a reduction in battery costs which makes electric two-wheelers comparable in price with ICE vehicles (after disregarding subsidies for EVs) would be the key factor driving electric two-wheeler sales. Should the government be successful in the implementation of inter-operability standards for batteries of electric vehicles, it would definitely lead to a spurt in electric two-wheeler sales given the convenience of switching spent batteries with fully charged batteries at charging stations. Additionally, there could be a reduction in retail prices of these vehicles as it would be possible to lease batteries at the time of purchase of an EV, rather than being forced to purchase an EV with a factory-fitted battery".

# MICROFINANCE INDUSTRY BEATS COVID BLUES, **LIKELY TO GROW BY 28% IN FY24**

- The Microfinance industry experienced a growth spurt in FY23, expanding at a rate of 37% Y-o-Y.
- NBFC-MFIs have surpassed banks in the overall microfinancing landscape, constituting approximately 40% of the total outstanding microfinance loans as of March 31, 2023.
- CareEdge Ratings anticipates growth momentum to continue, with the portfolio of NBFC-MFIs expected to grow at a rate of 28% y-o-y in FY 2024.

The microfinance industry has experienced a shift in market share, with NBFC-MFIs overtaking banks for the first time in four years. While banks held a dominant position during the Covid-19 period, the growth rate of NBFC-MFIs has now surpassed that of banks, resulting in NBFC-MFIs commanding a higher market share in the overall microfinance sector. As of 31st March 2023, NBFC-MFIs contributed around 40% to the outstanding overall microfinance loans, compared to banks' 34%. With a growth rate of around 37% during FY23, NBFC-MFIs are currently leading the industry.

**Portfolio Trends Across Categories**




Source: Data from CareEdge Ratings sample of NBFC-MFIs/MFIN/RBI;

The microfinance industry experienced a slowdown in growth in FY21 due to the challenges posed by the Covid-19 pandemic. However, growth rebounded in FY22 and FY23, with NBFC-MFIs growing at 17% and 37% Y-o-Y, supported by an improving macroeconomic environment. This growth momentum is expected to continue, with CareEdge Ratings projecting a healthy loan growth of around 28% in FY24 for NBFC-MFIs. Bihar, Tamil Nadu, Uttar Pradesh, Karnataka and West Bengal remain the top five states in terms of assets under management with Bihar leading the sector with around 15% market share as of December 31, 2022. In terms of product profile, Joint liability group (JLG) loans currently dominate the portfolio mix. However, with the new RBI guidelines, we are increasingly witnessing a shift towards individual lending. Further, RBI's new regulation of increasing household income to Rs. 3 lakh has given NBFC-MFIs an opportunity to expand their target market. Now, NBFC-MFIs can lend to the Non-MFI sector up to 25% of their total assets which was 15% of the loan book earlier.

### Profitability Indicators Improve with NIMs Expansion, Still Below Pre-Covid Levels

The NBFC-MFIs have demonstrated an enhancement in net interest margins (NIMs), registering approximately 10.1% during FY23, as opposed to the 9% recorded in both FY21 and FY22. This upswing can be attributed to the abolition of the lending rate cap regime in the revised RBI regulations and reduced interest income reversals due to the improved asset quality. While the comprehensive influence of the revised regulations is yet to fully materialize, the projection from CareEdge Ratings foresees a further escalation of NIMs in the forthcoming FY24.

Notably, the ratio of operating expenses to average assets has sustained a relatively elevated level of approximately 5.8% throughout FY23. This trend is propelled by the rapid expansion of branches, augmented technological advancements, and escalated compliance in alignment with the revised regulatory framework outlined by the RBI. Looking ahead, CareEdge Ratings anticipates a moderation in the rate of operational expense increment, concurrent with the realisation of operational efficiencies.

Evidently, the credit cost experienced a substantial rise, accounting for 4.7% of average assets in FY21. However, it demonstrated a marginal reduction to 3.7% in FY22 and further ameliorated to 3.4% in FY23. Supported by an improving macroeconomic milieu, the trajectory of the credit cost to average assets ratio is expected to undergo a further descent, projecting a reduction to 2.5% by FY2024. Nonetheless, it is noteworthy that this figure will persist at a higher level than the pre-Covid benchmarks.The improvement in margins along with the reduced credit cost has led to an improvement in profitability indicators, with a return on average assets of 2.6% in FY23 (vs 1.1% in FY22). Looking ahead, profitability is expected to improve further with higher margins, reduced credit costs, and improved collection efficiency. However, it is likely to remain lower than the pre-covid level in FY24.

### Asset Quality Improving

In the wake of the escalating impact of the Covid-19 pandemic on the income profiles of lower-income segments within the economy, coupled with the ensuing rise in debt servicing delays among end borrowers, the sector witnessed a notable surge in asset quality stress. The Gross Non-Performing Asset (GNPA) Ratio reached a zenith at 6.2% as of March 31, 2022, in stark contrast to the 2.05% recorded on March 31, 2020, primarily attributed to a significant upswing in slippages. However, marked by enhanced collection efficiency buoyed by an ameliorating macroeconomic landscape and substantial write-offs, an encouraging shift in the NPA trend is discernible, even though the GNPA ratio persists at elevated levels relative to the pre-Covid era. Moreover, a discernible reduction in the restructured loan portfolio is evident, with the book contracting from 9.5% as of March 31, 2022, to 5.1% as of September 30, 2022, and further to 1.6% as of March 31, 2023. Going forward, CareEdge Ratings expects the collection efficiency to remain high leading to improvement in asset quality metrics with the GNPA ratio reducing to 2% as of March 31, 2024.

Given the ongoing global upheaval, investor caution and selectivity are poised to intensify in subsequent times. In the broader perspective, we envisage the microfinance sector's gearing level to sustain a moderate stance at 4.1 times over the ensuing 12 months. Bearing in mind the inherent asset class attributes, any notable surge in gearing beyond the 4x threshold remains a pivotal aspect warranting oversight.

### CareEdge View

CareEdge Ratings foresees the growth trajectory within the Microfinance Institution (MFI) sector to sustain, projecting a year-on-year growth rate of approximately 28% for FY24. This impetus will be propelled by consistent disbursement expansion and an increasingly favourable macroeconomic landscape. A corresponding alleviation of asset quality strain is also anticipated, with the Gross Non-Performing Asset ratio projected to diminish to 2% by the conclusion of FY 2024, albeit remaining elevated in comparison to pre-Covid benchmarks. The expected upturn in the Return on Average Assets to approximately 3.8% during FY24 is underpinned by judiciously managed credit costs and ameliorating Net Interest Margins. However, it is imperative to acknowledge key risk factors. The burgeoning customer indebtedness in conjunction with a burgeoning average ticket size poses the peril of overleveraging for the sector. Given the intrinsic characteristics of the asset class, NBFC MFIs are notably susceptible to event-based risks, encompassing political vicissitudes, geographical uncertainties, and susceptibility to natural adversities. Moreover, the evolving global macroeconomic milieu, as well as the sustainability of support from impact funds and PE investors, necessitates vigilant monitoring.

Furthermore, the underwriting framework is undergoing a fundamental shift, transitioning from Joint Liability Group (JLG) lending to individual lending. The concurrent challenge is managing growth alongside credit quality, which warrants meticulous observation.

CareEdge
RATINGS

# HEAT MAP AND PROJECTION TABLE

| | | Aug-22 | Sep-22 | Oct-22 | Nov-22 | Dec-22 | Jan-23 | Feb-23 | Mar-23 | Apr-23 | May-23 | Jun-23 | Jul-23 | Aug-23 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| PMI-M | Unit | 56.2 | 55.1 | 55.3 | 55.7 | 57.8 | 55.4 | 55.3 | 56.4 | 57.2 | 58.7 | 57.8 | 57.7 | 58.6 |
| PMI-S | Unit | 57.2 | 54.3 | 55.1 | 56.4 | 58.5 | 57.2 | 59.4 | 57.8 | 62.0 | 61.2 | 58.5 | 62.3 | 60.1 |
| GST Collections | Rs lakh crore | 1.4 | 1.5 | 1.5 | 1.5 | 1.5 | 1.6 | 1.5 | 1.6 | 1.9 | 1.6 | 1.6 | 1.7 | 1.6 |
| E-Way Bill | Crore | 7.8 | 8.4 | 7.7 | 8.1 | 8.4 | 8.2 | 8.2 | 9.1 | 8.4 | 8.8 | 8.6 | 8.8 | 9.3 |
| Air Passenger Traffic | Crore | 2.5 | 2.5 | 2.7 | 2.8 | 3.1 | 3.1 | 2.9 | 3.1 | 3.1 | 3.2 | 3.0 | 3.0 | |
| Railways Passenger Traffic | Crore | 54.0 | 54.8 | 55.2 | 57.0 | 56.3 | 57.5 | 53.7 | 58.3 | 54.8 | 58.9 | 56.3 | 56.9 | 59.1 |
| PV Sales | Lakh | 3.4 | 3.6 | 3.4 | 3.3 | 3.0 | 3.5 | 3.4 | 3.6 | 3.3 | 3.4 | 3.4 | 3.6 | 3.8 |
| 2-3 Wheeler Sales | Lakh | 19.4 | 21.1 | 19.5 | 16.0 | 13.8 | 14.8 | 14.3 | 16.1 | 16.6 | 18.1 | 16.8 | 16.7 | 19.5 |
| Tractor Sales | Lakh | 0.6 | 1.3 | 1.3 | 0.8 | 0.7 | 0.7 | 0.7 | 0.9 | 0.9 | 0.9 | 1.1 | 0.7 | 0.6 |
| IIP | y-o-y% | -0.7 | 3.3 | -4.1 | 7.6 | 5.1 | 5.8 | 6.0 | 1.9 | 4.6 | 5.3 | 3.8 | 5.7 | |
| Core Sector | y-o-y% | 4.2 | 8.3 | 0.7 | 5.7 | 8.3 | 9.7 | 7.4 | 4.2 | 4.6 | 5.0 | 8.3 | 8.0 | |
| Power Consumption | y-o-y% | 0.6 | 11.3 | 0.5 | 12.3 | 9.8 | 12.0 | 7.7 | -2.1 | -1.8 | -0.4 | 4.3 | 8.3 | 16.3 |
| Petroleum Consumption | y-o-y% | 14.6 | 8.3 | 5.7 | 14.3 | 3.4 | 4.3 | 6.5 | 8.6 | 1.4 | 12.6 | 5.2 | 2.1 | 6.5 |
| Outstanding Bank Credit - Total | y-o-y% | 14.3 | 15.3 | 16.6 | 16.0 | 14.9 | 16.3 | 15.5 | 15.0 | 15.9 | 15.4 | 16.2 | 19.7 | |
| Capital Goods Import | y-o-y% | 26.5 | 17.8 | 3.9 | 14.5 | 9.9 | -3.6 | 5.0 | -2.2 | 0.3 | 14.1 | 3.1 | 10.9 | |
| Merchandise Exports | y-o-y% | 10.9 | 4.7 | -11.6 | 9.8 | -3.1 | 1.6 | -0.5 | -6.0 | -12.7 | -10.3 | -18.8 | -10.1 | |

Note: Bank credit data for July 23 includes the impact of the merger of a non-bank with a bank. Excluding the impact of the merger, bank credit growth was at 14.7% in July 23.

| Indicator | FY18 | FY19 | FY20 | FY21 | FY22 | FY23 | FY24 Forecast |
|---|---|---|---|---|---|---|---|
| Gross Domestic Product (y-o-y%) | 6.8 | 6.5 | 3.9 | -5.8 | 9.1 | 7.2 | 6.5 |
| CPI Inflation (y-o-y%) | 3.6 | 3.4 | 4.8 | 6.2 | 5.5 | 6.7 | 5.6 |
| Fiscal Deficit (As % of GDP) | 3.5 | 3.4 | 4.6 | 9.2 | 6.8 | 6.4 | 5.9 |
| Current Account Balance (As % of GDP)* | -1.8 | -2.1 | -0.9 | 0.9 | -1.2 | -2.0 | -1.8 |
| Rupee (USD/INR) (Fiscal year-end) | 65.0 | 69.2 | 75.4 | 73.5 | 75.8 | 82.2 | 82-84 |
| 10-Year G-Sec Yield (%) (Fiscal year-end) | 7.3 | 7.5 | 6.1 | 6.3 | 6.8 | 7.3 | 7-7.2 |

* Note: (-) Deficit / (+) Surplus; Fiscal deficit to GDP ratio data for FY24 are Budget Estimates (BE)

## About Us

CareEdge is a knowledge-based analytical group that aims to provide superior insights based on technology, data analytics and detailed research. CARE Ratings Ltd, the parent company in the group, is one of the leading credit rating agencies in India. Established in 1993, it has a credible track record of rating companies across multiple sectors and has played a pivotal role in developing the corporate debt market in India. The wholly-owned subsidiaries of CARE Ratings are (I) CARE Advisory Research & Training Ltd, which offers customised advisory services, credible business research and analytical services (II) CARE Risk Solutions Private Ltd, which provides risk management solutions.


## Corporate Office:

CARE Ratings Limited: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400022.
Phone : +91-22-6754 3456 | E-mail: corp.comm@careedge.in | CIN - L67190MH1993PLC071691

Other Offices:
Ahmedabad I Andheri-Mumbai I Bengaluru I Chennai I Coimbatore I Hyderabad I Kolkata I Noida I Pune

## Media Contact

Mradul Mishra I mradul.mishra@careedge.in I +91-22-6754 3596