CARE Ratings
Professional Risk Opinion

Assessment of Credit Quality of Rated Entities: Q1 FY22

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The last fiscal saw disruption in operations of corporates due to the pandemic-led lockdown and restrictions which strained their finances consequently prompting rating downgrades across sectors. CARE's Modified Credit Ratio (MCR) i.e. the ratio of (upgrades and reaffirmations) to (downgrades and reaffirmations) was at 0.99 for FY21. Nonetheless, the ratio saw a sequential improvement over the second half of FY21, improving from 0.92 in H1 FY21 to 1.03 in the second half of FY21 which can be linked to the unlocking process that was underway since June'20. Despite the reimposition of restrictions across regions in the country since end-Mar'21, the first quarter of the current financial year - Q1 FY22 has seen a further improvement in MCR on a four-quarter rolling basis, to 1.02. CARE Ratings upgraded 566 entities and downgraded 498 entities in the 12 months ending June 30, 2021.

The economy was in the nascent stages of recovery since H2 FY21 following the sharp contraction during H1 FY21. The vaccination drive also boosted business sentiment and raised optimism of a faster revival in the economy. However, the resurgence of the second wave of the virus since Mar'21 again raised uncertainty about the pace in recovery. Nevertheless, the impact of the second wave on the economy has not been as disrupting as the first wave. This can be attributed to the region-specific nature of lockdowns this time, as opposed to the nation-wide lockdown during Apr-May'20. Also, businesses have been found to be better attuned to working around the pandemic-led restrictions. In May 2021, core sector output rose by 16.8% as against a contraction of 21.4% witnessed in May 2020. Also, with peak out of fresh cases, the unlock process has again started in most parts of the country. The Government has also announced a slew of measures like the loan guarantee scheme for the Covid affected sectors, emergency credit lines and the Aatmanirbhar Bharat Scheme, which are largely extensions of the schemes announced in FY21 with a few new schemes announced. These measures have largely been geared towards making available liquidity in the system and have had limited impact on stimulating sustainable demand, which is contingent on job creation and income generation.

Sequential quarters in H2 FY21 saw signs of improvement in the credit quality of businesses and consequential higher upgrades than downgrades, with the upward trend continuing in the first quarter of FY22.

Key take-aways from the assessment of credit quality of entities rated by CARE Ratings in Q1 FY22:

- The credit quality of the rated entities improved on a sequential quarterly basis in the second half of FY21 with the improving trend continuing in Q1 FY22.
- Majority of the entities (79%) saw their credit ratings being reaffirmed in the 12 months ended June 30, 2021.
- The proportion of entities that saw their ratings being upgraded witnessed an improvement sequentially (as borne out in Exhibit 2 below).
- As entities below investment grade are more vulnerable to any unprecedented happenings, not surprisingly, the credit quality of entities with 'investment grade' ratings have been more stable than that of 'below investment grade' ratings. Around 60 % of total downgrades in 12 months ended June 30, 2021 were among the below investment grade entities.
- The credit rating downgrades in 12 months ended June 30, 2021 have been largely on account of the disruption due to Covid-19 and related lockdowns, thus reducing the scale of operations and impacting collections, liquidity and overall profitability of businesses.
- The credit quality in terms of MCR has improved for most sectors for the 12 months ended June 30, 2021 in relation to the corresponding period of the earlier two years.
- MCR for the Banking and financial services (BFSI) was low at 0.95 for 12 months ended June 30, 2021, with highest proportion of downgrades than upgrades. The sector faced asset quality issues with deterioration in the credit profile of borrower entities. Further, the ALM profile of NBFCs was affected as they faced a double whammy with the assets being restructured on RBI directives on moratorium and loan restructuring with no respite on the liability side.
- MCR for Infrastructure and Manufacturing/Services improved from sub-unity to marginally above one, indicating an improvement in the credit quality in these sectors and consequent higher upgrades than downgrades. Infrastructure sector saw improvement in credit quality in roads, construction, power generation, coal mining and shipping. In Manufacturing/Services sector, industries like cement, ceramics, chemicals, pharmaceuticals and

sugar saw improvement in credit quality while hospitality, education, gems and jewellery, real estate, textiles and wholesale and retail trade had higher downgrades than upgrades and a sub-unity MCR.

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).

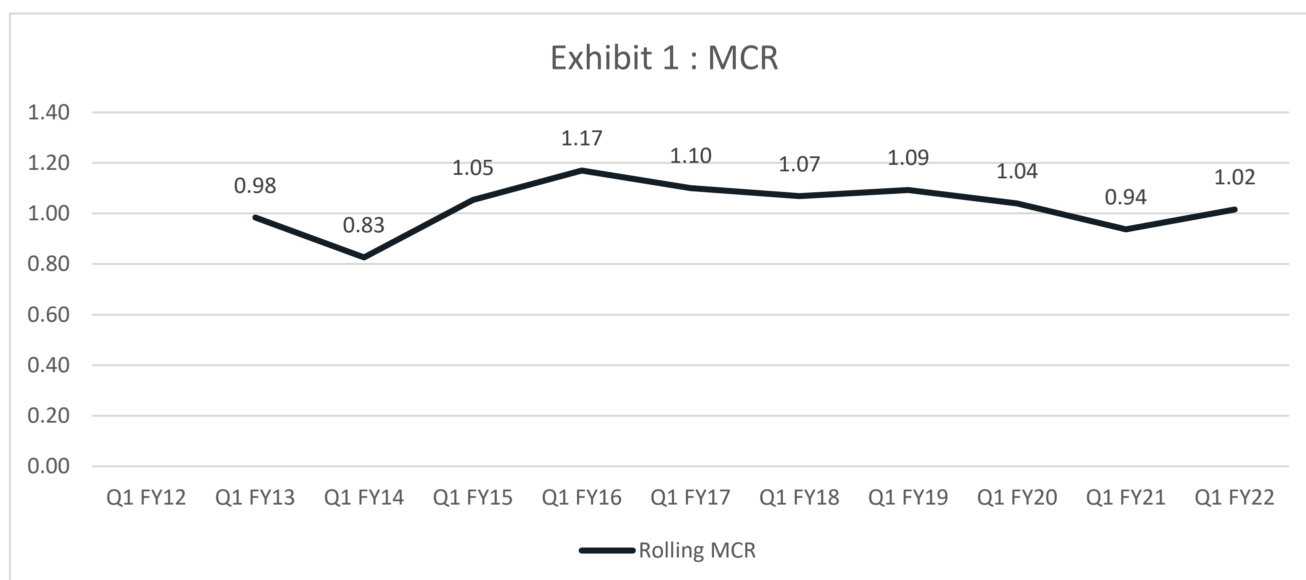
An increase in MCR denotes an increase in proportion of upgrades vis-à-vis downgrades, whereas a decrease in MCR shows the reverse. In other words, an increase in the MCR implies an improving credit quality of the rated entities while a decline in the same signals a deterioration in credit quality of 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. Entities which are categorised as "Issuer not co-operating" are excluded from this study as rating movements in this category are essentially a factor of lack of information on the credits and do not reflect the true credit quality.

(ii) Trend in MCR

Exhibit 1 captures the movement in MCR on a 4-quarter rolling basis.

The MCR for the 12 months ended June 30, 2021 was at 1.02, moving to above unity from sub-unity in the preceding period. The ratio has been below unity (1) from Q4 FY20 denoting higher number of rating downgrades and lower number of rating upgrades.



Source: CARE Ratings

Exhibit 2 captures the sequential movement in MCR on a quarterly basis. It is clear from the table that the MCR is on an improving trend reflective of the improving business sentiment after going to a low of 0.88 in Q1 FY21, which is the lowest level that it has touched since Q4 FY13.

Exhibit 2: Sequential movement in MCR in FY21

Quarter	MCR
Q1 FY21	0.88
Q2 FY21	0.96
Q3 FY21	1.01
Q4 FY21	1.03
Q1 FY22	1.04

(iii) Segment wise trend in MCR

The credit quality of entities in the below investment grade, has been moderate in the 12 months ended June 30, 2021 and June 30, 2020 at 0.96 and 0.92, respectively. The MCR of investment grade cases has however improved in Q1 FY22 and is above unity at 1.06. This proves the better resilience of the CARE Ratings' rated investment grade entities.

Exhibit 3: Rolling MCR- Investment Grade and Below Investment Grade Companies

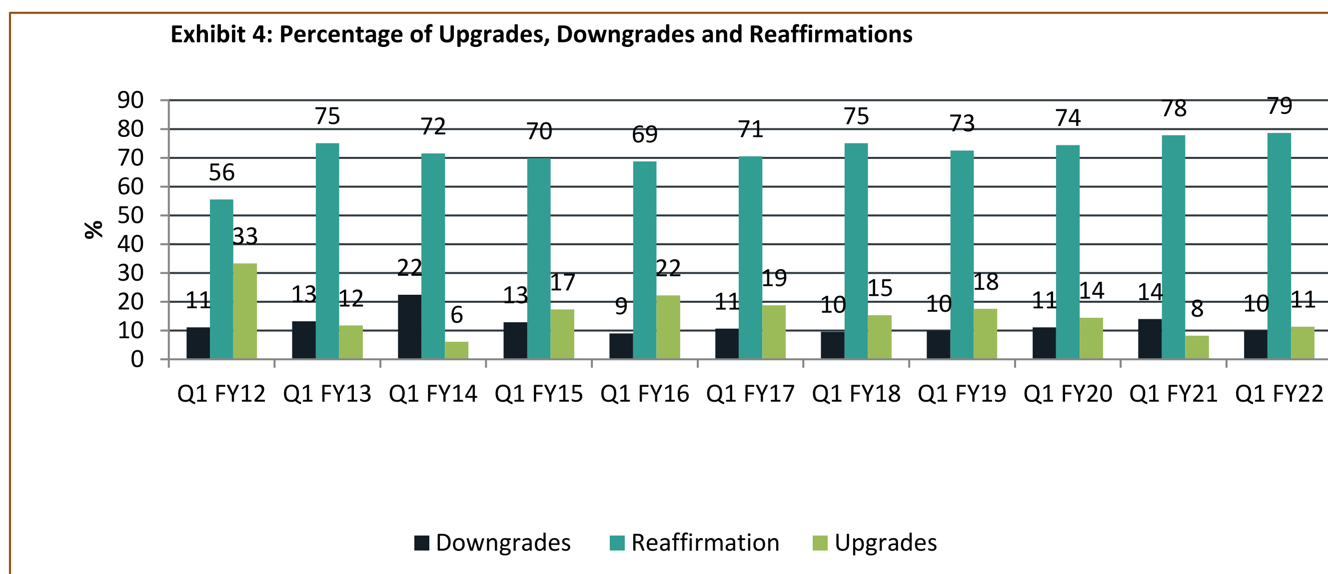
	Investment Grade	Below Investment Grade
Q1 FY13	1.07	0.79
Q1 FY14	0.89	0.75
Q1 FY15	1.12	0.98
Q1 FY16	1.27	1.06
Q1 FY17	1.18	1.01
Q1 FY18	1.14	0.98
Q1 FY19	1.15	1.02
Q1 FY20	1.07	1.00
Q1 FY21	0.95	0.92
Q1 FY22	1.06	0.96

Source: CARE Ratings

(iv) Proportion of Upgrades, Downgrades and Reaffirmations

Majority of entities saw their credit ratings being reaffirmed in the 12 months ended June 30, 2021. 79% of the entities saw their ratings being reaffirmed. 10% of the entities reviewed witnessed rating downgrades, down from 14% in the corresponding period last year, while 11% of the entities saw a rating upgrade, improving from 8% in the corresponding period in the last year Essentially, proportion of downgrades reduced in current period.

Exhibit 4: Percentage of Upgrades, Downgrades and Reaffirmations



Industry-wise Rating Movements

BFSI

MCR for the BFSI entities has been sub unity for the last two years, though there has been a slight improvement in latest rolling period from 0.90 to 0.95. MCR for banks has been sub-unity in all the past three years mainly due to asset quality deterioration and subdued profitability triggering downgrades. However, it may be noted that the recapitalisation of banks and the liquidity measures by RBI have averted any significant deterioration in the asset profile of banks limiting the damage caused by the pandemic. NBFC sector, which has been reeling under liquidity pressure since September 2018 had corrected with low leverage and liquidity buffers brought in by capitalisation. However, the Covid relief measures announced by RBI on restructuring of loans and moratorium, affected ALM profile of NBFCs as they faced a double whammy with the assets being restructured but no respite on the liability side. As such, MCR for NBFCs remained sub-unity for the last two years with a slight improvement in the latest period.

Infrastructure

Infrastructure MCR moved to above one in Q1 FY22 on a four-quarter rolling basis, from sub-unity in the previous comparable period. The upward movement has been supported by upgrades in the roads, construction and power generation sectors.

Roads
The toll roads sector was hit hard in Q1 FY21 due to the strict lockdowns imposed across the country affecting toll collections and triggering downgrades. The sector however showed a recovery with the unlock process and other factors like FASTag implementation, spurt in E-commerce and higher pace of road construction, with the MCR moving to above unity in Q1 FY22 from sub-unity in the earlier two periods. Annuity based road projects remained unaffected.

Construction
MCR for construction was also sub-unity in the last year with the pandemic bringing in execution challenges and migration of labour. However, with the unlock process, pace of execution picked up in Q3 FY21 and Q4 FY21 and revenue visibility also enhanced with infrastructure push by the Government awarding projects, triggering upgrades. In the second wave, the sector did not face execution challenges as restrictions imposed were limited. MCR for the sector thus moved up to 1.04 in Q1 FY22 (4 quarter rolling basis) from 0.89 in the earlier period.

Power generation
MCR for power generation improved to 1.15 in the latest period from sub-unity in the previous period, essentially due to better operational performance in the renewables space which showed resilience towards the pandemic-led disruptions.

Manufacturing/Services

MCR for manufacturing/services as a whole improved from sub-unity to marginally above one in Q1 FY22 (four-quarter rolling basis). Sectors like pharmaceuticals, chemicals, ceramics, iron & steel and sugar were least affected sectors due to the pandemic and demonstrated an uptrend in MCR. Sectors with a below unity MCR having high downgrades were hospitality, real estate, wholesale & retail trade, education, textiles and auto, largely due to the pandemic-led disruption in operations and the consequent impact on scale of operations, profitability, liquidity and debt repayment capacity.

Pharmaceuticals
MCR of pharmaceuticals rose above unity in Q1 FY21 after being sub-unity for the past two years. The pandemic and consequent increase in importance of healthcare supported the performance of the pharmaceuticals sector with increased scale of operations, profitability and revenue visibility. Infact, companies playing a role in the development of vaccines were benefitted and the sector saw higher number of upgrades.

Chemicals
Chemical industry received a demand boost from the end-user industries like pharmaceuticals and agro-chemicals. The upgrades in the sector were aided by growth in scale of operations, profitability and improved leverage, with the MCR moving to 1.12 in Q1 FY22 against 0.96 in the corresponding previous period.

Ceramics
The ceramics industry, which saw higher downgrades in H1 FY21 turned around in Q4 FY21 aided by growth in the export market, with India emerging as an alternate supplier to world markets that replaced Chinese suppliers. Increased scale of operations and profitability triggered upgrades in the sector.

Iron and Steel
The MCR of Iron and steel sector remained firm over the past three years at above unity in all the years. H1 FY21 saw a slight moderation in the MCR affected by the subdued demand in the lockdown, but bounced back in Q3 FY21 with higher upgrades supported by robust growth in operations and profitability.

Hospitality
Hospitality was the worst-hit sector by the pandemic with the MCR deteriorating significantly in the last three years. The hotel industry is among the sectors that have been most severely impacted by the outbreak of the Covid-19 pandemic on account of its inextricable linkage with travel and tourism, especially foreign travel and tourism, which evidently bore the first brunt of the global crisis, reflected in the downgrades in the sector. Likewise, it may be among the last sectors to recover, considering that due to its nature, travel and tourism is a discretionary activity. Domestic leisure travel had started showing signs of recovery from September 2020, but with the resurfacing of the Covid-19 restrictions from March 2021, the demand growth in the sector again derailed.

Real estate

The real estate sector has seen a low MCR for all of the last three years. It had been grappling with several shocks with demonetisation, GST and RERA which has resulted in downgrades in the past. In Q1 FY22 (4 quarter rolling

basis) as well, the sector witnessed low sales and bookings during the lockdown. Though the sales had picked up in some markets like Mumbai, with the state government announcing tax sops, the second wave again acted as a setback for the sector.

Automobiles

Q1FY21 was severely impacted with domestic sales near nil in April 2020 due to the nation-wide lockdown. However, the numbers improved every successive month of FY21 and showed an impressive recovery. The downgrades here have been largely in the auto ancillary segment due to subdued scale of operations in the first half of the year that affected the credit profile of players and also in the auto dealership segment as dealerships were closed during the lockdown. Demand had started picking up in Q3 FY21 driven by the pent-up demand, preference for personal mobility and uptick in manufacturing and infrastructure, but the second wave again put breaks on the demand growth with closure of dealer showrooms due to localized lockdowns and decline in production levels.

Wholesale and retail trade

MCR for wholesale and retail trade was sub-unity in the last two years. Wholesale and retail trade were also impacted on contraction in consumer demand due to the pandemic on account of restriction in movement, social distancing and reduction in purchasing power of consumers. This affected the turnover and liquidity profile of players in the sector causing downgrades. Retail, especially the non-essential category like fashion and luxury goods, was the worst hit.

Textiles

MCR for textiles, though below unity at 0.99 in Q1 FY22 (four-quarter rolling basis), improved marginally from 0.97 in the earlier year. Downgrades were mainly due to subdued demand and consequent stress on operations and profitability of the debt-laden textile sector. Both, domestic and export demand was affected due to the pandemic-led disruptions. In the medium to long term, some demand from the US and the EU markets is expected to shift (though gradually) from China to other major garment manufacturing countries like India, as the customers would like to decrease their dependence on China.

Exhibit 5: Trend in Industry-wise four-quarter rolling MCR

Sector	Q1 FY20	Q1 FY21	Q1 FY22
BFSI	**1.02**	**0.90**	**0.95**
Banks	0.96	0.92	0.97
NBFCs/HFCs/Other FIs	1.03	0.90	0.95
Infrastructure	**1.00**	**0.92**	**1.07**
Roads	0.82	0.88	1.02
Construction	1.01	0.89	1.04
Power Generation	1.11	0.98	1.15
Power - Transmission and distribution	0.96	0.95	0.91
Coal Mining	1.20	0.88	1.40
Shipping	0.75	0.89	1.22
Manufacturing/Services	**1.05**	**0.94**	**1.01**
Automobiles	1.15	0.85	0.99
Beverages	1.24	1.13	1.07
Cement and related products	1.06	0.96	1.14
Ceramics	1.12	0.98	1.03
Chemicals	1.10	0.96	1.12
Education	0.93	1.10	0.94
Gems & Jewellery	0.98	0.89	0.98
Healthcare	0.94	0.97	1.15
Hospitality	1.09	0.97	0.79
Iron and Steel	1.35	1.01	1.05
Paper and paper products	1.29	1.07	1.00
Pharmaceuticals	0.97	0.96	1.32
Real Estate activities	0.94	0.83	0.93
Rubber and plastics Products	1.10	1.04	1.13
Sugar	1.00	0.97	1.17
Textiles	1.02	0.97	0.99
Wholesale and retail trade	1.08	0.93	0.96

Concluding remarks

FY21 saw a moderation in the credit quality of CARE's rated portfolio, mainly due to the deterioration witnessed in the first half of the year. The MCR witnessed a sequential improvement from Q3 FY21 onwards and the upward trajectory continued in Q1 FY22. The recovery witnessed in this quarter would have been much better, had it not been hit by resurfacing of the pandemic with the second wave. Though the second wave pushed the recovery a bit farther, it did not create mass scale disruption in operations of most sectors, like in the first wave. With lockdowns being localised and less severe in the second wave, most sectors indeed saw a recovery, albeit slow paced. Also, the slew of measures announced by the government and the pick-up in the vaccination drive are expected to pave the way towards an economic revival.

CARE Ratings expects the recovery to be slow paced and thus estimates a stable MCR, closer to one for the coming quarters.

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