CareEdge RATINGS

FORESIGHTS

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Non-Life Insurance to Grow at 13-15% in FY24

Cement Industry Margins Set to Contract by 320-380 bps in FY23

Legacy Field Gas Producers May Lose ₹ 23k cr in FY24

INDIA – EXTERNAL SECTOR NAVIGATING THE STORM

India's exports will feel the pinch of slowing global demand. We project exports to contract by 2.3% in FY23 and grow by only 1.5% in FY24. While global headwinds have led to an inching up of the CareEdge External Sector Vulnerability Index, the index still remains within the comfort zone supported by healthy forex reserve buffer.

FOREWORD

SACHIN GUPTA

Chief Rating Officer
& Executive Director

As we welcome 2023 with positivity and enthusiasm, it appears the dark clouds of the Covid-19 pandemic and the subsequent economic mayhem are quickly receding.

The 25% y-o-y growth in the latest direct tax collection figures depicts the corporate sector is doing rather well. Moreover, the likely higher than the budgeted collection of gross tax to the tune of ₹3.5 lakh crore should aid in mitigating the higher expenditure on account of food, fertiliser and oil subsidy.

While the Indian economy has good news to offer, continued concerns about the slow growth and possible recession in the global economy, especially the US and the EU, could dampen India's exports. This issue of Foresights covers this subject in detail. I hope it gives you further insights in the matter.

Another key development that is expected to have a material impact on the global economy in 2023-24 is the sudden and complete reopening of China. After its nearly 3-year-long 'zero-Covid' policy, China's open borders may hurt in the immediate term, but for 2023-24, it could have several larger impacts.

Firstly, this sudden reopening could lead to a sharp rise in demand for goods and services in the country due to the 'revenge buying' phenomenon. While we do not expect it to be as prominent as the US (where the government had doled out freebies), it will still be a key growth driver for the overall global economy. This could have a mitigating impact on the otherwise slowing down large economies of the US and the EU.

Secondly, the sudden growth in demand could lift commodity prices, especially iron ore, copper, and crude oil – which China largely imports. The reversal in softening of commodity prices could make the fight against the surging inflation even more difficult and lead to sustained higher interest rates through 2023-24.

Thirdly, it would be interesting to see how the 'China+1' strategy of global businesses will evolve. With the shutdown of China, supply chain across the world was majorly impacted and Indian businesses, especially the ones on the manufacturing side, were expected to benefit. But as China returns to full-scale operations, we will have to wait and watch whether the Indian corporates are able to grab any meaningful share from the 'China+1' policy.

In essence, the year ahead promises to be one where a lot of interesting new developments are set to take place and define how the global and Indian economies shape up in the times to come.

I would also like to thank all the readers of Foresights once again sincerely for such a warm reception to our efforts with this monthly and hope for your continued support in 2023. Happy New Year, everyone!

Five Key Trends that will Affect India's Economy in 2023

NOTE FROM
RAJANI SINHA
Chief Economist

After two tumultuous years, finally we will be ending 2022 with some optimism. The pandemic is behind us and while the Ukraine-Russia war lingers, its reverberations have subsided as the world learns to survive with it. The Indian economy is projected to record relatively healthy gross domestic product (GDP) growth of 6.9% in 2022-23 and inflation has started moderating. Corporate balance sheets are in good shape, with deleveraging over the last few years and the banking sector non-performing assets having fallen. However, all is still not okay. Our problem of twin deficits has raised its ugly head again, with the current account deficit estimated at 3.6% of GDP and fiscal deficit budgeted at 6.4% of GDP in 2022-23. India is feeling the pinch of a global slowdown, with exports showing weakness. Hence, as we enter 2023, the big question is how India will weather the global slowdown. Here are five themes that are likely to have a significant bearing.

Global headwinds to accentuate: With global GDP growth slowing to 2.7% in 2023 from 3.2% in 2022, the Indian economy cannot remain immune. Global trade growth is projected to fall to 1% in 2023 from 3.5% in 2022. With exports contributing 20% to GDP, India will definitely feel the pain of this slowdown. India's merchandise exports have fallen by 16% in the three months to November compared to the previous three months. **Sectors with high export intensity like engineering goods, gems and jewellery, textiles and pharmaceuticals will specifically feel the pinch of global slowdown.** Given that many of our export-intensive sectors are also labour-intensive, this will have adverse implications for employment too. With our exports slowing and trade deficit widening, we will face challenges in financing the current account deficit, given the rise in interest rates globally.

Inflation concerns to abate: While consumer and wholesale inflation have fallen in the last two months, the critical aspect now is how much time it will take to get sticky core inflation down. Core inflation tends to get more ingrained in the system, making it difficult to reverse the trend. With the recent sharp fall in food price inflation (5.1% in November from 8.4% in September), household nflationary expectations are likely to moderate, and that, along with a moderation in global commodity prices, should help contain core inflation to some extent. While goods inflation has been falling, services inflation has been inching up. But it is also likely to moderate in 2023 as pent-up demand fizzles out. We expect the consumer price index-based inflation to average 5.2% in 2023-24, which will still be above the Reserve Bank of India's (RBI) 4% target. Moderation of inflation will be supportive of a consumption revival in 2023. With inflation coming within the target band, RBI will get a breather. However, with stubborn core inflation, we cannot rule out one more rate hike in the beginning of 2023.

Capital expenditure to pick up but at a gradual pace: The government will continue to focus on a capital expenditure-based recovery in 2023. Specifically, the transport sector, including roads and railways, will benefit from it. With corporate deleveraging in the last few years and rising capacity utilization levels, the ground is favourable for a private capital expenditure revival. The share of private players in new investment proposals data from the Centre for Monitoring Indian Economy has increased to 85-90% from 65-70% a year ago, indicating a stronger private-sector intent to invest. Government initiatives like the production-linked incentive scheme are also supportive of a pick-up in private capital expenditure. However, its pace will be gradual in the midst of the global slowdown and tightening financing conditions.

India will gain from China-plus-one strategies: Our increase in foreign direct investment (FDI) over the past decade has been quite gradual (5% compounded annual growth rate). In the next few years, we can expect a pick-up in FDI, given India's stable macro-economic environment and improved rank on the Ease of Doing Business index (No. 62 in 2019 from No. 77 in 2018). However, the pace of increase will also be gradual. For a big FDI jump, India will have to make the country's business environment and policies more conducive. **Better access to global markets through the right trade agreements will also give a push to FDI.**

Trade negotiations will gain prominence: India has recently signed trade agreements with the UAE and Australia. Next year will be busy for trade negotiations as India evaluates free-trade **agreements** with the UK, EU, Canada and Gulf Cooperation Council. India's share in global merchandise trade in the last decade has increased by a tiny 0.2 percentage point to 1.8% (China's share went up by 3.5 percentage points). New trade agreements are expected to help India gain a greater share. Of course, the terms of these trade pacts would be critical for India to benefit on a net basis and that is where caution is needed.

There is no shying away from globalization and 2023 will re-emphasize this for the Indian economy. The global slowdown and tightening of finance conditions will impact India's economy through various channels. The critical aspect will be how India navigates its way ahead. This includes how cautiously trade pacts with key economies are evaluated as the country further embraces globalization and its G20 presidency provides a special opportunity to influence the global landscape at a turbulent juncture.

The above views were also published in Mint, issue dated December 23, 2022.

COVER STORY

India – External Sector Navigating the Storm

Global trade was slowing even before the pandemic and war-related economic slowdown. This was visible post the global financial crisis and more notably since 2011. After growing at about 5% annually during 2002-2011, global exports rose by a meagre 2.6% annually between 2012 and 2021. The deceleration in global exports has been attributed to many factors such as maturing of supply chains, trade tensions in form of tariff wars, implementation of inward-looking policies, slow global growth, and uncertainties related to trade policies. Trade tensions between the two largest economies of the world have also led to trade diversification, which is a positive development for emerging and developing markets. India, however, has not been able to gain much from these diversifications, as reflected by its sticky share in global trade.

An analysis of the long-term trend in exports showed that after recording a healthy growth of 15.5% annually during 2002-2011, India's exports fell sharply tao about 4.1% a year during 2012-2021. Decomposition of India's export performance during the last decade reveals that a large movement in India's exports came from the movement in global exports, while India's share in global exports remained sticky. This shows that global factors have a strong bearing on India's export performance. In the last decade, while global exports were slowing, countries like Vietnam, China, Cambodia and Bangladesh did much better than the global average. Hence, these countries were able to increase their share in total exports of goods. India's share in global exports is 1.8%, a minuscule increase of 0.2 pp in the last decade. In the same period, China's share in global exports increased by 3.4 pp to 15.1%. Even for a smaller economy like Vietnam, the share has increased by 0.9 pp to 1.5%.

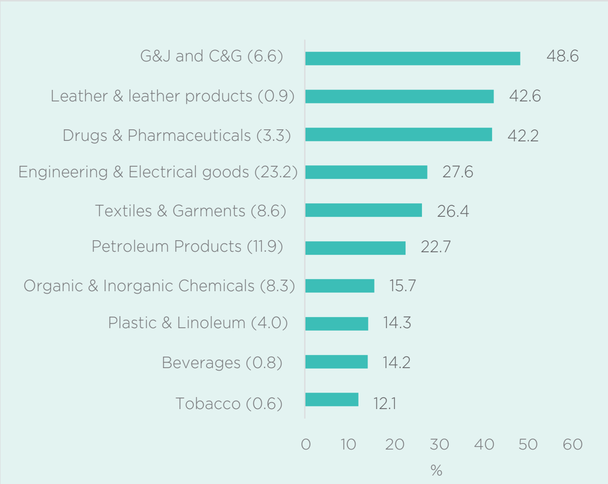
India's Exports to Feel the Pinch of External Headwinds

Amid multiple headwinds to the world economy, global trade lost momentum in the first six months of 2022. The World Trade Organisation (WTO) projects growth in global merchandise trade volumes to slow sharply from 3.5% in 2022 to 1% in 2023. India's merchandise exports growth could feel the pinch of global trade slowdown given its high correlation of 0.94 with global merchandise exports growth.

Overall merchandise exports during the last three months (September-November) contracted by 2.5% y-o-y as against a growth of 16% y-o-y in the previous three months. The double-digit export growth during June-August can be partially attributed to high global commodity prices. Exports of many items contracted on a y-o-y basis during the last three months. We estimate India's exports to contract by 2.3% in FY23. In FY24, with major economies likely to experience a sharp slowdown and global trade growth moderating, we project India's exports to grow by only 1.5%.

India's manufacturing sector which had already been reeling under pressure due to high raw material prices in H1 2022, is now feeling the pain of lower external demand. While overall manufacturing will feel the pain of lower external demand, the sectors with high export intensity will specifically be hit hard by the ensuing global slowdown. Sector like textile and garments with a share of 8.6% and engineering good with a share of 23% in total manufacturing output have export intensity (defined as Values of exports/Value of output) of 26.4% and 27.6% respectively. Some export intensive-sectors like textiles & garments, gems & jewellery, leather products are also highly labour-intensive. Hence slowdown in these sectors will have implications for the overall employment scenario in the economy.

Average Export Intensity (2011-12 to 2020-21)



Source: MoSPI, Ministry of Commerce & Industry and CareEdge
Note: Numbers in the brackets represent average share of these categories in the total manufacturing output from 2018-19 to 2020-21. G&J and C&G represent Gems & Jewellery and Ceramics & Glassware

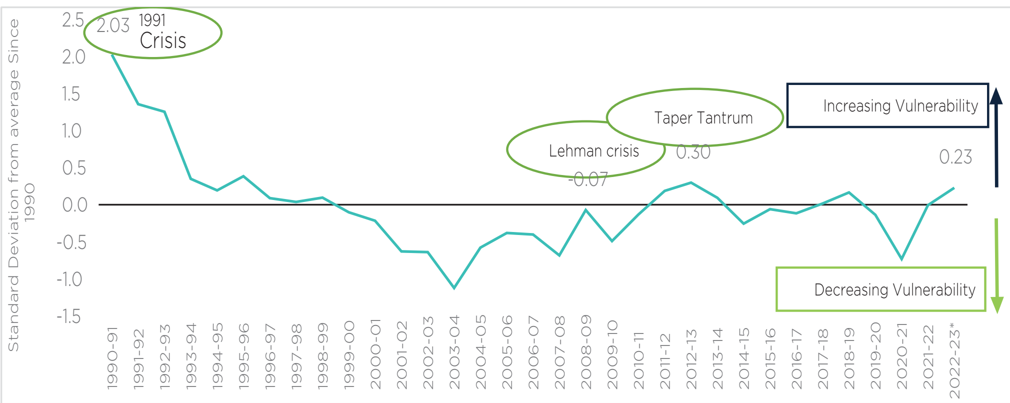
Trade Deficit to Moderate in FY24

Slowing global demand, elevated international commodity prices, and relatively resilient domestic demand translated into a sharp widening of the trade deficit in the current fiscal. From April-November, the monthly trade deficit averaged nearly US $ 25 billion, notably higher than the monthly average of US $ 16 billion for FY22. The widening in trade deficit is driven by the non-oil trade deficit. Within the non-oil trade deficit, the deficit in electronic goods climbed to US $ 37 billion so far in FY23, compared to an average of US $ 32 billion in the same period of the last five years. We estimate the trade deficit in FY23 to be around US $ 294 billion as against US $ 189 billion in FY22. While exports will remain weak, with the easing of global commodity prices, we expect some moderation in the trade deficit in FY24. We project trade deficit (as % of GDP) at 6.9% in FY24 as against an estimate of 8% for FY23. However, the trade deficit to GDP in FY24 would still be elevated compared to 6% in FY22. Moderation in trade deficit and upbeat trend in net services receipts and remittances could help ease the CAD. We project the current account deficit to moderate to around 2.2% of GDP in FY24 as against the projected 3.6% in the current fiscal.

India's External Vulnerabilities Inched Up Slightly but still within the Comfort Zone

We have created a composite External sector vulnerability (ESV) index based on eight variables of the external sector to gauge external sector resilience. In Q1 FY23, our ESV index inched above the long-term average but was still better when compared with the taper-tantrum episode. Two indicators (Net Foreign Investment as % of GDP and CAD as a % of GDP) flagged red signals when compared with four different challenging periods in the economy since 1990. Going forward portfolio flows and current account deficit are likely to remain volatile and we will be closely monitoring the movement in ESV index to identify any impending risk.

External Sector Vulnerability (ESV) Index



Source: RBI, CareEdge
Note: ESV index combines 8 parameters which measure the pressure in the external sector. Following indicators have been used: Total External Debt to GDP, Short-term Debt to Forex, Proportion of Short-term Debt to Total External Debt, Current Account Deficit as % of GDP, Debt Service Ratio, Import Cover, Net Remittances as % of GDP, Net Foreign Investment as % of GDP.

CareEdge View

As we move into 2023, the external environment will remain challenging, with major economies projected to record a sharp deceleration in growth if not a recession. This implies that external demand for India will remain weak. The tightening of financing conditions globally will continue to impede growth while causing volatility in the financial markets. Recent fears of a resurgence of Covid cases in China also raise concerns around the global supply chain. Given the volatile and uncertain global environment, India's economy will have to brace for tough times ahead.

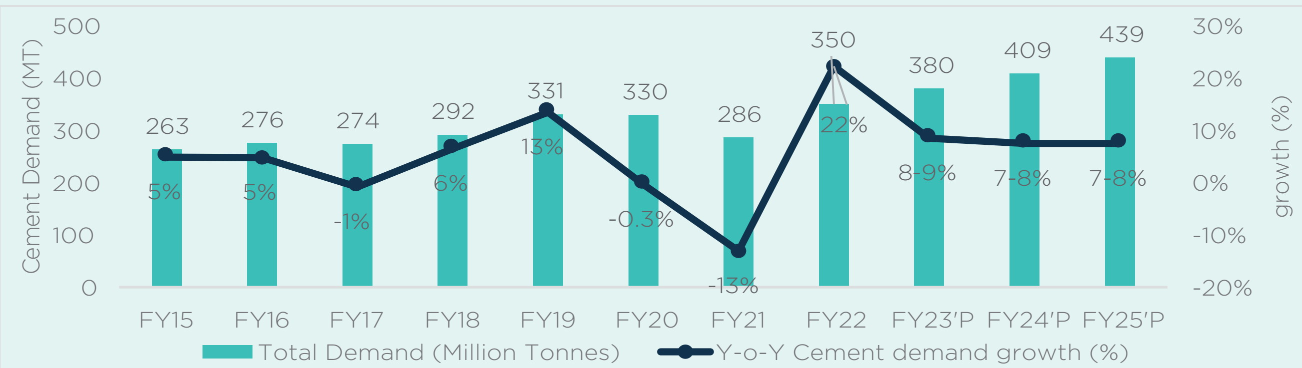
Cement Industry Margins Set to Contract by 320-380 bps in FY23

- Driven by the housing and infrastructure sectors, the cement industry has witnessed a V-shaped recovery and healthy growth in FY22.
- At 350 million tonnes, the demand surpassed pre-Covid levels of 331 MT in FY19 and is expected growth 8-9% growth y-o-y in FY23 supported by government spending on infrastructure and a pickup in real estate.
- The combined impact of all the input costs, primarily that of fuel is expected to inch up the cost for the cement players by `350–400 per tonne on a year-to-year basis,
- Hence a sustained increase in prices without impacting the demand momentum stands critical for the operational performance of the players in the near term.

The cement industry has benefitted from high volume growth, majorly driven by a revival in demand from the urban housing sectors, upcoming infrastructure projects such as the construction of roads, railways, and highways as well as generous rural demand. The long-term drivers of demand such as the National Infrastructure Plan, Bharatmala projects, mission 'Housing for All', rapid urbanisation, and rising rural incomes remain strong with increased government impetus on infrastructure projects amid the upcoming elections in 2024. While a decent demand and volume expansion was witnessed in the first half of FY23, October saw muted growth mainly due to the early festive season and unavailability of labour. The momentum, however, picked up from November 2022 and in the current year, on a full-year basis, it is expected that demand would register an 8-9% growth in FY23.

With healthy growth in volumes, many cement players have planned capacity additions to maintain their market shares. CareEdge expects a capacity addition of about 105-110 MT between FY22 and FY25. The pace of expansion and demand matching up to it will be a key monitorable that would determine any intermittent demand-supply imbalances.

Chart 1: Demand Growth of 8-9% in FY23



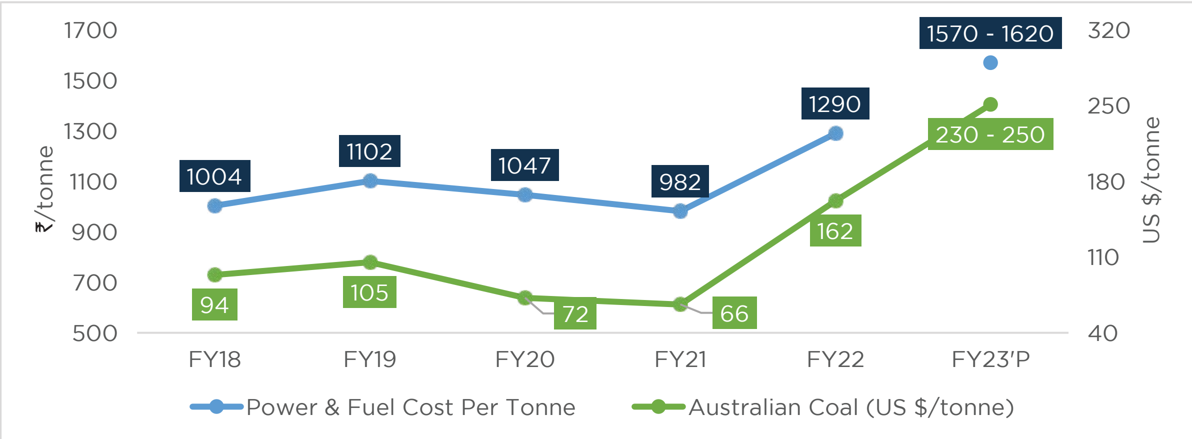
Source: CareEdge, CMIE

Cost Battle Intensified in FY23

The two main components in the cost structure are power and fuel and freight expenses, together constituting about 55-60% of the total costs. Power and fuel costs/tonne increased by 31% YoY in FY22 due to a significant increase in coal and pet coke prices and the cost inflation continues in FY23. In the current year, both pet coke and thermal coal have surged up substantially and are already over and above FY22. The average fuel cost for the industry has increased by

₹400-500 per tonne y-o-y in H1FY23. There has been a decline in imported coal and pet coke prices in the last month from their earlier peak levels, alleviating concerns of any further steep increase in the operating costs for the players. The fuel cost for the industry is believed to have peaked in Q2FY23, it should soften from those levels in Q3FY23 but these prices continue to be soaring high not just past averages but also Year to year. This cost is likely to increase by ₹300- 330/Tonne on a full-year basis. Not much increase in freight cost is expected in FY23 as the volatility in diesel prices has not been much on a year-to-year basis t high from the past average. This cost may either remain flat or just increase by 1% from FY22 levels.

Chart 2: Fuel Cost Increase: Unabated and Prolonged



Source: Sample set of Industry top 20 players (covering >80% of Industry) compiled by CareEdge, CMIE

Sustainable Price Hikes: Key Monitorable

The players need to take price hikes in a gradual manner such that it should not weigh down on demand revival. In CareEdge's estimates, an increase of approximately ₹25-30 per bag would be required to offset the cost inflation on a year-to-year basis and a hike of ₹45-50 per bag is required to restore the profitability to FY21 levels. The cement realisations have remained quite firm in the last two years which are FY20 and FY21 with players having taken timely price hikes leading to good profitability across the sector.

After that, the players started feeling the heat of rising input costs, particularly from H2 of fiscal 2022. We see that on a full-year basis, players reported a drop in margins by approximately 430 basis points in FY22 despite volumes and realisation registering growth. In the current year, the players will also be unable to fully offset the higher input costs through hikes in cement prices given the unprecedented input prices. While players have announced price hikes across regions in November 2022, the absorption and sustainability of these hikes are key monitorable. In CareEdge's estimates, the moderation in the EBITDA margins after taking price hikes in the range of 3.5-4% y-o-y will be in the range of 320-380 bps in FY23 or an EBITDA per tonne impact of ₹180-200.

CareEdge View

"The macros of the cement industry remain stable in the long term, driven by demand from the urban housing sectors, upcoming infrastructure projects as well as generous rural demand, though presently the sector is riddled with the cost-side issues. In the present circumstances where the sector is grappling with the higher fuel cost, a sustained increase in prices without impacting the demand momentum stands critical for the operational performance of the players in the near term. While the credit metrics of the industry largely remain stable due to the net cash-positive position of the large players, medium-sized players are likely to witness more moderation in the credit metrics due to subdued profitability and capex-related debt, which is expected to come on their balance sheets. The players need to take price hikes in a gradual manner such that it should not weigh down on demand revival. An increase of approximately ₹ 25-30 per bag would be required to offset the cost inflation on a year-to-year basis and a hike of ₹ 45-50 per bag is required to restore the profitability to FY21 levels," said Ravleen Sethi, Associate Director, CareEdge.

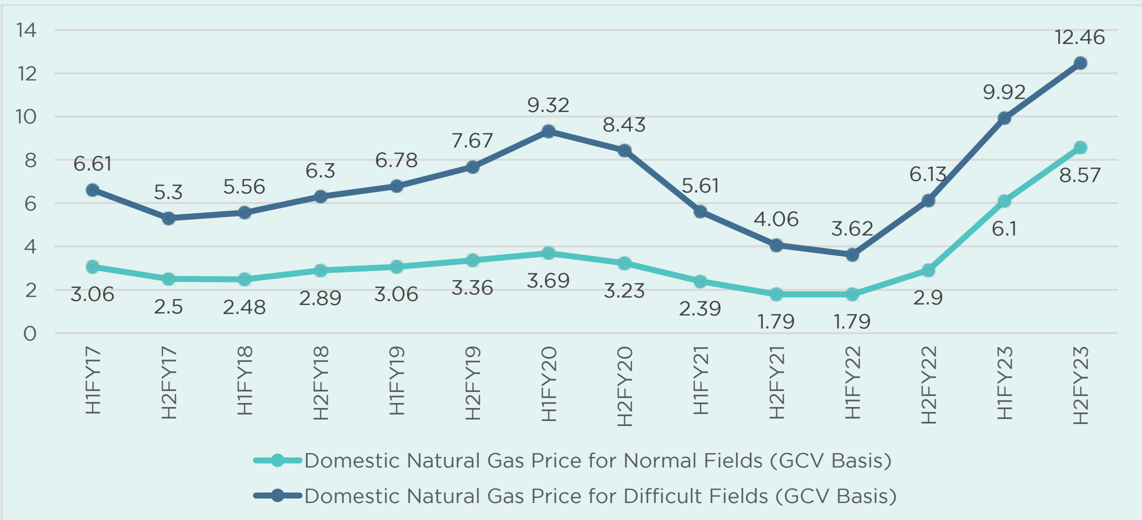
CareEdge RATINGS

Gas Pricing Recommendation: Legacy Field Gas Producers May Lose ₹23k cr. in FY24

- **CareEdge Ratings sees recommendations of the Kirit Parikh committee as a balancing act to safeguard the interest of gas consumers, city gas distribution companies and gas producers from difficult fields.**
- **It shall boost the use of natural gas and shall help the government to contain high inflation. Free pricing of domestic gas from difficult fields would attract sizeable investment from upstream companies.**
- **However, producers of domestic gas from legacy fields may lose around ₹23,000 crore in FY24.**

Prices of domestically produced natural gas as per the existing formula are decided on a half-yearly basis by the New Domestic Natural Gas Pricing Guidelines, 2014, issued by the Ministry of Petroleum and Natural Gas (MoPNG). The pricing formula takes into consideration the volume-weighted average price of natural gas for the trailing twelve months with a gap of one quarter from the four sources in international hubs i.e., Henry Hub (USA & Mexico), Alberta (Canada), National Balancing Point (European Union) and Russian natural gas.

Domestic Natural Gas Prices Ceiling (US $/MMBTU)



Source: Petroleum Planning and Analysis Cell; mmBtu: metric million British thermal units

Till FY22, prices of domestic natural gas basis the existing formula was moving largely in tandem with crude prices. However, prices of domestic natural gas surged significantly for H1FY23 & H2FY23 which was mainly because of a sharp increase in natural gas prices in the global markets on the back of economic recovery post-pandemic and short supply of natural gas by Russia due to the Russia-Ukraine war situation. The natural gas prices in the spot market went up to even more than $60/mmbtu at times in H1FY23 breaching its correlation with crude prices. In turn, prices of natural gas in India for domestic production also went up significantly without a correspondingly similar increase in exploration and production costs. It resulted in supernormal profits for gas producers on one side whereas it led to high inflation, demand for natural gas was impacted by industries and Govt.'s subsidy budget for the fertilizer sector went up. Accordingly, to balance the impact on both producers and consumers, necessitated the formation of the Kirit Parikh committee to review the pricing mechanism for domestically produced natural gas.

Domestic Gas Production, Imports & Consumption

Historically, India's consumption of natural gas has been significantly higher than its domestic production. The difference is met through imports. In FY22, the total consumption of natural gas in India stood at 180 million standard cubic metre per day (MMSCMD), of which 95 MMCMD was met through domestic production and 85 MMSCMD through imports. During FY22, domestic production of natural gas improved upon the commencement of production by Reliance and BP from some of their discoveries in the KG-D6 block. Further, around 12 MMSCMD of additional natural gas from the MJ field in the KG -D6 block is likely to be available by the end of FY23, which could further improve India's domestic natural gas production in FY24. For India's total domestic production in FY22, the majority of producers were ONGC, Oil India Limited, Reliance and Vedanta.

There had been growing consumption of natural gas in India over the past many years. Domestic consumption moderated in FY21 due to the pandemic and again got impacted in H1FY23 due to high prices wherein industrial consumers started to switch to alternate fuels. Going forward, demand for natural gas in India is expected to increase significantly on the back of the large size of capex undertaken by city gas distribution companies.

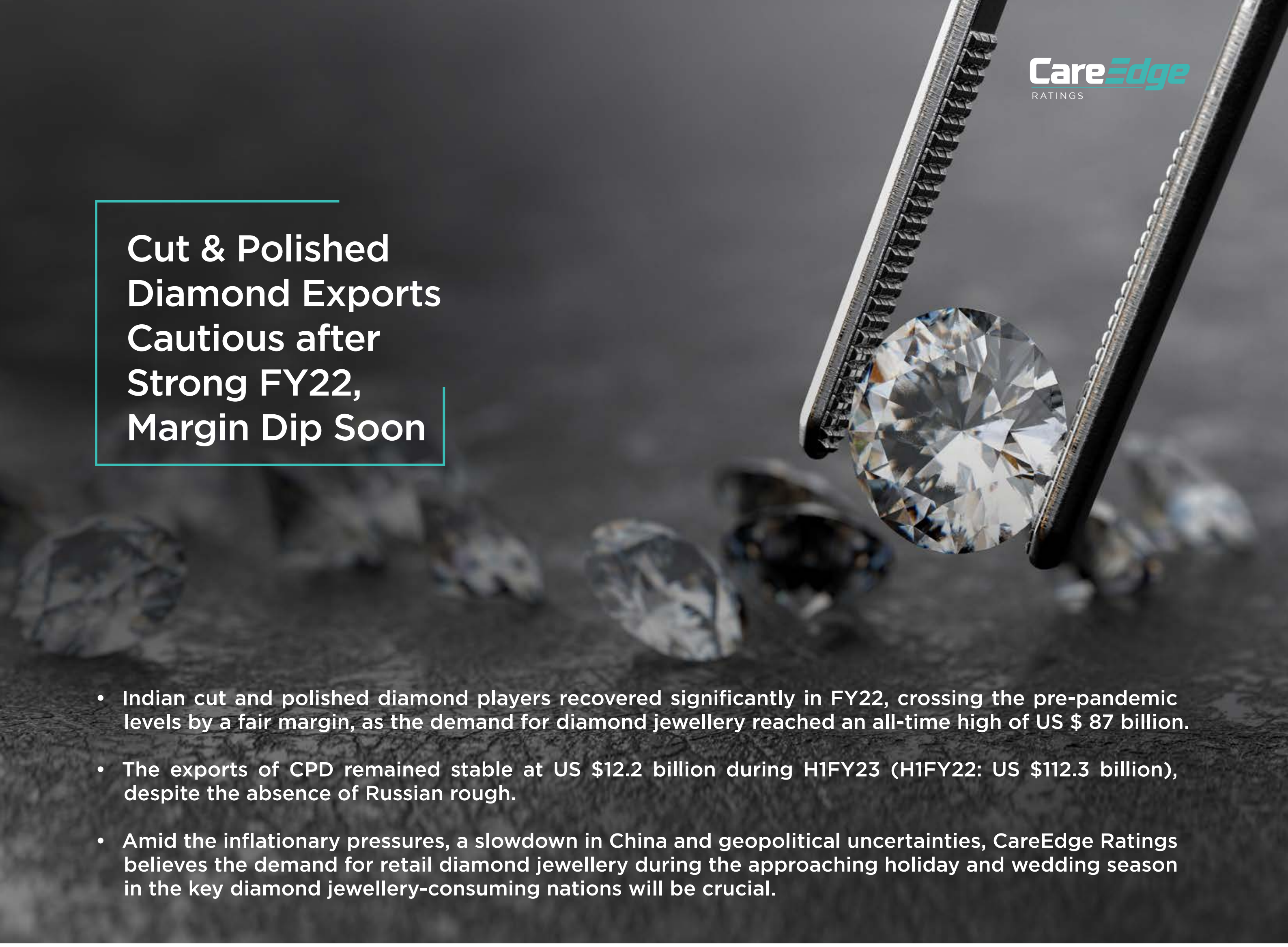
Key recommendations of Kirit Parikh committee

- Domestic gas produced from legacy fields where the cost has long been recov ered should have a floor price of $4/mmbtu and a cap price of $6.50/mmbtu
- Pricing of gas from such legacy fields should be linked to crude and above-said floor and the cap should apply
- Pricing of gas from such legacy fields should be under free pricing w.e.f. January 01, 2027
- Existing pricing mechanism should continue for the domestic gas production from difficult fields with a price cap being decided on a half-yearly basis
- Pricing of gas from difficult fields should also be under free pricing w.e.f. January 01, 2026

CareEdge View

Basis the recommendations of the Kirit Parikh committee, the price of domestic natural gas from legacy fields would be linked to crude prices with an applicable floor of $4/mmbtu and cap of $6.50/mmbtu. CareEdge Ratings expects, according to the existing formula, the price of domestic gas would otherwise have been at $10/mmbtu for FY24. The revision in the pricing mechanism is likely to result in a lower realisation of at least $3.50/mmbtu for domestic gas production from legacy fields. Accordingly, CareEdge Ratings believes that domestic gas producers of legacy fields would have the lower realisation of natural gas to the extent of ₹ 23,000 crore in FY24.

"The revised pricing formula suggested by the committee is expected to be more prudent wherein prices of natural gas would be linked to crude and in turn to the cost of production. Also, it would ensure full recovery of exploration costs even in the scenario of depressed gas prices in the international market. Keeping the difficult fields out of the purview of the revised gas pricing mechanism and allowing free pricing should attract sizeable investment in the sector. Further, it would help to contain high inflation and improve demand for gas from the industries. The revision is likely to be well accepted by upstream gas producers similar to the windfall tax imposed on locally-produced crude. However, this policy change could impact the producers of gas from legacy fields," said Hardik Shah, Director, CareEdge Ratings.



Cut & Polished Diamond Exports Cautious after Strong FY22, Margin Dip Soon

- **Indian cut and polished diamond players recovered significantly in FY22, crossing the pre-pandemic levels by a fair margin, as the demand for diamond jewellery reached an all-time high of US $ 87 billion.**
- **The exports of CPD remained stable at US $12.2 billion during H1FY23 (H1FY22: US $112.3 billion), despite the absence of Russian rough.**
- **Amid the inflationary pressures, a slowdown in China and geopolitical uncertainties, CareEdge Ratings believes the demand for retail diamond jewellery during the approaching holiday and wedding season in the key diamond jewellery-consuming nations will be crucial.**

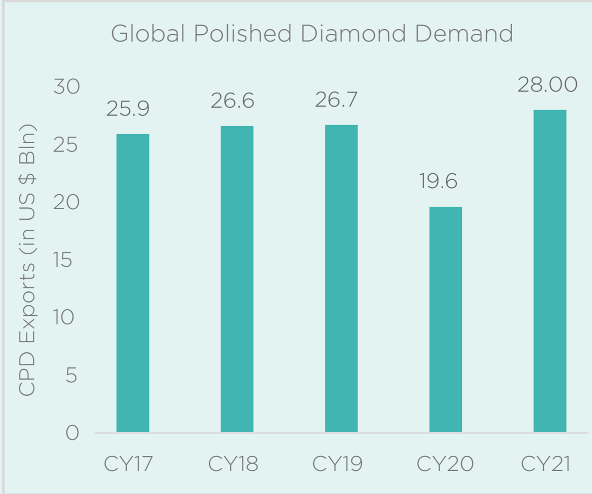
The diamond industry has largely been a physical industry starting with manual inspection of rough diamonds by sight holders and alliance members, attending diamond trade shows and finally, retail jewellery sales, wherein less than 10% of diamond jewellery sales were sold online. Travel restrictions due to the pandemic, and varying degrees and extent of lockdowns mandated alignment of trade practices to the new reality through the development of digital channels across the natural diamond value chain, ie, mining – processing – manufacturing and retail.

Major diamond mining companies focused on online sales through auctions and 3D scans and revisited allocations to minimise speculative sentiment. Local beneficiation plans gained importance as well. In the midstream segment, the entities focused on improving efficiency through automation and developed direct-to-customer sales channels including online sales of certified diamonds through proprietary online platforms. More conservative financing policies were also adopted by the segment. The lack of lifestyle-based spending and government stimulus drove consumer demand.

Demand for Natural Diamonds Crossed Pre-Covid Levels in CY21

The global natural diamond jewellery demand and global polished diamond demand witnessed a robust recovery at US $87 billion and US $28 billion, respectively, in CY21, crossing pre-pandemic levels of CY19 by around 10%. The year-on-year (YoY) growth of natural diamond jewellery demand was significant at 29% and consequently polished diamonds demand grew by 51% on a YoY basis in CY21. Over and above the fiscal stimulus, the lack of alternatives in terms of other luxury spending, experience-based activities, travelling, etc., made diamonds a preferred choice for customers, which had excess liquidity due to a reduction in the overall expenditure. Moreso, the reduction in unemployment rates and vaccination drives in the second half of the financial year resulted in faster inventory turnover and earlier-than-usual orders for depleted inventories.

Presently, more than half of the global natural diamond jewellery demand is contributed by the US, followed by China and Japan, which accounted for about 11% and 5%, respectively, in CY21.



Source: De beers Insight report

Midstream Segment Mirrors Industry Performance

The midstream segment, dominated by Indian entities, reflected a mirror image of the industry performance post-Covid-19 marked by a steady increase in the overall exports since Q2FY21. Moreso, it also ended a prolonged state of decline in the Cut and Polished Diamond (CPD) prices.

India is the world's largest centre for cutting and polishing diamonds with most players concentrated in the two cities of Gujarat- Surat and Navsari. With a global share of more than 90% in the processing of rough diamonds, CPD exports, such as accounting for 53% of the overall gems and jewellery exports from India. After robust growth in demand in FY19, FY20 was muted due to the adverse macroeconomic environment amid the US-China trade war, political unrest in Hong Kong and the early impact of Covid-19. The recovery in demand after the lifting of lockdown restrictions in the US and China resulted in a faster-than-envisaged recovery in demand from Q2FY21 onwards, which continued till Q4FY22.

Impact of War and Macro-economic Environment on CPD Exports

Since Q2FY21, exports of CPD have increased for five straight quarters till Q2FY22. It fell in Q3FY22 due to the Diwali break in November 2021. Contrary to the expectation of softening in the rough diamond prices after the Diwali break, it continued to increase creating an imbalance in the pricing parity of rough diamond vs polished diamond prices, marked by an increase in CPD exports by 11% to US $6.2 billion with a decline in volume by 15% to 64 lakh carats in Q4FY22 over Q3FY22. On an annual basis, exports of CPD rebounded significantly by 49% y-o-y to US $24 billion.

The Russian invasion of Ukraine in February 2022 spiked the prices of both rough as well as CPD to nearly a decade high. In CY21, Alrosa produced 32.4 million carats of rough diamonds valued at US $2.9 billion, accounting for about 25% of global production and 24% of the value of the total global rough production. Moreover, it commands about 40%-50% market share in smaller-sized diamonds. As a result, while CPD exports (in volume terms) declined by 19% during H1FY23, as compared with H1FY22, exports (in value terms) remained largely stable at US $ 12.2 billion in H1FY23. The increase in sales realisation also reflects a dip in the consumer demand from China, which consumes smaller-sized goods below 0.30-carat diamonds as compared to the US, which consumes larger sizes/ higher-value stones.

Overall exports of CPD to the US remained stable at US $4.1 billion during 5MFY23 and accounted for 41% of total exports. Exports to China (the second-largest export market) reduced due to a resurgence of Covid-19 and its zero-tolerance policy leading to intermittent lockdowns. Furthermore, real estate and banking crisis impacted consumer demand for discretionary products, including CPD, leading to a reduction in exports by 26% to US $2.2 billion. Other major CPD export destinations reported either stable or marginal improvement in exports.

Rough diamond imports increased with the resumption of operations and reflected an increasing trend in value terms till Q4FY22. However, it was primarily due to increase in the rough diamond prices as there was m-o-m drop in volume from Q2FY21 till Q1FY23.

Disruption in supply from the largest rough diamond miner along with the lack of demand for CPD from China has forced small and mid-sized entities in the midstream segment to contain their operational activities, as compared to a similar period in the previous year. The same can be corroborated by the sharp decline in the volume of rough diamonds imports witnessed in Q1FY23. The average cost of rough diamond imports increased by 30% m-o-m in March 2022 and April 2022 to US $217 in April 2022 from US $126 in February 2022 on account of uncertainty w.r.t rough diamond availability following the sanctions imposed by the US. Although the prices have reduced marginally in Q2FY23, it was higher by 25% when compared with Q2FY22. In addition, the increase in the procurement price per carat during H1FY23 to a certain extent reflects the absence of Alrosa, which is estimated to have the largest share in smaller-size diamonds. De Beers became a primary supplier of rough diamonds and reported healthy growth in sales, primarily backed by the increase in prices. During its first eight sights for CY22, De beers reported rough diamond sales of US $ 4.1 billion as against US $4.2 billion in CY21. During H1CY22, while De Beers' rough diamond sales in volume reduced by 20%, its price index increased by 28% to US $213/ per carat.

Way Ahead

Overstimulation of the US economy with more than US $5 trillion in stimulus payments followed by Russia's invasion of Ukraine has build-up inflationary pressure on essentials like clothing, food and energy. Strong recovery of the entire diamond value chain post the lifting of lockdown restrictions due to the lack of alternate avenues for spending on the backdrop of overstimulated economies buoyed the demand for diamond jewellery. The recovery in demand from these two key consuming nations remains crucial for the overall performance of the Indian midstream segment in FY23. Most of the dealers in the US have stocked jewellery for the forthcoming season, and hence sales during the forthcoming holiday season remain a key monitorable for a revival of rough diamond processing operations for the Indian midstream segment.

CareEdge Ratings expects the entities operating on a moderate scale with dependence on the secondary market to be impacted more when compared with entities having long-term supply contracts at both ends of the value chain. With the focus of the entire value chain to improve efficiency, reduce speculative movements in the prices, and promote sustainable and ethical luxury, we expect organised players with mine-to-market partnerships will continue to gain a larger market share in the near to medium term.

Impact on Credit Profiles

Of the Gems & Jewellery companies rated by us, 67% are in the investment grade category. Furthermore, on the back of improved demand from the end-user segment as well as the conservative approach adopted by the players, the Modified Credit Ratio ratio has seen an improvement to 1.22x in FY22. Considering that the debt profile of the entities in the CPD sector consists primarily of working capital borrowings, overall leverage and coverage metrics are expected to remain stable, albeit the total operating income and margins to witness a decline in FY23.

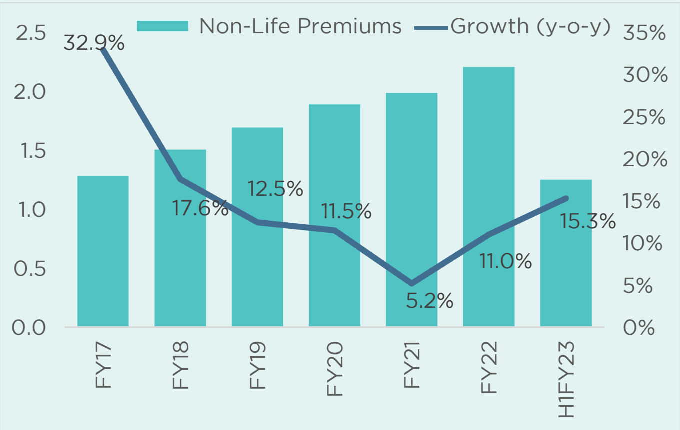
Non-Life Insurance to Grow at 13-15% in FY24

- The domestic non-life insurance industry's total premium grew from ₹1.3 lakh crore in FY17 to over ₹2.2 lakh crore in FY22 i.e., CAGR of nearly 11.5% driven by rising income level, better product fit, strong distribution channels and rising financial literacy.
- The gross premiums of the non-life insurance industry in India are expected to grow at 13%-15% over the medium term backed by supportive regulations and economic activity.
- Health, which is expected to cross the `1 lakh crore mark, along with motor that is envisaged to reach the `85,000 crore level by FY24, would continue to constitute the primary levers of non-life insurance growth.

Rising Per Capita Income, Product Innovations Drive Growth

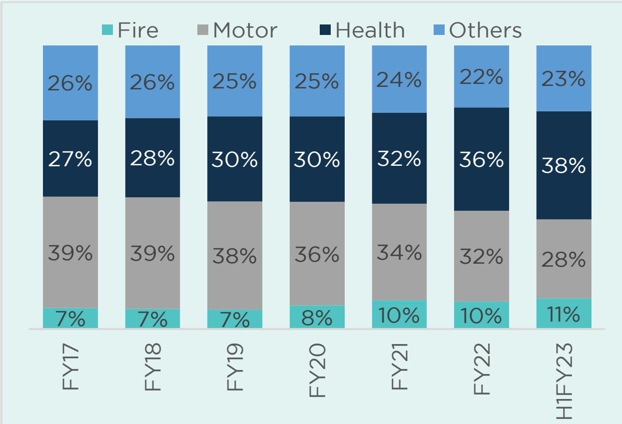
Currently, 30+ companies operate in India as non-life insurers. The public sector accounts for six companies and the remaining are from the private sector. Since the industry was opened to the private sector in 2001, it has witnessed several changes (regulatory and structural) and has undergone transformation leading to increased penetration/coverage, rise of multiple channels, and intensifying competitiveness in the market. The industry has also witnessed trends such as increased digital presence, emergence of InsureTech for innovations around customer education & service/ products/ technology/ delivery systems for access. The Indian non-insurance industry's total premium income grew from ₹1.3 lakh crore in FY17 to over ₹2.2 lakh crore in FY22 i.e., CAGR of nearly 11.5%. This growth has been driven by rising per capita income, product innovations and customisation, the development of strong distribution channels, and rising financial literacy. In H1FY23, the industry has grown by 15.3 % (on y-o-y basis), compared to 12.6% in H1FY22.

Figure 1: Movement in Premiums (₹ lakh crore)



Source: IRDAI

Figure 2: Movement in Premiums by Segment



Note: Health includes Personal Accident; Source: IRDAI

Health and Motor continue to be major contributors having a 66% stake in gross direct premium in FY22. Fire and Crop, each contribute around 10%-15% to the gross direct premium, while the other segments make up the balance. The share of public sector insurance companies has been on a downtrend. In non-life insurance, the FY22 numbers have continued the trend of private players outpacing their public peers, with the private companies (14.8%) growing at more than double the rate of their public counterparts (6%). The market share of private non-life insurance companies has increased to 59% in FY22 from 56% in FY20.

Key Sectoral Trends

Underwriting losses expected to narrow as Loss Ratio Expected to Stabilise, while Expenses of Management to Remain Range Bound:

For the health segment, the loss ratio peaked during FY22 due to Covid-led claims and has later moderated. This, along with increased pricing especially in group health insurance and rising awareness has helped the insurers to improve the top line benefiting the loss ratio. Going forward, we expect the loss ratio in the motor segment to remain largely in line with past trends. The loss ratio in the crop insurance segment which contributes around 10-15% of gross direct premium written, will continue to remain dependent on weather conditions and thus will remain volatile. For other segments, the loss ratio is expected to be in line with past trends subject to any external shocks. The overall loss ratio for non-life insurers peaked during FY22 at 92% due to Covid-led claims but moderated to 87% in H1FY23. The loss ratio is expected to further reduce to around 85-86% going forward.

The high customer acquisition costs continue to impact the expenses of management in the non-life insurance industry. Expenses of management to net earned premium has ranged between 29% - 33% in the past. It reduced to around 30% in FY22, however again normalized to 33% in H1FY23. CareEdge expects this ratio to remain largely range bound. Health insurance has a relatively high expense ratio as compared to other segments due to its operationally intensive nature from the perspective of claims management, engagement with agency channels and workflow running with the network hospitals.

The proposed regulation to remove the product-wise cap on commission rates and implement of overall limit on expenses of management to 30% for general insurers and 35% for health insurers is considered positive for the industry. This will provide the insurers much-needed flexibility to push key product segments and to make required investments in distribution networks.

Brokers continue to be the largest distribution channel

Public sector companies derive the largest share of their premiums from the agency channel, while their private counterparts source the highest share of their business from the broker channel. For the aggregate industry, brokers continue to remain the largest channel. Private companies have achieved nearly double-digit share in the Banca channel, while their public counterparts top out at just over 1%. The contribution of the Agency channel to the new business premium decreased from 24.28% in FY21 to 22.01% in FY22, Further, the direct selling channel's share is high, primarily based on group business being sourced directly by the companies.

Yield on investments will benefit from the rising interest rate environment

With consistent hikes in repo rates by RBI to tame inflation, the yield on debt securities is expected to improve. Further, the insurers have been shifting the portfolio to longer-tenure securities as they envisage the peaking of the current interest rate cycle. Assuming the return on equity to remain largely in line with the recent past, the overall return on investment is expected to increase to around 8.9% in FY23. Further, favourable regulations on increasing exposure to AT1 securities, a rise in exposure limit to 30% for the overall BFSI industry, increasing investment in InvIT / REIT, and relaxed dividend criteria for equity investments is likely to support the yield over the medium term.

Increased availability of resources to underwrite more risk

Private insurers, with solvency levels higher than 2x, largely have sufficient capital required to achieve their target growth. The public sector, on the other hand, except for two entities remains dependent on equity infusion from the government and regulatory forbearance to support growth. To provide sufficient availability of growth capital, the regulator has come up with several initiatives such as increase in the limit for raising sub-debt, relaxation for financial investors, etc. recently. The move will support the infusion of capital from private equity entities. Also, for the entities having sizable crop insurance in their portfolio, solvency margins are expected to benefit from the recent amendments in the solvency margin calculation. All these measures along with the expected improvement in profitability will provide additional growth capital.

Additional Factors Supporting Growth

India's non-life insurance penetration (premium as a percentage of GDP) is lower than the global average. India continues to be an underpenetrated insurance market with non-life insurance penetration of 1.0% in 2021, as compared to the global average of 4.1%. At $22 in 2021, the insurance density (premium per capita) in India also remains low as compared to the global average of $449. Both these indicators highlight the potential of the industry.

IRDAI, under its vision of insurance for all by 2047, has undertaken several initiatives which are expected to support the industry growth in the long run, which include easing the registration of Indian Insurance companies, 'use and file' procedure for most product filings to fasten response to emerging market needs, increase in tie-up limits for intermediaries. Corporate agents can now tie up with 9 insurers over the earlier limit of 3 insurance companies. Insurance marketing firms can tie up with 6 insurers from an earlier limit of 2, the experimentation period for innovative products/subsidiaries has been increased from 6 months to up to 36 months, under the Regulatory Sandbox regulations, and Bima Sugam portal to offer insurance products to the public at a lower cost.

Industry on the Growth Trajectory with GDPI Expected to Grow in Double Digits

CareEdge estimates that the Indian non-life insurance market would grow by approximately 13-15% over the medium term. The growth is to be driven by popularity of health insurance products / schemes, growing demand for motor insurance products due to the expected rise in per capita / disposable income levels, a greater volume of transactions under segments such as fire, marine, export credit, customised products especially in motor and health insurance and gradual introduction of new products. Further, improving profitability, stabilisation of loss ratios, expenses of management being controlled given the upcoming regulations around the same, enabling regulatory environment, strengthening of distribution networks (increase in the number of partners, digital issuance and online channels are expected to witness continued growth) higher investment yields due to a rising interest rate environment and adequate availability of growth capital will support growth.

- CareEdge expects the health insurance segment to continue to grow at around 15-18% and outpace the overall growth in the non-life insurance industry, reaching the ₹1 lakh crore mark in FY24.
- Further CareEdge anticipates that the demand for Motor insurance premiums would grow at 11.5%-13.5% crossing ₹85,000 crore in FY24 driven by post-covid rising demand for personal mobility space leading to a shift in vehicle ownership patterns increasing the opportunity for motor insurers, product innovations such as pay as you use, and increase in Motor TP coverage. The long-term drivers include strong growth in the automotive industry and reducing the uninsured vehicles on road.

Companies are expected to incur significant investments into overall digital enablement across the distribution channels along with expanding the online/digital distribution channel, simplifying the insurance purchase experience boosting underwriting capacities including automated/AI-based underwriting while maintaining a focus on cost improvement to sustain margins. Overall, the outlook is expected to be stable in the medium term. However, intensification of competition and an uncertain geopolitical environment, and high inflation, can negatively impact economic growth and subsequently the non-life insurance sector.

CareEdge RATINGS

ECONOMY DASH BOARD

HEAT MAP AND PROJECTION TABLE

		Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22	Dec-22
PMI-M	Unit	54.0	54.9	54.0	54.7	54.6	53.9	56.4	56.2	55.1	55.3	55.7	57.8
PMI-S	Unit	51.5	51.8	53.6	57.9	58.9	59.2	55.5	57.2	54.3	55.1	56.4	58.5
GST Collections	Rs lakh crore	1.4	1.3	1.4	1.7	1.4	1.4	1.5	1.4	1.5	1.5	1.5	1.5
E-Way Bill	Crore	6.9	6.9	7.8	7.5	7.4	7.4	7.6	7.8	8.4	7.7	8.1	8.4
Air Passenger Traffic	Crore	1.5	1.8	2.4	2.4	2.7	2.5	2.4	2.5	2.5	2.7	2.8	
Railways Passenger Traffic	Crore	34.5	41.4	48.4	45.6	50.1	50.1	51.6	54.0	54.8	55.2	57.0	56.3
PV Sales	Lakh	3.0	3.1	3.4	3.0	3.1	3.3	3.5	3.4	3.6	3.4	3.3	
2-3 Wheeler Sales	Lakh	15.7	14.8	16.1	16.1	16.6	17.4	18.1	19.4	21.1	19.5	16.0	
Tractor Sales	Lakh	0.6	0.6	0.8	1.0	0.9	1.1	0.7	0.6	1.3	1.3	0.8	
IIP	y-o-y%	2.0	1.2	2.2	6.7	19.7	12.6	2.2	-0.7	3.5	-4.2	7.1	
Core Sector	y-o-y%	4.0	5.9	4.8	9.5	19.3	13.1	4.8	4.2	7.8	0.9	5.4	
Power Consumption	y-o-y%	1.1	4.5	5.9	11.5	23.2	16.2	2.3	0.6	11.3	0.5	12.3	
Petroleum Consumption	y-o-y%	2.5	5.6	6.7	9.6	23.8	17.9	6.1	16.2	8.3	3.3	10.2	3.1
Outstanding Bank Credit - Total	y-o-y%	8.21	7.91	8.60	11.14	12.12	13.16	14.52	14.32	15.27	16.70	16.00	
Capital Goods Import	y-o-y%	24.6	14.5	18.8	17.1	17.2	18.6	27.4	26.5	17.8	3.9	14.5	
Merchandise Exports	y-o-y%	27.9	34.5	26.4	29.1	20.8	30.2	8.1	10.9	4.8	-11.6	9.6	

Note: Data for some Indicators are high in April-June quarter due to base effect

Indicator	FY18	FY19	FY20	FY21	FY22	FY23 Forecast
Gross Domestic Product (y-o-y%)	6.8	6.5	3.7	-6.6	8.7	7.0
CPI Inflation (y-o-y%)	3.6	3.4	4.8	6.2	5.5	6.6
Fiscal Deficit (As % of GDP)	3.5	3.4	4.7	9.2	6.7	6.5
Current Account Balance (As % of GDP)*	-1.8	-2.1	-0.9	0.9	-1.2	-3.6
Rupee (US$/ INR) (Fiscal year-end)	65.0	69.2	75.4	73.5	75.8	81-83
10-Year G-Sec Yield (%) (Fiscal year-end)	7.3	7.5	6.1	6.3	6.8	7.5

* (-) Deficit / (+) Surplus

Note: Gross Domestic Product Data for FY23 as per the First Advanced Estimate

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.

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