# Corporate Sector Credit: Key themes that influenced performance in FY2019 and near-term outlook

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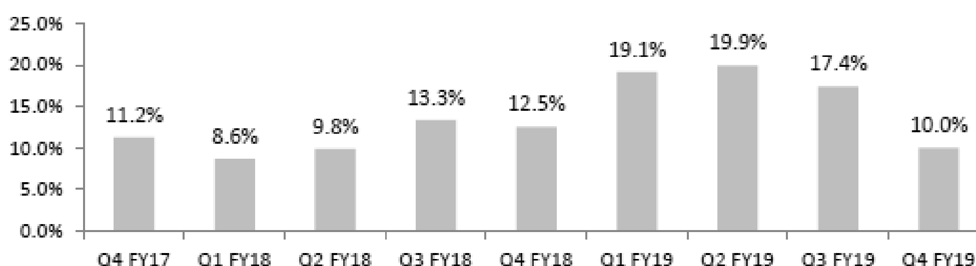
The performance of Corporate Sector in India was characterised by four key themes in FY2019. (1) First of all, most of the consumer-oriented sectors started facing slowdown in demand from H2 FY2019 onwards; (2) While consumer sentiments weakened, increased Government spending on infrastructure sectors continued to provide momentum to related sectors especially construction companies, steel and cement manufacturers. On the profitability front, the aggregate EBITDA margins of Corporate Sectors declined marginally during the year on back of weak consumer demand and rising cost pressure, especially due to upswing in commodity prices, crude oil and strengthening of US$ against the INR. Another trend, which has been influenced the overall credit metrics of companies over the past couple of years has been the M&A activity across select sectors triggered by availability of stressed assets thereby leading to increase in debt levels for some of the larger entities.

The financial results released by 642 companies in the Indian corporate sector shows revenue growth in Q4 FY2018-19 hit a six-quarter low at 10.0%. The key reason for decline in revenue growth was weak consumer sentiments and softening of commodity prices. The revenue growth in consumer-linked sectors in ICRA's sample was only 3.8% in Q4 FY2019 on a YoY basis, down from 27.9% in Q3 FY2019. Comparatively, the revenue growth in commodity linked sectors was at 12.4% in Q4 FY2019 on a YoY basis, down from 51.4% in Q3 FY2019.

**Exhibit: Trend in aggregate revenue growth of sample of 642 companies**





Source: Ace Equity, ICRA research

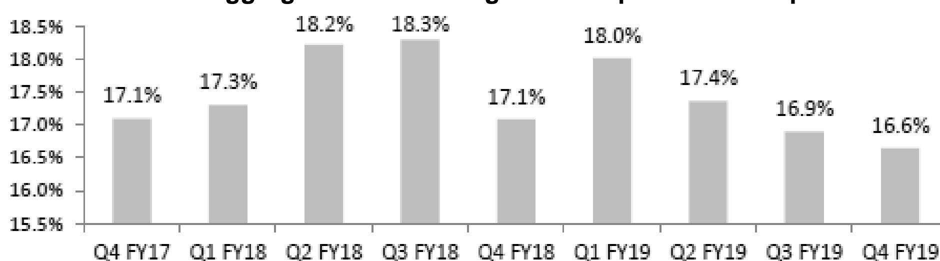
The weakness in the consumer-linked sectors was visible across most consumer-oriented sectors such as passenger vehicles, two-wheelers, consumer durables and FMCG since H2 FY2019. The decline in consumer sentiments was visible in both urban and rural segments. The commentary on rural growth from Auto OEMs and FMCG companies indicate a slowdown in growth which can be attributed to a muted rabi harvest. The FMCG sector reported healthy volume growth in FY2019, but volume growth for several companies declined in Q4 FY2019. Management commentary indicated at a slowdown in demand from the rural segment, although it continues to perform better than the urban markets. The decline in demand from rural markets also reflected by muted trend in tractor sector which has started contracting from February 2019 onwards.

Bucking the trend of weak demand visible across key consumption-driven sectors, higher spending on infrastructure projects remained healthy in FY2019, driven primarily by increased government spending. This was visible in the growth in Gross Fixed Capital Formation, which continued to grow in double-digits over the major part of the fiscal, although it slowed down in the last quarter, with government spending and infrastructure demand tapering down in the run-up to the general elections in May 2019. The GFCF growth is likely to have remained muted in Q1

FY2020 as well, although it is expected to revive gradually on the back of the stable government at the centre. The pickup in infrastructure demand bode well for sectors like cement and steel, which reported healthy uptick in volumes during the year. Although steel volume growth tapered down as the year progressed, this was largely because of weakening of demand from auto sector, while infrastructure demand continued to remain healthy. This was visible in the divergent trends between flat and long steel products.

The operating profit margin of the Indian corporate sector was stable between FY2016 and FY2018. However, the aggregate EBITDA margin declined by 50bps to 17.2% in FY2019 because of rise in energy costs, increase in input prices and INR depreciation coupled with weakening demand trends. However, easing in commodity prices may support margins in the near-term. Cost headwinds impacted margins in several sectors such as airlines, auto OEM, cement, consumer durables, telecom and tyre in FY2019. While higher fuel prices impacted airlines, cement and power sector, higher input prices led to a decline in margins of auto OEMs, consumer durables and tyre sector. The telecom sector also reported lower margins in FY2019 because of continued pressure on ARPUs, higher network operating costs and one-time provisions. However, some telecom operators reported an improvement in ARPUs in Q4 FY19 on a sequential basis. Although the overall margins of ICRA's sample declined 50 bps in FY2019, some sectors such as Iron & Steel, FMCG, IT and Pharmaceuticals reported stable or better EBITDA margins in FY2019. The EBITDA margin of ICRA's sample of 642 companies declined by 44 bps on a YoY basis and 23 bps on a QoQ basis to 16.6%. However, several sectors such as airlines, cement, consumer food and consumer durables reported a sequential improvement in margins because of price hikes initiated by companies in select sectors, lower cost of imports (benefits of improvement in INR vis-a-vis US$ in Q4 compared to Q3) and softening in commodity prices. Although commodity prices were higher on a YoY basis for both FY2019 and Q4 FY2019, there was a softening in prices of key commodities such as oil, steel and aluminium on a sequential basis which supported an improvement in the EBITDA margins on a QoQ basis.

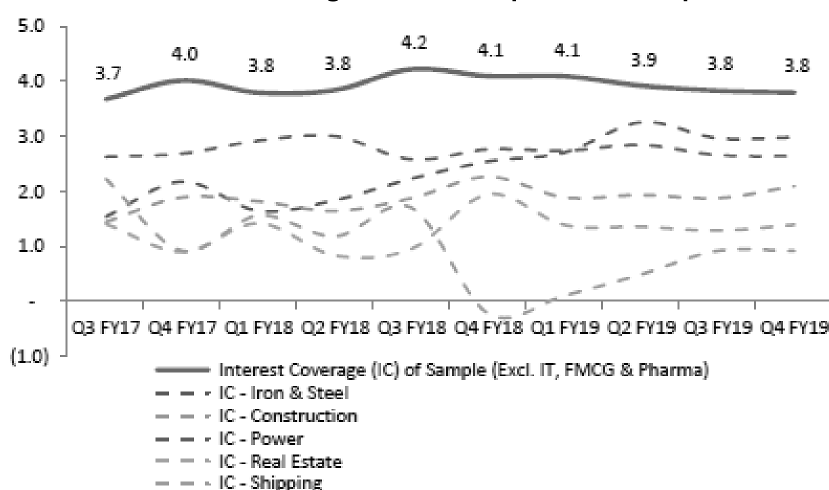
**Exhibit: Trend in aggregate EBITDA margin for sample of 642 companies**




Source: Ace Equity; ICRA research

The interest coverage ratio of ICRA's sample, adjusted for sectors with low debt levels (IT, FMCG and Pharmaceuticals) witnessed a decline to 3.8x from 4.1x in Q4 FY 2018. This was because the growth in absolute EBITDA (7.2% on a YoY basis) was significantly lower than the increase in interest costs (14.6% on a YoY basis). The sharp increase in interest cost was because of higher interest rates and increase in debt levels, including working capital.

**Exhibit: Trend in interest coverage ratio for sample of 304 companies**




Source: Ace Equity; ICRA research

From an outlook perspective, ICRA has 'Stable' outlook on most the sectors barring Residential Real Estate and Aviation. ICRA expects the demand in the automobile sector to remain subdued owing to weak consumer sentiments owing to rising ownership cost, subdued rural demand and tight financing environment given the liquidity constraints in the financial markets. The growth in the sector will start stabilising most likely from H2 FY2020 because of pre-buying related to the impending implementation of BS-6 norms from April 1, 2020, especially in the CV segment.

Despite expectation of slowdown in Automobile sales, the auto component industry is expected to grow between 10-11% in FY 2020 supported by increasing content per vehicle owing to transition to BS-VI and safety norms. Mandatory introduction of ABS and BS-IV norms will result in almost 15% in two-wheeler prices and will also push prices of diesel PVs by 8-10%.

ICRA expects cement demand growth of around 8% in FY2020. This growth is likely to be driven by housing, primarily rural housing and affordable housing, and improved focus on infrastructure segments, mainly road, railway and irrigation projects. The incremental cement demand of around 24-28 million MT is likely to be greater than the incremental supply of 17-18 million MT in FY2019-FY2020. This is likely to result in improvement in the capacity utilisation to 69% in FY2019 and 71% in FY2020 from 65% in FY2018.

The domestic steel demand growth is likely to moderate to 7.0% in FY2020 from 7.5% in FY2019 because of weakness in demand for flat products. Steel price has moderated from H1 FY2019 highs and near-term price hike is likely to be low given the subdued demand environment. Moderation in steel prices and elevated coking coal prices is likely to put pressure on profitability indicators in FY2020.

ICRA expects nearly two-third of capacity addition in the power sector to be driven by Renewables over the next two years. Utilisation levels of Thermal Plants is expected to increase to 62-63% aided by 5-6% energy demand and limited net capacity addition. DISCOM losses are expected to reduce gradually but overall progress on tariff hikes and AT&C losses remains below expectation.

Despite the reduction in debt levels and planned de-leveraging plans along with some improvement in operating profits, the coverage indicators would continue to remain weak for Telecom companies over the near-term.

The 'Negative' outlook for Residential Real Estate sector continues to reflect liquidity crunch on the back of slow sales and reduced availability of credit. However, ICRA's analysis suggest that the large players have continued to gain market share. For instance, the top ten listed entities registered a 44% y-o-y growth in area sold during FY2019; record sales achieved in both Q3 and Q4 FY2019.