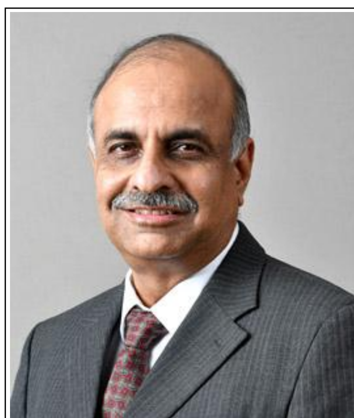
An uneven economic recovery on the anvil



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The 19th century novel, "A Tale of Two Cities" by Charles Dickens had the following opening lines, *"It was the best of times, it was the worst of times.......it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us."*

As history repeats, or at least rhymes, the same could be said of today's times as well. Across the globe, and in India, as the famed K-shaped recovery manifests against the backdrop of Covid, it is quite evident that the larger firms in several sectors are gaining further prominence, even as the smaller businesses struggle to survive. The market cap of the creamy corporates is scaling new heights, while job losses and rising unemployment rates stand in striking contrast. There is big money that is chasing the new-age business models, and there are the less privileged firms that need to depend on the oxygen of restructuring or liquidity facilities to save themselves from the ignominy of a failure. The pandemic has already and might further accentuate the social and the corporate inequalities. Certainly, the policy makers and the regulators have their task cut out in mitigating these imbalances, lest it should ignite other fires even when the pandemic flames are doused.

That said, the policy makers and India Inc. are no strangers to facing challenges and negotiating them. The past few years have been particularly challenging with the corporate and the financial sector entities in India facing all colours of risk - from demand risk, to regulatory risk, to currency risk, to commodity risk, to funding risk. If FY2020 was the year that brought with it the challenges of slowing economic growth, simmering global trade tensions, and the skepticism relating to the corporate governance practices followed by some large borrowers, the year FY2021 was even more overwhelming because of the pandemic that put unprecedented strain on the credit profiles of many entities across sectors. In a crisis like that induced by Covid, the stress scenario assumptions get severely tested and factors that are conventionally considered as uncorrelated begin to reflect otherwise.

The deleterious impact of the pandemic-induced crisis on the credit profiles of entities, however, was softened by the significant relief measures implemented by the Central Government and the Reserve Bank of India on the fiscal and the monetary policy front. These included cash transfers and food security for the vulnerable sections of the society, moratorium on loan payments, large repo rate cuts, various systemic liquidity enhancement measures, besides the provision of the government-guaranteed credit facilities for the eligible borrowers. These measures lent support to market stability and offered protection against widespread defaults. For perspective, as against 83 defaults in ICRA's rated universe in FY2020, there were only 44 defaults in FY2021.

While we tend to conceptualize our thinking in discrete time periods, as the author too does above, most risks tend to be continuous. The risks do not retreat or rise as a fiscal year begins or ends. But co-incidentally, the second wave of Covid in India reared its head at the beginning of summer this year, as did the first wave last year. If the first wave was replete with uncertainty and triggered a stringent nationwide lockdown, dislocating supply chains, hurting contact-intensive businesses, and causing India's GDP to contract by 7.3% in FY2021; the second wave was more spiteful in terms of causing a severe health crisis if not an economic crisis. While the second wave did not bring about incremental contraction in profits, the brakes that it put on recovery has been reason enough to be the nemesis of many businesses. For instance, in ICRA's portfolio of rated entities, the Real Estate, Power, Hospitality, Auto Ancillaries, and Textiles sectors have continued to experience a large proportion of downgrades in Q1 FY2022, continuing with the downward trend seen in FY2021. Many of the downgrades in these sectors were because of ICRA's view that these entities would not have the balance sheet strength to stave-off a continuing period of pale recovery.

Yet, the just-concluded quarter also marked a return of the rating upgrade momentum. For example, while on one hand, the **Real Estate** sector (particularly residential and retail) continues to face credit challenges, ICRA upgraded the ratings of 5% of its rated portfolio in the sector in Q1 FY2022. This is not a small proportion if one annualizes this number. However, all these upgrades were driven by firm-specific factors such as a favourable change in ownership, fresh funds infusion by the sponsors, successful asset monetization supporting a material reduction in debt etc. Likewise, the **Power** sector contributed significantly to both downgrades as well as upgrades. Two reasons stood-out as the trigger for most of the upgrades in the Power sector in Q1 FY2022: (a) a satisfactorily long track record of operating assets/ or

commission of new projects alleviating execution risks, and (b) clearance of part-receivables from the distribution companies (discoms) of Northern Telangana, Southern Telangana, and Uttar Pradesh under the liquidity support scheme/ Atmanirbhar package for the state discoms.

A couple of other sectors too have been at the forefront of upgrades lately viz., **Pharmaceuticals and Chemicals**. In the pharmaceuticals sector, upgrades pertained to select Active Pharmaceutical Ingredients/ formulation manufacturers that are experiencing a healthy organic growth driven by a solid demand for their respective therapeutic product segments. A couple of formulation companies that were upgraded are involved in making Covid vaccines: Biological E. Limited, that will be undertaking contract manufacturing for the Covid vaccine developed by Johnson & Johnson, besides developing its own Covid vaccine which is undergoing Phase-III trials; and Stelis Biopharma that has collaborated with one of Russia's sovereign wealth funds to manufacture the Sputnik-V vaccine. Some of the chemicals manufacturers that have been upgraded have seen an increase in their scale of operations and a shift in revenue mix towards more profitable products.

Overall, since January 2021, ICRA has revised its outlook on five sectors. The outlook on sectors viz., Construction Equipment, Commercial Vehicles, Road Logistics, and Telecom Towers has been changed to **Stable** from Negative, whereas the outlook on the Fertilizers sector has been changed to **Positive** from Stable. The outlook on 15 sectors continues to remain **Negative**. The salient ones being: Aviation, Hospitality, Retail, Power (Thermal & Distribution), Real Estate (Residential and Retail), Exhibitors, Telecom Services, and Non-Banking Finance Companies (NBFCs).

At present, ICRA's baseline expectation of the real GDP expansion in FY2022 is 8.5%, with an upside growth of 9.5% if vaccine coverage gets accelerated. But beneath this headline number, the economic recovery is expected to remain uneven in general and fragile in pockets.

- o The sharply higher daily infections in the second wave of Covid would likely have a prolonged negative impact on consumer sentiment.
- o The healthcare expenses related to the Covid treatment, amidst high retail prices of fuels, are likely to shrink disposable incomes, forcing a cutback in discretionary spending.
- o Notwithstanding the expectation of a normal monsoon supporting the prospects for the agri sector, the rural sentiment could be dampened by the sharp rise in rural infections during the second wave of Covid compared to 2020.. The combination of higher medical expenses, loss of employment as well as remittances following the return of a section of migrant labourers to the hinterland, could have a negative impact on rural demand, especially for big ticket items.

For economic recovery to take root, the health of the financial sector is a pre-requisite. For both banks and NBFCs, while asset quality pressures would rise in FY2022, particularly from the retail and the MSME segments, most banks are on a relatively stronger footing now with adequate capital cushions. For the NBFCs, however, the credit costs would likely remain high and they could see their restructured book double to 3.1-3.3% by March 2022. But the easy liquidity conditions prevailing currently and the relatively stronger balance sheets of financial institutions overall, imply that financial sector stress is unlikely to weigh on economic recovery. Nevertheless, other headwinds are gaining strength, mostly notably the hardening commodity prices, which is feeding into the inflationary impulses. This complicates the dilemma of the Monetary Policy Committee on the policy rate stance. The constrained fiscal flexibility of the Union and the State Governments also complicates the math. Finally, the possibility of a third wave of Covid infections striking cannot be ruled out either. In this milieu, it is hoped that the duality expressed by Dickens in the opening lines of his novel gives way to a reassuring economic resurrection in the times to come.