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# Credit profiles of Indian electric distribution and transmission firms improved but risks remain elevated

by Liu Yuan

The Indian power sector has witnessed exponential growth in the last few years on various fronts such as generation and transmission capacities, village and household electrification, and improving energy efficiency. All villages have been connected and electrification of all households has been completed in all but a few small pockets in two states. Despite having a surplus power generation capacity, challenges persist in the electric power distribution and transmission segments, which have long been the weakest link in the nation's power supply chain due to inefficient distribution infrastructure.

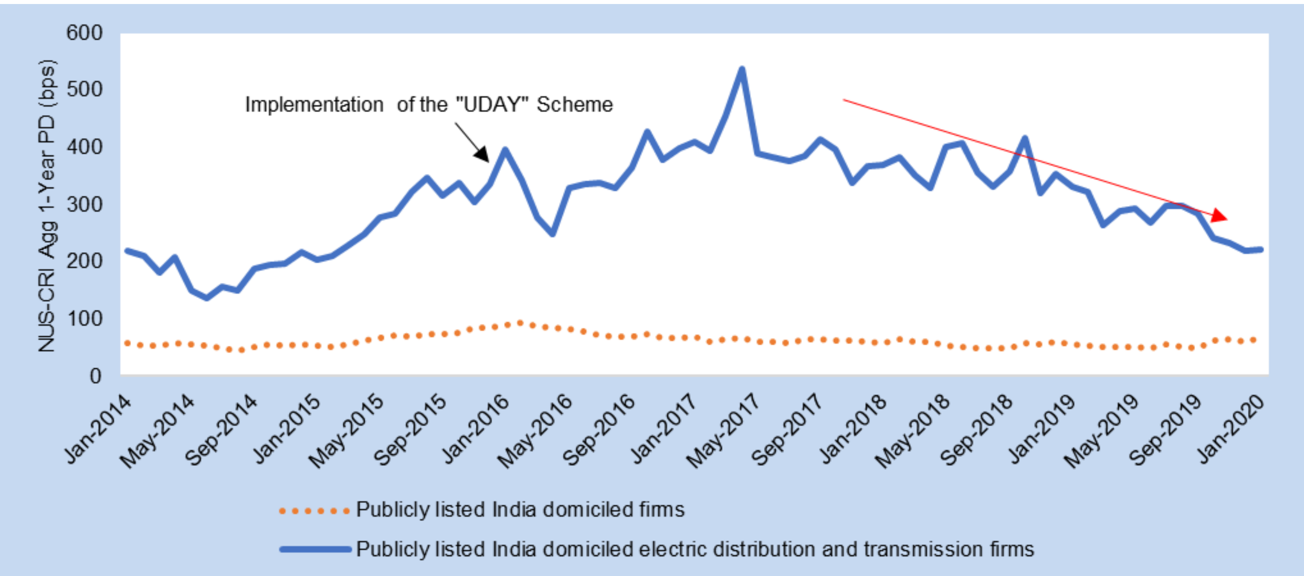


Figure 1: NUS-CRI Agg 1-year PD of publicly-listed India domiciled electric distribution and transmission firms and all publicly-listed India domiciled firms. *Source: NUS-CRI*

Tracked by the NUS-CRI Aggregate 1-year Probability of Default (Agg PD) (see Figure 1), India's electric distribution and electric transmission firms have a consistently higher Agg PD compared to all Indian firms over the past few years. In general, the credit quality between all publicly listed Indian firms and publicly listed Indian electric distributions and transmission firms diverged from mid-2014 to early 2017. Since then, the gap between the two Agg PDs tightened as the Agg PD of Indian electric distributions and transmission firms continued to decrease from around 500bps during its peak in early 2017 to around 200bps in Jan 2020.

For the past few years, the Indian government has put forward a series of measures to enhance Indian electric distribution and transmission firms' financial health and operational ability. For instance, to address the legacy of debt problems, the local governments took over 75% of debts from the state DISCOMS (electric distribution and transmission firms). Issued in November 2015, the scheme, also known as "UDAY", quickly reduced the financial leverage of India's electric distribution and transmission firms. From 2015 to 2016, the median total debt to total equity ratio of firms within the industry group decreased from 178.7% to 153.8%.

The Indian government is also involved in the infrastructure and technology upgrade in the electricity transmission and distribution segments to help improve the operational efficiency and profitability of the firms. India's Ministry of Power reported that the DISCOMS have incurred increasing losses for a long period of time. These losses were largely due to poor transmission infrastructure, inefficient billing and collection, as well as theft. To address these problems, the government put forward a series of measures, such as changing the meters and transformers to reduce technical losses, and building small meters which allowed remote reading that could help to reduce theft. After these measures were implemented, cash from operations and net income of India's electric distribution and transmission firms improved (see Table 1).

| | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|
| **Cash From Operations (USD bn)** | 4.24 | 4.57 | 4.46 | 5.59 | 6.81 |
| **Net Income (USD bn)** | 0.92 | 1.68 | 3.11 | 3.93 | 4.60 |

Table 1: Financial figures for publicly-listed India domiciled electric distribution and transmission firms. *Source: Bloomberg*

Lower borrowing cost is another factor that could account for the improving credit profile of India's electric distribution and transmission firms in recent years. According to the Reserve Bank of India, the bank group-wise weighted average lending costs have dropped from 2014 to 2019, with the rate decreasing from around 12.5% to 10.5% (see Figure 2). As highly-leveraged Indian electric distribution and transmission firms are highly reliant on bank loans, the decrease in interest rate was beneficial for the improvement in their credit profile. Meanwhile, the government also issued State Development Loans (SDL) with a maturity period of 10-15 years and its principal is subjected to up-to 5 year moratorium (interest rate of SDL was around 8%, which is a similar rate as the borrowing cost of India's state governments). For companies that were able to issue bonds, the yield to maturity (YTM) also decreased in the past year. Take Power Grid Corporation of India Limited (Power Grid), a company that transmits around 50% of the total power generated in India, for example. The YTM for one of its bond maturing in 2022 decreased from 4.6% in Nov 2018 to 2.8% in Jan 2020.

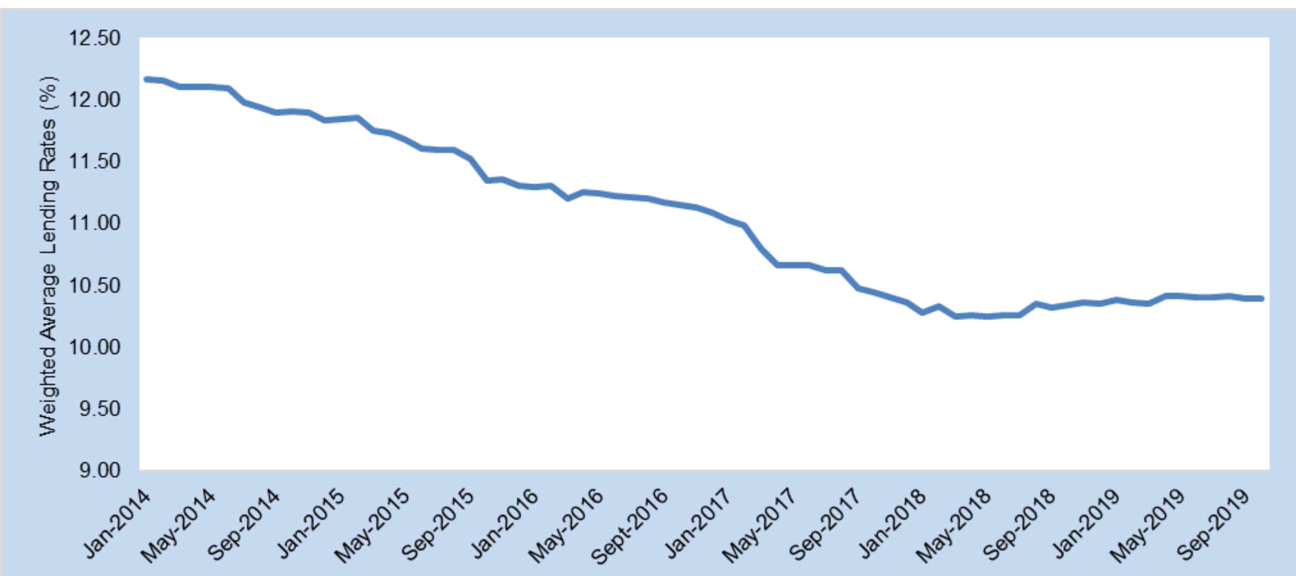


Figure 2: Bank Group-wise Weighted Average Lending Rates (%). *Source: Reserve Bank of India*

Despite the progress that state governments made in improving the operational efficiency and financial health of the DISCOMS, critics argued that the results from those reforms are not as successful as they were expected. The Indian government will initiate another wave of power reforms in 2020, which could cost as much as USD 35bn to turn around its struggling DISCOMS. According to an India's Ministry of Power spokeswoman, the new reforms will further focus on the infrastructure and technology upgrades of ailing utilities to make them more efficient and reduce financial losses.

Figure 3 below exhibits the NUS-CRI Aggregate Forward 1-year PD (Forward PD) term structure[1]. Looking at the Forward PD curves standing at two different time points – Jan 2016 and Jan 2020 – we could find an improving credit outlook of the Indian electric distribution and transmission firms after the implementation of the reform. The Forward PD curve of the industry group standing in Jan 2020, though trending upwards, stays well below that standing in Jan 2016 and the gap between the industry group and all Indian firms narrowed in Jan 2020 compared with that in Jan 2016, indicating that a more positive credit outlook. However, it is important to note that despite the recent improvements in the industry group credit profiles, credit risks remain elevated.

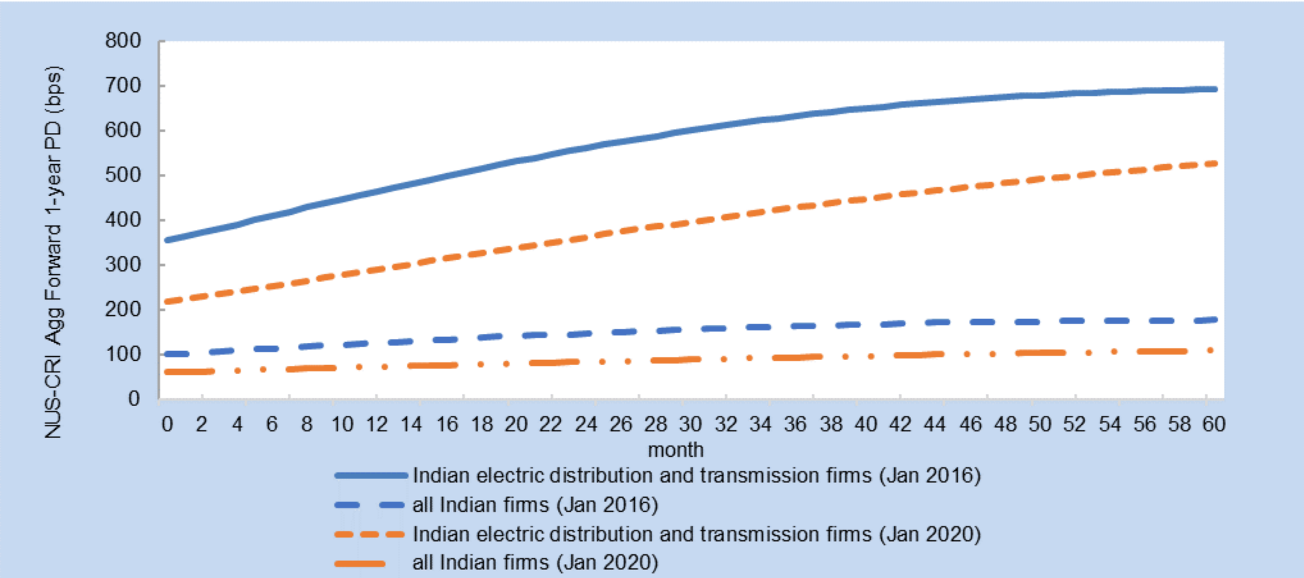


Figure 3: NUS-CRI Aggregate Forward 1-year PD term structure for publicly-listed India domiciled electric distribution and transmission firms compared with Forward 1-year PD term structure for all publicly-listed India domiciled firms standing in Jan 2016 and Jan 2020. *Source: NUS-CRI*

[1] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 12-month Forward 1-year PD is the probability that the firm defaults during the period from 12 months onwards to 1 year plus 12 months, conditional on the firm's survival in the next 12 months.

## Credit News

### China bond investors battle to claim cash after defaults

**Jan 10.** Bond defaults across China are rising as more borrowers failed to fulfill their obligations. When bond issuers run into trouble, investors are facing an increasingly tough task in extracting any returns. Last year, the percentage of borrowers in default that made some sort of interest or principal payments to bondholders dropped to 13% from 46% in 2016. Furthermore, a lack of a mechanism for handling corporate defaults have caused many uncertainties in debt recovery. Consequently, many investors walked away from the bond market, since holding distressed debt is too risky and the returns are shrinking.(FT)

### Mountain of risky corporate debt poses "stability concern"

**Jan 8.** The Federal Reserve Bank of New York reported that an increase in sales of riskier corporate bonds pose a "financial stability concern" as a change in investor sentiment could cause mass sell-off behavior. In recent years, low interest rates had spurred companies to issue more debt, increasing their leverage and dragging down credit ratings. For example, only 2 companies in the US have an AAA rating, while there is a dramatic rise of BBB-rated bonds. Investors are concerned that if economic conditions falter, downgrades of BBB-rated debt could trigger mass sell-offs from investors whose mandates forbid them from holding high yield bonds. (FT)

### Municipal bond issuers face steeper borrowing costs from climate change

**Jan 8.** Municipal bond investors in the US are becoming increasingly concerned with the financial risks of climate change, as increasingly frequent extreme weather conditions affect cities' ability to service their debt obligations. According to research from Blackrock, about 15% of municipal issuers are likely to see weather-related events that could knock out as much as 1% of their economic output. The "muni" market is estimated to be USD 4.1tn, one-quarter of the size of the US Treasury market, where American cities, counties, or other local governments raise money. Mellon Investments stated that it is only a "matter of time" before gaps in funding costs begin to emerge between cities with robust climate adaptation plans and those without. (FT)

### Mortgage bonds attract investors in low-yield world

**Jan 7.** Investors are looking at mortgage bonds once again after a midyear slump pushed yields on the securities to their highest levels in years relative to US Treasuries. The spread which investors were demanding to hold agency mortgage-backed securities issued by Fannie Mae, Freddie Mac and Ginnie Mae over the respective US Treasuries was 81bps last Tuesday, down 109bps from August, the widest gap since December 2013, but still comfortably above the 51bps spread over comparably rated corporate bonds. Agency mortgage-backed securities are either explicitly or implicitly backed by the US government, essentially removing default risk, but come with a major drawback: Homeowners can prepay their mortgages, depriving investors of expected interest payments. (WSJ)

### US corporate bond market extends 2019 rally into New Year

**Jan 7.** The US corporate debt market has continued its strong rally of December into the new year, in a reflection of geopolitical tensions and expectations that the interest rates will not be raised any time soon. The yield on high-yield bond index dropped to its lowest level in more than 5 years, while investment-grade bonds have also seen yields tumble, as prices climb. However, there are signs that corporate-bond investors are still attuned to risk: the incremental yield above US government bonds has risen 9bps since its low in December, and the Middle East tensions now become the major concern of US. (FT)

**Europe's new bond sales top USD 100bn in record-shattering week** (Bloomberg)

**Thousands of LCF bondholders may miss out on compensation** (FT)

**Green bonds set to keep flying off shelves in 2020** (FT)

## Regulatory Updates

### Lebanon central bank proposes Eurobond swaps for local bondholders

**Jan 13.** Lebanon's central bank has proposed that Lebanese holders of a USD 1.2bn Eurobond due to mature in March swap their holdings for longer-dated notes. Lebanon is currently suffering from its worst financial and economic crisis since the 1975-90 civil war and is now one of the most heavily indebted states globally. Slumps in its international sovereign bonds and rocketing credit default swaps might suggest that Lebanon may be heading towards a possible default in the future. The swap would require the approval of cabinet and a law, and also in agreement with the current bondholders. (Reuters)

### Bank caught in regulators' squabble over low-income loan rules

**Jan 8.** The Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corp (FDIC), two of three main banking regulators, proposed changes last month without support from the Federal Reserve. Now, the Fed has released its own regulations that could impede the other regulators' approach or lead to competing rules in the industry. The OCC oversees about 70% of activity under the low-income lending rules and the agency's proposal would apply to some 1,200 banks, as compared to the Fed which oversees 15% of activity. The regulatory split could lead to an unusual scenario where some US banks follow one set of rules while others have to abide by another. (WSJ)

**Carney says BoE could commit to "lower for longer" rates strategy** (FT)

**Singapore to drop quarterly reporting rule for listed companies** (Nikkei Asian Review)

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