India's manufacturing sector faces further credit deterioration

by Sean Lau Koon Leong

- **Even though the Indian government and Reserve Bank of India introduced various measures to help firms during the crisis, PD of the Indian manufacturing sector is likely to worsen.**
- **Forward PDs are expected to rise due to the worsening economic environment and impending end of the debt moratorium on the 28th of September.**

India's failure to contain the COVID-19 pandemic has increased pressure on its manufacturing sector. This can be attributed to expectations of lower sales and the poor profitability of the sector as consumer spending remains weak in the near term due to increased unemployment. This threatens the country's Make in India initiative as the nation looks to increase its manufacturing share of GDP to 25% by 2025, enabling the country to become one of the world's leaders in manufacturing. Over the last 20 years, the auto, pharma and chemical manufacturing subsectors have received significant foreign direct investments, making these sectors integral to India's manufacturing plans. As economic conditions worsen due to the pandemic outbreak and firms face profitability woes during this time, more defaults are expected to follow. In agreement, the NUS-CRI Aggregate Forward 1-year Probability of Default (Forward PD[1]) in Figure 1 below shows that the Forward PD will increase gradually across the manufacturing sector and abovementioned subsectors over the next five years.

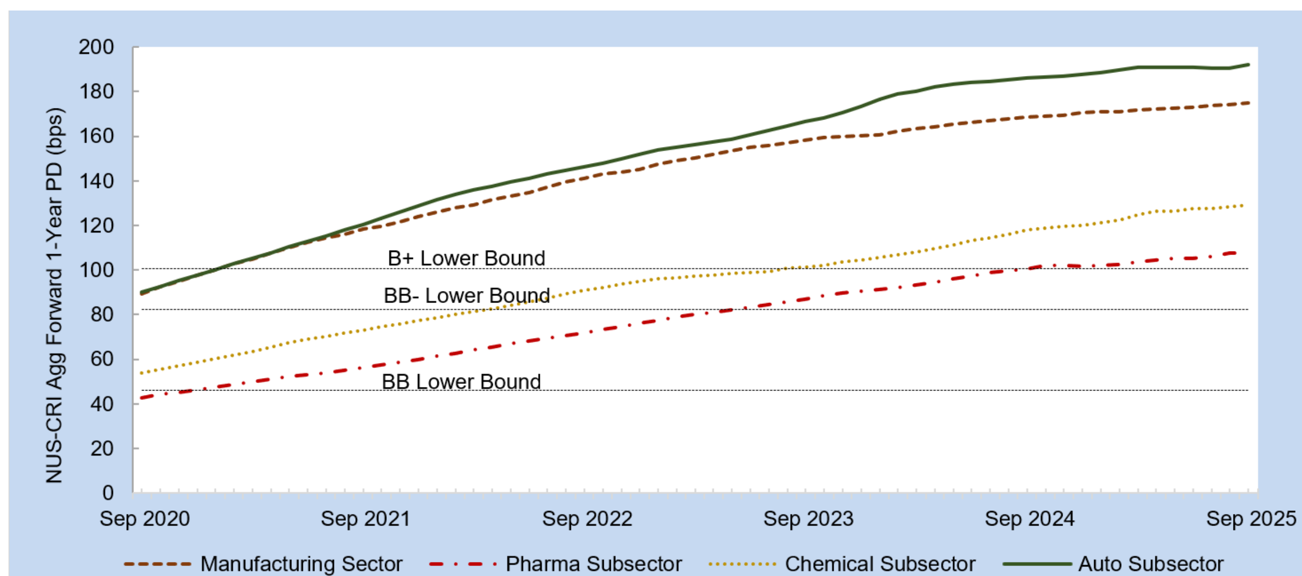

Figure 1: NUS-CRI Agg Forward 1-year PD of India domiciled manufacturing sector, Chemical subsector, Pharma subsector and Auto subsector with reference to PDIR2.0[2] bounds. *Source: NUS-CRI*

While most countries are emerging from lockdowns and their economies are poised to bounce back, India's number of daily virus cases continues to skyrocket. In fact, the nation has registered the world's highest number

[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 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 1 year plus 6 months, conditional on the firm's survival in the next 6 months.

[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

of daily cases, averaging about 95,000 cases for the last 5 days. Even though the sector experienced a rebound in Purchase Managers' Index (PMI) from 46 in July to 52 in August, the improving sentiment on the economy due to high pent-up domestic consumer demand is likely to be temporary. As consumer spending is expected to fall due to unemployment skyrocketing to 9.1% and the effects of reopening the economy slowly wear off, sales are poised to dip causing further distress in the short-term. Due to the pandemic, the Indian economy is set to contract at a double digit rate this fiscal year. This will put significant pressure on the revenues of all manufacturing firms as demand is likely to remain low for a sustained period.

The profitability of Indian firms will also face pressure from supply shortages and transportation delays resulting in higher cost of raw materials. This trend of heightened costs is likely to continue in the short term, thus damaging the bottom line of firms. The Indian manufacturing sector has a high fixed cost of 20-30% of total cost. The sector's median profit margin for the year ended March 31, 2020 (fiscal 2020) is a low 2.27%, indicating the sector's vulnerability to demand shocks. With factories also looking to implement costly health measures to prevent the spread of the disease, profitability issues are likely to worsen. Furthermore, the sector's relatively low median quick ratio of 0.66 for fiscal 2020 reflects the vulnerable liquidity position of the manufacturing companies. It is therefore not surprising to see a rise in PD levels in March and the continuation of its elevated levels as seen in Figure 2.

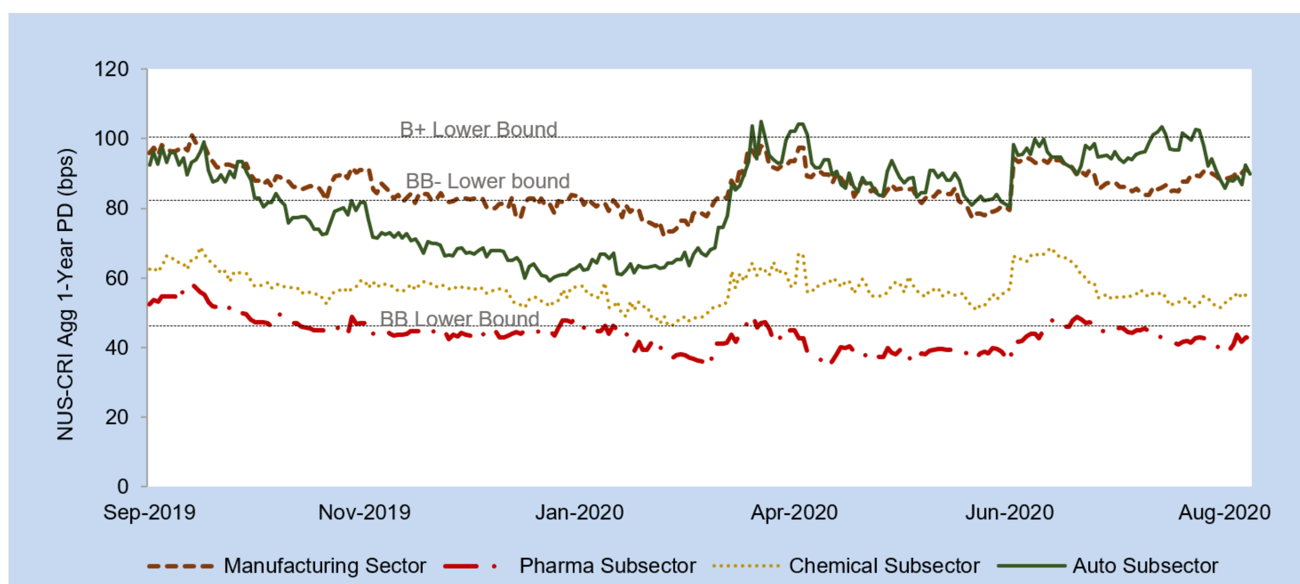

Figure 2: NUS-CRI Aggregate 1-year PD of India domiciled manufacturing sector, Chemical subsector, Pharma subsector and Auto subsector in the past year. *Source: NUS-CRI*

To provide more liquidity to support companies and financial institutions, the Reserve Bank of India (RBI) injected USD 50bn into the banking system in May. The RBI also cut the repo lending rate to 4%, reduced the reverse repo rate to 3.35%, and reduced the bank's reserve ratio to 3% in order to incentivize banks to provide liquidity to the struggling firms. A loan repayment moratorium was put in place to ensure that loans cannot be classified as non-performing assets due to non-payment until the 28th of September. The Government of India (GOI) also announced that INR 6tn of its stimulus package in May will go towards supporting businesses affected by the pandemic. This provided India's manufacturing firms with easier access to financing without requirements for collaterals and at a much lower interest rates than regular loans. Coupled with the easing of the lockdown, these measures allowed the manufacturing sector to raise funds and delay defaults. This might have contributed to the tapering of the rise in PD in March as seen in Figure 2.

The future impact on manufacturing subsectors such as Auto, Chemical and Pharmaceuticals is severe, as illustrated by the significant increase in Forward PD in Figure 1. The Auto industry is among those hardest hit by the pandemic. Potential demand for cars is further set to weaken due to the recent introduction of stringent regulations that increase the cost of owning a car in India. Manufacturer's cash reserves are also stressed due to the impact of working capital mismatches as domestic supply chains are disrupted. Furthermore, the Chemical industry has also been plagued with limited profitability, not only due to lower demand in the whole country, but also due to numerous operational issues such as costlier logistics due to inadequate infrastructure, limited raw

material availability, and high power costs. Similar problems are distressing the Indian pharmaceutical industry. With a lower competitive advantage compared to global competitors in API production and a lack of government incentives, subsidies and suitable infrastructure, the overarching trends indicate a rising PD for the subsector. This is confirmed by Figure 1's Forward PD which shows that the subsector's credit quality fell to a B+ equivalent rating when referenced to the PDiR2.0 bounds.

Overall, the speed of credit recovery for the manufacturing sector will depend heavily on the country's ability to control the spread of the virus. With India's economy unable to afford another lockdown, the number of COVID-19 cases could run to hundreds of millions. This would further damage the credit performance of manufacturing firms in the coming months, especially given that the debt moratorium is due to end at the end of the month. This explains the expected upcoming rise in the Forward PD starting next month as firms will have to start filing their defaults if they are unable to meet repayments. Strong reform measures are also required to re-instill confidence among corporates and consumers in the economy. This would pave the way for new waves of spending and investments in turn kick-starting economic growth, benefitting the manufacturing sector. It would then potentially set India on the path to achieve its ambition of becoming an exporting powerhouse.

Credit News

China's Aug new bank loans rise more than expected, broad credit growth quickens

Sep 11. In Feb 2020, the PBOC released a series of recovery measures which includes cuts in lending rates and reserve requirements. In addition, banks were urged to provide extensive loan support for pandemic-hit enterprises. Amidst signs that the economy is back on track towards recovery, analysts believe that no more cuts are to be expected for the rest of 2020. Aug 2020 saw a rise in exports and consumer demand. Data shown that the M2 money supply is up 10.4% from 2019 and outstanding yuan loans are up 13% as well. (Reuters)

America's USD 20tn debt pile is getting cheaper as it grows

Sep 11. Investors appear more comfortable than the United States Congress with regards to injecting further liquidity into the market. As the country's USD 20tn debt is getting cheaper compared to the size of the economy, and as the supply of US debt is increasing, yields on U.S. Treasury plunged to record lows early in the pandemic. Concerns have been raised regarding the increased spending from both political parties as stimulus efforts ground to a halt. Even though we have seen USD 20tn in public debt, which is more than the economy's total output, the average yield on this debt has dropped since December. As such, increasing debt levels have been bought on by further open market operations. This has raised questions regarding the U.S. government "requiring" financial markets approval on budget policies. Post the federal reserve's easement on U.S. inflation levels, the Fed has bought about USD 80bn in treasuries in the past month and has siphoned about USD 1.8tn of government debt since March. Concerns surrounding the devaluation of the USD have also been put to rest, with Monetary theorists advocating that USD can be self-funded, without the risk of overheating the economy. (Bloomberg)

Companies' urged to issue debt in calm before US election

Sep 11. With the coming US presidential election, many expect a possible disruption to the financial markets which could potentially deny corporates from favorable lending terms. During the last election of 2016, the yields of investment grade corporate bonds surged. This resulted in relatively elevated funding costs. As such, many recommend that the firms take advantage of the low interest rate environment presented to them today. The debt binge might cease to a slowdown as election season creeps in. (FT)

Bank of Japan coronavirus loans may ensure 'zombie' firms limp on

Sep 10. Bank of Japan's (BOJ) loan measures worth more than JPY 100tn have fueled lending in the markets and have kept firms afloat during the nation's worst economic slump, sparking fears regarding the creation of "zombie" companies. With prior experience in providing life support to inefficient firms, Japan is more vulnerable than peers in providing excess stimulus due to limited growth potential with a shrinking working population. These "life-lines" can be taken advantage of by loss-making firms as an "addictive" supply of cash. Zombie firms have been a problem in the market in the past, with unprofitable firms crowding out investment from healthier firms. It is of clear concern for Japan, which has increased stimulus measures until March 2021 and has a history of not-ending stimulus once started. Though analysts have voiced their concerns, BOJ has downplayed the concerns and has stated that it will end the lending once the demand for stimulus subsides. Further concerns regarding moral hazard have been raised, with regards to unnecessary loans being extended under lax standards. (Japan Times)

US companies stretch out debts to lock in low rates for longer

Sep 9. The bond binge, which is well supported by the Fed, has resulted in twofold of the refinancing that took place in 2019. In addition to the USD 250bn worth of refinancing, it was found that the repayment schedules of the debts are being stretched out. Relative to 2019, US firms have sold two times the value of 20 and 30 years bonds and more than fivefold of the value of 40 years bonds. With the looming uncertainty posed by the upcoming elections and the ongoing pandemic, it makes sense for the corporate treasures to term out the debt and hold on the cash. Conversely, this is not as favorable for investors who need to take on more risks to maintain their former returns. (FT)

Defaulted rice-to-fiberboard company wants to borrow USD 53mn (Bloomberg)

German firms spared from insolvency spike despite pandemic (Reuters)

Ryanair's bond draws EUR 4bn in orders as Covid fears swirl (FT)

Regulatory Updates

Mexico may extend relaxed bank credit rules to help economy grow

Sep 10. Mexico's finance ministry is considering extending relaxed banking credit rules to help its economy, after the 2021 budget signal further austerity with little flexibility. The possible extension can be present till next year and will be aimed at avoiding defaults and loss of collateral. Extension of these rules is said to be announced in a couple of weeks, with facilities restricting certain sectors of the economy to the new stimulus to limit the risk to financial institutions. As such, industries that had already reopened and potentially had better cash flow might be excluded, while industries such as airlines will be included as they face slower recovery. The Deputy Governor of the Mexican Central bank said that it may take up to two to three years for the economy to reach its pre-pandemic size. Emphasis is put on maintaining stable debt levels to ensure that the country doesn't face a downgrade from rating agencies. This follows as Mexico was in a mild recession prior to the pandemic, and is a country that collects only 15% of its GDP in taxes, which in turn equates to heavy reliance on the capital markets for spending power and budget deficit rebalancing. (Reuters)

MAS to ensure Singapore banks' smooth transition to Sora by end-2021

Sep 9. It is critical for the banks to keep up with the MAS led transition to SORA. Failure to do so might expose them to risks from the financial markets, operations, technology and legislation. Given the discontinuation of the LIBOR, SOR's computation is affected. Formerly, the SOR is utilized in the pricing of

bonds and loans. It is also the benchmark for SGD derivatives. In the replacement of SOR, SORA is selected as the new interest rate benchmark supported by the deep and liquid overnight funding market. To encourage participation, MAS will expand its SGD 500mn SORA notes issuance. (Straits Times)

China issues new rules to tighten control over financial holding firms (Reuters)

Bank of Canada head says too soon for exit from stimulus, will adjust QE as needed (Reuters)

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Contributing Editor: Emir Hrnjic, Anthony Prayugo