CareEdge RATINGS

FORESIGHTS

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CORPORATE **PROFIT MARGINS UNDER CHECK** IN **Q3 FY23**

CareEdge's detailed analysis of the Q3 results of a sample of 2,201 listed non-finance companies shows the challenging economic and financial conditions continued to impact the earnings of the corporates. Although revenue growth continued in double digits, there was a significant decrease in pace.

GDP Growth Slows to 4.4% in Q3 FY23

Cement Volume Set to Rise to 450MT by FY25

Insolvency Cases Rise by 25% in Q3, Recoveries Still on Downtrend

NOTE FROM
SACHIN GUPTA

Chief Rating Officer
& Executive Director

It remains to be seen whether the Silicon Valley Bank (SVB) debacle is an isolated incident or the beginning of a contagion. Nevertheless, like any disaster, it offers us some lessons.

The main cause of the fiasco was a combination of interest-rate risk and asset-liability mismatch. The bank relied on short-term and floating-rate deposits to finance long-dated and fixed-rate US government securities. As interest rates rose sharply and liquidity dried up over the past year, the bank incurred losses on what would have been an otherwise low-risk investment portfolio.

This exposes the bank's weak risk management practices. But the problem became acute when a multitude of high-value depositors, mostly venture capital-backed tech firms in Silicon Valley, sought to withdraw their deposits. For each withdrawal, the bank had to sell long-dated US government securities at a loss, further deepening the losses. As word spread, aided by social media, it quickly turned into a classic bank run.

Despite serving many high-tech clients, the bank's risk management seems ordinary. Fortunately, the US government has intervened to minimize the impact on the banking system by working out a timely solution and seeking to sell the bank to a stronger suitor.

I see three key takeaways from this fiasco for our financial sector:

- **Diversity of Liabilities:** The biggest challenge SVB faced was the sudden flight of deposits from VC-backed firms. Since it was a relatively concentrated group of companies holding short-term deposits with the bank, it was clearly a flight risk that crystallized. Therefore, banks and non-banking financial companies (NBFCs) should diversify their liabilities across a diverse set of counterparties, even if it comes at a marginally higher cost.

- **Asset Liability Management:** While it may sound clichéd, the fundamental principle of matching assets with liabilities cannot be overstated. Time and again, we have seen financial institutions fail due to poor asset-liability management (ALM). A few years ago, housing finance companies (HFCs) were funding 20-year home loans with 3-month commercial papers, which led to significant challenges for them. The SVB episode is another stark reminder for banks, NBFCs, and HFCs to be extremely cautious with ALM.

- **Supervisory Oversight:** The third and possibly the most critical learning is the essential role of banking regulators in monitoring banks regularly. In this case, there seems to be a regulatory miss. Our banking regulator, the Reserve Bank of India, has generally been quite vigilant in such matters, particularly with respect to scheduled commercial banks.

Overall, while it is still early days for the whole SVB story to unravel, it appears that the US government is backstopping the depositors who may not lose anything. The shareholders and bondholders, on the other hand, may lose everything. The question that remains is that of moral hazard: can banks, particularly the large ones, be mismanaged and run to the ground while depositors go unscathed?

NOTE FROM
RAJANI SINHA
Chief Economist

India's CPI inflation in February came higher than 6% for the second consecutive month. The rise in inflation was led by food and non-food categories such as housing, household goods and services and health. With core inflation remaining elevated at 6.3%, there are increased expectations of a further rate hike by the RBI in the next policy meeting in April.

On the global front, there is further uncertainty regarding the interest rate trajectory. While the US Federal Reserve had been indicating chances of a higher rate for a longer period, the recent episode of SVB (Silicon Valley Bank) collapse has resulted in market expectations of a less hawkish stance by the Fed.

Definitely, the decision by the RBI will be difficult in this uncertain global and domestic environment. If we look at the last few data points emanating from India, we are seeing a mixed signal. While indicators like GST and auto sales are still showing robust recovery for India, other indicators like Manufacturing GVA and exports are showing signs of weakness. There is no denying that with global growth slowing down in 2023, India will feel the pain. Moreover, some of the pent-up demand seen specifically in the contact intensive services sector is likely to fizzle out in the months to come. However, with the economy likely to record around 6% GDP growth in FY24, the Central Bank will not be overtly concerned about growth. Having said that, there is a need to exercise caution as the economic environment remains quite uncertain. Two of the MPC (Monetary Policy Committee) members have already been highlighting the risks of the Central Bank overshooting the rate hikes.

While inflation in the last few months has been coming above RBI's expectations, we expect it to moderate in the next few months supported by the base effect. Food inflation has been a big cause of concern, specifically cereal inflation, which has been hovering above 16%. Food inflation is contributing around 45% to overall inflation. On expectations of a healthy Rabi harvest, we expect food inflation to cool off. But again, we need to be cautious of weather-related disruptions and their adverse impact on food inflation.

As far as core inflation is concerned, it is found to be sticky. Hence, it will take time before we see a moderation in core inflation in response to the monetary tightening so far and fizzling out of pent-up demand. For the next fiscal, we expect average CPI inflation at 5.1% due to a combination of factors including support from a high base, the assumption of a normal monsoon, no major rebound in global commodity prices and moderation in domestic growth. However, with core inflation still high, we cannot rule out the possibility of another 25-bps rate hike by RBI in the April meet.

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Corporate Profit Margins Remain Under Check in Q3 FY23

The challenging economic and financial conditions continued to impact the earnings of the corporates in the third quarter of FY23. Although revenue growth continued in double digits, there was a significant decrease in pace. Despite an anticipated increase in demand during Q3 due to the festive and holiday season, net sales remained almost unchanged from the previous quarter. While there was some relief due to easing input costs, it was partially offset by an increase in interest and employee expenses. As a result, operating profit only experienced marginal growth during the third quarter. On a positive note, both operating profit margin and interest coverage ratio improved sequentially but remained lower than a year ago. Among sectors, automobiles, IT, power, and capital goods witnessed strong double-digit growth in both sales and profitability whereas, crude oil, iron and steel, non-ferrous metals, cement and textile dragged on overall profitability.

Corporate Performance (Excluding BFSI) – Q3 FY23

A. Aggregate Analysis – Q3 FY23

Net sales in the third quarter grew at 14.7% (y-o-y), moderating from 25.5% growth in the previous quarter. A major part of this growth in total revenue could be on account of higher realisations with some of the sectors passing on the high input costs to the final consumers. On a quarter-on-quarter basis, growth in net sales was muted at 0.6% in Q3 despite it being a seasonally strong quarter. The dampening effect of high inflation levels on consumers' purchasing power along with slowing external demand could have impacted the volume growth for some of the sectors.

Table 1: Quarterly Corporate Performance (Sample of 2,201 Companies Excluding BFSI)

Particulars	Unit	Q3 FY22	Q2 FY23	Q3 FY23
Net Sales	₹ Lakh Cr	26.1	29.7	29.9
	% y-o-y	26.5	25.5	14.7
Expenditure	₹ Lakh Cr	22.1	26.4	26.0
	% y-o-y	28.9	32.1	17.8
Cost of services and Raw Materials	₹ Lakh Cr	9.2	11.2	10.9
	% y-o-y	43.3	41.7	19.3
Employee Cost	₹ Lakh Cr	1.9	2.1	2.2
	% y-o-y	11.1	13.1	13.3
Operating Profit	₹ Lakh Cr	4.4	3.9	4.4
	% y-o-y	12.3	-7.4	0.5
Profit After Tax	₹ Lakh Cr	2.0	1.4	1.8
	% y-o-y	28.1	-27.1	-7.9
Ratios		**Q3 FY22**	**Q2 FY23**	**Q3 FY23**
Operating Profit Margin	%	16.9	13.0	14.8
Interest Coverage Ratio (ICR)	-	6.5	5.0	5.3

Source: Ace Equity; CareEdge

Notwithstanding the double-digit growth in net sales, growth in operating profit was muted at 0.5% (y-o-y). The sustained moderation of commodity prices helped ease the input price pressures on corporates. However, rising finance and employee costs were the drags on corporates' earnings and limited the upside in profitability. Financing costs for the corporates have accelerated in the past two quarters amid rising borrowing costs. In Q3, interest expenses by the corporates surged by 23% (y-o-y) compared with a 2% decline witnessed a year ago. At the same time, employee costs jumped by 13% (y-o-y), the highest increase in the last five quarters. Much of this was driven by the IT and automobile sectors. Overall, total expenses were still around 18% higher annually. However, on a q-o-q basis, total expenditure declined by 1.3% mainly supported by the easing of raw materials costs. This was reflected in a q-o-q growth of nearly 14% in operating profit of the firms despite a subdued sequential growth in total revenue.

If we look at the financial ratios, some improvement was witnessed in Q3 compared with the previous quarter. The operating profit margin improved to 14.8% from 13% in the previous quarter. At the same time, interest coverage ratio also moved higher to 5.3 from 5 in Q2 FY23. However, an annual comparison shows that both measures were lower compared to a year ago level.

B. Sectoral Analysis – Q3 FY23

Our analysis of 21 select sectors showed that except textile, all other sectors posted positive annual growth in net sales in Q3. Sectors such as automobiles, power, IT, cement, and capital goods, among other, posted double-digit growth indicative of easing supply chains and growing economic activity. However, the impact of slowing external demand and easing commodity prices were visible for sectors such as non-ferrous metals, iron and steel and chemicals which grew at a much slower pace. The net sales for textile sector continued to witness contraction on a y-o-y basis for the second consecutive quarter. The uneven nature of demand recovery is reflected in the data on sales and profits as sectors such as aviation, hospitality and automobiles, dominated largely by urban demand, featured in the highest growth bracket. These sectors have also benefitted from high pent-up demand.

Of the 21 sectors, about one-third sectors witnessed a fall in their operating profits on annual basis. The fall was sharp for sectors such as textile, non-ferrous metals, iron and steel and crude oil. Some of these sectors were adversely impacted by lower realisations owing to easing global metal and commodity prices. The global demand slowdown is another pain point which could have impacted the volume numbers. All these sectors have also witnessed a significant decline in their operating profit margins as well, compared with a year ago level.

Some major sectors which have seen an uptick in their profitability are automobiles, capital goods, FMCG, IT and power. These sectors have posted a positive growth in their operating profit on a sequential basis as well. Festive season led demand, cost rationalisation, easing input price pressures and sustained economic activity have resulted in higher profits for these sectors. Despite higher profitability, there was no major improvement in the operating profit margins for these sectors. In fact, for IT and power sectors, the profit margins in Q3 were lower than a year ago level.

Growth in Net Sales (% y-o-y) – Q3 FY23

Less than 10	10 to 20	Above 20
Chemicals	IT	Aviation
Media & Entertainment	Crude Oil	Hospitality
Logistics	Cement	Power
White Goods	Capital Goods	Retailing
Non - Ferrous Metals	Telecom	Realty
Iron & Steel	Infrastructure	Automobile & Ancillaries
Textile	Pharmaceuticals & Drugs	
	FMCG	

Source: Ace Equity and CareEdge
Note: Sectors are presented in descending order of growth

Growth in Operating Profit (% y-o-y) – Q3 FY23

Less than 0	0 to 20	Above 20
Cement	Capital Goods	Aviation
White Goods	FMCG	Hospitality
Crude Oil	IT	Automobile & Ancillaries
Media & Entertainment	Power	
Non - Ferrous Metals	Retailing	
Textile	Realty	
Iron & Steel	Infrastructure	
	Telecom	
	Pharmaceuticals & Drugs	
	Logistics	
	Chemicals	

Source: Ace Equity and CareEdge
Note: Sectors are presented in descending order of growth

Way Forward

The quarterly numbers for Q3 had little to cheer. The impact of unfavourable global economic and financial conditions is clearly visible on the performance of sectors having exposure to global demand. Sectors which did well in Q3 gained mostly from the strength in domestic demand impulses. However, in this case also there was divergence with sectors catering to urban population doing relatively better compared to others. This is because these sectors have a higher capability of passing on the input cost burden to their final consumers. Moreover, contact-intensive service sectors have continued to show strong pent-up demand.

Going ahead, signs of recovery in rural demand, improving consumer sentiments and expectation of moderation in consumer inflation could have positive implications for sectors such as FMCG, retailing and white goods. Sectors in the infrastructure space could gain from the government's focus on accelerating the pace of capital creation in the economy. However, the outlook for sectors such as textile, chemicals, iron and steel etc., remains uncertain amid the global recessionary concerns. Moreover, in the coming quarters, there is likely to be some waning of domestic pent-up demand seen in many of the sectors.

GDP Growth Slows to 4.4% in Q3 FY23

India's economy recorded GDP growth at 4.4% in the third quarter of FY23, down from 6.3% in the previous quarter (and lower than our estimate of 4.6%). The slowdown in growth compared with the second quarter was on account of normalisation of base and a contraction in the manufacturing sector's output. However, sequential improvement in Q3 over Q2 signals the economy's resilience despite challenging global economic environment. As per the Central Statistics Office's second advance estimate, for the full financial year economic output is expected to grow at 7%.

Exhibit 1: Quarterly GDP Growth (y-o-y%)

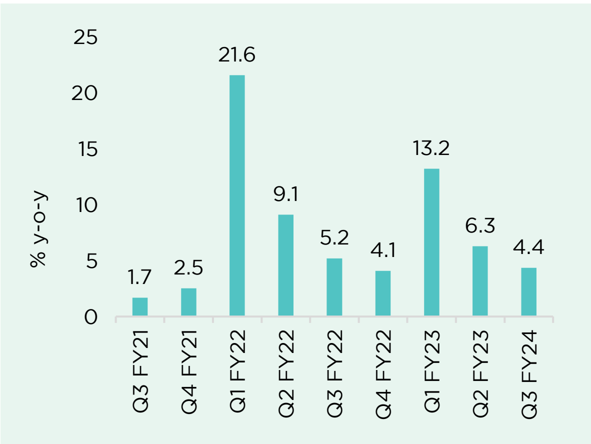
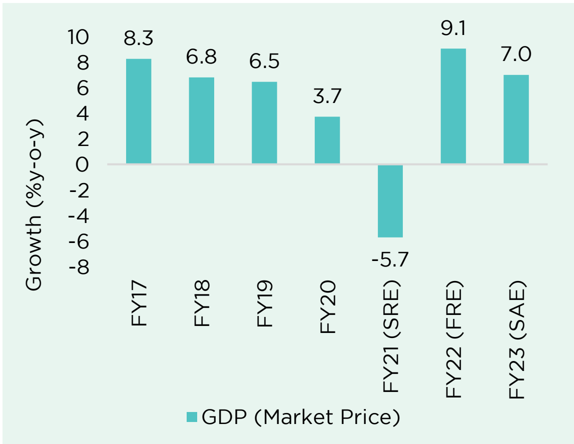


Exhibit 2: Annual GDP Growth (y-o-y %)



Source: MOSPI; SRE: Second Revised Estimates; FRE: First Revised Estimates; SAE: Second Advance Estimates

Which Sectors Led Growth?

Agriculture sector recorded a healthy growth of 3.7% in Q3FY23, compared with a growth of 2.3% in the corresponding quarter a year ago. As per the second advance estimate, foodgrains production grew by 2.5% in FY23 and stood at an all-time high of 323 million tonnes. Rising bank credit to agriculture sector, increased exports from agriculture sector and higher sowing of rabi crop are the positive developments for agriculture sector going ahead.

Industrial sector moved from contractionary to the expansion territory but grew modestly by 2.4% due to negative growth in the manufacturing segment. Subdued performance in the manufacturing sector can be attributed to slowdown in exports, lower discretionary demand and some fizzling off in the pent-up demand.

Services sector continued to witness buoyant demand and recorded a growth of 6.2%, primarily led by trade, hotels, transport, communication, and services related to broadcasting and finance, real estate & professional service. Healthy growth in various service sector indicators like air passenger traffic, port cargo traffic, GST collections and retail credit will support service sector going ahead.

Table 1: Supply-Side Components Growth (y-o y%)

	Q3 FY22	Q4 FY22	Q1 FY23	Q2 FY23	Q3 FY23	FY21	FY22	FY23 (SAE)
Agriculture, Forestry & Fishing	2.5	4.1	4.5	4.6	3.7	3.3	3.0	3.5
Industry	0.3	1.3	8.6	-0.8	2.4	-3.3	10.3	4.1
Mining & Quarrying	9.2	6.7	6.5	-2.8	3.7	-8.6	11.6	2.4
Manufacturing	0.3	-0.2	4.8	-4.3	-1.1	-0.6	9.9	1.6
Electricity, Gas, Water Supply & Other Utility Services	3.7	4.5	14.7	5.6	8.2	-3.6	7.5	9.0
Construction	-2.8	2.0	16.8	6.6	8.4	-7.3	11.5	9.1
Services	8.1	5.5	17.6	9.3	6.2	-7.8	8.4	9.1
Trade, Hotels, Transport, Communication & Broadcasting	6.3	5.3	25.7	14.7	9.7	-20.2	11.1	13.7
Financial, Real Estate & Professional Services	4.2	4.3	9.2	7.2	5.8	2.2	4.2	6.4
Public Administration, Defence and Other Services	16.7	7.7	26.3	6.5	2.0	-5.5	12.6	7.9
GVA (at basic price)	4.7	3.9	12.7	5.6	4.6	-4.8	8.1	6.7

Source: MOSPI; SAE: Second Advance Estimates

Growth in Expenditure Side

Consumption: Growth in Private Final consumption growth (PFCE), moderated to 2.1% in Q3 FY23. It was a notable deceleration from 9.7% in Q2 of FY23, largely on back of unfavourable base effect. Though the ratio of private consumption to GDP has improved to 61.6% from 59.5% in the previous quarter. Tapering-off of pent-up demand and high inflation affecting non-essential consumption could be the reason behind lower consumption growth. Going ahead falling rural and urban unemployment rate, improving consumer confidence, and falling inflation expectations should support consumption.

Investments: measured as Gross Fixed Capital Formation (GFCF) grew by 8.3% in Q3 FY23 supported by favourable base effect, but the ratio of investment to GDP ratio has fallen to around 32% from 34% in the previous quarter. But investment is likely to benefit from higher allocation to capex by centre and uptick in capex announcements by private sector. Moreover, RBI surveys show that business optimism is rising with business expectations index remaining at an all-time high and rising capacity utilisation also point towards an impending capex cycle. Slowdown in global demand and rising interest rates are headwinds for investment revival going ahead.

Table 2: Demand Side Components Growth (% y-o-y)

	Q3 FY22	Q4 FY22	Q1 FY23	Q2 FY23	Q3 FY23	FY21	FY22	FY23 (SAE)
Government Final Consumption	3.0	4.8	1.3	-4.4	-0.8	3.6	2.6	1.2
Private Final Consumption	7.4	1.8	25.9	9.7	2.1	-6.0	7.9	7.3
Gross Fixed Capital Formation (GFCF)	2.1	5.1	20.1	10.4	8.3	-10.4	15.8	11.2
Exports	23.1	16.9	14.7	11.5	11.3	-9.2	24.3	11.5
Imports	33.6	18.0	37.2	25.4	10.9	-13.8	35.5	18.8
GDP (at constant prices)	5.4	4.1	13.5	6.3	4.4	-6.6	8.7	7

Source: MOSPI; SAE; Second Advance Estimates

Way Forward

As the external demand conditions remain weak, it is critical that domestic demand should accelerate. Improving rural demand and rising rural wages are the positive developments for aggregate demand. However, there is expected to be some fizzling out of the pent-up domestic demand seen in the last few quarters.

Government focus on capex and improving intent of private sector to invest should be supportive of investment demand but lower external demand and raising interest rates poses downside risks for investment revival. We expect GDP growth to moderate to 6.1% in FY24.

CareEdge RATINGS

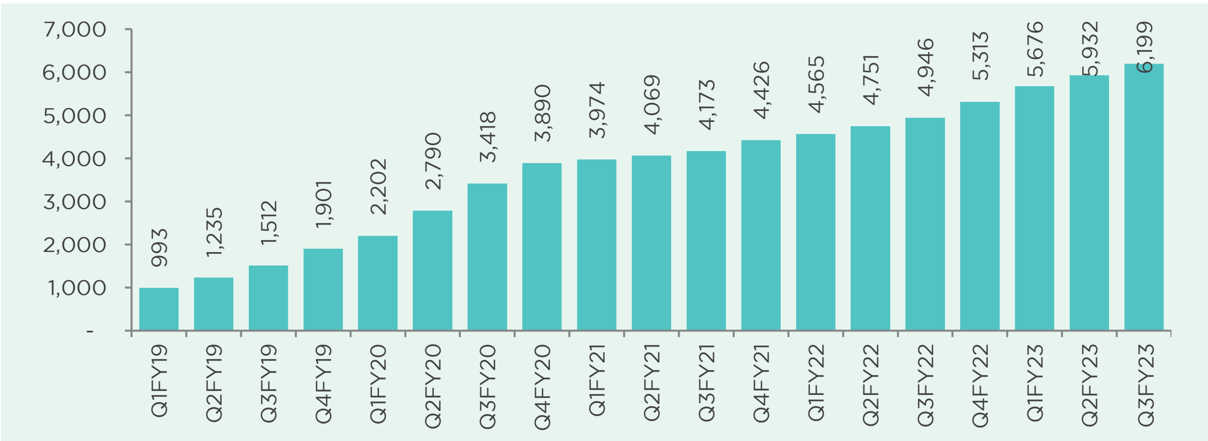
Insolvency Cases Rise by 25% in Q3, but Recoveries Still on Downtrend

Synopsis

- After slowing in the pandemic period of FY21 and FY22, the number of insolvency cases increased by 25% y-o-y in Q3FY23.
- However, despite the increase, the number of cases admitted to the insolvency process continued to be lower compared to earlier quarters in FY19/20.
- The distribution of cases across sectors continues to remain broadly similar, compared to earlier periods given the extended resolution timelines.

Corporate Insolvency Resolution Process Remains Popular...

Figure 1: Cumulative # of CIRPs Admitted

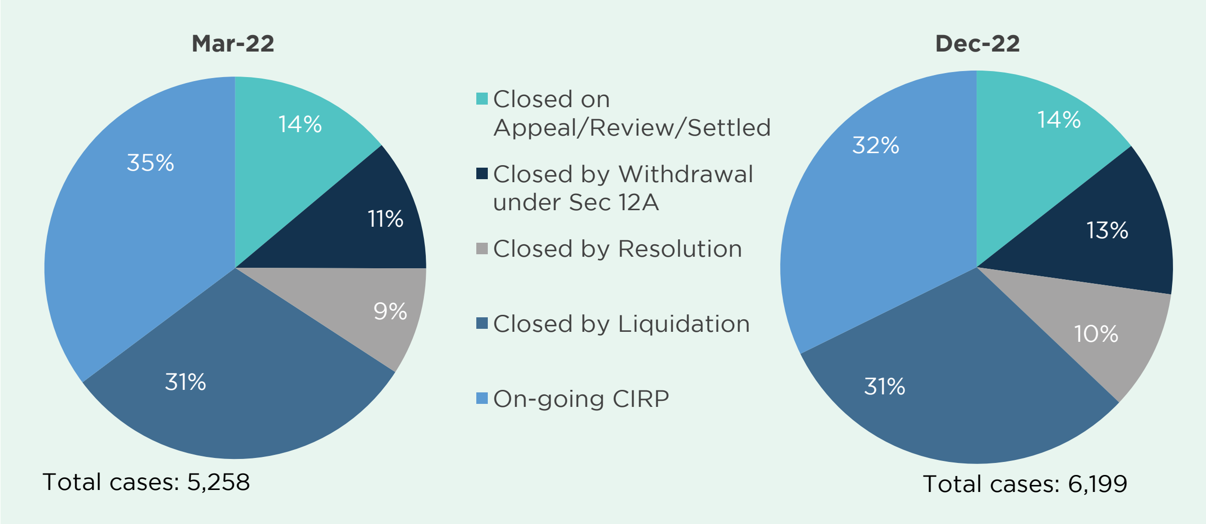


Source: Insolvency and Bankruptcy Board of India

The number of cases admitted for Corporate Insolvency Resolution Process (CIRPs) has increased each quarter since the launch of the Insolvency and Bankruptcy Code in 2016, highlighting the rising acceptance of IBC as an effective debt resolution mechanism. The admission of cases has increased y-o-y in Q3FY23 by around 25% after reducing in the last few quarters in FY21 and FY22, however, despite the increase, the number of cases admitted to the insolvency process continues to be lower compared to earlier quarters in FY19/20.

IBC has continued to gain in popularity, with close to 6,200 companies being admitted and a significant number of these cases on a cumulative basis till December 2022 being filed by the financial creditors (2,692 cases) and the operational creditors (3,133 cases). The share of corporate debtors has continued to remain the smallest over the same period. The share of the various sectors has largely remained constant compared with the previous period. The manufacturing sector accounts for the highest share at 39% of the overall cases, followed by the real estate (21%), construction (11%) and trading sectors (10%).

Figure 2: Status of CIRPs



Source: IBBI

The status of the cases has largely remained constant compared with the previous period. Of the total 6,199 cases admitted into CIRP at the end of December 2022:

- Only 10% have ended in approval of resolution plans, while 32% remain in the resolution process vs. 35% as of the end of March 2022.
- 1,901 have ended in liquidation (31% of the total cases admitted). Meanwhile, 76% of such cases were either BIFR cases and/or defunct. These cases had assets which had been valued at less than 8% of the outstanding debt.
- Around 14% (894 CIRPs) have been closed on appeal /review /settled, while 13% have been withdrawn under Section 12A. A significant number of withdrawn cases (around 54%) were less than ₹ 1 crore, while the primary reason for withdrawal has been either the full settlement with the applicant (306 cases) or other settlement with creditors (210 cases).

...Despite Haircuts of approximately 70%...

Figure 3: Summary of CIRPs Yielding Resolution

Particulars	Amt/%		
	Up to Mar. 2022	For Q3FY23	Up to Dec. 2022
Total admitted claims of Financial Creditors (₹ cr)	684,901.3	30,104.9	830,842.9
Liquidation value (₹ cr)	131,447.9	4,407	143,701.6
Realisable by FCs (₹ cr)	225,293.8	7,060	252,602.5
Realizable by FCs as a % of their claims admitted	32.9	23.45	30.4
Realisable by FCs as a % of their liquidation value	171.4	160.2	175.8

Source: IBBI

Post the implementation of the IBC, the overall recovery rate till Q4FY22 in India reached 32.9% which has been on a continuous declining trend. The recovery rate for Q3FY23 stood at 23.45%, while the overall recovery rate reached 30.4% till Q3FY23. Consequently, for the cases which have been resolved, the creditors have continued to face a haircut of approximately 70% on admitted claims.

CareEdge RATINGS

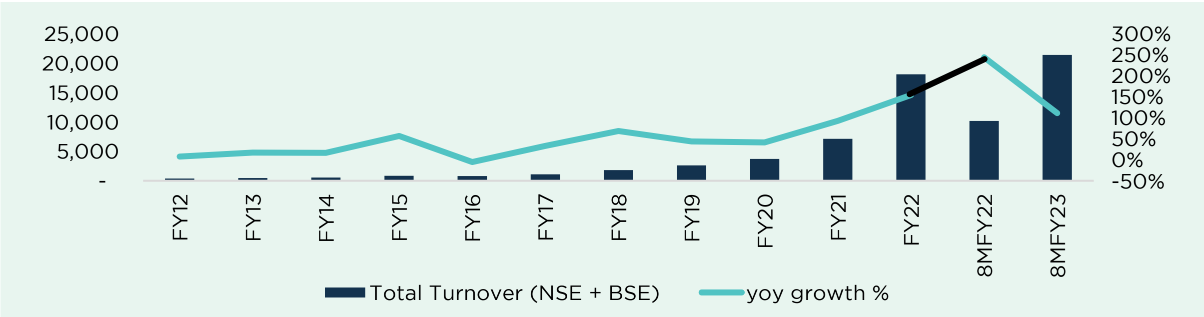
Broking Income Not Commensurate to Active Clients' Share, Moderation in Growth Likely

Synopsis

- The majority of the significant growth in capital market volumes in the past couple of years has been contributed by the Future & Options segment, which is relatively low yielding compared to the cash segment.
- However, such high growth in the F&O segment is not sustainable over long-terms and we expect it to normalise in the near term.
- All three types of brokers – discount brokers, traditional brokers, and bank-based brokers reported an increase in their active client base with discount brokers cornering a significant share of active clients of close to 70%.

In fiscal 2021, the market volumes grew by 92% y-o-y while in 2022 it grew further by 154%. This significant growth was driven by ample liquidity and also due to increased participation from retail investors. The F&O segment grew by 97% and 160%, respectively, in FY21 and FY22, while the cash segment grew by 70% in FY21 before tapering down to a modest 9% in FY22.

Figure 1: Overall Volume Growth (Rs. Lakh crore)



Source: SEBI Bulletin

Volumes in the F&O segment have always been significantly higher than the volumes in the cash segment, given the higher leverage enjoyed by the investor to take a larger position and less upfront cash requirement as compared to the equity segment. However, despite the sharp increase in F&O volumes, its contribution to the overall broking income remains relatively low and the cash segment remains the cash cow for the broking industry.

Figure 2: Volumes in F&O to Cash (Times)

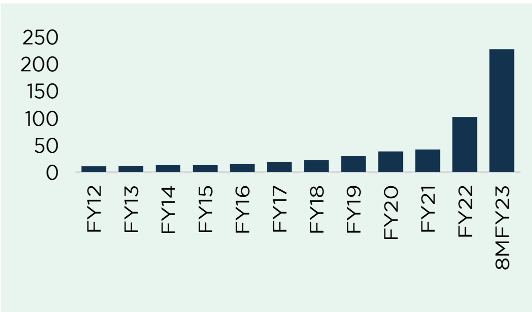
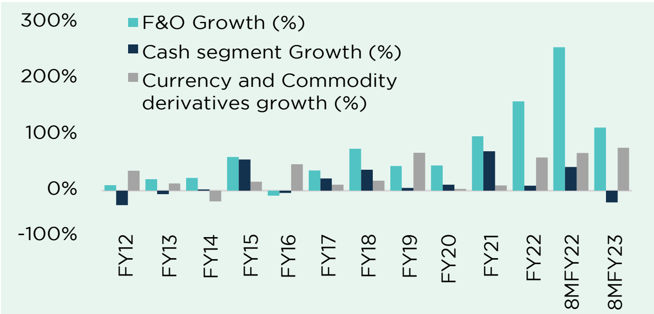


Figure 3: Segment growth %



Source: SEBI Bulletin

The total income of brokers comprises mainly of broking income and other income (fees income and interest income). Discount brokers are more dependent on their broking income which contributes upwards of 80% of their total income. Large traditional brokers and bank-based brokers have relatively better diversification in their total income profile with broking income contributing about two-thirds of the total income. These brokers have diversified their income stream through income from margin trading funding and providing wealth services such as insurance and mutual funds distributions. With the significant growth in active clients, the discount brokers have cornered an impressive share of close to 70% of total active clients at end of fiscal 2022; however, this has not commensurately translated in the share of broking income or profitability at an aggregate level. Discount brokers constitute about 40% of the total industry's broking income and around 30% of net profits. On the other hand, bank-based brokers contribute about one-third of broking income and close to 50% of net profits with an active client share of just over 20%. This can be explained by the fact that discount broker clients are majorly focused on trading in the F&O segment while bank-based brokers clients have higher share in cash segment. Traditional brokers, in the last few years, have been investing in technology and expanding their network to acquire new clients. Accordingly, their cost-to-income ratio has been elevated. CareEdge believes that once the cost-to-income ratio of traditional brokers normalises, their profit margins will improve from current levels. Like bank-based brokers, they are also expected to benefit from their diversified income sources and relatively higher share of cash segment trading.

Increasing regulatory compliance burden could lead to consolidation

Over the years SEBI has issued various rules and regulations to improve the functioning of capital markets and their intermediaries and protect investor capital from being misused. Some of the major regulations include peak margin (Sep 2021) which was introduced to set strict rules on leverage. Then the "Demat Debit Pledge Instructions" (DDPI) was implemented (July 2022) and it replaced the Power of Attorney (PoA) provided by clients to brokers. The Quarterly fund settlement (October 2022) where funds in the trading account must be transferred back to the client's bank account once in a quarter by the brokers will also help in mitigating the risk for investor capital. Further, SEBI is contemplating designating some of the country's top brokers as qualified stock brokers (QSBs) which will increase the compliance requirements for those QSBs and introduction of ASBA concept in the secondary market similar to one for the IPO market. Accordingly, the client's funds will be directly transferred to the clearing house and brokers would only execute trades for their clients to avoid potential misuse of clients' funds by the brokers. All the regulatory changes while good for capital markets and investors, increase the compliance and operational cost for broking companies. CareEdge believes that bank-based brokers are adequately prepared to handle additional requirements since they are already subject to additional oversight from the RBI. Some of the large traditional brokers have sufficient capacity to adapt swiftly to the changing regulatory requirements. However, a few of the small brokers may find the regulatory compliance burden high which could lead to pressure on their sustenance and lead to consolidation in the industry.

Outlook

The exponential growth in volume and active clients reported in the last two fiscal years is unsustainable over long term. Accordingly, CareEdge expects moderation in the active clients' growth in the near term. Nevertheless, the demographics of India and the fact that retail participation is still low in Indian capital markets augurs well for the long-term sustained growth of clients for the broking industry. For FY23 CareEdge expects that the total income growth for the broking industry will moderate to ~10% from ~47% in FY22. Accordingly, the total income for FY23 is expected to be around ₹ 28,000–30,000 crore with discount brokers continuing to contribute about 40% of the industry's total income. Further, traditional and bank-based brokers are expected to have a relatively flattish growth with total income more or less equal to the levels of FY22. The expectations of performance for FY24 are largely in line with the trends seen for FY23 with the potential for inorganic growth for some traditional brokers benefiting from consolidation in the industry.

As Infra Takes Centre Stage, Cement Volume Set to Rise to 450MT by FY25

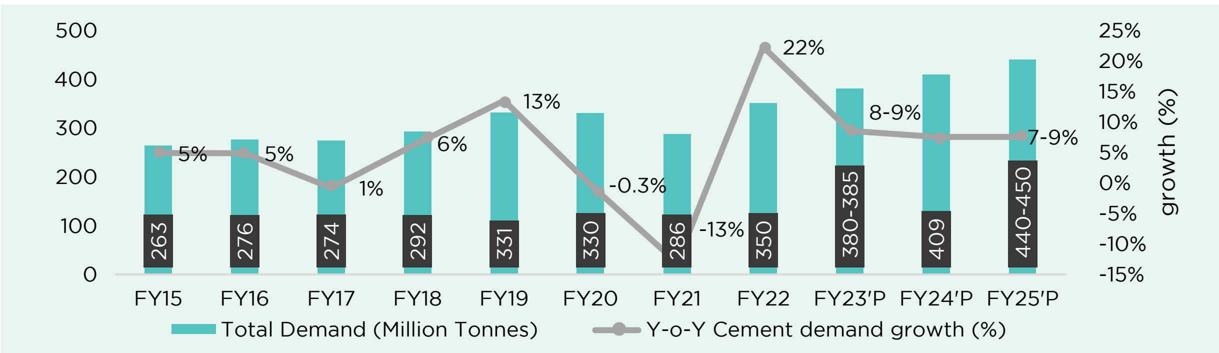
Synopsis

- The current upcycle in infrastructure and real estate is expected to significantly boost cement demand. We predict growth in cement volume by 8-9% in FY23, reaching 380-385 million tonnes (MT), and by FY25 year-end, reaching 440-450 MT.

- The Union Budget for FY24 marks the third consecutive year in which the government has increased the budget allocation for key infrastructure sectors, reflecting its commitment to infrastructure-led growth.

The cement industry has benefitted from high volume growth, majorly driven by a revival in demand from the housing sectors, upcoming infrastructure projects such as the construction of roads, railways, and highways as well as generous rural demand. The cement sector remains one of the key beneficiary of the economic growth as there is a positive corelation between GDP growth rate & cement demand growth. In the 9MFY23, the overall cement demand registered 11% growth over last year and on a full year basis CareEdge expects 8-9% growth.

Chart 1: Cement Demand to stay strong.



Source: CareEdge Ratings, Industry, CMIE

The central government continues to focus on increasing capex outlay to spur growth in light of the 2024 general elections. The capex for 2023-24 (Budget Estimate) at ₹ 10 lakh crore is almost 3 times of the capital expenditure in FY2019-20. The capex spree also augurs well with the central government's aim to make growth more inclusive as investment in infrastructure and productive capacity have a multiplier effect. The public sector capex has focused on improving the connectivity inside the country and gradually the allocation for highways and railways have surged from 35% in FY18 to 43% in FY23. The Union Budget 2024 also increased outlay on railways and plans 50 new airports.

On the real estate front to provide housing for all, the government has launched the smart city project and increased the allocation to the PM Awas Yojana budget allocation for FY24 by 66%. The private capex is expected to pick up in the coming years with the support of ₹ 1.94 lakh crore allocated towards 13 manufacturing sectors under the PLI scheme and rising domestic demand.

The combined effect of increasing infrastructure spends, real estate upcycle, low per capita consumption and the expected increase in private sector capex well supports the demand growth for cement in FY24-FY25. CareEdge expects the sales volume for the cement industry to grow by 8-9% in FY23 to 380-385 MT and to 440-450 MT by FY25 year-end with Central and eastern regions witnessing more lucrative demand. Given the demand is expected to remain robust in upcoming years, the cement players have also announced additional capacity to keep up with the growth pace.

Players on Expansion Spree will Keep Utilisations Under Check

Given the strong demand visibility for the cement sector as a whole, the cement players have shown enthusiasm to announce capacity additions over the next three years. The cement players are expected to add 85-100 MT of additional capacity till FY25 end, as opposed to 104 MT of capacity added in the last 5 years during FY17-FY22. Out of the total capacity addition, 30-32 MT is expected to be added by FY23 end and balance capacity over the next two years.

The robust capacity addition plans by players for FY23-FY25 are leading to additional capacity to be at 1-1.1x of the expected incremental demand of 90 MT during the same period. This is expected to keep the industry's capacity utilization (grinding) under check, and they are unlikely to improve beyond 67-69% despite a better demand outlook. However, going forward any variation in the demand drivers amid the upcoming capacity expansion will remain a key monitorable.

The cement industry is concentrated with the top 10 players having more than 68% of the installed capacity share. Going forward as well the capacity expansion during FY23-FY25 is expected to be predominantly undertaken by the top players and hence the consolidated nature of the sector is likely to continue. "The sector may also witness acquisition of mid or smaller-sized players by the top players amid the prolonged margin pressure which the sector is witnessing. This will lead to further consolidation in the sector and better pricing discipline amongst remaining players," said Ravleen Sethi, Associate Director, CareEdge.

Meaningful Price Hikes Not Coming this Fiscal

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. For the last 6 quarters, the growth in total cost per tonne has been at a much faster pace than the growth in net sale realization which has led to steep erosion in EBITDA per tonne for the players.

In the current year, the players will not be able to offset the higher input costs through hikes in cement prices given the unprecedented input prices. While players have announced price hikes across regions recently, the absorption and sustainability of these hikes remain monitorable. In CareEdge's view, these hikes are not enough for any major shift in the operating margins. CareEdge had already estimated a drop in margins for cement players in FY23 in its earlier report published in Dec 2022 titled "Cement Industry Margins Set to Contract in FY23, Price Hikes Imminent" and expects the profitability margins to remain moderated till H1FY24 on account of elevated fuel cost from the past average and not much price hikes coming through. This is going to moderate the credit profile of the players. The absolute profitability of major players may get cushioned on account of operating leverage on the back of robust demand drivers.

CareEdge Ratings View

"The macros of the cement industry remain stable in the long term, driven by demand from the housing sector, upcoming infrastructure projects as well as generous rural demand. The capex spree by the government on infrastructure and housing spending in the wake of the 2024 general election paints an encouraging picture of cement demand. The private capex is also expected to pick up gradually lending further support on the demand front. The cement players have also responded enthusiastically by announcing huge capacity addition over FY23-FY25. With several companies looking to commission capacities in the next 2 years, the industry's pricing may come under some pressure.

In the current fiscal as well, the players are walking on a tightrope, and they have not been able to offset the higher input costs through hikes in cement prices given the unprecedented levels of input prices with cement prices already being at their peak. Though price hikes and absorption of the same are imminent for the sector's profitability, but so far players have not been able to take meaningful hikes. Hence, Operating leverage driven by strong volume uptake and continuous focus of the players to improve cost efficiency are expected to aid margin in the medium terms for the sector," said Ravleen Sethi, Associate Director, CareEdge.

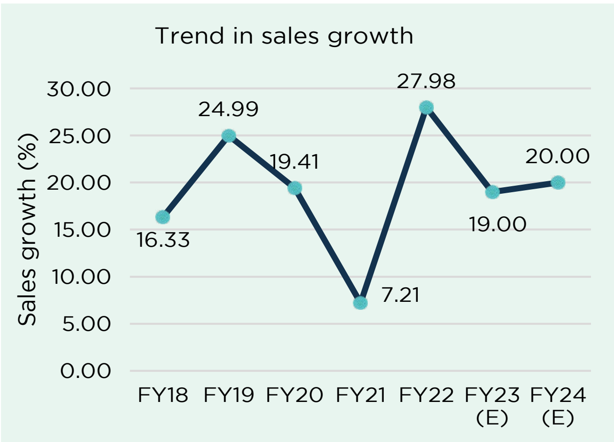
Speciality Chemicals: Growth Set to Continue Despite Margin Blip

Synopsis

- The Indian speciality chemicals sector has experienced significant growth, expanding by more than 17% in the last two fiscal years, ending FY22.
- According to CareEdge Ratings, this growth is expected to continue, with sales projected to increase by more than 19% until FY25.
- This growth is primarily driven by strong domestic demand and increased demand for exports, which has been bolstered by major global economies adopting the China +1 policy.

The Indian speciality chemicals sector has experienced significant growth, expanding by more than 17% in the last two fiscal years, ending FY22. According to CareEdge Ratings, this growth is expected to continue, with sales projected to increase by more than 19% until FY25. This growth is primarily driven by strong domestic demand and increased demand for exports, which has been bolstered by major global economies adopting the China +1 policy. The operating profitability margins of this sector saw significant improvements in FY21 and FY22, largely due to Covid-related disruptions. However, these margins have moderated in 9MFY23. CareEdge Ratings predicts that there may be some pressure on operating profitability in the near future due to the recessionary conditions in major global economies. Despite this, the operating profitability margins are expected to remain healthy, hovering around 18%. All sub-segments of the specialty chemicals sector have undertaken significant capex in the past three fiscal years, ending in FY22, and a similar size of capex is currently underway and expected to be completed by the end of FY24. The next phase of growth is expected to occur post-completion and stabilization of this capex. Despite the large size of capex, the capital structure of the majority of sub-segments in the specialty chemicals sector remains comfortable. This is due to healthy internal accruals, which are expected to enable them to pursue substantial capex in the future.

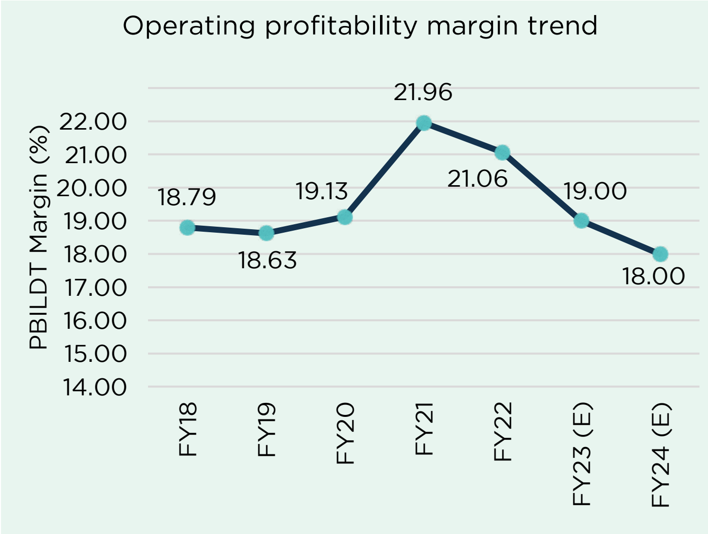
Healthy Sales Growth



Source: CareEdge Ratings, Annual reports of top 36 listed companies in the speciality chemical sector

The speciality chemicals sector began gaining traction even before FY18, and while sales growth was only marginally impacted in FY20 due to Covid-related disruptions in the latter part of the year, it was substantially affected in FY21 due to the outbreak of Covid. However, sales growth in FY22 was abnormally high due to pent-up demand and the low base of FY21. Looking ahead, we anticipate sales growth of nearly 20% to continue in FY23 and FY24, driven by both volume and value growth due to robust domestic demand and exports, thanks to the China + 1 policy adopted by major global economies. The major sub-segments of the speciality chemicals sector that contribute to this sales growth are fluorochemicals, amines, agrochemicals, pigments, surfactants, and fragrances.

Trend of Operating Profitability



Source: CareEdge Ratings, Annual reports of top 36 listed companies in the speciality chemical sector

The operating profitability margin for specialty chemical companies remained healthy at around 18% to 19%. It increased in FY21 and FY22 due to supply chain disruptions caused by Covid, which restricted imports and lowered raw material prices. However, with the normalization of supply chains, reduction in freight costs, and higher raw material prices, margins are expected to return to their earlier levels in the short to medium term. Operating profitability margins for fluorochemicals, amines, and agrochemicals remained strong even in 9MFY23 despite cost pressures, while margins for paint-related chemicals and pigments were impacted due to a slowdown in paint demand and the imposition of anti-dumping duty by China on imported pigments, respectively.

Capital Structure of Various Sub-segments of Speciality Chemicals

The capital structure of the majority of sub-segments in the speciality chemicals sector remains comfortable. The capital structure of amines is extremely comfortable due to its high operating profitability, leading to healthy net worth accumulation. The capital structure of paint-related chemicals is equally comfortable, as it is a relatively small segment with no major capex undertaken in recent years. The capital structure of fluorochemicals remains comfortable despite undertaking nearly Rs.10,000 crore capex in the last three years ended FY22. Agrochemicals, one of the major sub-segments of the speciality chemicals sector, is highly capital-intensive, resulting in moderate leverage. However, the overall gearing of pigments is high due to the large capex undertaken in recent years, while the operating profitability was impacted in FY22 and 9MFY23.

CareEdge Ratings' View

"Despite the significant expected growth in the coming years, India's share in the global speciality chemical sector is only expected to increase from less than 3% in 2015 to around 6% by 2025, indicating significant long-term growth potential. Demand growth is expected to be driven by import substitution and increased export demand due to the China + 1 policy adopted by global economies. Operating profitability margins for the speciality chemicals sector have been consistently high and further improved in FY21 and FY22 due to supply chain disruptions. However, normalization of supply chains, increased raw material costs, and reduced freight costs may result in margins returning to previous levels in the short to medium term. Indian companies in the speciality chemicals sector have completed significant capex in recent years and have ongoing capex for the next two to three years, with strong balance sheets expected to allow for even higher capex going forward. While a slowdown in demand from foreign countries due to near-term recessionary conditions in major global economies could temporarily pressure profitability margins, the sector is well-positioned for decent double-digit growth until FY30," said Hardik Shah, Director at CareEdge Ratings.

CareEdge RATINGS

HEAT MAP AND PROJECTION TABLE

		Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22	Dec-22	Jan-23	Feb-23
PMI-M	Unit	54.7	54.6	53.9	56.4	56.2	55.1	55.3	55.7	57.8	55.4	55.3
PMI-S	Unit	57.9	58.9	59.2	55.5	57.2	54.3	55.1	56.4	58.5	57.2	59.4
GST Collections	₹ lakh crore	1.7	1.4	1.4	1.5	1.4	1.5	1.5	1.5	1.5	1.6	1.5
E-Way Bill	Crore	7.5	7.4	7.4	7.6	7.8	8.4	7.7	8.1	8.4	8.2	8.2
Air Passenger Traffic	Crore	2.4	2.7	2.5	2.4	2.5	2.5	2.7	2.8	3.1	3.1	
Railways Passenger Traffic	Crore	45.6	50.1	50.1	51.6	54.0	54.8	55.2	57.0	56.3	57.5	53.7
PV Sales	Lakh	3.0	3.1	3.3	3.5	3.4	3.6	3.4	3.3	3.0	3.5	3.4
2-3 Wheeler Sales	Lakh	16.1	16.6	17.4	18.1	19.4	21.1	19.5	16.0	13.8	14.8	14.3
Tractor Sales	Lakh	1.0	0.9	1.1	0.7	0.6	1.3	1.3	0.8	0.7	0.7	0.7
IIP	y-o-y%	6.7	19.7	12.6	2.2	-0.7	3.3	-4.1	7.3	4.7	5.2	
Core Sector	y-o-y%	9.5	19.3	13.1	4.8	4.2	8.3	0.7	5.7	7.0	7.8	
Power Consumption	y-o-y%	11.5	23.2	16.2	2.3	0.6	11.3	0.5	12.3	9.8	12.0	7.7
Petroleum Consumption	y-o-y%	13.1	26.0	18.1	8.6	14.6	8.3	5.7	14.3	3.4	5.1	5.7
Outstanding Bank Credit - Total	y-o-y%	11.1	12.1	13.2	14.5	14.3	15.3	16.7	16.0	14.9	16.3	
Capital Goods Import	y-o-y%	17.1	17.2	18.6	27.4	26.5	17.8	3.9	14.5	9.9	-3.6	
Merchandise Exports	y-o-y%	29.2	20.8	30.2	8.1	10.9	4.7	-11.6	9.8	-3.1	1.4	

Note: Data for some indicators is high in April-June quarter due to base effect

Indicator	FY18	FY19	FY20	FY21	FY22	FY23 Forecast	FY24 F orecast
Gross Domestic Product (y-o-y%)	6.8	6.5	3.9	-5.8	9.1	6.9	6.1
CPI Inflation (y-o-y%)	3.6	3.4	4.8	6.2	5.5	6.5	5.1
Fiscal Deficit (As % of GDP)	3.5	3.4	4.7	9.2	6.7	6.4	5.9
Current Account Balance (As % of GDP)*	-1.8	-2.1	-0.9	0.9	-1.2	-2.4	-1.4
Rupee (USD/ INR) (Fiscal year-end)	65.0	69.2	75.4	73.5	75.8	81-83	81-83
10-Year G-Sec Yield (%) (Fiscal year-end)	7.3	7.5	6.1	6.3	6.8	7.4-7.5	7-7.2

* Note: (-) Deficit / (+) Surplus, Fiscal Deficit to GDP Ratio data for FY24 are Budget Estimates (BE) and FY23 are Revised Estimates (RE)

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.

Corporate Office:

CARE Ratings Limited: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400022.
Phone : +91-22-6754 3456 | E-mail: corp.comm@careedge.in | CIN - L67190MH1993PLC071691

Other Offices:
Ahmedabad I Andheri-Mumbai I Bengaluru I Chennai I Coimbatore I Hyderabad I Kolkata I New Delhi I Pune

Media Contact

Mradul Mishra I mradul.mishra@careedge.in I +91-22-6754 3596