Aditya Birla Sun Life AMC Ltd.

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A TALE OF RESILIENCE

FY24 Midyear Credit Outlook

Aditya Birla Sun Life AMC Ltd.

ADITYA BIRLA CAPITAL

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CORPORATE INDIA REMAINS IN GOOD HEALTH

Corporate India remains in good health with balance sheet deleveraging and low interest rates over the last two years. As expected, operating margins have now stabilized after the volatility in input costs. Hence, from a credit underwriting perspective, corporate India remains well-positioned.

We prefer cash-flow generating companies and sectors with good promoters, performance track record, and a conservative capital structure and will selectively invest in those sectors and companies that meet these criteria.

SUPPLY OF GOOD QUALITY CREDIT PAPERS

As credit growth picks up and liquidity tightens in the run-up to the festive season, we expect credit spreads to also start inching up offering risk-adjusted opportunities to invest in, like the brief spell when liquidity was tight earlier this year. Supply of good quality investment grade paper has finally increased in the bond market with the arbitrage with banking rates being nullified. Additionally, with dollar markets remaining tight, many large corporates who used to borrow abroad using dollar financing are finding domestic financing relatively cheaper. Hence, many good quality corporates are now coming back to the bond markets to raise money.

(Data is between August 07, 2016 – August 24, 2023) Source: Bloomberg

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As exhibited in the Bloomberg charts above, the 'AA' and 'A' rated corporate spreads reached near historical lows during Covid given the flush liquidity available in the banking system and the chase for top-rated papers. Post normalization after Covid, the spreads have now moved into the top quartile, experienced over the past 7-8 years, offering good quality opportunities on a risk-adjusted basis.

In our midyear credit outlook, our analysts look at some of the key industries and what lies ahead for these sectors.

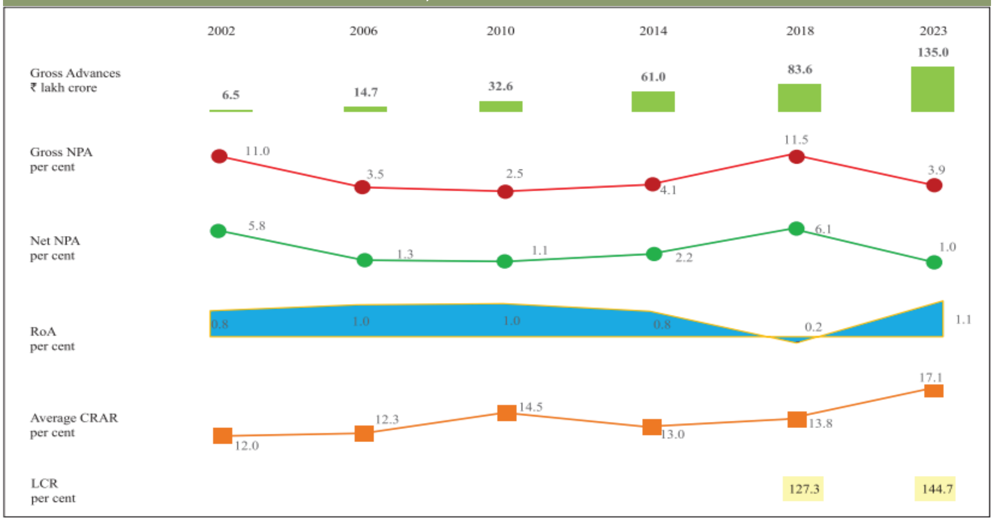
BANKING

"GOLDILOCKS" SCENARIO FOR THE BANKING SECTOR TO SUSTAIN

- Despite global headwinds marked by the failure of a few regional US banks, the Indian banking system remains resilient, supported by strong fundamentals. This has driven standalone rating upgrades of a few banks by global rating agencies recently.

- Deposit growth, which was hovering at 9-10% in the last few quarters, is estimated to pick up slightly, aided by Rs.2000 note withdrawal. Credit growth is likely to moderate from FY23 highs of 17-18% but still outpace deposits.

Indian Banking sector robustness indicators



Source: RBI Financial Stability Report, Jun 2023; Data as at end-Mar

- GNPAs (gross non-performing assets) fell to a 10-year low of 3.9% aided by corporate deleveraging and substantial write-offs (particularly by Public Sector Banks or PSBs) over the last 5 years, along with a pickup in credit growth lately. This trend should continue over the medium term.

- Balance sheets are healthy as reflected in historically high CRAR (Capital to Risk Weighted Assets Ratio) and CET 1 (Common Equity Tier 1) ratios at 17.1% and 13.9% respectively as of March 2023. (Source: RBI)

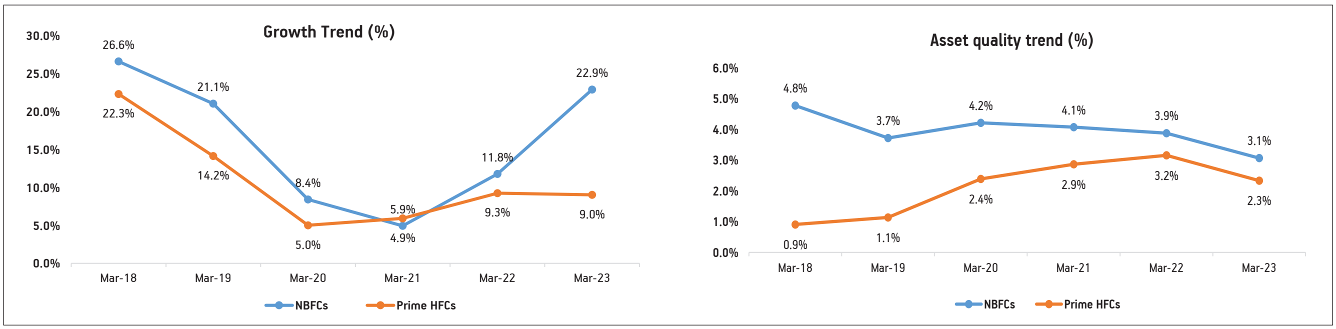
- NIMs (Net Interest Margins) may shrink with deposit repricing but ROAs (Return on Assets) could sustain at 1%+ driven by recoveries from resolutions of write-offs (mainly for PSBs and small private banks).

OUTLOOK

BANKING

NON-BANKING FINANCIAL COMPANIES

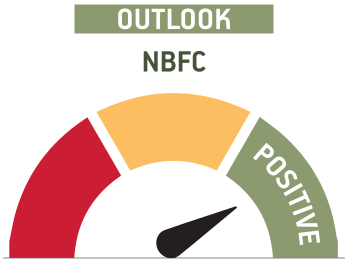
HIGH GROWTH TRAJECTORY TO CONTINUE



Source: ABSLAMC Research; Based on sample of 13 large NBFCs and 5 large Housing Finance Companies (HFCs) accounting for 70-75% of industry assets

- The NBFC (Non-Banking Financial Companies) sector is likely to continue on a high growth trajectory in FY24 as well with relatively lower credit costs as asset quality parameters continue to either improve or remain stable across the industry.

- However, NIMs are likely to see compression as the incremental cost of funds has inched up and rate cuts are unlikely in FY24.



OUTLOOK ON INDIVIDUAL ASSET CLASSES

Commercial Vehicle Financing

Segmental growth is back and is likely to be healthy in FY24 with the economy also doing well. Asset quality is likely to remain stable, with NIMs coming under pressure.

Microfinance

Growth in MFIs (Microfinance institutions) picked up well and is likely to continue over the next two fiscals. Having overcome asset quality challenges, most players have already spruced up their balance sheets. Incremental credit cost is expected to be low resulting in high profitability.

MSME (Micro, Small and Medium Enterprises) lending

We will remain cautious on this asset class in FY24 as well.

Unsecured lending

This segment has seen sharp growth and the trend is likely to sustain in FY24. With high growth levels, there are fears of overleveraging leading to potential weakening of asset quality - however, thus far, credit costs continue to be low. We expect the credit costs in this segment to only pick up from FY25 onwards.

HOUSING FINANCE COMPANIES

PRIME HFCS TO BE MEANINGFULLY SMALLER POST-HDFC MERGER

- Housing demand moderated a bit post the sharp rate hikes over the last 12-15 months - however, it still remains strong. Mid-ticket Housing Loans (HLs; Rs. 30-50 lakhs ticket size) are witnessing the most slowdown while premium and luxury demand remains strong.

- Prime HFCs (Housing Finance Companies) have been losing market share to banks since FY19 due to high price competition and the struggles of a couple of large players. With the HDFC merger, the HFC pie will shrink meaningfully.

- Profitability has settled at lower levels post the discontinuation of higher-margin developer financing (due to past struggles). However, it is protected given the largely variable loan book resulting in full pass-through of the rate hikes. Going forward, we expect the incremental credit costs to remain low aiding ROAs.

OUTLOOK

HFCs

STRONG GROWTH IN AFFORDABLE HFCS TO CONTINUE, ALBEIT ON A LOW BASE

- Affordable housing gained traction over the last 6-7 years with their share in overall HFC lending doubling from ~3% to ~6% as of March 2023.

- The largely underpenetrated market and government push will continue to drive high growth in this segment. The trend of increasing average ticket sizes should also support growth sustenance.

- Given high growth and a robust credit environment, asset quality is currently holding up well and is likely to remain stable in FY24. However, it remains vulnerable given the high restructured book and an inherently inferior borrower profile. We expect the slippages to increase as the books season and the credit/ economic environment normalizes.

- ROAs are likely to remain stable as the pressure on NIMs (with rising funding costs for small HFCs) will be offset by opex normalization (with scale) and the pickup in legal recoveries (which were slow during Covid). The solvency metrics should also remain comfortable given high equity funding in most Affordable HFCs resulting in low leverage.

Source: ABSLAMC Research

POWER

THERMAL PLFS TO SEE STRUCTURAL IMPROVEMENT

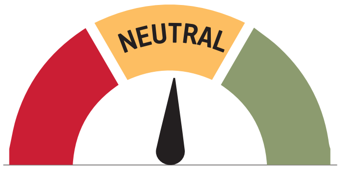
- Power demand surged by ~9% in FY23 and remained high so far, driven by increased residential demand and improved industrial and agricultural activities. It is expected to maintain its strong correlation to GDP (Gross Domestic Product) and grow by ~5-6% over the medium term.

- Coal-fired thermal plants will continue to be the prime contributor to the country's energy demand accounting for ~72-73% of total generation in FY24. In the absence of large-scale storage for renewables at viable rates, India would need thermal plants to avoid blackouts/energy crisis.

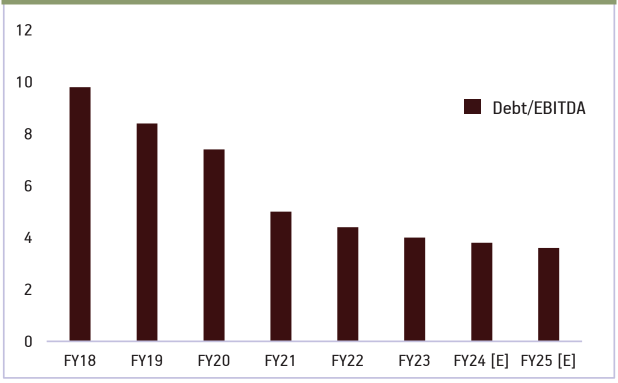
- Thermal PLFs (Plant Load Factor) are likely to see structural improvement to ~65% in FY24/FY25 compared to the 5-year average of ~60% driven by relatively lower capacity additions.

OUTLOOK

THERMAL



Debt/EBIDTA of thermal players to improve with reduction in working capital debt through LPS rules and sustenance of healthy operating performance



Source: ABSLAMC Research

- High generation, low capex, and improved realization of overdue receivables post implementation of late payment surcharge scheme, point to a stable credit outlook with comfortable Debt/EBIDTA metrics at ~4x in FY24/25.

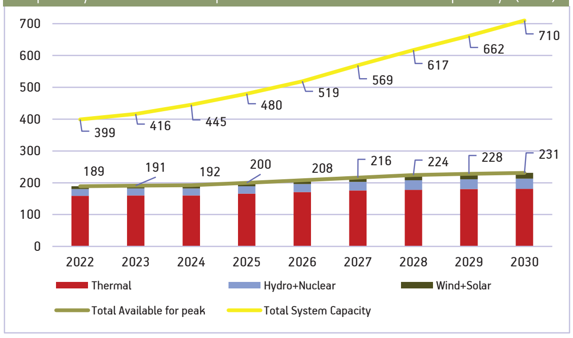
WIND CAPACITY ADDITION TO PICKUP PACE BACKED BY GOVERNMENT INITIATIVES

- Even a 5% annual growth in India's peak power demand of ~220 GW (gigawatt) would translate into a yearly capex requirement of USD 20-35 billion. While existing coal-based power plants do the heavy lifting, capacity addition would incrementally be through non-fossil fuels.

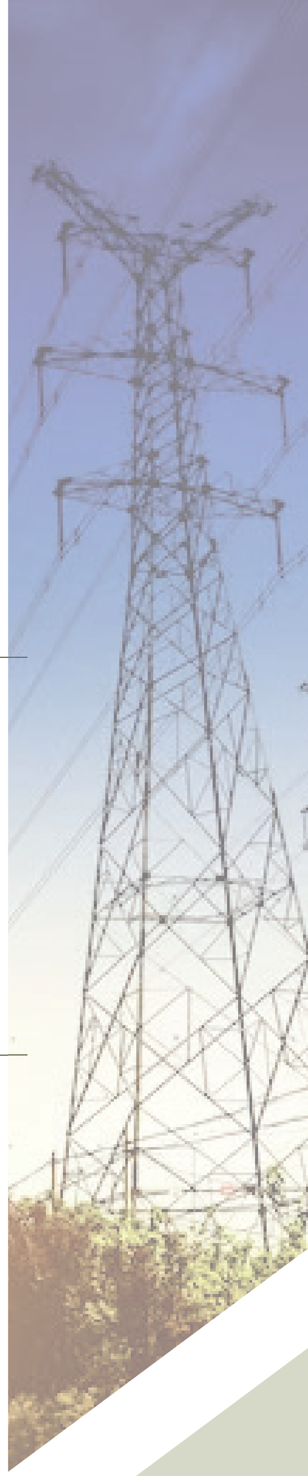
OUTLOOK

RENEWABLE

Capacity available for peak demand vs. Total Capacity (GW)



Source: ABSLAMC Research



- While solar had a dominant share in capacity addition in recent years, government initiatives (such as closed envelope bidding, 8 GW annual bidding target) in the wind segment are likely to drive substantial capacity growth.

- At the current rate of capacity addition, India is likely to see peak demand far exceeding peak capacity by 2030, necessitating storage options like Pump Storage Hydro Plants (PSHP) or lithium batteries. As PSHPs are more cost effective, this opportunity will benefit large private players with hydropower experience along with strong balance sheets.

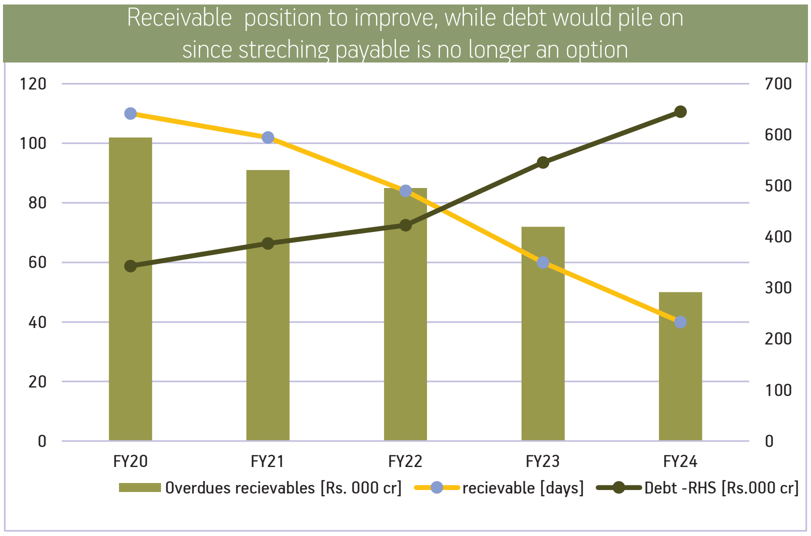
- The credit profile is expected to remain stable with the industry leverage ratio at ~6x despite large capex. Strong global investor interest and benefits arising from owning a large and diversified base are likely to result in further consolidation in the industry. Companies with diversified portfolios are expected to benefit.

REDUCTION IN OVERDUE RECEIVABLES AT THE COST OF DEBT PILEUP

- Various government initiatives have improved the performance of state discoms (distribution companies), reducing overdues and average aggregate technical losses.

- However, this has resulted in an increase in discom debt as stretching payables is not an option anymore. Timely and adequate tariff revision and infrastructure improvement (such as smart meter installation) are essential for overall efficiencies.

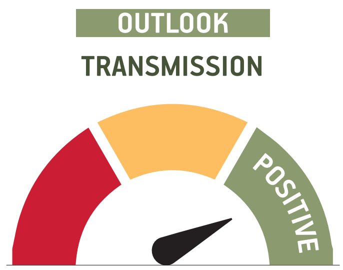
LARGE CAPEX PLANS IN TRANSMISSION



Source: ABSLAMC Research

- Indian power transmission needs a makeover for a grid that will be dominated by renewables. The government has proposed to install additional transmission capacity for the integration of over 500GW of existing and new renewable capacity at an investment of ~Rs. 2.4 trillion by FY 2030.

- Transmission developers with strong balance sheets and engineering companies are likely to benefit. The credit profile of transmission players remains comfortable with acceptable net debt/EBIDTA and interest coverage ratios.



METALS

STRONG DOMESTIC DEMAND IN FERROUS

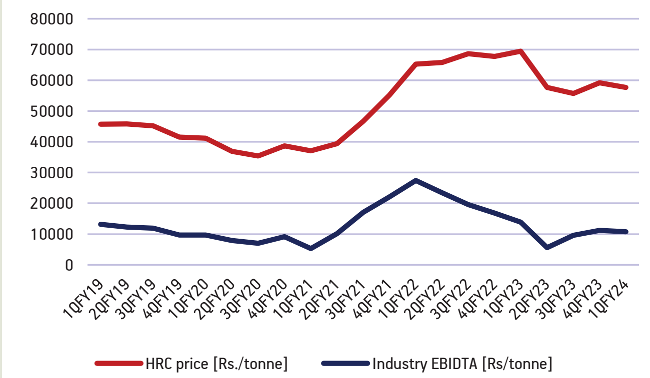
- Amid global economic slowdown, Indian steel demand remained resilient driven by infrastructure, real estate, and auto industries. H2 FY24 is likely to see a surge in demand driven by government infrastructure and construction spends ahead of national elections.

- China's steel production is forecasted to remain flattish in CY 2023, while expected improvement in real estate activities due to anticipated stimulus could result in lower exports from the country. This would benefit global steel producers and prices. However, aggregate pricing impact hinges on the timing of cuts and the effectiveness of the stimulus to revive China's domestic demand.

- Following the reversal of the export duty hike in November 2022, exports have been rising sequentially and the full impact of this duty reversal is expected by H1 FY24. However, exports may not reach the highs achieved in FY22 due to weak global demand.

- Indian steel prices have been falling since the start of CY23, albeit gradually vs global peers. We expect the prices to have bottomed out and gradually inch up in H2 FY24 from current levels.

Hot Rolled Coil (HRC) prices bottomed; EBIDTA/tonne to improve with lower raw material cost



Source: ABSLAMC Research

- Metal players' profitability was impacted due to lower commodity prices, but we foresee margins improving as raw material costs moderate and steel prices rise. An improved balance sheet will bolster their credit profiles, despite large ongoing/announced capex.

- The credit profile outlook remains positive, with expectations of a strong second half in FY24.

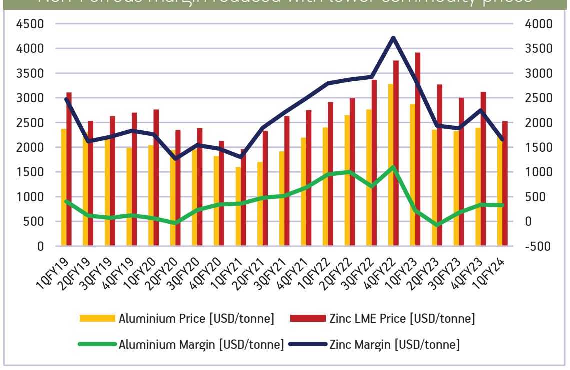
OUTLOOK

FERROUS

MARGINS IN NON-FERROUS TO REMAIN MODERATE

- Profitability and margins of Zinc and Aluminium players took a hit with commodity prices dropping by ~ 20% in YTDFY24 due to weak global demand.

Non-Ferrous margin reduced with lower commodity prices

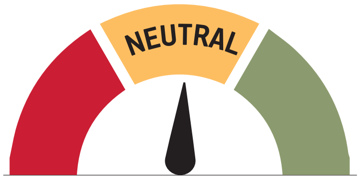


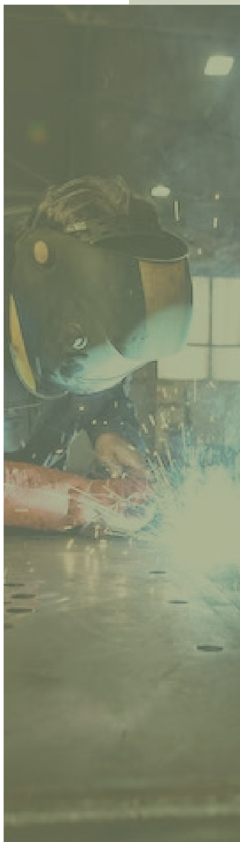
Source: ABSLAMC Research

- We expect zinc prices and margins to remain subdued in the medium term due to the expected surplus, while aluminium prices and margins will remain under pressure due to fading global energy cost support and subdued global demand.

OUTLOOK

NON-FERROUS





REAL ESTATE

CONTINUED DEMAND FOR RESIDENTIAL REAL ESTATE BENEFITING LARGE DEVELOPERS

Housing unit sales surged 21% YoY to ~126,500 in the top seven cities during H1CY23, led by Bengaluru and Mumbai.

Average property prices rose by ~6% YoY in 2QCY23 across eight major Indian cities.

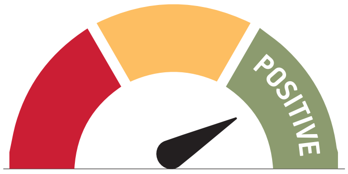
Millennials now prefer to buy homes rather than renting/leasing as rents have surged post Covid. This has led to the depletion of inventory and a price increase even as interest rates soared.

Developers continue to focus on the premium/ luxury segment. Continued demand for housing is expected to benefit large developers.

(Source : JLL, Prop Tiger, Anarock)

OUTLOOK

RESIDENTIAL REAL ESTATE



NET ABSORPTION NUMBERS IN COMMERCIAL REAL ESTATE EXPECTED TO REMAIN STRONG

The growth in segments such as engineering, R&D, emerging technologies, and BFSI is expected to generate strong demand in India. Hyderabad and Bengaluru are the micro markets which had the highest share in new completions in Q1 FY24.

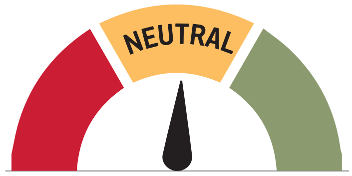
With moderate to strong pre-commitments in upcoming projects, net absorption numbers are expected to remain strong (~36-39 million sq ft for the full year) and keep vacancies within 16-17%.

Although global headwinds and sluggishness in the tech sector continue to pose challenges, India's demand for commercial office space is expected to remain resilient over the medium term.

(Source : JLL)

OUTLOOK

COMMERCIAL REAL ESTATE



ROADS

HEALTHY PROJECT AWARDS CONTINUE

- In FY24, the Government revised the highway construction target upwards to 13,800 km which would entail a capital outlay of Rs 2.58 trillion. By December 2023, they aim to utilize 91% of this capital outlay.
- NHAI's (National Highways Authority of India) highway award pipeline remains strong at 42,400 km; including ~ 13000 km of HAM projects. NHAI's leverage decreased to ~ 0.70x in December 2022 due to robust toll collection and government budgetary support, ensuring that the award programme is unlikely to stall due to funding constraints.
- Toll collection under FASTag was Rs. 54,144 Cr. (Avg. Daily Toll Collection Rs. 132 Cr. against Rs. 104 Cr. in FY22). On 29th April 2023, the daily FASTag toll collection achieved a historic milestone of an all-time high of Rs. 193.15 crore.
- Although this provides revenue visibility, bunching of projects for bidding in a short span can put pressure on the margin of large EPC (Engineering, Procurement, and Construction) players whenever execution begins.
- Competition from local players in highway bidding is forcing large players to diversify to other sectors such as railways, metros, water supply etc.

(Source: ABSLAMC Research, Media reports)

OUTLOOK

ROADS

TELECOM

NEW TECHNOLOGIES TO BOLSTER FUTURE POTENTIAL

- India is the second largest telecom market after China with a subscriber base of 1140 million and 84.5% tele density. With the consolidation in the sector, the top two players have emerged stronger. Consolidation trends persist.

- The Indian telecom industry is projected to grow by $12.5 billion every three years. It is experiencing a major shift as it adopts new technologies such as the Internet of Things (IoT), Artificial Intelligence (AI), and Machine Learning (ML) to improve efficiency, customer experience, and service delivery. Indian telecom players have been boosting capabilities in cloud services with growing partnerships.

- India's AI market is expected to reach US$7.8 Billion by 2025. While the AR/VR (Augmented Reality/Virtual Reality) market is expected to hit $1.6 billion by 2025 (Source: Deloitte-CII study), the cloud market is likely to triple in five years to US$17.8bn. (Source: International Data Corporation).

- While the 5G spectrum auction may raise debt levels of telecom players, improved profitability margin through lower operating costs like SUC (Spectrum Usage Charges), would support the elevated debt levels.

(Source: ABSLAMC Research, Media Reports)

OUTLOOK

TELECOM

AUTO

HEALTHY ORDER BOOK AND NEW LAUNCHES DRIVING GROWTH

PASSENGER VEHICLES

- PVs (Passenger Vehicles) maintained overall good growth momentum driven by sustained Utility Vehicle (UV) sales, pent-up demand, and easing of supply chain constraints (though not completely resolved).

- A healthy order book, new model launches in the UV segment, and replacement demand will aid sales and result in expansion of operating margins. The shift in consumer preference towards compact UVs may cannibalize the small car market.

- Despite rising interest rates, price hikes by OEMs (original equipment manufacturers), and regulatory changes, demand growth is expected to be in high single digits (on a high base) in FY24.

TWO-WHEELERS

- Even with a ~10% growth expected in FY24 (with improvement in utilization and margins) and positive growth in FY23, sales still lag behind FY19 numbers. After a decline in exports in FY23, marginal improvement is expected in FY24.
- Reasonably normal monsoons, normalization of economic activities, expectation of government's support to boost the rural economy prior to general elections, shift in consumer preference to higher "cc" (cubic capacity) scooters and multiple E2W (electric two-wheeler) model launches are likely to drive two-wheeler sales.
- With model launches in the costlier (premium >90K) segment gaining traction, competition is expected to intensify in premium motorcycles. E2W could impact scooter sales and the share of high-speed E2W is likely to increase further.
- OBD 2 (Onboard Diagnostics) norms will push up prices and the recent changes in FAME II subsidy for E2W can impact its penetration.
- Moped demand has been declining due to consumer shift towards similar-priced E2W or entry-level motorcycles.

OUTLOOK

AUTO

COMMERCIAL VEHICLES

- Commercial Vehicles (CVs) registered decent growth, with YoY growth in LCV (light commercial vehicles), M&HCV (medium and heavy commercial vehicles), and Passenger and Goods category for both FY22 and FY23.
- FY24 sales are projected to surpass the previous peak, with volumes expected to grow ~9-10% in FY24 aided by replacement demand, better fleet utilization, transporter profitability, healthy freight availability, Government's infrastructure spending, healthy traction from user industries and economic growth.
- The mandatory scrapping of Government vehicles older than 15 years, w.e.f from April 1, 2023, may provide some support to volumes. With better operating leverage and improvement in profitability, the credit profile of OEMs is expected to improve.

Source: ABSLAMC Research