Annual Fixed Income Outlook: 2019

ADITYA BIRLA CAPITAL

PROTECTING INVESTING FINANCING ADVISING

Index

Global macro

Global growth showing signs of moderation

World economic growth expected to slow, inflation low

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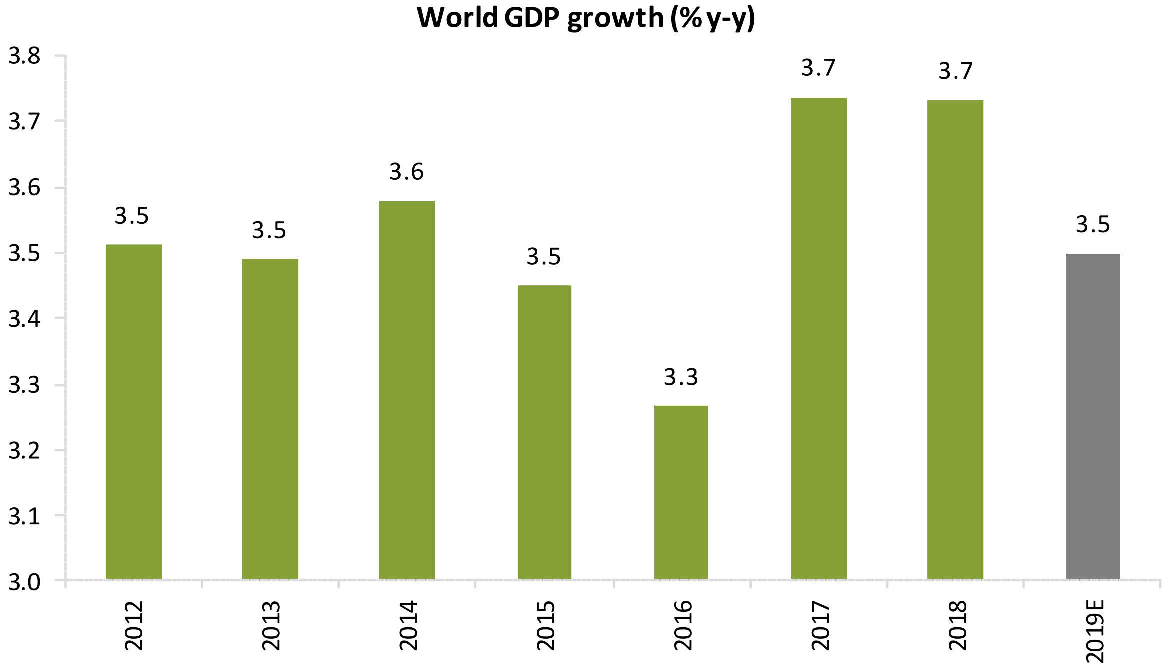
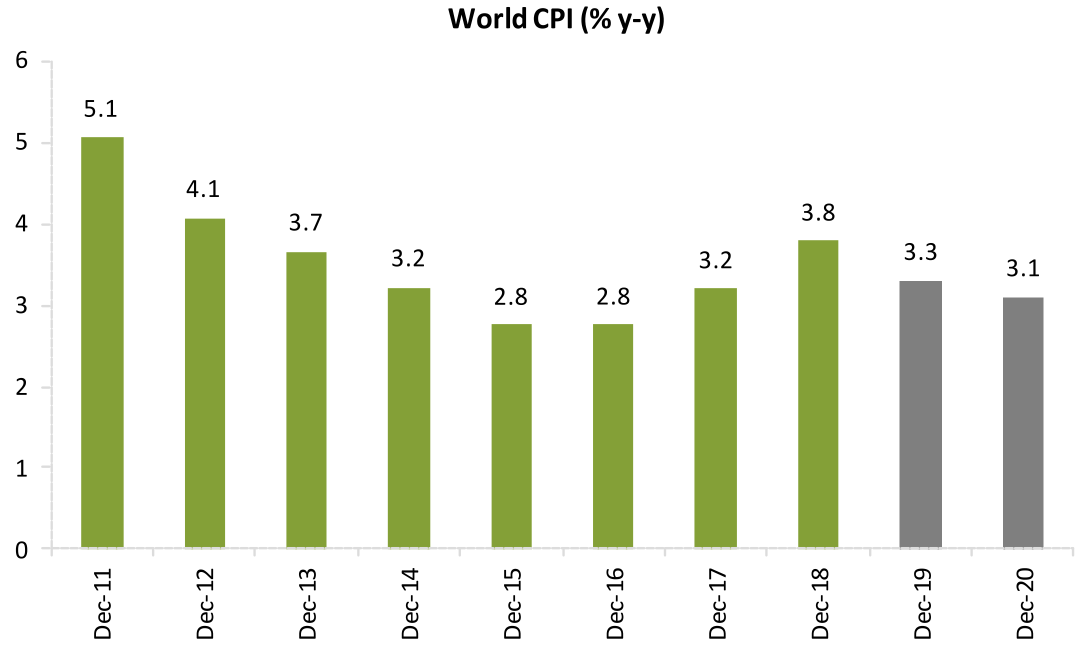
Global GDP growth moderating from high level



World CPI is expected to decline



- ✓ Global growth has entered a moderation phase after uptick that began from 2016. Bloomberg consensus and OECD forecast for world growth in 2019 is 3.5% compared to 3.7% in 2017 and 2018.
- ✓ The slowdown expectation of world economy is on account of growth peaking in major advanced economies, negative effects of the trade war as well as a weaker outlook for some key emerging market and developing economies arising from country-specific factors, less support from Central Banks, tighter financial conditions, and geopolitical tensions. US-China trade talk is the key variable.

Source: IMF, OECD, Bloomberg, ABSLAMC Research

Declining momentum amidst tightening financial condition

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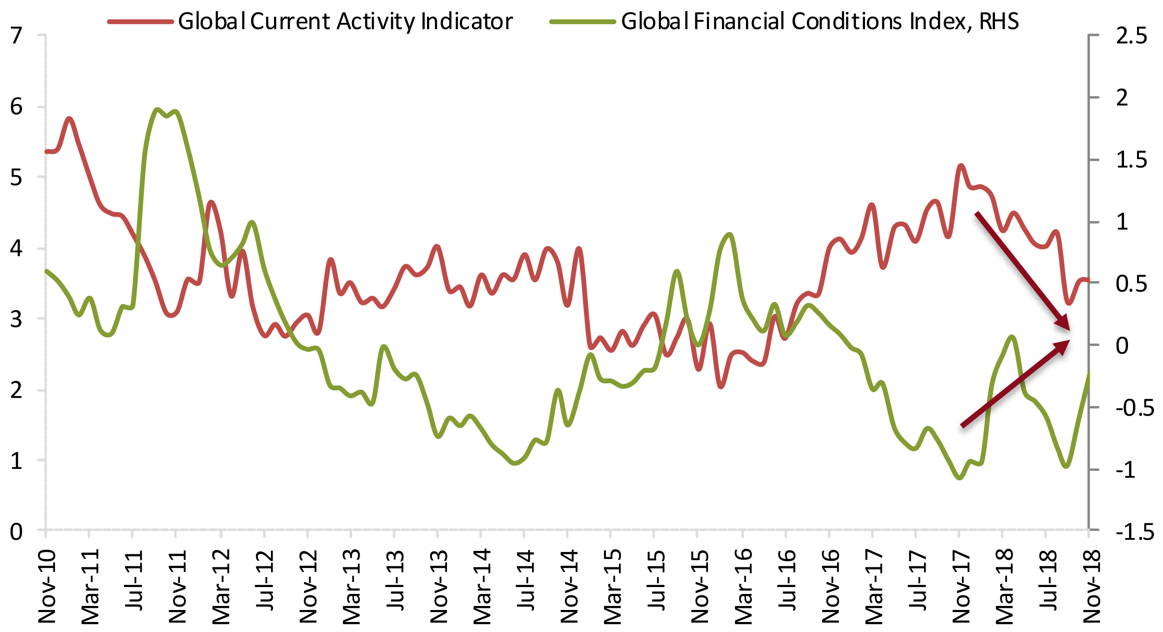
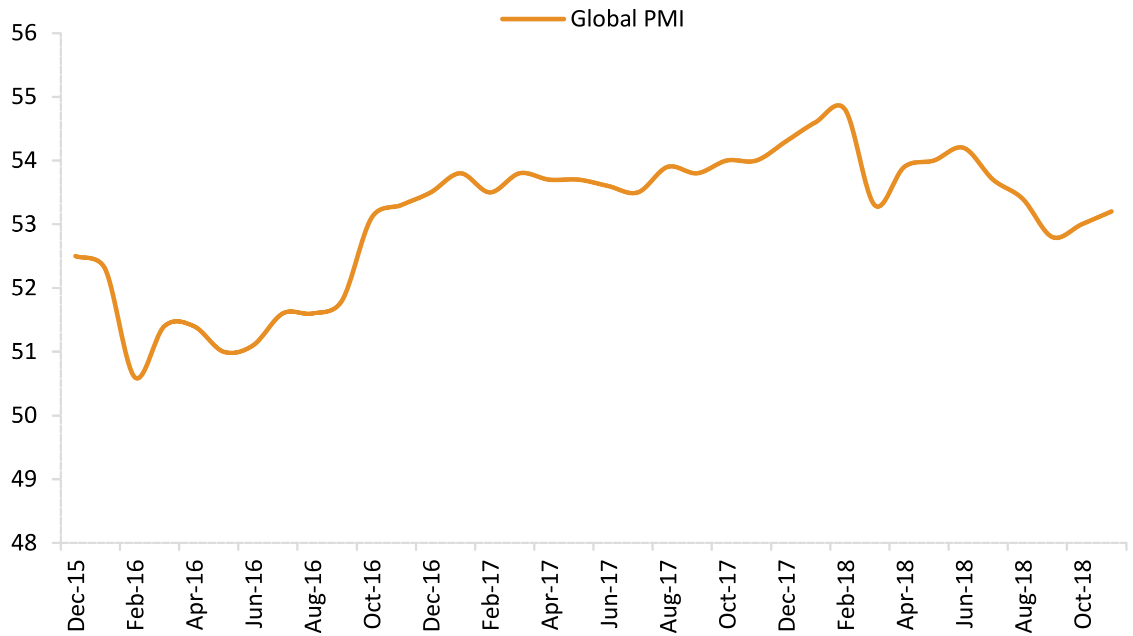
Global economy slowing amidst tightening financial conditions



Global PMIs have been moderating



- ✓ Global current activity indicators have been declining amidst tightening financial conditions
- ✓ Declining PMIs also pointing to declining momentum

Source: Bloomberg, ABSLAMC Research

EM-DM growth differential to rise on DM slowing

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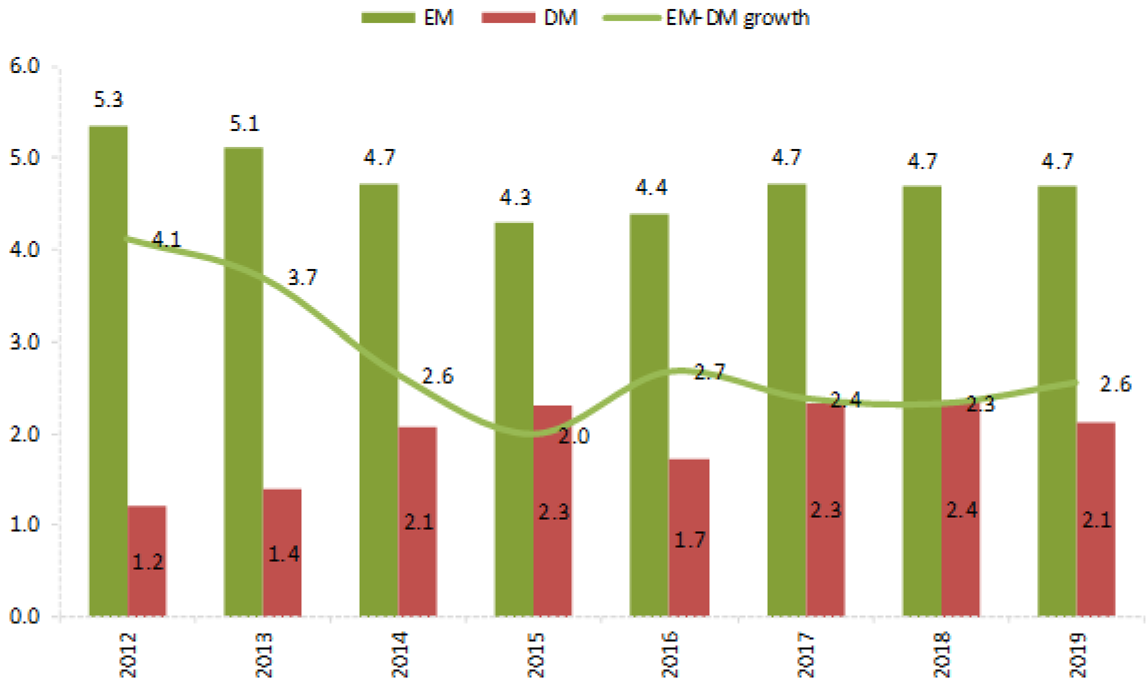
EM-DM growth differential to rise on lower DM growth



World trade moderating

- ✓ DM growth is set to decline with momentum peaking in US and EU. EM growth is expected to be stable but much depend on the efficacy of policy stimulus in China and the US-China trade negotiations
- ✓ World trade has so far been decent but faces uncertainty in 2019

Source: Bloomberg, ABSLAMC Research

Commodity prices under pressure

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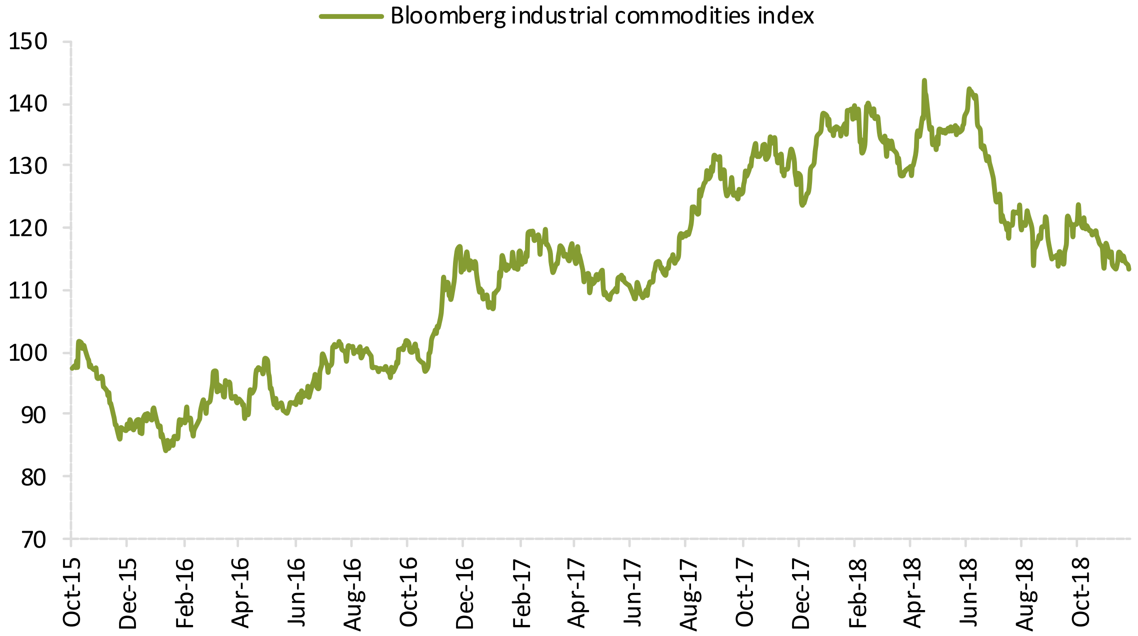
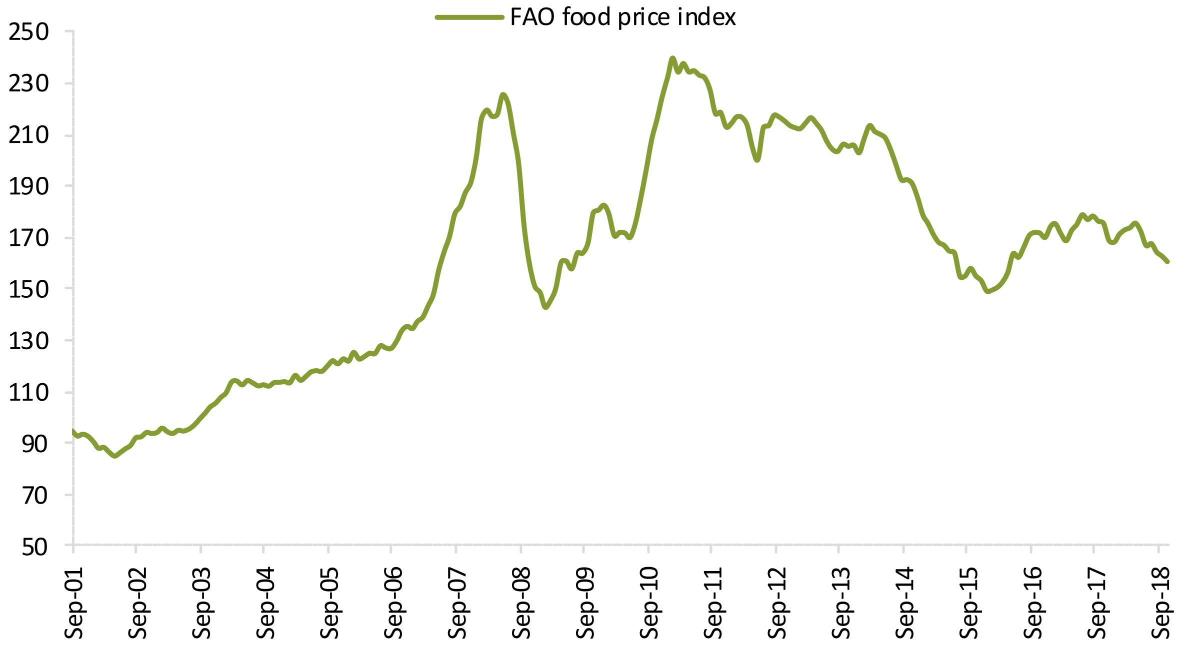
Industrial commodities inching downwards



Global food prices have remained low



- ✓ We expect commodities to stay weak through the year driven by weak global and in particular Chinese growth
- ✓ We expect ferrous metals to see more weakness than non-ferrous metals. But broadly the complex remain weak
- ✓ Low world food prices shall exert a benign influence on Indian food inflation as well

Source: Bloomberg, ABSLAMC Research

QE becomes QT…

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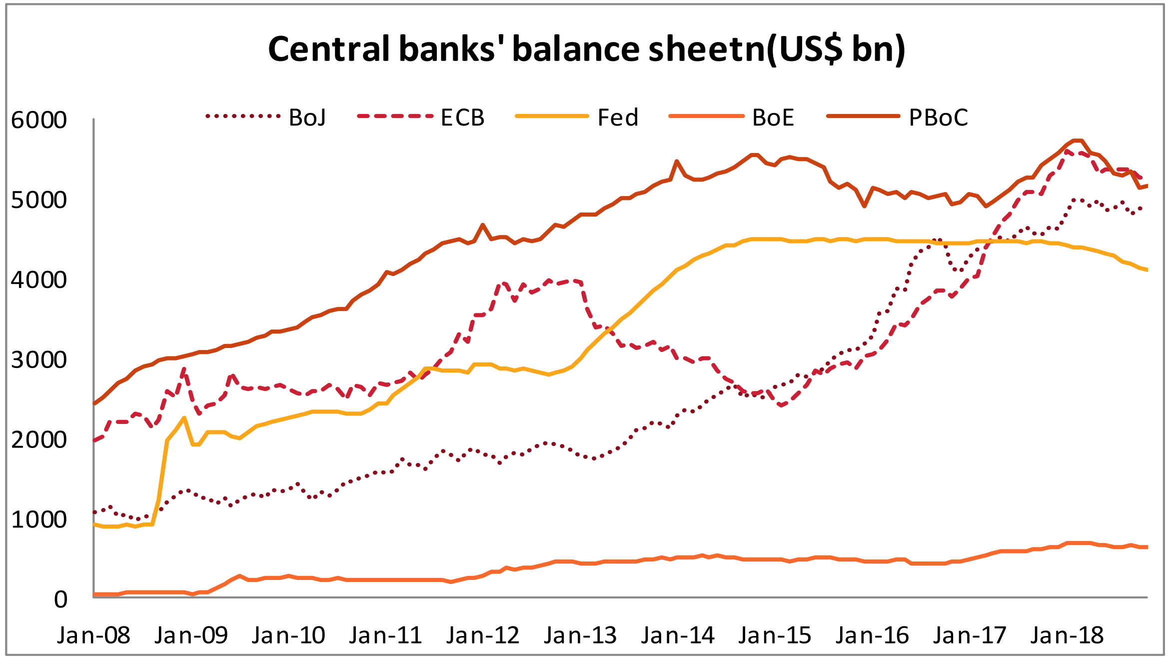
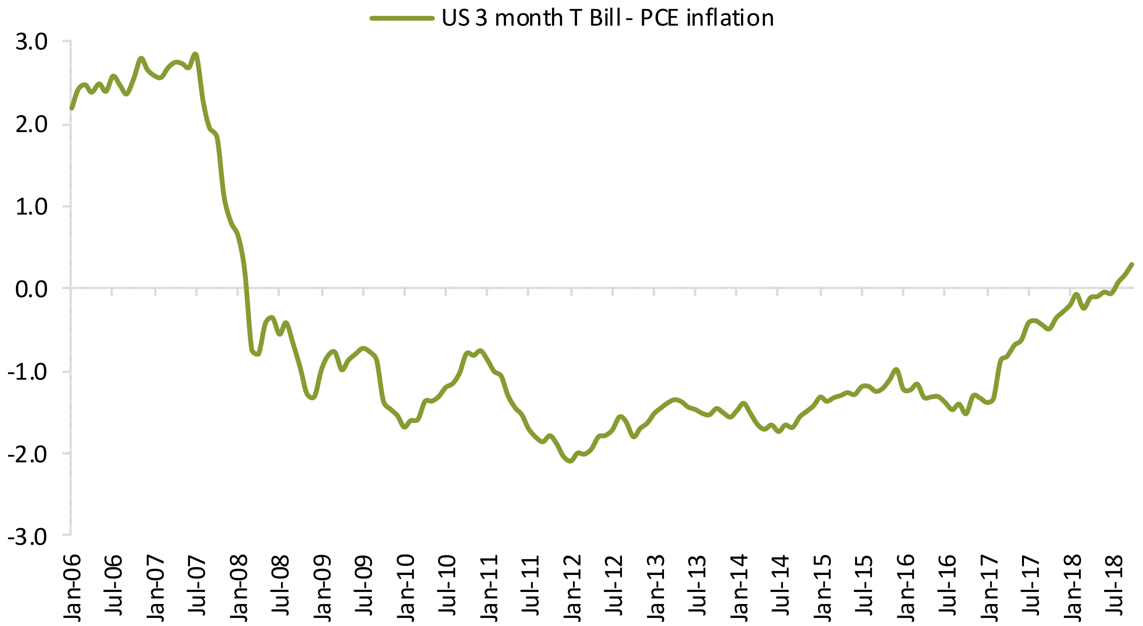
Central Banks' Balance Sheet



Cash giving positive real returns



- ✓ With Fed turning to balancing sheet reduction, and QE by ECB coming to end, BoJ is the only major central that will be increasing balance sheet in 2019. Overall QE by three major central banks would turn to QT in 2019, marking a watershed event for the global economy and markets addicted to Central Bank support
- ✓ However, we note that unlike rate normalization, the impact of balance sheet reduction is less clear on global markets and economy
- ✓ Given the US Fed's withdrawal of monetary stimulus, cash has once again started giving positive returns which shall have a profound impact on global risk assets.

Source: Bloomberg, ABSLAMC Research

... volatility to stay elevated

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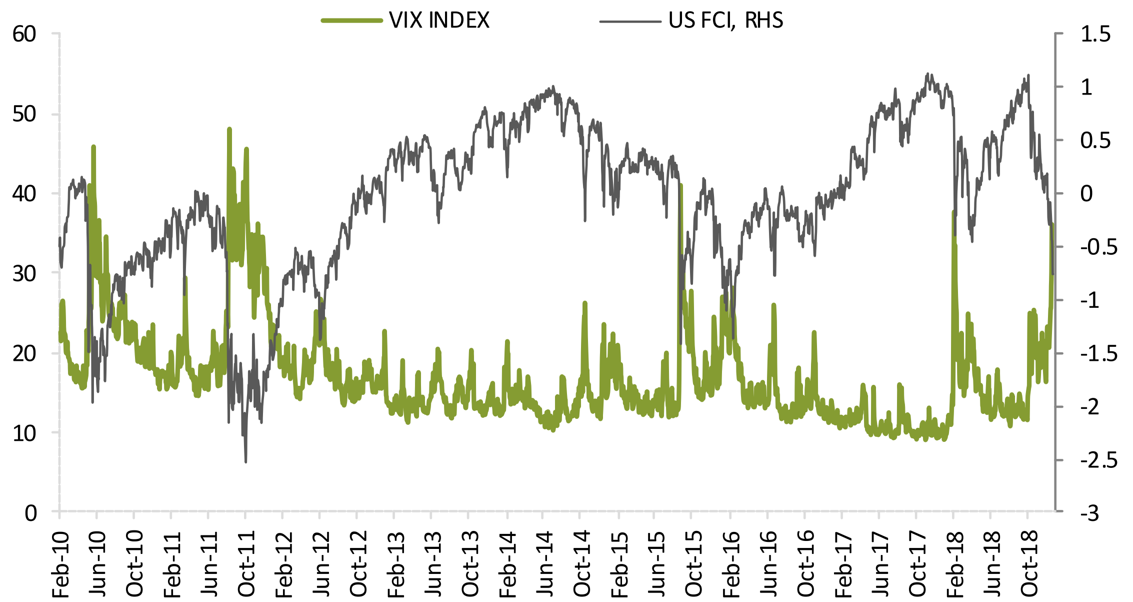
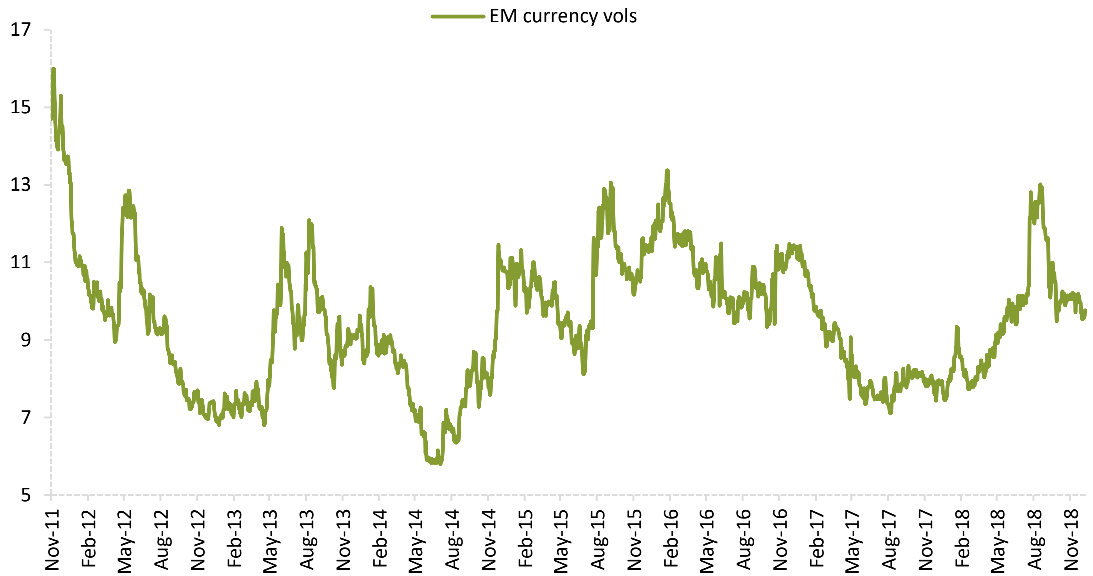
US financial conditions have tightened and volatility staying higher



EM currency Vols



- ✓ With weakening of Central Banks' policy put and global economy showing signs of weakness, market volatility to stay elevated in 2019

Source: Bloomberg, ABSLAMC Research

Fed rate hike expectations come down

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US rate hike expectations have come-off sharply

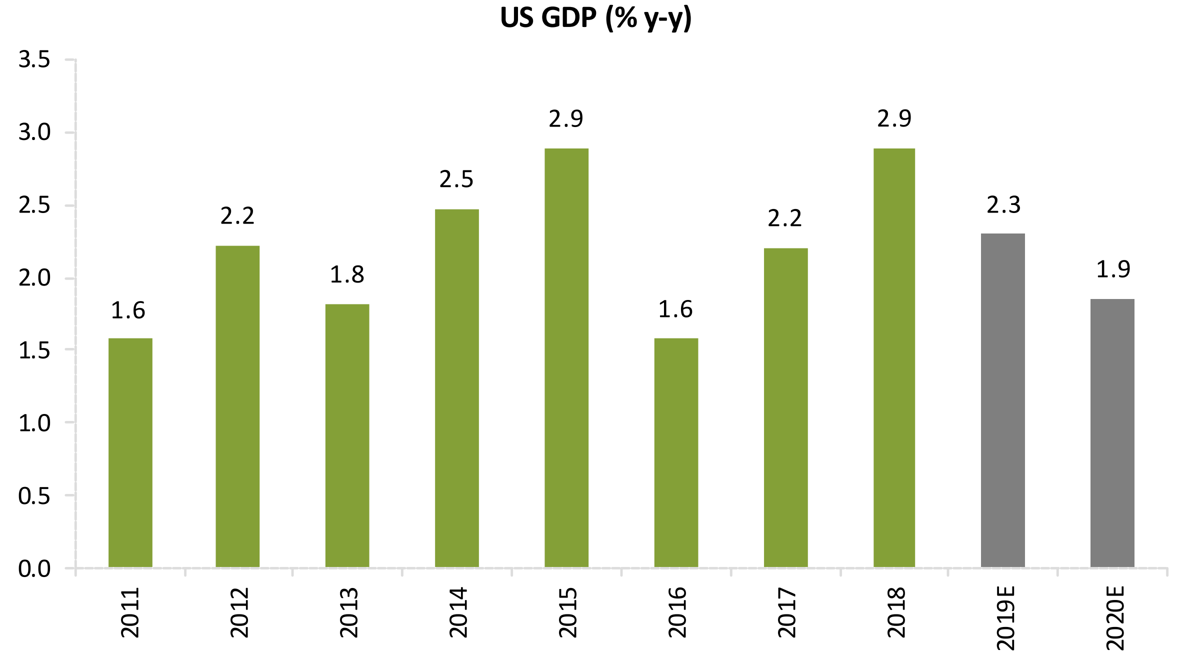
US 10 year rates decline sharply

- ✓ Given the sell-off in global markets, contained inflation and rising indicators of growth slowdown, US rates and Fed rate hike expectations has come down
- ✓ We believe that tight labour market keep possibility of at least one Fed rate hikes alive in 2019 but much would depend on the health of financial markets and outcome of US-China trade negotiations

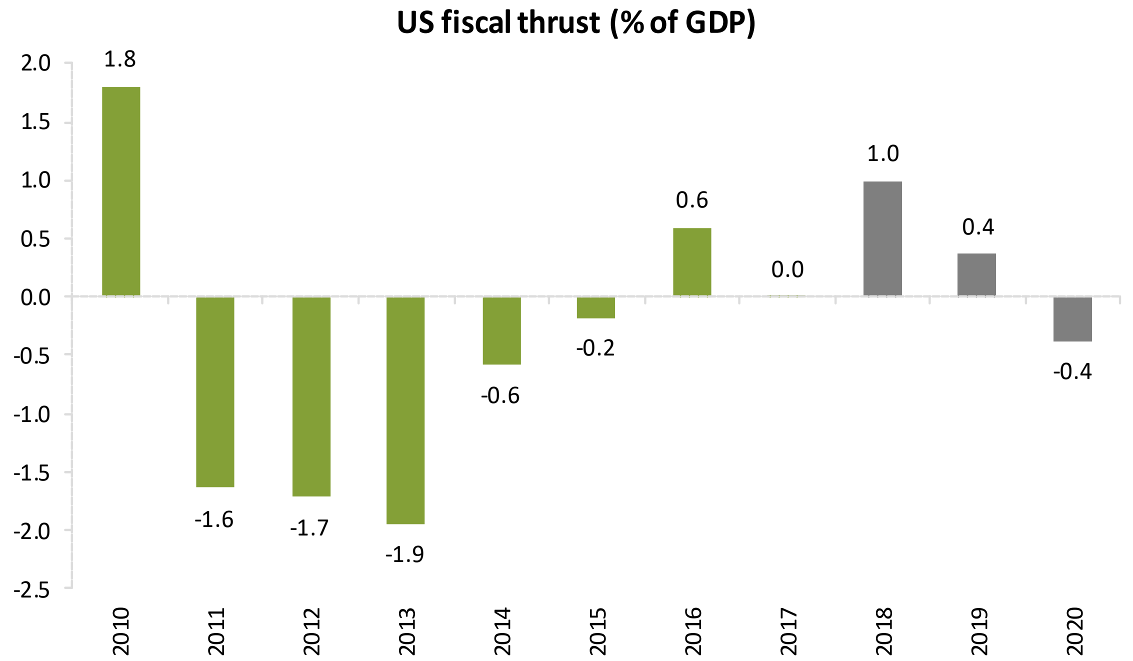
Source: Bloomberg, ABSLAMC Research

US GDP expected to slow

US GDP growth likely to slow from 2018 peak



Fiscal thrust likely to be lower in 2019



- ✓ US growth is likely to moderate from 2018 levels but still remain above potential at 2.3% y-y
- ✓ The decline is likely due to lower fiscal thrust, interest rate rise feeding into economy , tighter financial conditions, lower global growth, and capacity constraints of an economy running above its potential with a late cycle fiscal stimulus.

Source: US Federal Reserve, Bloomberg, ABSLAMC Research

US: Rising interest rates to gradually feed into economy

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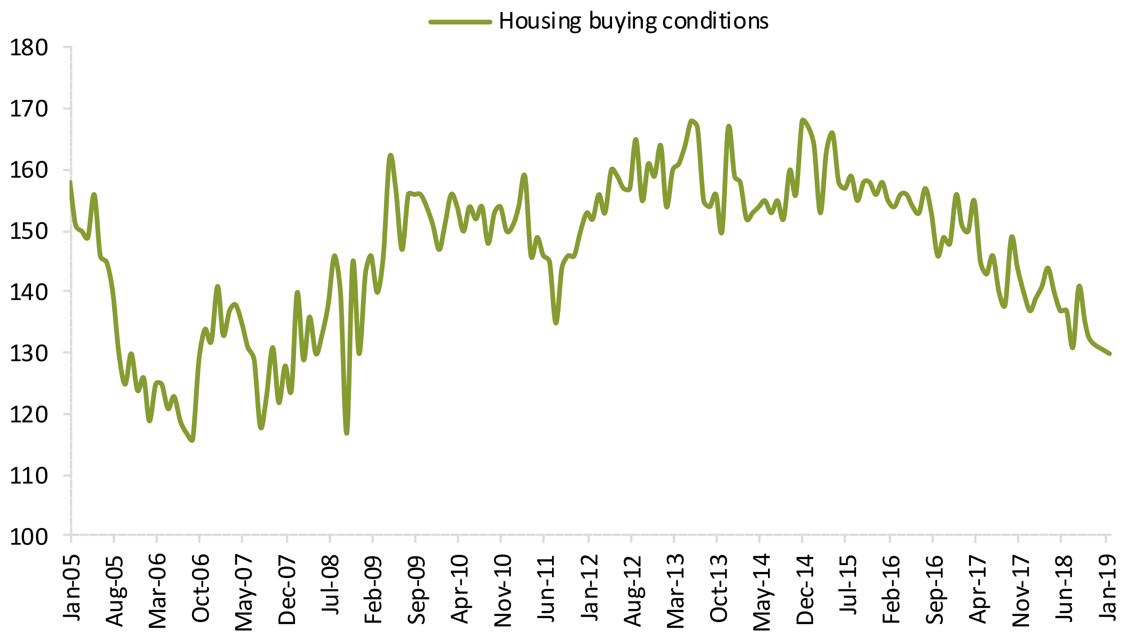
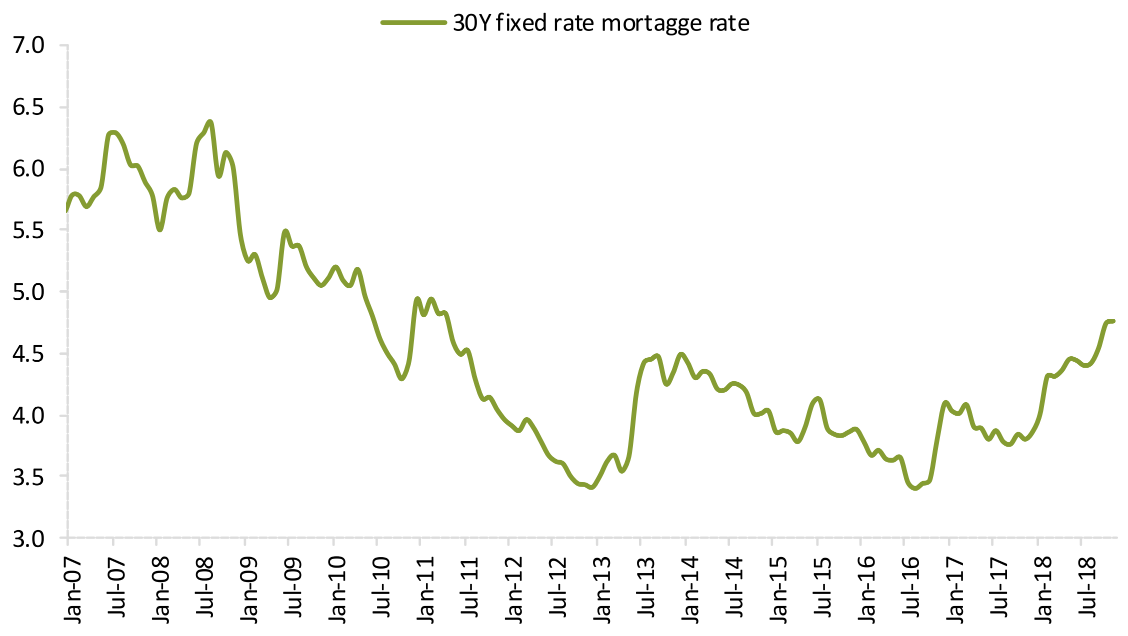
Housing buying conditions lowest in a decade



Mortgage fixed rate on uptick

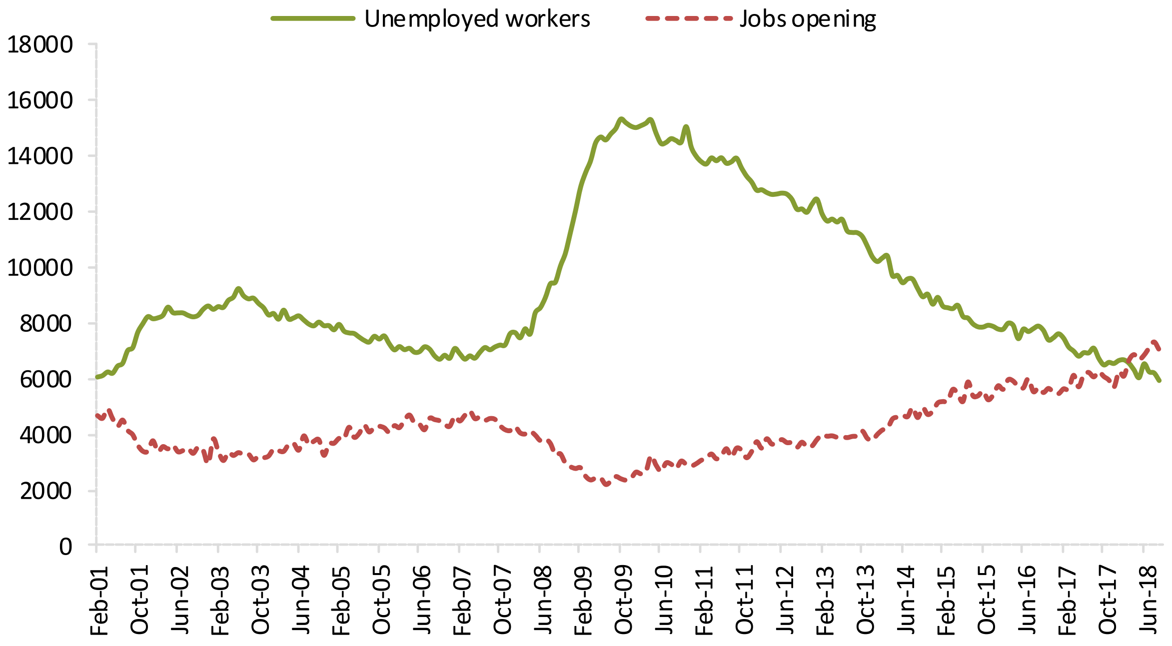


- ✓ Rising US rates have started to gradually feed into US economy especially in interest rate sensitive sectors

Source: Bloomberg, ABSLAMC Research

US labour market to stay tight

Job openings more than unemployed workers



US unemployment rate at multi decade low

- ✓ US labour market has become very tight with unemployment rate at multi decade lows and most indicators of labout market conditions showing tightness
- ✓ Surveys showing that employers finding difficult to get workers
- ✓ With US economic growth expected to be still above potential we expect labour market tightness to continue

Source: Bloomberg, ABSLAMC Research

US: Wages rising, but inflation still contained

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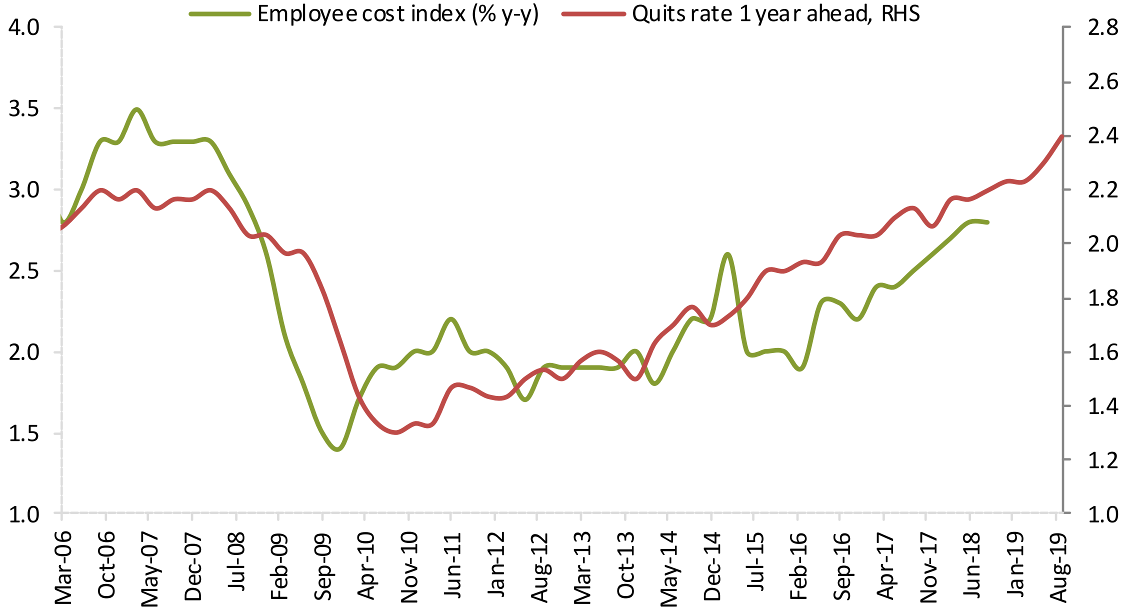
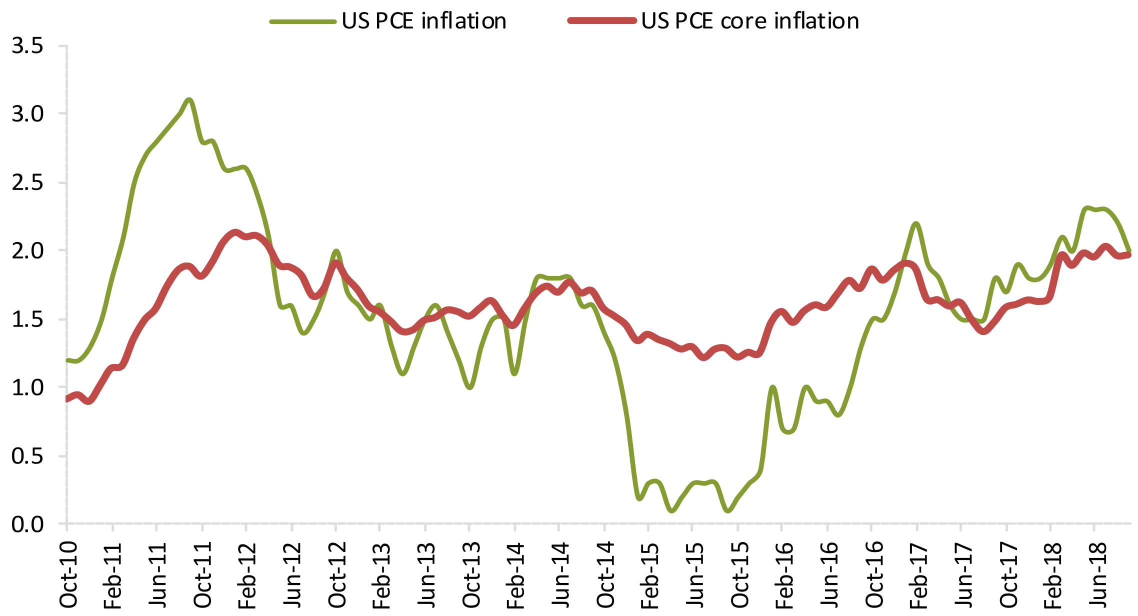
US wages rising



But US inflation still contained



- ✓ US wage rates are also rising and the rising quits rate suggests that employees are bullish about their growth prospects. This is also a lead indicator of wage growth in upcoming months
- ✓ Despite increasing signs of tightness in labour market and growth being above potential, US core inflation has so far remained well contained and shall be an important factor in fed's monetary policy as US is expect to witness even tighter labour market in 2019

Source: Bloomberg, ABSLAMC Research

US households in good shape

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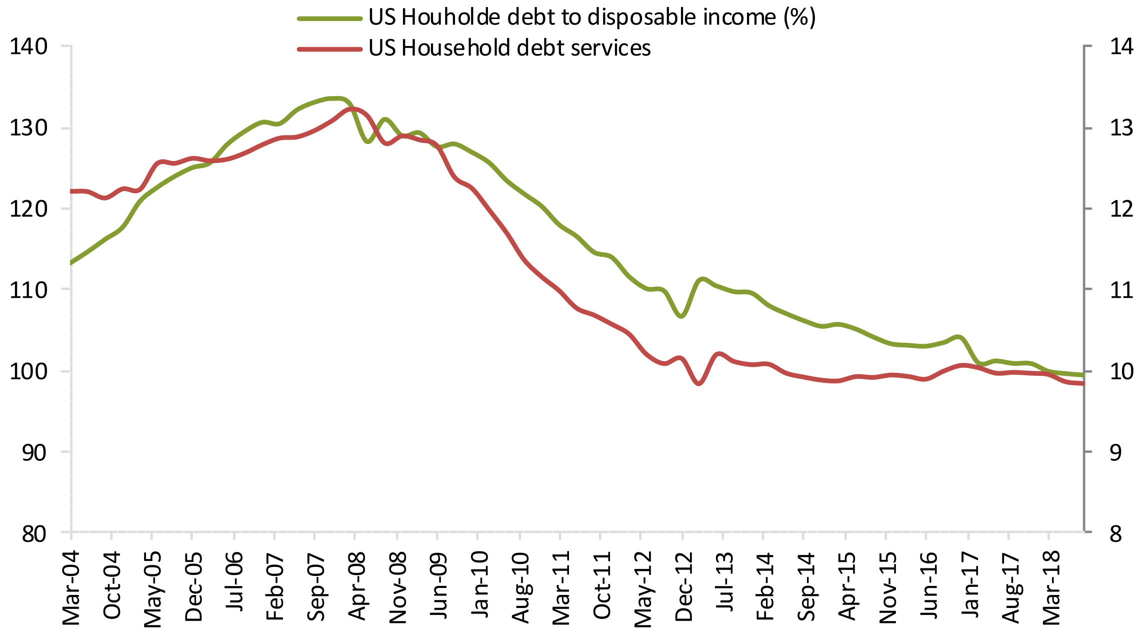
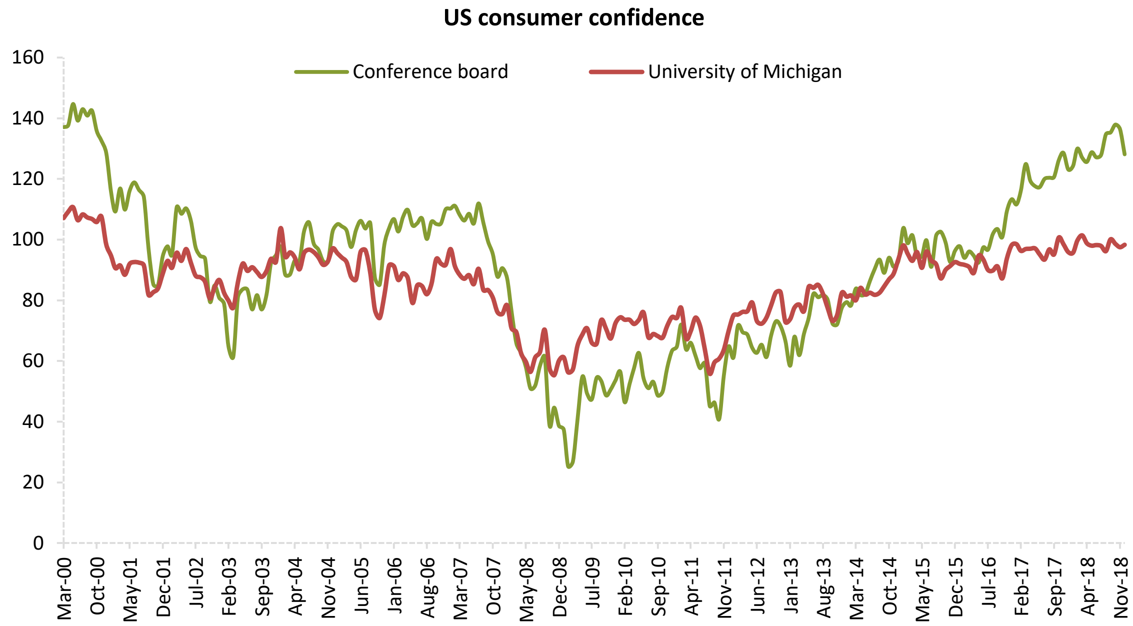
Household debt and debt servicing ability remains pretty comfortable



US consumer confidence close to highest in about two decades



- ✓ US household remains pretty comfortable in its debt servicing ability
- ✓ Healthy wage growth, low inflation and comfortable debt servicing ability means that US consumer confidence remains close to highest levels in about two decades

Source: Bloomberg, ABSLAMC Research

China: Managing the slowdown

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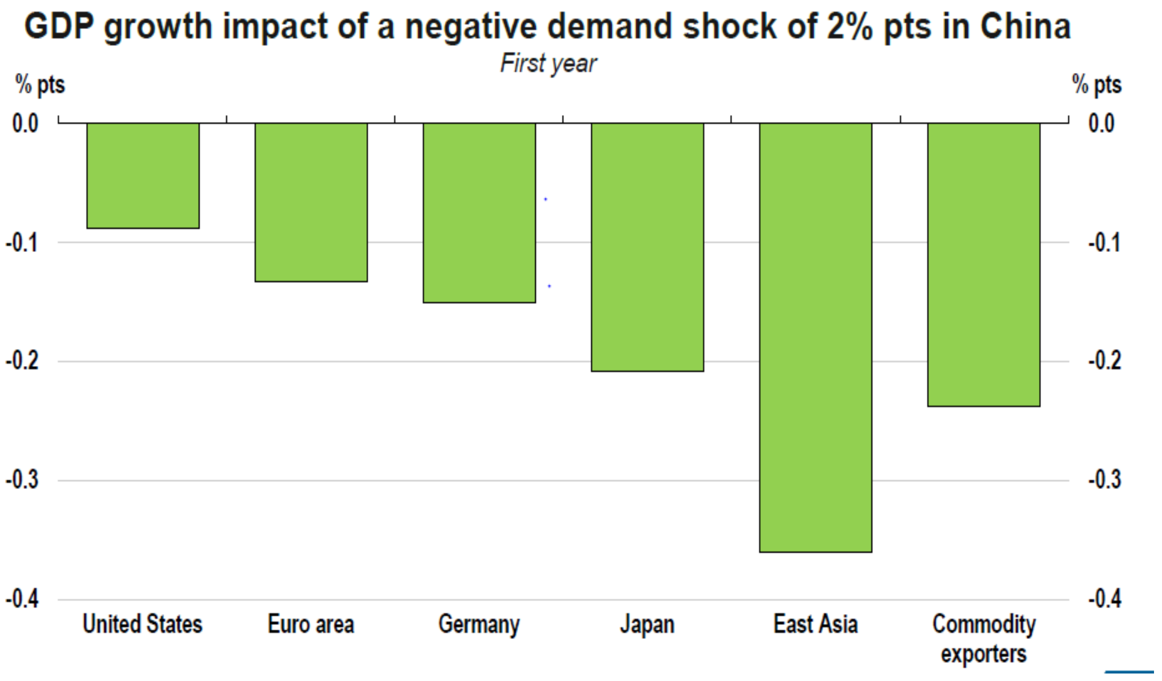
Global GDP growth moderating from high level, base case is of soft landing

Sharp China slowdown can be major risk for global economy



- ✓ We expect China to continue decelerating. We expect the ongoing policy easing starts to give floor to its growth by middle of 2019.
- ✓ However, we do not expect a major stimulus like in earlier episodes, since improving the quality of growth and steering it away from excesses remains one of the policy goals.

Source: Bloomberg, ABSLAMC Research

China growth has been steadily declining

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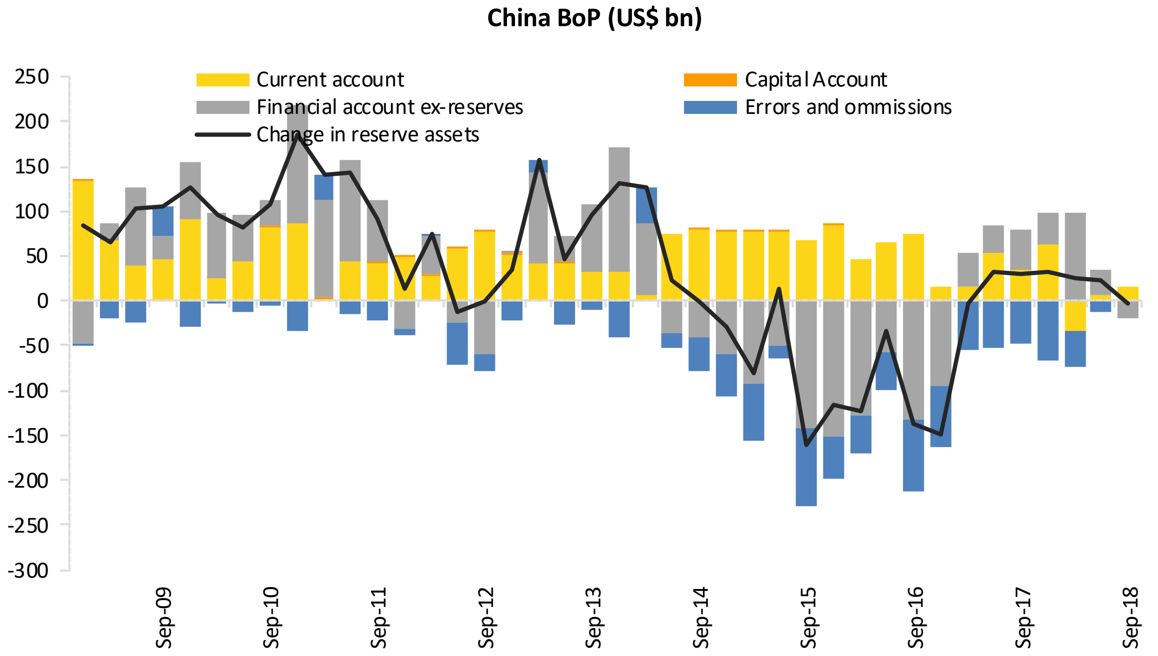
Steady decline in IP and FAI

China current account moving to deficit territory, making China net importer of global capital



- ✓ Most high frequency Chinese data like industrial production, fixed asset investment and retail sales are showing a declining trend
- ✓ We are also witnessing decline in China's capital account which shall probably be in deficit in 2019, making China a net importer of global capital

Source: Bloomberg, ABSLAMC Research

China: Credit growth declining, but overall credit remains high

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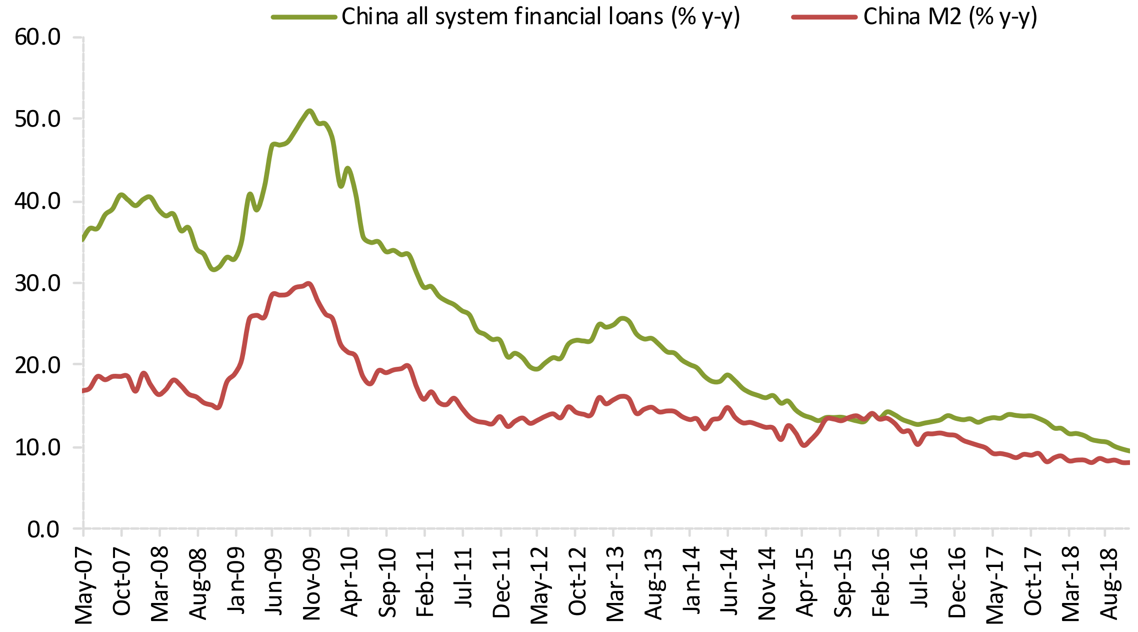
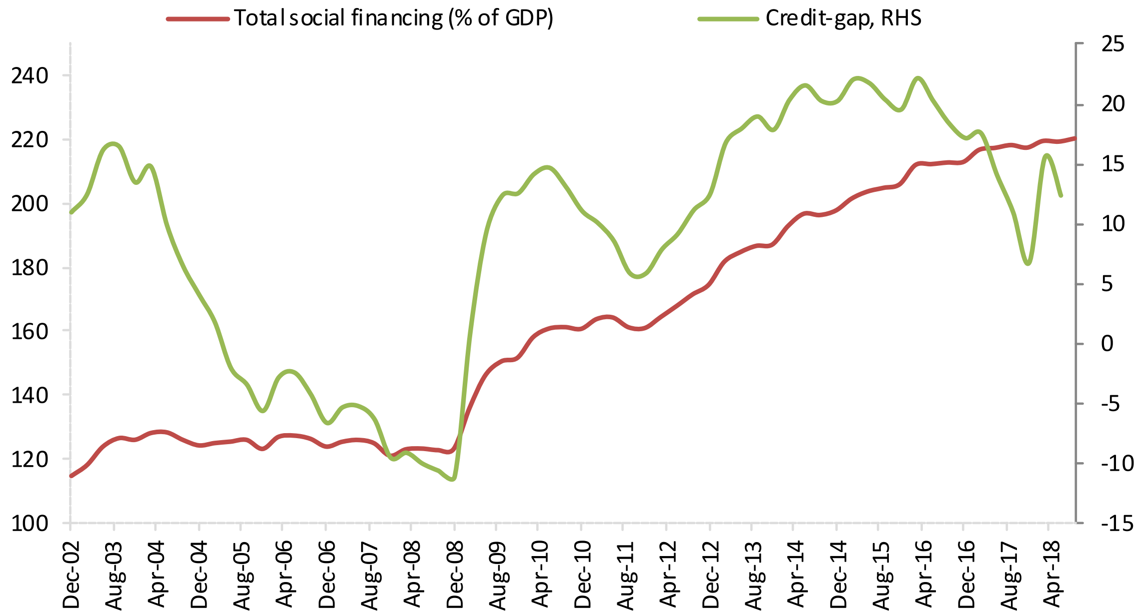
Credit growth steadily declining



Debt level still remain very high, credit gap positive

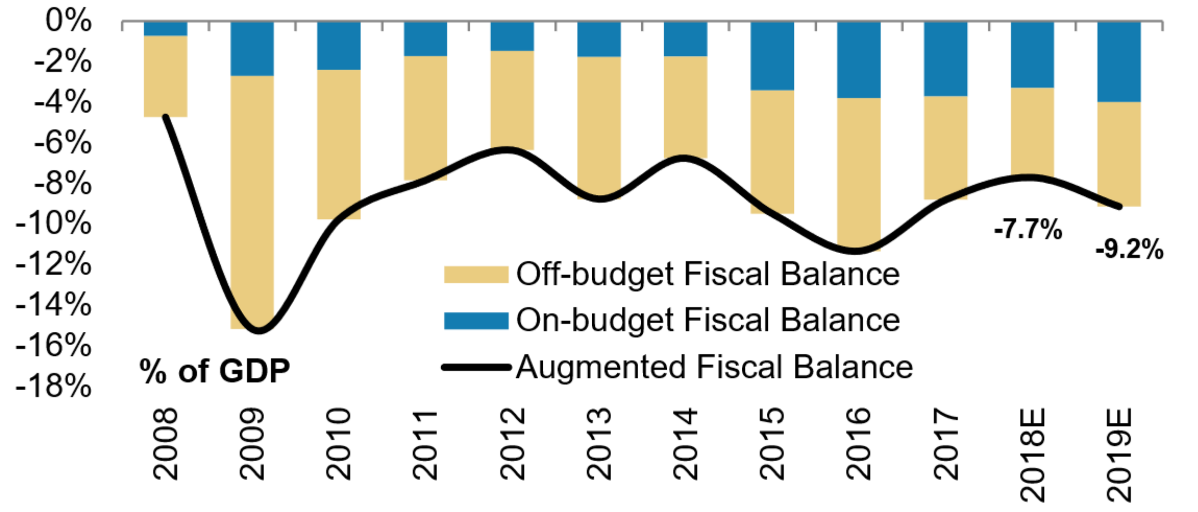


- ✓ While Chinese credit growth has slowed as authorities embark on reducing the high credit intensity, the debt level still remain very high
- ✓ Credit gap which is a good indicator for crisis still remains high
- ✓ High debt is a key reason why Chinese policy stimulus is expected to be *de minimis*

Source: Bloomberg, BIS, ABSLAMC Research

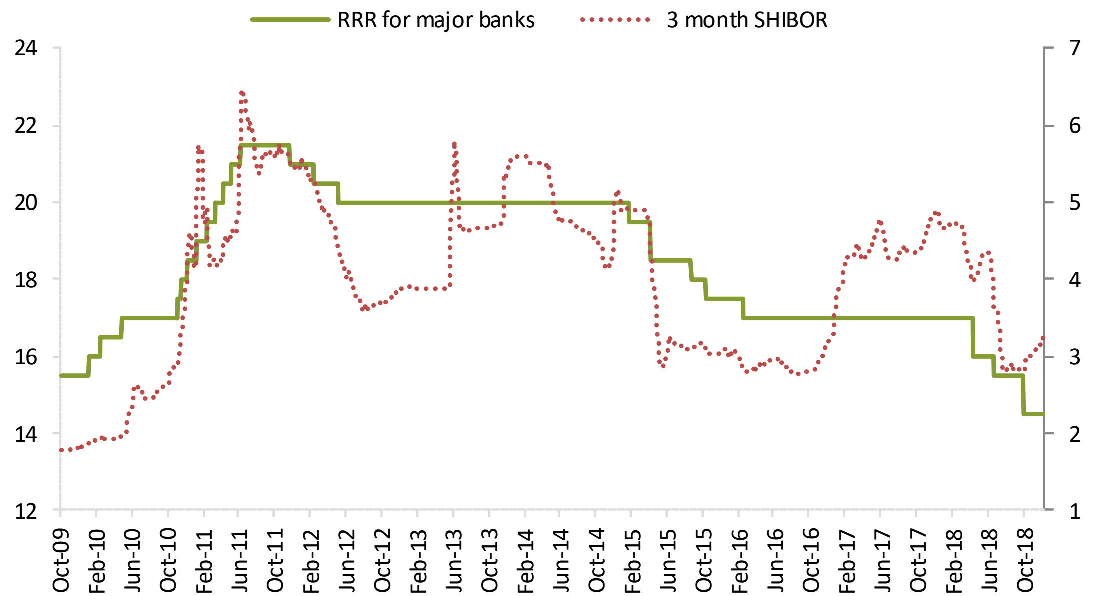
China: Moderate stimulus is likely

There is room for fiscal easing



Main drivers of higher augmented fiscal deficit in 2019	% of GDP
- 2-3ppt VAT cut in the 16% bracket	0.4-0.6ppt
- Higher local government special bond issuance (Rmb2trn vs. 1.35trn in 2018)	0.5ppt

More monetary stimulus is likely in 2019



- ✓ Given the high debt levels and policymakers' goal to make growth more sustainable, we expect policymakers to be comfortable with gradual growth slowdown and provide a moderate stimulus which shall provide a floor to growth
- ✓ We expect a combination of both fiscal and monetary stimulus in 2019

Source: Morgan Stanley Research, Bloomberg, ABSLAMC Research

Europe: GDP expected to move lower

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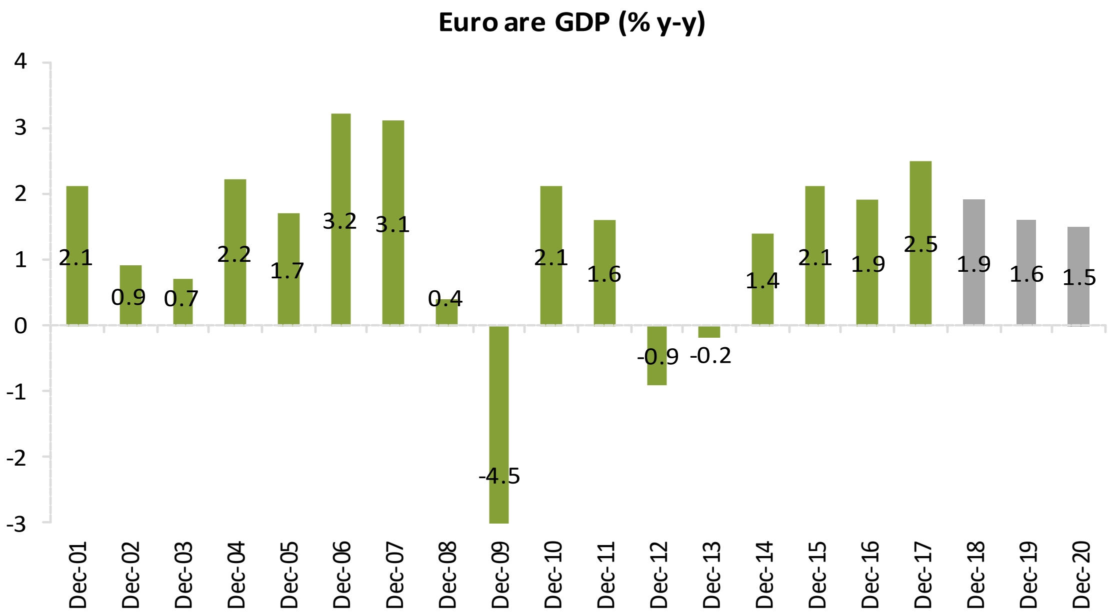
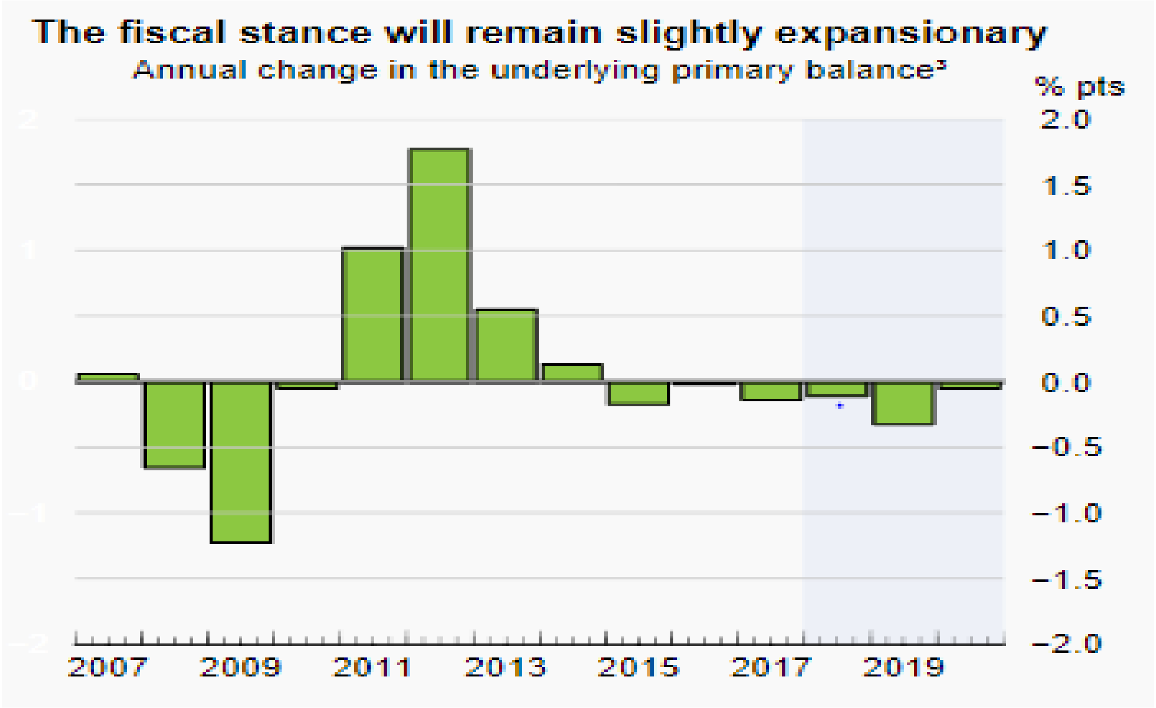
European GDP likely to moderate but remain above potential



Fiscal stance is likely to be expansionary

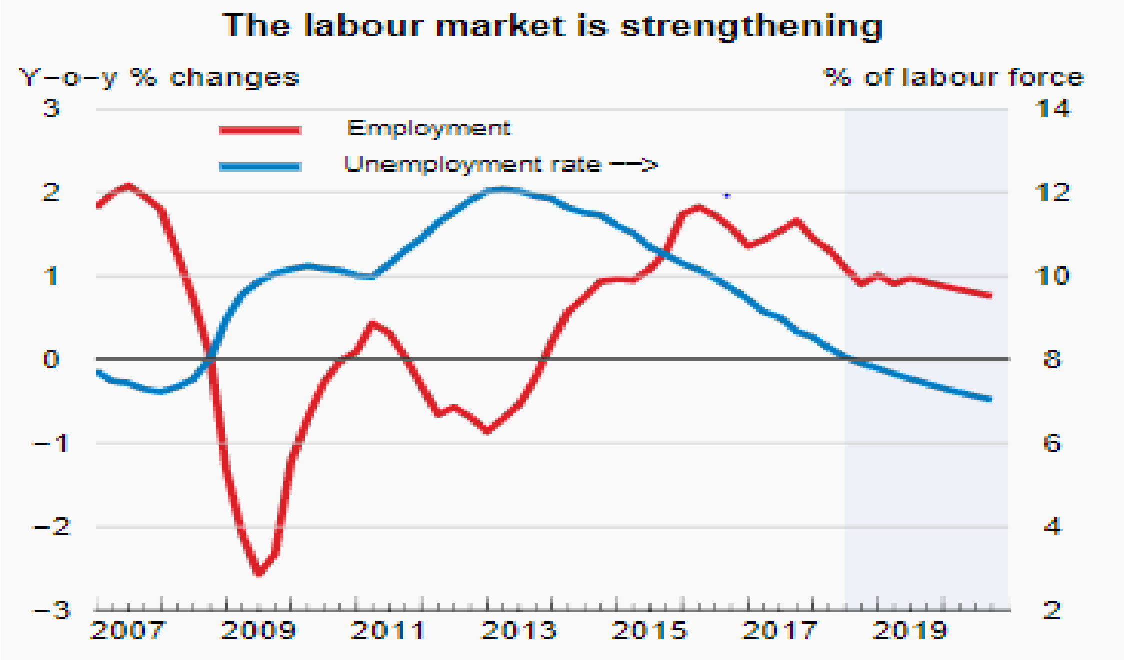


- ✓ Euro area economic growth is expected to moderate to ~1.6% in 2019 and 1.5% in 2020 (Bloomberg Consensus forecast)
- ✓ Accommodative monetary policy, some fiscal easing and lower crude price shall support domestic demand, in particular private consumption

Source: OECD, Bloomberg forecast, ABSLAMC

Europe: Moderate stimulus is likely

European unemployment rate moving below potential



More monetary stimulus is likely in 2019

- ✓ European labour market is improving and is expected to improve further in 2019 as economy continues to grow above potential
- ✓ Inflation is projected to rise gradually, as stronger wage growth and dissipating slack translate into sustained increases in core inflation.

Source: OECD estimates, ABSLAMC Research

Summing up

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- ✓ Global growth is showing signs of moderation amidst tightening financial condition and is **expected to slow to 3.5% in 2019** compared to 3.7% in 2017 and 2018.
- ✓ The slowdown expectation of world economy is on account of growth peaking in major advanced economies, negative effects of the trade war as well as a weaker outlook for some key emerging market and developing economies arising from country-specific factors, less support from Central Banks, tighter financial conditions, and geopolitical tensions. US-China trade talk is the key variable.
- ✓ Central banks proceed ahead with withdrawal of extraordinary monetary accommodation, quantitative easing turns to quantitative tightening in 2019 even as Fed may turn dovish compared to 2018
- ✓ Slowing economy and less support from Central banks keep volatility elevated in financial markets and financial conditions tight
- ✓ Commodities stay under pressure on account of slowing global economy. Stronger than expected stimulus in China or quick resolution of US-China trade negotiation are upside risk factor
- ✓ **US growth is likely to slow to 2.3%,** but still remain pretty decent in 1H; risk of a sharper slowdown in 2H. Tight labour market keep possibility of at least one Fed rate hikes alive in 2019 but much would depend on the health of financial markets and outcome of US-China trade negotiations
- ✓ **China to continue decelerating to 6.3%**, but the ongoing policy easing starts to give floor to its growth by middle of 2019
- ✓ **Euro area economic growth is expected to moderate to ~1.6%** in 2019
- ✓ EM-DM growth differential and valuation may result in relative EM outperformance. US-China trade discussion, sharp deterioration in global liquidity and sharper than expected slowdown in China are key risk to EM outperformance

India

Growth prospects look better, inflation benign

Growth momentum to inch-up, election and global growth key risk

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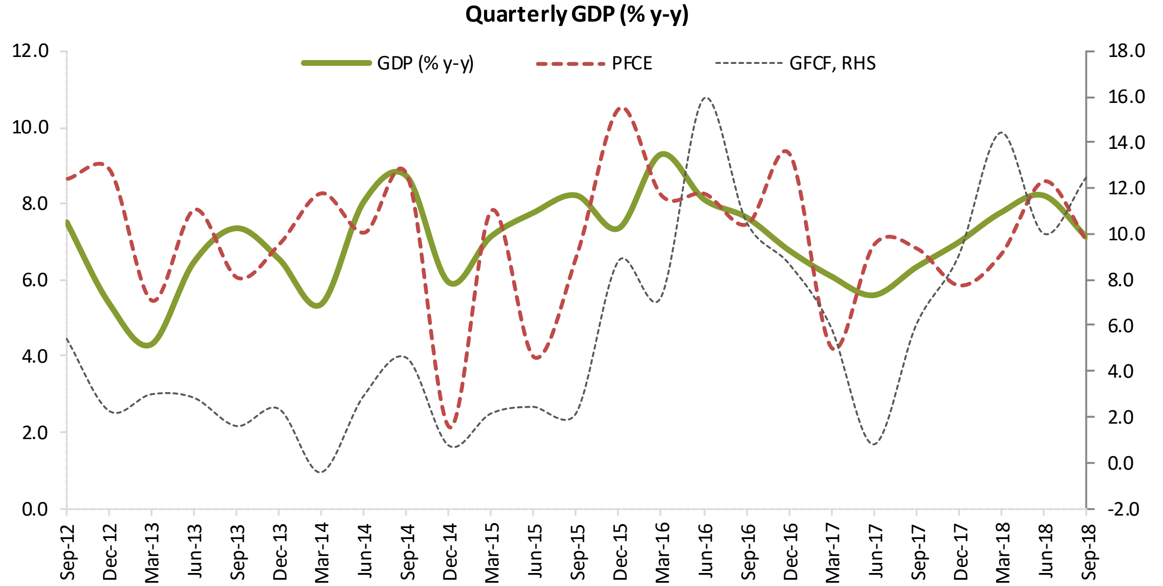
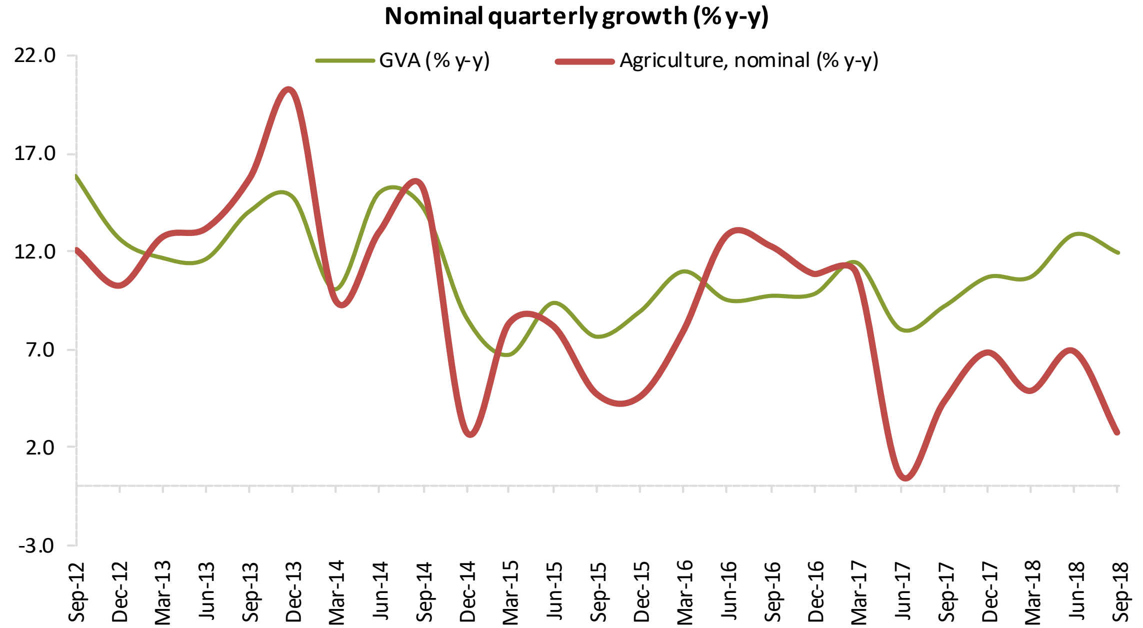
GDP growth moderated in 3Q



Nominal agricultural GDP witnessing sharp decline owing to low food prices



- ✓ We expect marginal uptick in growth towards 7.2% to 7.5% level in FY20 (7.2% in FY19), in our base case assumption of stable government post elections and only a moderate global growth slowdown
- ✓ High capacity utilization should drive a nascent investment recovery. Moreover, lower crude price, peaking banking sector NPAs, possibility of a rural stimulus and election related spending are other tailwinds.
- ✓ NBFC slowdown, weak global growth and impact of political uncertainty on elections are likely to be key drags to growth

Source: CEIC, ABSLAMC Research

Fiscal targets drag on growth

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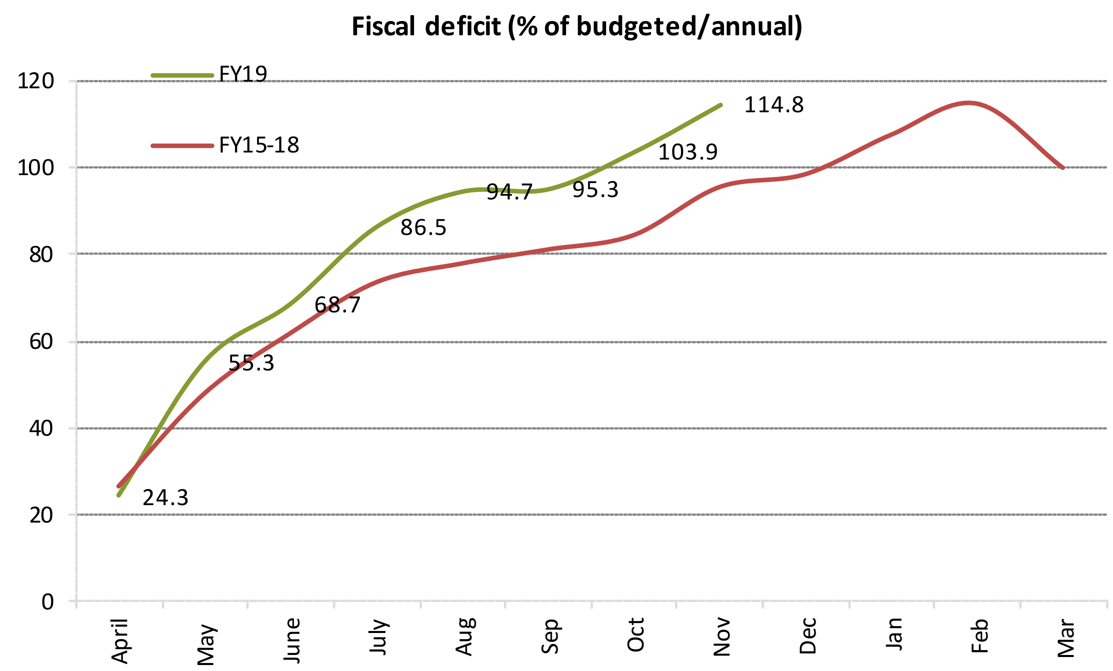
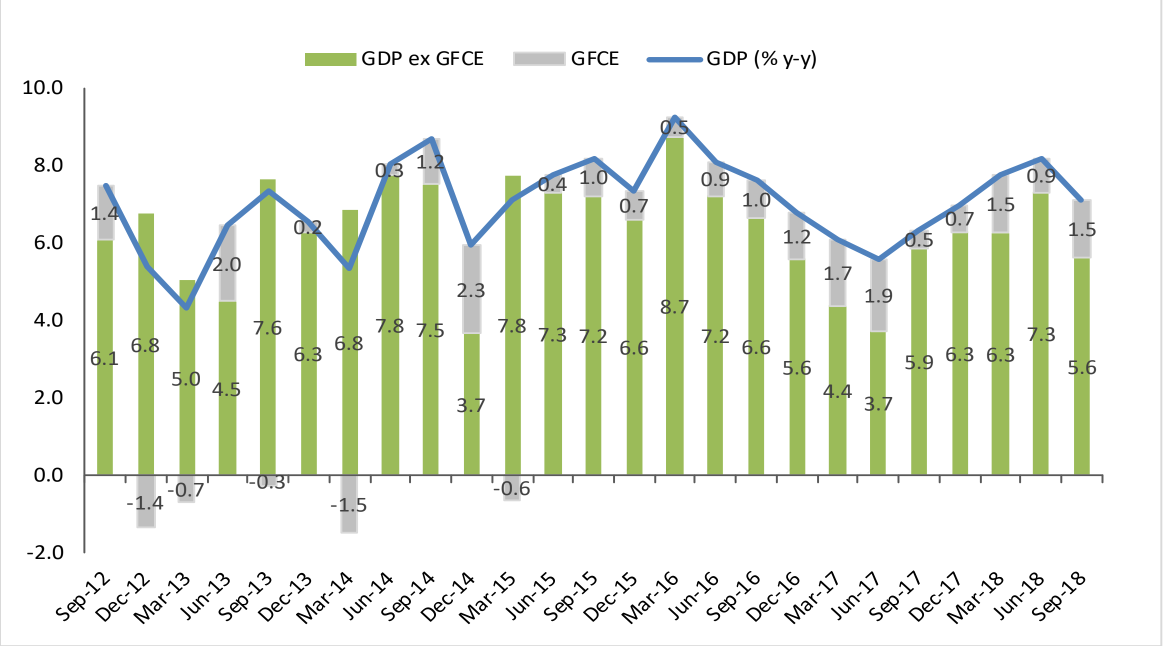
Fiscal deficit running ahead of budgeted targets



Government expenditure has been a key component of GDP growth in recent quarter



- ✓ We note that fiscal deficit is running ahead of budgetary targets and government has repeatedly reiterated its commitment to stock to fiscal discipline
- ✓ Given that government final consumption expenditure has been an important component of recent GDP numbers, possible expenditure containment towards fiscal discipline would have a negative impact on growth in 4QFY19

Source: CEIC, ABSLAMC Research

High capacity utilization to sustain pick-up in investments

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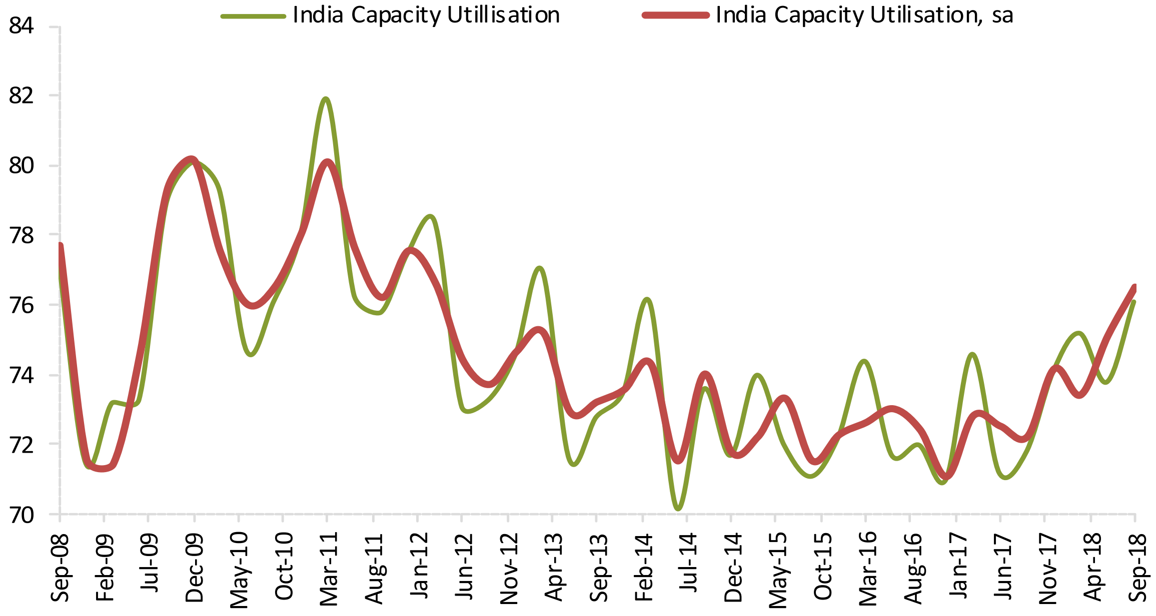
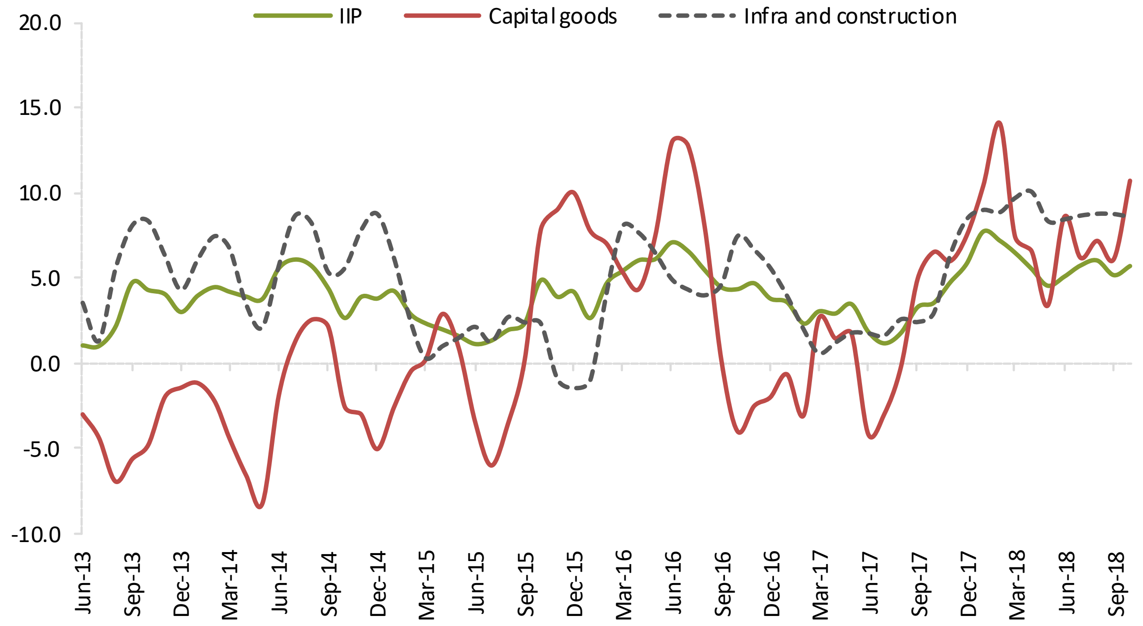
Capacity utilization at highest since 2012



Healthy growth in capital goods, infra and construction index in IIP

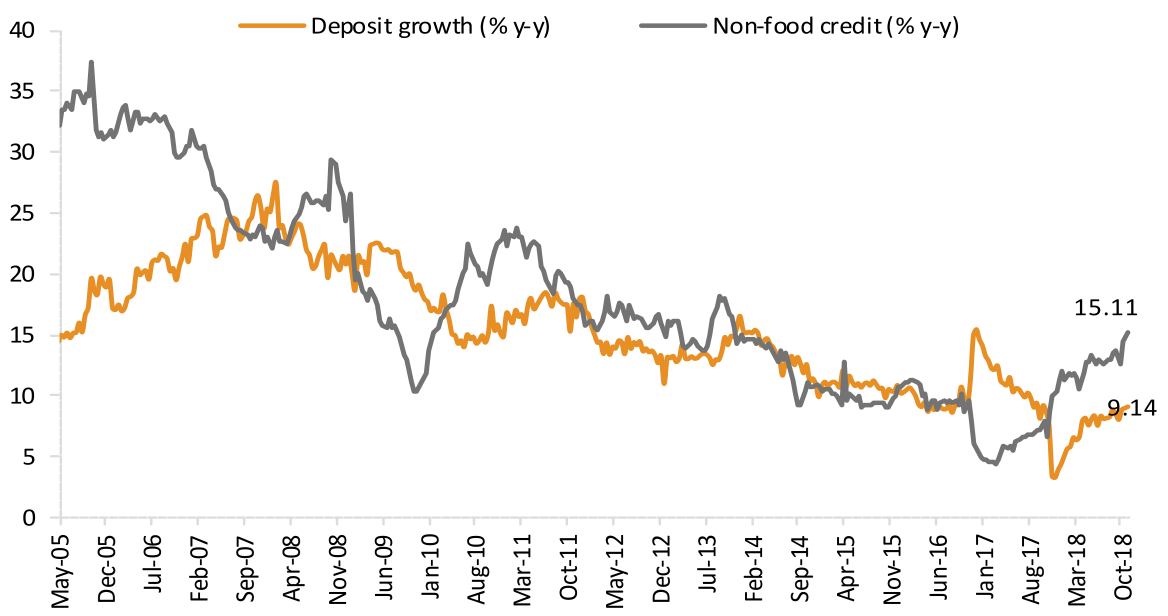


- ✓ Given low investments in last few year, capacity utilization has risen to highest level since 2012
- ✓ While public capex into infrastructure continue to drive investments, we are witnessing early signs of revival in private capex as well
- ✓ If global sentiments doesn't worsen significantly and we have a stable government in post General election, then we are set for a further pick-up in investment cycle in 2019

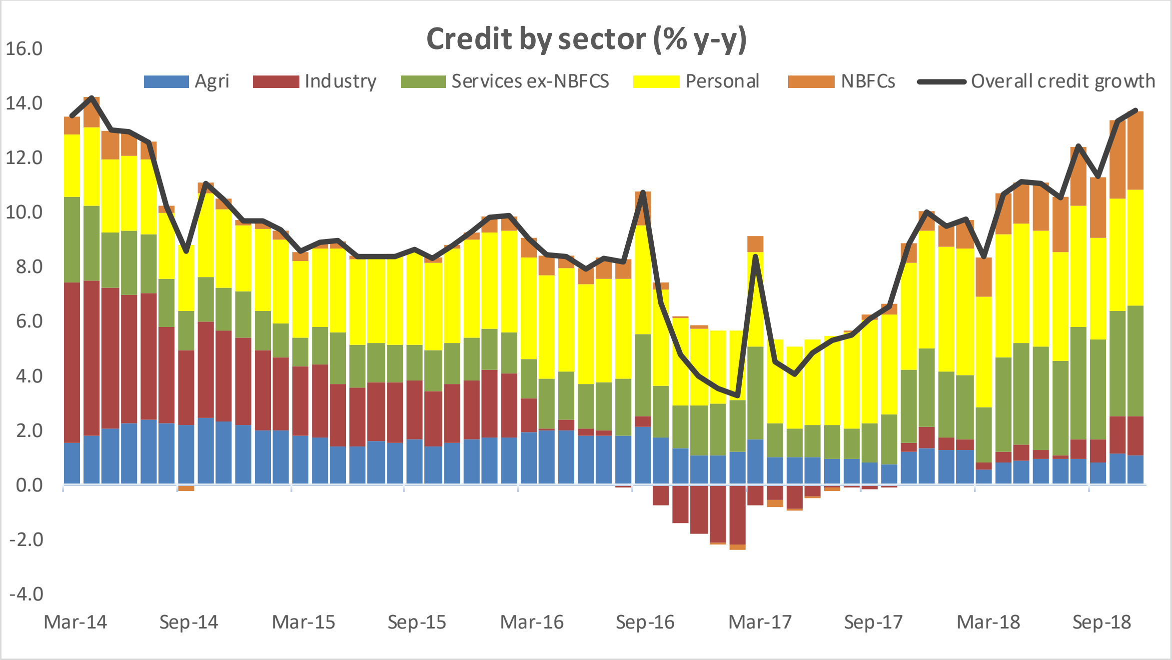
Source: CEIC, ABSLAMC Research

Bank credit growth to stay healthy

Credit growth picking up



Credit growth by sector



- ✓ Bank credit growth has risen to a healthy rate of above 15% and we expect it to continue given the improvement in bank balance sheet, lower rates and slowdown in NBFC credit disbursals
- ✓ Sectoral breakdown of bank credit show the positive trend of rise in industrial credit growth from negative territory. Moreover NBFCs continue to be an important segment driving bank credit growth

Source: CEIC, ABSLAMC Research

NBFC would be a drag on overall system credit growth

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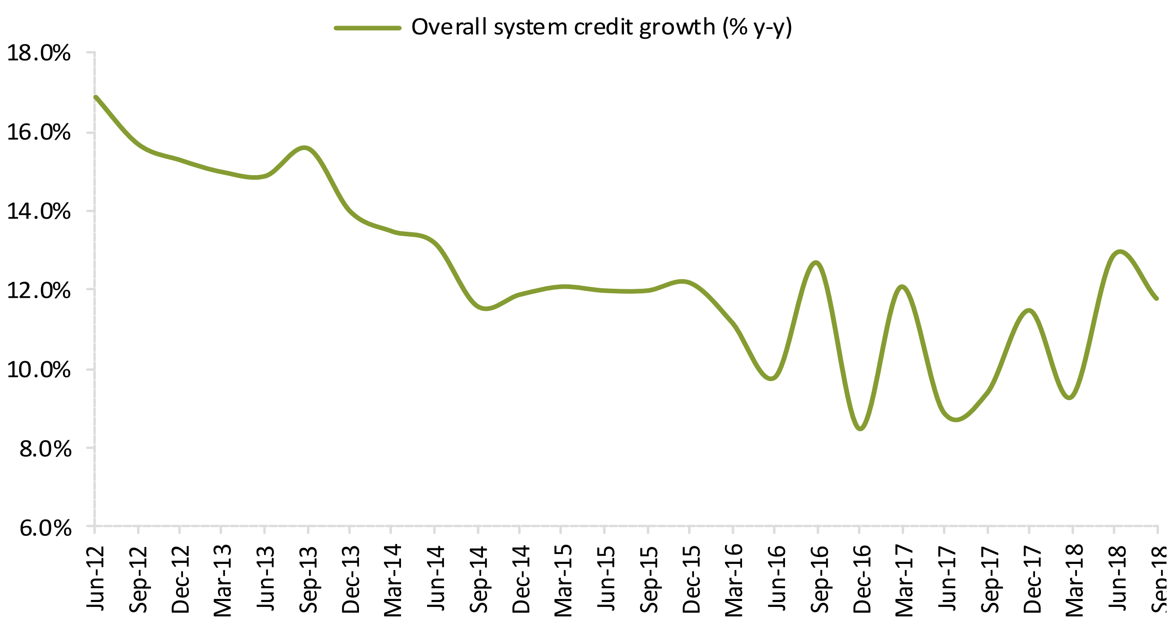
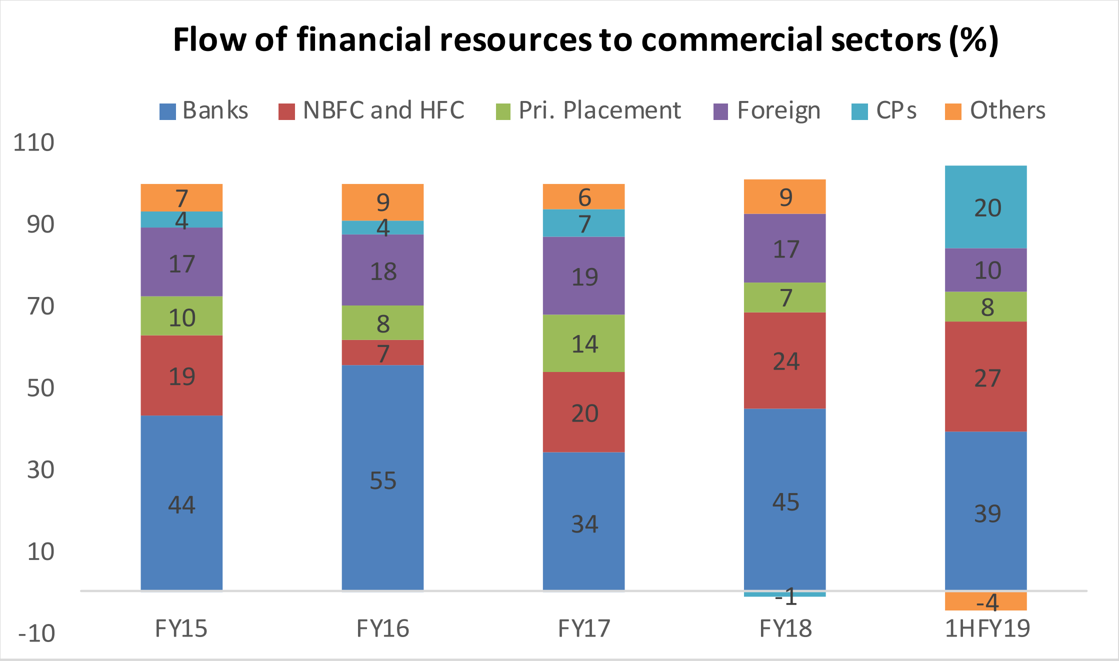
Overall system credit growth



Share of NBFCs have risen



Source: RBI, CEIC, ABSLAMC Research

Inflation declines towards lower end of RBI target range

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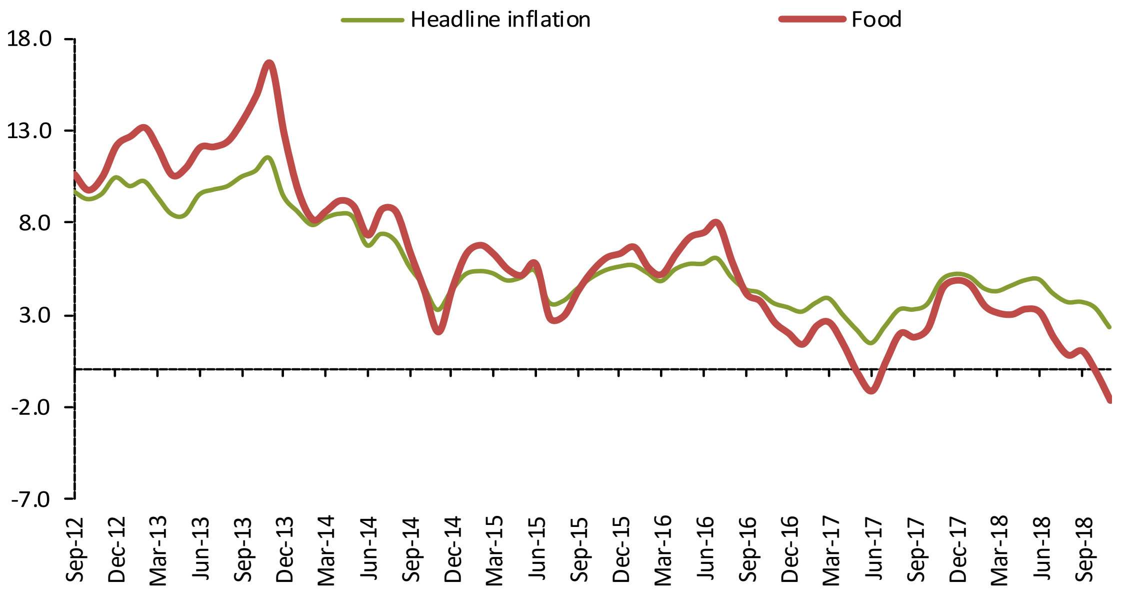
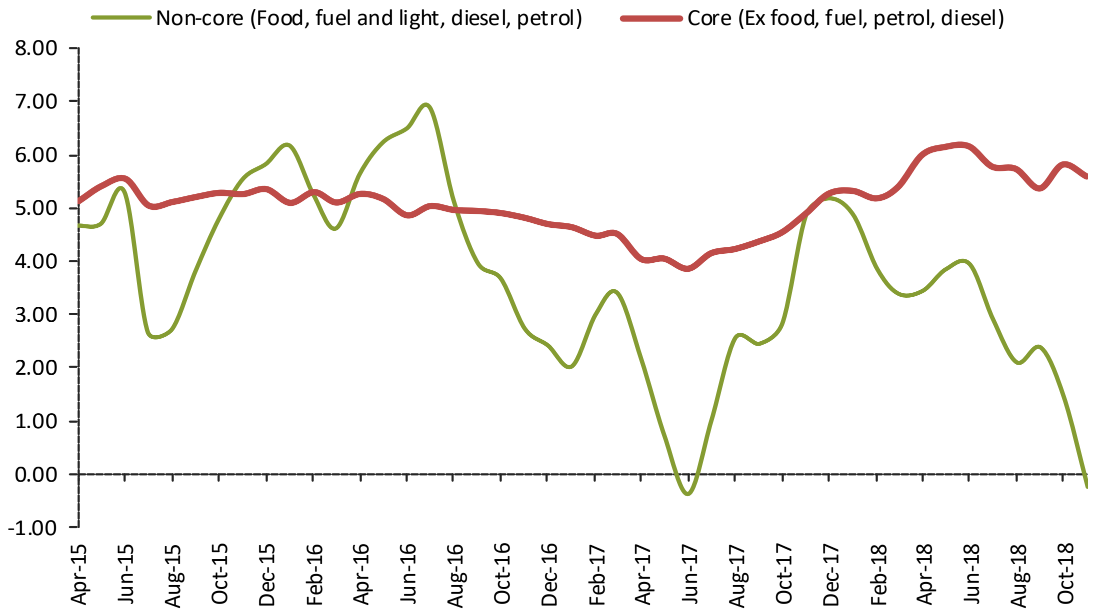
Headline inflation trending down, food inflation very benign



Core remains elevated, but non-core very low



- ✓ Headline inflation consistently undershot RBI and consensus forecast through the year and trended towards lower end of RBI target range story in 2018. Divergence between core and non-core inflation remained quite high
- ✓ **We expect the sharp decline in food inflation to at least partially normalize in 2019 and convergence in food and non-food inflation in 2019 towards ~4.5% range.** Crude price and fiscal stance in an election year will be key risk factors in 2019.

Source: CEIC, ABSLAMC Research

Low inflation driven almost entirely by food disinflation

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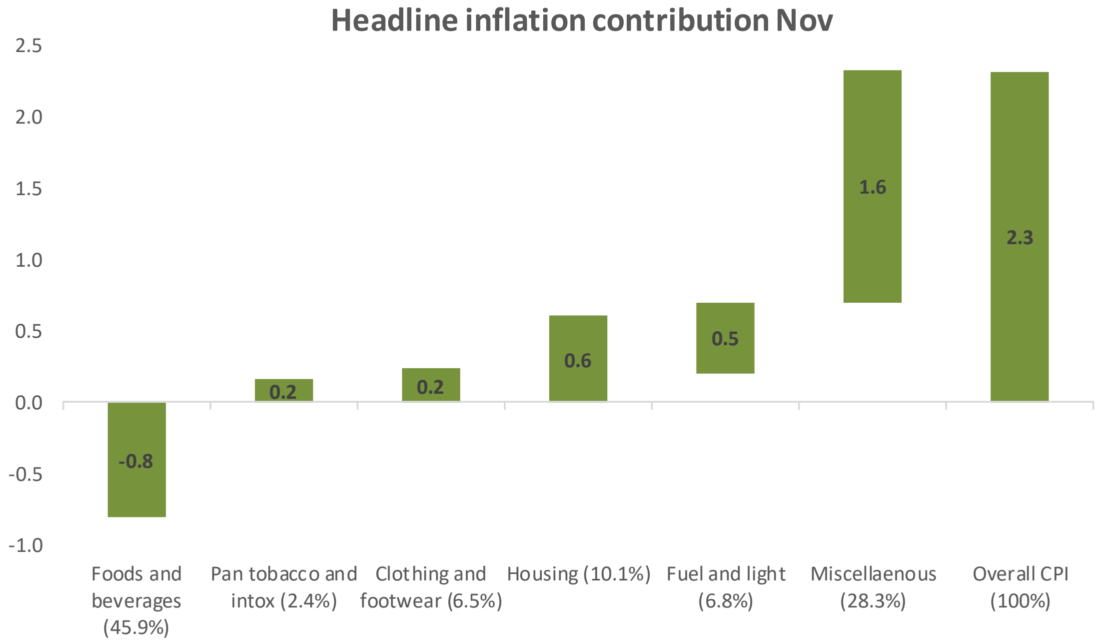
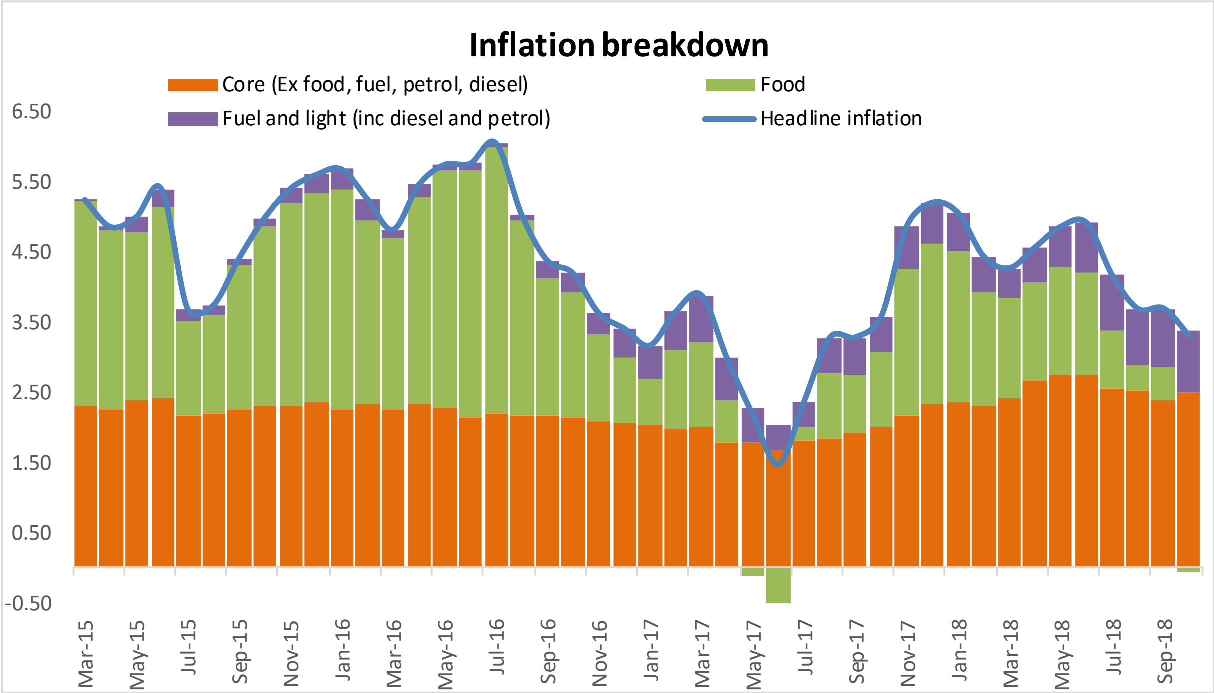
Lop-sided inflation breakdown



Disinflation entirely due to food



- ✓ Inflation story in 2018 is lop-sided, with very low food inflation driving down overall headline inflation, even as core inflation stayed elevated

Source: CEIC, ABSLAMC Research

Government food management has been important factor

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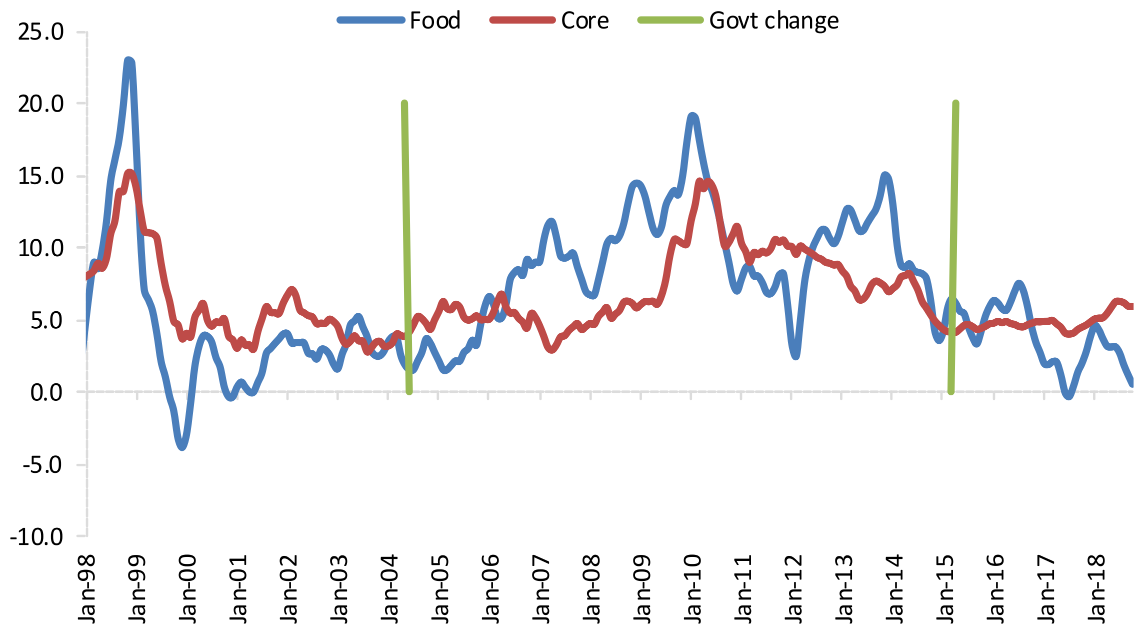
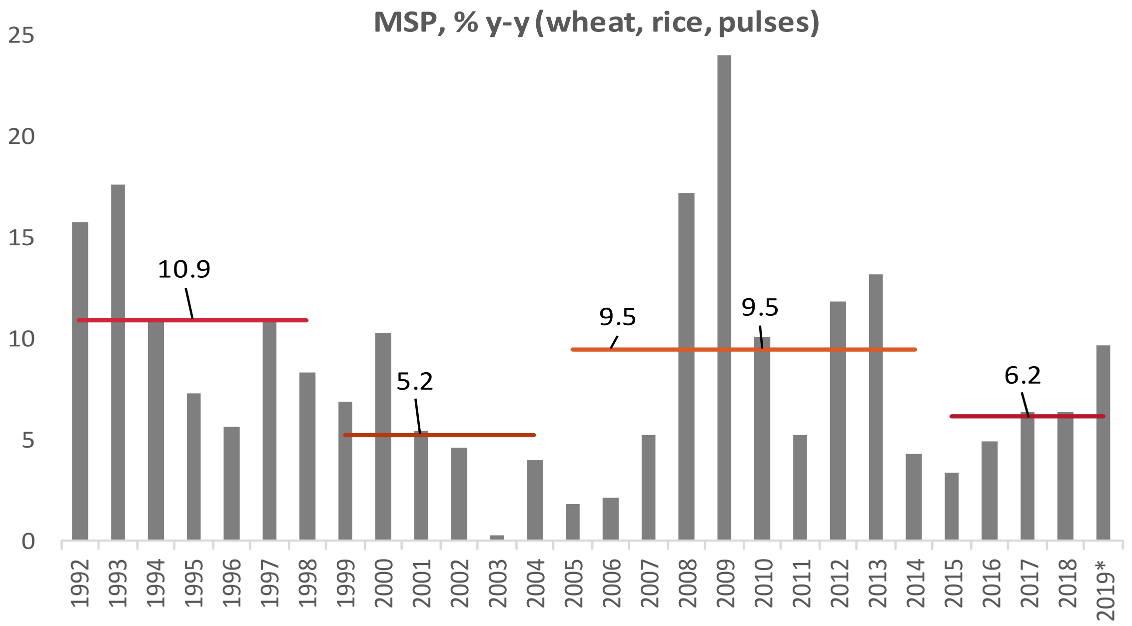
Food vs Core inflation: Government food management policy has likely been an important factor in low food inflation



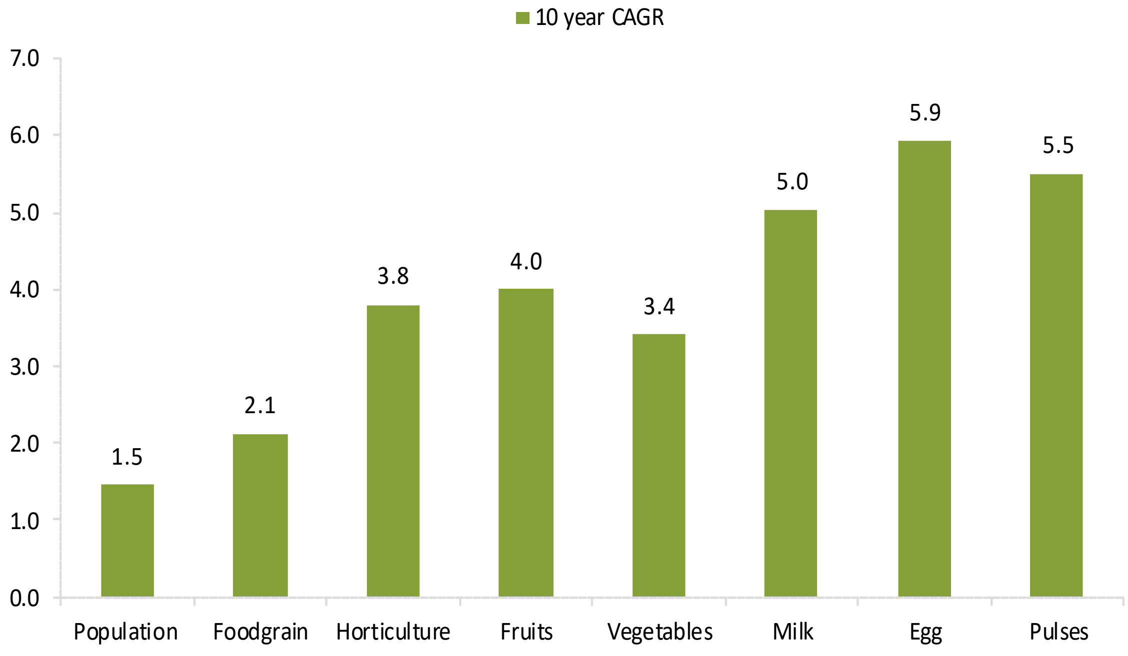
MSP increases have been relatively restrained in current dispensation



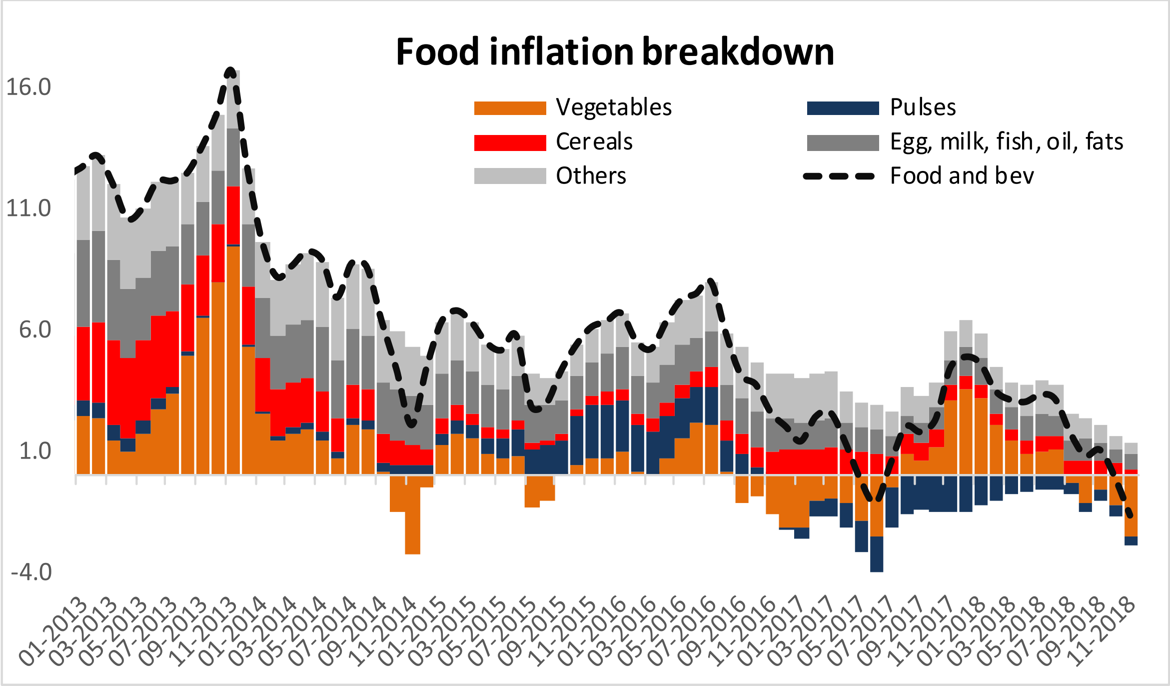
Source: CEIC, ABSLAMC Research

Food availability has improved significantly

Food availability has improved significantly



Broadbased food deflation

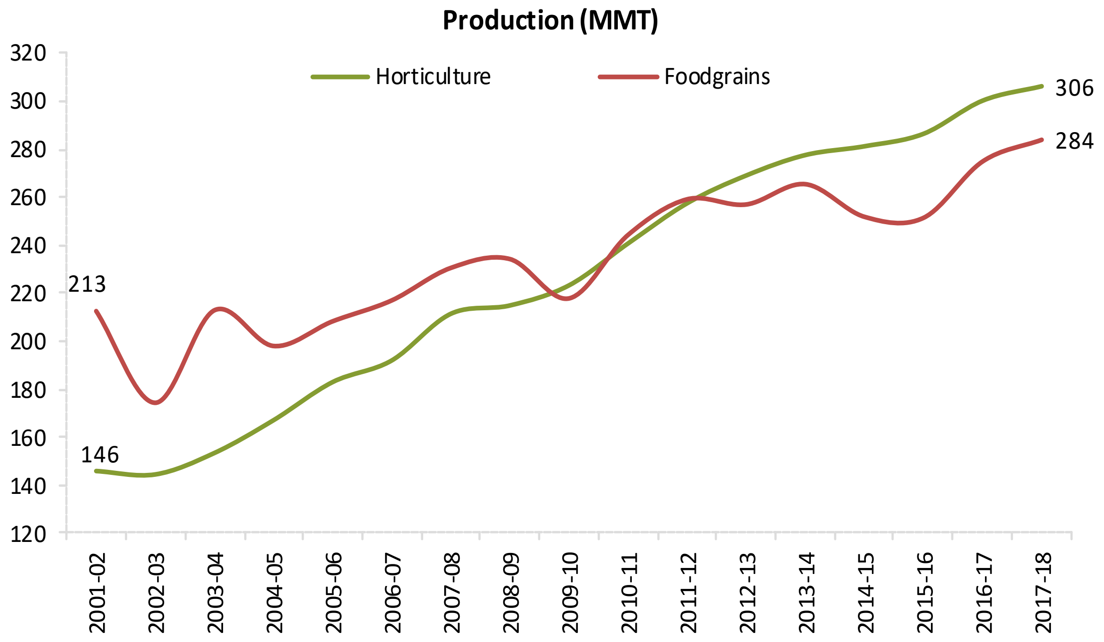


- ✓ Very low food inflation has been quite broad-based and driven by strong supply response across food products
- ✓ Supply response has been especially strong in horticulture and protein items which have witnessed the sharpest decline in inflation

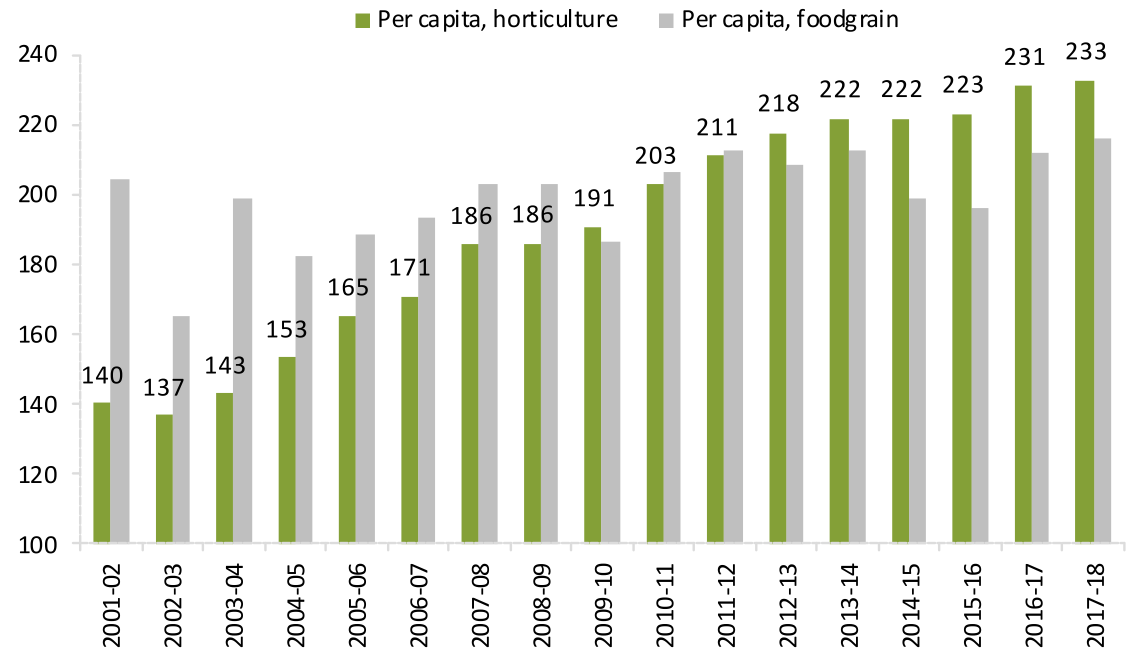
Source: CEIC, ABSLAMC Research

Horticulture has seen remarkable jump in output

Horticulture output rises above foodgrain production



Steady increase in per capita production



Source: CEIC, ABSLAMC Research

However, there is demand side story as well

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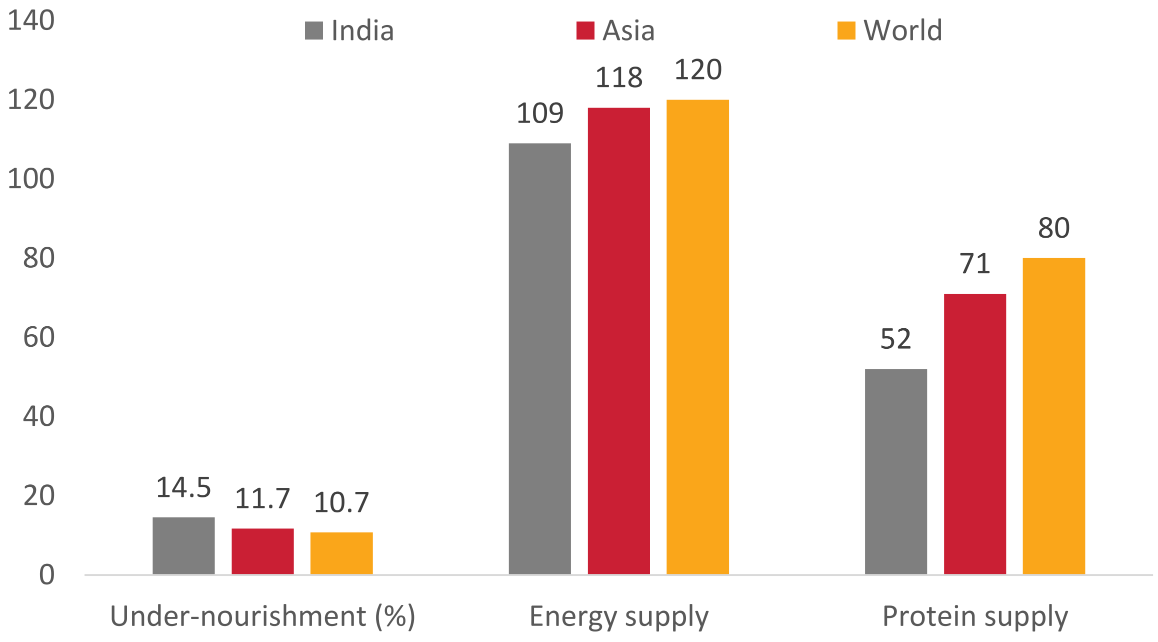
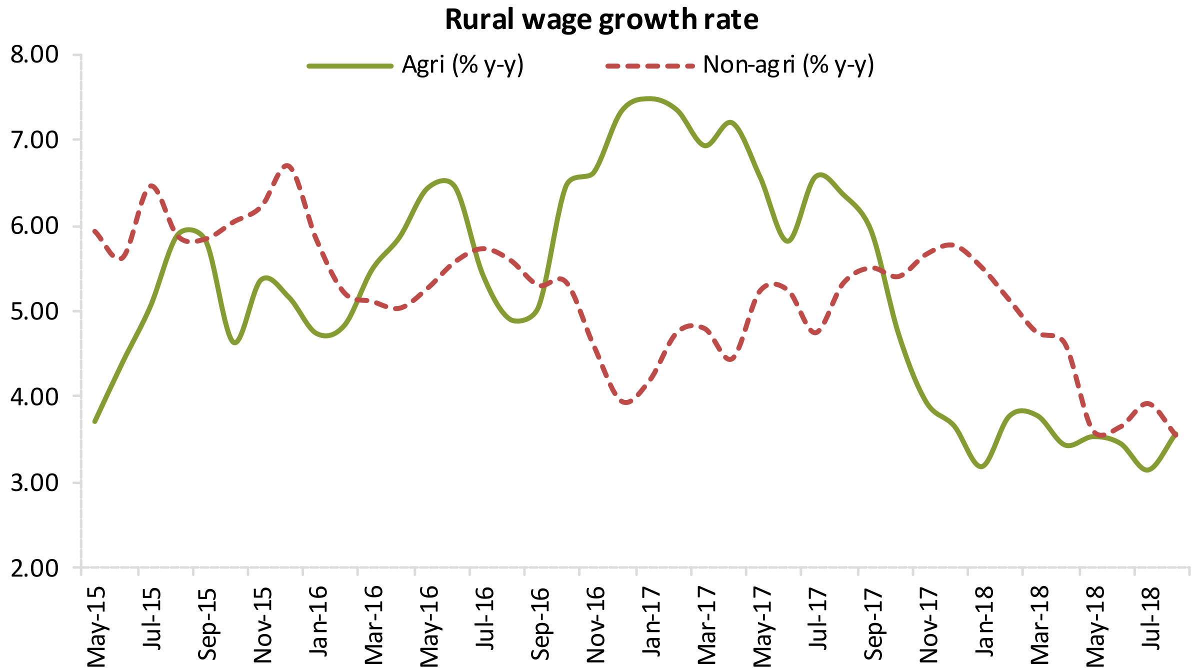
Number of undernourished in India remains high



Lower rural wage growth maybe indicating low rural demand

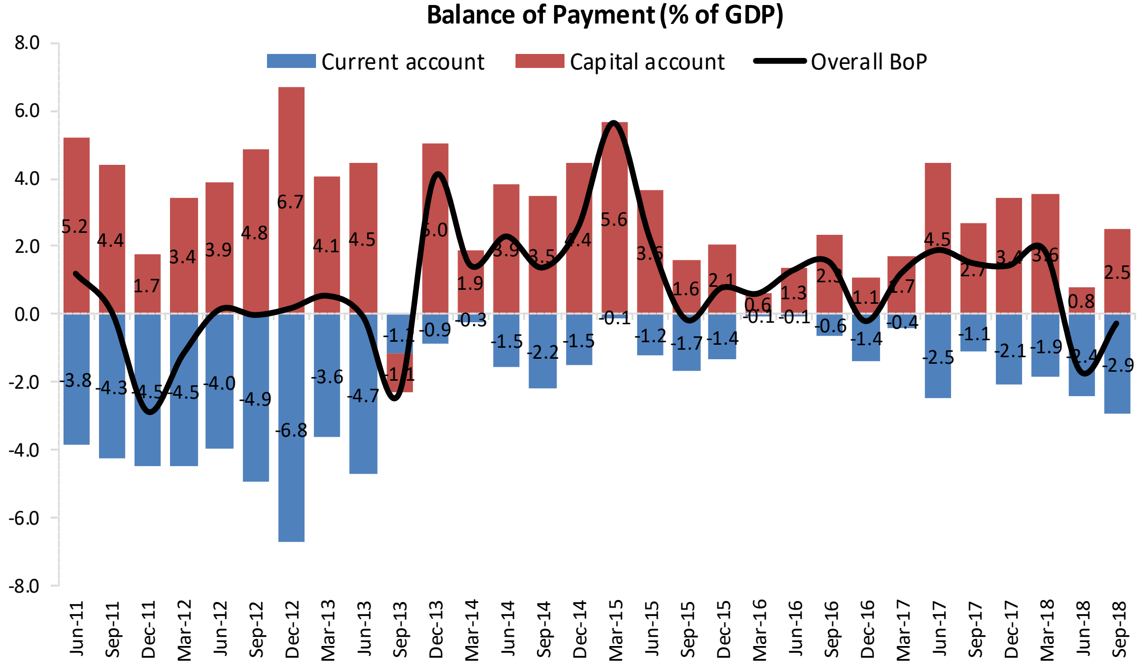


✓ While strong supply response has been a key factor for low food inflation, we note that under-nourishment level in India is still high and weak demand and low rural wage growth could also be one of the reason for low food inflation.

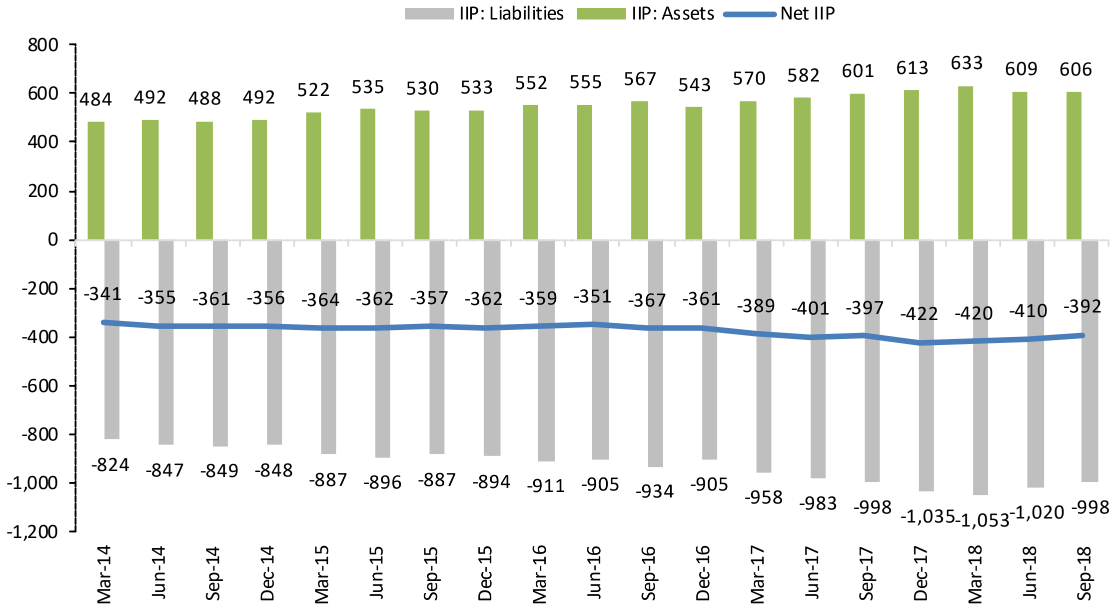
Source: FAO, CEIC, ABSLAMC Research

Lower crude to drive improvement in current account

BoP to return to surplus



Net IIP liabilities has declined



- ✓ Indian BoP has been in deficit 1H FY19 given the rise in current account deficit due to higher trade deficit (crude an important reason) as well as decline in capital account surplus due to FII outflows
- ✓ While the recent increase in CAD is largely due to higher oil deficit, there has been a steady decline in current account ex-oil, gold reflecting deterioration in competitiveness.Assuming average crude of 65, we expect current account deficit to be around 2.2% of GDP.
- ✓ The improvement in net-IIP liabilities reflect capital outflows in 2Q and 3Q CY18

Source: CEIC, ABSLAMC Research

INR over-valuation has corrected

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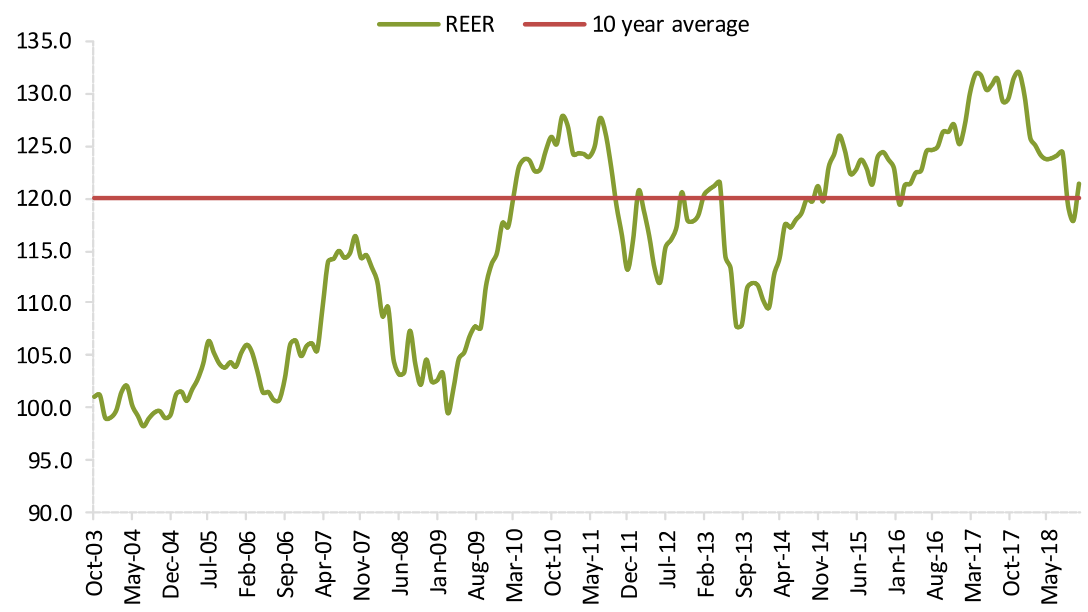
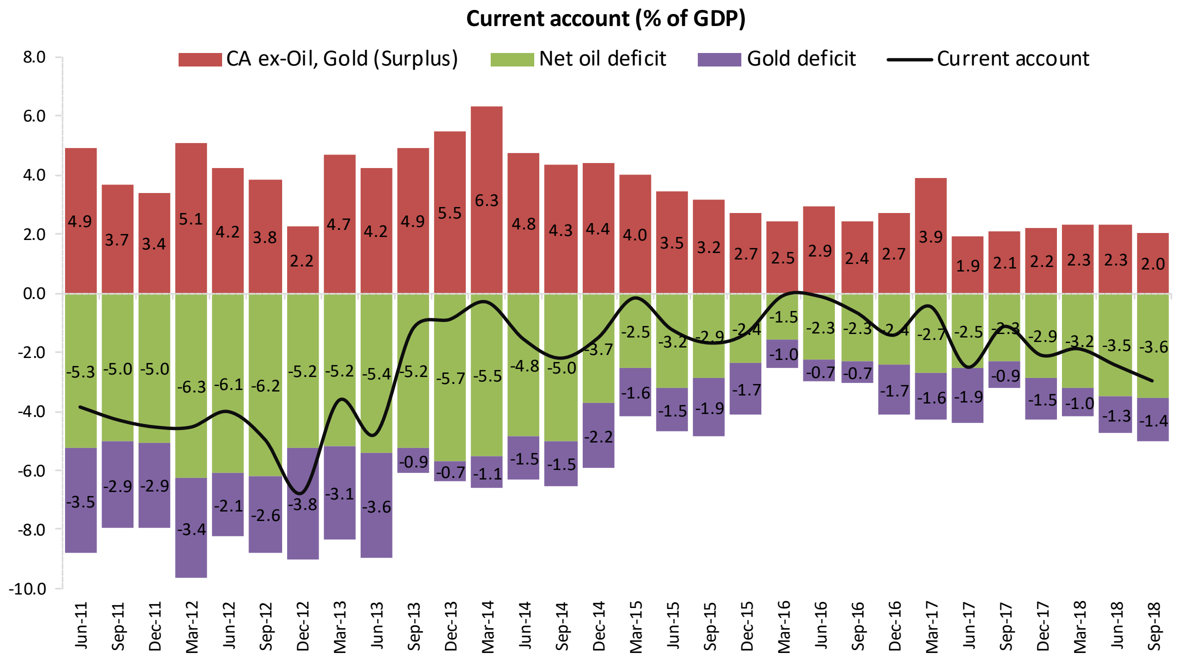
INR REER declines to average level



Non-oil, non-gold current account has steadily weakened



- ✓ The recent fall in INR has reduced its over-valuation in real exchange terms (REER) and should help in improving competitiveness and current account balance
- ✓ Note the steady declining in current account ex-oil ex-gold, which reflect steady weakness in competitiveness, partially due to an over-valued exchange rate
- ✓ We expect 68-75 range in INR through the year

Source: CEIC, ABSLAMC Research

Low crude price is quite positive for India external account

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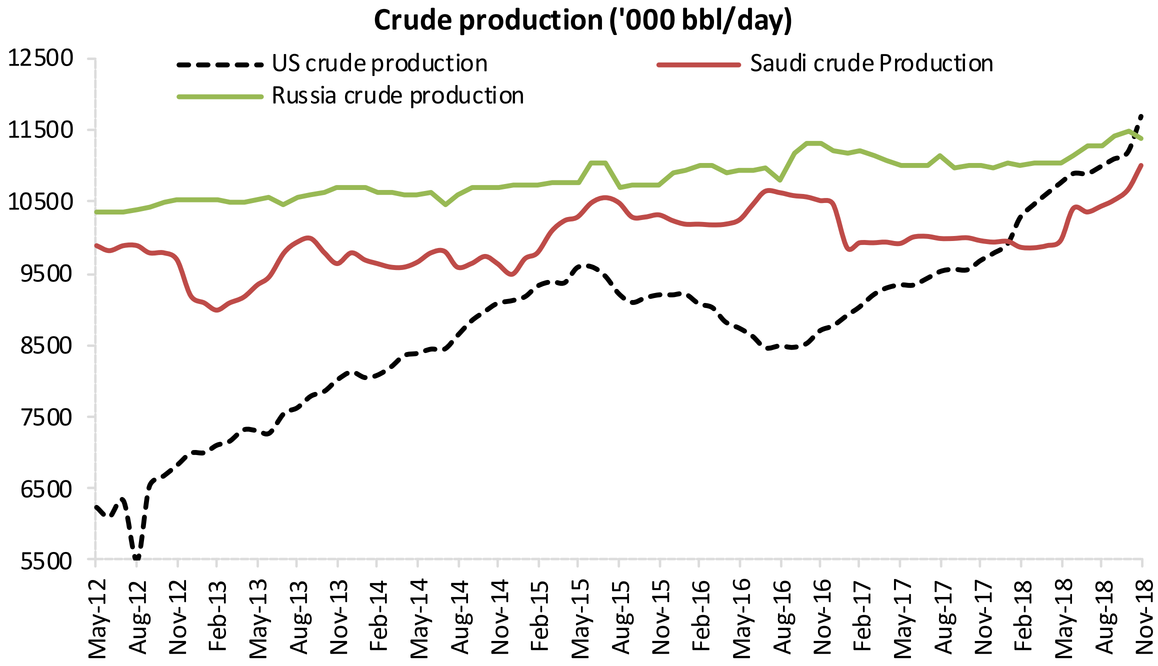
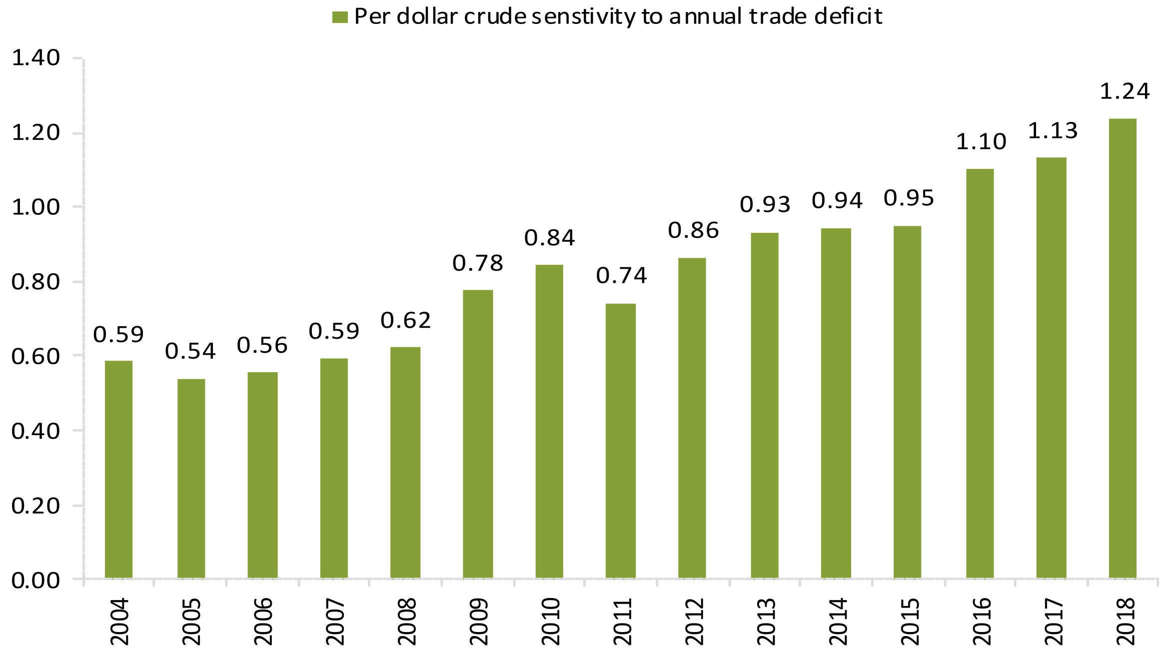
Sharp rise in shale oil production drives down crude oil prices



Crude price sensitivity has increased through the years as imports increase



- ✓ Sharp fall in crude price, driven by strong growth in US shale output, is the key reason for our benign outlook on external account
- ✓ Per dollar movement in crude price has ~1.25 bn annual impact on trade deficit

Source: CEIC, ABSLAMC Research

Forex reserve cover has depleted following heavy RBI intervention

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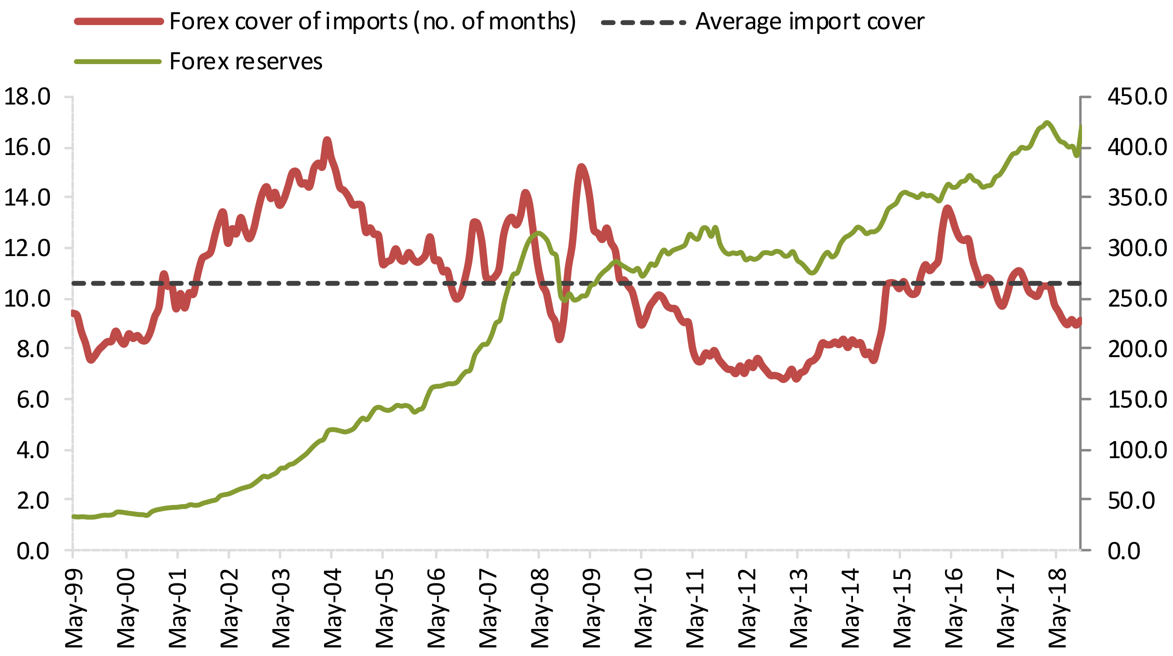
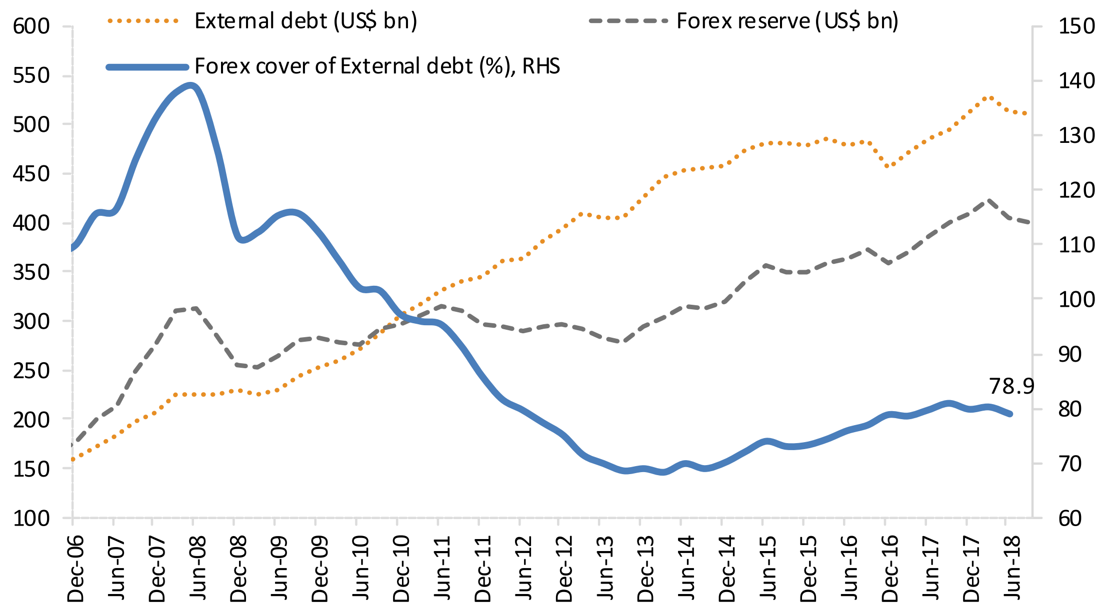
Import cover of forex moves below 10 year average



Forex reserve cover has marginally declined despite lower external debt



- ✓ Heavy intervention by RBI in the currency market- above 31bn USD in spot, besides 23bn in forwards- has lead to forex reserve falling to US393 bn
- ✓ Consequently the forex import cover has declined to below 10 year average and external debt cover has also declined. RBI would ideally like to recoup its forex reserves should there be a BoP surplus

Source: CEIC, ABSLAMC Research

Foreign flows likely to remain under pressure

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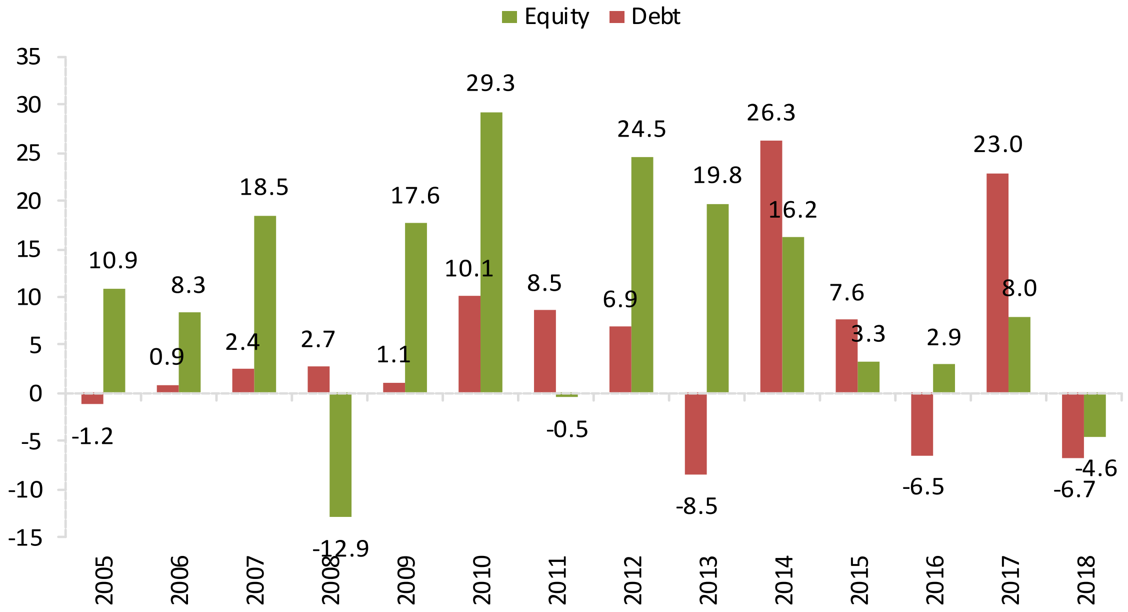
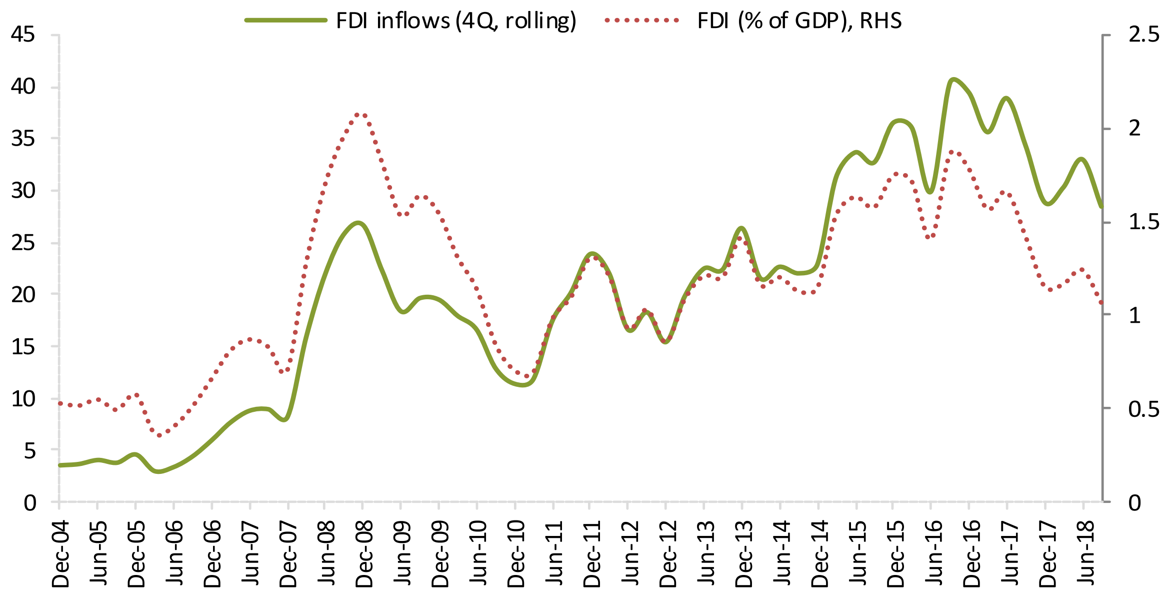
2018 has witnessed highest FII outflow on record



FDI flows albeit decent have also trended lower



- ✓ Given the global backdrop of sell-off in EM assets, India also witnessed outflows by foreign investors
- ✓ In 2019 foreign flows shall remain under pressure unless there is clarity on government formation post General election.
- ✓ Beside the India specific political risk, EM outlook, especially with respect to US-China trade negotiations and general global growth outlook shall be key variable determining foreign flows picture

Source: CEIC, ABSLAMC Research

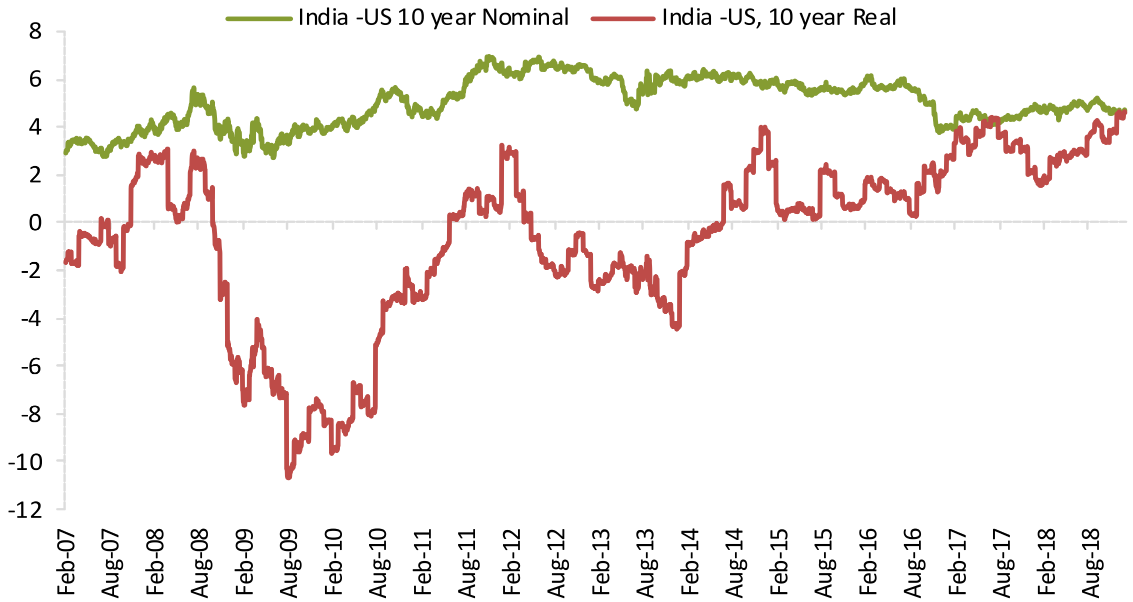
Summing up

- ✓ We **expect marginal uptick in growth towards 7.2% to 7.5% level in FY20 (7.2% in FY19),** in our base case assumption of stable government post elections and only a moderate global growth slowdown
- ✓ High capacity utilization should drive a nascent investment recovery. Moreover, lower crude price, peaking banking sector NPAs, possibility of a rural stimulus and election related spending are other tailwinds.
- ✓ Given low investments in last few year, capacity utilization has risen to highest level since 2012
- ✓ While public capex into infrastructure continue to drive investments, we are witnessing early signs of revival in private capex as well
- ✓ **If global sentiments doesn't worsen significantly and we have a stable government in post General election, then we are set for a further pick-up in investment cycle in 2019**
- ✓ We expect the sharp decline in food inflation to at least partially normalize in 2019 and **convergence in food and non-food inflation in 2019 towards ~4.5% range**
- ✓ Assuming average crude of 65, **we expect current account deficit to be around 2.2% of GDP.**
- ✓ We believe 10year is at neutral zone currently and we expect a range of 7.10 to 7.70 in 1H.
- ✓ The key risk in 1H are Indian general election, evolution of Fed monetary policy, US-China trade talks, slowing global growth and turbulent financial markets. Given the sharp decline in food inflation we expect policy bias to change to neutral in Feb policy.
- ✓ 2H will be determined by the election outcome and extent of global slowdown and unwind of Fed interest rate expectation.
- ✓ Shorts term rates have peaked for this cycle so have AAA Corp spreads. 1-3 year bonds wind-down the extra spread in the run up to Mar/Apr as huge OMOs start to improve ICD's.

Spread and asset allocation

India spread at elevated levels

India Vs US real spread at elevated levels



India Vs EM 10 year rates

Source: Bloomberg, ABSLAMC Research

Corporate spreads at elevated levels

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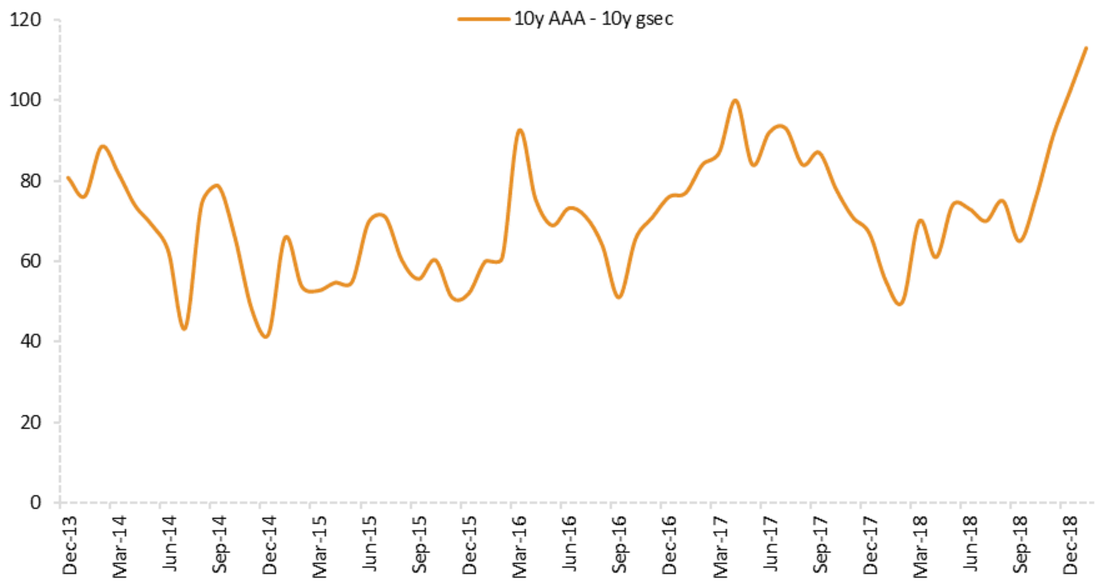
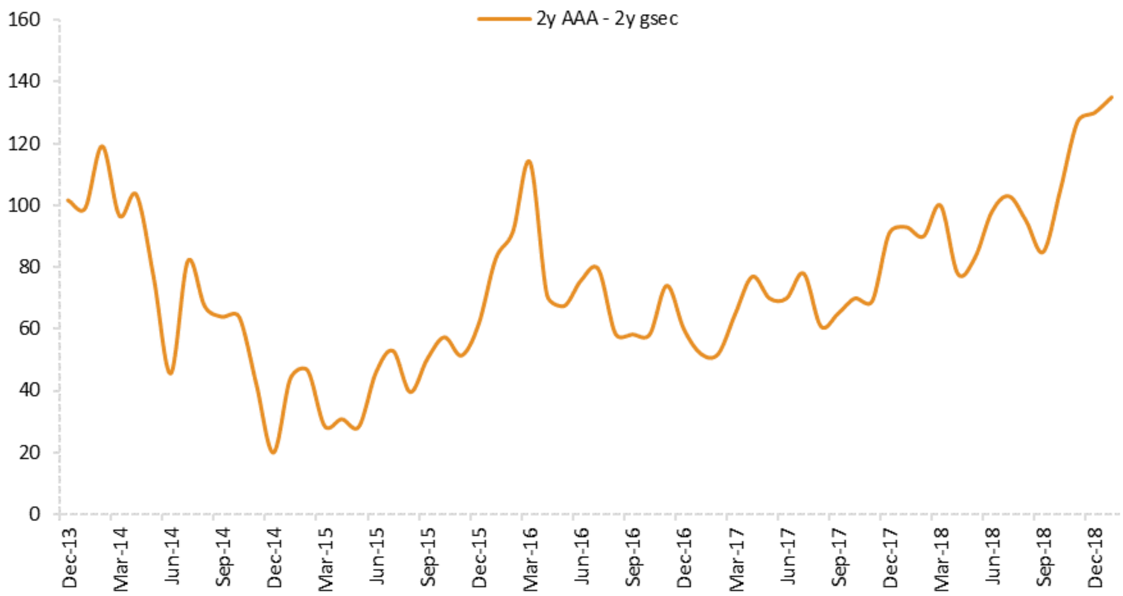
AAA PSU Spreads at Multi Year High



Short End looks attractive



- ✓ Tight liquidity caused spreads to go up, but now with RBI aggressively providing durable liquidity, we find short end corporate spreads to be attractive

Source: CEIC, ABSLAMC Research

Short end AAA Spreads are at 5yr High

Source: Bloomberg, ABSLAMC Research

… so are AA Spreads

Source: Bloomberg, ABSLAMC Research

Asset allocation

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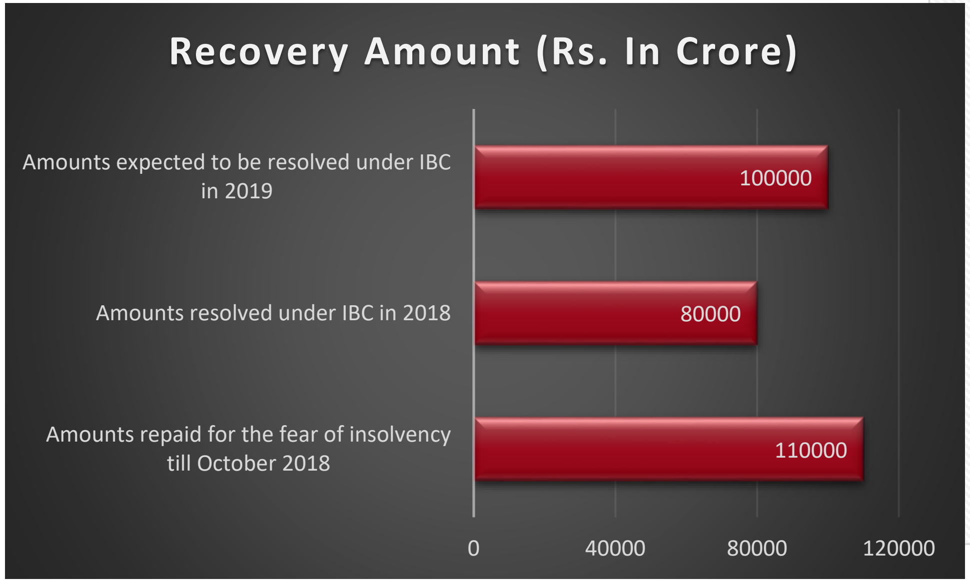
Investor type	Fund proposition (Duration)
Conservative investors	Low Duration Fund, FMPs
Active Investors- Moderate Volatility and low credit risk (Predominantly AAA papers)	Banking and PSU fund, Corp bond Fund
Active Investors- Moderate Volatility and credit risk (Mix of accrual and AAA funds)	Credit Risk Fund

Credit Outlook

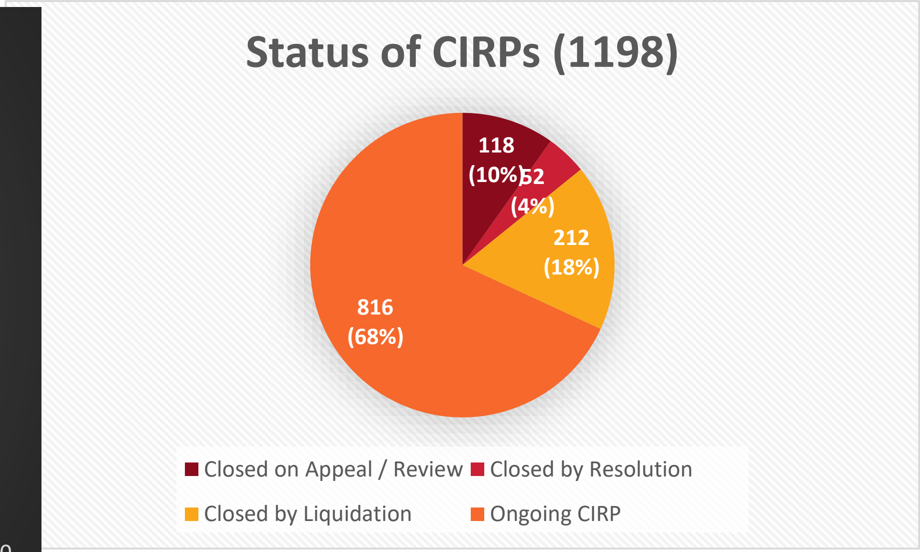
Legal – Developments and Outlook

Legal Outlook

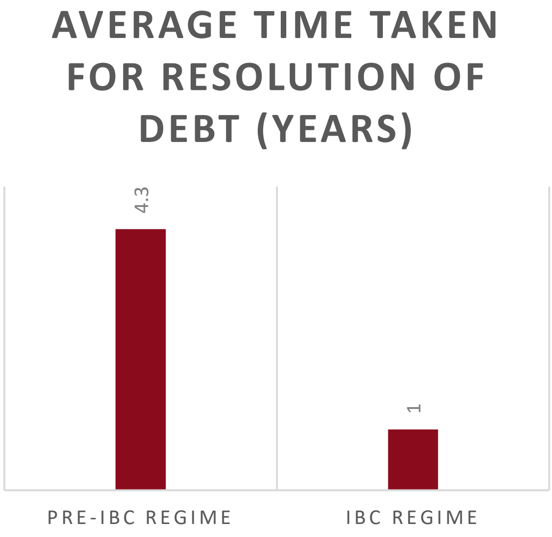
- ✓ The legal reforms (implemented and in pipeline) have created a very positive outlook for lending business since the creditors have been provided with a potent tool for recovery from defaulting corporates in the form of Insolvency and Bankruptcy Code, 2016.
- ✓ NCLTs (under the IBC) have helped resolve insolvency and bankruptcy proceedings and recover debt of more than ₹80,000 crore in 2018 and is expected to resolve insolvency cases amounting to more than ₹1 trillion in 2019.
- ✓ It has been reported that many promoters have settled the dues out of the court for the fear of losing control over their companies running their flagship business.



Source: Times of india, business standard, mint



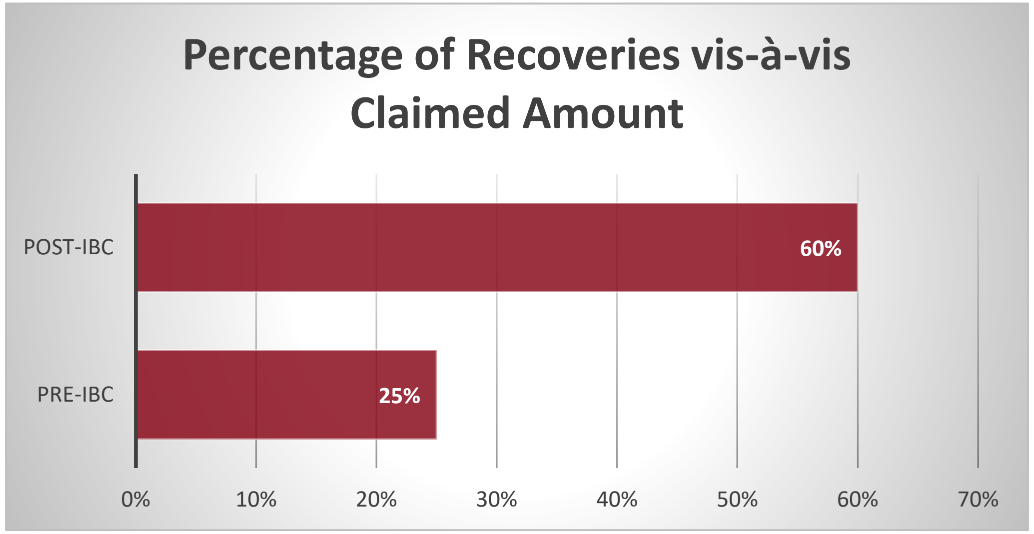
source: ibbi.gov.in



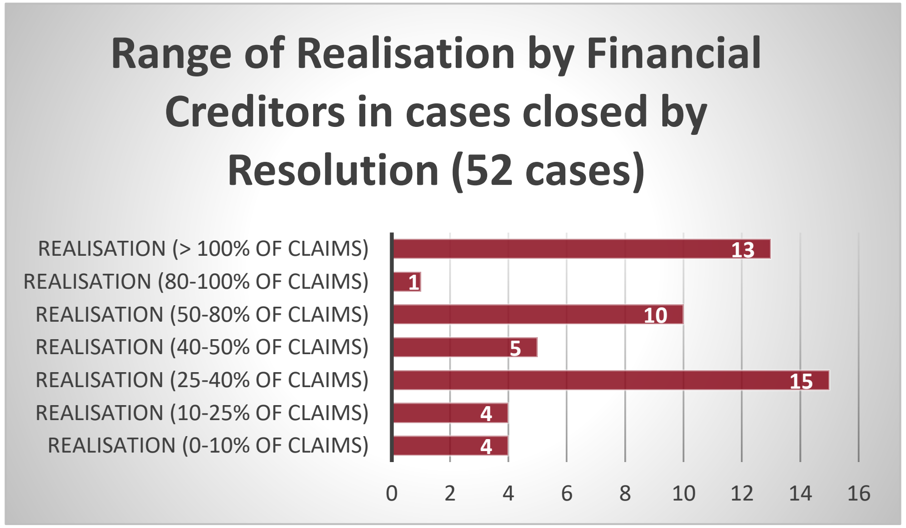
source: Financial express

Legal Outlook

- ✓ The courts have laid down many important legal principles under IBC boosting the recovery process by creditors (in some cases settling the legal positions). Following are some recent principles (subject to final adjudication by Supreme Court in a few cases):
- ✓ NCLT, Delhi bench considered put-option agreement as a guarantee and thus a 'financial debt' enabling the lender to recover money from the purchaser as its financial creditor;
- ✓ The Supreme Court allowed invocation of personal guarantee holding that the moratorium under section 14 of IBC will not apply to the guarantors which has since been clarified vide an ordinance.
- ✓ The Supreme Court held homebuyers to be 'financial creditors' which has since been clarified vide an ordinance.



Source: economic times, financial express, ibbi.gov.in



Source: ibbi.gov.in

Legal Outlook

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- ✓ NCLAT has held that the resolution plan cannot discriminate between similarly placed creditors (whether operational or financial).
- ✓ NCLAT has held the personal guarantor has no right against the corporate debtor effectively permitting a guarantor's right of subrogation being taken away under a resolution plan.
- ✓ The Government's plan to de-clog NCLTs by amending the Companies Act, 2013 to do away with minor offences, divest NCLTs of its responsibility to approve M&A transactions and to add additional NCLT and NCLAT benches increasing their bench strength will result in NCLTs getting more time and manpower to resolve insolvency and bankruptcy cases.
- ✓ Apart from the aforesaid, the fast paced legal reforms under legislations such as Fugitive Economic Offenders Act, 2018, The Companies (Amendment) Ordinance, 2018, The Negotiable Instruments (Amendment) Act, 2018, The Commercial Courts, Commercial Division and Commercial Appellate Division Of High Courts (Amendment) Act, 2018, Insolvency and Bankruptcy Code (Amendment) Act, 2018 and pending bills such as, The Arbitration and Conciliation (Amendment) Bill, 2018 and the Insolvency and Bankruptcy Code (Amendment) Bill, 2018 are aimed at expediting debt recovery and will play an instrumental role in providing additional ammo to the creditors.

Real Estate

Real estate: Residential – 1st Half 2018.

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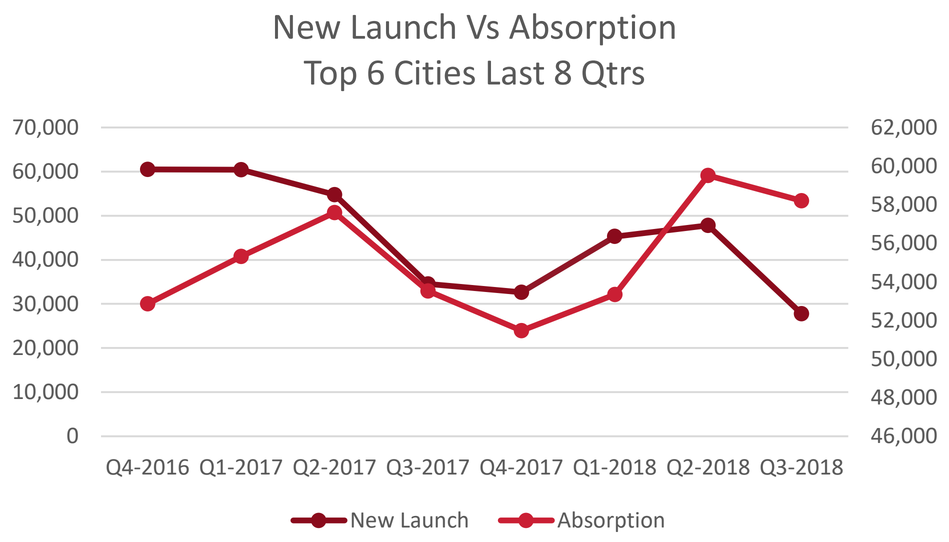
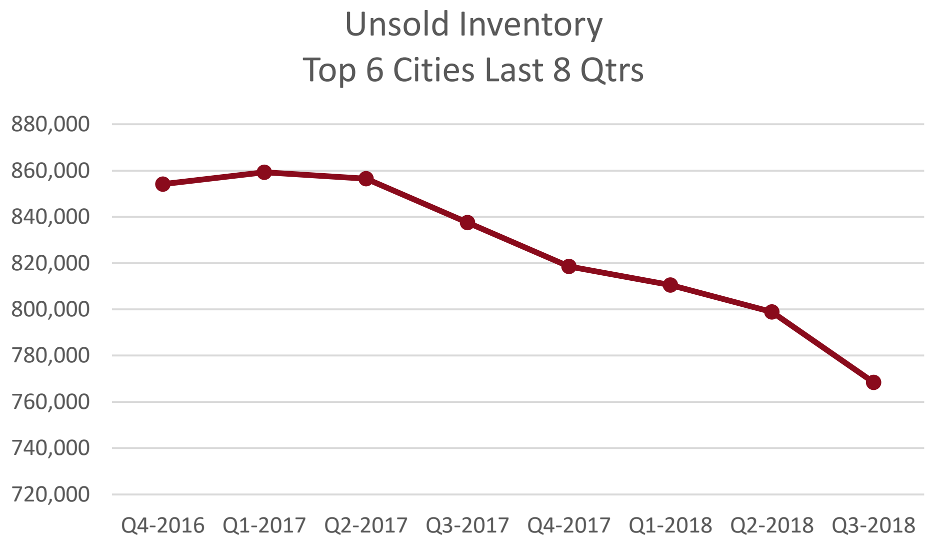
Strong Absorption vs falling new launches

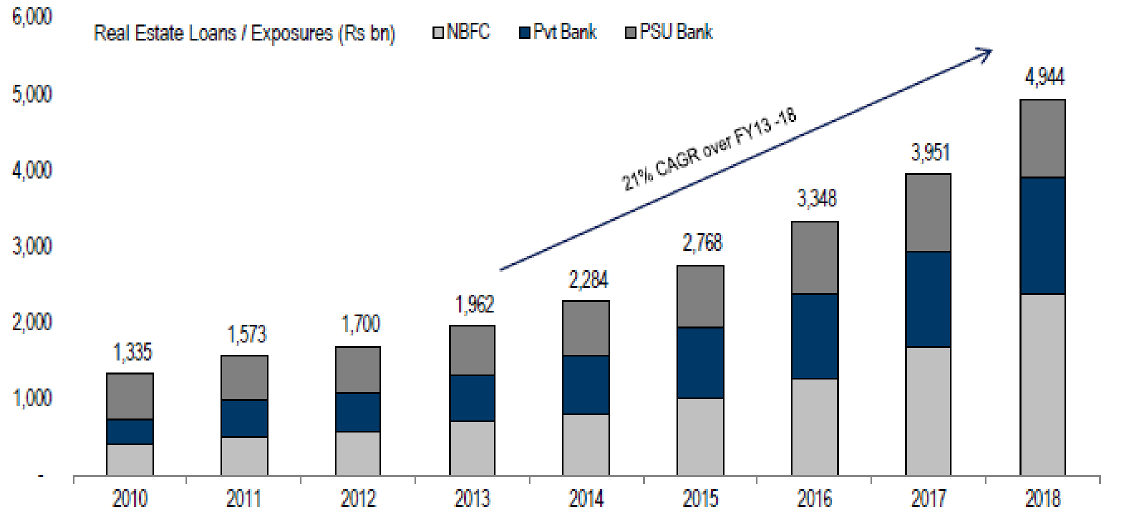


Inventory overhang getting reduced



- ✓ New Residential absorption bottomed in Q42017. However, there has been a steady uptick over last 3 quarters.
- ✓ Launches, which are best indicator of developer and buyer sentiment, had tapered off from 65k units in FY16 to 15k units in Sept 2018. Sentiment continues to be poor but demand had stabilized and improved – with increased affordability.
- ✓ Slowing down of new launches has lead to reduction in inventory and developers focusing on ongoing project execution.
- ✓ Strong demand in affordable housing has lead to developers increasingly launching and re-pricing projects at lower ticket sizes that cater to the needs of bulk home buyers.
- ✓ Affordable housing is expected to lead the demand for housing in 2019 with consumers preferring ready-to-move in inventory, and gated communities vs standalone buildings.

Real Estate Way Forward: Q3 2018; impact on supply & demand



Source: Company data, Credit Suisse estimates

Real Estate lending has grown at 20% CAGR in last 5 years – led by NBFCs

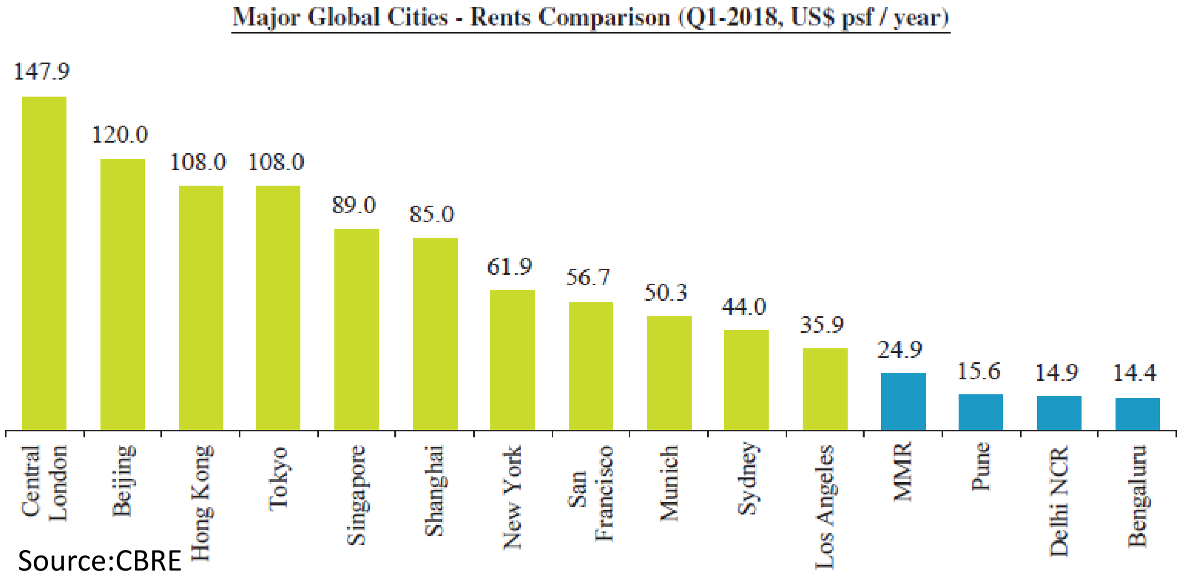
- ✓ In light of the recent liquidity crisis, funding to RE developers from non-banking financiers have slowed considerably. **In addition to developer finance, this slowdown has extended to mortgage finance as well.**
- ✓ Effects of recalibration of interest rates should take a toll on demand over next 6-9 months as both legs of the financing cycle – developer to project (CF) and project to consumer (mortgage) re-settle – and a new lending rate environment emerges.
- ✓ Banks are expected to make use of this opportunity to gain market share. Non-bank's ability to finance will likely remain constrained in 2019. The slowdown in financing of mortgages would also reduce **affordability & demand to take 10-20% hit in first 6-9 months of 2019.**

Opportunity

- Real estate opportunity in 2019: We expect Real Estate sector likely to have a subdued 2019. Opportunity could be in piggy backing with consumer equity (as opposed to developer equity) in projects. Pre-sold projects/Mortgage finance/Rental re-pricing could be the play for 2019.

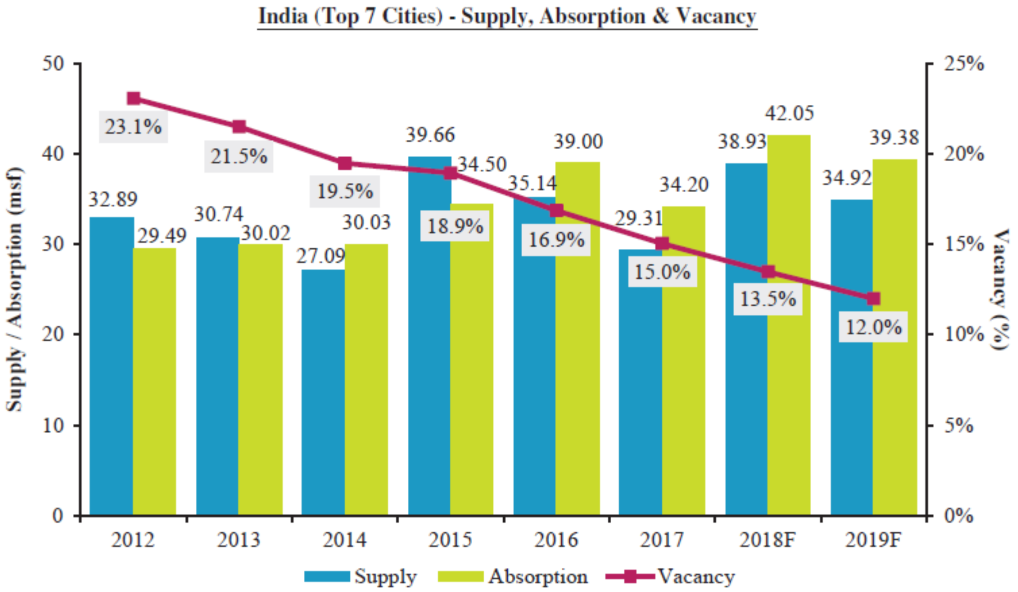
- A steady demand scenario in the face of consistently low supply has pushed down vacancy levels from 21% in 2013 to 13.5% in 2018
- Leasing crossed 32 Mn sqft in first three quarters of 2018, an increase of 7% Y-o-Y. Transactions crossed 10.9 Msqft in Q3 2018 alone. Bangalore, followed by Mumbai, Hyderabad and NCR led leasing activity.
- On the Commercial Real estate the **rental growth story remains intact as supply continues to lag demand. Tier 2 developers will find it difficult to compete as the commercial segment is seeing a steeper upgradation of work areas/space than the residential segment**.

Key Commercials markets in India offer significantly cheaper rentals compared to global commercial hubs



Source:CBRE

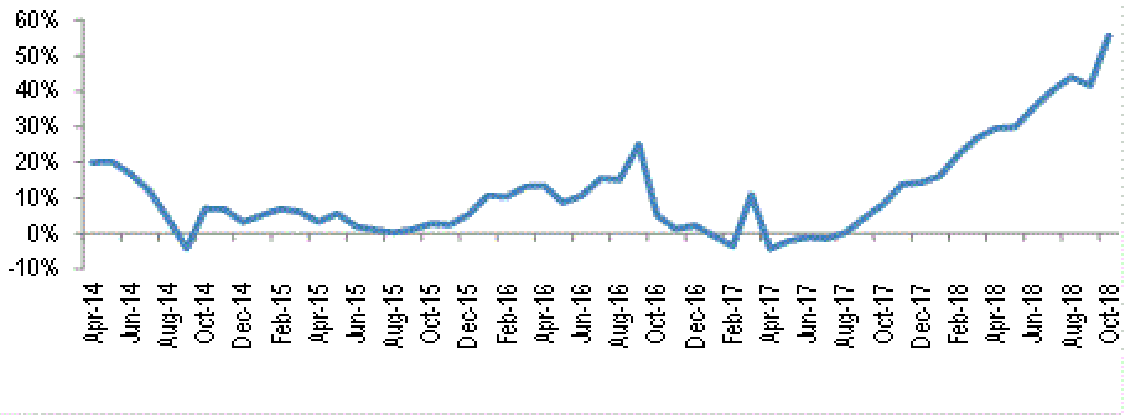
Demand Still running ahead of supply. Disruption to delay supply further



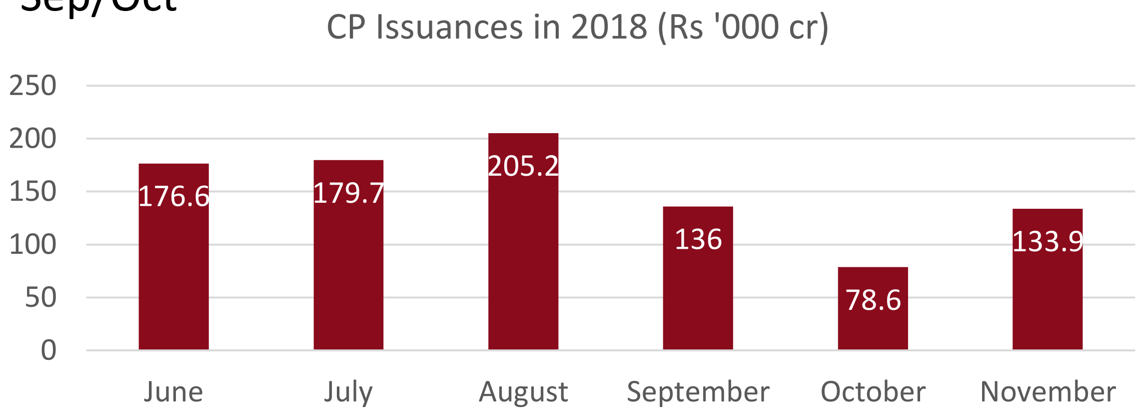
NBFCs and HFCs

2018: Liquidity shocks largely abated, flow towards quality

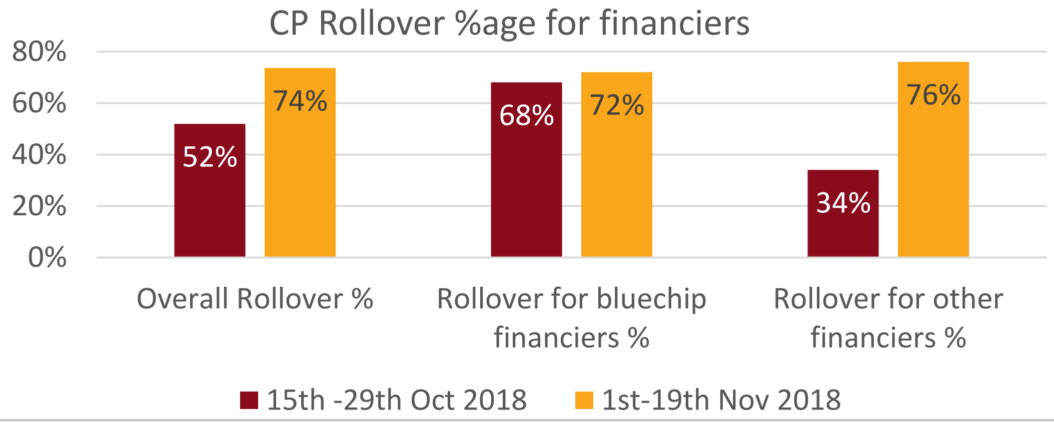
Credit growth to NBFCs had accelerated substantially (yoy%)



Before liquidity from capital markets was tightened in Sep/Oct



Liquidity to sector started opening up in November



'Flight to safety' and risk aversion have widened differences between issuers who are perceived to be of good quality vs the rest

Concentration of MF Funding to NBFCs	Sep-18	Nov-18
Top 5 issuers as % of Total funding	25%	32%
Top 10 issuers as % of Total funding	44%	49%

Source: RBI, Industry Research

2019: Asset quality pains could start to emerge for some players

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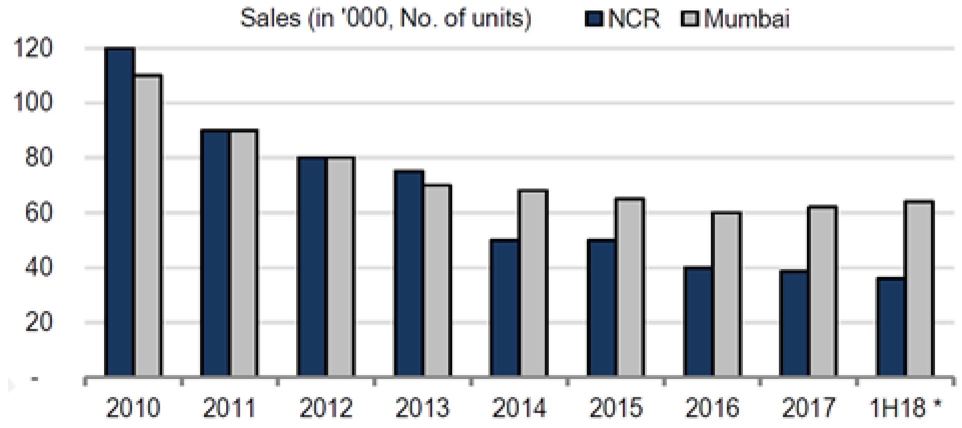
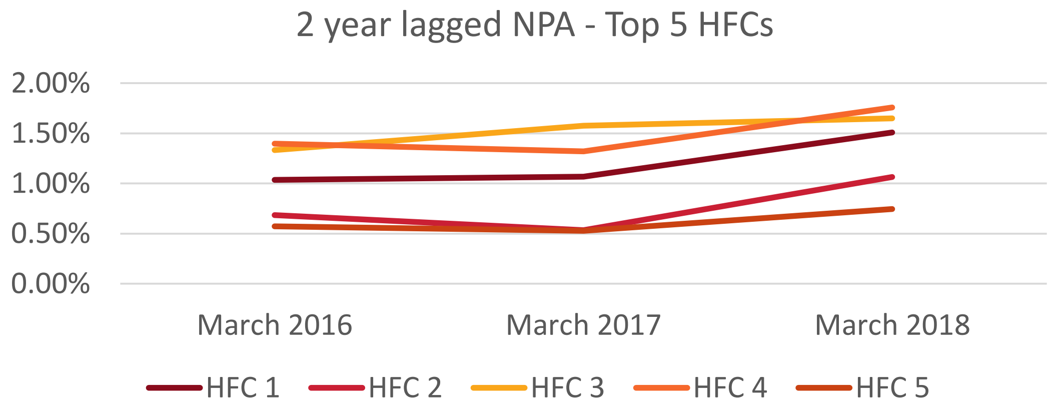
Sales in Real Estate have still not picked up meaningfully



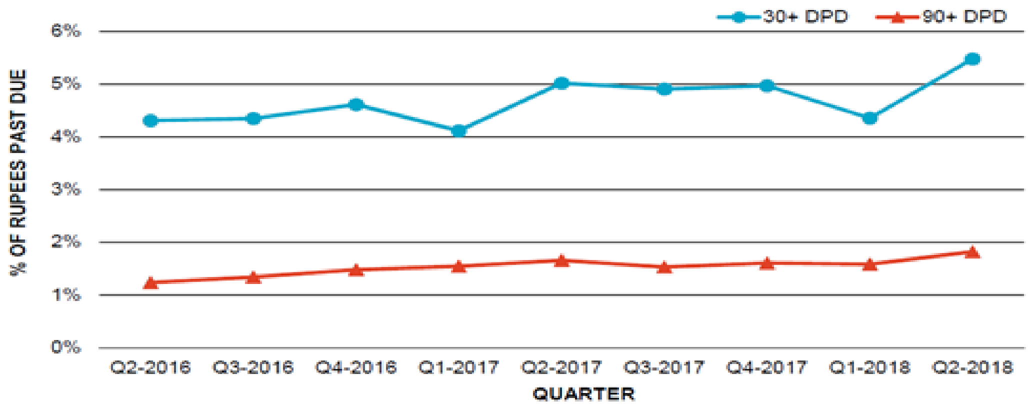
But Non-Banks have been financing almost all incremental debt in the sector, essentially doubling down on near term RE sector revival

	2015	2016	2017	2018	3 yr CAGR (%age)
Non Banks (%age share)	29.7%	38.3%	44.6%	51.2%	40.5%
Banks (%ge share)	70.3%	61.7%	55.4%	48.8%	3.7%
Total (Rs lakh cr)	2.37	2.88	3.35	3.81	17.1%

Asset quality is slowly worsening for the largest mortgage financiers



And the micro data for nation-wide mortgage asset quality is showing a worsening trend too



Source: Company, Industry Research, CIBIL

2019: Retail asset classes expected to perform well

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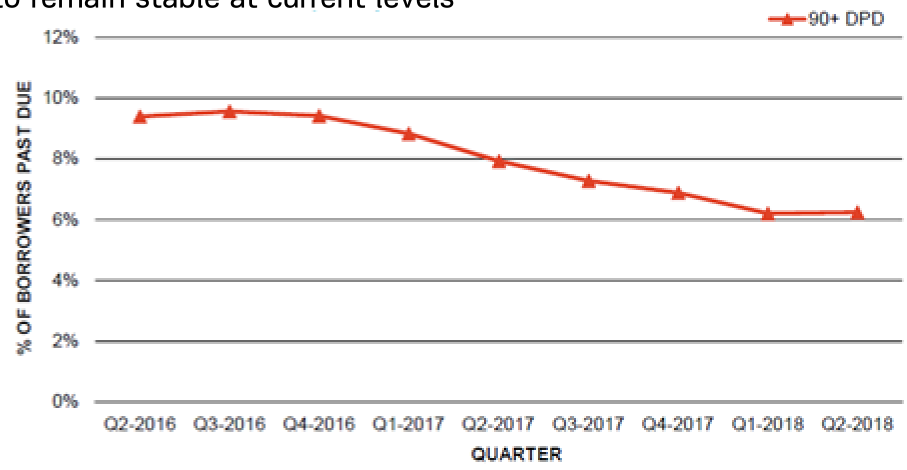
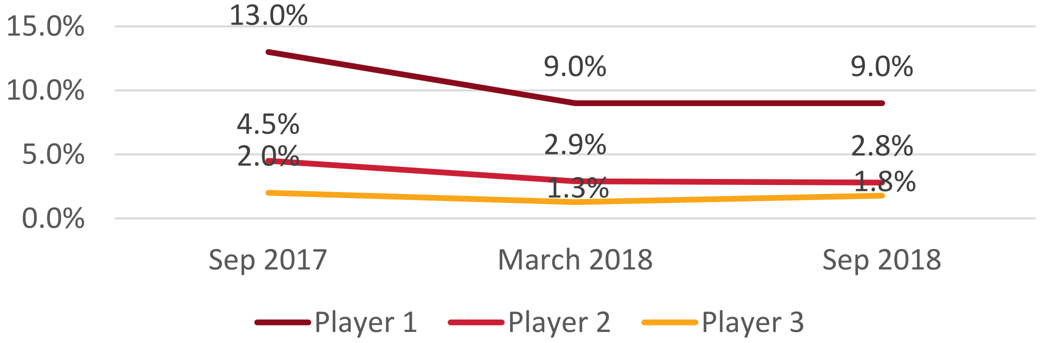
As an asset class, auto loans have shown a secularly positive trend. All vehicle financiers have migrated to the 90dpd convention, and asset quality is expected to remain stable at current levels



GNPA % of vehicle financiers have stabilized



Source: Company, CIBIL, MFIN

Microfinance asset quality continues to be very good, and with a stable to positive outlook for the rural economy, the asset class is expected to continue doing well

	State	PAR 30		
	Month	Mar-18	Jun-18	Sep-18
1	Uttar Pradesh	10.80%	6.34%	5.89%
2	Maharashtra	10.40%	8.37%	4.97%
3	Madhya Pradesh	6.30%	5.22%	3.58%
4	Karnataka	3.70%	3.41%	2.04%
5	Jharkhand	3.40%	2.37%	2.49%
6	West Bengal	1.10%	0.98%	0.65%
7	Tamil Nadu	1.50%	1.36%	1.09%
8	Orissa	0.60%	0.49%	0.48%
9	Bihar	0.80%	0.36%	0.51%
10	Kerala	2.70%	2.62%	2.89%
	Total	**4.44%**	**3.20%**	**2.40%**

Equity infusion in the sector over the last 12-18 months have strengthened the sector's capital base – increasing its resilience to face election year shocks (if any)

Rs cr	Sep-17	Mar-18	Sep-18
Debt	29451	39902	44273
Equity	7432	11109	12876
D/E	4.0	3.6	3.4

2019: SME financiers could face headwinds

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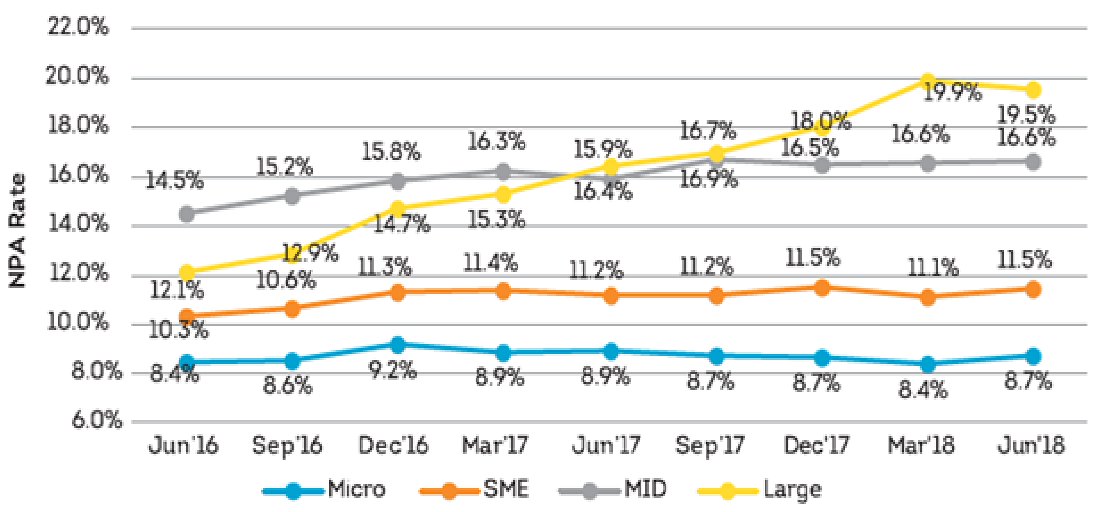
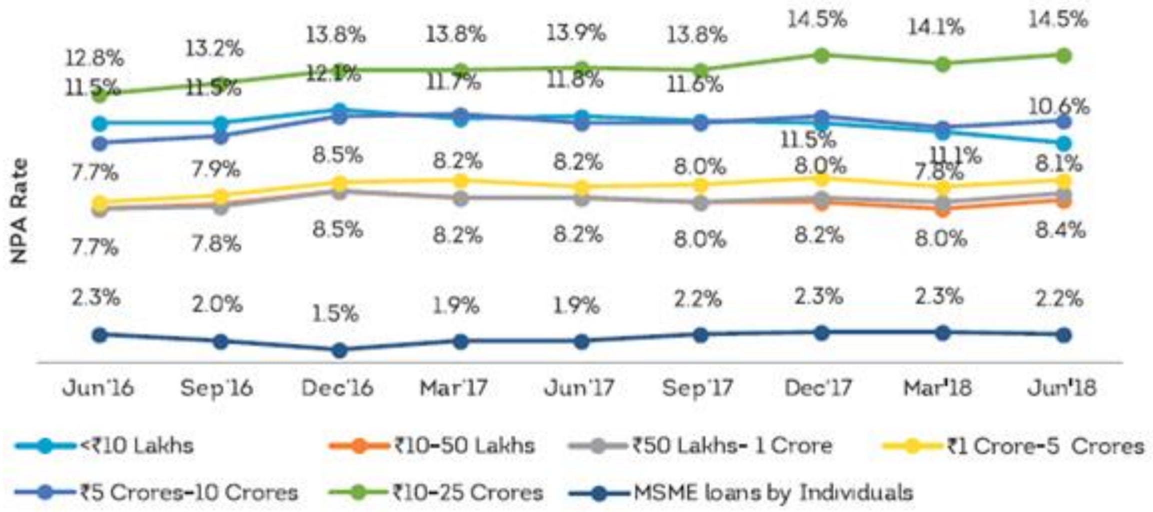
SMEs as a sector have historically continued to perform well versus large commercial lending (>100 crores)



But some granular ticket sizes (<10 Lakh ticket size) have not performed well.



Given that

a) large amount of capital deployed by various Banks/NBFCs in the SME segment over the last 1 year has somewhat loosened credit standards and;

b) LAP funding (another route for SME financing) is going to be much more subdued going forward,

We expect to see some SME financiers face asset quality issues over the next 12-18 months

Source: CIBIL

2019: NBFC/HFC Intra - Sector allocation

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Asset Class

Prefer: Retail Loan NBFCs, Asset Financier

Cautious: Real Estate Financing, Mortgage Financing

Preferred Issuer Characteristics

a) Long vintage, high pedigree NBFCs with healthy profitability. Issuers which have high rating (AAA/AA+) from rating agencies as well as through in-house credit research

b) NBFCs with loan assets that are bankable/securitizable, and where repayment is cash-flow backed

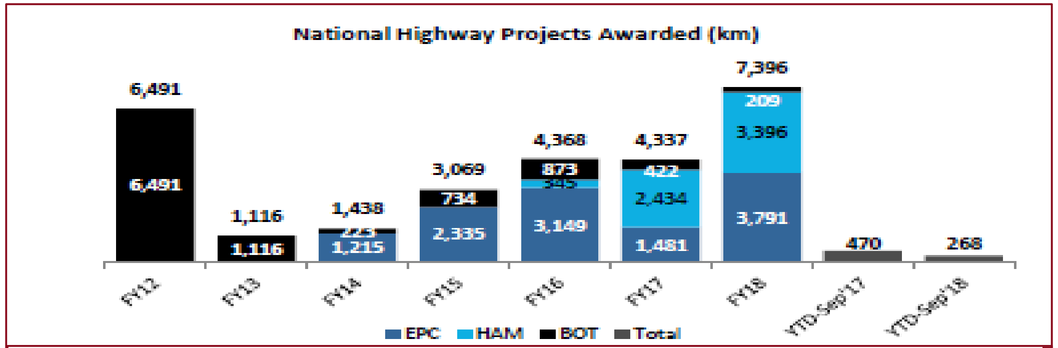
c) Well capitalized balance sheets with demonstrated ability of promoter to raise additional equity capital

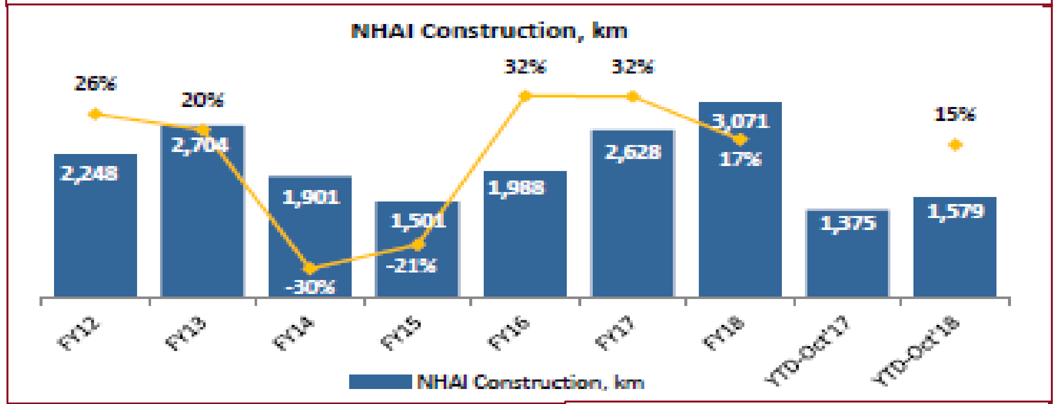
Sector Exposure Approach

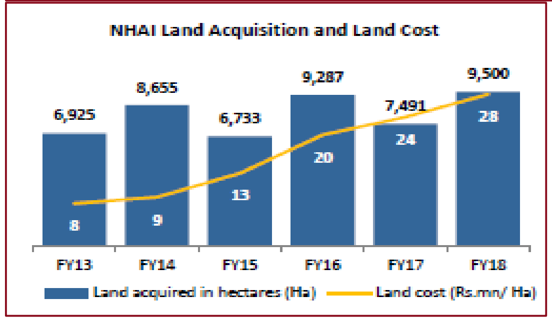
a) Portfolio Concentration: Defensive in terms of both NBFC sector concentration and Issuer concentration for all non-AAA Issuers across portfolios.

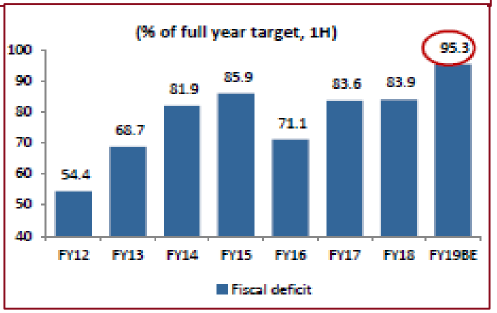
b) Credit Opportunity: Continue to seek out idiosyncratic opportunities with a specific focus on smaller, less discovered NBFCs such that there is a sufficient margin in the risk-reward ratio.

Roads & Infrastructure









Source: Spark Capital, ABSLAMC Research

❑ Recent Trends

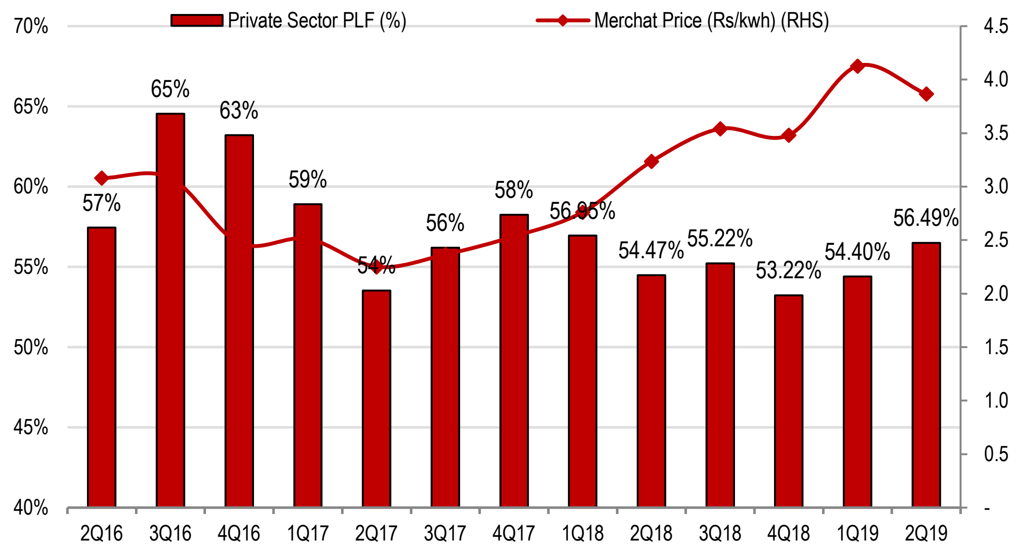
- Projects in the Road sector have an increasing share of EPC and HAM models, with a minimal share of BOT (Toll) segment;
- During H1'FY19, the Govt. missed its project award target and awarded only 268 k.m against its target of ~3000 k.m. This was mainl due to (i) delay in finalising DPR and (ii) increase in Land acquisition costs, which delayed land acquisition; For FY'19, ~ 4000 k.m of roads as expected to be completed(target of 6000 k.m);
- New projects have been largely won by ~6 co. in FY'18 (6 out of 30 projects yet to achieve Financial closure in BOT (HAM) space);
- Subdued Investors' interest for TOT project has compelled NHAI to extend deadline for 3 times; bid value of highest bidder in ToT 2 was ~15% lower than IECV as compared to 1.5x higher during ToT1.
- The new project award activity is expected to be slower in Q4'FY'19 due to (i) General Elections in May 2019 (ii) few HAM projects are yet achieve F.C. (iii) worsening fiscal deficit of centre (reached 95% of Full year target in H1 of FY'19)

❑ View / Outlook

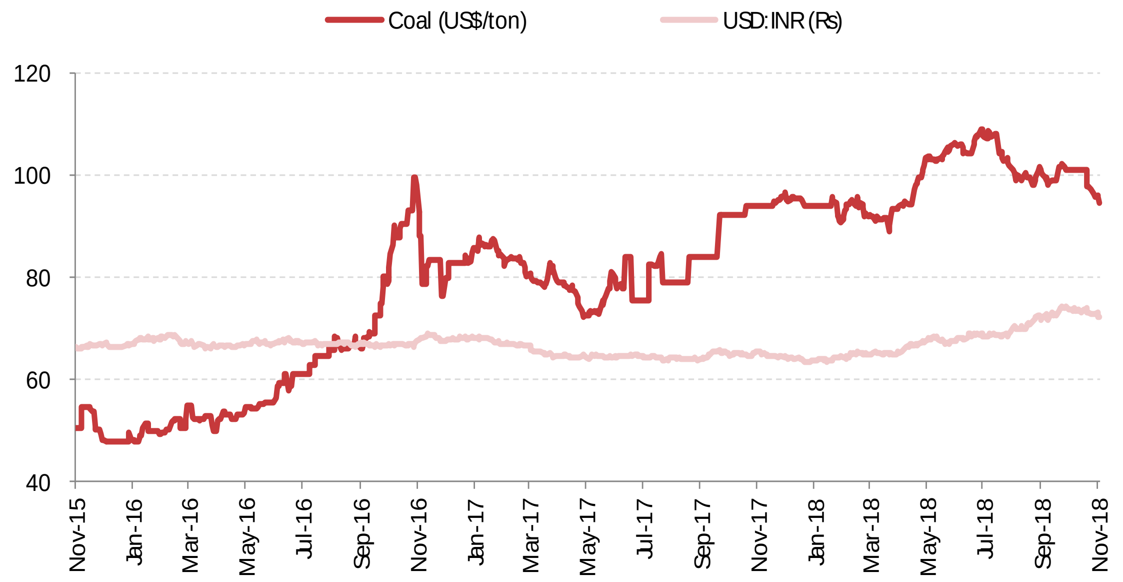
- Companies with EPC projects are expected to do well as Banks would be comfortable lending for their working capital requirements;
- Banks are expected to remain cautious with funding HAM projects as (i) many PSU banks are under PCA and don't have the appetite to take further Infra exposure; (ii) Some Private Sector banks and NBFCs would take exposure selectively considering non-levered Balance sheets and risk return trade offs;
- More HAM projects are expected to hit the market to refinance existing debt at lower cost.

Power-Thermal showing sign of improvement

Thermal coal PLF and merchant price increasing



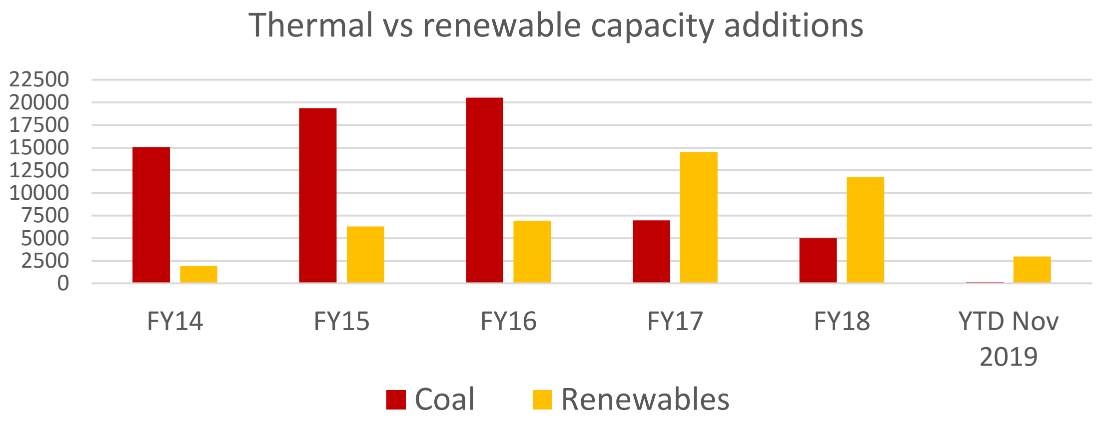
Imported coal price showing sign of mdoeration

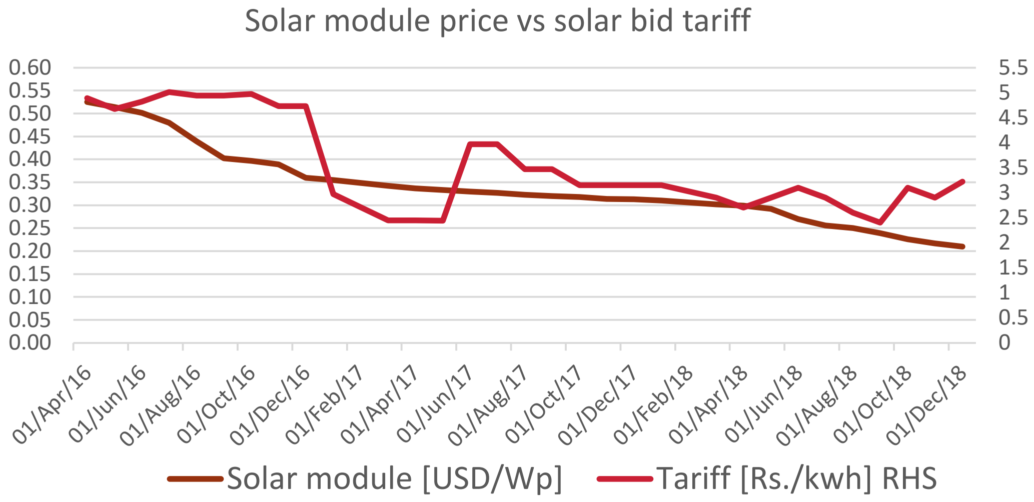


- ✓ Private IPP [coal based] PLFs saw improvement in Q2 2019 due to increase in demand coupled with no new addition of capacity.
- ✓ Daily/monthly merchant prices remain volatile (reached ~Rs.6/kWh in October 2018) although average quarterly price remains below ~Rs.4/kwH.
- ✓ Price of imported coal has increased sharply in H12018 which, coupled with the rupee depreciation has impacted the viability of imported coal based power plants. However, imported coal prices have started moderating, providing some breather to power producers.

Source: ABSLAMC Research, Industry Research

Renewable –capacity addition surpass coal; returns under pressure





- ✓ Only 165 MW [net capacity] was commissioned in coal based capacity till Nov. 2018.
- ✓ Capacity addition in FY2019 has primarily been in the renewable segment at 6.5 GW. However, the same is ~60% short of the target [16 GW].
- ✓ Capacity addition FY 2019 was impacted due to (i) arbitrary ceiling tariff & in tender/bidding impacting returns of bidders (ii) constraint in Transmission capacity; (iii) high cost of land acquisition and (iv) slow auction of renewables in FY18 for solar and Wind commissioning is also delayed by 6 – 8 months under various auction.
- ✓ At current bidding levels, renewable players are likely to make low returns. The subdued interest from bidders has resulted in increase in solar tariff recently to Rs.3.2 in Gujarat bid in December 2018.

Source: ABSLAMC Research, Industry Research

Power –overall demand to increase; coal PLFs to increase

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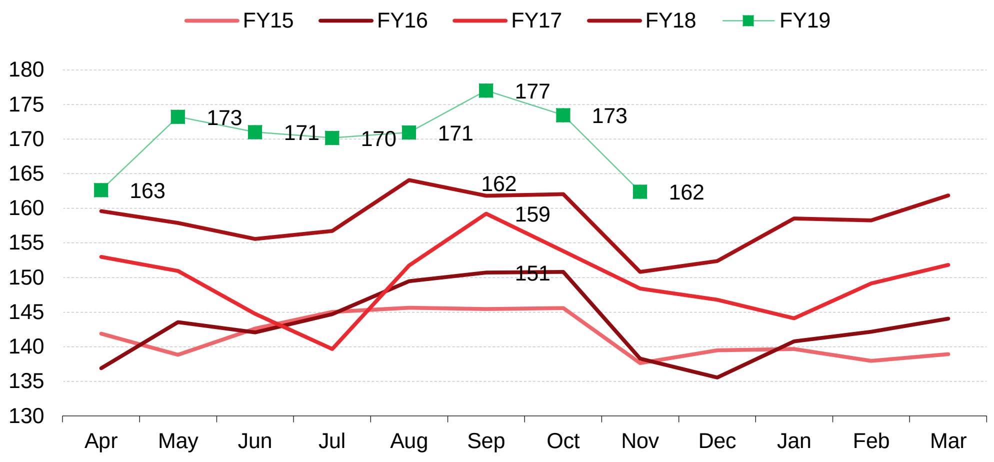
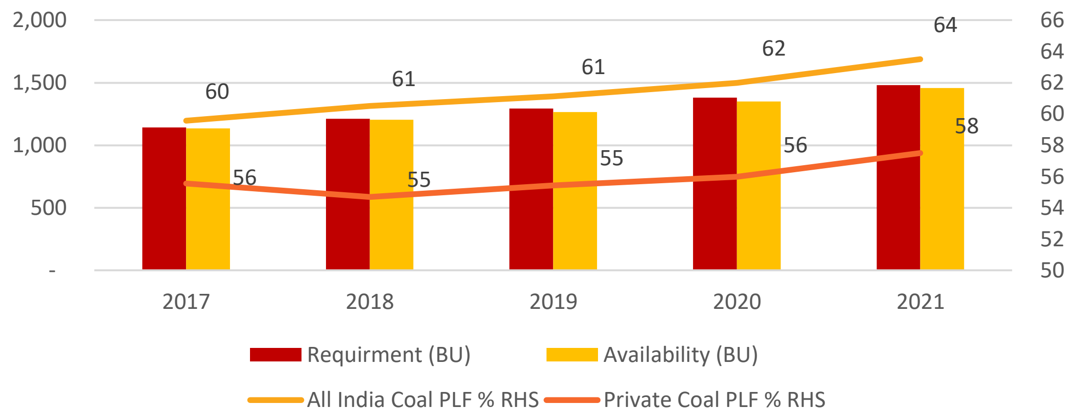
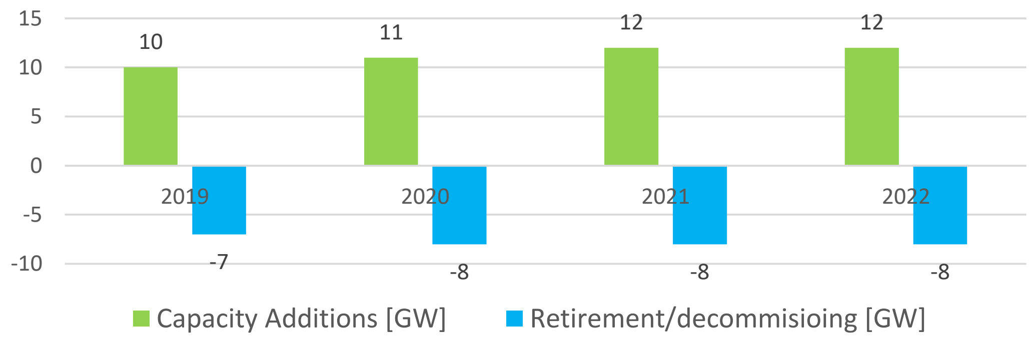
Increasing power demand



Energy requirement,availability and All India & private coal PLF



Coal capacity addition to be almost equal to retirement of old plants

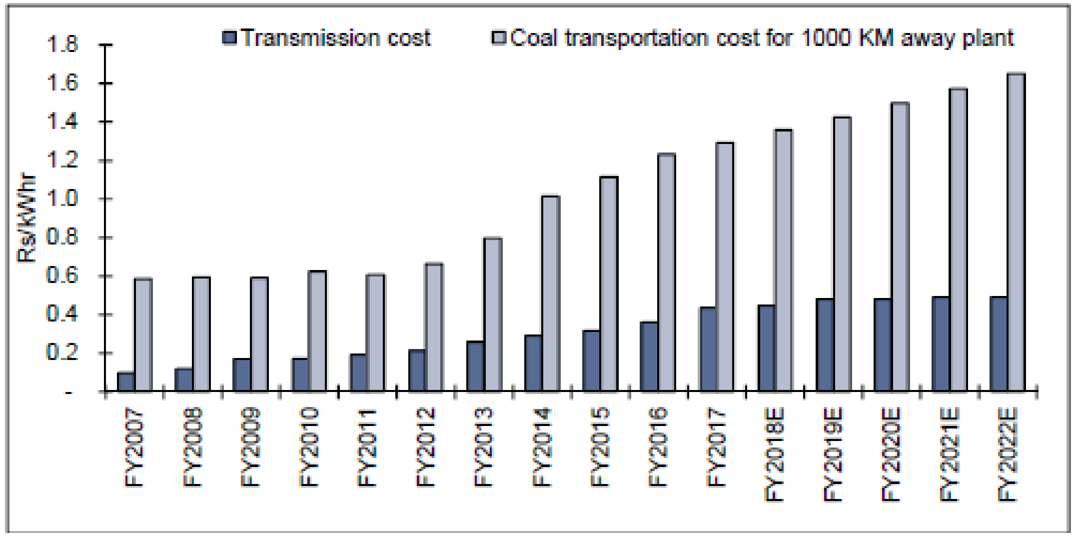


- ✓ Average Power demand is expected to see positive growth given the pre-election season.
- ✓ Merchant tariff is expected to remain moderated considering SEB health, reluctance of SEB to sign long term PPA and demand supply balance.
- ✓ ~35 GW out of 197GW of coal-fired power plants are > 25 years old and have outlived their useful life, thereby limiting supply.
- ✓ We don’t expect coal PLF to see a steep increase since increasing renewable integration will require thermal to recede. PLFs to increase to 60-64% by FY 2022.

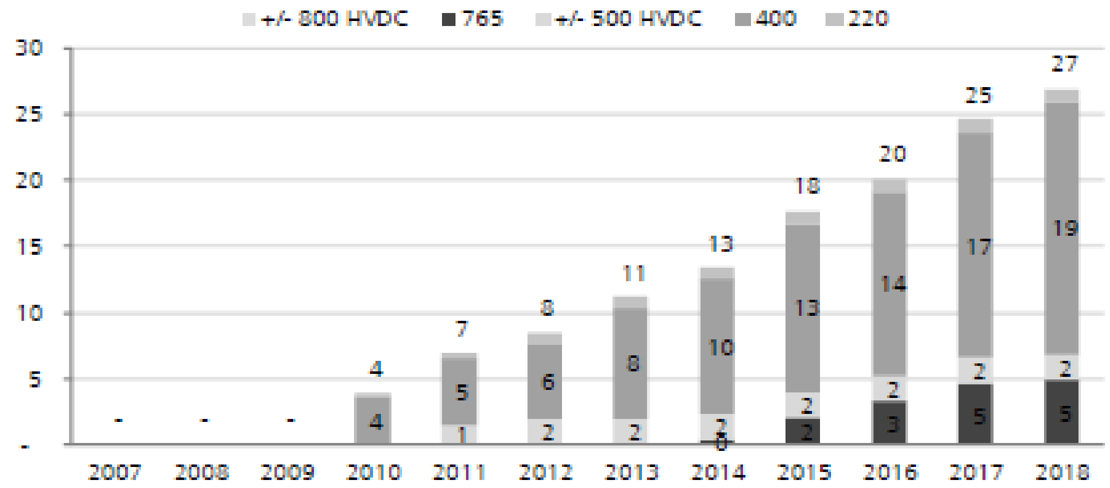
Source: ABSLAMC Research, Industry Research

Transmission –continue to attract private investments

Improving transmission connectivity making it an attractive proposition over coal transport despite increasing per unit cost



Private sector has stepped up participation in transmission in recent times Private transmission capacity, March fiscal year-ends ('000 cktkm)



Over FY18-22, investments in the transmission segment are envisaged at INR2.5tn, a whopping 1.5x jump over FY12-16. We estimate ~INR0.75n of projects to be awarded on tariff-based competitive bidding (TBCB) basis, an opportunity for the private sector, though PGCIL also bids under this mode.

Source: ABSLAMC Research, Industry Research

Outlook

- ✓ Power sector is expected to move to a relatively balanced position considering slowing capacity additions, capacity retirement and elevated demand. We expect merchant price would remain moderated at ~3.5/Kwh levels and coal PLF to be in the range of 62-64% by FY 2021.
- ✓ With the recent development including positive Supreme Court order for the imported coal based power plants, positive CERC norms for regulated business, thermal power projects are expected to benefit. Regulated utilities are expected to have strong growth visibility.
- ✓ Govt focused approached towards the revival of stressed power plants including Samadhan Scheme [11 plants with 12 GW capacity is expected to result in consolidation in the sectors with large players eying to acquire assets at substantially low price. However, we expect that the progress will be slow due to large number of lenders involved with many of them under PCA, and difficulty in reaching consensus on the amount of haircut proposed (~55-60%).
- ✓ Coal allocation under Shakti and medium term PPA [PTC scheme] is likely to revive stressed capacities without FSA/PPAs.
- ✓ Power transmission sector is expected to attract private investment considering its better returns, low O&M risk and counterparty risk. We expect that while Intra-state would continue to led by state transmission companies, inter-state segment would have tariff based bidding for projects for ~Rs.0.75 trillion. Considering the past trend [38 out of 47won by private players], private transmission companies would have large pipeline for inter-state projects. The companies specialised in executing transmission projects are also expected to do well. Sector is witnessing consolidation and is currently an oligopoly of three players.
- ✓ On the renewable front, a sharp reduction in the tariff has led to a question mark on project viability and feasibility. Considering the high variability in generation, uncertainty on cash flow receivable, and availability of long tenure debt at competitive rates , we continue to remain selective for the renewable projects.
- ✓ As an asset class, we would continue to be positive for transmission, neutral for thermal and cautious for renewables.

Telecom

Telecom – Current Trends

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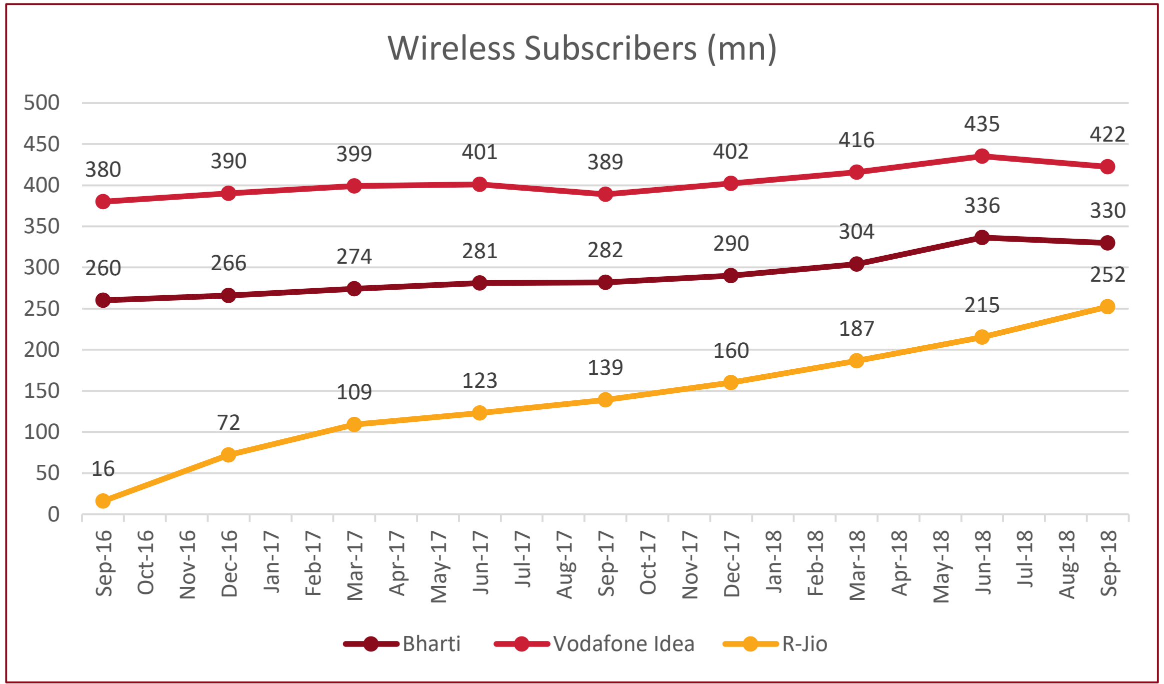
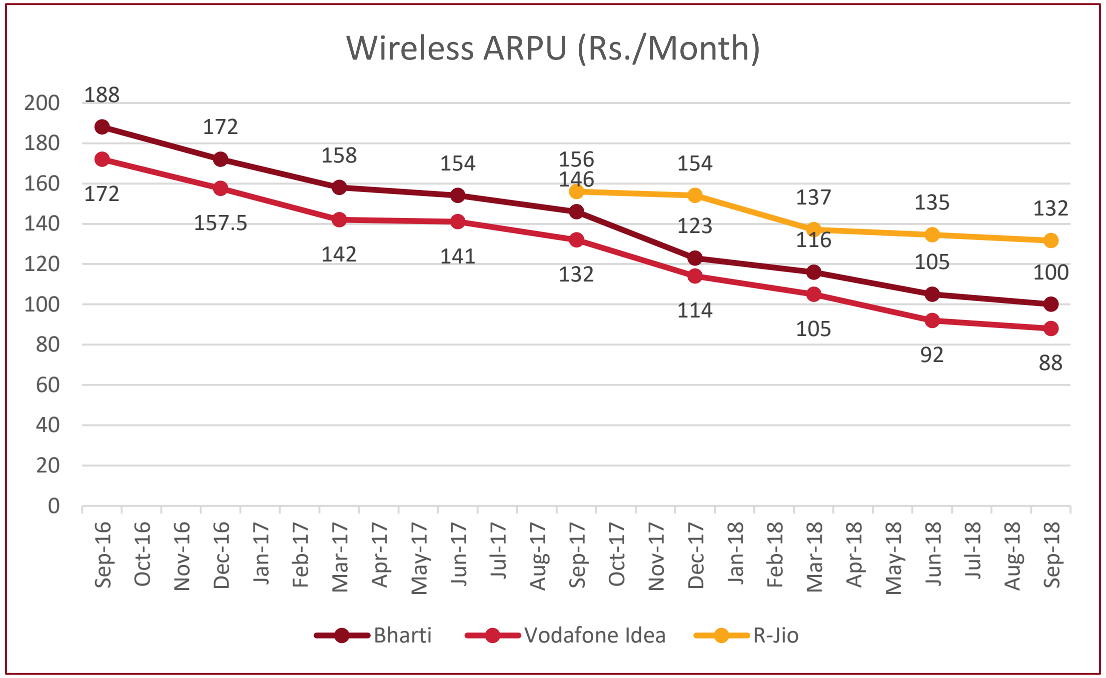
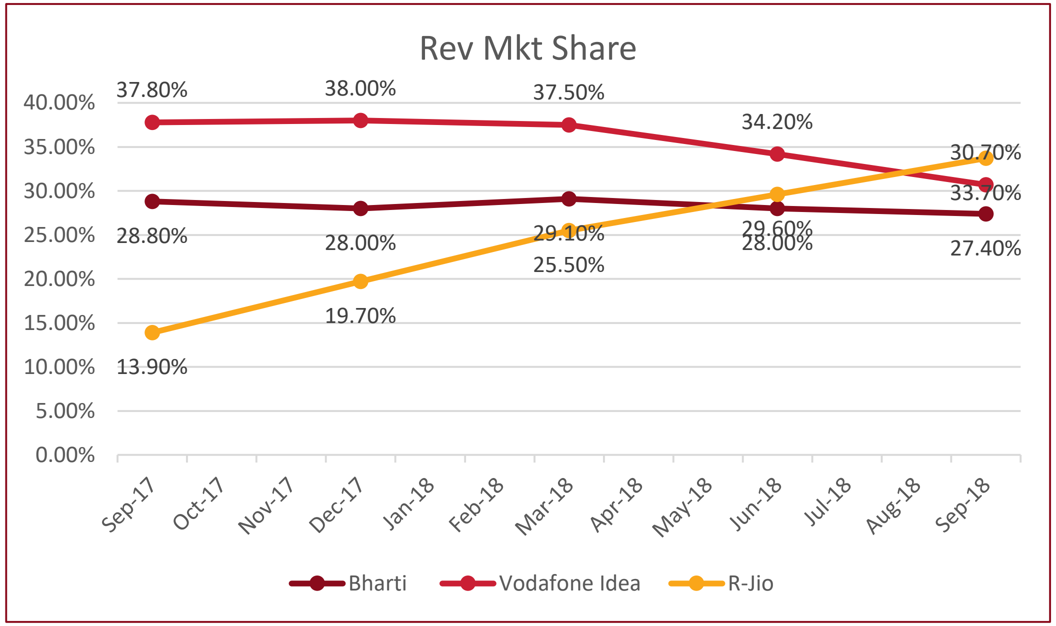




Source: ABSLAMC Research, Industry Research

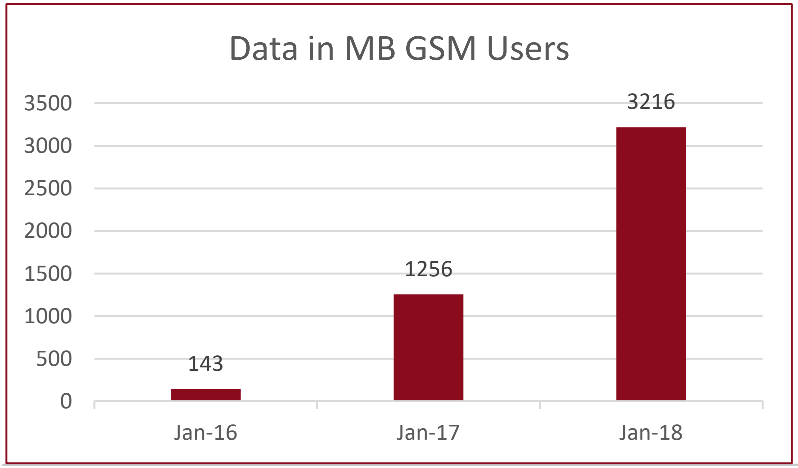
- ✓ R-jio entered the Indian Telecom market in Sept 2016 and reached Subscriber base of 252 mn in just 25 months;
- ✓ ARPU witnessed downward trend of all players for the past 2 years (i) aggressive pricing strategy adopted by Reliance Jio (ii) Regulatory changes –reduction in Interconnection Usage Charges (IUC) and International Termination Charges (ITC) by TRAI..Industry Adjusted Gross Revenue (AGR) fell from 44570 Cr. in Q1 of Fy'17 to Rs. 25580 Cr. in Q1 of FY'19;
- ✓ This forced other Telecom Players to offer discounts to retain market share, however this led to fall in profitability margin and consider sell of other non core assets to raise Equity to fund capex and protect capital structure;

Telecom – Current Trends



Broadband Subscriber Base	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
Bharti (mn)	60	69	83	93	99
%	21%	24%	27%	28%	30%
Vodafone Idea (mn)	76	87	97	106	100
%	20%	22%	23%	24%	24%
R-Jio (mn)	139	160	187	215	252
%	100%	100%	100%	100%	100%

Source: ABSLAMC Research, Industry Research



- Industry witnessed consolidation with Top 3 Pvt Sector Players account for 84% Subscribers market of the Country;
- R-jio's Revenue Market share surpassed Vodafone Idea and Bharti in Sept 2018 and became No.1 with 33.70%;
- Bharti and Vodafone Idea yet to make substantial progress to broaden their Broadband Subscriber base before they became ready for 5G;
- Meanwhile, Data consumption registered 375% CAGR growth in the past 3 years and is going to be a revenue driver in years to come;

Telecom

View

- Outlook for the Sector is expected to remain “Negative” with strong competitive headwinds as most operators will look for greater entrenchment or push for higher market share;
- ARPU is expected to remain under pressure until Reliance Jio captures significant Subscribers Market Share;
- With data being available at cheap / very affordable prices, broadband wireless users are expected to reach ~520-530 mn by March 2019;
- APRU is expected to increase gradually with introduction of minimum recharge pack and simplification of tariff structure to reduce the inactive users;
- Companies are not expected to bid for 5G spectrum atleast for 1-2 years due to (i) stretched Balance sheets (ii) pressure on profitability (iii) yet to expand 4G network fully;

Summing up

- ✓ Liquidity issues facing NBFCs is now behind us. Targeted lending has commenced to those NBFCs who have good lineage, good asset quality and long seasoning
- ✓ 2019 shall see asset quality issues emerge for NBFCs – particularly those in the housing and real estate space. We prefer NBFCs who are in the retail space.
- ✓ Real Estate developers particularly those in residential space shall face headwinds with the liquidity issues being faced by NBFCs having transcended to this area.
- ✓ Commercial RE shall continue to be robust till such time as supply lags demand
- ✓ EPC companies shall continue to do well but renewable companies will remain under pressure
- ✓ Telecom sector shall remain sluggish till such time as competitive pressures remain and predatory pricing continues
- ✓ 2019 should see many proceedings under IBC concluding and settling points of law which till now are still ambiguous. With the law getting settled, the hands of creditors shall be strengthened.

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