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India's economic prospects remain stable and strong, with GDP growth likely to average more than 7.5% in the medium term. Economic growth is also benefiting from higher consumption and private investment demand, owing to a growing middle class and favorable demographics. As a result, Indian banks will have abundant opportunities for profitable growth, with minimal downward pressure on pricing or asset quality.

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India's corporate landscape could see a year of record M&A deals in 2007, with companies actively considering nonorganic growth options. The number of M&As surged over the past three years, rising 26% in 2006 to 349 (from 276 in 2005), valued at US$11.9 billion. The rising tide of M&As has yet to affect credit risk profiles of Indian corporates significantly.

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Operating in an environment of strong economic growth for the past four years, the Indian corporate sector has demonstrated a trend of consistent double-digit revenue growth. The trend is evident across a broad spectrum of industrial sectors, notably software and IT services and automotive sectors. In 2006 alone, foreign direct investment flowing into India increased by 43.9% to US$9.5 billion.

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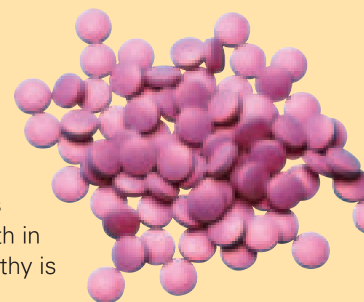
By Prakash Kabra, CRISIL Ltd., Mumbai

India's pharmaceutical industry ranks fourth in the world in volume and 13th in value terms. Keeping the sector healthy is the dominance of branded generic medicines—the proportion of innovative drugs that are still under patent is low. The size of the industry is about US$5.6 billion (INR250 billion), which is expected to grow 8% to 10% annually.



India

Back In Investment Grade After 16 Years

Editor's note: On Jan. 30, 2007, Standard & Poor's Ratings Services raised its sovereign credit ratings on the Republic of India to BBB-/Stable/A-3 from BB+/Stable/B.

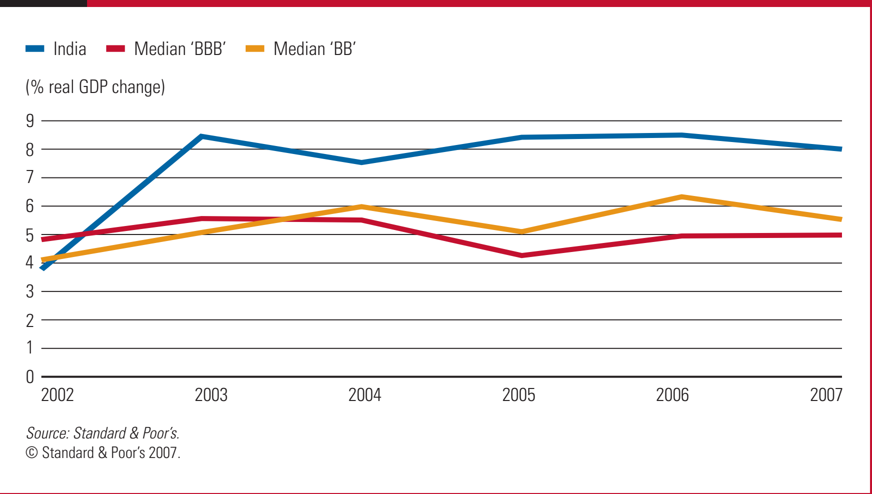
India is the thirteenth sovereign currently rated by Standard & Poor's that has made the transition to investment grade from speculative grade, and signals the first time the country has moved back into this category since 1991. The upgrade on India's ratings to investment grade reflects the country's strong economic prospects and external balance sheet, and its deep capital market, which supports a weak, but improving, fiscal position.

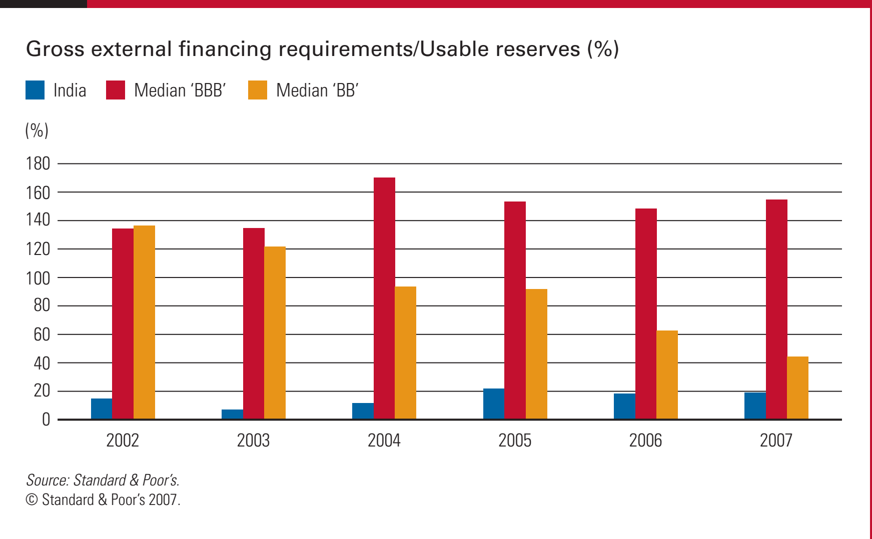
India's economic prospects remain strong and are rising gradually, with GDP trend growth likely to average more than 7.5% in the medium term *(see chart 1)*. The service sector is dynamic, while the industrial sector is benefiting from gradual deregulation, trade liberalization, and modest improvements in infrastructure. The country's business environment is likely to improve in the coming years, sustaining private investment and economic growth. Economic growth is also benefiting from higher consumption and private investment demand, owing to a growing middle class and favorable demographics. Investment is also likely to engender employment growth. Gradual reforms and consistent monetary and fiscal policy stances have sustained macroeconomic stability, leading to strong growth prospects that attract foreign and nonresident Indian capital to help fund fiscal deficits. India's strong institutions have also provided for relative stability in policy, politics, and business environments against volatility usually associated with lower income levels.

Moreover, India's external balance sheet is strong due to reserves accumulation and prudent debt management *(see chart 2)*. This has helped lower the external liquidity risk from its fiscal vulnerability. As illustrated by its strengthening liquidity, India's resilient external position—one of the strongest among sovereigns in the 'BBB' rating category—is likely to be maintained in the coming years. Its foreign exchange reserves, now more than 16x short-term debt and 5x gross financing requirements, provide a buffer from changes in external and domestic investor confidence. These strengths are likely to continue, despite the current account deficits, on the expectation of strong capital inflows.

Fiscal consolidation commitments across all levels of governments look to be entrenched *(see chart 3)*. The pace of deficit narrowing should continue, and faster than Standard & Poor's initial projection. The central government's budget deficit for the current year seems to be back on track to meet its target of 3.8% of GDP due to strong revenue collection and expenditure control. State governments' fiscal estimates for the current year suggest that the combined central and state government deficit is likely to fall below 7% of GDP. The secular decline in general government deficits in the medium term is likely to continue due to tax reform and improved administrations, and implementation of fiscal responsibility laws across more state governments, currently enacted by 23 out of 29 state governments.

Continuous monetary and financial reforms since India's macroeconomic crisis in 1991, coupled with stricter fiscal financing regulations, are leading to more robust capital and government securities markets. India's capital market is deep, and the average maturity of government securities extends beyond 14 years. The government recently passed an ordinance handing the central bank operational flexibility to set the statutory liquidity ratio, which should further support more market-oriented deficit financing and reinforce fiscal discipline.

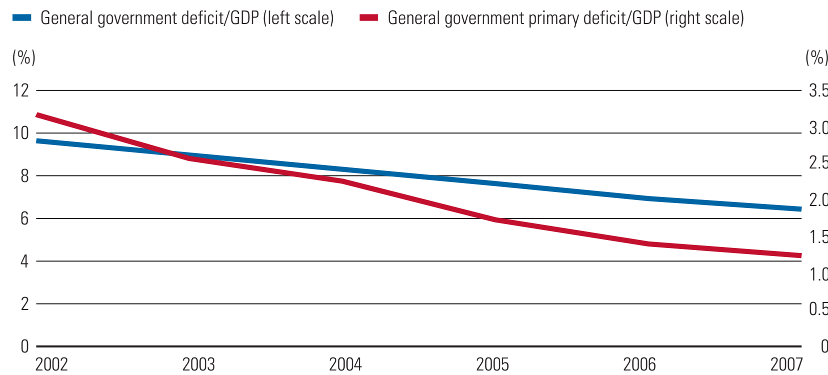




The ratings on India remain constrained by the weak fiscal profile, especially its high government debt burden and deficit, which is still one of the worst among all rated sovereigns *(see chart 4)*. The consolidated debt of India's central and state (general) governments is projected at 85% of 2007 GDP, while interest payments are likely to consume about 30% of general government revenue. India's contingent liabilities are also high. Government-guaranteed debt alone amounts to 10% of 2007 GDP, and the state-owned enterprises are generally inefficient, including the still underreformed electricity sector. The ratings are also constrained by the low per capita income of the country, reflecting the challenges of poverty alleviation. Infrastructure needs remain high in both the huge agricultural sector and the industrial sector.

With the raising of India's ratings, Standard & Poor's has also raised to 'BBB+', from 'BBB', its transfer and convertibility (T&C) assessment for India-based nonsovereign issuers. The T&C assessment remains two notches above the long-term foreign currency sovereign credit rating for India. The assessment reflects Standard & Poor's view that the probability of the sover-

Chart 3 **Improving Fiscal Picture**



Source: Standard & Poor's.
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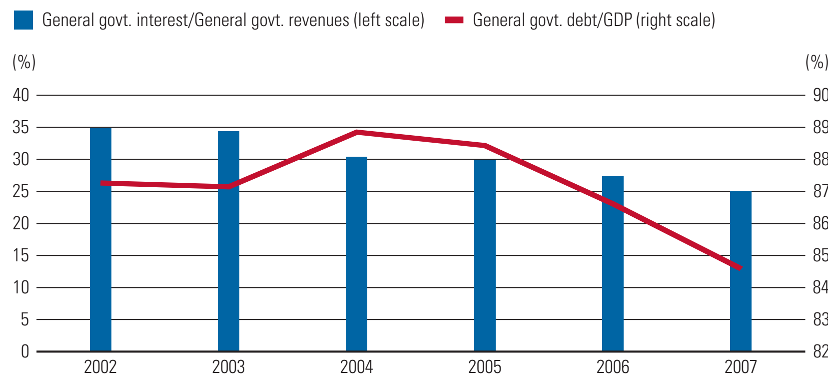
Chart 4 **Fiscal Profile Still Weak**



Source: Standard & Poor's.
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eign restricting access to foreign exchange needed for non-sovereign debt service is less than the probability of the sovereign defaulting on its foreign currency obligation.

The sovereign's stable outlook balances India's strong external liquidity and growth prospects and its weak fiscal flexibility. The outlook also reflects the country's ongoing efforts at fiscal consolidation, which are important to keep interest rates down and facilitate growth in the longer term. Further rating improvements will depend on sustained prudent fiscal policy that leads to a decline in the government debt and interest burden, and further reforms that lift the country's growth prospects and income levels. An inappropriate policy mix that increases the vulnerability of India's still-weak fiscal flexibility and erodes external and growth strengths could lead to downward pressures on the rating. **CW**

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India **GO>**

Analytical Contacts:

Ping Chew
Singapore (65) 6239-6345

Sani Hamid
Singapore (65) 6239-6346

Bank Industry Risk Analysis

Opportunity Knocks For India's Banks As Strong Growth Continues

With continuing stable and strong economic prospects, the door of opportunity for further strengthening of the Indian banking industry remains wide open. India's GDP growth is likely to average more than 7.5% in the medium term. The business environment is expected to improve in the coming years, sustaining investments and economic growth. Economic growth is also benefiting from higher consumption and private investment demand, owing to a growing middle class and favorable demographics.

As a result, Indian banks will have abundant opportunities for profitable growth, with minimal downward pressure on pricing or asset quality. As in the past, consumer credit will continue to be the prime driver of credit growth. Corporate growth, on the other hand, is expected to remain stable and healthy, though debt leverage has begun to rise.

In addition, the regulatory environment has strengthened, as recent banking reforms have tightened operational, prudential, and accounting standards. The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, credit information bureau, and corporate debt restructuring mechanism have helped to rein in nonperforming assets (NPAs) and improve the credit discipline in the banking system.

India has been classified as a group-6 Bank Industry Country Risk Assessment (BICRA) country (out of 10, 1 is the strongest), based on the strong growth outlook for banks, strong regulatory environment, and the stable financial profile of the industry. The risks associated with rapid credit growth, potential volatility in the economic environment, a fragmented sector structure, and still-developing risk management capabilities are constraining factors.

In a high-impact, but low-probability scenario of an economic recession, we estimate that gross problematic assets (GPAs) in the Indian banking system could reach the 25%-40% range. This view is based

on potential volatility in the economic environment, predominance of corporate exposure with rising debt leverage, and still-evolving risk management capabilities. The growing proportion of consumer credit in banks' loan portfolios and lower proportion of mandated lending are positive factors for the Indian banking system.

The financial profile of the banking industry is adequate and stable. Asset quality has improved vastly over the past four years and currently compares favorably with regional as well as similar BICRA countries. The rapid credit growth in the system continuing from the previous three years may cause a rise in problematic assets, which Standard & Poor's Ratings Services currently estimates to be at 8%. Stiff competition will continue to put pressure on the banks' profitability, as the Indian banking sector remains highly fragmented.

India's political leaders, across all parties, have failed to push ahead with reform forcefully.

Economic Growth

India's GDP growth should average more than 7.5% in the medium term, given the average monsoon rainfall, a pickup in private investment and industrial growth, and despite rising interest rates and oil prices. The agriculture sector is now comparatively less of a drag on the economy because the robust service and industrial sectors contribute about 5% of annual GDP growth. Although consumption growth might slow, investment should take over as the growth driver due to high capacity utilization. Economic growth in India has been better balanced between domestic demand and net exports than it has been in many other Asian countries. Decentralization, however, has led to more divergent economic performances, with southern and western states, even including those states governed by communist parties, generally more successful in promoting development and growth. The savings rate has increased steadily over the past decade to 27% of 2005 GDP (savings statistics are not reconciled with balance of payments and national income), from 24% in 2001, following income growth.

India's economy has become more resilient. The industrial sector boasts some very competitive companies and is overcoming the regulatory regime. The setting up of special economic zones should drive more investment and manufacturing expansion. The sector's funding costs are low, and it is beginning to win external orders. Textile orders have been particularly buoyant after the phasing out of the Multi-Fiber Agreement. India's cheap and skilled labor can be a considerable competitive advantage, just as in China, if issues such as inadequate infrastructure and other bottlenecks can be resolved.

Opportunities And Credit Growth

Given the country's stable and strong economic prospects, Indian banks are likely to continue to have abundant opportunities for profitable growth. The credit portfolio of the banking system has experienced a growth of about 30% in each of the previous two fiscal years *(see chart)*. Consumer credit has been the prime driver of credit growth and now constitutes more than one-fourth of the entire system's credit portfolio.

Housing loans, which are inherently less risky, form almost half of the outstanding consumer credit. Standard & Poor's has a favorable view of banks' increased lending to the under-penetrated consumer sector because delinquencies are likely to be lower than in the corporate sectors. Growth of consumer loans will continue to be strong, though rising interest rates and property prices will likely counter that of housing loans. Corporate credit is expected to continue growing with the industrial sector in India. The proportion of consumer credit in the banking industry's credit portfolio is likely to continue rising over the medium term.

Private sector increasingly driving economic reforms

India's policy environment remains encumbered by an entrenched bureaucracy, coalition politics, and fragmented administration. The consensus behind economic reform is solid after more than a decade of cautious liberalization, but reform is still limited in its content. On the one hand, a vibrant business community and a growing middle class have pressed for greater economic opening. On the other hand, India's political leaders, across all parties, have failed to push ahead with reform forcefully. Nevertheless, the pace of reforms is partly dictated by the growing clout of the private sector, which has gained greater influence over policymakers in recent years. The government is thus compelled to pursue reforms that drive economic and revenue growth and assist the private sector (for example, deregulating sectors such as airlines, or attracting greater foreign direct investments into ports), while also gradually improving efficiency in existing public sector enterprises. However, there will likely be only glacial progress in opening up more sectors to private and foreign investments, including agriculture and banking, or in pursuing tax reform and increasing infrastructure investment.

India's external balance sheet has strengthened significantly as a result of reserve accumulation and prudent debt management, which also helps to lower the external liquidity risk from its fiscal vulnerability. India's resilient external position is likely to be maintained in the coming years. Its foreign exchange reserves, now more than 16x short-term debt and 5x gross financing requirements, provide a buffer against changes in external and domestic investor confidence. These strengths are likely to continue, despite the current account deficits, on the expectation of strong capital inflows.

Gradual reforms and consistent monetary and fiscal policy stances have also sustained macroeconomic stability, leading to strong growth prospects that also attract foreign and nonresident Indian capital to help fund the fiscal deficits. India's strong institutions have also provided for relative stability in policy, politics, and business environments—countering the volatility usually associated with lower income levels.

Inflation in India, though rising, has been kept manageable, with consumer price index inflation rate generally low as a result of deregulation, reduction of custom tariffs, and administered price and sale support mechanisms. However, inflationary pressures are now building due to increasing domestic demand, a reduction in spare industry capacity and high oil prices. India's central bank, the Reserve Bank of India (RBI), has been introducing tightening measures to counter inflationary pressures. Since December 2006, it has increased the cash reserve ratio for Indian banks to 6% from 5%. This reduces liquidity in the system, and will slow credit growth and raise market interest rates.

Government Influence

Historically, the government used the banking sector as an instrument to fulfill its economic and social objectives. The government continues to prescribe priority segments which need to be financed by the banks—at least up to 40% of banks' total credit portfolio. The banking sector is also used to finance the public sector through high statutory liquidity ratio; currently at least 25% of deposits of each bank need to be invested in government securities. RBI was empowered recently to set this threshold, thus likely diluting this prescription.

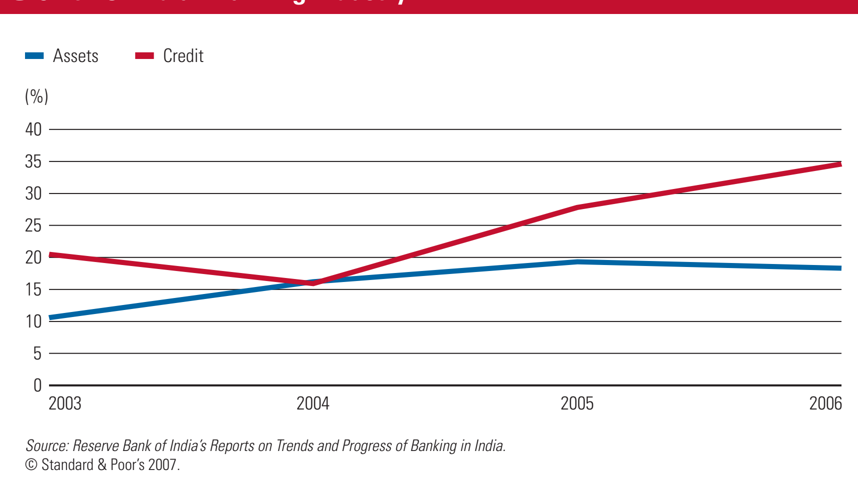
Despite the government's role in the economy, the legacy of policy-influenced lending is less prevalent in India's banking sector than in economies such as China (although China is moving toward more market-driven solutions). The lending decisions of the Indian banks, including those for directed credit segments, are commercially taken by the banks. The embedded risk of weak-quality government-directed loans is unlikely to be high.

Credit discipline

Since 2002, the authorities had implemented several measures to further strengthen the processes for the resolution of non-performing assets in the banking system such as SARFAESI Act, credit information bureau and the corporate debt restructuring mechanism.

The SARFAESI Act provides foreclosure powers to banks and financial institutions, so as to enable them to foreclose and sell underlying assets without court intervention. Under the act, secured creditors collectively have the right to enforce security interest if their loan is classified as an NPA in accordance with the guidelines issued by RBI. The act lays down the steps to be taken for possession of assets and prescribes methods of sale via private treaty, obtaining quotations from interested parties, public auction and public

Growth Of Indian Banking Industry



Source: Reserve Bank of India's Reports on Trends and Progress of Banking in India.
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Indian Banking Industry: Aggregate Financial Performance

	—Year ending March 31—			
(Bil. INR)	**2006**	**2005**	**2004**	**2003**
Total assets	27,879	23,560	19,740	16,992
Total deposits	21,645	18,376	15,785	13,557
Net loans	15,157	11,157	8,616	7,405
Shareholders' funds	1,831	1,496	1,166	979
Profit after tax	246	210	223	171
Gross NPL	518	595	644	687
Key ratios				
Return on average assets (ROAA) (%)	0.96	0.97	1.21	1.06
Common equity (CE)/total assets (%)	6.60	6.40	5.90	5.80
Tier-1 CAR ratio (%)	9.30	8.40	8.10	8.50
Gross NPL (%)	3.30	5.20	7.10	8.80
Net interest income margin (%)	3.02	3.08	3.09	2.91
Government securities holdings/total assets (%)	24.80	29.70	32.40	31.60

INR—Indian rupee.

tender. The act also spells out guidelines for the formation and functioning of securitization companies and reconstruction companies as well as empowers these asset reconstruction companies to employ all methods available for asset reconstruction and recoveries. This act, by bypassing the lengthy civil legal process, has corrected the balance of bargaining power between the banks and their creditors more evenly, thus improving the credit discipline in the system.

The Credit Information Bureau (India) Ltd. (CIBIL) was incorporated in 2000, with the objective of providing comprehensive credit information to its members by collecting, collating, and disseminating credit information pertaining to both commercial and consumer borrowers. Its members comprise banks, financial institutions, nonbanking financial companies, housing finance companies, and credit card companies. Data sharing is based on the principle of reciprocity, which means that only members who have submitted all their credit data, may access credit information reports from CIBIL. CIBIL improves the credit grantor's portfolio quality by providing essential information to enable informed and objective credit decisions. Sharing of credit information has further aided improvement of credit discipline.

Sharing of credit information has further aided improvement of credit discipline.

The corporate debt restructuring (CDR) system in India became effective in March 2002. This provides a framework for ensuring a relatively timely and transparent mechanism for the restructuring of corporate debt for viable entities outside the purview of the Board for Industrial Financial Reconstruction (BIFR), debt recovery tribunals, and other legal proceedings. The CDR system operates under a three-tier structure, comprising of:

- CDR Standing Forum and its Core Group—the policymaking body;
- CDR Empowered Group—the functional group deciding on the restructuring cases referred to the CDR mechanism; and
- CDR Cell—the secretariat to the CDR system.

Further revisions to the guidelines were made in February 2003, some of which included:

- Segmenting of restructuring under the CDR system into two types, whereby assets under the "Standard" and "Substandard" categories would be restructured under Category I, and assets under the "Doubtful" category would be restructured under Category II.
- Eligibility to include suit-filed cases provided the proposal to restructure is supported by at least 75% of the lenders by value.
- Eligibility of large BIFR cases to be decided by the CDR Core Group.
- Discretion to join the CDR system on a case-by-case basis for investment institutions and foreign lenders that have provided finance from outside the country.

Banking Industry Country Risk Assessment

The BICRA assessment of the Indian banking industry is at an intermediate level, at group 6, reflecting the strengths and weakness of a country's banking system relative to those in other countries and is an integral part of estimating the probability of a banking crisis and the potential depth or damage of a crisis. BICRAs classify countries into 10 groups ranging from the strongest banking systems (group 1) to the weakest (group 10) from a credit perspective. Some other countries in group 6 are Thailand, Brazil, Bulgaria, Poland, and Croatia.

The BICRA assessment on the Indian banking industry is based on:

- Strong economic prospects providing opportunities for banks to grow their corporate as well as consumer businesses;
- A strong regulatory environment that has supported the banking industry through a good institutional framework, improving banking supervision, and monetary policy management;
- The stable financial profile of the sector—though it faces risks associated with rapid credit growth;
- Potential volatility in the economic environment;
- A fragmented sector structure with constraints in network and manpower rationalization, which undermine the system's cost efficiencies and enhance competitive pressure; and
- A still-developing risk management structure, which will be tested in a downturn following the current rapid growth phase.

Gross problematic assets range

A major analytical component of each BICRA is an estimate of the incidence of GPAs during the full course of economic recession. This estimate is expressed as a percentage of domestic credit to the private sector and nonfinancial public enterprises. Problematic assets include overdue loans, restructured assets (where the original terms have been altered), foreclosed real estate, and other assets recovered in loan workouts, and NPAs sold to special-purpose entities. GPA ranges also reflect the costs and problem asset levels of past banking system problems. We categorize the GPA estimates into six ranges, the narrowest being 5% to 15% and the widest 50% to 75%.

In this high-impact but low-probability scenario, we estimate that GPAs in the Indian banking system could reach the 25%-40% range. The GPA bracket reflects:

- The loan portfolio composition, which comprises about a 55% exposure to

the corporate sector, whose profile, though improved, in an economic stress situation will deteriorate sharply;

- The significant challenges that Indian banks face as compared with other banking systems on a global basis, which are specifically related to risk management capabilities, cost efficiencies, and economic environment volatility;
- The positive contribution of the considerable and growing proportion of consumer credit (with about half being housing loans) in banks' loan portfolios; and
- The lower prevalence of policy-influenced lending in India's banking sector, despite the government's role in the economy and compared to economies such as China.

Financial Profile

The financial performance of the Indian banking system is characterized by adequate capitalization, improving asset quality, and largely stable core earnings.

Capitalization

The system's capitalization continues to remain adequate despite a 15%-20% growth in system assets. The Tier-1 capital adequacy ratio (CAR) for the system (as at end-March 2006) stood at 9.3%, which was well above the minimum Tier-I CAR of 4.5% mandated by RBI. The ACE ratio has improved, supported by Indian banks' healthy retained earnings as well as new equity issuances in preparation for Basel II implementation. Indian banks will continue to need capital infusions to support their strong balance sheet growth and implement RBI's new capital adequacy framework (which is based on minimum capital requirements under the Basel II accord). Hybrid capital instruments (Tier I and Upper Tier II) are expected to comprise a significant proportion of the new capital raised.

Asset quality

Improvement in the credit quality is evident from the system's regulatory nonperforming loans-to-total loans ratio, which had improved to 3.3% (on a 90-day-past-due recognition basis) as at end-March 2006, from around 8.8% (on a 180-day-past-due recognition basis) as at end-March 2003. India's gross nonperforming loans have also declined significantly in absolute terms. This is in line with Standard & Poor's current estimates of problematic assets at around 8%.

This overall improvement is largely attributed to the recovery and write-offs done by the Indian banks over the past three to four years, which have been supported by good economic prospects as well as banks' healthy earnings. This trend is likely to be sustainable and perhaps improve, as the proportion of healthier retail assets increases and the performance of the corporate sector remains healthy, in line with the favorable economic conditions. Nevertheless, as the new loans acquired over the past three years have not been fully seasoned (i.e. the true quality is not yet visible), absolute NPA in 2007 may increase marginally once seasoning occurs.

Profitability

Core earnings, as measured by net interest income margin, for Indian banks have been largely stable, and this trend has been continuing. The stability of earnings has improved, as indicated by the rising proportion of fee income. With rising interest rates, the contribution of treasury income has fallen over the past few years. This decline in treasury income has pushed the Indian banks to focus more on generating fee income. While the growth in fee income is gradual, it will be helped by two factors: widening of core banking services and the introduction of third-party products such as mutual funds, insurance, securities, and commodities. Technology is also enabling much of this broadening of services by the banks.

The outlook for the Indian banking industry's earnings is stable. **CW**

For more articles on this topic search RatingsDirect with keyword:

Analytical Contacts:

Ritesh Maheshwari
Singapore (65) 6239-6308

Ivy Tan
Singapore (65) 6239-6393

S I A
Eastern Turkistan
Tangla Ra.
Lhasa
Bhutan
Yunnan
Manipur
Calcutta
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India's Global M&A Ambitions May Weaken Credit Risk Profiles

Editor's Note: This report has been authored by Gurpreet Chhatwal, Head, Corporate & Infrastructure Credit Ratings, and Manish Kumar Gupta of Standard & Poor's India-based affiliate CRISIL Ltd. The thoughts expressed in this guest opinion are those of the writer and do not necessarily reflect the views of Standard & Poor's. This article also includes ratings from CRISIL, which are determined under separate criteria that are not harmonized with Standard & Poor's ratings criteria. Standard & Poor's does not issue locale scale Indian ratings.

India's corporate landscape could see a year of record M&A deals in 2007, with companies actively considering nonorganic growth options. The number of M&As surged over the past three years, rising 26% in 2006 to 349 (from 276 in 2005), valued at US$11.9 billion *(see charts 1 and 2)*, with foreign acquisitions by Indian companies exceeding inbound and domestic M&A activity. As the number of deals keeps mounting, so have deal sizes been inching up, and another record year for M&As is expected in the country.

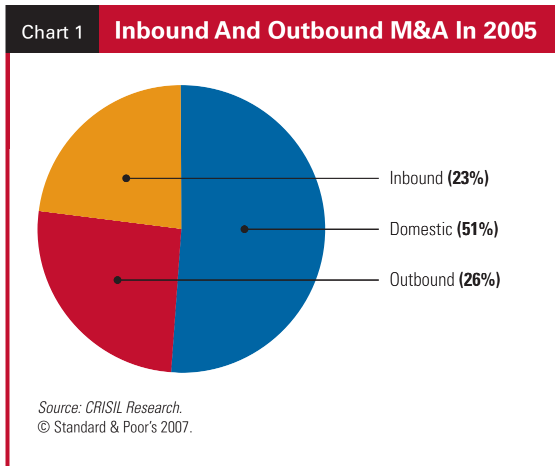
Improved financial strength, declining leverage, and improving cash generation mean that the rising tide of M&As has yet to affect credit risk profiles of Indian corporates significantly. Improving business diversity postacquisitions have also lent some stability to the overall credit profiles of the Indian corporates, negating the impact of the debt undertaken to fund acquisitions. The balance could tip, however, given the ambitions of corporate India in making major acquisitions abroad, and growing reliance on debt to fund buyouts, thus weakening their credit risk profiles. The prevailing hyperliquidity and greater risk tolerance among investors and lenders also fuel this pattern.

Nonorganic Growth Strategies Driving M&As

The appetite for nonorganic growth is expected to increase in the medium term. The two most active sectors in the past—pharmaceuticals and information technology (IT) and IT-enabled services (IT

and ITES)—are likely to see fairly intense M&A activity in the next few years, while M&As are likely to increase in commodity industries in the immediate future and in the emerging domestic retail sector over the medium term.

Chart 1 **Inbound And Outbound M&A In 2005**



Source: CRISIL Research.
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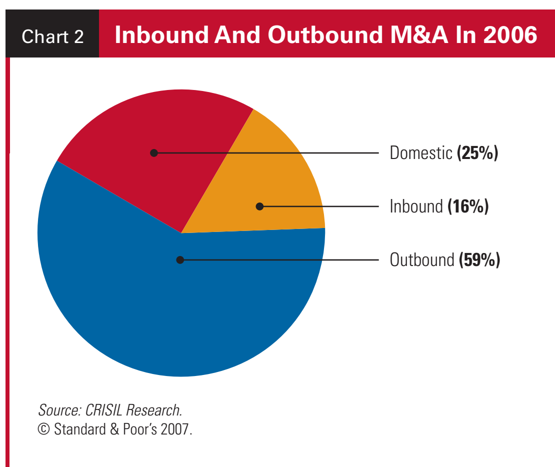
Chart 2 **Inbound And Outbound M&A In 2006**



Source: CRISIL Research.
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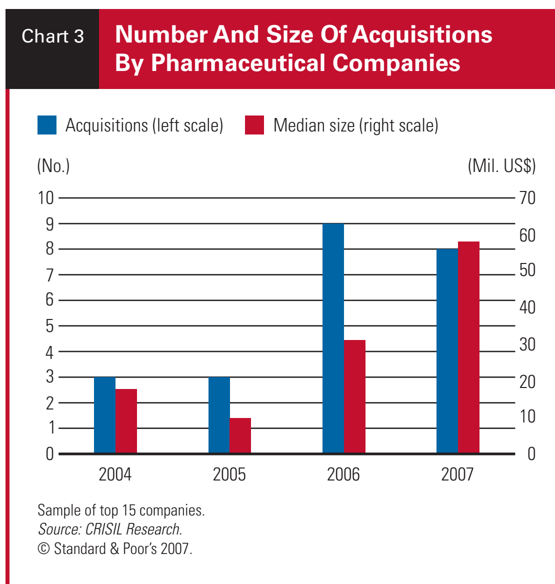
Chart 3 **Number And Size Of Acquisitions By Pharmaceutical Companies**



Sample of top 15 companies.
Source: CRISIL Research.
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Pharmaceuticals

The Indian pharmaceutical industry has graduated to acquisition sizes of more than US$500 million in the past two years *(see chart 3)*, and this has doubled the balance sheet sizes of some players. Funding has not been a constraint: Indian pharmaceutical companies have leveraged their balance sheets and tapped a buoyant stock market to fund acquisitions with a mixture of debt and equity. The main drivers for the increasing M&A activity in this sector include the sheer size of the generics opportunity in the international markets, the desire to acquire and improve access to distribution networks in regulated markets, the broadening of product offerings, and the leveraging of India's cost advantage. We expect Indian pharmaceutical companies' search for nonorganic growth to increase over the next few years, with deal sizes soaring.

IT and ITES

While this sector has seen some inbound action, the main M&A activity has tended to cluster around Indian IT and ITES players investing abroad. The deal sizes, though smaller than in the pharmaceutical sector, have been increasing. The main drivers for the increasing M&A activities include the Indian companies' desire to migrate up the value chain, expand domain knowledge either within a vertical market or in multiple vertical markets, and acquire a stable, diverse customer base in lucrative developed countries. This trend is expected to continue, with deal sizes rising further. Debt could become a funding option, though equity and internally generated cash have been the norm thus far.

Manufacturing sector

In their aim to acquire global scale nonorganically, and diversify revenues, Indian commodity players have been

weighing their M&A options. Tata Steel Ltd.'s bid for Corus Group of the U.K., Hindalco Industries Ltd.'s bid for Novelis Inc. in Canada, and Ballarpur Industries Ltd.'s interest in Sabah Forest Industries of Malaysia are instances of the initial few M&A deals in the sector, and are expected to be completed in 2007.

Retail

India's retail industry is likely to see the emergence of several midsized players in the near future. Initial losses, a desire to gain market share, price competition, and the importance of scale economics in the retail industry are expected to drive consolidation in this sector.

Corporate India's Credit Risk Profile Likely To Weaken

Corporate India's credit risk profile has remained relatively stable thus far. The future, however, may be different: with M&As expected to increase, corporate credit quality appears likely to deteriorate. While large-scale acquisitions tend to have a positive bearing on the business risk profile of the entities, the incremental debt required to finance the transaction tends to weigh down on the financial profile of the combined entity. The key reasons for the expected deterioration in credit quality are discussed below.

Strong financial profiles supported M&As in the past...

Indian companies' balance sheets had improved during the past five years, and were often strong enough to withstand the adverse financial impact of M&A. (M&A often resulted in rising leverage associated with debt funding for the acquisition or takeover of the existing debt of the acquired or merged entity.) In general, strong demand growth, improving productivity, and access to cheaper funds saw margins improve for most companies during 2001-2006 (as represented by profitability ratios and returns on capital employed). Buoyant equity markets, robust accruals, and absence of significant capacity expansions were also among the factors that contributed to considerable improvements in corporate India's capital structure, and consequently, debt protection measures (represented by ratio of funds from operations to total debt, interest coverage and debt service coverage ratios) improved significantly. As a result of this improvement in financial risk profiles, Indian companies were well positioned to withstand the increased leverage and higher interest burden of bigger M&A spending.

Also, in 2005-2006, M&A deal sizes were smaller than the recent ones, and therefore, did not significantly impact the financial risk profiles of the acquiring or merged entities. While there were about five deals in 2006 and six in 2005 above US$500 million, the majority of the deals were smaller.

With companies setting their sights on larger and larger deals, there is a marked preference for LBOs.

...Increasing deal sizes are a concern now

Indian companies in various industry segments are currently aiming for large-size acquisitions, which could change the scale of their balance sheets. Tata Steel's offer for Corus and U.K.'s Vodafone A.G. bid for Hutchison Whampoa Ltd.'s 67% in Hutchison Essar Ltd. are deals in excess of US$10 billion each (this is almost equal to the aggregate M&A activity in the country in 2006). Such large M&As are likely to affect the financial risk profiles of both the acquirer and acquired. These deals, involving sizeable debt funding, are also sensitive to the value addition or synergy benefits from the M&A, and to the outlook on revenue growth, profitability, and the stage of the industry cycle; any adverse deviations from the original assumptions could result in a disproportionate impact on the financial risk profile of the entities involved.

Equity-funded M&As supported credit profiles in the past...

M&A activity was funded largely via retained earnings and buoyant equity markets in the past. In the pharmaceutical and IT and ITES industries, the preferred sources of funding for M&As were equity or foreign currency convertible bonds.

...Leveraged buyouts (LBOs) are a concern now

With companies setting their sights on larger and larger deals, there is a marked preference for LBOs. Tata Steel and Ballarpur Industries' bid for Corus and Sabah Forest Industries, respectively, are representative LBO transactions, potentially involving sizeable components of debt. LBOs involve using the cash flows of the target company to service the acquisition consideration, which is in the form of debt. In the Indian context, acquirers have also attempted to protect their balance sheets by setting up ring-fenced special-purpose companies (SPCs) to take on debt, without legal recourse to the acquirer, for the acquisition. Large LBOs typically impair the acquired company's financial risk profile since most of the debt taken on for the acquisition has to be serviced by the acquired entity. The acquirer's financial risk profile is also adversely affected, prima facie, to the extent of the equity consideration and, ultimately, by the necessity to support the acquired entity.

Strong business risk profiles underpinned overall credit risk profiles in the past

In the past few years, M&A had strengthened the business risk profiles of some Indian companies. This is because most of the M&A was centered on improving the competitive position of the companies and fostering higher integration and greater revenue diversity. The Indian telecommunications (telecom) sector is a prime example, where M&As favorably influenced the sector and the players' business risks.

The sector saw a great deal of M&As in the early 2000s, driving further consolidation. Interim increases in leverage during the M&A and an uncertain regulatory environment initially affected the credit risk profiles of most players negatively. However, with improvement in the regulatory policy environment, consolidation enabled the players to rapidly improve scale; this benefited their business risk profiles considerably, resulting in steep improvement in the rating of the Indian telecom industry and of most players over the past three years.

Transactions that strengthened business risk profiles

Coromandel Fertiliser Ltd. (rated AA/Stable/P1+ by CRISIL), a midsize complex fertilizer manufacturer, enhanced its market share and pricing power in its core markets of South India by acquiring Godavari Fertilisers Ltd., a competitor, in July 2003. Similarly, Ranbaxy Laboratories Ltd. (rated 'P1+' by CRISIL), one of the largest Indian pharmaceutical companies, has been able to significantly diversify its revenues across the U.S., Brazil, Russia, India and China (BRICs), Africa, Latin America, the Middle East, and Asia Pacific, through acquisitions, joint ventures, and new product launches. Tata Chemicals Ltd.'s (rated 'P1+' by CRISIL) soda ash business saw its business risk profile strengthened in the wake of its acquisition of U.K.'s Brunner Mond Group (BMG) Ltd. in December 2005.

Furthermore, the M&A focus of corporate India in the past was often toward value-driven acquisitions in niche market segments. This, and the fact that commodity and equity markets had not reached their peaks then, kept M&A valuations at manageable levels. The following acquisitions are examples: Tata Motors Ltd.'s Daewoo commercial vehicle unit in Korea (in 2004) for Indian rupee (INR) 5 billion, Dabur India Ltd.'s Balsara group of companies (2005) for INR1.43 billion, and Mcleod Russel India Ltd.'s Williamson Tea Assam Ltd. (2005) for INR1.86 billion.

Valuations lifted by peaking economic cycle is a concern now...

Unlike in the past, several commodities and equity markets are nearing their peaks, and the Indian economy, along with some other global markets, has been booming. These factors, in conjunction with increased acquisition activity, have resulted in valuations rising significantly. Also, Indian companies are setting their sights on large and strategic companies, which come at a high price. The high valuations, in the context of an evolving and competitive market scenario, could potentially suppress the returns and extend the payback period. Long periods of suboptimal returns could weaken the credit profiles of the companies involved; furthermore, larger acquisitions also bring greater challenges of integration and harvesting the synergies, potentially pushing back the positive impact of the acquisition.

...So is peer pressure for M&As

Another key difference from the past is that there is pressure on Indian corporates today to seriously consider nonorganic growth options. This is a result of the M&A success stories of competitors or other Indian companies. Admittedly, there is still not much evidence of M&A activity that has gone wrong. However, the euphoria surrounding M&As could drive corporates to rush into them without proper due diligence, especially in understanding the local environment, cultural differences, and legal structures. This may result in painful and expensive adjustments that ultimately impact credit profiles. Integration issues and management synergies constitute other risk areas in M&As.

Table 1 Inbound And Outbound M&A In 2005

Industry sectors	Number of deals	(%)	Mil. US$	(%)
IT-ITES	68	25	974	8
Pharmaceutical	39	14	674	6
Auto ancillaries	22	8	453	4

Source: CRISIL Research.

Table 2 Inbound And Outbound M&A In 2006

Industry sector	Number of deals	(%)	Mil. US$	(%)
IT-ITES	79	23	2014	17
Pharmaceutical	34	10	2158	18
Media	23	7	345	3

Source: CRISIL Research.

Record M&As Could Come At A Price

Indian companies are surging ahead in M&As so fast in the first two months of 2007 that volume in dollar terms has eclipsed that of China's. With the pharmaceutical sector's opportunity in generic medicine and manufacturing sector's desire to acquire global scale nonorganically, and diversify revenues, deals could be quite big. Throw in the ingredients of strong liquidity, greater risk tolerance among investors and lenders, companies' desire to widen their reach, expand market share and brands, the M&A pot could grow to a new record in 2007. Given the rising use of debt funding and high valuations, however, credit profiles of the companies involved could suffer. **CW**

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Analytical Contacts:

Gurpreet Chhatwal, CRISIL Ltd.
Mumbai (91) 11-4250-5105

Manish Kumar Gupta, CRISIL Ltd.
Mumbai (91) 11-4250-5115

India Top 100 Corporates Overview

Satisfactory Financial Profile Expected To Continue

In the past four years, the Indian corporate sector has been operating within a favorable macroeconomic environment, with the economy continuing its strong growth trend and expanding at an average of 8.6% per year. This growth is relatively broad-based, underpinned by domestic consumption and investment.

Foreign direct investment (FDI) flowing into India increased by 43.9% to US$9.5 billion in 2006. This represents the third consecutive year of rising FDI inflows after a 20% increase in 2005, and a 19.3% rise in 2004. The surge of FDI inflows reflects India's strong economic growth and increasingly liberal foreign investment policies, albeit starting from a low base. The bulk of the FDI has gone into services such as IT and communication centers. Corporates in the software and IT sector, as well as increasingly in the manufacturing sector, are expected to benefit from further FDI growth, which will likely remain strong.

Standard & Poor's Ratings Services and CRISIL Ltd. have evaluated the credit trends of 100 selected corporations in the past three to four years and have assessed their credit profiles. The 100 corporations were selected for being prominent players in key industries in India, or because they attract investors'

attention as active issuers in the international or domestic capital markets.

Some companies, especially state-owned enterprises, have not yet released their full audited financial statements for fiscal 2006 (ended March 31, 2006), and only income statements were available at the time of publication. For these companies, our assessment of their fiscal performance is based on the released financial information. The results should be interpreted with this limitation in mind.

The top 100 corporates represent a wide spectrum of industries, with oil and gas, utilities, minerals and other metals, and steel, being the four largest industry sectors, accounting for 37.9%, 17.4%, 10.4%, and 9.9% of the estimated aggregate asset value of this segment, respectively *(see chart 1)*. Other significant sectors are the automotive and telecoms sectors. Standard & Poor's assesses these corporations' consolidated or stand-alone financial figures, whichever is publicly available, and has not attempted to deconsolidate these assets when constructing chart 1.

Rising Leverage, But Still Satisfactory Financial Profile

Continued revenue growth

Operating in an environment of strong economic growth for the past four years, the Indian corporate sector has demonstrated a trend of consistent double-digit revenue growth *(see chart 2)*. This trend is evident across the broad spectrum of industrial sectors in India. In particular, for the 2003-2006 period, the software and IT services and automotive sectors reflected strong compound annual growth rates (CAGR) of 35% and 29%, respectively. The revenue growth in the software and IT services sector was mainly supported by the continued trend in offshore IT services, especially from the U.S. and Europe, while the revenue growth in the automotive sector was underpinned by favorable demographic and economic factors, such as rising income levels and a growing middle class. Operating margins and cash flows have remained largely stable for Indian corporates although some initial indications of pressure were exhibited in 2006 *(see chart 2)*.

Pressure on margins for some industries

The selected corporates' operating margins are starting to experience some pressure. This can be attributed to volatility in prices, which have either affected the companies' top line sales or their costs of production. Most selected corporates in the oil and gas sector were affected by higher crude prices. Refining companies suffered an increase in the cost of production, while not being able to offset the cost by raising selling prices, due to government measures. Overall aggregate operating margins (excluding the oil and gas segment), however, remained stable at 22.5% in fiscal 2005 and fiscal 2006. Nevertheless, there are some industries that are facing operating margin pressures. For instance, steel firms saw margin compression from softening steel prices and the software and IT sector had to manage with the industry's wage inflation, which somewhat impacted their operating margins in the past five years. Cash flow generation, as indicated by funds from operations (FFO), for Indian corporates remained satisfactory, although its rate of growth softened in the past three years as a result of pressure on margins.

Table 1 Median Operating Margin Of Selected Corporates By Industrial Sector

(%)	Automotive	Consumer Products	Mineral/ Other Metals	Oil & Gas	IT Services	Steel	Utilities	Total
2003	12.3	24.3	23.6	9.1	24.9	21.9	31.6	18.7
2004	12.0	25.5	32.0	9.6	27.5	22.7	33.8	16.9
2005	10.5	20.6	41.9	10.0	26.4	32.9	32.9	17.1
2006	10.8	21.3	37.0	5.5	28.4	23.8	33.5	17.3

Table 2 Sectoral Aggregate FFO To Total Debt Of Selected Corporates By Industrial Sector

(%)	Automotive	Consumer Products	Mineral/ Other Metals	Oil & Gas	IT Services	Steel	Utilities	Total
2003	50.5	248.9	57.4	64.5	2,216.2	9.1	29.5	45.1
2004	76.2	163.1	76.3	75.0	469.7	29.8	35.1	57.8
2005	64.5	162.9	78.6	87.1	965.9	75.2	28.9	67.2
2006	59.6	727.9	115.2	66.9	1,457.4	46.3	27.1	58.7

FFO—Funds from operations.

Table 3 Total Debt Of Selected Corporates By Industrial Sector

(%)	Automotive	Consumer Products	Mineral/ Other Metals	Oil & Gas	IT Services	Steel	Utilities	Total
2003	78.4	16.1	139.3	612.1	1.5	317.0	337.7	1,947.2
2004	82.6	27.7	143.9	595.3	9.6	265.3	396.9	1,954.4
2005	118.1	25.9	157.7	598.1	6.4	250.0	469.2	2,105.4
2006	148.3	7.2	167.5	808.8	5.9	303.7	533.6	2,594.9
Change over 2003 (%)	89.30	(55.112)	20.20	32.13	299.35	(4.189)	58.03	33.26

Increasing leverage and capex...

In a benign operating environment, Indian corporates have increasingly taken the opportunity to raise their capital expenditure (capex) plans, while gradually leveraging up. Overall aggregate total debt of the top 100 corporates has increased by a CAGR of about 10% in the past three years to about Indian rupee (INR) 2.6 trillion (US$59.4 billion), while capex has grown to about INR856 billion in the same period. This trend was seen in sectors such as automotive, steel, oil and gas, telecoms, and utilities.

...Financial profile expected to remain satisfactory

Increasing leverage and pressure on operating margins resulted in the Indian corporates' FFO to total debt breaking its improving trend *(see chart 3)*. Nevertheless, Standard & Poor's believes that the overall financial profile of Indian corporates remains satisfactory. On an aggregate basis, while FFO to total debt declined to about 58% in 2006 from about 67% in the previous year (and from an average of about 61% in the past three years), it remains at a satisfactory level.

While total debt for Indian corporates has been gradually increasing for the past three years, the overall gearing measures remain modest, mainly as a result of a relatively low base as compared with the 2000-2001 period, as well as benefiting from stable operating cash flow generation in recent years. The overall aggregate debt-to-EBITDA ratios have inched up slightly to about 1.42x in 2006, from the past three-year average of about 1.28x. Notwithstanding the slight rise, these gearing positions are still at a modest level.

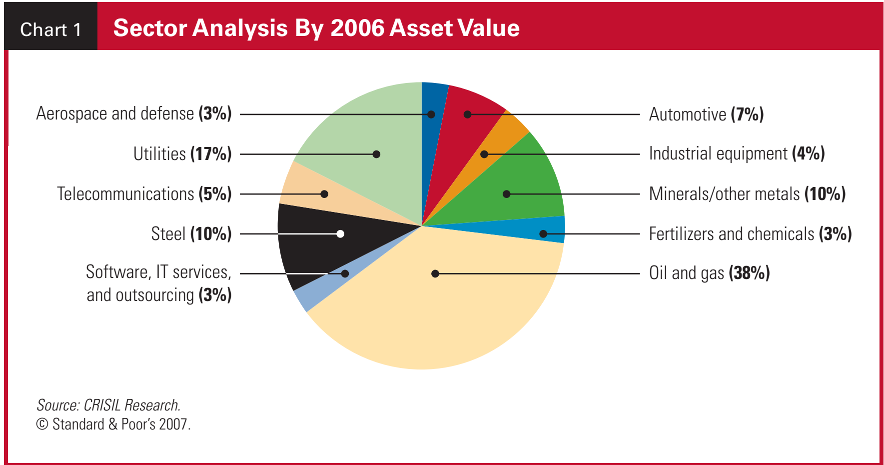
Despite the generally favorable operating environment, there are significant divergences in revenue growth and cash flow measures among different industry sectors *(see chart 4)*.

Sector Commentary

Oil and gas

Indian oil and gas companies continue to demonstrate satisfactory business and

Chart 1 **Sector Analysis By 2006 Asset Value**



Source: CRISIL Research.
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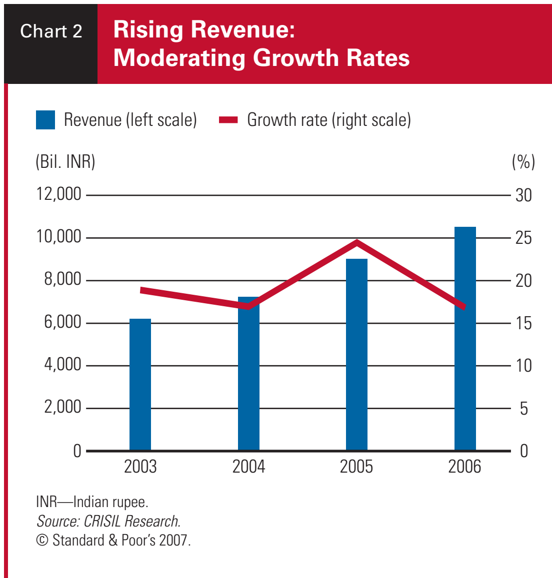
Chart 2 **Rising Revenue: Moderating Growth Rates**



INR—Indian rupee.
Source: CRISIL Research.
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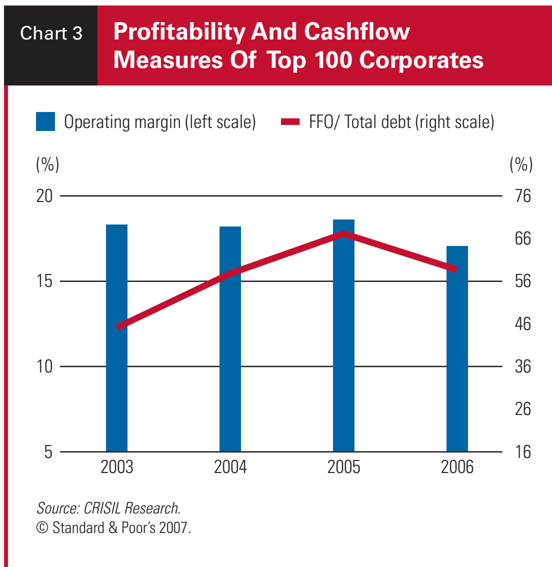
Chart 3 **Profitability And Cashflow Measures Of Top 100 Corporates**



Source: CRISIL Research.
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financial risk profiles. The sector's profitability remains supported by strong revenue growth trends, averaging about 20% in the past three years. Most of these companies are government-owned and are involved in both the refinery and retail businesses. Operating margins have been under pressure and experienced a sharp drop in 2006. For the refiners, this was mainly due to the sharp rise in crude oil prices that occurred that year, and for the retail business this was driven by the inability to pass on the increased costs to end customers, and high fuel costs due to the government price control and shared subsidy arrangement. The trend of operating margins under pressure however, contrasted with that of Reliance Industries Ltd. (BBB/Stable/—), which continued to display a stable and strong financial profile. The company's competitive advantage in refining and petrochemicals is underpinned by the level of technology employed in its highly integrated production facilities.

Total debt levels started to rise again in the past two years but remain comfortable against current cash flows, as evidenced by an aggregate FFO-to-total-debt ratio of about 67% in 2006. While Standard & Poor's expects debt levels of oil and gas companies to continue to increase in line with their capital expansion plans, this is likely to remain within manageable limits, and overall financial risk profiles should remain satisfactory.

Utilities

The utilities sector demonstrates stable business and financial risk profiles. Operating margins and cash flows for the past three years have remained stable at about 30% to 32%, largely reflecting low off-take risk with the ability to pass through any increase in production costs to the end customers. Although utilities companies enjoy steady cash flows from long-term contracts, a possible delay in receivables due to the credit quality of the companies' off-takers (in particular, the state electricity boards) could place additional financial stress on the companies.

Total debt for the industry has been gradually rising and, in the past three years, has picked up pace. Nevertheless, the sector's capitalization remained stable at a satisfactory level, with total debt to capital in the 36% to 37% range for 2002-2006. The increase in debt is also in line with a rise in capex, particularly in 2005 and 2006. Such increases in capex are mainly attributed to low investments in plant and equipment in earlier years, resulting in relatively inadequate infrastructure and high utilization rates. NTPC Ltd. (BBB-/Stable/—) remains the largest electricity generator in the country. Its adequate financial risk profile is supported by its diversified generation portfolio and dominant market share. The stable regulatory regime of the utilities sector is also considered a moderately positive factor for the industry.

Steel

The steel industry is cyclical and most companies in this sector demonstrate an aggressive financial risk profile. In the past two or three years, the sector has undergone a gradual improvement in its operational structure, with more companies moving toward a more integrated structure, resulting in better cost and operating efficiency. Operating margins improved to about 33% in 2005 but declined to 25% in 2006, mainly as a result of a drop in steel prices. In the short term, operating margins of steel companies are expected to come under pressure, primarily driven by a soft steel prices outlook.

While overall debt has largely declined, particularly during the 2002 restructuring, steel companies have started to leverage up. This could be a concern, particularly as debt increases against a backdrop of declining operating cash flows as a result of pressure on margins. The sector is also undertaking increasing capex programs, which require higher debt. In the past four years, capex to total assets has risen by about eight percentage points to almost 11.5% in 2006. Another risk factor for the industry, particularly for the larger players, is the active M&A that has taken place in the industry, both domestically and in the global arena. As a result of M&A activity, the ratings on Tata Steel Ltd. (BBB/Watch Neg/—) are on CreditWatch with negative implications following the takeover of U.K.-based steel maker, Corus Group PLC (BB/Watch Dev/B). The size of the acquisition and the potential cash outflow in Tata Steel's offer could have an adverse impact on its financial risk profile.

Table 4 Sectoral Aggregate CAPEX/Total Assets Of Selected Corporates By Industrial Sector

(%)	Automotive	Consumer Products	Mineral/ Other Metals	Oil & Gas	IT Services	Steel	Utilities	Total
2003	3.8	4.6	5.1	4.7	4.5	3.1	7.3	5.6
2004	4.4	4.1	5.9	5.7	6.3	5.0	6.3	5.8
2005	6.6	4.4	7.9	5.5	10.6	8.5	7.2	6.7
2006	6.0	4.7	6.0	6.8	8.3	11.5	9.3	8.1

Table 5 Sectoral Aggregate Total Debt To EBITDA Of Selected Corporates By Industrial Sector

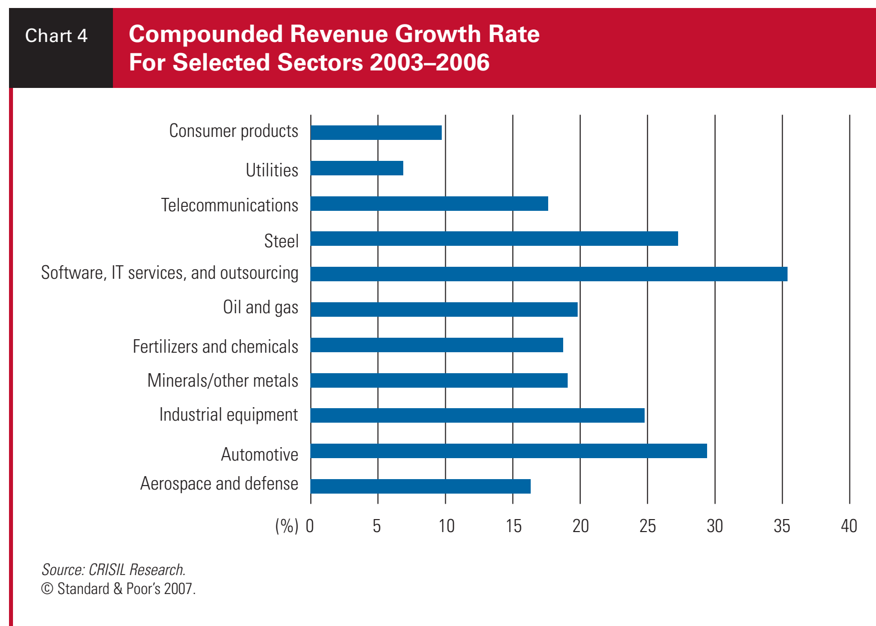
(%)	Automotive	Consumer Products	Mineral/ Other Metals	Oil & Gas	IT Services	Steel	Utilities	Total
2003	1.5	0.3	1.4	1.2	0.0	5.4	2.8	1.7
2004	1.1	0.5	1.2	1.1	0.2	2.2	3.5	1.5
2005	1.3	0.5	1.0	1.0	0.1	1.1	3.6	1.3
2006	1.4	0.1	0.7	1.3	0.1	1.6	3.7	1.4

IT services

The business risk profile of the IT services sector in India continues to improve, with a CAGR of more than 30% for the fiscal 2003 to fiscal 2006 period, and the top three companies growing at a CAGR of 35% for the same period. This growth is supported by the continued trend in global offshore IT services, especially from the U.S. and Europe, as major multinational companies increasingly adopt IT offshore services and global delivery models. At the same time, top Indian IT services firms such as Tata Consultancy Services Ltd., Wipro Ltd., and Infosys Technologies Ltd. (BBB/Stable/—) have begun to offer a broader range of products and services such as business process outsourcing and package implementation with the goal of becoming total solutions providers to their clients.

Although median operating margins of the selected corporates hovered in the 26% to 28% range for the past four years, they declined from above 30% from 2000 to 2002. This was largely a result of (a) increasing labor costs with wage inflation increasing more than 15% per year, especially for skilled labor with three to five years' work experience, and (b) lower all-in margins as Indian IT firms move into larger contract sizes, especially for contracts in excess of US$30 million, and for the top three Indian IT firms.

With FFO to capital expenditure above 3x, Indian IT firms continue to operate at free operating cash flow, and total debt remains minimal at an aggregate INR5.9 billion for the selected corporates. Hence, the financial risk profile remained modest in fiscal 2006, with aggregate cash balances to total assets of the selected corporates remaining above 35% from fiscal 2004 to fiscal 2006.



The steel industry is cyclical and most companies in this sector demonstrate an aggressive financial risk profile.

Automotive

India's automobile industry remains vulnerable to cyclical domestic demand, which is closely linked to the agricultural sector and the country's economic growth. Domestic automobile companies face intense competition from their global counterparts, as most of them manufacture and sell passenger vehicles in India. To keep pace with the competition, investments in the automobile industry have increased significantly in the past few years. Although aggregate revenues of the selected corporates posted CAGR of 29% for the fiscal 2003 to fiscal 2006 period, revenue growth slowed to 11.3% in fiscal 2006 from 28.7% in fiscal 2005, and 51.4% in fiscal 2004. This was largely due to slowing sales growth as (a) rising fuel costs and uncertainties over emissions legislation have somewhat subdued growth rates in the commercial vehicles segment, and (b) higher interest rates, fuel costs, and fewer new model introductions impacted sales in the passenger car segment. Although median operating margins for the selected corporates were about 12% in fiscal 2003 and fiscal 2004, they have declined to 10.5% for fiscal 2005 and 10.8% for fiscal 2006. This was largely due to rising input prices (specifically, steel prices) and increased competition, particularly in the passenger car segment, and affected the operating margins of large corporates such as Tata Motors Ltd. (BB+/Stable/—).

The selected corporates increased aggregate debt by 89.3% from 2003 to 2006 (CAGR at 23.7%) to INR148.3 billion to partially fund capacity expansion and hence, their aggregate FFO to total debt declined to 59.6% in fiscal 2006 from 64.5% in fiscal 2005. Despite the increase in financial leverage, Standard & Poor's believes that the industry's financial profile has not significantly deteriorated in fiscal 2006 and that it remains adequate with aggregate debt-to-EBITDA ratio for selected corporates at 1.4x for fiscal 2006 and 1.3x for fiscal 2005.

Minerals/other metals

Selected corporates in this sector include nonferrous metal producers such as aluminum, copper, zinc, and

iron ore as well as mineral mining such as coal and lignite. Aggregate revenues for the selected corporates grew by a CAGR of 19% for the fiscal 2003 to fiscal 2006 period with aggregate revenue growth increasing to 23.3% in fiscal 2006 from 18.8% in fiscal 2005, and 15.3% in fiscal 2004. Selected corporates in this sector benefited largely from price increases in the commodities markets, as well as from buoyant global demand, especially from Asia, in 2005 and 2006.

Although median operating margins for the selected corporates showed a dip to 37% in fiscal 2006, compared with steady increases to 42% in fiscal 2005 from 32% in fiscal 2004, operating margin performances were mixed at the subsector level. Operating margins compression was largely seen in aluminum and copper companies in fiscal 2006 with (a) a number of shutdowns for maintenance and repairs resulting in lower-than-expected smelter capacity utilization, and (b) increased competition from reduction in import duties. Mineral mining companies, such as coal mining, experienced increases in operating margins from higher selling prices, especially in fiscal 2006.

Although this sector is cyclical and influenced by global commodity prices, Indian companies are likely to be less afected by industry cyclicality than their global and Asian peers because they usually have more integrated operations and a large market share, and are low-cost producers globally. Hence, business risk profiles remained satisfactory in fiscal 2006.

The financial risk profiles of selected corporates in this sector remained strong in fiscal 2006, largely driven by steady improvements in financial ratios such as aggregate debt to EBITDA improving to 0.7x from 1x in fiscal 2005, and aggregate FFO to debt improving to 115% from 79% in fiscal 2005. The selected corporates managed to improve their financial risk profiles by keeping minimal debt levels with aggregate debt increasing by 20% in the fiscal 2003 to fiscal 2006 period.

Consumer products

Aggregate revenues for the selected corporates in the fast moving consumer goods (FMCG) grew by a CAGR of 9.7% for the fiscal 2003 to fiscal 2006 period with a spike in aggregate revenue growth to 19.3% in fiscal 2006, compared with 5.4% in fiscal 2005 and 5.3% in fiscal 2004. The key contributor to this increase was ITC Ltd.'s 35% surge in revenue in 2005, supported by the 30% rise in export businesses and expansion of newer businesses such as branded packaged foods, lifestyle retailing, greeting and gifting, and stationery. Excluding ITC Ltd., aggregate revenue for the selected corporates grew by a CAGR of 4.5% for the fiscal 2003 to fiscal 2006 period.

Business sentiment in the FMCG sector has significantly improved in the past three years with buoyant growth underpinned by (a) rising domestic disposable income, (b) favorable demographic profile, and (c) high growth potential as domestic FMCG penetration per capita is low, even when compared with its Asian counterparts (e.g., India's consumption of shampoo is US$0.30 per capita whereas Indonesia's is US$1.10 per capita, and Malaysia and Thailand's are above US$2.00). Median operating margins decreased to 21% and 20% for fiscal 2006 and fiscal 2005, respectively, from above 24% in 2002 and 2003. Margins have been largely afected by higher input and cost of production prices (such as oil prices), and an increase in competition as international companies seek market share.

Historically, the selected FMCG corporates have a modest financial leverage. For the past four years, aggregate debt to EBITDA was in the 0.3x to 0.5x range and aggregate FFO to debt was in the 150% to 250% range. Aggregate debt further declined by 72% in fiscal 2006. Hence, aggregate debt to EBITDA and aggregate FFO to debt improved to 0.1x and 727%, respectively.

Challenges Lie Ahead In The Short Term

Indian corporates are expected to continue to benefit from a buoyant macroeconomic environment in the medium term, sustained by a combination of domestic consumption and investment. Nevertheless, in the short term, they face the following key challenges:

- Investment and productivity growth can be hampered if there are significant underinvestments in the country's infrastructure and logistics (e.g., roads, railroads, shipping ports, and power and utilities);
- An overheating economy with rising inflation, especially on asset prices, may result in rising interest costs from tighter monetary policies, and increasing leverage, especially for debt-funded expansions;
- Aggressive acquisitions, domestically and abroad, especially if significantly funded by debt (steel and minerals/other metals sector);
- Weakened external demand for exports (IT services and shipping sectors);
- Increasing domestic competition, both from domestic and foreign companies (automotive and paper sectors);
- Start of business downturn cycles (steel sector); and
- Exposure to volatility of product prices in commodity sectors (oil and gas, metals, chemical/petrochemical sectors), particularly for nonintegrated producers.

Standard & Poor's expects that the overall Indian corporate sector should be able to broadly manage these challenges, and maintain its satisfactory financial profile, while there may be individual companies that could experience some weakening credit profiles in the near to medium term. CW

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Analytical Contacts:

Anshukant Taneja
Singapore (65) 6239-6340

Adrian Chee
Singapore (65) 6239-6306

Wee Lee Cheng
Singapore (65) 6239-6353

Guest Opinion

Indian Pharmaceutical Industry

Generics In The Pink Of Health

Editor's Note: This report has been authored by Prakash Kabra, Manager—Corporate Infrastructure Ratings, of Standard & Poor's India-based affiliate CRISIL Ltd. The thoughts expressed in this guest opinion are those of the writer and do not necessarily reflect the views of Standard & Poor's. This article also includes ratings from CRISIL, which are determined under separate criteria that are not harmonized with Standard & Poor's ratings criteria. Standard & Poor's does not issue locale scale Indian ratings.

India's pharmaceutical industry ranks fourth in the world in volume and 13th in value terms. Keeping the sector healthy is the dominance of branded generic medicines—the proportion of innovative drugs that are still under patent is low. The size of the industry is about US$5.6 billion (INR250 billion), which is expected to grow 8% to 10% annually. The highly fragmented industry has more than 20,000 pharmaceutical units, with the top 10 companies accounting for about 38% of the domestic market share. Although a significant amount of drug patents are due to expire in the next three years, India's established process-chemistry skills and cost advantage will serve as a booster shot to keep the industry thriving. Nevertheless, a few industry concerns have the potential to stem the expected growth and pressure the credit profiles of large Indian multinational pharmaceutical companies.

Industry Characteristics And Growth Drivers

Indian pharmaceutical companies are redefining their business models by adopting different strategies and focusing on distinct aspects of the value chain.

Export-driven growth and increasing presence of domestic players in the regulated markets

India's exports of pharmaceutical formulation posted a compounded annual growth rate of 20% between 2001 and 2005 touching almost US$2.4 billion in fiscal 2006 (ended March 31, 2006). Formulation exports are expected to jump 32% to US$9.6 billion by fiscal 2011, primarily driven by drugs worth US$60 billion going off patent in the U.S. over the next three years, and the increasing share of abbreviated new drug application (ANDA) filings, which are applications to manufacture generic drugs, and approvals received by the Indian pharmaceutical players.

Adoption of product patent regime drives, more focus on R&D and out-licensing

With the adoption of the product patent regime in January 2005 (where drugs introduced after 2005 will have patent protection in India for both the product and the process) and the growing opportunities in the regulated markets, Indian pharmaceutical companies have increased their R&D spending. There is a large focus on developing noninfringing bioequivalent generic products for drugs going off patent. In addition, the larger Indian companies are also investing in new chemical entities and new drug delivery systems. The average R&D expenditure of major Indian pharmaceutical companies has almost doubled to 9% to 10% of operating income over the past two years. Companies are also devising strategies to minimize their exposure to the inherent risks associated with R&D. In some cases, the companies have licensed their molecules to global innovator companies or hived off the R&D activities to a special-purpose vehicle.

Acquisitions and consolidations

Given the large global generic drug opportunity, Indian pharmaceutical companies have sought to boost their competitive advantage through the inorganic route by acquiring companies, both at home and abroad, in order to consolidate their market positions, shore up their product portfolios, and enter into new geographies.

Partnering with global companies

One of the ways in which Indian pharmaceutical companies are addressing the slowing new product introductions in the domestic market is by winning licenses to manufacture drugs for innovator companies. Global innovator companies are also partnering with Indian companies by authorizing generics for the drugs whose patents are expiring.

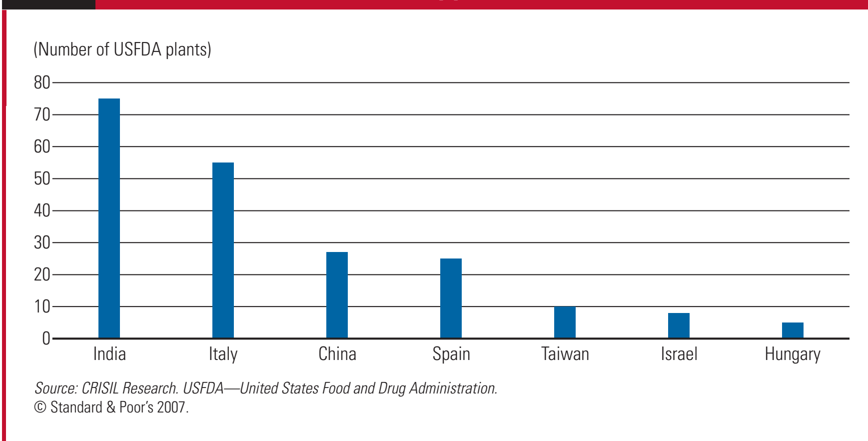
Contract research and manufacturing

The global pharmaceutical industry is going through a fundamental shift, with a rapidly changing business landscape. Mounting cost pressures, declining R&D productivity, and increasing drug development costs are forcing multinational companies to outsource their core and noncore activities to low-cost destinations like India. In the 2005 calendar year, contract research in India was valued at US$100 million to US$120 million, and is growing 20% to 25% each year. Revenues from contract research alone are expected to hit US$318 million by the end of 2010.

India's Big Pharmaceutical Companies Have Key Strengths

India offers several distinct economic advantages to large pharmaceutical companies.

Chart 1 **India Has The Most USFDA Approved Plants Outside U.S.**



Source: CRISIL Research. USFDA—United States Food and Drug Administration.
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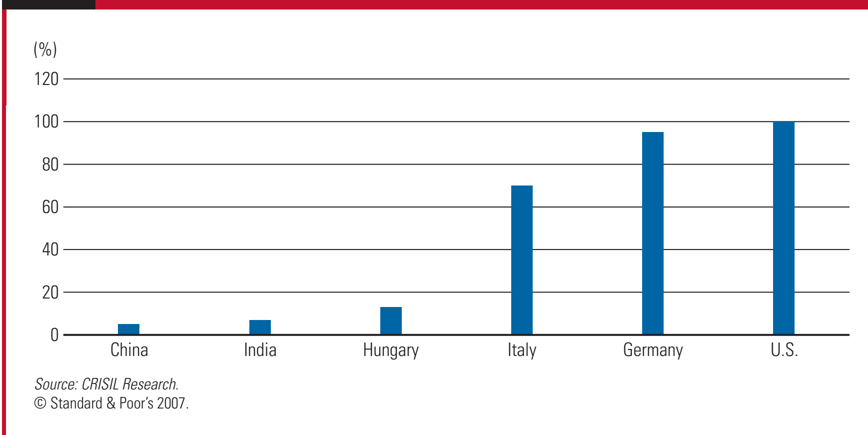
Chart 2 **Cost Comparison Of A Skilled Chemist Across Key Nations**



Source: CRISIL Research.
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Despite India appearing well poised to conquer more of the global pharmaceutical pie, just like it did in IT outsourcing, there are key industry concerns.

Cost advantage

India offers superior cost advantage throughout the drug development process by having world-class U.S. Food and Drug Administration (USFDA) compliant manufacturing facilities at 30% to 40% lower costs. Labor costs are 20% to 25% that of developed countries and initial capital expenditures are also lower. However, with global generic majors such as Teva Pharmaceutical Industries Ltd., Watson Pharmaceuticals Inc., and Mylan Laboratories Inc. already acquiring manufacturing facilities in India, the cost advantage of Indian companies is expected to decline over time.

Highest number of USFDA compliant facilities outside the U.S.

India has the largest number of USFDA approved plants outside the U.S. *(see chart 1)*; according to CRISIL Research, India had 75 approved manufacturing plants in fiscal 2006. Indian players are increasingly going for compliance with international regulatory agencies such as USFDA and Medicines Control Council (MCC) of South Africa for their manufacturing facilities.

Skilled manpower and highly trained pool of chemists

India has a pool of trained chemists that is six times as large as that in the U.S. and available at about one-tenth the cost *(see chart 2)*. In addition, the talent pool has significant process chemistry skills pertinent to the development of generic drugs. This is because the prior process-patent regime encouraged reverse engineering skills.

Highest number of DMF and ANDA filings

Indian companies have been at the forefront, both in terms of Drug Master Files (DMF; confidential detailed information on the drug that is submitted to USFDA) and ANDA filings with an approximate 44% share in DMFs and about 21% share in ANDAs *(see charts 3 and 4)*. With drugs worth US$60 billion going off patent over the next three years in the regulated markets, the Indian players are steadily increasing their filing in the U.S., and this trend is likely to continue.

Key Weaknesses Have Potential To Increase Risk

Despite India appearing well poised to conquer more of the global pharmaceutical pie, just like it did in IT outsourcing, there are key industry concerns.

Pricing pressures in the global generic drugs

Generics, being commodities, have been facing intense pricing pressure on the back of increased competition among players. The competition is expected to rise further due to the entry of equally cost-effective Chinese players and aggressive acquisitions in the global generics space.

Distribution network

Access to the distribution network is the key to success in regulated markets such as the U.S. and Europe. Most Indian companies have a smaller product basket in the regulated markets when compared with generic majors such as Teva and Watson, resulting in lower bargaining power with the distributors who control the generics market.

Regulatory uncertainty

The Indian pharmaceutical industry is highly regulated, with drugs being subjected to price control to make them affordable to the masses. In a trend reversal, the government is currently exploring increasing the number of drugs under price control. Although the product patent regime took effect in January 2005, its scope and effectiveness have not been established. Hence, the level of protection for global innovator companies and the ability of Indian generic drug companies to introduce new products in the domestic market seem uncertain. There are lawsuits pending in international courts challenging the adequacy of protection offered under Indian patent law; the outcome of such lawsuits can have a significant impact on the ability of domestic companies to introduce new products in the Indian market.

Increasingly aggressive financial profiles

Indian pharmaceutical companies' appetite for inorganic growth has increased dramatically over the past few years. That is demonstrated in both the increased valuation multiples and the size of the target companies relative to the acquirer's balance sheet. Furthermore, most of the acquisitions have been debt-funded, leading to a much more aggressive financial profile. The high valuations of these acquisitions in the context of an evolving and competitive market scenario could potentially suppress the returns and extend the pay-back period. The risk is compounded by the complexity of integrating international operations and managing the risks of the local environment.

Outlook: Generics Offer Growth, But Credit Quality May Come Under Pressure

The global generics market continues to offer significant growth opportunities with drugs worth US$60 billion going off

patent over the next three years. India is well placed to benefit from this opportunity because of its established process chemistry skills and cost advantage. At the same time, the overall exposure to the highly competitive regulated generics market is expected to increase due to large debt-funded acquisitions. Hence, the credit profiles of large Indian multinational pharmaceutical companies may come under pressure. On the domestic front, growth would be primarily driven by the lifestyle drugs segments and those for conditions such as cardiovascular diseases, central nervous system, and diabetes. However, new product launches, differentiated product offerings, a strong R&D pipeline, and conducive regulatory norms will be critical success factors.

Profiles Of Key Domestic Players

Ranbaxy Laboratories Ltd. (rated 'P1+' by CRISIL)

Ranbaxy Laboratories Ltd. is the largest Indian company in the global generics market and among the top 10 players in the world. The company has a highly diversified revenue profile across North America, Europe, Brazil, Russia, India, China, and South Africa. It derives about 78% of its consolidated revenues from the international markets. Since January 2006, Ranbaxy has made a spate of acquisitions, funded from the proceeds of the foreign currency convertible bond issue of US$440 million (INR19.80 billion) raised in February 2006. With the acquisitions made in regulated markets, Ranbaxy's business profile will be increasingly dependent on the successful integration of the acquired businesses, and the streamlining of operations, among others. The acquisitions will also increase the company's exposure to the highly competitive regulated generics markets.

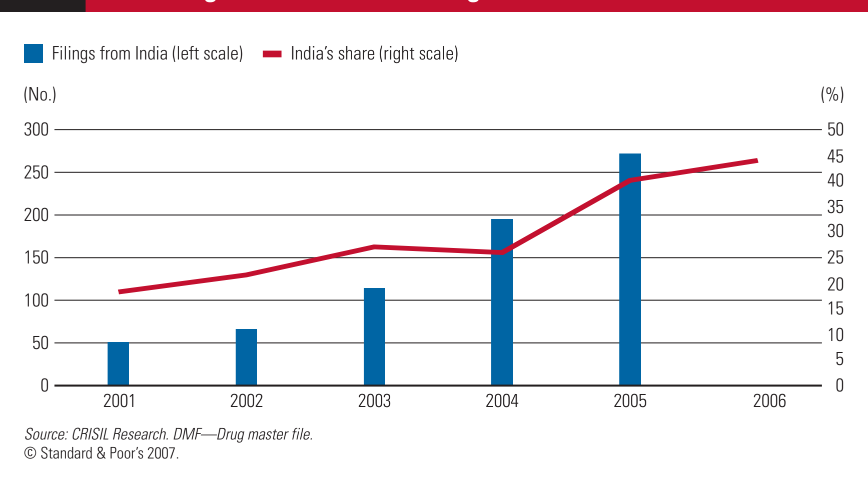
Dr. Reddy's Laboratories Ltd. (rated 'P1+' by CRISIL)

Dr. Reddy's Laboratories Ltd. is one of India's largest pharmaceutical companies, with considerable strength in R&D. The company has R&D agreements with strategic investors such as ICICI Ventures, Citigroup Ventures, and Rheoscience. The company has a diversified geographical presence, with revenues spread across India (34% of its total revenues in fiscal 2006), America (16%), Europe (11%), and the rest of the world (38%). The company's acquisition-led strategy has helped to further diversify its product mix and deepen its pipeline of products, besides enhancing its geographical reach. However, the company's debt-funded acquisition of Betapharm for €480 million in February 2006 has significantly impacted its capital structure and weakened its debt protection measures.

Wockhardt Ltd. (rated 'P1+' by CRISIL)

Wockhardt Ltd. is one of India's leading pharmaceutical companies, with more than 60% of its revenues derived from international markets. The company has a strong presence in Europe, supported by a number of acquisitions. Wockhardt has a strong focus and superior product mix in the domestic market. Its debt-funded growth strategy has weakened its capital structure. However, the company's liquidity and financial flexibility are strong. **CW**

Chart 3 **Increasing Number Of DMF Filings From India**



Source: CRISIL Research. DMF—Drug master file.
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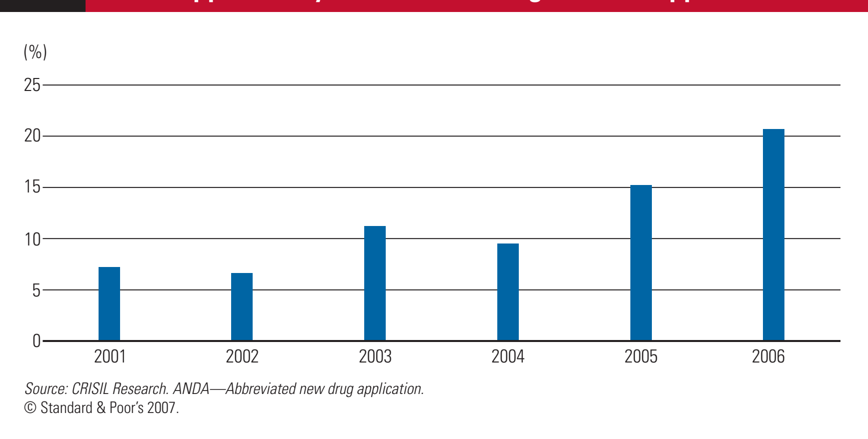
Chart 4 **ANDA Approvals By India As Percentage Of Total Approvals**



Source: CRISIL Research. ANDA—Abbreviated new drug application.
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Analytical Contacts:

Prakash Kabra, CRISIL Ltd.
Manager—Corporate Infrastructure Ratings
Mumbai (91) 22-6691-3283