FairConnect Business Advisors Private Limited

FairConnect Comment

Study on 'Defaults in 2016-17 across issuers rated by Four Largest Rating Agencies' in India:

Careful credit selection in BBB / A rated space can lead to 'Resilient Superior Returns'

Key Highlights:

- **Default rates across the four Largest Rating agencies have shown an ordinal trend and have seen a decline across rating categories for most rating agencies over last one year**
- **Study of Issuers that defaulted in FY 2017 reveals the following:**
  - Over 760 issuers defaulted in 2016-17, out of these 17% were originally rated in investment grade; 7% were rated in investment grade immediately prior to default
  - More than 50% of the defaulting issuers were originally rated in Investment Grade in Power, Road and Transport sector
  - Of the investment grade issuers that defaulted, over 75% were initially rated in BBB category
  - Issuers in Engineering and Capital goods, Metals & mining, Food products, Textile, Construction, Power, Roads and Transport sector accounted for around half the defaults
  - Only three issuers from Financial Sector Defaulted in 2016-17, out of these two were originally rated in Non-investment grade and one defaulted on a hybrid instrument
  - More than 60% of issuers in 'Non-investment grade universe defaulted' within three years of original rating assignment, while only around 25% of the investment grade defaults crystalized over the same time frame
  - Corporate bond market in India is focussed on AAA / AA credits owing to the credit risk concerns. Analysis of credit spreads for A / BBB rated entities and defaults across rating agencies reveal, if the credits are chosen carefully and suitable credit risk enhancement are put in place, there is scope to earn superior risk adjusted return through investments in BBB/A rated credits

1. Default rates have shown an ordinal trend across Rating categories for all Rating agencies

Table-1: Three Year Default rates for Rating Agencies

Rating	CRISIL		ICRA		CARE		India Ratings	
	Three-year Default rate over five-year period ending							
	Mar-16	Mar-17	Mar-16	Mar-17	Mar-16	Mar-17	Mar-16	Mar-17
AAA	0.00%	0.00%	0.0%	0.0%	0.00%	0.00%	0.00%	0.00%
AA	0.13%	0.12%	0.3%	0.3%	1.05%	0.99%	0.00%	0.00%
A	1.64%	1.09%	1.3%	0.8%	4.05%	3.42%	3.16%	3.65%
BBB	3.23%	2.23%	4.0%	3.5%	5.08%	5.27%	8.15%	8.08%
BB	8.85%	7.32%	5.1%	6.0%	10.40%	8.54%	10.20%	9.56%

Source: SEBI disclosures on websites of CRISIL, ICRA, CARE and India Ratings

Table-2: One Year Default rates for Rating Agencies

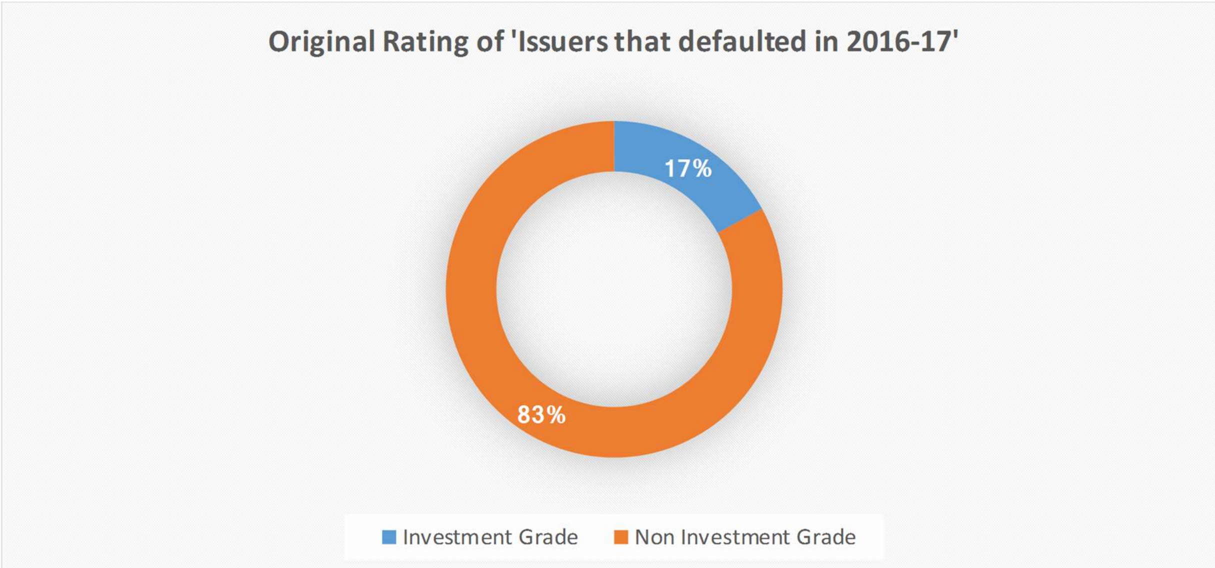
Rating	CRISIL		ICRA		CARE		India Ratings	
	One-year Default rate over five-year period ending							
	Mar-16	Mar-17	Mar-16	Mar-17	Mar-16	Mar-17	Mar-16	Mar-17
AAA	0.00%	0.00%	0.0%	0.0%	0.00%	0.00%	0.0%	0.00%
AA	0.07%	0.07%	0.1%	0.1%	0.12%	0.11%	0.0%	0.00%
A	0.16%	0.15%	0.3%	0.3%	0.29%	0.40%	0.55%	1.00%
BBB	0.66%	0.58%	1.9%	1.7%	1.36%	1.50%	2.92%	2.31%
BB	3.16%	2.83%	2.9%	3.2%	4.14%	4.01%	3.41%	3.13%

Source: SEBI disclosures on websites of CRISIL, ICRA, CARE and India Ratings

Default rates across rating agencies show an ordinal trend, that is default rates go up as one moves to lower rating category.

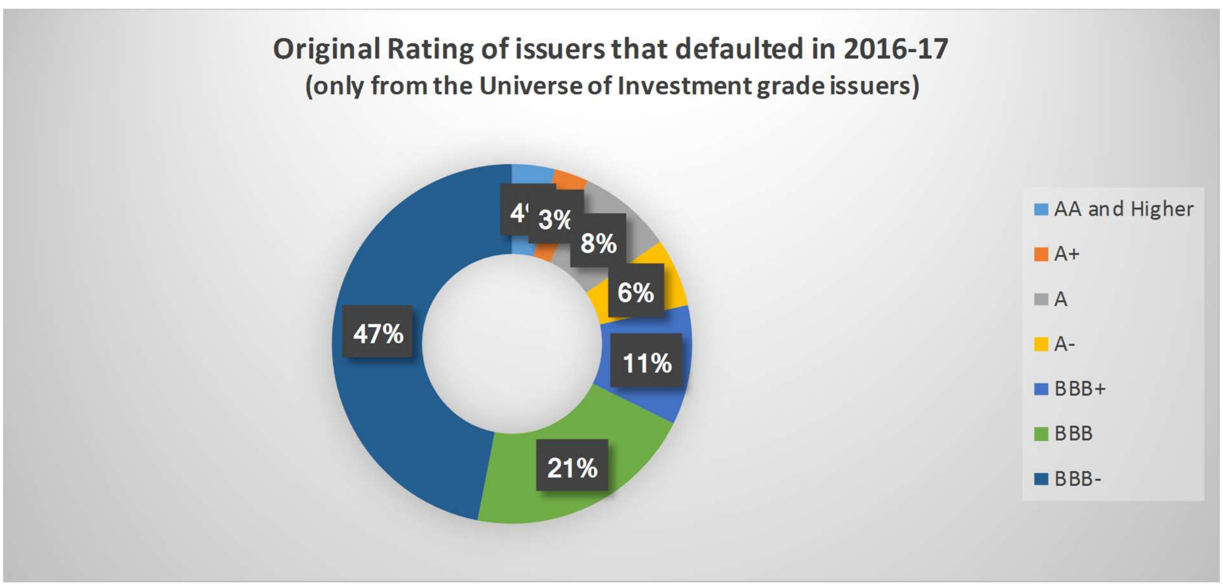
Further default rates for ICRA and CRISIL have shown reduction over one year across all rating categories, while that for CARE and India Ratings have seen a reduction in all but one rating category.

2. Defaults in 2016-17



Source: SEBI disclosures on websites of CRISIL, ICRA, CARE and India Ratings

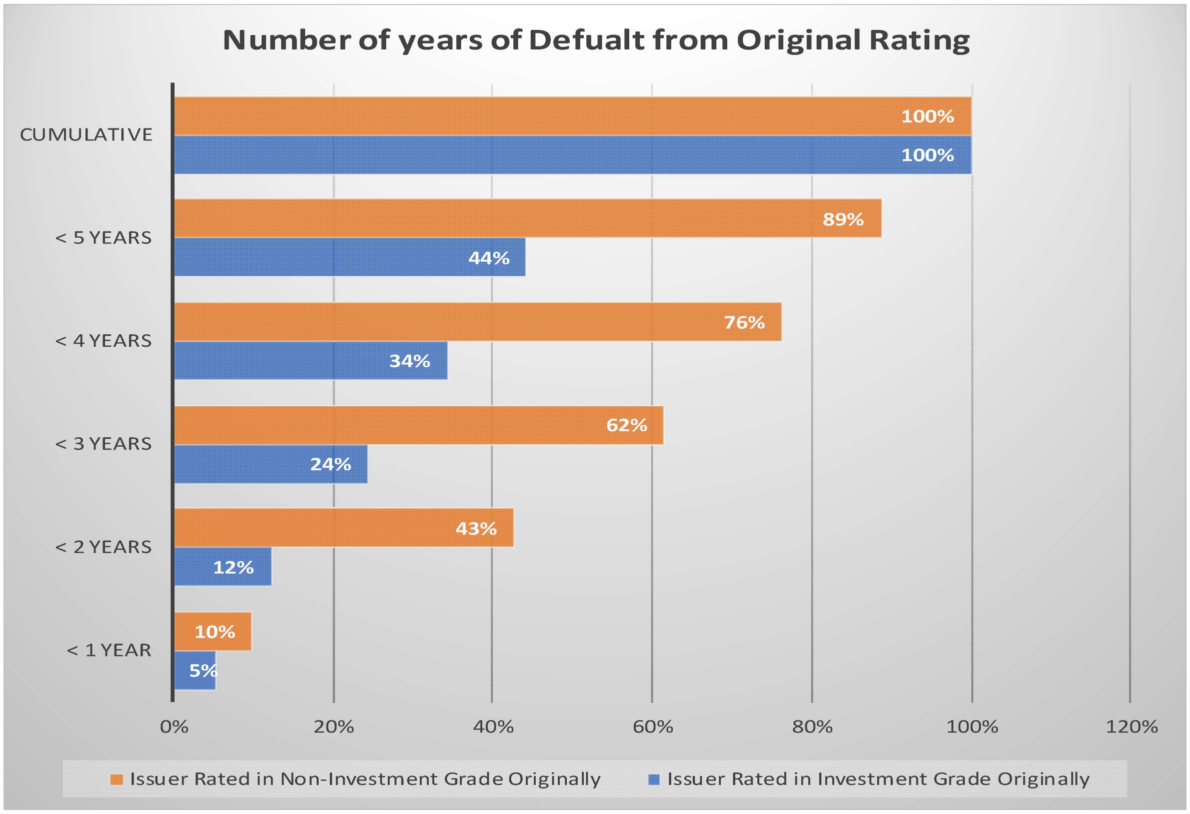
Over 760 issuers defaulted in 2016-17, out of these 17% were originally rated in investment grade and 7% were rated in investment grade immediately prior to default.



Source: SEBI disclosures on websites of CRISIL, ICRA, CARE and India Ratings

Of the 18% issuers rated in investment grade, 4% were rated originally in AA or higher rating category, 18% were rated in A category and balance 78% were rated in BBB category.

3. Time to default from Original Rating for Investment Grade Issuers

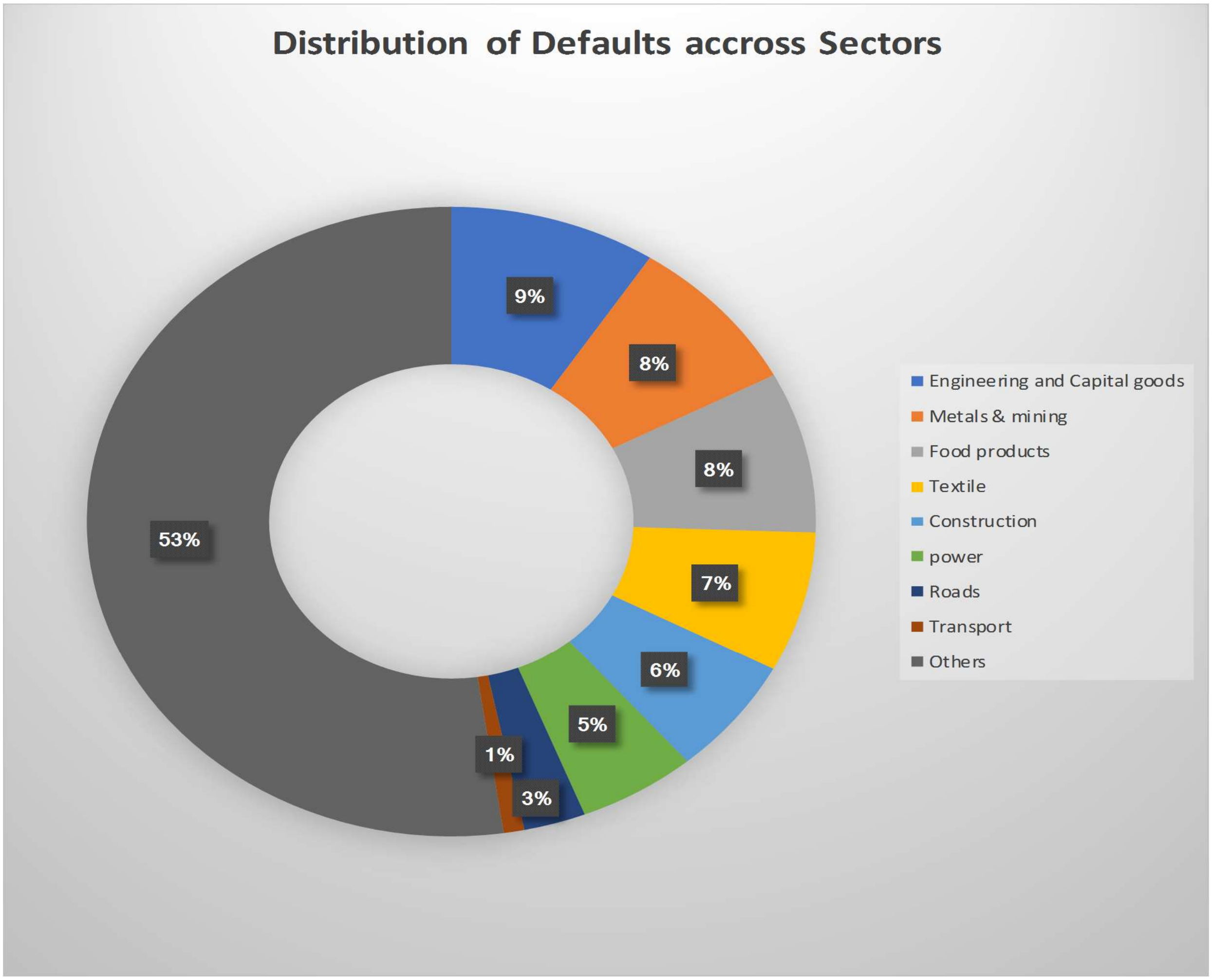


Source: SEBI disclosures on websites of CRISIL, ICRA, CARE and India Ratings

Universe of defaulting issuers rated originally in investment grade vs non-investment grade were quite different on 'time to default'. More than 60% of issuers in 'Non-investment grade universe defaulted' within three years of original rating assignment, while only around 25% of the investment grade defaults crystalized over the same time frame.

4. Sector wise trend

4.1. Around half of the defaults were from companies operating in 8 sectors

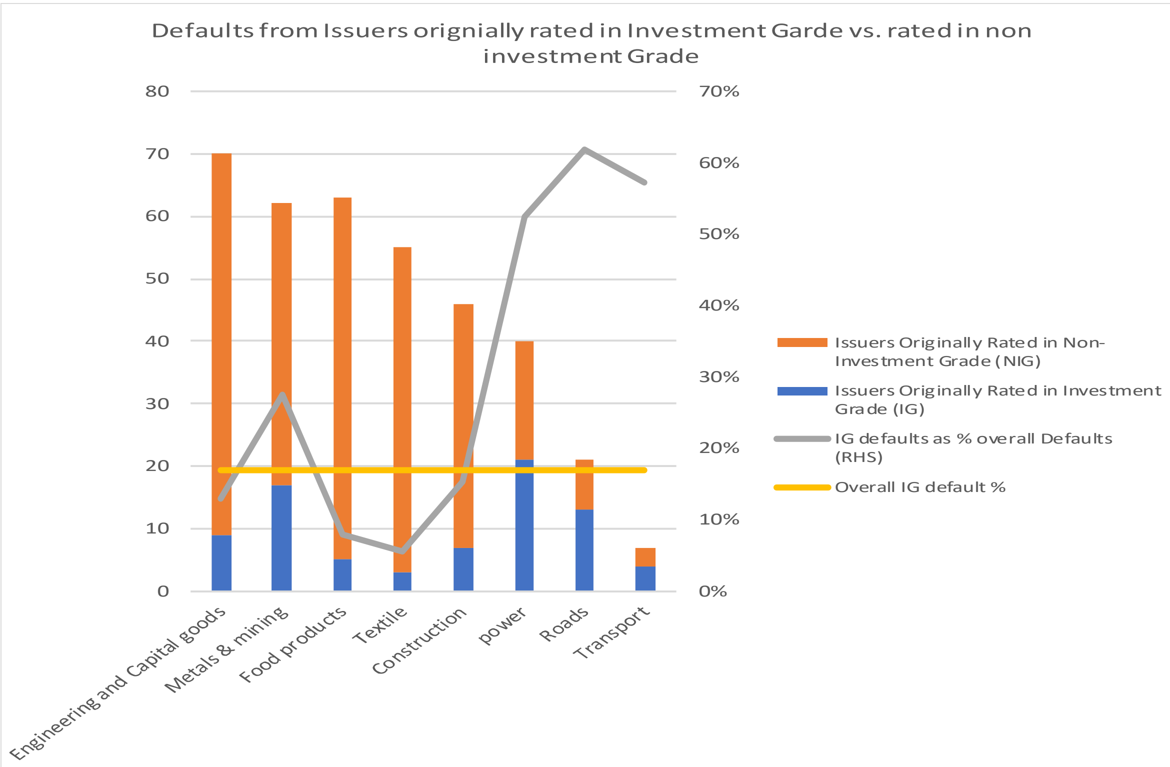


Source: SEBI disclosures on websites of CRISIL, ICRA, CARE and India Ratings

Engineering and Capital goods, Metals & mining, Food products, Textile, Construction, Power, Roads and Transport accounted for around half the defaults.

Three issuers from Financial Sector Defaulted in 2016-17, out of these two were originally rated in Non-investment grade and one defaulted on a hybrid instrument. More defaults are likely on hybrid instruments as some of the Public-Sector Banks are likely to breach Basel III triggers for hybrid coupon payments.

4.2. More than 50% of issuers that defaulted in some select sectors were originally rated in Investment Grade



Source: SEBI disclosures on websites of CRISIL, ICRA, CARE and India Ratings

Of the total 760+ defaults that crystallized in 2016-17, 17% of the issuers were originally rated in investment grade.

However, in Power, Road and Transport sector, issuers that defaulted in 2016-17, more than 50% of the defaulting issuers were originally rated in Investment grade.

To sum it up:

Credit spreads in A /BBB rating category could vary from 200 - 600 basis points, way higher than 25-100 basis points for AAA/AA rated credits.

Corporate bond market in India is focussed on AAA / AA credits owing to the credit risk concerns. Defaults across rating agencies reveal, if the credits are chosen carefully and suitable credit risk enhancement are put in place, there is scope to earn superior risk adjusted return through investments in BBB/A rated credits.

May 2017

Annexure-1: Instrument-wise definition of default

Annexure-A1: Instrument-wise definition of default

Facilities	Rating Scale	Proposed Definition of Default
Fund-based facilities & Facilities with pre-defined repayment schedule		
Term Loan	Long Term	A delay of 1 day even of 1 rupee (of principal or interest) from the scheduled repayment date.
Working Capital Term Loan		
Working Capital Demand Loan (WCDL)		
Debentures/Bonds		
Certificate of Deposits (CD)/ Fixed Deposits (FD)	Short Term/ Long term	
Commercial Paper	Short term	
Packing Credit (pre-shipment credit)	Short Term	Overdue/unpaid for more than 30 days.
Buyer's Credit	Short Term	Continuously overdrawn for more than 30 days.
Bill Purchase/Bill discounting/Foreign bill discounting /Negotiation (BP/BD/FBP/FBDN)	Short Term	Overdue/unpaid for more than 30 days.
Fund-based facilities & No Pre Defined Repayment Schedule		
Cash Credit	Long Term	Continuously overdrawn for more than 30 days.
Overdraft	Short Term	Continuously overdrawn for more than 30 days.
Non fund-based facilities		
Letter of credit (LC)	Short Term	Overdue for more than 30 days from the day of devolvement.
Bank Guarantee (BG)(Performance/ Financial)	Short Term	Amount remaining unpaid from 30 days from invocation of the facility.
Other Scenarios		
When rated instrument is rescheduled:		Non-servicing of the debt (principal as well as interest) as per the existing repayment terms in anticipation of a favourable response from the banks of accepting their restructuring application/ proposal shall be considered as a default. Rescheduling of the debt instrument by the lenders prior to the due date of payment will not be treated as default, unless the same is done to avoid default or bankruptcy.
Curing Period		90 Days – for Default to Speculative Grade and generally 365 Days for Default to Investment Grade

**For bank loan ratings, default recognition will need to be in line with the RBI guidance*

Source: SEBI

Annexure-2: Rating Definitions

	Rating	Definition
Investment Grade	AAA	Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such instruments carry lowest credit risk.
	AA	Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations. Such instruments carry very low credit risk.
	A	Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk.
	BBB	Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.
Non-Investment Grade	BB	Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.
	B	Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.
	C	Instruments with this rating are considered to have very high risk of default regarding timely servicing of financial obligations.
	D	Instruments with this rating are in default or are expected to be in default soon.

Rating symbols should have CRA's first name as prefix

Modifiers {"+" (plus) / "-"(minus)} can be used with the rating symbols for the categories AA to C. The modifiers reflect the comparative standing within the category.

Source: SEBI

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