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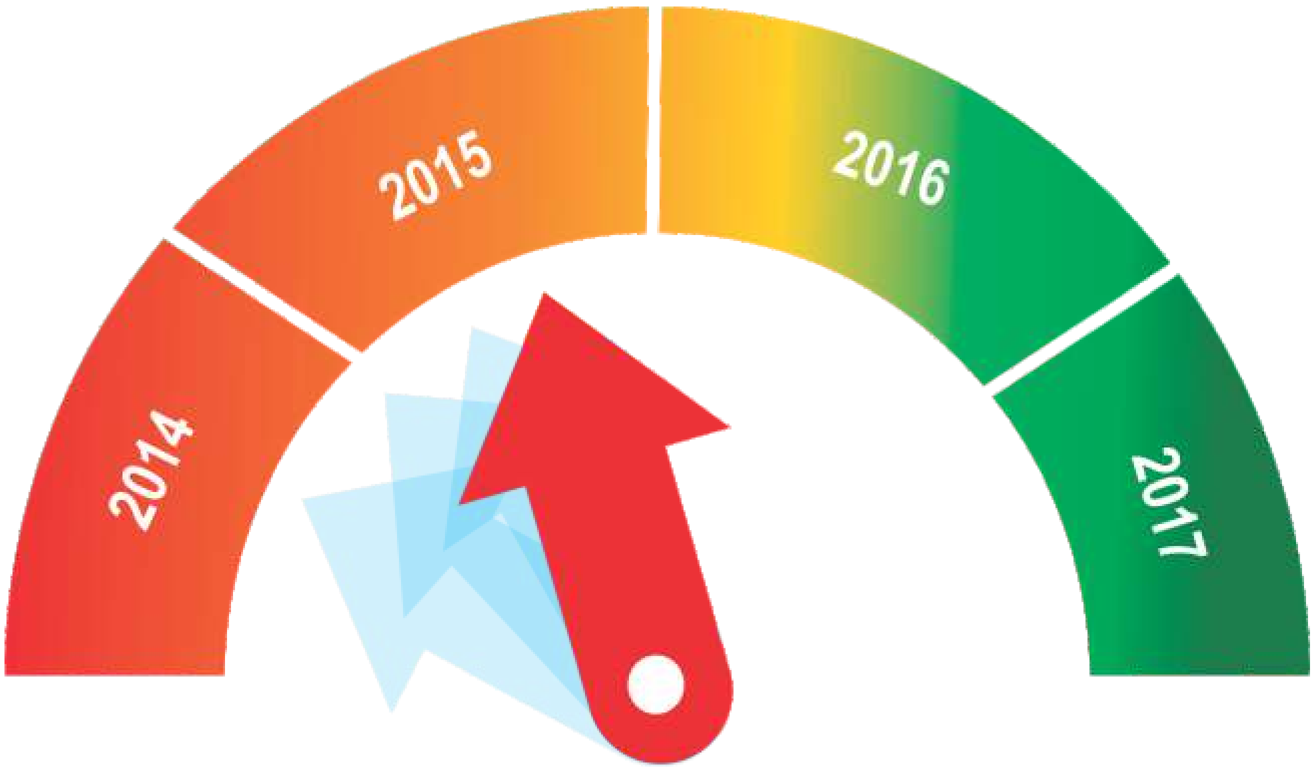
May 2015

Modified expectations



Why it will be a slow grind up

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Executive Summary

When the Narendra Modi-led National Democratic Alliance came to power with a resounding majority last year, it had inherited a frail economy. Twelve months on, the macros are looking better, growth is inching up, inflation has tempered and current account deficit is in the safe zone.

Feverish speculation about big-bang reforms and a quick turnaround in the economy are getting the deserved reality check. The recent rise in crude oil prices, possibility of a weak monsoon amid rising rural distress, and the parliamentary logjam over two critical pieces of legislation – on land acquisition and Goods & Services Tax -- are also helping rationalise expectations.

Winding back, the main reasons for a sharp slowdown in India's growth since 2012 were the discontinuation of stimulus to rein in rising fiscal deficit and inflation, and policy paralysis that slowed decision making and made it difficult to do business.

The Modi government is addressing policy paralysis by energising the bureaucracy, fast-tracking decision-making, and enhancing the ease of doing business. This will create enablers for growth, but cannot push demand up in the short term. There is no monetary and fiscal bazooka at hand either – which is also because of the legislative mandate to bring down fiscal deficit. And monetary policy turned mildly favourable only this year.

In other words, there is little that can be done to engineer a quick revival in demand. That's exactly why corporates are shy of undertaking fresh investments, as we show in our telling analysis of the results of CNX 500 companies in the first nine months of fiscal 2015 on *Page 14*. We see private corporate investments picking up only in fiscal 2017.

This lack of demand is also reflected in low utilisation of capacities. Net-net, we believe demand will pick up only slowly. And as is the typical progression in such a milieu, consumption demand will improve first, which then will trigger investments.

Independent studies done by CRISIL Research and CRISIL Ratings conclude similarly on the outlook for consumption-driven sectors. CRISIL Research data show consumption-linked sectors have done better than investment-linked ones in the last fiscal and will continue to do so in fiscal 2016 as well. CRISIL Ratings' data on upgrades and downgrades confirm the relative strength of consumption-linked sectors compared with investment-linked sectors. Yet capacity utilisation will be slow to pick up.

As for major reforms, given the lack of numbers in Rajya Sabha, we believe the government will have to show exceptional statecraft to cobble up consensus to pass the Bills.

These are reasons why we believe India is on a slow grind up.

We evaluated the Modi government's one-year performance using four metrics: What has worked so far, where are the signs of a pick-up, what hasn't worked so far, and what lies ahead. Our study blends in CRISIL's unparalleled expertise in macroeconomic, industry, corporate and banking analysis, to offer a 360-degree view on India. The key findings are:

Modified expectations

What has worked?

- The government has not been able to effect a quick turnaround in the economy but has made progress in putting in place building blocks needed to raise India's potential growth. Initial steps at improving transparency, enhancing the ease of doing business, improving the efficiency of the goods and labour markets, and financial sector reforms will pave way for higher growth over the medium run
- Prudent tactical moves have helped keep a tab on inflation even in the bad monsoon year of 2014. Restraint in increasing minimum support prices and release of food grain stocks into the market have helped kept food inflation under control and allowed RBI to cut interest rates

Where are the signs of pick-up?

- Credit ratio, or the ratio of upgrades to downgrades, is ticking up
- Business and consumer confidence is also looking up

What has not worked?

- Difficulty in arriving at a consensus carries the risk of delay and dilution of key legislations such as the Land Acquisition Bill and the Goods & Services Tax (GST) Bill
- Inability to use policy tools such as interest-rate cuts and fiscal spending to stoke demand
- Inability to revive manufacturing and address enhanced rural distress
- Our study of CNX500 companies shows that while regulatory issues and high leverage constrain corporate performance and investment decisions, lack of demand is the single-biggest factor holding back private-sector investments

What lies ahead

- Our analysis shows that consumption will lead the investment cycle. Lower food and fuel inflation and reduction in interest rates will support private consumption. Industry-level granular findings confirm the strength of consumption-linked sectors over investment-led sectors. Credit ratings data, too, show that consumption-linked sectors enjoy higher upgrades than investment-linked sectors
- With a gradual pick-up in consumption demand and public investments in select infrastructure sectors, private investment activity should revive by fiscal 2017
- We expect GDP growth to grind up to 7.9%, inflation to come down to 5.8% and current account deficit at 1% of GDP in fiscal 2016, given a normal or near-normal monsoon

SECTION A

What has worked so far

- Macro-economic indicators have improved
- Short-term issues that needed fixing are fixed
- Early steps taken to improve infrastructure and institutions

The macros are improving gradually

Over the last one year, several steps have been initiated to unshackle binding constraints to growth. The government has cleared many infrastructure bottlenecks, speeded up decision-making, fast-tracked project clearances, cut red tape and sorted out mining issues. These steps, and the fortuitous kicker from a slump in global crude oil prices and the commodity complex, have engineered a moderate turnaround in the economy. Low oil prices have helped rein in inflation and tamed the beast of twin deficits – fiscal and current account.

Consequently, GDP growth increased to 7.4% from 6.9% in fiscal 2014, while inflation dropped to 6% from 9.5%, and CAD and the government's subsidy burden, both nearly fell by 50 basis points as a percentage of GDP, with the latter helping fiscal consolidation. And after a sweat-inducing lag, monsoon caught up a lot last year to prevent sharp spikes in food prices.

Steps taken to raise India's 'potential-growth' rate: For long-term well-being, a country needs to raise its ability to grow faster without creating inflationary pressures. This is its 'potential-growth' rate. There are many factors that combine to increase the potential-growth rate and one of the important ones is competitiveness.

The World Economic Forum's Global Competitiveness Index *(Chart 1)* shows India's competitiveness has been continuously eroding in the last six years. Specifically, India ranks poorly in institutions, infrastructure, macroeconomic environment, health and primary education and the efficiency of its goods and labour markets.

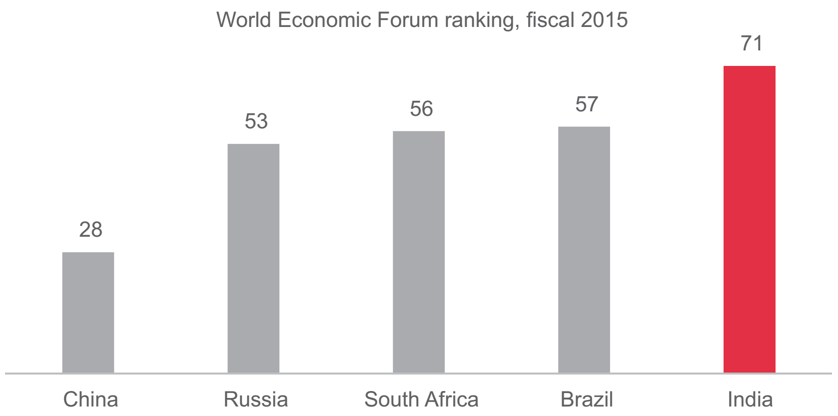
Our assessment shows that the Modi government has identified the major issues correctly and put in place some crucial building blocks *(see Page 6)*, but it will have to do a lot more. The challenge will be to stay the course yet step on the gas, and get corporates to hitch their wagon to the government's star.

Improving India's competitiveness

We use the World Economic Forum (WEF) rankings and methodology rooted in Michael Porter's *The Competitive Advantage of Nations* (1990) on the stages of development and benchmark India's growth potential/ competitiveness versus competitors. As per the WEF, the Indian economy is still in the factor-driven stage, and needs to transit from agriculture to manufacturing.

For the sixth consecutive year, India's ranking on the WEF Global Competitiveness Index saw a decline in fiscal 2015, and was the lowest among BRICS nations. Out of 144 countries, India

Chart 1: Global competitiveness indicators



Source: World Economic Forum

Table 1: India's competitiveness ranking

		India	China	Indonesia
		Ranking in fiscal 2015		
Factor-driven	Overall	92	28	46
	Institutions	70	47	53
	Infrastructure	87	46	56
	Macro-economic environment	101	10	34
	Health and primary education	98	46	74
Efficiency-driven	Overall	61	30	46
	Higher education and training	93	65	61
	Goods market efficiency	95	56	48
	Labour market efficiency	112	37	110
	Financial market development	51	54	42
	Technological readiness	121	83	77
	Market size	3	2	15
Innovation-driven	Overall	52	33	30
	Business sophistication	57	43	34
	Innovation	49	32	31
GCI	Overall	71	28	34

Note: Ranking out of 144 countries,
Source: World Economic Forum

ranks 71 on the overall index, 92 on factor-driven parameters, 61 on efficiency-driven parameters and 52 on innovation and sophistication parameters. While we rank high on innovation (49) and business sophistication (57), we are far behind our competitors on the efficacy of institutions, infrastructure, macroeconomic environment and health and primary education. These are critical for pushing our competitiveness in the factor–driven parameters and for making manufacturing India's growth engine. It is imperative, therefore, to improve our building blocks.

What has been done to raise India's competitiveness? The Modi government has announced a slew of measures since taking the reins a year back. We analyse what these steps amount to in terms of improving India's potential growth. We use the likeness of a speedometer to gauge the performance so far – the needle is the starting point and the arrow indicates the direction and extent of reforms.

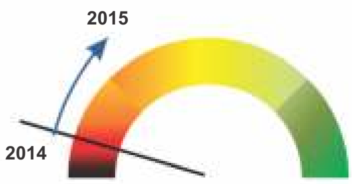
How to read the readings

Starting point: WEF Global Competitiveness Rankings for fiscal 2015

Arrow indicates the extent of action taken by the Modi government so far

- No action
- Identified problem and initial steps taken
- Plan laid out and measures announced
- Work in progress
- Action completed

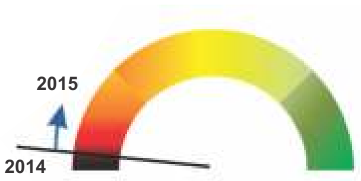
Institutions



The state of institutions, both administrative and legal, is still a work in progress.

Hits:	Misses:
▪ Simplification of procedures ▪ Inter-ministerial coordination ▪ Reduction in bureaucratic tape ▪ Web-based environment clearances ▪ Revamping Project Monitoring Group ▪ Mining Bill passed and GST passed in Lok Sabha	▪ Administrative barriers to entry: World Bank estimates 12 procedures and a month required to register a business ▪ Uneven and distortionary tax system ▪ Judicial reforms ▪ Steps to formalise the large informal economy

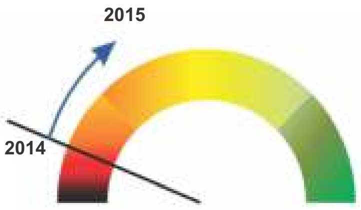
Efficiency of labour market



Reform in the labour market is at a nascent stage

Hits:	Misses:
▪ Proposed amendments to The Apprentices Act with the states taking lead in labour reforms (e.g. Rajasthan) ▪ Skilling India	▪ Reforms proposed have been moderate and there is little progress after announcements

Infrastructure



Efforts to improve aspects of infrastructure bottlenecks have been initiated.

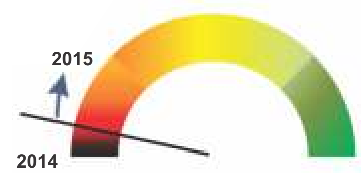
Hits:	Misses:
▪ FDI in railways, construction ▪ Increased investment in roads, urban infrastructure ▪ Renegotiation of contracts for roads and ports ▪ Reforms in the power sector including transparent allocation of coal blocks through auctions ▪ Mines and Minerals Amendment Bill passed	▪ Lack of reforms in oil, gas and telecom sectors ▪ Insufficient progress on the Land Acquisition Bill ▪ Slow progress on Delhi Mumbai Industrial Corridor

Efficiency of goods market

Some efforts to improve efficiency of the goods market have been initiated.

Hits:	Misses:
▪ GST Bill passed in Lok Sabha ▪ Delisting of fruits and vegetables from APMC Act ▪ Initial plan for a National Agriculture Market laid out ▪ Deregulation of diesel	▪ GST Bill diluted ▪ Slow progress on improving the food supply chain ▪ Removing distortions in the subsidy regime

Health and primary education

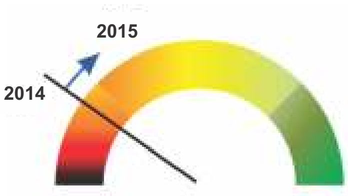


Little progress has been made to improve health and primary education.

Hits:	Misses:
▪ Women and child development programme announced ▪ Heath and Family welfare programme announced ▪ School education programme announced	▪ Funds allocated to these programmes in the budget are limited. Health sector spending accounted for 0.9% of GDP while the share on education was at 0.2% – unchanged from last year.

Modified expectations

Financial market development



The reform process is in an early stage and few programmes have been announced.

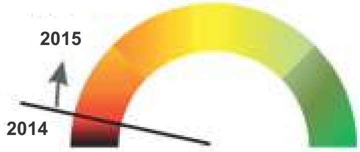
Hits:

- 120 million accounts opened under Jan Dhan Yojana
- Promoting creation of payment banks for financial inclusion
- FDI in insurance raised to 49% from 26%
- Public contracts Bill for resolution of disputes announced
- Indian financial code to revamp regulation of financial markets announced
- Monetary policy framework
- Financing Agency for micro units proposed
- Strengthening stressed asset resolution and recovery mechanism
- Initiated life insurance and pension schemes

Misses:

- Need to develop long-term strategy for effective governance, management, funding, capability building for PSBs to surmount challenges of asset quality and capital
- Lack of meaningful progress on bond market and securitisation
- Many PSBs are still without a chairman and MD

Technological readiness



Plans announced on technological readiness have been forthcoming.

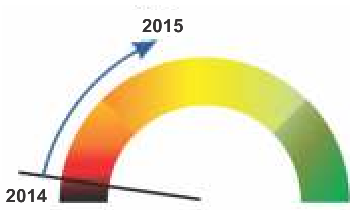
Hits:

- Digital India
- Adoption of Aadhar ID system for social welfare programmes

Misses:

- Internet access remains a challenge in rural areas

Macroeconomic environment



The government has implemented steps to improve the macro-economy.

Hits:

- Fiscal consolidation
- Steps to control inflation such as the price stabilisation fund, a strong stand on hoarding, encouraging states to delist fruits and vegetables from the APMC Act, lower increase in minimum support prices.
- Monetary policy framework

Misses:

- Structural measures to increase agricultural productivity
- Credible measures to boost manufacturing sector
- Creating employment opportunities

SECTION B

Where are the signs of pick-up

- Consumption outlook is improving
- Higher credit-rating upgrades in consumption-linked sectors

There's promise in higher rating upgrades

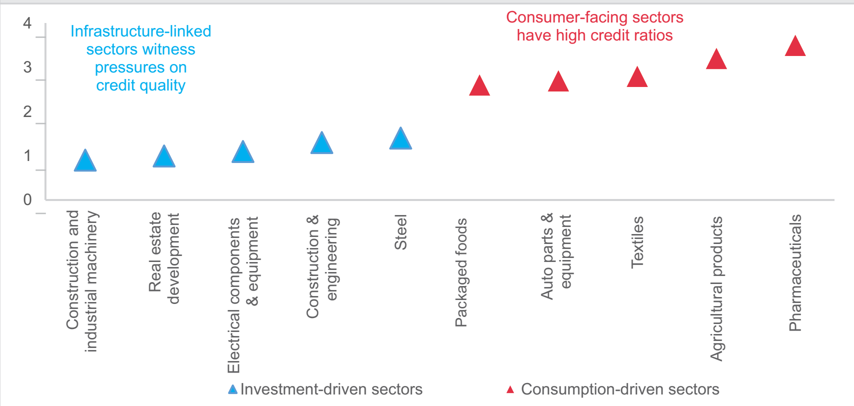
Ratings data show debt remains a bone in the gullet: CRISIL Ratings' analysis of data for the second half of fiscal 2015 shows some improvement in the credit ratio, or rating upgrades to downgrades *(Chart 2)*. Almost two-thirds of the 816 upgrades seen in the second half were driven by business-related factors such as scaling-up of operations, and a modicum of improvement in demand in consumption-linked sectors. Export-linked sectors and non-discretionary consumer segments such as agricultural products, textiles, packaged foods and pharmaceuticals continued to see the highest upgrade rates. But demand isn't anywhere close to the levels required to kick-start the corporate investment cycle.

Value of debt downgraded far more than that upgraded: On the other hand, there were 466 downgrades in the second half of which almost 60% were attributable to weak liquidity. Investment-linked sectors such as capital goods, construction, engineering, steel and real estate continued to log the highest downgrade rates.

However, a pervasive improvement in credit quality remains elusive because the value of debt seeing downgrades is far more than those seeing upgrades. This is reflected in the ratio of debt of upgraded firms to that of downgraded firms, which stood at 0.72 times. This proportion is even weaker for large-sized firms at 0.45 times. Also, companies with high debt continue to see more downgrades than upgrades.

CRISIL believes heavy burden of debt will continue to constrain the ability of large firms to improve their credit profiles. A chunk of their debt was taken for projects/ capacity expansions that haven't been completed, or are facing demand slack after completion. Essentially, a backwash of irrational expansions undertaken well before the Modi government took the reins.

Chart 2: Improving credit ratios in consumption-led sectors



Source: CRISIL Ratings

Business and consumer confidence is looking better: Leading and coincident indicators do show initial signs of improvement in investment outlook, especially in consumer-facing sectors. Confidence indicators are looking up, too *(Chart 3-4)*. The RBI's quarterly survey covering 1,565 manufacturing companies, released in April 2015, shows that industrial outlook has been on a steady uptrend since June 2014. And as per the latest survey, outlook is improving for production, order book, capacity utilisation, cost of raw material, profit margins and employment, though it remains dismal for exports and price-setting *(Table - 2)*.

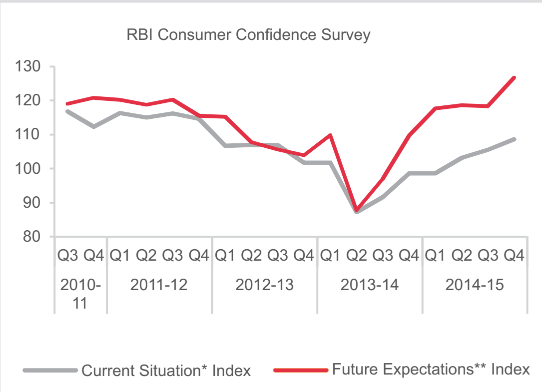
Table 2: Business expectations survey

	NCAER Business Confidence Index Q4 2014-15	FICCI Overall Business Confidence Index February 2015	CII Business Confidence Index Q3: 2014-15	RBI Business Expectation Index: Expectation for Q1 2015-16
Current level of the index	148.4	70.5	56.4	115.2
Index as per previous survey (last quarter)	142.5	70.4	56.2	115.6
Index levels one year back	122.3	60.8	49.9	111.1

Source: RBI, CRISIL Research

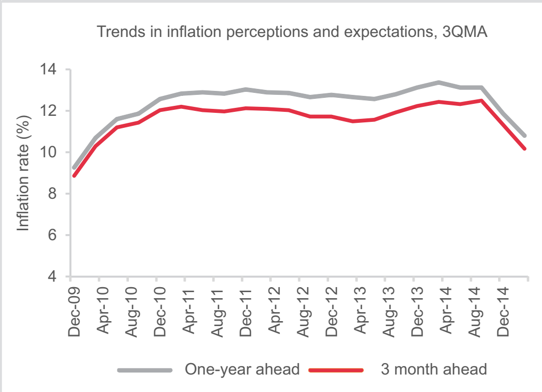
The indicators of private consumption are also showing a steady uptick. One, the RBI's consumer confidence survey results show continued improvement in future expectations on employment and spending. More than 80% of the respondents in the latest survey (March 2015) expect an increase in current as well as future spending perceptions on essential items, while 40% expect an increase in non-essential spending (Charts 3-4). More than 50% of the respondents expect improvement in employment situation one year ahead. Second, inflation expectations have eased, positively influencing purchase decisions. The RBI's April 2015 survey results show that inflationary expectations are coming down. Third, retail-loan growth has been rising fast in sectors such as vehicle loans (22%), consumer durables (34%) and housing (18%). Besides, automobiles (passenger vehicles and scooters), organised retail and airlines are also seeing improved consumer demand *(Charts 5-6).*

Chart 3: Consumer confidence improves



*Note: * Current situation compared to a year ago,*
*** Future expectations for a year ahead*
Source: RBI

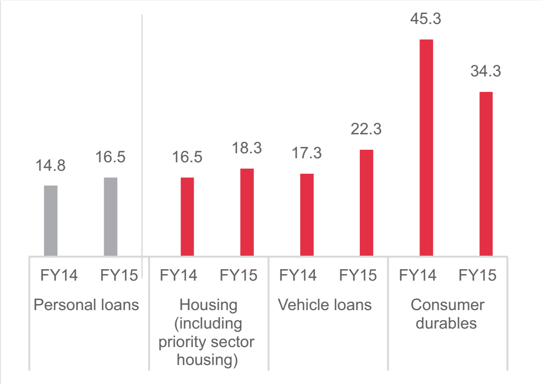
Chart 4: Inflation expectations ease



Note: 3QMA=3 quarter moving average
Source: RBI

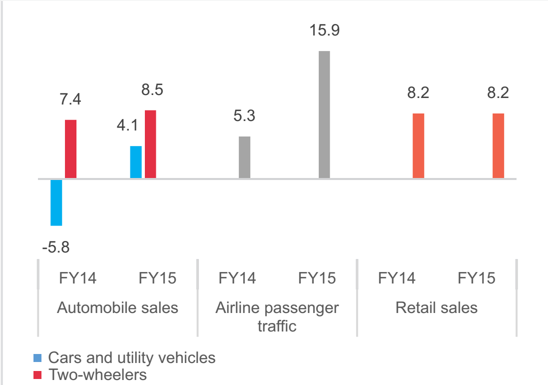
Modified expectations

Chart 5: Retail loan growth improves (%, yoy)



Source: RBI

Chart 6: Auto sales (%, yoy) also look up



Source: RBI

Private consumption will provide fillip: We believe private consumption could be the bulwark this year, but it will improve only gradually. But this will depend a lot on a normal monsoon. Over the last few years, key contributors to the decline in private consumption – high fuel prices, inflation and interest rates – have started to turn around and will continue to do so in fiscal 2016. Lending rates are edging down, too, though by a mere 20 bps or so till now. We believe the push to consumption spending from easing of lending rates this fiscal will be small and gradual. Still, this will be positive for interest-rate sensitive sectors such as automobiles, housing and consumer durables.

Household spending power has increased: CRISIL estimates household spending power has increased by Rs 1.4 trillion in fiscal 2016 because of low fuel prices, benign food inflation and steadily improving income growth. This money could be spent on consumer discretionary items if consumers feel the gains as lasting. But if perceived as transient, it could be deployed in savings. However, with real returns on savings expected to rise only marginally this year as nominal interest rates ease and inflation falls, households could spend rather than save the extra money. In nominal terms, the Rs 1.4 trillion increase in the spending power of households is close to 2% of their annual spending.

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SECTION C

What hasn't worked so far

- Inability to pump-prime constrains manufacturing
- Investment cycle in limbo, agriculture remains stressed
- Consensus to pass key legislations elusive

The tyranny of inheritance

Inability to pump-prime, having inherited high fiscal deficit and inflation: Typically, a slowing economy is accelerated through deep interest-rate cuts and increase in government spending. But fiscal profligacy of the past and inflationary concerns preclude such steps. Public spending is also restrained by the legislative mandate to bring down India's fiscal deficit-to-GDP ratio. On its part, the Reserve Bank of India (RBI) has cut interest rates by 50 basis points so far in 2015, to 7.5%, but this has not benefited the economy much because the banking sector's bad-loan mountain increases risk aversion, restricts transmission of interest rate cuts and subdues credit growth. Fiscal and monetary restraint entails sacrificing growth in the short run, but will eventually foster macro stability and improve India's ability to sustain higher growth rates in future.

Slack demand – and not policy – holding back private investments, especially in manufacturing: Despite some macros turning green, the investment cycle in India is stuck and demand for a number of consumer goods remains subdued..

CRISIL Research analysed the performance of 411 of the CNX 500 companies (the rest belong to BFSI and oil & gas sectors, which were excluded), accounting for 90% of the market capitalisation of the National Stock Exchange, and compared their revenue and operating profit growth in the first nine months of fiscal 2015 to nominal GDP growth. It showed 69%, or 285 companies, have performed below par, while 126 companies, or 31%, outperformed *(Table 3)*.

While regulatory issues and high leverage are constraining corporate performance, our analysis shows that it is demand slowdown that's hurting India Inc the most. This is especially true of manufacturing companies. A good 126 companies, or 56% of the 285 underperformers, are impacted by a demand slowdown *(also see Chart 8 on capacity utilisation)*. The No. 2 factor was intensifying competition, which impacted 45 – or 16% -- of the laggards. Policy was only the No. 3 factor, affecting 42 – or 15% -- of the companies, while high debt or leverage was the No. 4 factor, affecting 29 – or 10% -- of the companies. But from a banking sector perspective, the contribution of highly leveraged companies to total outstanding debt is very high at about 22%.

Table 3: Poor demand curbs corporates, not so much policy

Analysis of 411 companies from the CNX 500 index, excluding from the BFSI and oil & gas sectors

Results for the first nine months of fiscal 2015 versus nominal GDP growth

69% companies underperformers

31% companies outperformers

What constrained performance

What constrained performance	Proportion Of: Companies	Revenues	Debt	
Demand	56%	53%	38%	*Slowdown in demand*
Competition	16%	14%	7%	*Increased competitive intensity*
Leverage	10%	7%	22%	*High debt / inability to service debt*
Policy	15%	20%	28%	*Policy changes / regulatory bottlenecks*
Company-specific issues	3%	6%	5%	*Issues like demerger, plant closure, etc.*

Stagnant manufacturing, stress in agriculture: The 'Make in India' programme will take a long while to make a difference to India's manufacturing sector. But improving growth in the sector is crucial because one million Indians are entering the workforce every month and to boot, there is also labour spillover from farms. The agriculture sector, employing close to 50% of the workforce, continues to battle low productivity and a raft of other inefficiencies. Damage due to unseasonal pre-summer rains on the back of a sub-normal monsoon last fiscal has aggravated farm distress *(see The criticality of monsoon for hinterland, Page 22).*

Consensus to pass key legislations elusive, risking dilution of reforms: The government lacks majority (having only 63 out of 244 seats) in the Rajya Sabha, and the situation is unlikely to change anytime soon. The government will, therefore, need do the hard yards, show statecraft and build political consensus to pass crucial Bills on land and GST that will spawn structural reforms. Consequently, there is a risk the eventual legislations are watered down. Deft political management and effective communication will be essential if the government has to take forward the economy.

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SECTION D

What lies ahead

- Debt pile in infra, bad loans will curb speed of recovery
- Private consumption growth crucial to investment cycle
- Normal monsoon a critical need

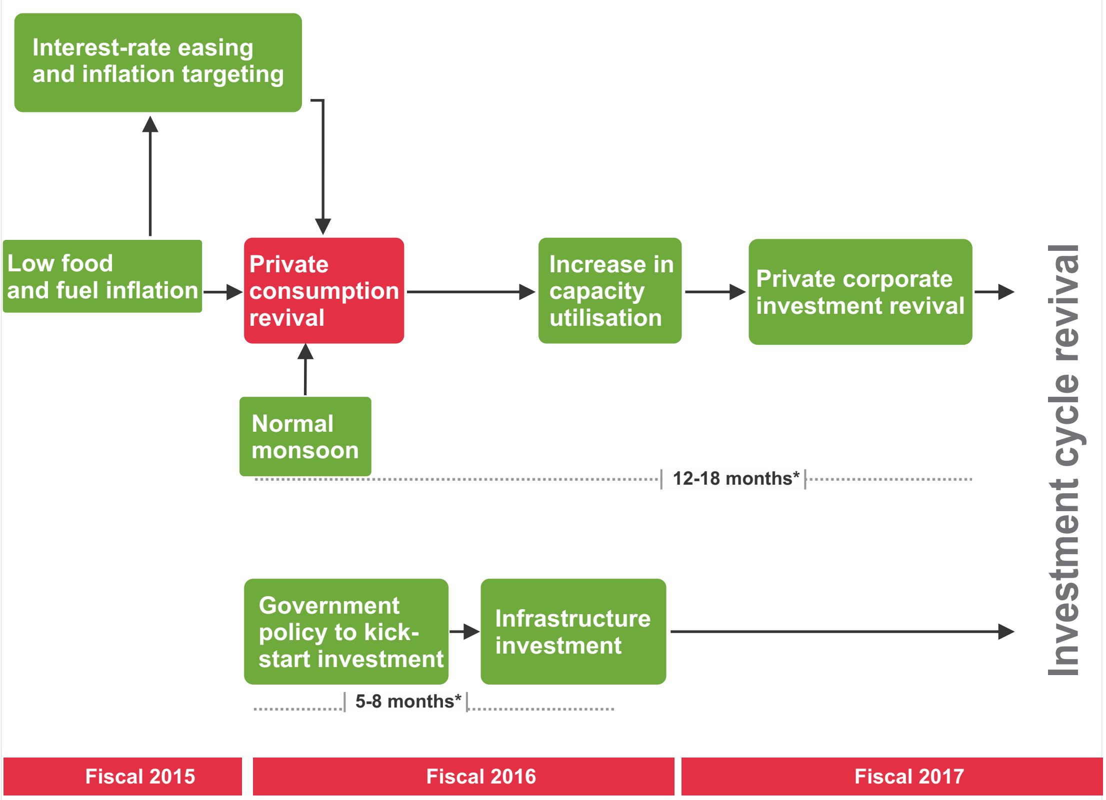
Expect a slow recovery in fiscal 2016

If monsoon delivers, we expect a 50 bps uptick in GDP growth: We forecast India's GDP growth to touch 7.9% in fiscal 2016, from an estimated 7.4% in 2015. The recovery, as we see it, will be triggered by a lift in private consumption and a mild pick-up in public sector-led infrastructure projects.

The key risk to watch out for in the immediate term is a sub-normal monsoon. It can depress rural demand and delay the consumption-led recovery that we envisage.

The headroom in capacity utilisation needs to close first: We believe that given the current macro-economic pace, it could be 12-18 months *(Chart 7)* before headroom in capacity utilisation in the manufacturing sector gets closed, and private investment cycle is set in motion. That's because, despite underlying optimism, companies are chary of putting money where their mouth is; they are seeking affirmations that growth triggers are well-pulled and will stay so.

Chart 7: It will take 12-18 months for private investment cycle to revive



**Measurement from beginning of fiscal 2016*
Source: CRISIL Research

The path growth could take

Closing in on a goldilocks spell: We believe a gradual upturn has begun, and indications are there should be steady progress this time *(Table 4)*. And if inflation remains under leash – as it seems now – at least a goldilocks spell can be had. But with limited counter-cyclical tools available to pump the prime, unlike in 2009, and covenants of fiscal consolidation shackling government spending, the speed of rebound will be limited.

Speed will also depend on how domestic consumption shapes up. The trifecta of lower food inflation, drop in oil prices – which have left more money in the hands of people in the last 10 months -- and mild easing of interest rates could stoke private consumption that, in turn, will improve sales in the automobiles, retail, consumer durables and fast-moving consumer goods sectors. But there is unlikely to be a dramatic change in the wealth effect such that demand would overwhelm extant capacities in the current fiscal.

Table 4: Better-looking colours of the macro-economy

	2012-13	2013-14	2014-15	2015-16 F
GDP growth (%)	5.1	6.9	7.4	7.9
Inflation (%)	10.2	9.5	6.0	5.8
CAD/GDP (%)	4.7	1.7	1.2	1.1
Fiscal deficit/GDP (%)	4.8	4.6	4.1	3.9
Exchange rate (year-end, Rs/$)	54.4	60.1	62.6	63
10-year yield (year-end, %)	7.9	8.8	7.7	7.5
Investment/GDP (%)	31.9	30.7	29.8	-
NPA/advances (%)	3.3	3.9	4.3	4.5

Source: CSO, RBI, CRISIL Research
Note: F=CRISIL forecast

On the infrastructure side, investments will start much earlier – indeed, in the current fiscal itself – following a government-led push to spending in sectors such as roads, railways, irrigation and urban infrastructure. But for private corporate investment in infrastructure to start, resolution of policy bottlenecks, more equitable sharing of risks and rewards with private sector (for PPP projects) and improved demand visibility are critical. That will take time, and could turn favourable only after the current fiscal. Highly leveraged corporates, especially in the infrastructure space, would also be averse to taking risks and therefore, the government will have to bear more risks, till private sector cash flows and confidence levels improve.

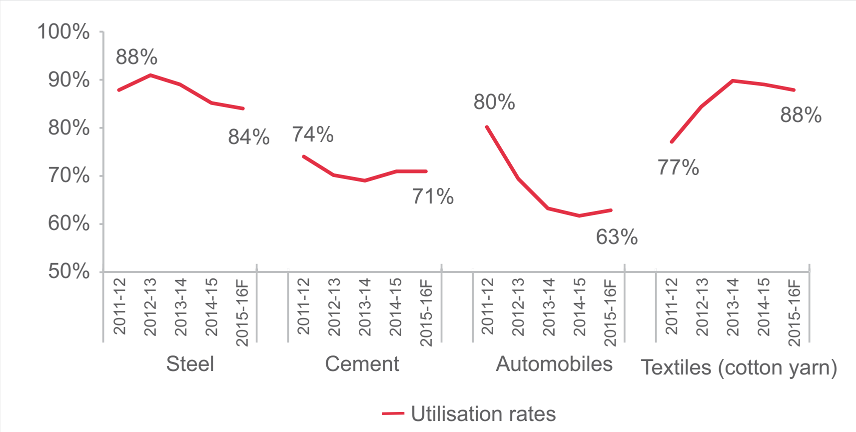
Exports offer no ballast: The global economy is expected to navigate a mild and uneven recovery path in 2015. Muted world trade growth will restrict exports. The World Trade Organisation expects world trade to grow at 3.3% in 2015 and 2016 compared with over 5% recorded since 1990. Also, an appreciation in the rupee in real terms has hurt India's competitiveness.

Investment revival is the biggest challenge

We do expect a minor uptick in investments in select sectors, especially infrastructure, where government role is dominant. But in manufacturing, which is dominated by the private sector, revival will depend on the speed at which private consumption demand improves. Also, some push to investments this year will come from unclogging of projects.

Investment revival is inarguably the single-biggest challenge for the Modi government. Over the last few years, investments have trailed GDP growth and the overall investment rate has slipped to 29.8% in fiscal 2015 from 33.6% in fiscal 2012. The reasons are well known. In the manufacturing sector, swathes of under-utilisation *(Chart 8)* and poor visibility on demand have slowed the pace of investments. In the infrastructure sector, high leverage and interest costs (the sector's interest cost to operating income ratio rose to 11.5% in fiscal 2014 from 4.6% in fiscal 2010), falling returns on investment due to delays in project implementation, and lack of visible demand pick-up are deteriorating private-sector investment.

Chart 8: The capacity utilisation picture



Note: Utilisation rate for automobiles is the average for passenger cars, two-wheelers, commercial vehicles and tractors
P: Projected
Source: CRISIL Research

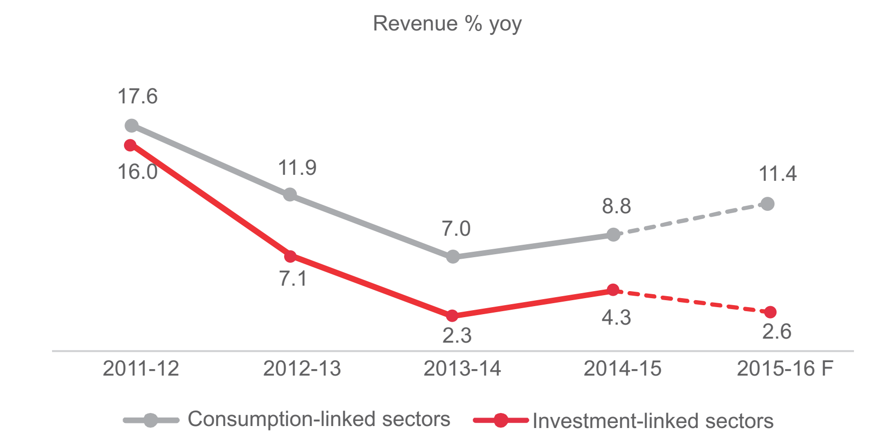
Good thing is, ease of doing business is improving: Since taking over, the Modi government's emphasis has been on reviving the investment climate by improving the ease of doing business. A number of steps have been taken in this regard (detailed in the appendix). However, the nature of these measures is such that immediate gains would be less than what will accrue in the medium-to-long term. Such steps include launch of online portals and monitoring of timelines for providing project clearances and providing licences, consolidation of ministries to ensure faster decision-making and taking the ordinance route to push through the Bills. Results are most visible in the roads sector where debottlenecking has significantly improved the pace of paving.

Public spending in infrastructure received a significant boost in the Budget announcements for fiscal 2016 with spending allocation for roads, railways, irrigation and urban infrastructure increasing nearly 1.5 times.

However, overall capex spending has not gone up much and hence, only a few sectors are set to benefit from higher government spending. But the private sector will go full tilt on investments only once the demand picks up and other factors constraining it are addressed, so removing them in double-quick time is an imperative.

Growth in investment-linked sectors has lagged consumption-driven sectors in the past few years. And we believe this gap will widen further in fiscal 2016 *(Chart 9)*.

Chart 9: Revenue growth to be higher for consumption-linked sectors



Note : F: CRISIL Forecast

Source: CRISIL Research

The criticality of monsoon for hinterland

Our views are predicated on a par monsoon: The IMD has predicted a 7% rainfall deficiency (southwest monsoon) in 2015, and going by international weather forecasters, El Nino conditions – which typically distorts spatial distribution of monsoon – have emerged. An important assumption in our growth estimates is that rainfall will be normal or near-normal this fiscal.

Deficient monsoon will cull 50 bps from GDP growth: According to our calculations, a deficient monsoon will take away 50 basis points from our GDP forecast of 7.9% for fiscal 2016. This is the worst-case scenario. But, we go by the assumption that although some monsoon deficiency is predicted in 2015, spatial distribution of rainfall could still be normal, leading to a normal agriculture year, as past experience shows. For instance, in the last 15 years, there were two years when rainfall deficiency was 7-10% -- similar to the Indian Meteorological Department's (IMD) forecast for 2015 -- but in these years agriculture production did not suffer because rainfall was timely and well distributed. Also, the latest forecast is the IMD's first forecast and more reliable ones will only be available in June (*Table 5*).

Angst in rural India: Last fiscal, monsoon deficiency was 12%, with some regions facing acute shortage of rains. In March and April 2015, unseasonal, pre-summer rains damaged crops in regions already reeling from inadequate monsoon. A second straight year of weak monsoon will decrease the efficacy of India's irrigation ecosystem and hit agriculture output and farmers severely. Already, rural wage growth has plummeted to around 8% in latest count, from a peak of 18-20% in 2012. Therefore, a weak monsoon will also completely wipe off gains in other sectors of the economy. For details, see our report titled, 'Clouds over rain' released in April. Mitigatory and pre-emptive steps by the government are therefore an imperative.

Focus areas for government: Given the current situation of agriculture and its importance in both employment and growth, the government needs to go on mission-mode to find solutions, such as to reduce systemic dependence on rainfall by exponentially increasing the drip irrigation ecosystem, improving skillsets at the farm-gate through many more targeted initiatives, bringing sea-change in the farm-to-fork transaction chain and rapidly ramping up warehousing and cold storage infrastructure with win-win revenue models.

Table 5: Monsoon and agriculture GDP

	IMD first (April) forecast for rainfall (% deviation from normal)	IMD second (June) forecast for rainfall (% deviation from normal)	Actual rainfall deviation from normal (%)	Agriculture GDP (%, y/y)	Number of subdivisions receiving	
					Normal / excess	Deficient
Fiscal 2001	-1.0*		-9.0	0.0	28	7
2002	-2.0*		-9.0	6.0	30	6
2003		1.0*	-19.0	-6.6	15	21
2005	0.0	0.0	-13.0	0.2	23	13
2010	-4.0	-7.0	-23.0	0.8	13	23
2013	-1.0	-4.0	-8.0	1.4	23	13
2015	-5.0	-7.0	-12.0	1.1	24	12
2016 forecast	-7.0	-	-	3.0	-	-

*Note: Years when monsoon deficiency was 7 to 10%, *first forecast issued in May*
Source: IMD, CSO

Banking hobbled, bad-loan millstone hangs heavy

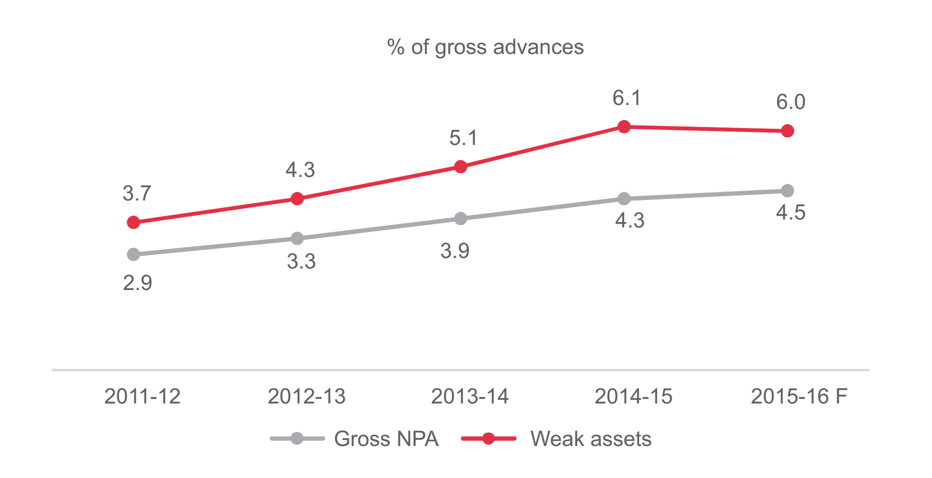
Exposure of banks to vulnerable sectors remains high: While credit growth should pick up from the lows of fiscal 2015, continued deterioration in the asset quality of banks and the resultant risk aversion will remain a headwind in fiscal 2016. Gross non-performing assets (GNPAs) of banks shot up from 3.9% as of March 31, 2014, to 4.3% by the end of the previous fiscal. Growth in slippages are expected to decelerate in the current fiscal, but reported GNPAs will still remain at elevated levels as some of the assets restructured in the previous 2-3 years, especially in the infrastructure, construction, and textiles sectors, degenerate into NPAs again.

We forecast GNPAs to edge up 20 basis points to around 4.5% of advances -- or rise by Rs 600 billion to Rs 4 trillion -- by March 31, 2016 *(Chart 10)*. Indeed, overall weak assets of the banking sector could cross Rs 5 trillion. Worryingly, exposure of banks to vulnerable sectors is expected to remain high (65% to the medium- and high-risk sectors), just the way it was in fiscal 2015.

Bad loans are seen rising mainly because of the withdrawal of regulatory forbearance on restructuring, and high slippages from restructured assets. As much as 40% of assets restructured between fiscals 2012 and 2014 have degenerated and become NPAs again.

CRISIL believes the government's stance to provide capital only to PSBs meeting its performance thresholds – even as they reel under asset quality and profitability pressures – will force many to grow at a significantly slower pace and spawn capital stress for many weak banks.

Chart 10: Dirty picture



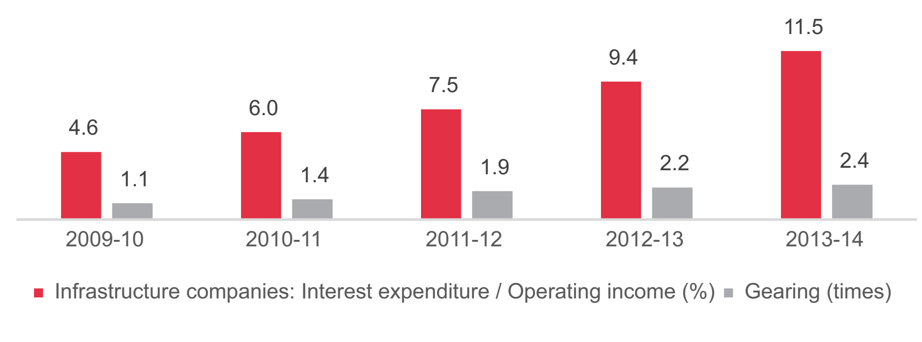
Note: F = forecast. According to CRISIL's definition, weak assets include gross NPAs + 30% of restructured assets (excluding those of state power utilities) + 75% of security receipts

Source: CRISIL Ratings

Leverage pain will continue in infrastructure

Debt piling up in the books of infrastructure companies is a major roadblock to reviving investments. In infrastructure, especially for companies engaged in road and power-generation projects, accumulated debt is so high their interest cost threatens to go off the charts. Their ratio of interest cost to operating income galloped to 11.5% in fiscal 2014 from 4.6% in fiscal 2010 *(Chart 11)*.

Chart 11: The debt-wish saga



Source: CRISIL Research

In the past, many private developers have bid aggressively for projects, especially in roads and power. However, most projects have seen execution delays due to issues such as fuel availability, land acquisition and environmental clearances; resulting in significant cost overruns. Also, volume growth for operational projects has been below expectations on account of slowdown in economic activity.

As a result, poor operational cash flows coupled with rising debt burden have led to a sharp deterioration in the debt-servicing ability of many companies. Banks, too, are wary of lending to the sector.

Many private infrastructure companies have either sold or are in the process of selling their operational assets on lender pressure to pare debt even as they need to find funds to bid for new projects. Many others have resorted to restructuring of debt and assets.

We believe it will take time for companies to clean up their balance sheets and a significant pick-up in private infrastructure investments looks at least a couple of years away.

Till then, the public-sector has to carry the can.

ANNEXURE

Steps taken to improve India's competitiveness

According to the World Economic Forum's competitiveness index, India ranks lowest among BRICS nations. So, we have tried to assess the first year of Modi government and the steps taken by it against the standard pillars of competitiveness – the set of institutions, policies, and factors – that determine the level of productivity of a country.

Institutions

- **Fast-tracking of projects by the Project Monitoring Group (PMG under the Cabinet Secretariat**
  - The committee has not only cleared more projects, but is also making sure they take off. Issues have been resolved in 322 projects worth Rs 14 trillion, with 55% in coal and power sectors as of October 2014.
  - The PMG has approved 181 of 500 projects in 15 months, of which 40 have been cleared by the new government.
  - The changes made by the new government to the PMG include - 1) it does not merely set timelines for actions by ministries, but also monitors their progress 2) it is a single authority that coordinates approvals from different ministries, unlike earlier, when monitoring was done by The Department of Financial Services.
- **Revving up the bureaucratic clan**
  - Secretaries from different, in some cases widely different, ministries have been teamed up into 8 working groups with 9-11 members each and have been tasked with getting fast results on crucial projects.
  - Project areas covered are: industry; skill development; infrastructure relating to rail, road & air; urban development; rural infrastructure and human resource management; agriculture and agro processing; financial services; health and social issues.
  - Ministerial involvement is significantly reduced and these groups will directly submit their reports to the Cabinet Secretariat, which will pass them on to the PMO
- **Steps towards reducing bureaucratic red tape**
  - Limiting the decision-making process to four layers (no file will be signed by more than four officials)
  - Setting a two-week deadline to answer queries
  - Seven-slide presentations by bureaucrats to ministers, rather than lengthy reports
  - Reducing the length of official forms to one page
  - For citizens submitting documents to the government, self-certification is sufficient; no need for verification by government officials
  - Creating a website to provide real-time information on which bureaucrats are in the office on a particular day

- **Increasing single-window clearance limit for New FDI Proposals to expedite fresh investments**
  - The government has more than doubled the threshold of investment that can be cleared by the Foreign Investment Promotion Board (FIPB).
  - The FIPB can now clear projects worth Rs 3,000 crore, up from Rs 1200 crore earlier, beyond which proposals used to land up in a Cabinet sub-committee headed by Prime Minister which used to increase the delays`
- **Steps towards improving ease of doing business**
  - Environmental clearances
    - Web-based clearances: Environmental and forest clearances to be tracked online and granted simultaneously, as against the rule earlier that environmental clearance should be approved before an application is made for forest clearance led to delays
    - A four-member committee has been set up to modernise five key environmental laws concerning protection and conservation of the environment, forest, wildlife, water and air.
    - Irrigation projects of less than 2000 hectares need no environmental clearance and those between 2000 and 10000 hectares only require state approval and not central approval.
    - For other sectors such as thermal coal, paper pulp, mining, pollution industries near national parks – state governments have been given greater power to grant environmental clearances.
    - Prospecting for minerals in forest areas will not require tribal consent or compensatory afforestation, and government inspection of these activities will not be required up to 100 hectares
    - Right to forest land will now be determined by district administration rather than tribal village leaders
    - According to a draft notification, infrastructure projects will not have to take approval from environment impact assessment (EIA) authorities at the state level
    - Rules of FRA (Forest Right Act) compliance have been made more flexible-a project will have to apply for FRA compliance only if the area was declared a forest before 1930 and a tribal group lived their according to the last two census surveys.
- **Simplification of procedures**
  - Online single window for providing clearances and filing compliance (eBIZ)
  - Online portal for firms to comply with 16 central labor reforms
- **Mining Bill**
  - In the Budget session of Parliament (conducted between February and May), the government passed the Coal Mines Special Provisions Bill and the Mines & Minerals Development and Regulation Bill in Rajya Sabha, where it is in minority. This law

allows the government to allow private companies to mine coal and sell it in the open market – ending state monopoly. In addition, it will enable transparent allocation and auction of iron ore and other minerals.

- **Insurance Bill**
  - The government had passed an ordinance on the insurance Bill in January, raising the cap on foreign investment in the insurance sector from 26% to 49%. This Bill has been passed in both houses of Parliament – Lok Sabha passed it on March 4 and Rajya Sabha on 26 March.
- **Land Acquisition Bill**
  - The Right to Fair Compensation and Transparency in Land Acquisition, Rehabilitation and Resettlement (Amendment) Bill was passed in Lok Sabha on 10 March 2015. However, it is yet to be passed in Rajya Sabha where the NDA government doesn't have majority. Land being a state subject, it would be prudent if the central government pushes states to effect amendments at their level the way it is being done with regard to labour laws.

Infrastructure

- **Increased budgetary allocation to infrastructure**
  - Allocation for infrastructure up 1.5 times from \$30.3 billion in fiscal 2015 to \$46.4 billion in fiscal 2016
  - The allocation to Roads is up by 178%, followed by Railways (52%), Urban Development (37%) and Power (11%)
- **FDI limit increase in defence, railways and construction aimed at boosting domestic manufacturing.**
  - The ceiling on FDI in defence has been raised to 49% from 26% on the condition that control of joint ventures for manufacturing remains in Indian hands.
  - The cabinet has approved 100% FDI in some areas of railway infrastructure, including high-speed rail, suburban corridors, and dedicated freight corridors.
  - The Cabinet has approved easing of FDI rules in construction, in line with the Budget proposal. This entails reducing the minimum built-up area to 20,000 sqm from 50,000 sqm, and lowering capital requirements to \$5 million from \$10 million. Both requirements are waived if the investor commits at least 30% of the total project cost to low-cost housing. Though the cabinet has not reduced the three-year lock-in period, foreign investors will now be permitted to exit upon project completion or three years from the date of final investment, subject to development of trunk infrastructure.
- **Renegotiation of contracts for roads**
  - Rules for private-sector involvement in road funding have been made more flexible, moving from the build, operate and transfer (BOT) model for public-private partnership projects to engineering, procurement and construction (EPC) for the next two years. This will help in providing relief to cash-strapped and highly leveraged road

developers. Also, they can reschedule premiums due to the government and ensure early exit from projects.

- **Renegotiation of contracts for port**
  - The shipping ministry is seeking powers to amend the model concession agreement (MCA) for port projects. Pricing ambiguities are a key reason for delays in port projects. For instance, private terminal operators are pushing for a shift from a royalty-payment model to a revenue-sharing model for government-owned ports. This is because tariff regulation at ports makes them commercially unviable – terminal operators are not allowed to fully pass through the cost of the royalty payment to end users. The shipping ministry partially deregulated tariff rates in 2013, but these guidelines are applicable only to projects awarded since August 2013. Legacy cases need to be dealt with swiftly. In this context, reports that the ministry is considering a mechanism to renegotiate the terms of PPP projects is a positive development, and should provide an impetus for port activity.
- Developing smart cities and Sagarmala are ambitious projects, but nothing concrete has happened in that direction yet

Macro environment

- **Inflation control**
  - Efficient use of food grain stocks
  - Lower increase in MSP (minimum support prices) for food grains
    - The government announced price increases of 1.5-4.0% yoy for the kharif (summer) crop, similar to FY14, but significantly lower than the double-digit increases in FY13 and FY10. For the rabi (winter) crop, the government recently announced price increases of 2.0-4.5%. This is lower than the 9-11% average increases seen over the past eight fiscal years.
    - Encouraging states to de-list fruits and vegetables from the APMC Act
    - State governments have been advised to amend the Agriculture Produce Marketing Committee (APMC) Act to check monopolistic buying from farmers. In June, the government reiterated its predecessor's instruction to states to de-list fruits and vegetables from the APMC Act; this change can be implemented by notification, as it does not require legislative amendment of the Act. Uttarakhand had already complied with this directive at the beginning of the year, followed by Delhi.
  - Tough stand on food hoarding
    - The new government has taken a tougher stance against food hoarders/middlemen, and has sought to improve co-ordination between the central and state governments on this front. Earlier this year, potatoes and onions were brought under the ambit of the Essential Commodities Act and states were authorised to impose stock limits to prevent hoarding
  - Price Stabilisation Fund (Rs 5 billion)

    - The fund will reportedly be operated by the Department of Consumer Affairs (DCA), and will be used by state governments to intervene in the market to counter abnormal price increases for essential perishable commodities including tomatoes, onions, potatoes and pulses. The fund will only be used during the peak summer months.
  - Adoption of new monetary policy framework and setting of inflation target
    - The RBI and the government adopted a new monetary policy framework to target inflation at 6% in FY16 and 4% with a band of +/-2% in subsequent years. This will increase clarity and transparency on monetary policy.
- **Fiscal consolidation**
  - Fiscal deficit target brought down to 3.9% of GDP for fiscal 2016 from 4.1% in fiscal 2015
  - Diesel deregulation: After gradually increasing the diesel price every month to reduce the gap between domestic and global prices, the government announced a full deregulation of diesel prices in October. It will help the government reduce sensitivity of fiscal finances from future fluctuations in global oil prices
  - Natural gas pricing: The government raised the natural gas price to $5.61 per million British thermal units (mmBtu) from $4.2/mmBtu effective 1 November. This is much lower than the initially proposed $8.41/mmBtu. These prices will be revised semi-annually (the initial proposal was for quarterly revisions). This decision had been pending for some time and will provide clarity to producers and consumers.
- **Current account deficit**
  - While the current account deficit came down in fiscal 2015, the containment was largely on account of a lucky fall in oil prices.
  - Some steps the government can take for long-term sustainability of CAD:
    - Developing indigenous oil fields and other renewable forms of energy to reduce dependence on imported energy
    - Inflation-adjusted savings instruments to reduce gold imports
    - Moving swiftly towards reforming labour laws so that manufacturing in sectors where India imports a lot can pick up, e.g. electronics.

Health and primary education

- The government has allocated only a marginally higher sum towards these in the budget and also, there doesn't seem to be any concerted effort on the ground for improving these areas

Higher education and training

- **Higher budgetary allocation for higher education**
  - The Union Budget has allocated Rs. 147 billion in fiscal 2016 for higher education, up 17% compared to fiscal 2015
- **National Council on Skill Development Agency and National Skill Development Corporation**
  - NSDC is responsible for training 150 million young people by 2022
  - Government has formulated the National Policy on Skill Development, which gives the broad framework for skill development in the country
  - A separate ministry, namely the Ministry of Skill Development and Entrepreneurship, has been created for better coordination and planning of skill development
  - The government has signed 13 MoUs with Canada, which will facilitate collaborations for skill development in a variety of different sectors, including water, aviation and hydrocarbon

Goods market efficiency

- **Thrust on Goods & services Tax (GST)**
  - Lok Sabha (lower house) passed the 122nd Constitutional Amendment - Goods and Services Tax Bill on May 6, 2015. This will allow for a national sales tax, a step toward creating a unified market by April 2016 provided the Bill is passed in Rajya Sabha and then ratified by at least 15 of India's 29 states.
  - But far from creating a barrier-free pan-Indian market for smooth transaction of goods and services across the country, the GST in its present form system may well create new tax hurdles. Some issues with the current proposed form of GST are:
    - Exclusion of potable alcohol, tobacco and petroleum products
    - Imposition of a 1% tax on all cross-border sales of goods and services by states
    - Not covering real estate sector under GST

Labour market efficiency

- **Proposed amendments to The Apprentices Act and looking at labor reforms**
  - To increase the availability of skilled manpower through on job training, an increase in overtime worked, relaxing the earlier bar on employing women in factories for night shifts
- **State level labor reforms**
  - In Rajasthan - 1) Amendment to Industrial Dispute Act to allow employees to lay off up to 300 employees without government approval (vs 100 currently) and form a trade union only if it gets 30% of total workers (vs 15% currently). 2) Amendment to the Factories Act to increase the threshold limit of employment for factories operating

without power (from 20 to 40) and for factories with power from 10 to 20. 3) Contract labour Act will be applicable to only companies that employ more than 50 workers

- These changes have been approved by the Rajasthan Assembly and also the President, which means any other state will be free to adopt them. Under Article 252(2) of the Constitution, state law prevails over central government law if the President approves it.

Financial market development

- **Jan Dhan Yojana**
  - Aims to provide bank accounts with a debit to every household in India.
  - This will provide universal access to banking facilities to rural households and boost financial savings to help the government plug fiscal subsidy leakages.
  - This entails providing a bank account with an overdraft facility of Rs 5,000 (once the account has been active for six months and linked to the account holder's Aadhar identity number), a debit card and Rs 100,000 accident insurance cover.
  - In the second phase of the programme, the government has proposed a pension scheme for identified individuals in the informal sector and the offer of micro-finance products through government-owned insurance companies.
- **Adoption of Aadhar ID system for social welfare programmes**
  - The government has not only supported the project (started by its predecessor government) but has also pushed for its linkage with several welfare projects such as the Jan Dhan Yojana and the direct benefits transfer scheme in cooking gas.
  - The total number of Aadhaar numbers generated by UIADAI stood at 81.78 crore as on April 20, 2015
- **Promoting creation of payments banks**
  - The objective of licensing small banks is to promote financial inclusion by offering savings vehicles and credit to small business units and other unorganised sector entities
  - RBI has received 72 applications for small finance banks and 41 for payments banks.
  - Some licenses are expected to be issued soon

Technological readiness

- **Digital India**
  - E-governance initiative targeting high-speed internet villages by 2018, and bringing down electronic imports.
  - This policy will help in improving information flow, reduce corruption and improve productivity

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Notes

Notes

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