MACRO PULSE

NOVEMBER 2021

Acuite RATINGS & RESEARCH

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From the desk of the Chief Analytical Officer

We are glad to bring you the **eleventh edition** of **Acuité Macro Pulse (Nov 2021)** as we get close to the end of the third quarter of the current financial year.

As the global markets were getting increasingly confident about the declining virulence of the Covid pandemic, the news of a new variant hit us in late Nov. While the ability of "Omicron' to cause serious disease and lead to higher mortalities is yet to be established, the increasing spread of the strain across Europe, US and also India has started to generate fresh uncertainties for the global economy. Nevertheless, the country today is in a better position to handle a new wave of the pandemic. The total vaccine doses given by the first week of Dec-21 have exceeded 1.3 billion and it is reported that 36% and 58% of the total population have been fully and partly vaccinated in India. That is a fairly significant progress although it is slightly lower than our expectations which had included the coverage of vaccination in the younger population group i.e. those with age less than 18 yrs. What continues to be a matter of relief is the daily caseload in India has reduced further in end Nov to the band of 8,000-10,000 despite the unlocking of the economy and the ongoing festive season. There are no major concerns on mortalities as of now either though the Central and the State Governments have started to take precautions to ensure no rapid spread of the new variant.

The good news amongst this new uncertainty is the Q2 GDP growth of the current year which printed at 8.4% and reflects the pickup in consumption demand on unlocking of the economy. The sequential revival in economic activity was clearly reflected in our **proprietary AMEP (Acuité Macroeconomic Performance) index** expanding by 7.2% QoQ in Q2 FY22 from a contraction of 9.3% in Q1 FY22. This steady revival track is further in evidence in the current quarter with the index touching a new high of 125.2 in Oct-21 from 115.7 in Sep-21 which is not only 9.3% YoY higher than Oct-20 but also 11.5% higher than the pre-pandemic period of Oct-19.

With the progress in vaccination and the pickup in the contact intensive sectors, the ongoing revival in private consumption, a healthy kharif crop estimate, continuing buoyancy in exports and also the supportive policy environment, we continue to stick to our FY22 GDP growth forecast of 10.0%, assuming however, no adverse impact of the new variant through lockdowns. Nevertheless, inflationary headwinds continue to remain as we have been reiterating in this report over the last few months. While the headline CPI print has been comfortable, the elevated core CPI and the WPI inflation prints continue to be of concern. Higher pass through of increased input costs in an economy in an improving demand scenario and supply bottlenecks in some sectors imply significant upside risks to the current inflation forecasts for the next few quarters. Further, the withdrawal of excess liquidity in the developed economies may induce higher volatility in the Indian capital and forex markets.

Along with our extensive coverage on the key macroeconomic variables spread over six chapters, we have included here a **special study on the Corporate Performance for the previous quarter**. There are several interesting insights in this study which shows the resilience of the overall corporate sector through the pandemic although the MSME sector clearly continues to remain under strain. Hope you like this edition and take care. Cheers,

Suman Chowdhury
Chief Analytical Officer

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Growth

Sequential momentum on watch

KEY TAKEAWAYS

- The continued dip in Covid infections, progress on vaccination along with festive season has pushed forward India's sequential growth recovery well into Q3 FY22. India's GDP growth print in the previous quarter was encouraging at 8.4% YoY, highly in line with our expectations.
- Growth momentum in the month of Oct-21, as highlighted in our previous edition of Acuité Macro Pulse, has already seen considerable upside with most high frequency indicators recovering to or above pre-pandemic levels.
- Since then, in early part of Nov-21, we however, notice some slowdown in incremental economic activity, attributable to seasonality on account of Diwali holidays.
- We remain mindful of risks from global supply chain disruptions, elevated commodity prices and marginal slowdown in global growth amid resurgence in Covid cases. While another wave of Covid in India does remain a possibility amidst discovery of a new Covid variant, the economic fallout is expected to be much lower.
- We hold on to our FY22 growth estimate of 10.0% with downside risks, as festive demand, progress on vaccination, government's fiscal spending and export momentum offer support.

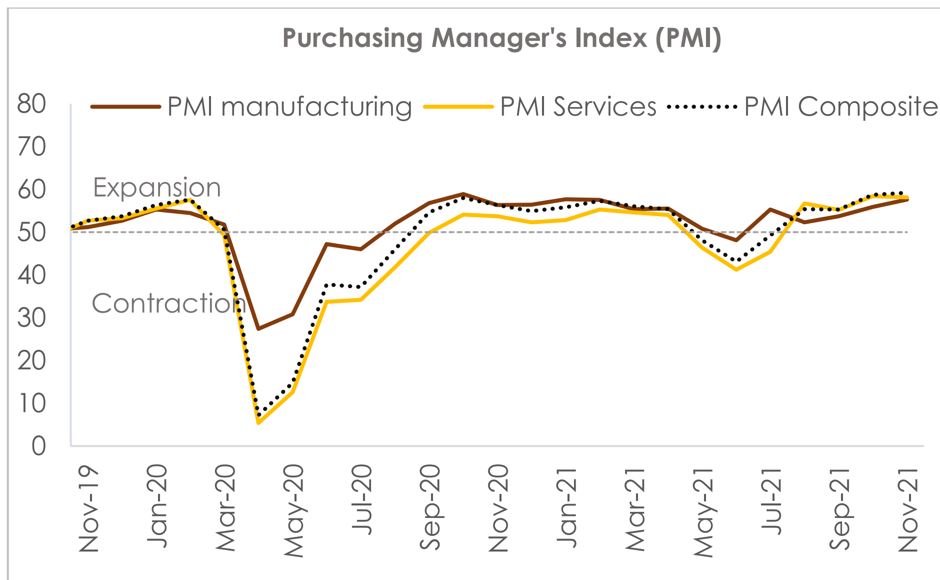
India's annualized Q2 FY22 GDP growth came in at 8.4% from a record high print of 20.1% YoY. In addition to favourable base of the last year, the expansion was driven by pick-up in pace of consumer expenditure followed by increase in gross fixed capital formation i.e. public investments. From the supply side, GVA also registered a similar outturn with annualized print clocking a growth of 8.5% in Q2 FY22 from 18.8% in Q1 FY22. The expansion was primarily driven by a sharper growth in services (10.2% YoY) followed by agriculture sector (4.5% YoY). On sequential basis, post the second wave driven contraction in Q1 FY22, the GDP and GVA print have expectedly, recorded a strong expansion of 10.4% and 7.9% respectively. The sequential revival in economic activity was clearly reflected in our **proprietary AMEP (Acuité Macroeconomic Performance) index** expanding by 7.2% QoQ in Q2 FY22 from a contraction of 9.3% in Q1 FY22.

Going forward, continued dip in Covid infections, progress on vaccination along with festive season has pushed forward India's sequential growth recovery well into Q3 FY22. This is also evident in our AMEP index that saw considerable upside with most high frequency indicators recovering above their pre-pandemic levels in Oct-21. In first half of Nov-21, we however notice some slowdown in incremental economic activity, which we attribute to seasonality on account of Diwali holidays. Going forward, the sustainability of such improvement within manufacturing and services sectors post Q3 FY22 needs to be monitored to gauge the durability of recovery beyond the festive boost.

High frequency lead indicators: A granular look at recovery

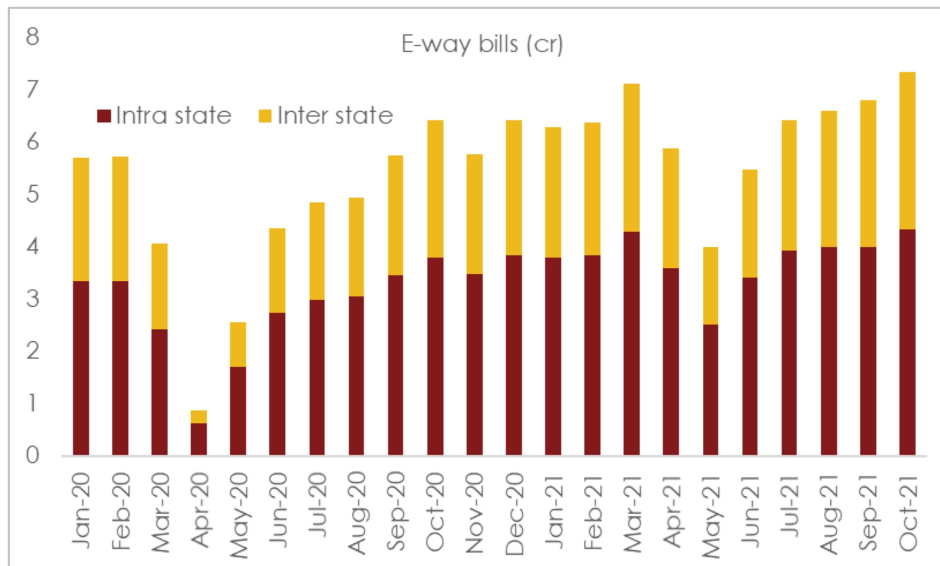
- India's IIP growth has decelerated to 3.2%-3.3% YoY in Sep/Oct-21 from 12.0% in Aug-21. The slowdown was broadly in line with expectations and can be primarily attributed to a dilution of the favorable statistical base. While there has been a sizeable 2.4% sequential contraction in industrial activity in Sep-21, reflecting the impact of few temporary disruptions such as adverse weather conditions and the coal shortages, the latest data shows that the index has climbed 4.3% MoM in Oct-21.
- PMI manufacturing rose to an 8-month high of 55.9 in Oct-21 from 53.7 in Sep-21. The upside was led by output and new orders, with the latter rising at the fastest pace in 7 months. However, input cost inflation surged to a 92-month high led by higher prices of chemicals, fabrics, metals, electronic components, oils, plastics, and transportation. Further, PMI manufacturing in Nov-21 further grew at a fastest pace in 10 months increasing to 57.6 in Nov-21 buoyed by a strong pickup in demand.
- PMI services rose to a near 10-1/2 year high of 58.4 in Oct-21 from 55.2 in Sep-21, led by pick up in new businesses. Amidst the recovery taking shape in the sector, firms were able to raise output prices at the strongest pace since Jul-17 and hire additional workers in the month. For the month of Nov-21, PMI services came in at 58.1, a tad lower that Oct-21.

Chart 1: Services PMI decade high in Oct-21 with strong momentum continuing in Nov-21



- E-way bills generated rose to a record high of 7.35 Cr in Oct-21 from 6.79 Cr in Sep-21. However, E-way bills generated have moderated in Nov-21 to a 5-month low of 6.12 Cr, possibly due to seasonal phenomenon usually observed during the festival holidays and post festive season peak purchases.

Chart 2: Number of E-way bills generated at a record high in Oct-21, led by festive demand



Growth Outlook

Headwinds to growth have risen over the last few weeks. Though not formidable yet, but the following factors remain on watch:

- **Global supply chain disruptions** especially of semiconductors which may still take a few months to normalize. As such, domestic automobiles sector along with a few others could continue to face some heat over Q3-Q4 FY22. Auto production in Oct-

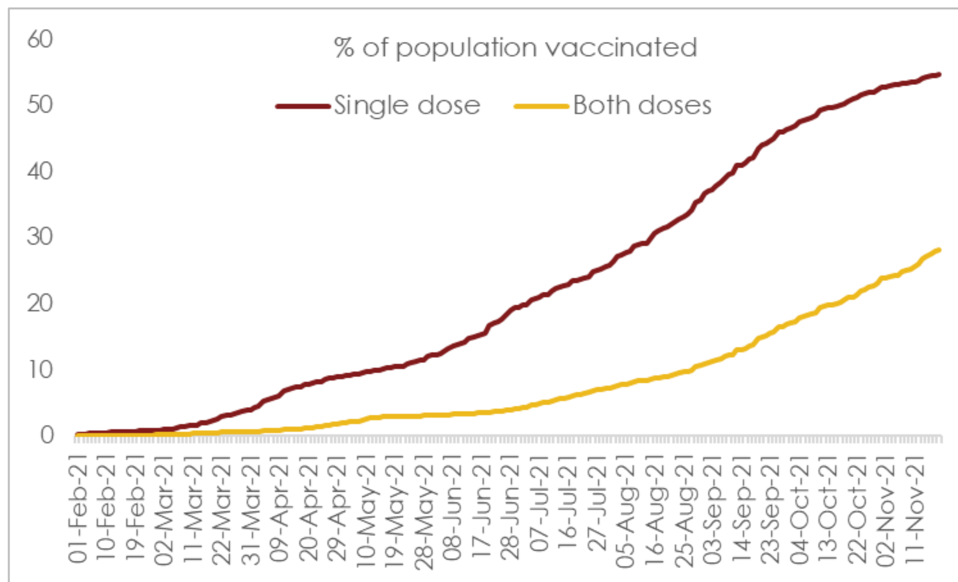
21 continued to contract for the third consecutive month by 22% YoY from -19% in Sep-21.

- **Elevated commodity prices** have led to a surge in input costs, weighing on producer margins in the manufacturing sector (likely to get reflected in Q3 FY22 corporate earnings). This has led to passing on of higher costs to consumers through a calibrated increase, already seen in sectors such as FMCG, auto and electronics.
- **Persistence of higher global inflation** which may translate into a faster normalization of monetary policies in some of the developed economies, translating to a volatility in capital flows.
- Lastly, **resurgence in Covid cases** in some parts of Europe and the discovery of a new Covid variant 'Omicron' has further cast some clouds on global growth prospects.

The above risk factors notwithstanding, sequential growth momentum is expected to draw support from:

- **Festive demand:** The recently concluded festive season in India is believed to have generated record sales for both online and offline retailers as per media reports (Bloomberg Quint). This highlights the impact of pent-up demand that is gradually getting unlocked with the receding wave of Covid and phasing out of state level lockdown restrictions.
- **Progress on vaccination:** At present, India has inoculated 58% of its population with single dose and fully vaccinated 36% as in the first week of Dec-21. As single-dose coverage nears two third of the population by year-end, it should provide a strong boost to consumer sentiment and demand recovery and reduce the risks of any severe third wave in the country.
- **Government spending:** As of Apr-Oct'21, central government's cumulative expenditure touched 52.4% of FY22 budget estimates vis-à-vis 47.3% of actuals in the corresponding period in FY21, with a preference for pushing capital expenditure higher. Meanwhile, revenue expenditure is likely to pick up pace in H2 FY22 to meet budgetary targets as well as demand for unallocated items (like Covid related expense, fertilizer subsidy, wage hikes, MGNREGS enhancement, etc.). The acceleration in government spending during the second half of the year is likely to be further supportive of rural demand as well as overall capital formation.
- **Exports:** Notwithstanding some moderation in Nov-21, cumulative exports for FY22 continue to appear strong, aided by demand as well as price impact.
- Lastly, **the latest cut in excise duty/VAT** on fuel prices does stand to offer some respite in transportation costs and improve demand at the margin.

Chart 3: The gap between partially and fully vaccinated population begun to narrow



We continue to retain our FY22 GDP growth forecast at 10.0% with moderate downside risks**.** While the possibility of another wave of Covid remains, we believe that the economic fallout could be much lower on account of vaccine penetration and existing seroprevalence.

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Inflation

Look beyond the headline

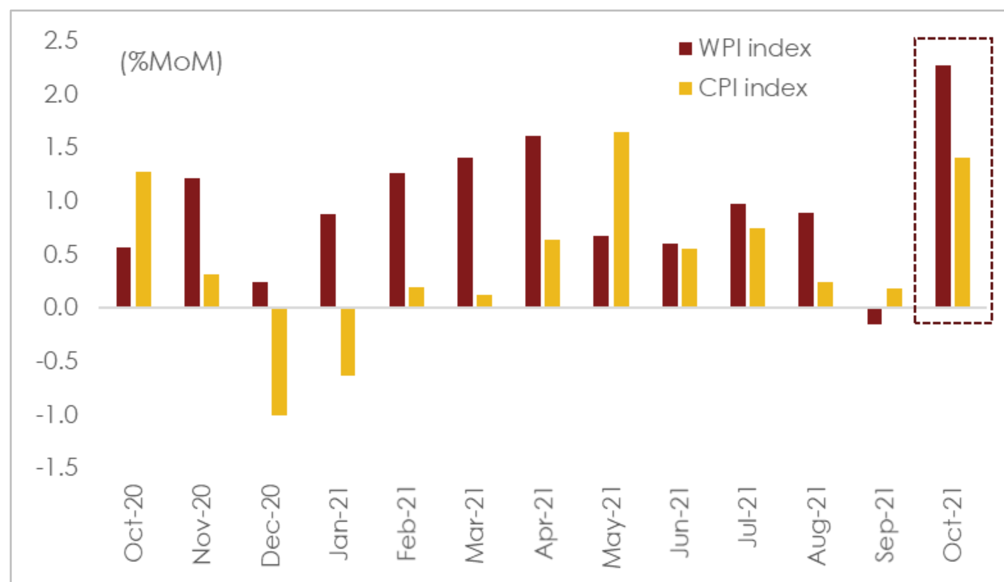
KEY TAKEAWAYS

- Annualized inflation, on both retail and wholesale indices, rose in the month of Oct-21. The upside was however modest as a favourable base at play masked the strong sequential momentum in prices on both the metrics.
- CPI inflation rose marginally to 4.48% YoY from 4.35% in Sep-21, despite a strong 1.4% MoM jump in prices.
- WPI inflation soared to a 5-month high of 12.54% YoY in Oct-21 from 10.66% in Sep-21, on the back of a broad-based increase. On sequential basis, the index jumped up by 2.3% MoM, the fastest pace of monthly increase on record.
- Going forward, comfort on food inflation with a healthy Kharif output along with the latest reduction in excise and VAT on petrol and diesel are likely to keep headline inflation and household inflation expectations on a leash.
- However, escalating pressure in case of commodity prices along with likely demand side pressures (as lockdown restrictions ease and vaccination progress) could play an offsetting role.
- For FY22, we continue to expect average CPI inflation to print at 5.5%, moderately lower vis-à-vis the 7-year high level of 6.2% in FY21 but higher than the RBI forecast of 5.3%.

Overview
Annualized inflation, on both retail and wholesale indices, rose in the month of Oct-21. The upside was however modest as a favorable base at play masked the strong sequential momentum in prices on both the metrics. To put this in perspective -

- CPI inflation rose to 4.48% YoY from 4.35% in Sep-21, despite a strong 1.4% MoM jump in prices. The headline inflation remains well within the RBI's policy target band for the fourth consecutive month, continuing to offer comfort.
- WPI inflation soared to a 5-month high of 12.54% YoY in Oct-21 from 10.66% in Sep-21, on the back of a broad-based increase. On sequential basis, the index jumped up by 2.3% MoM - the fastest pace of monthly increase on record.

Chart 1: Both WPI and CPI indices record a strong sequential momentum in Oct-21



Key highlights: Oct-21 CPI Inflation

- The sequential momentum was broad-based in Oct-21, with every sub-category witnessing a pick-up vis-à-vis Sep-21.
- Bulk of the momentum was driven by food prices, which rose by a sharp 2.3% MoM. A combination of excessive rainfall in Sep-21 (which weighed on standing crop yields along with a late withdrawal in Oct-21), festive season demand upside and higher fuel and transport costs appear to have played a role. At a granular level, price pressures were led by Vegetables, Sugar & Confectionery and Oils & Fats. On annualized basis, however, food inflation remained largely subdued at 1.82% vs. 1.61% in Sep-21 owing to a favorable base (Oct-20 had too seen a spike in food index).
- Fuel price momentum increased to 0.98% MoM vs. 0.74% in Sep-21, led by Diesel, Kerosene, Coal, LPG, and Firewood prices. On annualized basis, fuel inflation remained at a series high of 14.35% reflective of an adverse base, higher domestic taxes, and the run up in global crude oil prices.
- Core inflation (i.e., CPI ex Food & Beverages and Fuel & Light indices) increased by 0.69% MoM in Oct-21 MoM compared to 0.19% in Sep-21. The upside was broad-based, with strong ascent seen in Housing and Miscellaneous sub-categories.

Annualised core inflation rose to breach the 6.0% handle yet again after a gap of 3 months, coming in at 6.17% compared to 5.86% previously (see Table1).

Table1: Key highlights of CPI inflation

CPI sub-components				
	%MoM		%YoY	
	Sep-21	Oct-21	Sep-21	Oct-21
CPI headline	**0.18**	**1.41**	**4.35**	**4.48**
Food	0.06	2.26	1.61	1.82
Pan, Tobacco & Intoxicants	0.16	0.31	4.23	4.27
Clothing & footwear	0.55	0.61	7.22	7.53
Housing	-0.18	0.93	3.58	3.54
Fuel & Light	0.74	0.98	13.63	14.35
Misc.	0.25	0.63	6.38	6.83
Core Inflation	**0.20**	**0.69**	**5.86**	**6.17**

Oct-21 WPI inflation

- WPI inflation soared to a 5-month high of 12.54% YoY in Oct-21 from 10.66% in Sep-21, on the back of a broad-based increase. On sequential basis, the index jumped up by 2.3% MoM - the fastest pace of monthly increase on record.
- Among the internals, Fuel and light index rose by 8.72% MoM – led by surge in Lignite coal (+20.2% MoM), Electricity (+18.8% MoM), Naphtha (+12.8% MoM) and ATF prices (+14.3% MoM); reflecting the shortage in domestic coal availability and spillovers of global energy crisis in the month.
- Akin to retail side, wholesale food prices too rose by a strong 5.05% MoM, of which, fruits and vegetables standalone recorded a jump of +22.4% in the month.

Looking ahead: Points of comfort

Notwithstanding the jump in prices in Oct-21, food inflation is likely to remain broadly comfortable over the coming months. Estimates of a record Kharif output as per Government's first advance estimates, late withdrawal of Southwest monsoon supporting Rabi sowing, along with administrative interventions (on edible oils and pulses) are likely to help keep a lid on food inflation over the next few months. However, recent unseasonal rains in some parts of India could lead the vegetable mandi prices to be volatile in the short term. Nevertheless, in addition to a favorable base:

- The recent reduction in central excise duty on petrol and diesel, along with cut in VAT by several states in quick succession should help ease CPI inflation to the tune of 25-30 bps (direct and second order impact combined) beginning Nov-21.
- Both of the above, will help assuage household inflation expectations, which in the last three rounds of RBI survey have remained northwards of 10.0%.

Points of discomfort

- Notwithstanding the recent marginal comfort derived from decline in crude oil prices amid worries over new Covid variant dampening oil demand, global oil prices have remained elevated in Nov-21. To be specific, India crude basket averaged to USD 80.5 pb in Nov-21 – a rise of over 10.3% since Sep-21 end. The continued and swift increase in input costs (as reinforced by wholesale inflation) is beginning to get passed

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on to consumers in a calibrated manner across various industries such as FMCG, electronics, automobiles etc.
- The recent recovery in consumption as a combination of pent-up, vengeance and festive demand can be expected to continue as lockdown restrictions are eased further and vaccination coverage improves. This could keep goods inflation elevated.
- Demand for services is also seeing a strong pick-up. Not surprisingly, PMI services soared to over a decade high of 58.4 in Oct-21 compared to 55.2 in Sep-21. This could trigger a faster upward adjustment in services inflation, which so far has remained benign and ranged (4.5%). More so, services inflation is seen to be stickier historically, which could provide further downward rigidity to core inflation.

Looking ahead, amidst favorable base factor at play in the near term, the ongoing comfort on inflation is likely to persist well into Q3 FY22. However, inflation trajectory is set to firm up in Q4 FY22 hovering close to upper tolerance threshold of RBI's inflation targeting band on narrowing output gap and imported price pressures. **Overall, while we continue to maintain our FY22 CPI inflation forecast at 5.5%, there could be some upside risks to that figure if high commodity prices and raw material shortages persist.**

On global front, continued surge in commodity and raw material prices, persistence of supply bottlenecks, along with demand push inflation following the easing of Covid lockdowns worldwide have remained the major cause of concern causing inflation rates in many countries to go up sharply. Inflation rate in the US surged to a 31-year high of 6.2% YoY in Oct-21. Similarly, in China, the producer price index rose to 13.5% YoY, the fastest pace in 26 years, amidst shortages of coal, electricity, and other raw materials. With rising inflationary pressure in most DMs and EMs many central banks have started to reconsider their earlier belief of inflation being 'transitory' and are now coalescing around higher inflation rate to be enduring. This has forced few central banks to start considering normalization of pandemic era accommodative policies. To recall the Fed has already begun tapering their bond buying programme by USD 15 bn per month from USD 120 bn per month. Amidst high inflationary pressures, BoE is also on the course to be the first major central bank to hike interest rates. Notwithstanding the steady progress amongst many G-20 economies towards policy normalization amidst price pressures that has catapulted CPI inflation in their economies to multi year highs, India's central bank has continued to persist with its principle of 'gradualism' to nurture the nascent growth recovery and ensure its durability.

As such, the RBI in its bi-monthly policy review, maintained status quo on interest rates in Dec-21, while reiterating its accommodative stance. While the former decision was completely unanimous backed by a 6-0 voting outturn, the latter saw a dissent with 5-1 voting outturn for the third consecutive meeting.

Going forward, while the RBI continued with its liquidity calibration in its recent policy, it is difficult to comment on the timing of the reverse repo rate hike. There may be a possibility of such an increase in Feb-22 provided the high frequency economic indicators continue to remain robust and the recent discovery of a new Covid variant 'Omicron' doesn't start building up another pandemic wave in the country. Continuing uncertainty on the residual risks of the pandemic can reinforce the 'wait and watch' approach of RBI, thereby slowing down the progress on the policy normalization path

Government Finances

Revenues provide fiscal tailwinds

KEY TAKEAWAYS

- India's central government fiscal deficit for the period Apr-Oct'21 stood at 36.3% of budget estimates (BE) for FY22 compared to 52.3% of actuals over the corresponding period in FY21.
- The relatively lower accretion to fiscal deficit this year continues to reflect strong revenue collection (except disinvestments), even as expenditure disbursal momentum showed signs of pick-up.
- The recently announced cut in excise duty on petrol and diesel is likely to have a cumulative impact of around Rs 400 bn (0.2% of GDP) of foregone revenue for the remainder of FY22 and hence will not materially alter the overall buoyant tax collection.
- Revenue expenditure (ex-interest and subsidy payment) is flat on FYTD basis while capex continues to get prioritized.
- While FY22 budgeted expenditure could overshoot by Rs 1.9-2.0 trn, the revenue is likely to be strong enough to limit the overall fiscal deficit slippage to about Rs 268 bn, as per our preliminary estimates.
- Nevertheless, fiscal deficit ratio is expected to improve to 6.6% compared to BE of 6.8% on account of higher inflation led Nominal GDP base.
- Having said so, the realization of record high disinvestment target of Rs 1750 bn would be crucial in managing the fiscal risks.

India's central government fiscal deficit for the period Apr-Oct'21 stood at 36.3% of budget estimates (BE) for FY22 compared to 52.3% of actuals over the corresponding period in FY21. The relatively lower accretion to fiscal deficit this year continues to reflect strong revenue collection (except disinvestments), even as expenditure disbursal momentum showed signs of pick-up.

Receipts: Providing a linchpin

Total receipts have been buoyed by robust tax as well as non-tax revenue accretion.

On FYTD basis (Apr-Oct'21), gross tax revenue collection clocked a robust growth of 55.8% YoY compared to a contraction of 16.7% seen in the corresponding period in FY21. However, it's not just the annualized growth that looks better (which is strongly aided by a favourable statistical base from last year) – in fact, gross tax revenue has already clocked 61.7% of BE for the full year (vs. 43.2% of actuals in the corresponding period in FY21), concluding the first seven months of the fiscal year on a strong note. Further, vis-à-vis 2-years ago period (to avoid the pandemic related distortion), gross tax revenue still clocks a healthy growth of 29.7% during Apr-Oct'21 vs. Apr-Oct'19.

- While strong momentum in tax collection is broad based, it is being powered by robust growth in customs and corporate tax. We also note that total GST collections stood at Rs 1.30 trn in Oct-21, the 2nd highest level on record so far.
- Backed by expectation of further improvement in tax buoyancy in H2 FY22, the central government recently announced a reduction in excise duty on petrol and diesel by Rs 5 and Rs 10 per litre (excise duties saw a sizeable increase at the start of the pandemic in FY21) respectively to provide relief to consumers from record high domestic prices. As per our estimates, this would have a cumulative impact of around Rs 400 bn (~0.2% of GDP) of foregone revenue for the remainder of FY22 and hence will not materially alter overall tax collection.

Net tax revenue on FYTD basis (Apr-Oct'21) clocked a robust growth of 83.0%% YoY vs. a contraction of 15.8% seen in the corresponding period in FY21 on account of support from gross tax collections and relatively lower tax devolution to states.

Non-tax revenue too recorded a strong annualized growth of 78.0% YoY in Apr-Oct FY22 compared to a contraction of 48.2% seen during the corresponding period in FY21. Notwithstanding the favourable statistical base support, the key reason for robust performance under this category stems from a significantly higher than budgeted dividend from the RBI, transferred in May this year vis-à-vis August last year due to synchronization of RBI's financial year with the GoI's from current fiscal year.

Aided by statistical base, non-debt capital receipts clocked a healthy expansion of 20.3% YoY in Apr-Oct'21 vs. a contraction of 38.9% seen in Apr-Oct'20. So far, the government has garnered Rs 93.29 bn out of the budgeted Rs 1.75 tn.

Expenditure: Disbursals pick up momentum

Total expenditure disbursal picked up momentum after remaining subdued in the initial months of the fiscal year. ForApr-Oct'21, expenditure clocked a growth of 9.9% YoY compared to 0.4% in Apr-Oct'20. On BE basis, this translates into 52.4% of the full year target vis-à-vis 47.3% seen in the corresponding period in FY21. Few observations:

- While headline revenue expenditure expanded by 7.5% YoY (53.7% of FY22 BE) during Apr-Oct'21vis-à-vis an expansion of 0.7% (47.4% of FY21 actuals) seen in Apr-Oct'20, bulk of the growth is led by interest payments and subsidies. Excluding these, revenue expenditure stood flat at 0.2% YoY in Apr-Oct'21 vs 0.8% in Apr-Oct'20. The slower disbursal in pace of revenue spending in FY22 so far reflects the outsized impact of COVID relief work undertaken by the central government during the nationwide lockdown in Apr-May FY21. With the central government re-initiating some of the earlier programs under the "Atma Nirbhar Bharat" scheme from May-Jun 2021 onwards (along with DA/DR hikes), to provide relief from the second wave of Covid, revenue expenditure could pick up momentum in the coming months.
- Thrust on investment continues with capital expenditure clocking a growth of 28.3% YoY (45.7% of FY22 BE) during Apr-Oct'21 vis-à-vis a contraction of 1.9% (46.5% of FY21 actuals) seen in H1 FY21. Growth in capital expenditure was led by the Ministry of Road Transport and Highways, which exhausted ~68% of its FY22 BE as of Sep-21. Continued thrust on public capex provides comfort and would be important for supporting the economy at a time when private sentiment could remain subdued, at least in the near term.

Outlook

Despite the economic challenges at the beginning of FY22, the central government's fiscal situation appears comfortable backed by strong tax and non-tax revenue collections. As per our estimates, the combination of vaccination cost, COVID relief program, hike in DA/DR allowance, and higher fertilizer subsidy outgo (that was extended by Rs 287 bn in Oct-21would entail an additional spending of Rs 1.9-2.0 tn (0.8-0.9% of GDP) in FY22. Interestingly, in the recent development, the centre sought an additional expenditure of Rs. 3.7 trn. Out of the total amount, Rs. 745 bn is expected to be matched with equal savings under other heads leading the net cash outgo to be around Rs 3 trn needed for equity infusion into Air India Assets Holding Company (Rs 620 bn), additional fertiliser subsidies (Rs 584 bn), export incentives (Rs 531 bn), food warehouses (Rs 498 bn), and the rural job scheme (Rs 220 bn).

As such, there is a likelihood of fiscal deficit exceeding the budgeted Rs. 15.1 trn, however as % of GDP it is likely to come at around 6.8% as in FY22 taking into consideration higher than budgeted nominal GDP led by higher inflation.

Having said so, we continue to emphasize that the realization of record high disinvestment target of Rs 1750 bn and progress on the National Monetization Plan would be crucial in managing the overall fiscal risks. The recent announcement of Air India disinvestment is going to provide comfort (despite it being a low-ticket item). Traction in case of large ticket size disinvestments, like LIC could boost confidence further in the disinvestment execution ability of the Government.

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<u>**Table 1: FYTD (Apr-Oct) comparison of key drivers of fiscal deficit**</u>

Key Fiscal Variables (Cumulative Position as of Apr-Oct)				
	% of FY Actual/Target		%YoY	
	FY21	FY22	FY21	FY22
Revenue Receipts	42.4	70.5	-23.8	82.1
Net Tax	40.4	68.1	-15.8	82.9
Non-Tax	55.8	85.1	-48.2	78.0
Non-Debt Capital Receipts	28.5	10.5	-38.9	20.3
Total Receipts	41.9	64.7	-24.2	80.7
Revenue Expenditure	47.4	53.7	0.72	7.47
Capital Expenditure	46.5	45.7	-1.95	28.33
Total Expenditure	47.3	52.4	0.40	9.95
Fiscal Deficit	**52.3**	**36.3**	**-**	**-**

Rates

The normalization precursor

KEY TAKEAWAYS

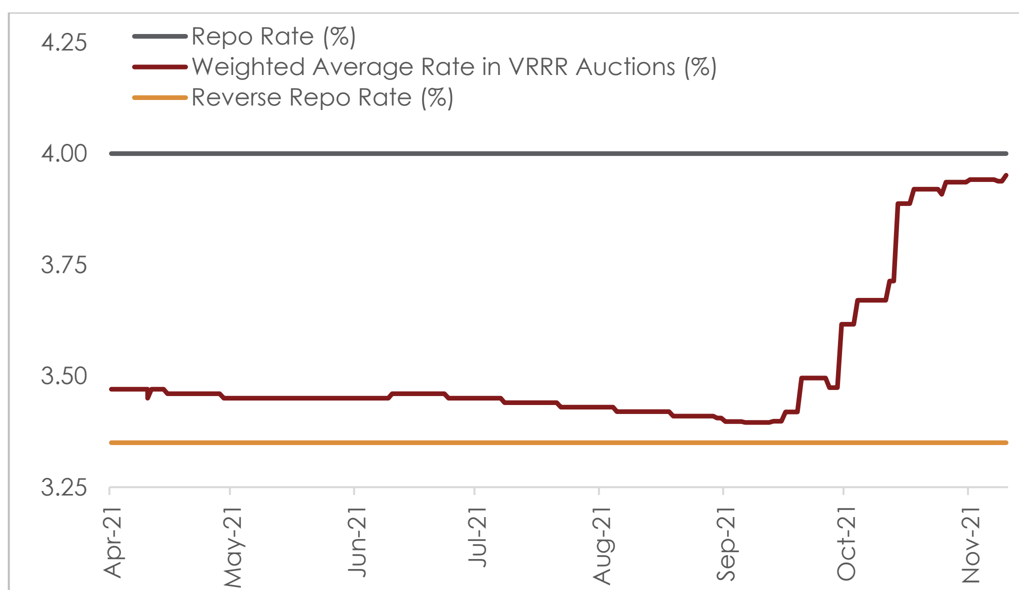
- After bottoming out at 5.97% in May-21, India's 10Y g-sec yields have been steadily inching higher with bond yields averaging at 6.35% in Nov-21, the highest since the beginning of the pandemic. In recent weeks, led by the sharp upward move in VRRR auction cut-offs, short term money market rates have hardened considerably.
- While the RBI in Dec-21 policy review kept the rates unchanged, it will continue with its surplus liquidity calibration.
- The ongoing normalization in monetary policy by key central banks across the world along with expectation of domestic inflation creeping up, is likely to provide upside to yields with 10Y g-sec rate expected to move towards 6.50% by Mar-22.
- However, any aggressive upside would be limited on account of the strong reaffirmation of the accommodative monetary policy stance by RBI in Dec-21 and the deferral of the first reverse repo rate hike along with expectation of progress on India's inclusion in the global bond indices next year.

After bottoming out at 5.97% in May-21, India's 10Y g-sec yield inched higher with bond yields averaging at 6.35% in Nov-21, the highest since the beginning of the pandemic.

Precursor to monetary policy normalization
Since the start of H2 FY22, the 10Y g-sec yield has moved up by a cumulative 18 bps. The impact on the shorter end of the curve has been more pronounced as yields on 1-3 year maturity government bonds jumped by about 20-50 basis points during the same period. While there has been relief from concerns over additional government borrowing in H2 FY22 along with the moderation in inflation trajectory, the firmness in the yields is largely a reflection of a steep rise in global commodity and crude oil prices in the months of Oct-Nov'21 along with commencement of liquidity normalization by the RBI since Oct-21 policy review.

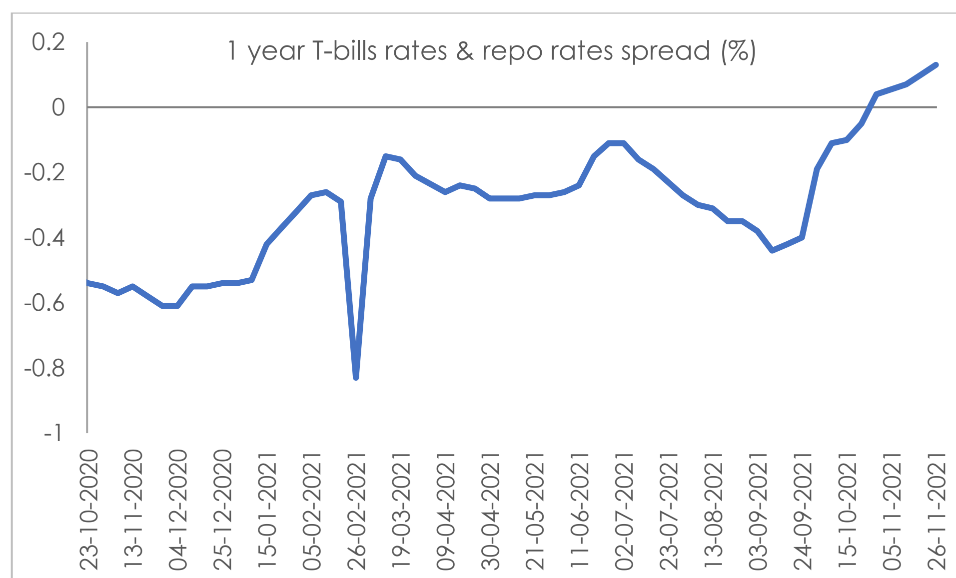
The rise in short term g-sec yield has been in focus as this is an outcome of active calibration of money market liquidity by the RBI. To recall, the central bank in its Oct-21 policy review had augmented its liquidity calibration effort through the expansion of the scope of VRRR (variable reverse repo rate) auctions along with discontinuation of the government bond acquisition programme (G-SAP). While the RBI in its Dec-21 monetary policy kept the key rates unchanged it has continued to focus on "rebalancing of liquidity'. As such the auctions amount under VRRR is set to go up higher to Rs. 6.5 trn-7.5 trn in Dec-21. At the same time, the auctions will have a higher proportion of 28 days vis-à-vis the primary tenor of 14 days. Importantly, the weighted average rate under these VRRR auctions has hardened from pre Oct-21 policy level of 3.47% to 3.95% currently, close to the repo rate that has been maintained at 4.00% by the MPC since May-20.

Chart 1: In recent VRRR auctions, the cut-offs have moved towards repo rate



Further, it is important to highlight that the average spread of 1Y T-Bill rate over repo rate has turned positive (currently averaging around +10 bps in the month of Nov-21 so far as compared to average -41 bps in Sep-21) for the first time since the beginning of the pandemic.

Chart 2: Average spread of 1Y T-bill and repo rate has turned positive in Nov-21



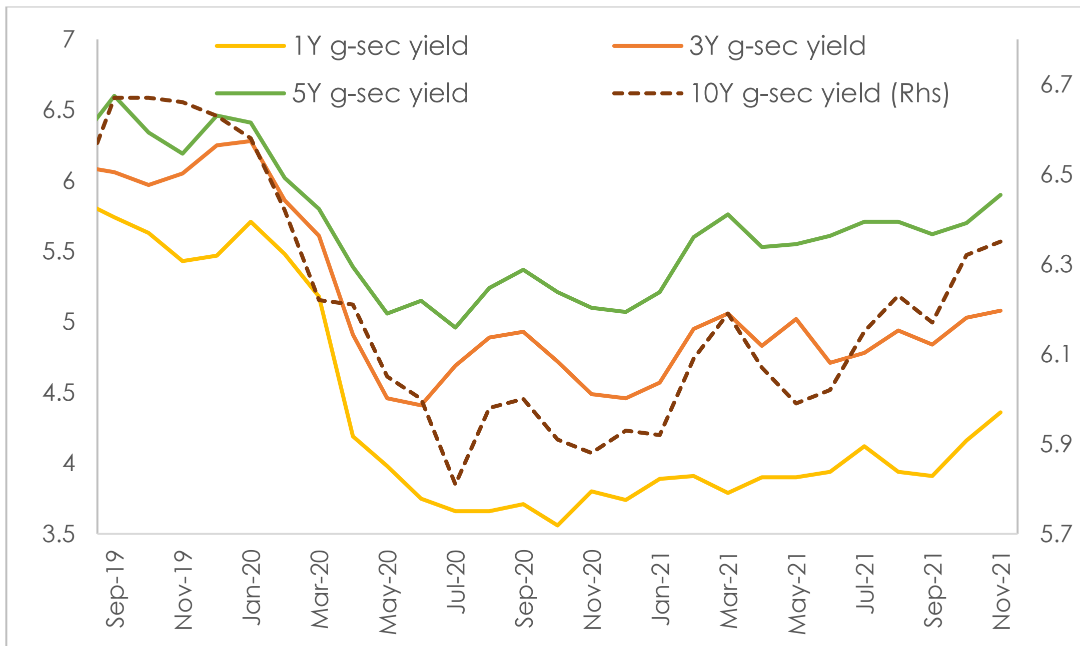
Going forward, while the calibration of the surplus system liquidity will continue till the next policy meeting, it is difficult to comment on the timing of the reverse repo rate hike. There may be a possibility of such an increase in Feb-22 provided the high frequent economic indicators continue to remain robust and the recent discovery of a new Covid variant "Omicron' doesn't start building up another pandemic wave in the country. Continuing uncertainty on the residual risks of the pandemic can reinforce the 'wait and watch' approach of RBI, thereby slowing down the progress on the policy normalization path

Outlook

From the bond yield perspective, while yields at the shorter end of the curve are poised to remain firm amidst central bank accelerating its policy normalization, we also expect 10Y g-sec yields to average towards 6.50% by Mar-22. It may be pertinent to mention that some banks and NBFCs have started to increase their deposit rates albeit marginally. Having said so, the following factors could limit any sharp upward movement in bond yields:

- Expectation with respect to India's inclusion in the global bond indices next year is gaining traction. We believe the upcoming FY23 Union Budget in Feb-22 would shed some light on the policy aspects and preparedness for the same.
- Prospects of modest fiscal consolidation in FY23 and the roadmap ahead on asset monetization that is expected to be announced in the FY23 Union Budget.

Chart 3: Impact of policy normalization more pronounced at shorter end of the curve (%)



Rupee

Signs of increasing volatility

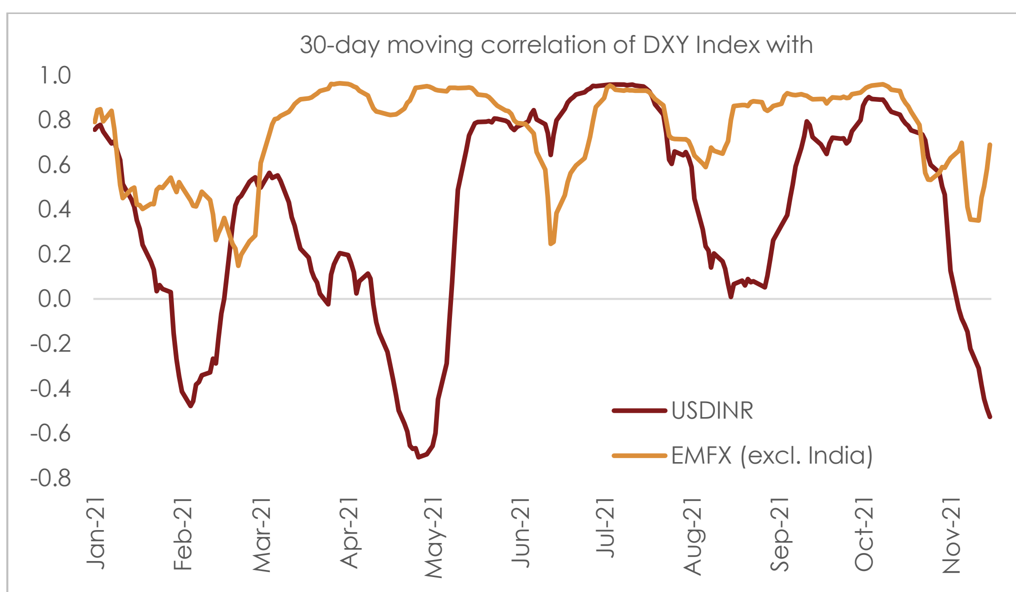
KEY TAKEAWAYS

- After two consecutive months of weakness in Sep-Oct 2021, the Indian rupee had exhibited signs of consolidation in Nov-21 but again turned volatile in early Dec-21.
- With support from portfolio inflows in Nov-21, INR had outperformed most of its peers – this opens up space for some mean reversion.
- We continue to remain USD bulls on the back of constructive outlook on US growth, which along with extremely elevated inflation will ensure US maintains its head start in monetary policy normalization among G3 central banks.
- Domestically, easing of lockdown restrictions and progress on vaccination is seen to be putting pressure on India's merchandise trade deficit from the demand side along with elevated price impact of global commodities providing an adverse backdrop.
- We expect BoP surplus to moderate in FY22 to USD 50 bn from USD 87 bn in FY21.
- We continue to expect INR/USD to move up towards 77.0 by Mar-22 with the current levels hovering at 75.7.
- Geopolitical intervention to curb elevated oil price and likelihood of India's inclusion in the global bond indices could provide downside risk to our INR/USD forecast.

After two consecutive months of weakness in Sep-Oct 2021, the Indian rupee did exhibit signs of consolidation in Nov-21 but has again been subject to depreciation pressures from the last week of the previous month.

The stability and consolidation had stood out last month as this has happened in the backdrop of a strong dollar (3.0% MoM gain in the DXY Index in Nov-21) and broad-based weakness in key emerging market currencies. However, we note that Asian currencies, anchored by the recent CNY strength, have outperformed rest of the EMFX basket during this period. In addition, a gush of portfolio flows into India (USD 3.3 bn on MTD basis) acted as a buffer against the broad weakness in EMFX. However, we have witnessed some reversals in the portfolio flows over the last two weeks.

Chart 1: In recent weeks INR's correlation with USD weakened, making case for a reversal



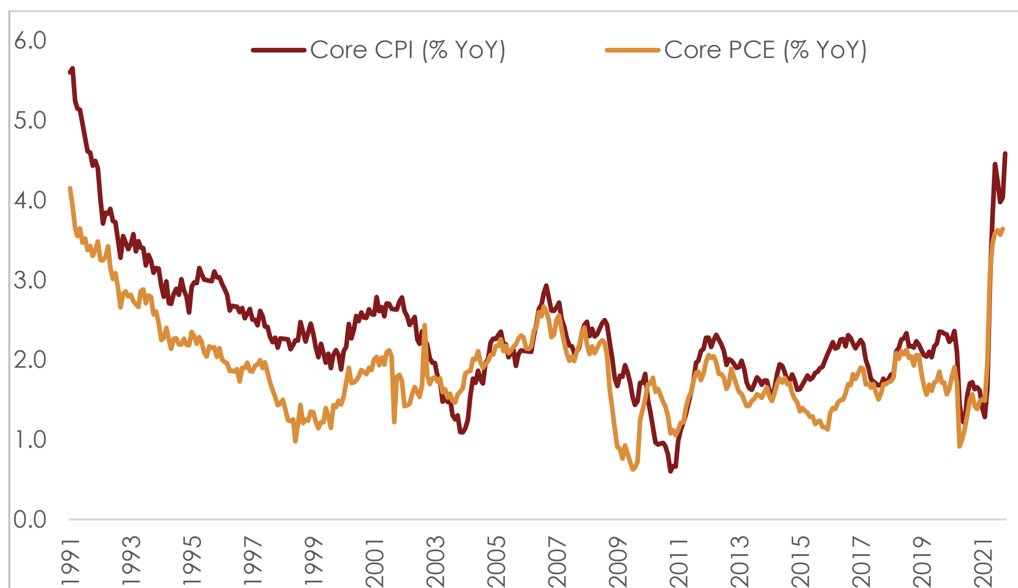
Note: EMFX (excl. India) represents GDP weighted basket of top 10 EM currencies

Overall, the global and domestic macro backdrop for INR remains similar to the one highlighted in the October edition of Acuité Macro Pulse report.

- On the global front, we continue to remain dollar bulls. Our optimism on the dollar stems from economic outperformance of the US economy (averaged over 2021 and 2022, the IMF expects US GDP to grow by 5.6%, thereby making it one of the strongest growth centers among DMs) with fairly large support from both monetary and fiscal policies (the recently approved USD 1.2 tn bipartisan infrastructure bill that includes USD 550 bn in new spending which will supplement USD 5 tn of fiscal support since the start of the pandemic).
- With the US economy already attaining its pre Covid levels in Q2-21 and inflationary pressures running at multi-year highs (CPI inflation for Oct-21 topped 6% levels on annualized basis), the Fed is on course for monetary policy normalization. For Nov-21,the Fed had already announced tapering of its USD 120 bn per month QE program by a magnitude of USD 15 bn every month. While the QE program is projected to conclude by May-22, further buildup in core inflationary pressures could potentially

swing the decision towards a faster pace of taper, while also pushing the FOMC dot plot towards two rate hikes in H2 2022.

Chart 2: Core inflation in US is at a three-decade high



Outlook

In the near term, the ongoing gradual normalization of domestic economic activity post the second wave of Covid will continue to remain one of the most important factors driving INR. With retail mobility indicators exceeding pre-Covid levels, demand for imports is likely to remain strong on account of revenge spending and pent-up demand, thereby resulting in merchandise trade deficit to remain elevated. In addition, high commodity price effect would also weigh on total merchandise trade deficit. Simultaneously, the progress on vaccination coverage is also likely to support demand conditions. As of Nov-21, India inoculated 56% of its total population with one dose of Covid vaccine. Going forward, we expect close to two third of the total population to get the partial vaccination cover by Dec-21.

As such, we expect India's current account to post a deficit of USD 38 bn in FY22 vis-à-vis a surplus of USD 24 bn in FY21. The overall BoP is likely to see a moderation in surplus to USD 50 bn in FY22 from USD 87 bn in FY21. While the projected full year BoP surplus for FY22 appears healthy, this is inclusive of the robust USD 32 bn surplus recorded in Q1. Hence, the expected incremental BoP surplus between Q2-Q4 FY22 would moderate substantially to USD 18 bn. The relatively lower BoP surplus vs-a-vis FY21 could potentially increase INR's sensitivity to global FX volatility if faster than anticipated normalization in US monetary policy plays out on inflation threat.

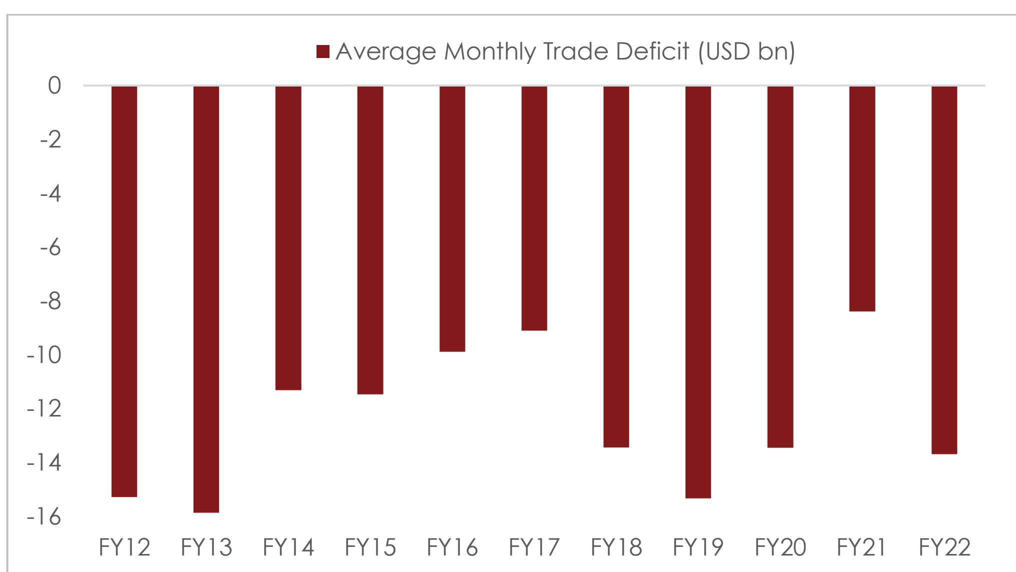
Amidst the likelihood of a USD supportive backdrop and moderation in incremental BoP surplus, we continue to expect INR to face depreciation pressures. Having said so, the intensity of adjustment is likely to be less severe vis-à-vis the 2013 'Taper Tantrum' episode on account of relatively better domestic macros and strong FX Reserve cover (USD 640 bn

currently that corresponds to about 14 months of import cover). As such, we continue to expect INR/USD pair to touch 77.0 levels by Mar-22.

Having said so, the following factors could reduce the extent of weakness and provide downside risk to INR/USD forecast:

- The use of strategic petroleum reserves by the US along with exhortation by the US government to increase oil supplies has resulted in a 6.5% drop in the price of Brent oil on MTD basis. Additionally, the resurgence in Covid cases along with discovery of new virus strain has led global crude oil prices fall to USD 71 pb currently from USD 80-85 pb in Nov-21. This would help to lower the pressure on key oil importers like India, if sustained.
- India's inclusion in global bond indices is likely to happen next year. An event like this could create new source of foreign inflow, thereby altering the currency dynamics.

Chart 3: The average monthly trade deficit in FY22 (so far) is already at a 3-year high



Note: The average for FY22 covers Apr-Oct period

Global Overview

Recovery to resilience?

KEY TAKEAWAYS

- From global perspective, the end to 2021 looks set to be as dynamic as its beginning.
- Last year, this time around we were discussing the timeline of vaccinations and economic recovery due in 2021. Thankfully, vaccinations against Covid have allowed the commentary to shift to resilience of recovery as 2021 draws to an end.
- While most developed economies are expected to revert to pre-pandemic levels by end of 2021/early 2022, few headwinds to the ongoing recovery have risen lately, though progress on vaccinations continues to offer hope.
- Further, inflation is turning out to be higher and stickier than key central banks had anticipated (driven by higher energy/commodity prices, supply constraints and recovering demand).
- Global Inflation's 'transition period' seems to have gotten longer, increasing the risks of higher inflation becoming entrenched. Not surprisingly, few global central banks are beginning to exit from the ultra-loose monetary policy.

Global overview

From global perspective, the end to 2021 looks set to be as dynamic as it's beginning. Last year, this time around we were discussing the timeline of vaccinations and economic recovery due in 2021. Thankfully, vaccinations against Covid have led economies to gradually move towards normalization as 2021 draws to an end. While most developed markets are expected to revert to pre-pandemic levels by end of 2021 or early 2022, few headwinds to the ongoing recovery have risen lately, though progress on vaccinations continues to offer hope.

- **The fight against COVID is not over yet.** The number of Covid cases in Europe have been rising past couple of weeks, which is staring at a fifth wave of infections. While US has seen a dip in cases on a trend basis over the last few weeks, European countries such as UK, Germany, Belgium, Netherlands and France have seen a rise in infections. As a result, so far Netherlands and Belgium have introduced partial lockdowns, while Austria has resorted to a full lockdown. Germany too has warned of a potential lockdown if the sharp pace of increase in daily Covid cases persists. Additionally, there has been a discovery of a new a Covid variant 'Omicron' which has again cast some clouds on overall global growth recovery.
- **Globally, inflation is turning out to be higher and stickier than key central banks had anticipated** driven by higher energy/commodity prices, supply constraints and recovering demand. In the US, CPI inflation surged to a 30-year high; in UK to a decadal high and in Eurozone to a level last seen in 2008! Key central banks have also now started coalescing around the thought of higher inflation to remain entrenched for a longer period than anticipated earlier. Thus, few central banks are beginning to exit from the ultra-loose monetary policy. In Nov-21, the Federal Reserve began to taper its bond buying, the Bank of England (BoE) recently admitted that rate hikes may be needed over the coming months, and European Central Bank (ECB) is set to phase out purchases under the Pandemic Emergency Purchase Programme (PEPP) starting Jan-22.
- **The surge in freight rates** – an outcome of strengthened demand amidst supply outages is expected to linger into 2022, as per UNCTAD's recently released Review of Maritime Transport report. The impact of heightened freight rates on economic recovery is proving to be uneven, with a stronger hit on less developed economies. The shaping up of global supply chains and the concomitant logistic costs in 2022, will prove to be a true test of the strength of the ongoing economic recovery.
- Globally, **vaccination coverage though slowing, continues to expand.** By the first week of Dec-21, over 8.0 bn doses of Covid vaccines have been administered across 184 countries, i.e., at a pace of 33 mn doses/day. Amidst the surge in cases and the discovery of the new variant in South Africa, an increasing number of nations are imposing stricter rules on the unvaccinated. The virulence of the new variant "Omicron" will be a monitorable over the next few months. However, the possibility of a new antiviral pill showing promise as per initial trials, could prove to be a game changer in 2022.

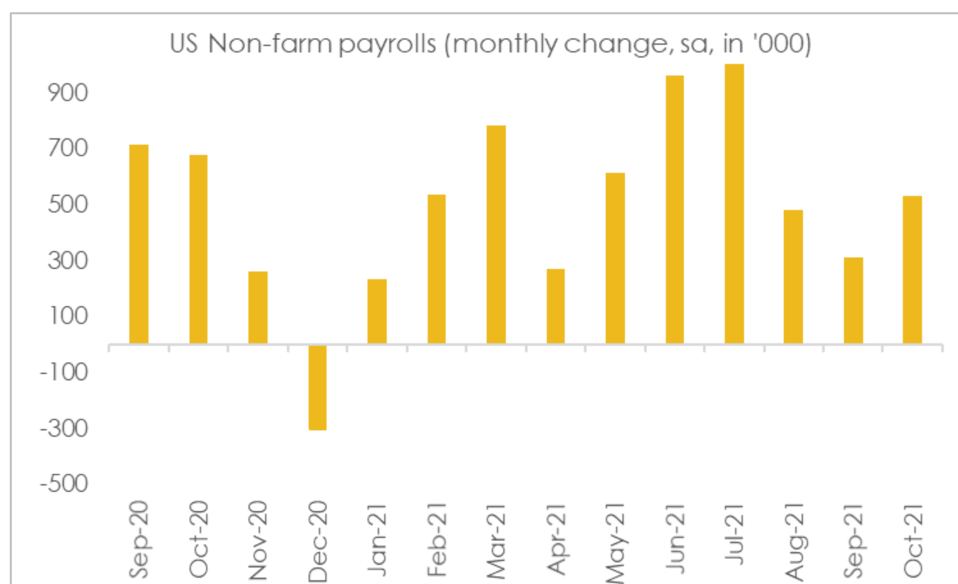
US

As highlighted in our last edition of Acuite Macro Pulse, US GDP witnessed a soft patch in Q3-21 with growth slipping to 2.0% (i.e., QoQ, seasonally adjusted annualised rate) from 6.7% in Q2-21. The spread of Delta variant along with ongoing supply constraints weighed. Thankfully, since the start of Q4-21, Covid infections have eased giving a boost to consumer mobility. As per early trends seen so far, it appears that GDP growth will rebound in Q4-21, notwithstanding the rising inflation. The latest print on retail sales reported a spending increase of 1.7%MoM in Oct-21, beating consensus estimates of 1.4%. Atlanta Fed's latest GDP nowcast for Q4-21 is running at a strong 8.2%YoY (as of 17th Nov-21).

Another impetus, that is likely to support growth well into 2022, is expected from the recently passed a USD 1.2 tn bipartisan infrastructure bill. This new legislation is set to deliver USD 550 bn of new federal investments in US infrastructure over five years, including funds for roads, bridges, mass transit, rail, airports, ports and waterways.

Underscoring the recovery, Nonfarm Payrolls for Oct-21 painted a rosy picture of the labour market on more than one count. Payrolls increased by 531k, to beat market estimate of 425k; with the unemployment rate dropping from 4.8% to 4.6%. Further, payrolls for previous two months were revised up by a cumulative 235k with average hourly earnings also improving by 0.4% MoM. The increase in private sector jobs were significant, at 604k (vs. 365k in Sep-21) led by service sectors of leisure and hospitality.

Chart 1: Strong addition to US Non-farm payrolls in Oct-21



Amidst the continuing economic recovery, the transitory surge in US CPI inflation is proving to be more long lasting. The latest print for the month of Oct-21 jumped to a 30-year high of 6.2%YoY led by a sharp 0.9%MoM jump in prices. The upside was led by prices of food, auto and fuel products. Further, core CPI was also above expectations, up by 4.6%YoY in the same period.

Basis the strength in labour markets and the soaring inflation, as widely expected FOMC (Federal Open Market Committee) decided to dial back its bond buying program beginning Nov-21. Fed has outlined that it will reduce its purchases of treasury securities by USD 10 bn and that of MBS (Mortgage-Backed Securities) by USD 5 bn every month. With inflation

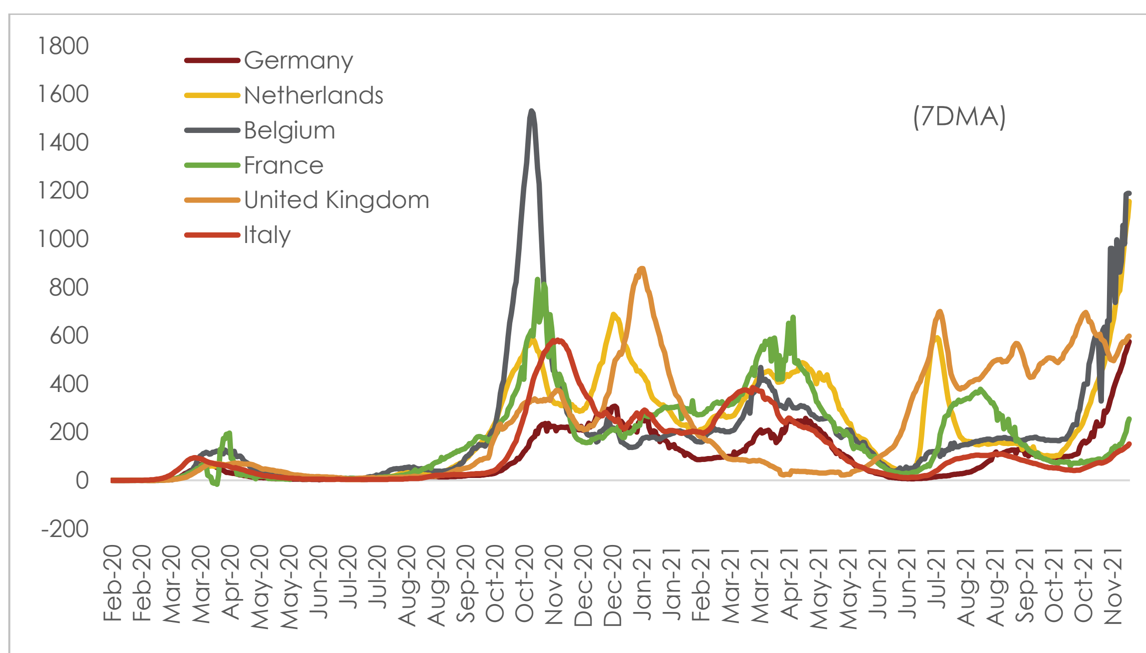
proving out to be more persistence than forecast, Federal Reserve Chair Jerome Powell in his latest testimony before the Senate Banking Committee said that it was appropriate to consider finishing tapering of asset purchases a few months earlier than previously expected.

EUROZONE

Headwinds to growth in the Eurozone are mounting. It appears that after a robust momentum in Q3-21, the ongoing quarter will see growth give up some pace. Bottlenecks and disruptions to supply chains are continuing to weigh on economic activity, especially in the automobiles sector. In addition, elevated energy prices and Covid infections once again on a rise are expected to weigh on investments and consumption, both. In early signs, retail and leisure footfalls are on a slight downward trend across key European countries. Among other macroeconomic data confirming the slowdown, Markit's manufacturing PMI dipped to an eight-month low of 58.3 in Oct-21 from 58.6 in Sep-21 with services PMI too softening to 54.6 from 56.4 in Sep-21, with further risk of downside on reimposition of lockdowns.

Growth performance at a country level is looking more divergent within the region. The largest economy of Germany, grew by less than expected at 1.8%QoQ as in Q3-21 owing to manufacturers facing shortage of raw materials, including plastics, metals and paper. In contrast, France expanded strongly at 3.0%QoQ led by an increase in household spending and the reopening of key sectors. Italy too beat expectations with 2.6%QoQ growth. Offering hope, despite a slowdown in pace of vaccination coverage, nearly 613 mn doses of the vaccine have been administered in the EU region, with 68% of the full population being fully vaccinated (as of Nov-21). The scale of vaccinations remains one of the biggest growth support factors for the region.

Chart 2: Daily new confirmed cases (per mn people) are seeing a surge in Europe



On the inflation front, prices continue to see an unabated increase. The flash Harmonised Index of Consumer Prices (HICP) inflation estimate for Oct-21, came at 4.1%YoY - a rate matched only once before historically (in Jul-08) for the series beginning since 1997. While

energy prices remained the predominant driver (~24%YoY increase), core inflation also rose to 2.1%YoY (vs. 1.9% in Sep-21). ECB Chairperson, Christine Lagarde recently commented that inflation in the eurozone will "*last longer than originally expected*" but should decline next year as energy prices and bottlenecks ease and reinforced that the ECB won't hike interest rates until the medium-term inflation outlook rises above its 2% target. Currently, the ECB expects inflation to fall back to 1.5% by 2023.

UK

Defying market expectations of a rate hike which had in fact developed over a short period of time, the BoE kept policy rates on hold at its Nov-21 meeting. The policymakers indicated that they needed more time to assess the dynamic economic situation especially with respect to the end of furlough scheme. Having said so, accompanying policy minutes were fairly hawkish citing that - "*It would be necessary over coming months to increase Bank Rate in order to return CPI inflation sustainably to the 2% target.*" Inflation projections as per the Monetary Policy Report remain fairly elevated, above the 2.0% target in a no-change (i.e., on interest rates front) scenario. As such, market participants are continuing to expect rate hike either in Dec-21 or Feb-22.

From macro data perspective, GDP grew by 1.3% QoQ in Q3-21, down from 5.5% in the previous quarter. Growth was driven by spending on services, as pandemic restrictions were gradually lifted. The start to Q4-21 however has been somewhat muted amidst supply disruptions and rising inflation, leading to growth downgrade for 2021and 2022 both. BoE now expects UK economy to expand by 7% in 2021, revised lower by 25 bps and 2022 growth is projected at 5% - a downward revision of 100 bps.

In his testimony to the Treasury Committee, BoE Governor Bailey told MPs that he was '*very uneasy*' about UK's inflation situation. As per Bailey, UK economy faces much more "two-sided risks" than before i.e., with weaker growth on one side, and rising inflation on the other. True to his assessment, UK's CPI inflation accelerated to a 10-year high of 4.2%YoY in Oct-21 vs. 3.1% in Sep-21 and BoE's target of 2.0%. The central bank expects annualised inflation to rise further to around 5.0% in the spring of 2022 before falling back toward its 2.0% target by late 2023, as the impact of higher oil and gas prices fades and demand for goods moderates.

JAPAN

The Japanese economy contracted by more than expected in Q3-21, by 3.0%YoY compared to a growth of 1.5% in Q2-21. The degrowth can be attributed to weak consumption amidst Covid restrictions, along with global supply disruptions (especially in the automobiles sector) that hit exports and investments, both. In a bid to support growth, Japan's PM recently announced a record ~USD 500 bn of stimulus package, including cash handouts and aid to ailing businesses. The proposal however is still due for parliament's approval, which is expected to convene in Dec-21. The package also earmarks spending for vaccine research after facing criticism over being dependent on imports for coronavirus vaccines. Japan has so far approved vaccines from Pfizer, Moderna and AstraZeneca for administration in the country; with nearly 76% of the population being fully vaccinated.

Corporate Performance

Q2FY22

Q2 results reveal significant corporate recovery post second wave

MSME sector, however, continues to be under profitability strain

KEY TAKEAWAYS

- A study undertaken by Acuité Ratings on the latest quarterly financial performance of 1849 listed companies throws some interesting insights. While the large and the mid corporate sectors have shown a solid recovery in Q2FY22 after unlocking of the economy following the disastrous second Covid wave, the MSME sector still continues to lag behind.

- The resilience of the domestic corporate sector is reflected by the 23.6% growth in total revenues in Q2FY22 as compared to the pre-pandemic period i.e. Q2FY20. It also highlights a healthy revival in consumption demand after the removal of most lockdown restrictions and partly, the buoyancy in exports.

- It is interesting to note that the pandemic has actually led to a significant improvement in profitability of the overall corporate sector with more than 700 bps increase in the PBDIT margin in Q2FY21 YoY. We believe this is primarily due to the sudden drop in commodity prices and the rationalization of operating costs in the larger part of FY21. However, it is clear that such an improvement may not be sustainable given the steep hike in commodity costs including crude oil prices in the current year. We already note an average drop of 100 bps in PBDIT margin in the second quarter of the year and it is expected to normalise even further in H2FY22.

- The study reveals that the large corporate sector has been a significant beneficiary of the weaker commodity prices and the cost rationalization initiatives taken in the early part of the pandemic. While they comprise 22% of the sample portfolio, they have accounted for 90% of the aggregate PBDIT and 95% of the gross PAT quantum. 67% of the large corporates in the sample had a conservative leverage level of less than 0.5 times and they have also benefitted from the sharper drop in the interest rates on their borrowings.

- However, the recovery is only partial in the MSME sector in terms of revenues. The gross income in the MSME pool in the second quarter of the current fiscal is still 11.5% lower compared to that in Q2FY20. Further, the pandemic has aggravated the profitability pressures that the MSME sector was already witnessing in FY20; while the average PBDIT margins in this group was in the band of 8.5%-10.0%, it has continued to record aggregate losses over the last two years albeit the quantum has reduced materially by 46% in Q2FY22 YoY.

- The debt levels of the corporate portfolio have increased at an annual average of 11.9% over the last two years primarily due to a pickup in working capital borrowings including the facilities availed under Emergency Credit Line Guarantee Scheme (ECLGS). We believe that the reported growth in borrowings will start to drive a moderate level of credit growth in the current year.

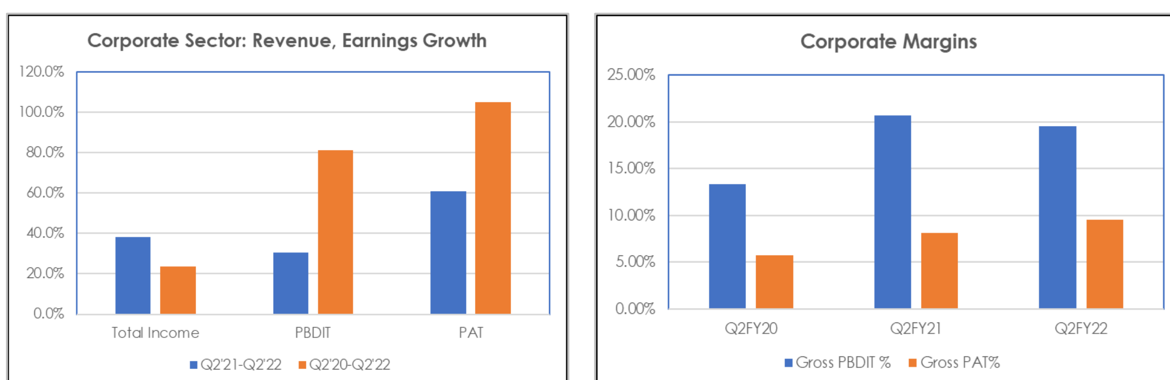
Introduction

Acuité Ratings has undertaken a study on the financial performance of 1849 listed corporates that have published their second quarter (Q2FY22) results by end of Nov'21. The objective of the study was to understand the impact of the Covid pandemic on the business position i.e. both revenues and margins as well as the trajectory of the leverage in the balance sheet. The study covers a diverse set of companies across the manufacturing, services and the trading sector spanning large, mid and MSME businesses. For the purposes of this report, we have defined large corporates as those with quarterly revenues beyond Rs 500 Cr, mid-sized between Rs 50 – 500 Cr and MSMEs as those with total income less than Rs 50 Cr per quarter. In our study sample, 31% are MSMEs while 47% are from the mid-corporate sector and the balance 22% represent the large corporate sector.

Overall Conclusions

An overall analysis of the aggregate corporate portfolio highlights the following:

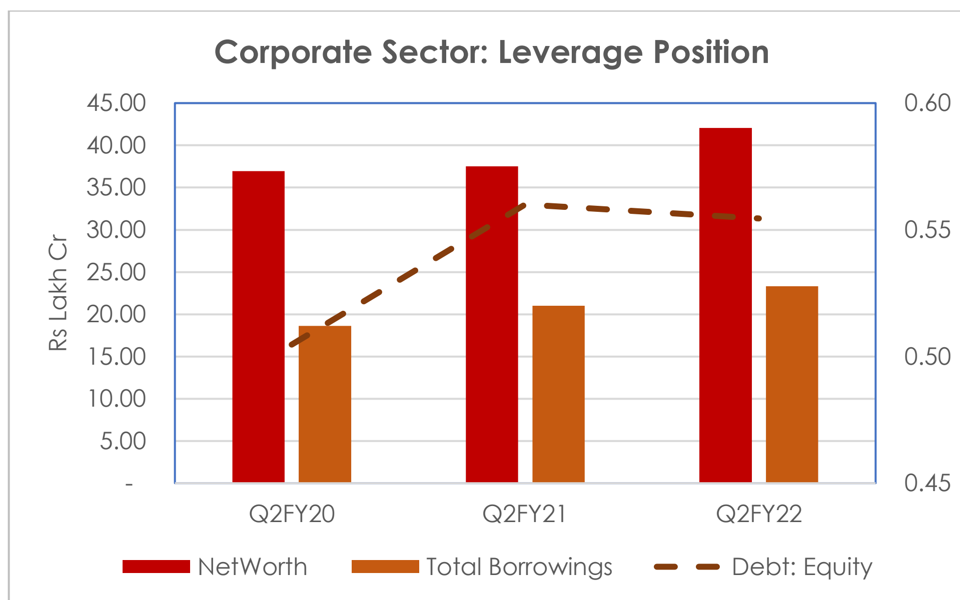
- The aggregate revenues of the portfolio in Q2FY22 have grown sharply by 38.0% on an annualised basis but even compared to the pre-pandemic quarter of Q2FY20, the reported growth stands at 23.6%. This reflects a healthy recovery in corporate performance in the current fiscal on the back of the unlocking of the economy and a revival in consumption demand.
- Importantly, the profitability has witnessed a sharper improvement with PBDIT growing by 81% compared to Q2FY20 and the net profits have more than doubled (105%) over this 2 yr period.
- The average operating i.e. PBDIT margin for the corporate portfolio had jumped from 13.3% in Q2FY20 to 20.7% in Q2FY21 while slightly moderating to 19.5% in Q2FY22. The PAT margins have also moved up sharply from 5.7% in the pre-pandemic quarter to 9.5% in the last quarter. Clearly, the improvement in profitability in the overall corporate sector has been driven by the lower input and operating costs particularly over the earlier part of the pandemic period though raw material costs have started to increase perceptibly in the current year, raising doubts on the sustainability of the higher margins.



Source: CMIE Prowess, Acuité Research

As regards the debt levels of the sample portfolio, it has increased at an annual average of 11.9% over the last two years. We reckon that this is primarily due to a pickup in working capital borrowings including the facilities provided and availed under Emergency Credit Line

Guarantee Scheme (ECLGS). Higher cost of commodities and raw materials have been a factor over the last one year. This, however, has not been reflected in banks' credit growth as a part of the additional borrowings might have been raised through debt instruments. However, we believe that the reported growth in borrowings will start to drive a moderate level of credit growth in the current year.



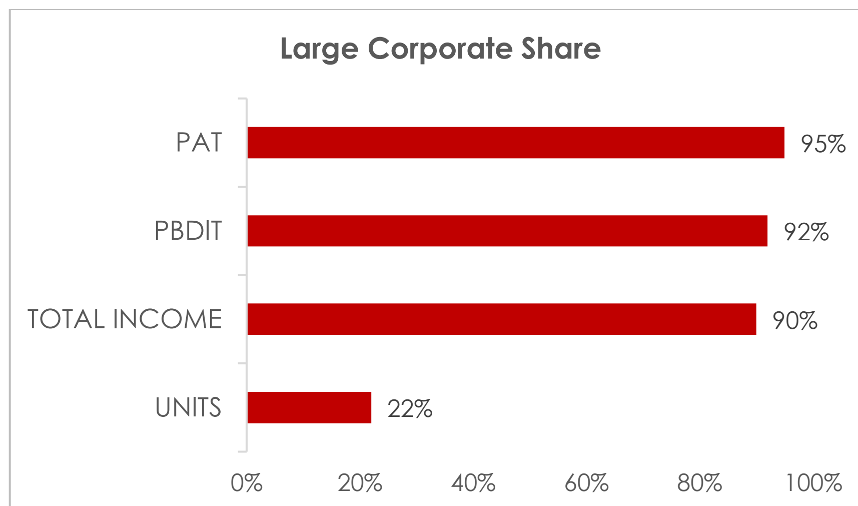
Source: CMIE Prowess, Acuité Research

Having said that, the leverage levels haven't really increased in the corporate sector in a material manner, going up from 0.50x as on Sep-19 to 0.55x as on Sep-21 given that internal accruals have also risen in a healthy way.

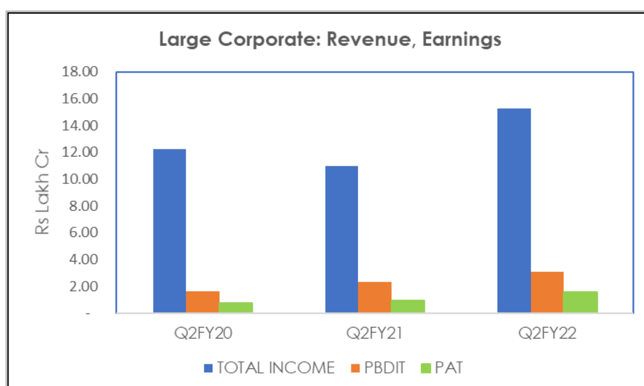
What is noteworthy is the average of the top listed companies in India is relatively low and at a collective level, they have the flexibility to raise debt for the upcoming private sector capex cycle. The study reveals that 63% of the companies in the sample portfolio (excluding a few where the networth data was not available) had a conservative leverage of less than 0.5x as on Sep-21.

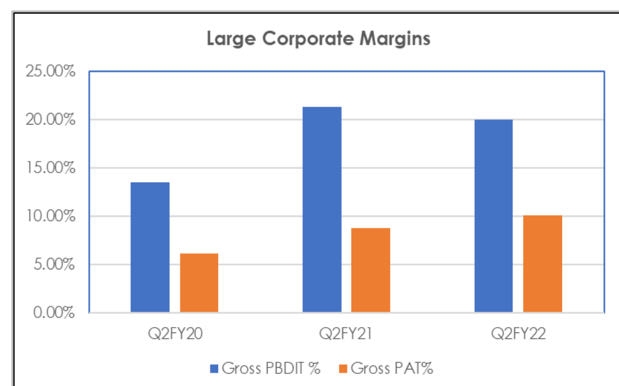
Large Corporate Sector

As the next step in this study, Acuité has split the sample portfolio into Large, Medium and MSME groups as mentioned earlier, depending upon their quarterly revenues. In our sample, there were 411 companies that had quarterly total income of Rs 500 Cr or above and therefore, they have been categorised as "Large Corporate Sector".



It is interesting to note that while large corporates comprise only 22% of the sample population, it accounts for a dominant part of not only revenues but also operating profits and net profits. While this has been the broad pattern even before the pandemic, we note that the share of large corporates in aggregate profits has slightly increased during the pandemic period. The economies of scale apart, large corporates also benefit from a superior leverage position and finer interest rates.





Source: CMIE Prowess, Acuité Research

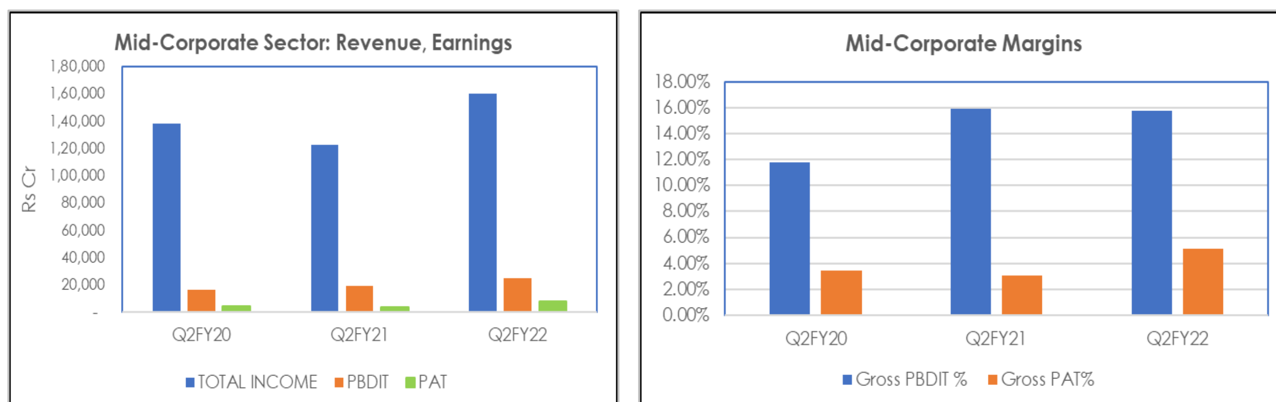
The large corporate pool largely mirrors the overall performance of the sample population:

- The revenues did drop by 10.1% in Q2FY21 due to the impact of the pandemic but has come back strongly in Q2FY22, growing by 39.1%.
- The profitability trends have been similar as in the overall sample except that the extent of growth in PBDIT and PAT in the pandemic year i.e. previous year has been stronger.
- The average operating i.e. PBDIT margin for the large corporate portfolio had jumped from 13.5% in Q2FY20 to 21.3% in Q2FY21 while slightly moderating to 20.0% in Q2FY22. The PAT margins have also moved up sharply from 6.1% in the pre-pandemic quarter to 10.1% in the last quarter. What has particularly contributed to the expansion of the

net margins for this segment is the lower interest cost both due to better working capital management as well as some reduction in interest costs.

Mid Corporate Sector

In our sample, there were 875 companies that had quarterly total income between Rs 50 and Rs 500 Cr and therefore, they have been categorised as "Mid Corporate Sector". This comprises the bulk of the sample population in volume terms (47%).

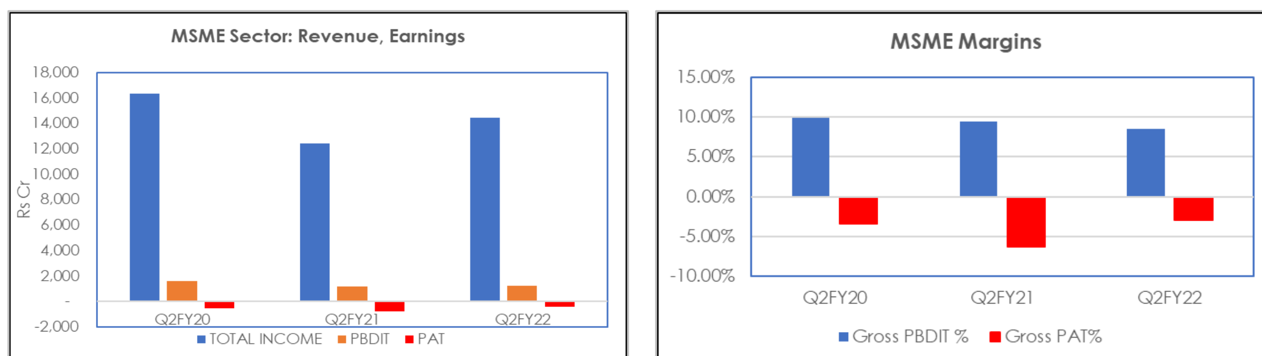


Source: CMIE Prowess, Acuité Research

- The aggregate revenues of the mid segment in Q2FY22 have grown significantly but to a lesser extent as compared to the large corporate sector at 30.4% on an annualised basis and at 15.7% on a two year basis. The revenue recovery has been particularly high at 30.4% over the last one year.
- The profitability growth has been strong but again lower vis-à-vis larger companies at 55% compared to Q2FY20 but the net profits have risen at a faster pace at 74% over this 2 yr period.
- The average operating i.e. PBDIT margin for mid corporate segment has risen from 11.8% in Q2FY20 to 15.9% in Q2FY21 and has been broadly stable at that level in Q2FY22. While the PAT margins were slightly lower in Q2FY20, it has seen a perceptible improvement in Q2FY22. This highlights the fact that the unlocking of the economy has had a more positive impact on this category in terms of net margins.

MSME Sector

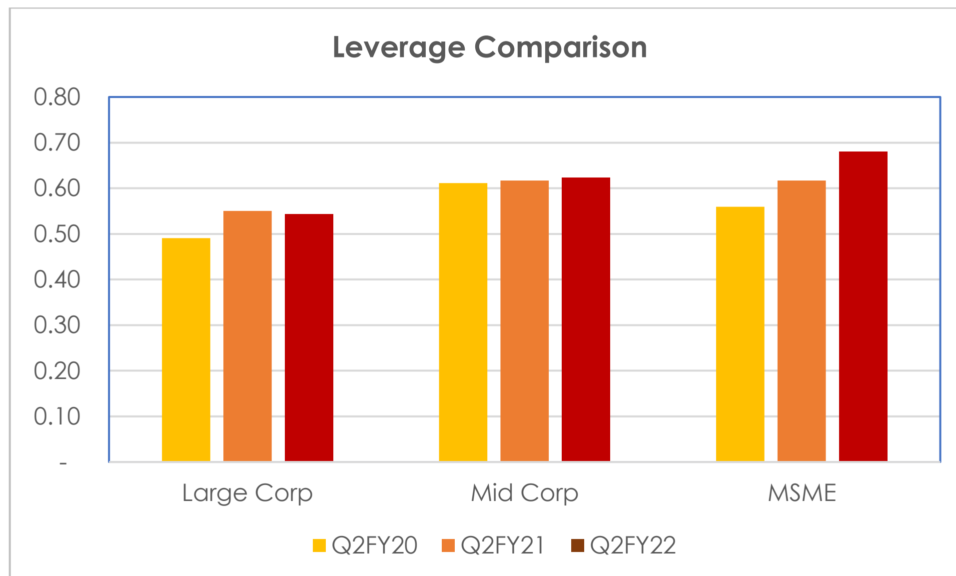
The sample consisted of 563 companies that had quarterly total income less than Rs 50 Cr and they have been designated as part of the "Small and Medium Enterprises Sector". This comprises a sizeable 31% of sample population in volume terms.



Source: CMIE Prowess, Acuité Research

It is pertinent to note that the revenue and the profitability trajectory for the MSME sector has been significantly different as compared to large and mid-corporates.

- The gross revenues in the MSME sector did witness a moderate recovery in Q2FY22 and grew by 16.7% from a lower level induced by the pandemic; Q2FY21 revenues had sharply slipped by 24.2% from the pre pandemic year. However, it is still to catch up with the latter levels with a gap of 11.5% persisting with the latest quarter. We reckon that this is partly due to the fact that there is a larger proportion of services sector companies in this segment that have been more adversely impacted by the pandemic.
- The stress in the segment is reflected by the substantial 27.7% drop in the PBDIT levels last year itself (Q2FY21) and while there was a modest recovery of 4.7% in the current year, it lags behind the pre Covid levels in a substantial manner. What is further relevant to highlight is that the aggregate PAT of the group has remained negative throughout these three years although the quantum of losses has reduced by 46% since last year.
- The average operating i.e. PBDIT margin for the MSME portfolio has been in a narrow range between 8.5%-10.0% over the last 2 years. However, it is clear that these margins were not adequate to cover the other fixed costs including interest, leading to negative net margins. It needs to be pointed out that the profitability in this segment was under strain even in the pre-pandemic year which had seen a weak GDP growth of 4.5%.
- The average leverage in the MSME segment at 0.68x are moderately higher vis-à-vis the overall average levels at 0.55x as on Sep-21. The gross borrowings have increased by 8.2% over the last one year, leading to a slight increase in leverage.



Source: CMIE Prowess, Acuité Research

A comparison of the leverage position across the corporate segments indicates that the pandemic has not led to any sharp increase in borrowings or leverage in any. For both large and mid-corporate on a collective basis, the leverage levels have been very stable in the last two years. There has been, however, a moderate increase in leverage in the MSME sector due to weak earnings and some increase in working capital borrowings including the ECLGS facilities that were available at fine rates.

About Acuité Ratings & Research Limited:

Acuité Ratings & Research Limited is a full-service Credit Rating Agency registered with the Securities and Exchange Board of India (SEBI). The company received RBI Accreditation as an External Credit Assessment Institution (ECAI), for Bank Loan Ratings under BASEL-II norms in the year 2012. Since then, it has assigned more than 8,900 credit ratings to various securities, debt instruments and bank facilities of entities spread across the country and across a wide cross section of industries. It has its Registered and Head Office in Kanjurmarg, Mumbai.

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