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FORESIGHTS

CORPORATE PROFITABILITY RECOVERS IN Q3 FY25

The global economy is facing turbulence due to a tariff war, which is impacting growth and inflation and causing volatility in financial markets. However, despite global headwinds, recent data suggests improvement in economic activity. Sales and profitability for Indian firms improved in Q3 FY25 but stayed below par. Factors like recovering rural demand, lower income tax burden, rate cuts, falling food inflation, and increased public spending should boost economic activity. However, monitoring any external risks will be crucial.

NOTE FROM SACHIN GUPTA

Chief Rating Officer & Executive Director

The Turbulent Trump!

In the past 6-7 weeks, the world has experienced significant turmoil since Donald Trump assumed office, resulting in geopolitical and business turbulence. While both areas are enormously consequential, this discussion will concentrate on the implications for business and finance, particularly in India.

However, before delving into this, I must acknowledge that the sheer volume of announcements and executive orders issued (and subsequently revoked) by Donald Trump makes it nearly impossible for any analyst to assess the true impact fully. Even if one could gauge the direct consequences of these actions, the effects of subsequent counteractions and their repercussions are unfathomable.
Against this backdrop, I will highlight three risks likely to arise, along with some mitigating factors.

Firstly, global inflation is anticipated to rise, leading to high interest rates. This point is widely accepted. Fundamental economics indicates that tariffs function similarly to taxes, raising the cost of goods. Consequently, these tariffs and retaliatory measures will inevitably drive-up prices globally, curbing the Federal Reserve's capability to lower interest rates.

As observed, elevated US interest rates strengthen the dollar, resulting in capital flight from emerging markets such as India. This outflow of dollars constrains the Reserve Bank of India's (RBI) ability to stabilise the rupee while lowering interest rates.

Secondly, private sector capital expenditure in India will be affected. The Indian economy has long awaited the resurgence of private investment, despite capacity utilisation exceeding 75% in numerous sectors; this revival seems unlikely in the current climate. The rationale is straightforward: as Donald Trump frequently highlighted, India does impose higher tariffs. Due to increased pressure to reduce tariffs and heightened import competition, domestic manufacturers may refrain from expanding capacity. Indian exports could also face stiff competition from Chinese products in non-US markets. As a result, Indian manufacturers are expected to adopt a defensive strategy to safeguard their markets and profit margins, rather than pursue capacity expansion.

Thirdly, global supply chains will undergo reconstruction. Countries like India might respond to US tariff pressures by importing goods directly from the US instead of sourcing them from other nations. Furthermore, multinational corporations that have relied on low-cost manufacturing sites outside the US for imports are likely to relocate their production closer to home. This shift will significantly reshape global supply chains. In India, we can expect an increase in oil and gas imports, defense, and nuclear energy equipment.

With the rise in freight and logistics costs, these new supply chains will likely be less efficient, further contributing to inflationary pressures.

Mitigating Factors – Rupee Depreciation, Impact of China, and Trade Deals

The rupee has recently depreciated by 3-4%, providing exporters some leverage when negotiating with their US clients in the post-tariff landscape beginning April 2. Certain Indian businesses may seize the chance to gain market share from China in sectors like electric vehicles and solar energy equipment, where significantly higher tariffs have been placed on Chinese products.

Additionally, India is actively pursuing a trade agreement with the US, allowing it to offer specific concessions while requesting reduced tariffs for Indian exports. In summary, the upcoming months are poised to be characterised by considerable volatility in business sentiment, as clarity gradually emerges in various industries. The US's effort to reclaim manufacturing share from the global market through tariff threats will likely experience many fluctuations before achieving a medium-term balance.

NOTE FROM RAJANI SINHA

Chief Economist

India in Midst of Global Turbulence

The global economy is going through a turbulent time, grappling with a tariff war and adverse implications for growth and inflation. The uncertain environment has resulted in volatile financial markets. India's Nifty index has fallen by around 9% in the last three months, with FII outflows of around USD 13 billion since the beginning of the calendar year. The Indian rupee has weakened by 2.8% against the dollar in the last three months and forex reserves have fallen from a high of USD 700 billion in September to USD 638 billion by end February.

Amid this volatile environment, some reprieve was provided by the latest GDP data. GDP growth improved to 6.2% in Q3 FY25 from 5.6% in Q2 FY25. Moreover, the full-year GDP growth for FY23 and FY24 was revised to 0.6 pp and 1.0 pp respectively. While the improvement in Q3 growth was on expected lines, the concerning aspect was that investment growth in Q3 remained muted at 5.7%, around the same as Q2. While the manufacturing sector growth improved, it was still feeble at 3.5% in Q3, as compared to 2.1% in Q2. We expect GDP growth to accelerate in Q4 to around 7%, as consumption gathers further momentum and the government's capex picks up strongly.

With the US threat of reciprocal tariffs, there are concerns about the adverse implications for the Indian economy. US is India's largest export destination with exports to US accounting for around 18% of India's total exports. India enjoys a trade surplus of around USD 35 billion with the US. As per our rough estimates, reciprocal tariff could adversely impact India's GDP by around 0.1% directly. This assumption weakens the rupee to counter some of the tariff impact. However, the indirect impact is even more concerning as global trade slows and inflation increases. Volatile capital flows and their impact on India's external sector are other concerning factors.

Despite ongoing worries about growth, easing inflation is a welcome sign. India's CPI inflation dropped notably to 3.6% in February, down from 4.3% in January. This decline has primarily been driven by a significant decrease in food inflation, which fell to 3.8% from 5.7% last month. According to recent data, vegetable inflation, previously a major contributor to high overall inflation, has now entered a deflationary phase. Other food components have also seen reduced inflation rates, except edible oils and fruits, which remain in double digits. Overall, inflation is expected to remain manageable, at close to 4% in the upcoming months. We anticipate the RBI will reduce the policy rate by another 25 basis points in the forthcoming MPC meeting in April. While currency fluctuations may persist in the short term, the RBI will likely focus on supporting growth.

CORPORATE PROFITABILITY RECOVERS IN Q3 FY25

The corporate performance of non-financial firms showed a recovery in Q3 FY25, following a contraction in H1 FY25. This recovery in Q3 was primarily driven by a rebound in sales growth and a moderation in expenditure growth, with expenditure growth remaining below net sales growth. Key factors supporting corporate performance include a rebound in government spending, a decline in global commodity prices, easing inflationary pressures, and a recovery in rural consumption demand. However, geopolitical tensions, global policy uncertainty, weaker urban consumption demand, and sluggish external demand continue to present significant risks that require close monitoring. This report analyses the corporate performance of 1321 listed non-finance companies.

Corporate Performance – Q3 FY25

In Q3 FY25, the growth in net sales of non-financial firms improved to 7.4% Y-o-Y from 6.2% Y-o-Y in the previous quarter (Table 1). The expenditure growth moderated in Q3 FY25 to 7.1% Y-o-Y from 7.9% Y-o-Y in Q2 FY25. Despite some moderation in Q3, expenditure growth continued to remain elevated. A recovery in revenue growth, along with moderation in expenditure growth, resulted in improved profitability.

Overall Quarterly Analysis

Particulars	Unit	Q3 FY24	Q4 FY24	Q1 FY25	Q2 FY25	Q3 FY25
Net Sales	Rs Lakh Cr	23.9	25.2	24.7	24.6	25.6
	% y-o-y	5.9	7.5	7.7	6.2	7.4
Expenditure	Rs Lakh Cr	20.0	21.0	20.6	20.7	21.4
	% y-o-y	4.5	6.8	8.8	7.9	7.1
Cost of Services and Raw	Rs Lakh Cr	8.3	8.6	8.5	8.7	8.8
Materials*	% y-o-y	6.0	7.0	10.5	9.0	5.9
Employee Cost*	Rs Lakh Cr	2.2	2.2	2.3	2.3	2.3
	% y-o-y	10.2	6.5	7.4	8.1	7.4
Operating Profit	Rs Lakh Cr	4.4	4.8	4.6	4.5	4.8
	% y-o-y	14.2	12.6	2.5	0.0	9.2
Profit After Tax	Rs Lakh Cr	2.1	2.5	2.2	2.1	2.5
	% y-o-y	14.0	14.2	-0.7	-5.8	16.8
Ratios						
Operating Profit Margin	%	18.5	19.0	18.7	18.4	18.8
Interest Coverage Ratio (ICR)	-	7.5	8.4	8.1	7.4	7.8

Source: Ace Equity & CareEdge; Note: Results based on a sample of 1321 listed non-finance companies;
* Data pertains to a smaller sample of 1063 listed non-finance companies

Consequently, operating profit margin improved to 18.8% in Q3 FY25, higher than 18.4% in Q2. With the recovery in operating margins, the profit after tax (PAT) growth stood at 16.8% Y-o-Y, contrasting with the contraction in the previous two quarters.

Sales growth in Q3 aligns well with expectations, reflecting the continued recovery of economic momentum. This is driven by favourable trends in high-frequency indicators, including rising government capital expenditure, growth in industrial production, increasing GST collections, and intense agricultural performance. Furthermore, our forecasts indicate that GDP growth is expected to strengthen in Q3, reaching 6.3%, an increase from 5.4% in Q2. Within expenditures, employee cost in Q3 rose by 7.4% Y-o-Y as against 8.1% Y-o-Y growth in the prior quarter. This could be indicative of weakness in the labour market and wage growth, with implications for consumption demand. Meanwhile, the growth in the cost of services and raw materials moderated even sharply to 5.9% Y-o-Y in Q3 from 9% Y-o-Y in Q2. Lower global commodity prices have aided this reduction. In Q3 FY25, Bloomberg global commodity prices have contracted by ~3.3% YoY, mainly due to moderation in Brent crude prices. On the financing front, higher policy interest rates and falling liquidity surpluses have elevated borrowing costs for corporations in Q3. However, we expect further policy rate cuts of 25-50 bps, which should help soften interest rates in the medium term.

We have closely analysed the financial performance of 20 select sectors (detailed in Annexure I) for Q3 FY25. Among these, eight sectors reported double-digit growth in both net sales and operating profit. Key performers include capital goods, hospitality, chemicals, retailing, telecom, textile, non-ferrous metal and white goods, all of which sustained double-digit growth in both metrics—among the major sectors, iron and steel, crude oil, cement and media/entertainment performance remained muted in Q3.

Growth in Select Sectors in Q3 FY25 (Y-o-Y, %)

Sales Growth (% y-o-y)		
Less than 7	**7 to 14**	**Above 14**
Crude Oil	Media & Entertainment	Chemicals
		Telecom
Aviation	Automobile & Ancillaries	Textile
		Capital Goods
Cement	Logistics	Hospitality
Iron & Steel	Pharmaceuticals & Drugs	Retailing
		White Goods
Power	Infrastructure	
IT	FMCG	
	Non-Ferrous Metals	

Growth in Operating Profit (% y-o-y)		
Less than 7	**7 to 14**	**Above 14**
Iron & Steel	Infrastructure	Chemicals
Media & Entertainment	IT	Capital Goods
		Telecom
Automobile & Ancillaries	Power	White Goods
Logistics	Crude Oil	Aviation
Cement	Pharmaceuticals & Drugs	Non-Ferrous Metals
FMCG	Textile	
	Hospitality	
	Retailing	

Source: Ace Equity and CareEdge. *Crude Oil covers petrochemicals, refineries, and oil exploration

Way Forward

Sales and profitability for Indian firms improved in Q3 FY25 but stayed below par. We anticipate improvement persisting in the coming quarters as well. Factors such as recovering rural demand, lower income tax burden, policy rate cuts, falling food inflation, and recovery in public capital expenditure should support improvement in corporate profitability. The GDP growth for H1 FY25 slowed to 6% Y-o-Y from 8.2% in FY24. However, we anticipate this slowdown will be temporary, with a projected growth rate of 6.3% Y-o-Y in Q3 and 7% in Q4. For FY26, we expect GDP growth at 6.7%. The RBI has already reduced the policy repo rate by 25 bps in the February policy meeting and has implemented measures to support liquidity conditions. We expect additional rate cuts of 25-50 basis points in FY26, contingent on the growth-inflation dynamics.

Despite this, a significant pickup in private capital expenditure has yet to materialise. A sustained recovery in consumption will be critical to drive a meaningful uptick in corporate capex. On the external front, global growth remains relatively weak. Commodity prices, including Brent Crude, will likely remain subdued due to weak demand from China and anticipated increases in US petroleum production under the new administration. The overall performance of corporates in the coming quarters will depend upon the unfolding of the global growth scenario and domestic demand conditions. Monitoring any external risks associated with geopolitical tensions, trade policy uncertainty, commodity price shocks and weather events is crucial. Domestically, the pace of economic recovery will be a critical factor influencing corporate performance in the coming quarters.

STRUCTURAL EVOLUTION OF INDIAN PRIVATE BANKS: A SHIFT TOWARDS STABILITY AND RETAILISATION

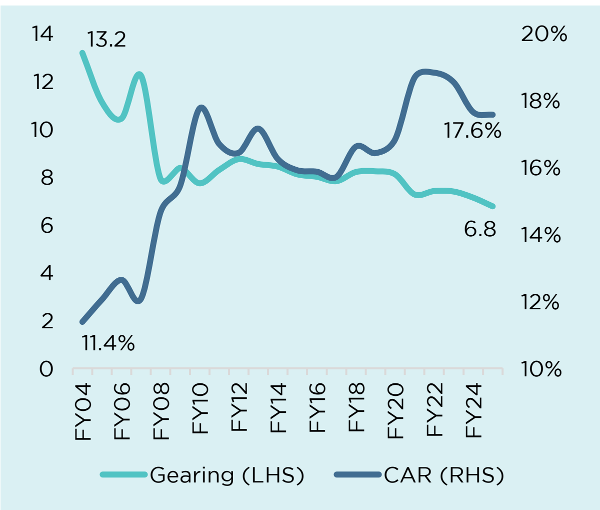
Over the past two decades, the Indian banking industry has faced multiple transformative challenges that have strengthened the regulatory framework, including Basel III norms, the Insolvency and Bankruptcy Code (IBC), and the Prompt Corrective Action (PCA) framework.

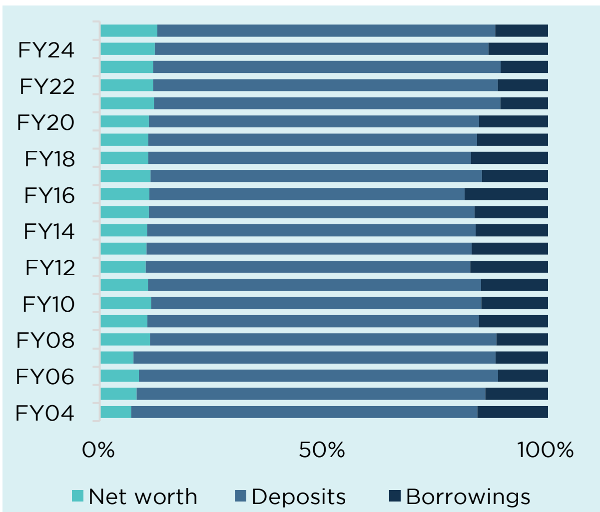
Impact on the Liabilities

The gearing ratio, which reflects the relationship between deposits and borrowings to net worth, has significantly declined among Private Banks. This marked improvement in the gearing levels of Private Banks can be attributed to their efforts to strengthen their liability profiles. Over the years, the RBI has issued directives to improve capital adequacy and ensure that banks maintain sufficient buffers to withstand economic stress.

As of September 30, 2024, the ratio had reduced to 6.8 times from 13.2 times on March 31, 2004, driven by

Trend of Gearing and Liabilities Composition





Source: Ace Equity; RBI data. Numbers are on an aggregate basis a substantial increase in net worth. Net worth grew at a higher CAGR of 24%, rising to Rs.12,657 trillion, compared to deposits, which grew at a CAGR of 20%, reaching Rs.74,069 trillion. Private Banks actively raised capital in the years following major stress events in the banking sector. Consequently, capital adequacy ratio (CAR) has also improved significantly, rising to 17.6% from 11.4% over the same period.

Over the past 20 years, Private Banks have significantly more than doubled their deposit market share, rising from 14% to 35%. Going forward, CareEdge estimates that private sector banks would gradually increase their deposit market share by increasing their number of branches, interest rates, and technological upgrades.

Impact on the Assets

Asset side of Private Banks also underwent significant transformation in the composition of their assets. In 2004, a substantial portion of the total assets of Private Banks was allocated to investments, primarily in government securities and other low-risk instruments.

The SLR (Statutory Liquidity Ratio) requirement has come down over the current 18% from 25%, which reflects the lower share of investments. Over the years, this trend has shifted, with advances gradually replacing investments as the dominant component of bank assets.

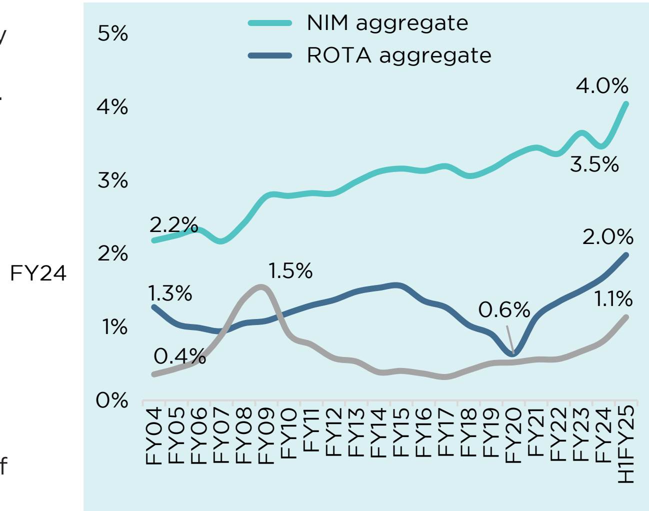
The credit-to-deposit (CD) ratio has risen gradually for the banking industry and Private Banks. For Private Banks, the increase in CD ratio has been more pronounced, rising from 69% as of March 31, 2004, to a substantial 91% by September 30, 2024 (more pronounced post-merger of NBFC with a bank in FY24) significantly above the ideal range of 75%-80%. Rising stress in the retail segment, coupled with elevated credit-to-deposit (CD) ratios, has led to a slowdown in credit growth for Private Banks. In response, these banks are prioritising deposit growth, which, alongside increased securitisation efforts, is anticipated to help moderate the CD ratio over the medium term.

Strong capitalisation and improved solvency ratios have enabled Private Banks to better manage asset quality stress, with the Net NPA to equity ratio improving to 3% as of September 2024 from 14% in FY18.

Recent Stress

Some Private Banks, NBFC-MFIs, and Small Finance Banks are facing stress in the unsecured loan segment, including credit cards, personal loans, and microfinance, a challenge that surfaced in Q1FY25 and may persist into the next fiscal.

Volatile profitability



Source: Ace Equity; RBI data. Numbers are on an aggregate basis

Net Interest Margin (NIM) of Private Banks has improved steadily over the past two decades, due to efficiency and high-yielding segments. ROTA) has been volatile. Private Banks are posting record profits. However, the NIM will likely moderate in the near term due to a slowdown of advance growth, competition in raising deposits, moderating asset quality and possible rate cuts. If implemented, the LCR guidelines will likely have an impact on profitability.

CareEdge Ratings View

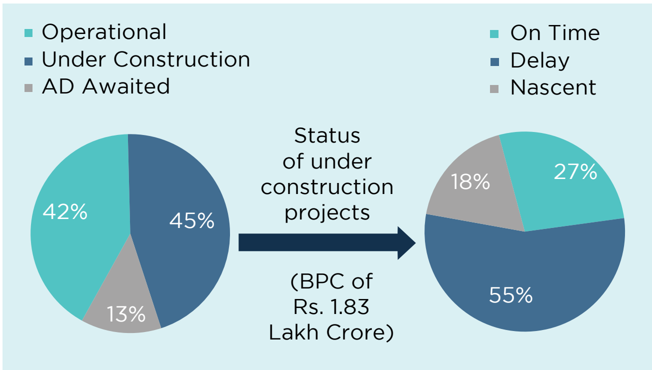
Indian Private Banks have undergone a transformative journey over the last two decades, marked by regulatory reforms, strengthened capital bases, and a shift towards digital and sustainable banking. They have made significant strides in increasing deposits, reducing gearing ratios, and reorienting their loan books towards retail advances. However, unsecured lending stress, rising credit costs, and stricter liquidity norms continue to test the sector's resilience. Despite these hurdles, Private Banks remain well-positioned to steadily expand their market share in deposits and advances, backed by robust capital adequacy, strong risk management practices, and relatively low NPAs.

RS 1 TRILLION NH HAM PROJECTS FACING SEVERE DELAYS – IMPACTS CONSTRUCTION PACE

CareEdge Ratings has conducted an extensive analysis of 374 Hybrid Annuity Model (HAM) projects awarded by the National Highways Authority of India (NHAI) between 2015 and 2024. These projects span an impressive aggregate length of approximately 16,000 Km and have a total Bid Project Cost (BPC) exceeding Rs 4.03 lakh crore. As of September end 2024, 42% of the sample BPC, aggregating over Rs 1.65 lakh crore, have been commissioned, while around 45% of the projects, aggregating over Rs 1.80 lakh crore, are in the construction phase, and the balance of 13% are awaiting appointed date to commence construction.

Heightened Execution Challenge
Among the under-construction projects, 55%, with an aggregate BPC of Rs 1 lakh crore, have been delayed beyond six months. In a previous article dated April 30, 2024, CareEdge Ratings highlighted that around 33% of the projects were delayed as of June 30, 2023; this figure has risen to approximately 55% as of December 2024. The sponsor profile continues to be diverse across the delayed projects. While grant of extension of time (EOT) mitigates the project specific risk to an extent, it impacts overall construction pace and profitability of roads developers.

Status of HAM projects



Source: CareEdge Ratings

Prominent factors contributing to these delays include (i) a standard construction period of two years regardless of project complexities, (ii) heightened competitive intensity, (iii) non-availability of hindrance-free Right of Way (RoW), and (iv) excessive rainfall.

As of December 31, 2024, projects with a Bid Project Cost (BPC) exceeding Rs 40,000 crore have been awaiting their appointed dates for over a year since being awarded, up from Rs 14,500 crore as of June 30, 2023, raising concerns about potential project terminations. The primary reason for the prolonged delays in receiving the appointed dates is the intensified focus on greenfield expressways and highways, which has compounded land acquisition challenges.

Deepening Competitive Intensity & Consequent Construction Pace

The rising competitive intensity in highway projects is evident from the diminishing premium of bid project costs over the NHAI costs, with projects being bid at a discount over the past two years ending FY24.

According to CareEdge Ratings, ensuring the availability of 80-90% unencumbered RoW at the time of appointed date issuance, besides taking proactive measures in case of delays attributable to developers, is critical for improving the pace of construction. Emphasising the quality of construction is also crucial in view of heightened competition. Therefore, doubling the defect liability period from five to ten years for Engineering Procurement and Construction (EPC) projects is a step in the right direction.

CareEdge Ratings forecasts a nearly 7-10% decline in the pace of National Highways construction in FY25 compared to FY24. The construction rate is expected to slow from 12,350 km in FY24 to 11,100-11,500 km in FY25, closer to nearly 31 km/day.

In line with CareEdge Ratings estimates for FY24, the pace of construction for national highway projects saw a notable increase of 20% ("Indian Road Sector: Navigating a Smooth Journey", dated May 11, 2023), reaching 34 km/day on a YoY basis. Yet, this was below 37 km/day accomplished in FY21. The highways sector has witnessed a combination of a rise in project complexities, participation from sponsors with moderate capabilities and significant delays in receipt of appointed dates after projects are awarded, contributing to a slackened construction pace.

As anticipated earlier by CareEdge Ratings, the execution pace of the National Highways is expected to decline by ~7-10% during FY25 over FY24 (as cited in "Work in Slow Progress: National Highways Execution to Decline by 7-10% in FY25", dated April 30, 2024). This is corroborated by a 6% decline witnessed in the road construction pace during 9MFY25 (21 km/day) over 9MFY24 (23 Km/day).

Impact Analysis on Sponsor

CareEdge Ratings conducted a comprehensive financial analysis of 17 sponsors, who also serve as EPC contractors, actively engaged in under-construction HAM projects. Timely execution resulted in a compound annual growth rate (CAGR) of 14% in total operating income (TOI) from FY21 to FY24.

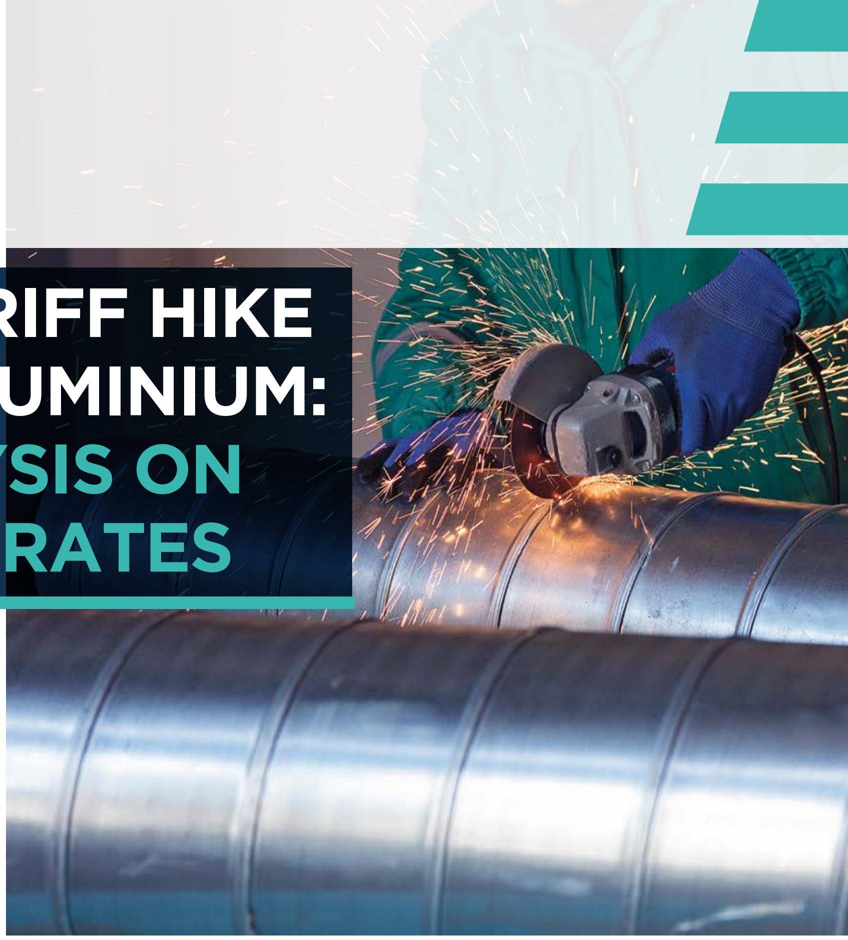
However, CareEdge Ratings expects a 5% decline in TOI during FY25 due to heightened execution challenges, project delays, and pending receipt of appointed dates for many HAM projects.

Lower project awards during FY24 and the first half of the current fiscal have reduced revenue visibility, with the order book and TOI ratio declining from 2.78x in FY22 to 2.15x in FY24. Additionally, a significant portion of the order book awaits appointed dates, resulting in a much lower executable order book and moderating revenue visibility for road-focused players. Operating profitability is expected to steadily decline by 200 basis points (bps) in FY25 from FY23 levels due to increased competition and high overheads. Furthermore, with the discontinuation of the Atma Nirbhar Bharat scheme for releasing monthly payments, the working capital cycle for the sponsors is expected to rise by around 15-20 days in FY25.

CareEdge Ratings View

"Among the under-construction projects, totalling Rs 1.83 lakh crore, 55% with an aggregate BPC of Rs 1 lakh crore are delayed by more than six months. CareEdge Ratings reiterates that the execution pace of the National Highways is expected to decline by ~7-10% during FY25 over FY24. It is owing to escalating execution challenges, heightened competitive landscape, and significant delay in receipt of appointed dates post award of the project," said Maulesh Desai, Director, CareEdge Ratings.

"Revenue visibility of major road developers has been impacted by the diminished pace of NHAI project awards and pending construction commencement for a large chunk of projects. Operating profitability is estimated to steadily decline by 200 basis points (bps) in FY25 from FY23 levels, led by increased competition and high overheads. Furthermore, with the discontinuation of the Atma Nirbhar Bharat scheme for releasing monthly payments, the working capital cycle is expected to increase by around 15-20 days. Nevertheless, comfortable leverage and capital structure impart resilience to the credit profile of major road developers. Players with a pool of operational assets shall be better positioned to manage their leverage and liquidity," added Setu Gajjar, Assistant Director, CareEdge Ratings.



US IMPORT TARIFF HIKE ON STEEL & ALUMINIUM: IMPACT ANALYSIS ON INDIAN CORPORATES

The USA has imposed a 25% import tariff on steel and aluminium products worldwide to boost domestic production. A similar order was issued in 2018 after several bilateral talks with countries impacted by the tariff hike. Subsequently, relief was extended to numerous significant and strategically important steel and aluminium exporting countries to the US. This time, however, the order also encompasses the termination of any previous exemptions granted to these countries. The implications for Indian companies are covered below.

Likely impact on Indian steel and aluminium industry:

- India's direct steel exports to the US are minimal, constituting around 4% of total exports 2024. Thus, the direct impact on sales volume is expected to be limited.
- Global steel consumption declined for the second consecutive year in 2024, with major developed countries and China experiencing reduced demand, resulting in an oversupply situation, adding pressure on realisations.
- India continues to witness good demand for steel, growing at around 10-13% during the last three fiscal years (FY22 to FY24).
- An increase in import tariff by the US could result in the diversion of surplus production by major Asian steel manufacturing countries to Indian markets, which is likely to keep realisations under check.
- During 10MFY25, realisations of the domestic steel industry have already witnessed moderation with growing steel imports whereby India has turned a net importer vis-à-vis a net exporter.
- India exports around 40% of its primary aluminium production, with around 6-8% of its exports directly to the US. The tariff hike is expected to have a relatively more significant impact on aluminium exports and realisations than steel. However, comfort can be drawn from India being one of the lowest-cost aluminium producers globally, due to its quality bauxite reserves, partially safeguarding from increased competition in the global markets.

Broader Implications:

1. US Market Dynamics: Despite having adequate capacity, the US has imposed tariffs to boost domestic production. The lower utilisation rates and higher production costs have led to a reliance on imports, with US steel prices commanding a premium.
2. Global Trade Shifts: Major steel exporters to the US, including Canada, Brazil, Mexico, and several Asian countries, may redirect surplus production to other markets, including India, increasing competition and affecting domestic prices and profitability.
3. Future Outlook: Amid a subdued global environment, India's steel consumption is expected to increase at a CAGR of around 8% over the next 2-3 years, primarily driven by sustained momentum in end-user sectors such as infrastructure and construction. However, the increased competition from redirected surplus production may continue to pressure margins.

Outlook

The US tariff hike on steel and aluminium is likely to have a mixed impact on Indian corporates. While the direct impact on steel exports is limited, the indirect effects on price realisations and profitability due to increased competition are significant. The effect is more pronounced for aluminium due to higher export dependency, but India's cost competitiveness offers some resilience.

CareEdge RATINGS

REVISITING DEPOSIT INSURANCE: SHOULD THE LIMIT BE INCREASED?

Deposit insurance covers all commercial as well as cooperative banks. However, deposit insurance is not available to NBFCs that accept public deposits. As of March 31, 2024, registered insured banks stood at 1,997, including 95 commercial banks, 43 RRBs, two LABs and 1,857 cooperative banks. The insurance limit has moved from Rs 1,500 in 1962 to Rs 5 lakhs in 2020, while the premium has risen from 5 paise per Rs 100 to 12 paise per Rs 100. After the limit was enhanced in FY20, the share of insured deposits spiked to 49%, which was subsequently reduced. In FY24, insured deposits stood at Rs 94.1 lakh crore, accounting for 43.1% of all assessable deposits, a steep decline compared with the peak of 75.3% in FY97. The share of protected accounts remained at 97.8% in FY24, which continues to be lower than the 99.4% coverage achieved in FY95.

However, for the last decade, the average cover has been around 95%, indicating a significant presence of small deposit holders in the banking system. India has significantly lower coverage than select countries globally, and the US & Australia have maximum coverage. With recent restrictions on the New India Cooperative Bank Ltd., along with the announcement by the Deposit Insurance and Credit Guarantee Corporation of settling dues of eligible depositors and the surrounding furore, which have been accompanied by calls to increase the deposit insurance limit, we examine several approaches towards improving the deposit insurance limit.

- **International Norms:** According to global norms, the system coverage should ideally be around 80% - 90% of all accounts and 20% - 30% of all deposits by value. Since India already has coverage levels higher than these limits, there seems to be no apparent need for a further increase in the deposit insurance limit under this approach.
- **Based on Per capita GDP:** If we average the insurance limit/ per capita GDP and apply the same to India's FY24 per capita GDP, the expected deposit insurance limit of Rs 2,105,845.
- **Inflation-based approach:** The current limit was last revised in 2020, using the spliced WPI series (base year FY12), and adjusting for inflation, the approximate amount reaches Rs 621,511.
- **Based on other countries:** If we average the limit per depositor per institution divided by the per capita income of select countries while excluding India and then apply the same to the per capita GDP of FY24, we arrive at an expected deposit insurance limit of Rs 518,118.

CareEdge Ratings View

Amidst media conversations of an increase in the deposit insurance limit, we have tried to provide alternative approaches to arrive at the same. While one approach necessitates no change, other approaches suggest the range of deposit insurance to be between Rs 520,000 and Rs 2,100,000. Other factors impacting the quantum of deposit insurance limit would include the extent of deposit coverage required, risk ratings of banks covered under the deposit insurance scheme, and pricing. Meanwhile, it should be noted that commercial banks pay a higher amount and share of the premium (94.4% share of insurance premium in FY24). Still, cooperative banks have accounted for the larger share of the insurance payouts. Currently, the premium is flat, which applies equally to all banks; in the future, risk-based insurance premium pricing could be explored to ensure appropriate pricing for risk coverage.

CAGR ~20%

CareEdge RATINGS

INDIAN MUNICIPAL BOND MARKET: HIGH POTENTIAL, SLOW PROGRESS

India is experiencing an unprecedented increase in its urban population, growing from approximately 28% in 2004 to around 36% in 2024 and projected to reach 40% by 2036. This trend requires not only enhancing current infrastructure but also developing new facilities.

Financing avenues for the above include municipal revenue, fiscal transfer, projects under Public-Private Partnership (PPP) and borrowings.

- Municipal revenue sources are limited, forming just over 1% of the country's GDP and recording CAGR growth of ~15% over FY21-24. State-level policies and limited autonomy curb abilities to raise taxes and user charges. This results in inadequate cost recovery and impedes municipal revenue growth.
- Fiscal transfers are the grants or devolution received from the Central or State, which may burden the state exchequer.
- PPP investments have not been encouraging for the ULBs due to revenue autonomy and growth limitations.
- Bank borrowings have limitations in terms of the cost of funding, tenure, etc. Thus, bond financing could be explored to ease the capital requirement of urban infrastructure growth capex and is an essential tool in the overall capital budgeting plan.

Exhibit 1: Financial Health of Municipal Corporations

Particulars	FY21	FY22	FY23	FY24 E
Revenue growth (%)	20	16	12	17
Revenue Receipts/Revenue Surplus (%)	22.35	25.85	24.27	22.31
Debt/Revenue Surplus (x)	0.99	0.75	0.84	0.91

Source: CareEdge Ratings

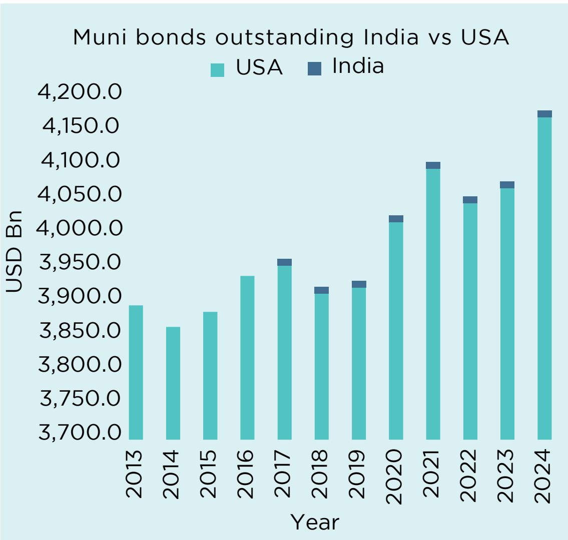
Exhibit 1 above represents the financial performance of 30 ULBs. Brihanmumbai Municipal Corporation has been excluded from the sample given the sheer large size compared to the rest. The revenue of the stated sample ULBs has witnessed a CAGR growth of ~15% over the last four years (FY21-FY24E), with a consistent revenue surplus being reported by them. Increased property tax has driven revenue growth and is mainly led by a rise in non-tax revenue in fees and user charges.

On average, property tax revenue has registered a compound annual growth rate (CAGR) of less than 10% during FY21-FY24E. CareEdge Ratings has also observed that all the municipal bond issuances typically stipulate the escrowing of property tax with coverage of 1.5-2x, thus underscoring the importance of own revenues and strengthening the bond structure. The borrowing level of the ULBs has been low, with the debt/revenue surplus comfortably below unity. Thereby, ULB can benefit from increased financial leverage.

Indian Municipal Bond Market: Present Status and Potential

The municipal bond market remains at a nascent stage of development. As compared to the USA bond market, the aggregate issuance in India has been ~Rs 3,000 crore (~USD 35 million) of bonds raised during the past two and a half decades ended October 2024 as against ~USD 512 billion by USA Municipal bodies in calendar year 2024 alone.

Exhibit 2: Comparison of Indian and US Municipal Bond Market



Source: SEBI and SIFMA

As of December 2024, outstanding municipal bonds in the USA totalled USD 4,171 billion, compared to USD 0.28 billion in India. According to a study by CareEdge Ratings, ULBs in India had total borrowings of approximately USD 1.44 billion as of March 31, 2024, with bonds constituting a mere 18% of the overall borrowing. Nevertheless, the robust profitability, indicated by a 20-25% revenue surplus and a low leverage ratio (debt/revenue surplus below one), presents opportunities for raising incremental debt including muni-bonds. The liquidity available with the ULBs in cash and cash equivalents provides additional financing support for urban infra-capex requirements.

Impediments to the growth and way forward

- The lack of emphasis on capital budgeting policies and hesitancy to take on debt have significantly contributed to the low borrowing rates of ULBs. A socialistic mindset and hesitance to raise fees due to concerns over public backlash and insufficient recovery of user charges has further restricted their ability to generate revenue.
- CareEdge Ratings asserts that reforms aimed at improving the collection of user charges, promoting long-term financial planning, and enhancing revenue collection efficiency (including outstanding dues) are crucial for increasing municipal corporations' revenues. Some suggested actions include standardising property tax regulations nationwide, linking property tax evaluations to capital value, enhancing service delivery, and embracing digitalisation.
- ULBs function as quasi-governmental entities whose operations differ from corporate structures. Bond investors and credit assessments demand similar standards, necessitating enhanced disclosure norms, adherence to regulatory frameworks, and improved management information systems to access the bond market.
- The relatively small size of many ULBs across the country may limit their bond issuance capabilities; therefore, pooling bonds presents an opportunity for them to gain prominence. Investors, particularly insurance and pension funds, are often restricted by investment guidelines that favour higher-rated bonds in limited supply. As a result, fostering retail investor participation, and establishing additional credit enhancement measures for bond issuance can create a supportive framework for developing the municipal bond market.

CHINA'S CREDIT PROFILE CAN WITHSTAND THE IMPACT OF THE 10% TARIFF BY THE US

CareEdge Global believes China's credit profile [rated 'CareEdge A (Unsolicited)'] should be able to bear the near-term impact of the current 10% additional tariff imposed by the US. Nonetheless, any further increase in tariffs in the future may add to uncertainty. In this context, a key monitorable for CareEdge Global will be the likely future policy direction on the trade front.

New Tariffs Under Trump 2.0

On February 1, President Trump signed an executive order imposing an additional 10% tariff on all US imports from China. In response, China retaliated with tariff and non-tariff measures. However, the threat of further tariffs remains, with President Trump proposing 60% tariffs on Chinese goods during his presidential campaign. A key development to watch is the upcoming USTR report, which will review the US-China Economic and Trade Agreement and assess whether China complies with the terms. President Trump has also directed the USTR to recommend appropriate measures, including the imposition of tariffs, based on the findings. The report, due by April 1, 2025, will play a pivotal role in shaping US-China trade relations.

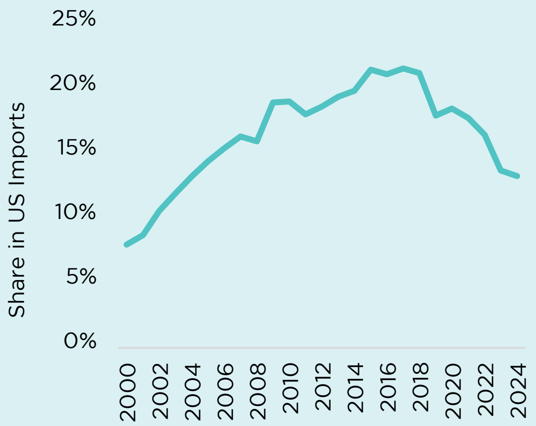
Reflecting on the First Trade War: China's Response & Possible Strategies Amid New Tariffs

During the first US-China trade war, the trade-weighted tariff rate on Chinese goods rose sharply, reaching ~21% in 2019 from ~3% in 2018. The Phase One trade deal in 2020 reduced the rate to ~19% but remained significantly higher than before the trade war.

China has adopted several strategies to mitigate the impact of tariffs. The yuan depreciated by 10-12% against the dollar during the first trade war. This would have helped offset more than 50% of the tariff hikes. Some reports also suggest some rerouting of exports to the US may have happened. Still, the share of Chinese goods in US imports fell to 13% in 2024 from 22% in 2017. China's trade surplus with the US declined to USD 360 billion in 2024 from a peak of USD 404 billion in 2022. However, China's overall trade surplus has continued to grow, reaching a record high of nearly USD 1 trillion in 2024, driven by an increase in surplus with the rest of the world as it explores new markets. China's advancement up the value chain, focusing on high-tech exports like electric vehicles, lithium-ion batteries, and solar panels, has also supported its trade profile.

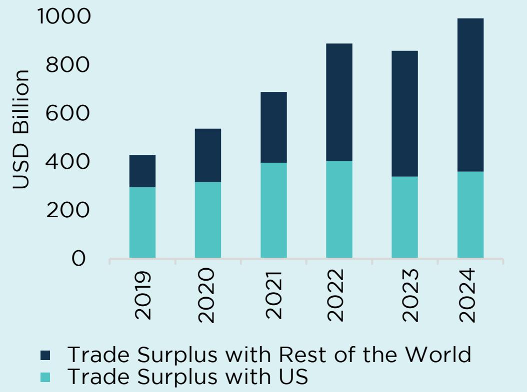
We believe China will use similar strategies this time to navigate tariffs. The yuan has depreciated by around 3.4% between October 2024 and February 2025 (as of February 26), driven by concerns over a new trade war and widening interest rate differentials with the US. The yuan may weaken further as a countermeasure against aggressive tariff actions; however, depreciation may slow to contain capital outflows. The yuan may not depreciate too much, which could provoke tariff threats

Exhibit 2: Share of Chinese Goods in



Source: US Census Bureau, CEIC

Exhibit 3: China's Trade Surplus with the US Has Seen Some Moderation Recently



Source: General Administration of Customs, CEIC

from other countries amid rising global trade protectionism. China could take further retaliatory actions if the US increases tariffs. Additionally, over the past years, Chinese companies have set up factories abroad, which could allow them to shift some of their US-bound production overseas to avoid tariffs. The government may also provide stimulus to mitigate the tariff impact.

Domestic Challenges Remain: Property Sector Troubles and Weak Consumption

China's real GDP growth was 5% in 2024, meeting the government's target but lower than 5.4% in 2023. Domestically, two key challenges continue to weigh on the economy - ongoing property sector troubles and weak consumption.

In 2024, China increased stimulus efforts to support the economy. However, the ability of these measures to meaningfully revive growth is yet to be seen. Policymakers have also committed to implementing a moderately loose monetary policy and a more proactive fiscal policy in 2025. These measures may focus more on boosting consumption and supporting viable investments, in contrast to previous stimulus efforts that led to unsustainable expansion in infrastructure and the property sector. However, we believe China aims to rein in its off-budget government debt, which increased significantly during previous phases of policy easing when local governments borrowed extensively through local government financing vehicles to provide stimulus. As a result, this focus on managing off-budget debt might limit the scope of stimulus this time around.

Looking at Tariffs from a Sovereign Credit Rating Perspective

The tariffs are expected to reduce China's exports to the US, lower its sizeable current account surplus marginally, and affect the foreign direct investment flows into the country. Real GDP growth could decline by around 25 basis points in 2025, and disinflationary pressures might increase, adding to the challenges from a troubled property sector and a weakening domestic consumption.

In response, China may provide an economic stimulus to partly offset the negative impact on economic indicators. Some currency depreciation may also be likely, consistent with the previous experience. The country may also impose additional tariffs on its imports from the US. These measures can help partly offset China's evolving global and domestic economic environment.

However, the country's strengths, such as a strong external position, a low current interest-to-revenue ratio of the general government and a high share of domestic funding of government debt, will enable it to manage the impact on its credit profile. Moreover, China's export dependence on the US has reduced since the first trade war, supporting its credit profile. China's exports to the US now account for 2.8% of its GDP (2024), down from 3.5% before the start of the first trade war (2017). Further, this time, given that other countries are also facing tariff threats from the US, the impact on China's trade may be lower relative to other countries. As a result, the actual effect of the additional 10% tariff in China may be limited. Nonetheless, any further increase in tariffs in the future may add to the uncertainty. In this context, a key monitorable for CareEdge Global will be the likely future policy direction on the trade front.

CareEdge RATINGS

HEAT MAP AND PROJECTION TABLE

		Feb-24	Mar-24	Apr-24	May-24	Jun-24	Jul-24	Aug-24	Sep-24	Oct-24	Nov-24	Dec-24	Jan-25	Feb-25
PMI-M	Unit	56.9	59.1	58.8	57.5	58.3	58.1	57.5	56.5	57.5	56.5	56.4	57.7	56.3
PMI-S	Unit	60.6	61.2	60.8	60.2	60.5	60.3	60.9	57.7	58.5	58.4	59.3	56.5	59.0
GST Collections	Rs lakh crore	1.7	1.8	2.1	1.7	1.7	1.8	1.7	1.7	1.9	1.8	1.8	2.0	1.8
E-Way Bill	Crore	9.7	10.4	9.7	10.3	10.0	10.5	10.5	10.9	11.7	10.2	11.2	11.8	11.2
Air Passenger Traffic	Crore	3.1	3.3	3.2	3.5	3.3	3.2	3.3	3.2	3.4	3.5	3.8	3.7	
PV Sales	Lakh	3.7	3.8	3.4	3.5	3.7	3.6	3.7	3.8	4.1	3.6	3.5	4.1	3.9
2-3-Wheeler Sales	Lakh	19.3	19.0	21.4	20.1	19.9	18.5	21.5	25.0	26.3	20.5	15.6	19.9	18.6
Tractor Sales	Lakh	0.5	0.7	0.8	0.9	1.1	0.7	0.6	1.1	1.5	0.8	0.6	0.7	0.7
IIP	y-o-y%	5.6	5.5	5.2	6.3	4.9	5.0	0.0	3.2	3.7	5.0	3.5	5.0	
Core Sector	y-o-y%	7.1	6.3	6.9	6.9	5.0	6.3	-1.5	2.4	3.8	4.4	4.8	4.6	
Power Consumption	y-o-y%	8.4	9.1	10.5	15.3	8.9	8.2	-4.9	0.6	1.1	4.0	5.9	2.7	-0.8
Petroleum Consumption	y-o-y%	8.2	1.7	7.8	1.9	2.3	10.7	-3.1	-4.4	4.1	10.6	2.3	3.0	-5.4
Outstanding Bank Credit - Total	y-o-y%	20.5	20.2	19.0	20.8	17.3	13.6	13.6	13.0	11.7	12.1	11.2	11.4	
Capital Goods Import	y-o-y%	10.0	0.9	3.2	7.0	11.6	6.2	8.7	8.6	4.1	5.5	4.9	15.5	
Merchandise Exports	y-o-y%	11.9	-0.6	2.0	13.2	2.4	0.6	-9.9	-0.2	16.6	-5.1	-1.2	-2.4	

Indicator	FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25 Forecast	FY26 Forecast
Gross Domestic Product (y-o-y%)	6.8	6.5	3.9	-5.8	9.7	7.0	8.2	6.5 (SAE)	6.7
CPI Inflation (y-o-y%)	3.6	3.4	4.8	6.2	5.5	6.7	5.4	4.7	4.2
Fiscal Deficit (As % of GDP)	3.5	3.4	4.6	9.2	6.8	6.4	5.6	4.8	4.4
Current Account Balance (As % of GDP)*	-1.8	-2.1	-0.9	0.9	-1.2	-2.0	-0.7	-0.9	-
Rupee (USD/INR) (Fiscal year-end)	65.0	69.2	75.4	73.5	75.8	82.2	83.4	86-87	87.5-88.5
10-Year G-Sec Yield (%) (Fiscal year-end)	7.3	7.5	6.1	6.3	6.8	7.3	7.1	6.6-6.7	6.4-6.5

*(-) Deficit / (+) Surplus; FAE: First Advance Estimate

About Us

CareEdge is a knowledge-based analytical group offering services in Credit Ratings, Analytics, Consulting and Sustainability. Established in 1993, the parent company CARE Ratings Ltd (CareEdge Ratings) is India's second-largest rating agency, with a credible track record of rating companies across diverse sectors and holding leadership positions in high-growth sectors such as BFSI and Infra. The wholly-owned subsidiaries of CareEdge Ratings are (I) CARE Analytics & Advisory Private Ltd (previously known as CARE Risk Solutions Pvt Ltd), (II) CARE ESG Ratings Ltd, (previously known as CARE Advisory Research and Training Ltd) and (III) CareEdge Global IFSC Ltd. CareEdge Ratings' other international subsidiary entities include CARE Ratings (Africa) Private Ltd in Mauritius, CARE Ratings South Africa (Pty) Ltd, and CARE Ratings Nepal Ltd. For more information: www.careedge.in

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