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India's Credit Growth Reveals Fault Lines

Societe Generale's Kunal Kumar Kundu says weak demand and project uncertainty has hurt borrowing.

By
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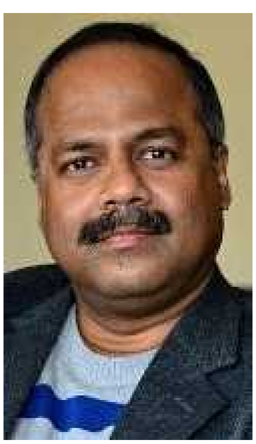
February 27, 2015

India's weak pace of credit growth, despite the economy bottoming out – even if we ignore the new set of growth numbers which show the economy to be steaming ahead – indicates that the recovery seemingly taking shape is not yet based on solid foundations.

Part of the reason for slow overall credit growth is due to an increase in the use of alternative sources of funding by larger and more credit-worthy corporate firms. There has also been lower demand for credit by the oil companies as crude prices nosedived.

However, it is also a reflection of the increasing strain faced by Indian corporate firms (especially small and medium companies) as domestic demand weakened and projects remained in limbo. With NPAs (non-performing assets) rising, especially those of state-owned lenders, the perceived riskiness of the borrowers have resulted in the downward rigidity of interest rates – even as monetary policy has started to ease. In fact, the easing monetary policy cycle is unlikely to result in a reversal of the trend unless relevant reforms take place and business confidence improves.

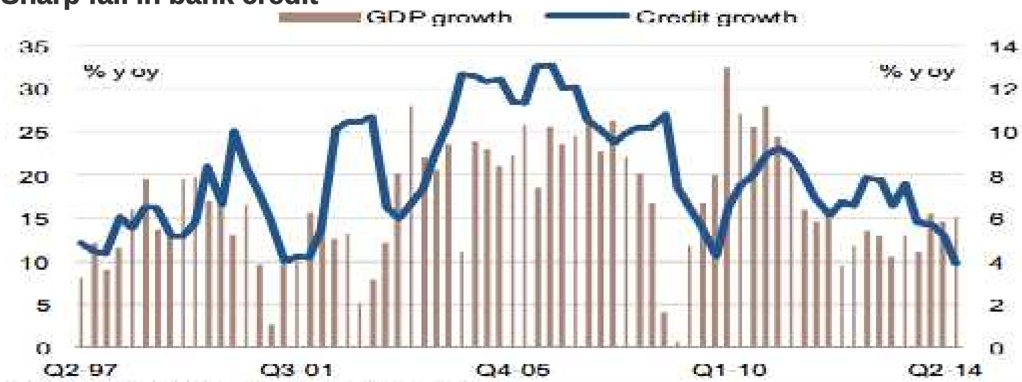


Credit growth continues to worsen even as economic activity shows improvement

RBI's recently released data on credit growth in various sectors does not seem to share the same sense of optimism as that of India's Central Statistical Organisation (CSO) in regards to India's GDP growth. While CSO data showed that the economy never had a slowdown, the credit growth data shows that it didn't pick up much either. When India's credit growth seemed to have bottomed out during mid-2013, we warned that India's credit growth lacked credibility. Sure enough, it resumed its downward journey and has now reached alarming levels.

Rising alternate funding sources and falling crude prices have led to lower demand for bank credit

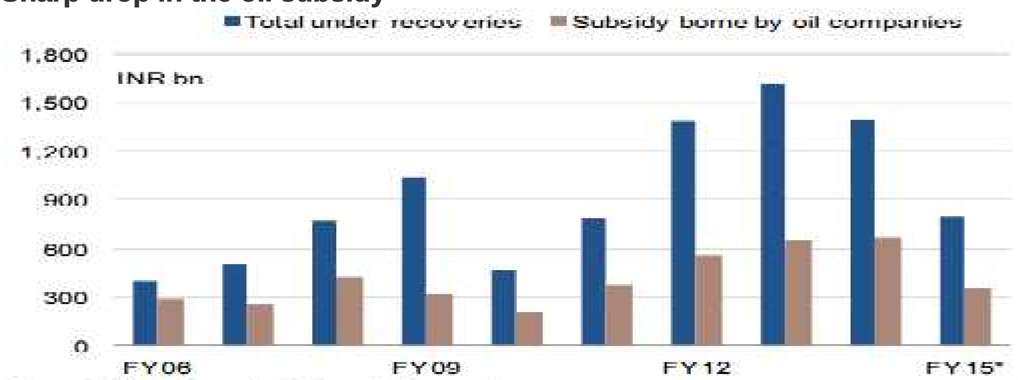
Sharp fall in bank credit



Source: RBI; SG Cross Asset Research/Economics

Note: GDP data is as per the old base given inadequate history of new data series

Sharp drop in the oil subsidy



Source: RBI; SG Cross Asset Research/Economics

Larger and more credit-worthy corporate firms have been able to raise resources due to rising inflows (domestic and foreign) into corporate bonds while deleveraging of balance sheet helped some others. RBI's decision not to increase the limits of FII (foreign institutional investment) investment into government bonds will continue to result in inflows to corporate bonds, as the attractiveness of Indian assets remain strong. So far this year, FII inflow of approximately $28bn has taken place in Indian corporate bonds.

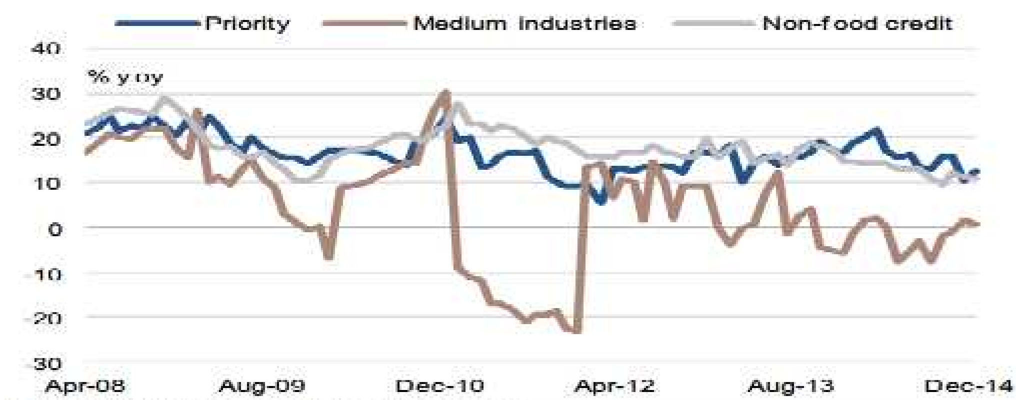
As per available information, Indian corporate entities have lined up borrowing plans from European and Japanese banks flush with stimulus cash, taking advantage of syndicated loan costs that are at a seven-year low. According to Bloomberg data, Power Finance Corporation and Rural Electrification Corporation plan to raise close to $2bn. Hindustan Petroleum Corporation has recently hired three banks from Europe and four Asian lenders to arrange for a $400m facility. By tapping offshore loans, Indian companies are containing costs as borrowing at home remains among the most expensive in Asia.

Much improved macro sentiment led to improved sentiment among the lenders while at the same time, global liquidity helped ease spreads on dollar loans for Indian corporate firms.

Hence, margins on loans denominated in US dollars, euros or Japanese yen signed in the six months to December 2014 averaged 183 basis points, the lowest since 2008.

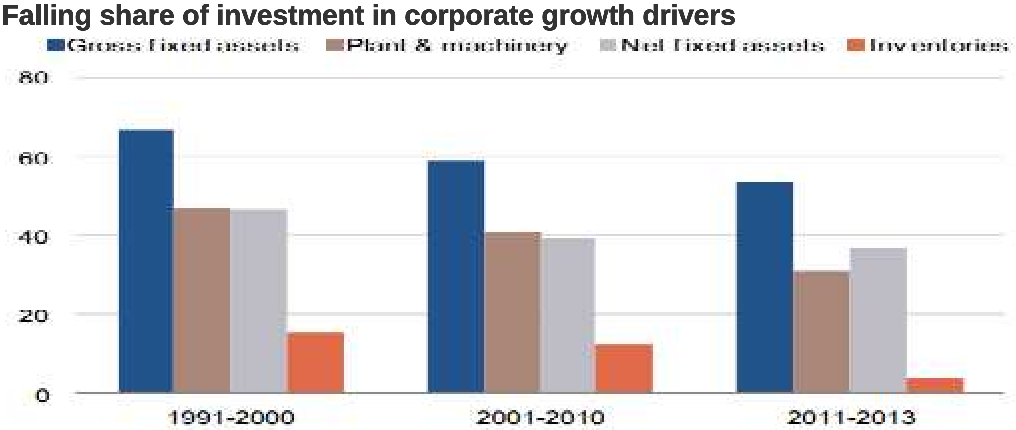
Sharp decline in crude prices ensured substantial contraction in the oil subsidy outgo. Earlier, when the fiscally strapped government was increasingly passing on the burden of subsidies to the oil companies, they were forced to borrow heavily from the market during periods of high subsidy to meet their working capital requirements. However, the current weak oil price environment has resulted in much lower outgo and hence a substantially truncated working capital requirement.

Bank credit to medium industries – sustained slowdown



Source: RBI; SG Cross Asset Research/Economics

Falling share of investment in corporate growth drivers



Source: Hindu Business Line; RBI; SG Cross Asset Research/Economics

Lower credit growth is also a reflection of rising stress for medium-sized companies

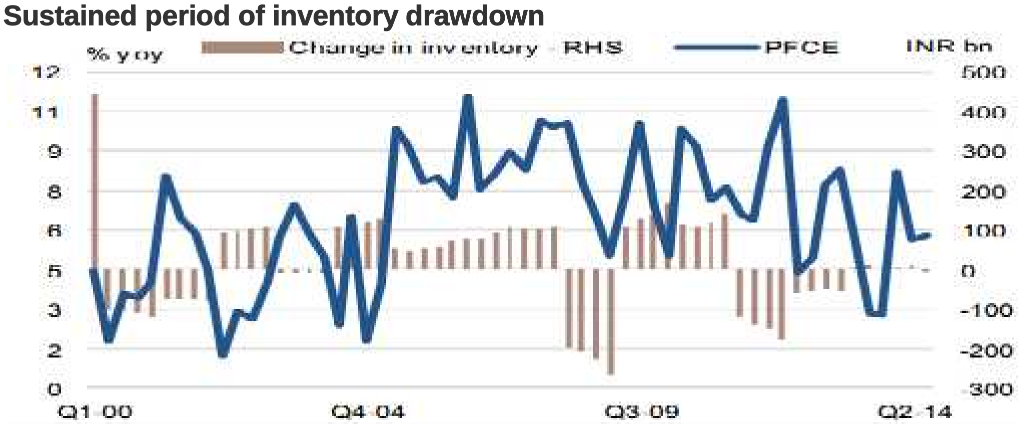
The disaggregated credit growth data shows that medium-sized manufacturing companies have been experiencing a fairly prolonged period of contraction in credit growth. This is a reflection of the increasing uncertainty they face, especially given their lack of pricing power. Add their generally lower credit quality and the credit flow contraction does not come as a surprise.

Over the years, RBI has been analysing the performances of Non-Government Non-Financial (NGNF) companies, the majority of which are small and medium industries. As per the data, the annual average share of gross and net fixed assets, plant and machinery, and inventories in total assets have been declining. The decline was fairly sharp during the decade of 2001-2010 as compared with 1991-2000 – and this trend also continued over the next three years for which the data is available. The ratio of gross fixed assets to total assets fell from around 67% during 1991-2000 to 59% during the next decade and to a further 54% over the next three years. A similar trend is visible in others as well. This is a strong indication that small and medium manufacturing companies have been having a fairly rough ride over the years.

Weak demand environment

Source: RBI; SG Cross Asset Research/Economics

Sustained period of inventory drawdown



Source: RBI; SG Cross Asset Research/Economics

Persistent weak demand and slow reforms have impacted business sentiment

Over the past four years, India's domestic demand has remained weak while investment demand fell even more sharply. Not surprisingly, India has experienced one of the longest periods of inventory drawdown. Even the stalled projects are moving at a much slower pace despite this being one of the top priorities for the newly elected government. In such a weak environment, every spurt in domestic demand has been met by the drawing down of inventories rather than an increase in production. This also explains the lowest level of capacity utilisation that is currently being experienced.

After the new government came to power last year, there was widespread expectation of fast tracking of reforms. However, over the past few months expectations were belied.

Despite their positive intent, reforms have failed to take off as politics got in the way. Of late, multiple corporate firms have started voicing their concerns about the virtual lack of progress on the reforms front. Not surprisingly, India's Economic Policy Uncertainty Index has started to deteriorate once again.

Rising threat of NPA reduces desire to lend

Banking sector NPAs, especially those of the state-owned or public sector banks (PSBs), have been on the rise. Asset quality pressures have taken a heavy toll on the performance of the PSBs, with NPAs darting up to INR2,727bn (5.1% of the gross advances) as of December 2014, as against INR2,282bn during December 2013. In addition, a further 6.5% of PSB loans have been restructured as of 31 December 2014. Essentially, 11.6% or approximately INR6,380bn of the loan portfolio of PSBs, are stressed. To get a better sense of the magnitude, it is important to note that India's estimated fiscal deficit for FY15 is INR5,311.8bn, which is nearly 17% lower than the stressed assets of the PSBs. On the other hand, as of December 2014, the gross NPAs and restructured advances of the private banks were around 2.1% and 2% respectively.

The rising rate of failure of companies with restructured debts is another source of worry.

As per the data provided by the Corporate Debt Restructuring (CDR) cell, the debt restructuring packages of 121 companies with loans of more than INR300bn have failed during the past four years. These packages have failed even after banks reduced interest rates, provided a moratorium on repayment – and in some cases have even accepted haircuts. There is a possibility that the rate of failure might even increase. Many of these restructured packages were based on assumptions about a robust pickup in both the economy and domestic demand. However, despite what the CSO data might want us to believe, the realities at ground level are different and the growth – albeit having bottomed out – is yet to pick up pace. Therefore, banks remain sceptical about extending loans (especially to small and medium industries) – so not reducing lending rates does not come as a huge surprise.

As mentioned earlier, we do not share the same optimism as the CSO in regards to India's growth trajectory. The underlying indicators do not corroborate the robust headline data.

Manufacturing in India will continue to struggle unless the government moves fast on land reform bills and the implementation of the GST, among many other reform requirements.

The slowdown in investment remains a clear concern and, despite the best of intents, the government may not be able to push the envelope as far as their commitments on infrastructure investment is concerned given the fiscal constraints. Unless reforms take place in earnest and private sector investment picks up, the India growth story may not look as rosy as many are currently expecting. We hope that the forthcoming union budget (to be presented on 28 February) will provide some answers.

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