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Falling interest cover more due to declining profits

Interest rate cycle has taken a reversal if we compare H1 of FY23 to H1 of FY22. From an ultra- low rate of 4% in H1FY22, repo rate has been raised to 5.9% in H1FY23. In this context it is important to examine how the interest coverage ratio for the corporate sector has fared. This is an important indicator as it measures the debt servicing capacity of companies. Undoubtedly, in the current rising rate cycle, the interest coverage ratio (ICR) measured as ratio of Earning before Interest and Tax/Interest Payments, has come down. However, a decline in ratio should be viewed with caution as profits in general have also fallen this year for non-finance companies.

We have examined which industries have been impacted the most in terms of rising interest payments and declining profit in terms of interest cover ratio. Further, classification with respect to turnover wise also reveals some interesting conclusions. Our sample includes 3053 companies (excluding banks and finance companies).

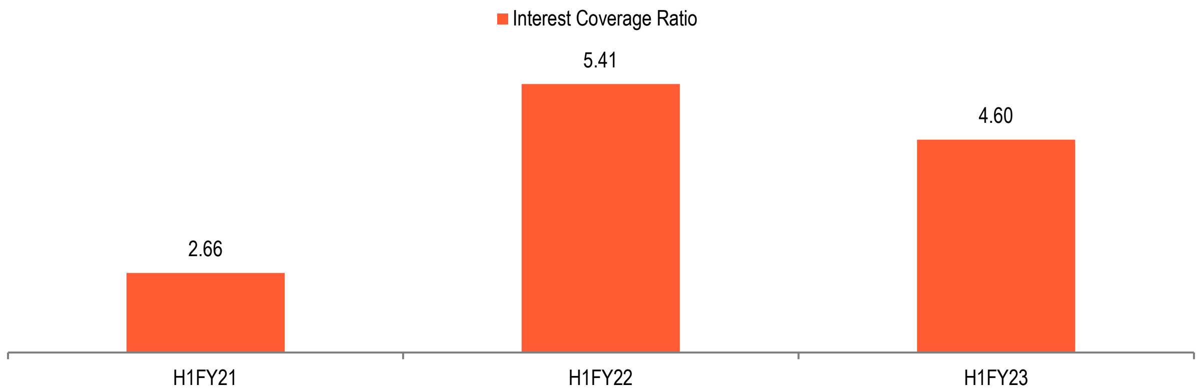
Some interesting results:

- *With 190bps hike in repo rate and 96bps hike in WALR of SCBs on fresh rupee loans in H1FY23, ICR of companies has come down.*
- *It fell down to 4.60 in H1FY23 from 5.41 in H1FY22.*
- *Excl. IT and FMCG companies, the ratio is even lower at 3.72 in H1FY23.*
- *However, the fall in ICR can be attributed more due to fall in profits rather than rising interest payments for most sectors.*
- *What is worrisome is that the concentration of deteriorating ICR is for infra, power, telecom, iron and steel and construction material sectors which are all linked to the infrastructure space.*

Interest payment increased in line with rising rate cycle:

- H1 of FY22 witnessed lowest repo rate of 4%. However, with rising inflation and tightening financial conditions globally, the rate cycle went for a complete reversal. With a 190bps repo rate hike materializing in H1FY23, interest cost of companies rose sharply. It rose by 13.9% in H1FY23 compared to 6.3% decline seen in H1FY22.
- Gross profit on the other hand fell by 1.1% in H1FY23 (on account of rising raw material cost) compared to 62.1% increase in H1FY22.
- A combination of the above led to decline in ICR of companies. It fell to 4.60 in H1FY23 from 5.41 in H1FY22 Notably, in H1FY23, weighted average lending rate of SCBs on fresh rupee loans have increased by 96bps to 8.59% in Sep-22 against 7.63% in Mar'22. In the same period of previous year WALR have fallen by 2bps. Credit offtake in the same period witnessed double digit growth of 16.4% in H1FY23 compared to 5.6% in H1FY22 and 5.1% in H1FY20.

Figure 1: Interest coverage ratio has come down



Source: Ace Equity, Bank of Baroda Research, H1: Apr-Sep

Table 1. Both PBT and gross profits have fallen and interest payments have increased sharply

	H1FY21	H1FY22	H1FY23
PBT			
Absolute, Rs crore	1,52,008	3,79,308	3,52,741
%	-	149.5%	-7.0%
Gross Profits			
Absolute, Rs crore	3,69,890	5,99,477	5,92,611
%	-	62.1%	-1.1%
Interest Payments			
Absolute, Rs crore	91,752	85,976	97,894
%	-	-6.3%	13.9%

Source: Ace Equity, Bank of Baroda Research

- Interestingly, if we exclude FMCG and IT companies, which have very low interest payments on account of companies generally being cash rich, ICR turns out to be much lower at 3.72 in H1FY23.

Table 2. Excl. FMCG and IT

	H1FY21	H1FY22	H1FY23
PBT			
Absolute, Rs crore	77,840	2,83,508	2,59,958
%	-	264.2%	-8.3%
Gross Profit			
Absolute, Rs crore	2,84,180	492309	487252
%	-	73.2%	-1.0%
Interest Payments			
Absolute, Rs crore	89,645	84,212	95,674
%	-	-6.1%	13.6%
Interest Coverage Ratio	**1.87**	**4.37**	**3.72**

Source: Ace Equity, Bank of Baroda Research, Note FY21 figures left blank as FY20 witnessed loss

Major infra based companies showing risk in terms of high ICR?

In H1FY23, major infrastructure segments such as telecom, aviation, iron and steel, power and construction material have noted either a sharp fall in ICR or have ICR which is below 2, which indicates vulnerability. For aviation, the ICR turned out to be negative as this sector continued to make loss in H1FY23 as well, similar to that being noticed in the same period of last year, though the quantum of loss have been brought down (which has caused improvement in ratio though negative).

Table 3. Industries which pose risk in H1FY23

Interest Cover	Industries
Interest cover of less than 2	Infrastructure, (1.57)
	Realty, (1.39)
	Telecom, (0.46)
	Aviation, (-0.54)

Source: Ace Equity, Bank of Baroda Research Note: Industries marked in red are the highly vulnerable ones as their interest coverage ratio is less than 1, Figures in bracket are ICR

Table 4. Industries where ICR have fallen sharply in H1FY23 compared to H1FY22

Interest Cover	Industries
	Iron and Steel, 570bps fall in ICR (4.41)
	Crude oil, 280bps fall in ICR (4.54)
	Construction materials, 200bps fall in ICR (3.42)
	Textiles, 130bps fall in ICR (2.87)
	Power, 30bps fall in ICR (3.03)

Source: Ace Equity, Bank of Baroda Research, Figures in bracket are ICR

The study show that out of the 35 sectors considered, 19 showed improvement in ICR in H1-FY23, while 9 witnessed a decline in this ratio. For other 7 sectors while there was a decline in ICR it was still very high and hence does not pose a potential cause for vulnerability.

Out of the 9 industries which witnessed a decline and would be a cause of concern, photographic products has been excluded as the size is very small. For the other eight sectors, the following has been the driving factors. Interest cost increasing at higher than the sample average of 13.9% would be a risk factor.

Sector	Interest costs growth rate	Profits growth
Construction materials	Low growth	↓
Crude oil	↑	↓
Infrastructure	Just below average	Low growth
Iron and steel	Just below average	↓
Logistics	Low growth	↓
Power	↑	Low growth
Realty	↑	↓
Textiles	Low growth	↓

The table shows that in general decline in profits contributed to lower ICR for 6 of the 8 industries. Power was affected by high interest costs with PBT growth slowing down. The same held for crude oil and realty. For infra, the decline in ICR was from 1.68 to 1.57 which was due to both low growth in profit as well as interest cost rising by 13% which is just below that of the sample average. In case of construction material, logistics, textiles and iron and steel it was mainly drop in profit which affected ICR.

Size-wise performance:

Size wise classification also reveal some important results. For companies with net sales above Rs 125 crore (for half year) the ICR did decline as this set includes companies in iron and steel, crude oil, power, infra, construction material where the profits were affected significantly. For companies with net sales between Rs 2.5-25 crore, ICR has been negative as gross profits have fallen sharply by 76% in H1FY23. For companies with net sales below Rs 2.5 crore, the ICR has improved they have moved from making losses to profit in FY23. Also interest cost got capped where loans were under ECLGS.

Table 5. Companies with net sales above 125 crore are facing higher risk in terms of falling ICR

Net Sales	ICR, Sep-20	ICR, Sep-21	ICR, Sep-22
0-2.5 crore	-0.11	-0.26	1.29
2.5-25 crore	1.29	0.23	-0.12
25-125 crore	0.47	1.79	1.80
>125 crore	2.80	5.70	4.80

Source: Ace Equity, Bank of Baroda Research Note: Negative ratio is due to declining profit, Negative ICR indicate loss

Conclusion: The current rising interest rate cycle has not yet impacted the debt servicing ability of companies. Barring specific industries a modicum of resilience has been witnessed so far. The ICR fall in H1FY23 seems to have been driven more by the decline in profits due to higher expenditure costs. The higher interest cost impact on ICR was significant in case of specific industries like power, crude and infrastructure.

Appendix:

Table 1. Industry wise Interest coverage of companies

Industry	H1FY22			H1FY23		
	PBT, YoY	Interest Payments, YoY	Interest Coverage Ratio	PBT, YoY	Interest Payments, YoY	Interest Coverage Ratio
Agri	-13.4%	-10.9%	3.3	42.2%	-7.6%	4.6
Alcohol	-	-54.6%	12.8	72.9%	7.3%	20.1
Auto & Ancill	244.4%	-7.9%	7.7	36.8%	8.8%	9.5
Aviation	32.4%	-11.3%	-2.5	-	18.9%	-0.5
Capital Goods	1644.0%	-16.9%	4.1	117.1%	-8.6%	8.3
Chemicals	47.3%	-22.1%	11.4	36.9%	38.4%	11.3
Construction Materials	67.9%	-8.0%	5.4	-43.8%	2.4%	3.4
Consumer Durables	62.2%	-24.4%	10.1	71.4%	20.8%	13.9
Crude Oil	56.1%	-22.1%	7.3	-28.0%	28.0%	4.5
Diamond & Jewellery	-	-7.8%	3.4	1.5	0.1	6.4
Electricals	60.2%	-1.2%	4.8	24.9%	20.2%	4.9
Ferro Manganese	276.2%	-7.1%	22.2	-18.9%	8.5%	16.8
Gas Transmission	44.2%	-47.9%	34.8	-2.0%	-5.6%	36.1
Healthcare	-6.5%	-15.5%	11.1	11.1%	3.6%	11.9
Hospitality	-61.0%	3.8%	0.0	-	-22.8%	5.7
Inds. Gases & Fuels	100.2%	0.5%	33.8	3.1%	12.5%	31.1
Infrastructure		-4.4%	1.7	-4.3%	13.0%	1.6
Iron & Steel	713.9%	-23.2%	10.1	-58.3%	11.7%	4.4
Logistics	14.4%	5.0%	3.1	-6.8%	8.4%	2.8
Media & Entertainment	520.6%	-10.1%	2.8	30.5%	0.8%	3.4
Misc.	322.2%	-13.1%	35.9	-22.0%	-2.0%	28.8
Non - FerMetals	60.8%	-9.4%	9.9	14.5%	23.2%	9.3
Paper	1366.0%	-1.5%	3.2	187.8%	-7.9%	8.0
Photo Product	-	10.1%	0.6	-	6.0%	0.2
Plastic Products	108.4%	-1.4%	7.0	3.8%	-5.6%	7.6
Power	53.5%	-5.3%	3.3	-0.5%	15.0%	3.0
Realty	-	-13.8%	1.5	-21.8%	-1.0%	1.4
Retailing	-	-14.9%	1.6	667.6%	17.2%	5.0
Ship Building	50.5%	-2.7%	22.1	54.5%	4.3%	32.2
Telecom	-	23.1%	0.4	-	15.3%	0.5
Textile	-	-5.2%	4.2	-38.3%	5.0%	2.9
Trading	869.8%	2.3%	3.9	91.9%	12.3%	5.9
Grand Total	**264.2%**	**-6.1%**	**4.4**	**-8.3%**	**13.6%**	**3.7**

Source: Ace Equity, Bank of Baroda Research, Note: Sectors posing a risk have been marked, Negative ICR indicates loss

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