INDIA RATING UPGRADE

Govt. reforms and steps to formalize economy get India a (long awaited and long due) rating upgrade

India Fixed Income Research

After over a decade, Moody's has upgraded India's sovereign rating by one notch to Baa2 from Baa3. The rating upgrade comes on the back of continued progress in the nation's economic and institutional reforms. Moody's also changed the outlook on the rating to stable from positive. A series of reforms such as the new monetary policy framework, Goods and Services Tax (GST), measures to check the banking sector's bad loans ratios, demonetization, the widely debated Aadhaar biometric system, and the Direct Benefit Transfer system were the key drivers of this rating upgrade.

Well-deserved upgrade: No country was insulated from the global financial crisis and in the advent of this crisis, India loosened its purse strings so as to tide over the adverse impact; adopting an expansionary fiscal policy. However, these measures came with their own set of consequences; putting India on an inflationary path. In addition to this, significantly higher commodity prices (oil), higher gold imports and appalling growth in exports deteriorated the external balance as well. All these factors put India in the fragile-5 economies in 2013, a period well known as the 'taper-tantrum' period. The weak macroeconomic fundamentals made India vulnerable to external shocks. Nevertheless, the bold (to some extent unconventional) measures taken by the RBI (in 2013) to reduce India's vulnerability to such shocks and also the government's efforts to adhere to fiscal consolidation helped stabilize the economy by 2014. The absolute win on the political front in combination with positively evolving macroeconomic landscape brought about a change in India's rating "outlook" in 2014 but not a rating upgrade (until now!). India's macroeconomic fundamentals have changed considerably over the last four years and have turned (& remained) favorable. Plus, the govt. has announced a string of measures/reforms which would have a positive impact on India's economic growth in the long-term! In our view, the journey that India has traveled over these last four years is simply commendable and it was about time that a rating upgrade was awarded.

Bond Market Reaction & Our View: While a rating upgrade has been overdue, the timing of this upgrade was clearly a positive surprise. In fact, at a time when bond markets have been in a downward spiral and sentiments have remained sour, the upgrade has provided a positive tilt to the markets. At the opening itself, the 10Y benchmark opened well in the green, rallying by ~10bps. While this update has provided a positive bias, the momentum might not sustain as overhangs such as elevated crude oil prices, oversupply (G-sec, SDLs, OMO Sales), fiscal slippage concerns, inflation trajectory and increased possibility of a status-quo on domestic policy rates might force yields to stay firm. At the same time, the hardening of US yields in the run-up to a third rate hike in December is further exerting upward pressure on domestic yields. We note that, not only is India facing an upward pressure on yields, but also other EMs have seen yields on their sovereigns tread higher; however, the extent of weakness varies across EMs. India, in particular, is likely to see a cap on further slippage following the upgrade.

While India is not immune to external shocks, the FPI limit framework for investing in G-secs & Corp bonds has limited the impact of external shocks on yields. Thus, domestic factors have played a greater role in influencing the yield trajectory, lately. Interestingly, the spreads on corporate bonds have actually witnessed some compression and today on this development corp bonds have seen a similar positive momentum and traded at much softer levels. The bond markets have given a thumbs-up to the move despite the above mentioned overhangs. In the short-term, yields should trade around these levels and participants will track the MPC commentary around inflation and more importantly, the fiscal situation. It would be interesting to see if the domestic rating agencies follow suit and upgrade companies in the ensuing months, particularly PSU banks in the backdrop of recap bonds. Meanwhile, Moody's has also upped the ratings of Exim Bank, Indian Railway Finance Corp, SBI and HDFC Bank.

Jagdeep Kannarath
+91 22 6620 3083
jagdeep.kannarath@edelweissfin.com

Achala Jethmalani
+91 22 6141 2719
achala.jethmalani@edelweissfin.com

17 November, 2017

India's (new) peers, at Baa2

Countries	Rating	Outlook
Bulgaria	Baa2	Stable
Colombia	Baa2	Stable
Italy	Baa2	Negative
Oman	Baa2	Negative
Panama	Baa2	Positive
Philippines	Baa2	Stable
Spain	Baa2	Stable
Uruguay	Baa2	Stable

The older lot, at Baa3

Countries	Rating	Outlook
Bahamas	Baa3	Negative
Hungary	Baa3	Stable
Indonesia	Baa3	Positive
Kazakhstan	Baa3	Stable
Romania	Baa3	Stable
South Africa	Baa3	Negative

Source: Bloomberg, Trading Economics, Edelweiss Research

Data on key economic parameters

Data on key economic parameters, Moody's	As of 2016
GDP per capita (PPP basis, USD)	6,694
Real GDP growth (% change)	7.10%
Inflation Rate (CPI, % change Dec/Dec)	3.90%
Gen. Gov. Financial Balance/GDP	-6.40%
Current Account Balance/GDP	-0.70%
External debt/GDP	20.40%

Source: Moody's
Other remarks:
Level of economic development: High level of economic resilience
Default history: No default events (on bonds or loans) have been recorded since 1983

Nevertheless, a rating upgrade is more than symbolic even as investors have remained upbeat on India for a long time (even when it was at Baa3) as was evident in the robust capital inflows! Recently, China was downgraded by Moody's (Sep'17), South Africa was downgraded by Moody's (Jun'17), Brazil's outlook was revised to negative from stable – all of this suggests that India would definitely stand to gain from this development as it bolsters investor sentiment and allows investors to invest (or add to portfolio) in Indian local currency bonds. In fact, once some of the overhangs are behind us or even recede, the negative bias that has pushed yield on the 10Y north of 7.0% (from the levels of 6.50% seen around 3M ago), yields should recover to lower levels. The upgrade will also have a beneficial impact on corporate India borrowing, both onshore and offshore, as corporate will find it easier to borrow via the bond markets and diversify their investor base.

Moody's Rating Rationale:

The upgrade decision is premised upon the following important factors

- Continued progress on economic and institutional reforms – this will, over time, enhance India's high growth potential and also aid in reducing government debt burden over the medium term
- While India's high debt burden remains a constraint on the country's credit profile, Moody's believes that the reforms put in place have reduced the risk of a sharp increase in debt, even in potential downside scenarios
- Adoption of a flexible inflation targeting regime and the formation of a Monetary Policy Committee (MPC) has enhanced transparency and efficiency
- Inflation has declined markedly
- Foreign exchange reserves have increased to all-time highs - creating significant policy buffers to absorb potential shocks
- Word of caution: Much remains to be done with respect to –
    - the challenges with implementation of the GST
    - ongoing weakness of private sector investment
    - slow progress with resolution of banking sector asset quality issues, and
    - lack of progress with land and labor reforms at the national level
- Moody's ended on a positive note - However, Moody's expects that over time at least some of the above issues will be addressed, resulting in a steady further improvement in India's government effectiveness and overall institutional framework.

Why the Stable Outlook?

- The **high public debt burden remains an important constraint on India's credit profile relative to peers**. This constraint is **not expected to diminish rapidly**, with low income levels continuing to point to **significant development spending needs** over the coming years.
- Measures to encourage greater formalization of the economy, reduce expenditure and increase revenues will likely take time to diminish the debt stock.

What could move up the Rating?

- A material strengthening in fiscal metrics
- A strong and durable recovery of the investment cycle, probably supported by significant economic and institutional reforms
- A greater expectation of a sizeable and sustained reduction in the general government debt burden, through increased government revenues combined with a reduction in expenditures, would put positive pressure on the rating
- Implementation of key pending reforms, including land and labor reforms, could put additional upward pressure on the rating

What could move the rating down?

- A material deterioration in fiscal metrics and the outlook for general government fiscal consolidation would put negative pressure on the rating
- The rating could also face downward pressure if the health of the banking system deteriorated significantly or external vulnerability increased sharply

Moody's Ratings:

Moody's has also raised India's long-term foreign-currency bond ceiling to Baa1 from Baa2, and the long-term foreign-currency bank deposit ceiling to Baa2 from Baa3. The short-term foreign-currency bond ceiling remains unchanged at P-2, and the short-term foreign-currency bank deposit ceiling has been raised to P-2 from P-3. The long-term local currency deposit and bond ceilings remain unchanged at A1.

Edelweiss Securities Limited, Edelweiss House, off C.S.T. Road, Kalina, Mumbai – 400 098.
Board: (91-22) 4009 4400, Email: *fixedincome@edelweissfin.com*

Ajay Manglunia	Head, Fixed Income Markets	ajay.manglunia@edelweissfin.com	+91 22 6623 3343

DISCLAIMER

Edelweiss Securities Limited ("ESL" or "Research Entity") is regulated by the Securities and Exchange Board of India ("SEBI") and is licensed to carry on the business of broking, depository services and related activities. The business of ESL and its Associates (list available on www.edelweissfin.com) are organized around five broad business groups – Credit including Housing and SME Finance, Commodities, Financial Markets, Asset Management and Life Insurance.

This Report has been prepared by Edelweiss Securities Limited in the capacity of a Research Analyst having SEBI Registration No.INH200000121 and distributed as per SEBI (Research Analysts) Regulations 2014. This report does not constitute an offer or solicitation for the purchase or sale of any financial instrument or as an official confirmation of any transaction. Securities as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956 includes Financial Instruments and Currency Derivatives. The information contained herein is from publicly available data or other sources believed to be reliable. This report is provided for assistance only and is not intended to be and must not alone be taken as the basis for an investment decision. The user assumes the entire risk of any use made of this information. Each recipient of this report should make such investigation as it deems necessary to arrive at an independent evaluation of an investment in Securities referred to in this document (including the merits and risks involved), and should consult his own advisors to determine the merits and risks of such investment. The investment discussed or views expressed may not be suitable for all investors.

This information is strictly confidential and is being furnished to you solely for your information. This information should not be reproduced or redistributed or passed on directly or indirectly in any form to any other person or published, copied, in whole or in part, for any purpose. This report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject ESL and associates / group companies to any registration or licensing requirements within such jurisdiction. The distribution of this report in certain jurisdictions may be restricted by law, and persons in whose possession this report comes, should observe, any such restrictions. The information given in this report is as of the date of this report and there can be no assurance that future results or events will be consistent with this information. This information is subject to change without any prior notice. ESL reserves the right to make modifications and alterations to this statement as may be required from time to time. ESL or any of its associates / group companies shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. ESL is committed to providing independent and transparent recommendation to its clients. Neither ESL nor any of its associates, group companies, directors, employees, agents or representatives shall be liable for any damages whether direct, indirect, special or consequential including loss of revenue or lost profits that may arise from or in connection with the use of the information. Our proprietary trading and investment businesses may make investment decisions that are inconsistent with the recommendations expressed herein. Past performance is not necessarily a guide to future performance .The disclosures of interest statements incorporated in this report are provided solely to enhance the transparency and should not be treated as endorsement of the views expressed in the report. The information provided in these reports remains, unless otherwise stated, the copyright of ESL. All layout, design, original artwork, concepts and other Intellectual Properties, remains the property and copyright of ESL and may not be used in any form or for any purpose whatsoever by any party without the express written permission of the copyright holders.

ESL shall not be liable for any delay or any other interruption which may occur in presenting the data due to any reason including network (Internet) reasons or snags in the system, break down of the system or any other equipment, server breakdown, maintenance shutdown, breakdown of communication services or inability of the ESL to present the data. In no event shall ESL be liable for any damages, including without limitation direct or indirect, special, incidental, or consequential damages, losses or expenses arising in connection with the data presented by the ESL through this report.

We offer our research services to clients as well as our prospects. Though this report is disseminated to all the customers simultaneously, not all customers may receive this report at the same time. We will not treat recipients as customers by virtue of their receiving this report.

ESL and its associates, officer, directors, and employees, research analyst (including relatives) worldwide may: (a) from time to time, have long or short positions in, and buy or sell the Securities, mentioned herein or (b) be engaged in any other transaction involving such Securities and earn brokerage or other compensation or act as a market maker in the financial instruments of the subject company/company(ies) discussed herein or act as advisor or lender/borrower to such company(ies) or have other potential/material conflict of interest with respect to any recommendation and related information and opinions at the time of publication of research report or at the time of public appearance. ESL may have proprietary long/short position in the above mentioned scrip(s) and therefore should be considered as interested. The views provided herein are general in nature and do not consider risk appetite or investment objective of any particular investor; readers are requested to take independent professional advice before investing. This should not be construed as invitation or solicitation to do business with ESL.

ESL or its associates may have received compensation from the subject company in the past 12 months. ESL or its associates may have managed or co-managed public offering of securities for the subject company in the past 12 months. ESL or its associates may have received compensation for investment banking or merchant banking or brokerage services from the subject company in the past 12 months. ESL or its associates may have received any compensation for products or services other than investment banking or merchant banking or brokerage services from the subject company in the past 12 months. ESL or its associates have not received any compensation or other benefits from the Subject Company or third party in connection with the research report. Research analyst or his/her relative or ESL's associates may have financial interest in the subject company. ESL and/or its Group Companies, their Directors, affiliates and/or employees may have interests/ positions, financial or otherwise in the Securities/Currencies and other investment products mentioned in this report. ESL, its associates, research analyst and his/her relative may have other potential/material conflict of interest with respect to any recommendation and related information and opinions at the time of publication of research report or at the time of public appearance.

Participants in foreign exchange transactions may incur risks arising from several factors, including the following: (i) exchange rates can be volatile and are subject to large fluctuations; (ii) the value of currencies may be affected by numerous market factors, including world and national economic, political and regulatory events, events in equity and debt markets and changes in interest rates; and (iii) currencies may be subject to devaluation or government imposed exchange controls which could affect the value of the currency. Investors in securities such as ADRs and Currency Derivatives, whose values are affected by the currency of an underlying security, effectively assume currency risk.

Research analyst has served as an officer, director or employee of subject Company: No

ESL has financial interest in the subject companies: No

ESL's Associates may have actual / beneficial ownership of 1% or more securities of the subject company at the end of the month immediately preceding the date of publication of research report.

Research analyst or his/her relative has actual/beneficial ownership of 1% or more securities of the subject company at the end of the month immediately preceding the date of publication of research report: No

ESL has actual/beneficial ownership of 1% or more securities of the subject company at the end of the month immediately preceding the date of publication of research report: No

Subject company may have been client during twelve months preceding the date of distribution of the research report.

There were no instances of non-compliance by ESL on any matter related to the capital markets, resulting in significant and material disciplinary action during the last three years except that ESL had submitted an offer of settlement with Securities and Exchange commission, USA (SEC) and the same has been accepted by SEC without admitting or denying the findings in relation to their charges of non registration as a broker dealer.

A graph of daily closing prices of the securities is also available at www.nseindia.com

Analyst Certification:

The analyst for this report certifies that all of the views expressed in this report accurately reflect his or her personal views about the subject company or companies and its or their securities, and no part of his or her compensation was, is or will be, directly or indirectly related to specific recommendations or views expressed in this report.

Additional Disclaimers

Disclaimer for U.S. Persons

This research report is a product of Edelweiss Securities Limited, which is the employer of the research analyst(s) who has prepared the research report. The research analyst(s) preparing the research report is/are resident outside the United States (U.S.) and are not associated persons of any U.S. regulated broker-dealer and therefore the analyst(s) is/are not subject to supervision by a U.S. broker-dealer, and is/are not required to satisfy the regulatory licensing requirements of FINRA or required to otherwise comply with U.S. rules or regulations regarding, among other things, communications with a subject company, public appearances and trading securities held by a research analyst account.

This report is intended for distribution by Edelweiss Securities Limited only to "Major Institutional Investors" as defined by Rule 15a-6(b)(4) of the U.S. Securities and Exchange Act, 1934 (the Exchange Act) and interpretations thereof by U.S. Securities and Exchange Commission (SEC) in reliance on Rule 15a 6(a)(2). If the recipient of this report is not a Major Institutional Investor as specified above, then it should not act upon this report and return the same to the sender. Further, this report may not be copied, duplicated and/or transmitted onward to any U.S. person, which is not the Major Institutional Investor.

In reliance on the exemption from registration provided by Rule 15a-6 of the Exchange Act and interpretations thereof by the SEC in order to conduct certain business with Major Institutional Investors, Edelweiss Securities Limited has entered into an agreement with a U.S. registered broker-dealer, Edelweiss Financial Services Inc. ("EFSI"). Transactions in securities discussed in this research report should be effected through Edelweiss Financial Services Inc.

Disclaimer for U.K. Persons

The contents of this research report have not been approved by an authorised person within the meaning of the Financial Services and Markets Act 2000 ("FSMA").

In the United Kingdom, this research report is being distributed only to and is directed only at (a) persons who have professional experience in matters relating to investments falling within Article 19(5) of the FSMA (Financial Promotion) Order 2005 (the “Order”); (b) persons falling within Article 49(2)(a) to (d) of the Order (including high net worth companies and unincorporated associations); and (c) any other persons to whom it may otherwise lawfully be communicated (all such persons together being referred to as “relevant persons”).

This research report must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this research report relates is available only to relevant persons and will be engaged in only with relevant persons. Any person who is not a relevant person should not act or rely on this research report or any of its contents. This research report must not be distributed, published, reproduced or disclosed (in whole or in part) by recipients to any other person.

Disclaimer for Canadian Persons

This research report is a product of Edelweiss Securities Limited ("ESL"), which is the employer of the research analysts who have prepared the research report. The research analysts preparing the research report are resident outside the Canada and are not associated persons of any Canadian registered adviser and/or dealer and, therefore, the analysts are not subject to supervision by a Canadian registered adviser and/or dealer, and are not required to satisfy the regulatory licensing requirements of the Ontario Securities Commission, other Canadian provincial securities regulators, the Investment Industry Regulatory Organization of Canada and are not required to otherwise comply with Canadian rules or regulations regarding, among other things, the research analysts' business or relationship with a subject company or trading of securities by a research analyst.

This report is intended for distribution by ESL only to "Permitted Clients" (as defined in National Instrument 31-103 ("NI 31-103")) who are resident in the Province of Ontario, Canada (an "Ontario Permitted Client"). If the recipient of this report is not an Ontario Permitted Client, as specified above, then the recipient should not act upon this report and should return the report to the sender. Further, this report may not be copied, duplicated and/or transmitted onward to any Canadian person.

ESL is relying on an exemption from the adviser and/or dealer registration requirements under NI 31-103 available to certain international advisers and/or dealers. Please be advised that (i) ESL is not registered in the Province of Ontario to trade in securities nor is it registered in the Province of Ontario to provide advice with respect to securities; (ii) ESL's head office or principal place of business is located in India; (iii) all or substantially all of ESL's assets may be situated outside of Canada; (iv) there may be difficulty enforcing legal rights against ESL because of the above; and (v) the name and address of the ESL's agent for service of process in the Province of Ontario is: Bamac Services Inc., 181 Bay Street, Suite 2100, Toronto, Ontario M5J 2T3 Canada.

Disclaimer for Singapore Persons

In Singapore, this report is being distributed by Edelweiss Investment Advisors Private Limited ("EIAPL") (Co. Reg. No. 201016306H) which is a holder of a capital markets services license and an exempt financial adviser in Singapore and (ii) solely to persons who qualify as "institutional investors" or "accredited investors" as defined in section 4A(1) of the Securities and Futures Act, Chapter 289 of Singapore ("the SFA"). Pursuant to regulations 33, 34, 35 and 36 of the Financial Advisers Regulations ("FAR"), sections 25, 27 and 36 of the Financial Advisers Act, Chapter 110 of Singapore shall not apply to EIAPL when providing any financial advisory services to an accredited investor (as defined in regulation 36 of the FAR. Persons in Singapore should contact EIAPL in respect of any matter arising from, or in connection with this publication/communication. This report is not suitable for private investors.