Interest-rate surge hurts corporate profits

Interest expenses of listed firms (ex-BFSI) were up 18.5% YoY in Q2FY23

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Following the contribution of loans to the corporate bottom line for nearly two years after the outbreak of the pandemic, interest costs on those have begun to weigh on companies' earnings.

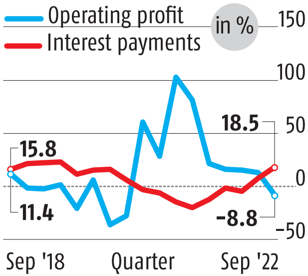
The combined interest expenses of listed companies (ex-BFSI) were up 18.5 per cent year-on-year (YoY) in Q2FY23 as against an 8.8 per cent YoY decline in their combined operating profits during the period.

This is the fastest growth in the companies' interest expenses in at least three years.

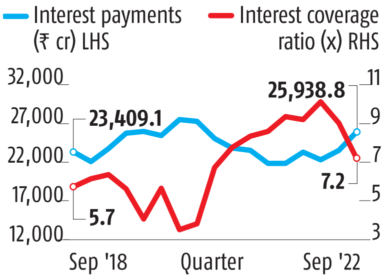
As a result, their interest coverage ratio (ICR) declined sharply to 7.2X in Q2FY23 from 9X in Q1FY23 and a high of 10.1X in Q3FY22. In contrast, operating profits had grown faster than interest costs in the previous eight quarters, leading to a steady improvement in the ICR.

BORROWING COSTS BITE

Trend in Ebitda, interest payment growth



Trend in interest payments, interest coverage ratio



Note: Quarterly data; based on a common sample of 414 non-BFSI companies

Source: Capitaline Compiled by BS Research Bureau

The ICR is the ratio of a company's operating profit to its interest burden in a given period and shows its debt-servicing capacity. The higher the ICR, the greater is a company's ability to service its debt.

"The gains to corporate earnings from lower interest rates seem to be over and borrowing costs are expected to remain high in the short to medium term. This will have an adverse effect on corporate profits," said Shailendra Kumar, chief investment officer, Narnolia Securities.

The combined profits before tax of non-BFSI (banking, financial services, and insurance) companies in the *Business Standard* sample were down 20.2 per cent YoY in Q2FY23 while their reported net profits were down 24.4 per cent YoY in the quarter.

Turn to Page 6

rency is the settlement of securities. While the trades are displayed on the RBI's anonymous negotiated dealing system-order matching platform, the settlement is not conducted by CCIL.

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"We have to understand how multilateral institutions, international financing institutions, are going to be better-reformed institutions. Are they going to serve with better vigour...do they have newer thoughts, are they looking at 21st century ways of leveraging the funds they have? Do they know or do they want to bring in greater resources?" the finance minister said, adding that Prime Minister Narendra Modi had already set the tone of this debate by calling for the reform of institutions like the UN, IMF, and World Bank.

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As a result, the companies' net profit margin declined to 6.3 per cent of their revenues in Q2FY23, the lowest in the last nine quarters.

The yield on the benchmark 10-year government of India bond is up nearly 100 basis points since the beginning of calendar 2022 while the Reserve Bank of India has raised its policy rate by 190 basis points in the period, forcing lenders to revise their lending rates.

Analysts expect a further rise in the interest burden as the central bank raises rates to battle inflation and companies increase borrowing either for working capital or to fund capex.

According to Kumar, a high double-digit rise in companies' interest expenses is both due to price as well as volume effects.

Analysts say there has been a rise in working capital borrowing by manufacturing companies in the past one year due to a surge in commodity prices and increase in inventory of raw material and finished products across the manufacturing value chain.

There is a fear that a further rise in the interest burden will result in financial stress in many sectors and contribute to a rise in non-performing assets for banks.

"A combination of a decline in operating profits resulting from higher commodity and energy prices and higher interest burden has severely affected the cash flows of many companies. If this trend continues for some more quarters we will see a rise in bank non-performing assets in the second half of FY23, and FY24," said Dhananjay Sinha, director and head (research, strategy and economics), Systematix Group.

As of now, however, lenders seem to be benefiting from a rise in interest rates in recent quarters. Listed banks' combined interest expenses were up 17.5 per cent Y-o-Y in Q2FY23, a sharp acceleration from the 8.4 per cent Y-o-Y growth in Q1FY23, but their interest income grew even faster. The banks' combined gross interest income was up 20.5 per cent YoY in Q2FY23, growing at the fastest pace in at least three years. This resulted in another quarter of expansion in net interest margins for banks.

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