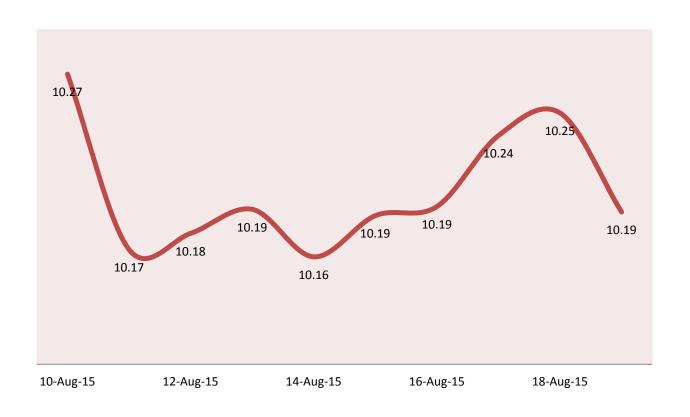


# Yuan Devaluation - Impact study



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## The Yuan impact study

August 2015

### **OVERVIEW**

### **Background**

On August 11, 2015, the People's Bank of China (PBOC) shifted to a new mechanism of fixing the daily reference rate of the Chinese Yuan (CNY) (around which the currency is permitted to fluctuate +/- 2%), at the previous day's inter-bank market closing. This change would make the exchange rate relatively more market-determined and flexible. The enhanced integration with global financial markets would aid the country's attempt to secure the inclusion of the CNY in the International Monetary Fund's (IMF's) Special Drawing Rights (SDR) basket, which is likely to be a key motivation underpinning this reform.

Following the improved flexibility, the CNY has weakened by ~3% relative to the USD (between August 11 and 17, 2015), reflecting market concerns regarding a slowdown of Chinese economic growth and flagging exports. However, this has given rise to the apprehensions that the currency may weaken further unless Chinese macroeconomic fundamentals stage an improvement and that the devaluation had actually been permitted to boost the competiveness of Chinese exports. This in turn set off concerns that other countries would attempt competitive devaluation of their currencies to support their exports, including major commodity exporters with a substantial dependence on China.

## Impact on emerging market currencies

Several emerging market currencies, including the INR, have adjusted following the changes related to the CNY. The INR depreciated by ~2% relative to the USD, in line with currencies such as the Indonesian Rupiah, Turkish Lira etc., which is muted as compared to the 4% depreciation displayed by the Malaysian Ringgit over the same time period.

As a result, the INR has strengthened somewhat relative to the CNY over the last week. Nevertheless, the INR-CNY pair has recorded depreciation (in nominal terms) of 1% since the beginning of this fiscal and 4% on a y-o-y basis. This in conjunction with the hikes in customs duty on certain products undertaken recently by the Government of India (GoI) would limit the adverse impact of recent developments on the competiveness of Indian traded goods. While some sectors may nonetheless face competitive pressure from cheaper Chinese imports, the adverse impact of the same on

### **OVERVIEW**

the Indian current account deficit is likely to be cushioned by the recent fall in commodity prices. ICRA expects the current account deficit to narrow in FY 2016 from 1.3% of GDP in FY 2015 and economic growth to come in at the lower end of our forecast band of 7.4-7.6%.

### **Currency outlook**

If the CNY continues to depreciate relative to the USD, we expect the INR as well as other emerging market currencies to follow suit. Moreover, we anticipate that emerging market currencies would weaken relative to the USD once the US Federal Reserve hikes the federal funds rate.

However, we expect the INR to displayed greater resilience to such global events, as compared to other emerging market currencies, based on the improvements in Indian macroeconomic fundamentals, particularly a cooling of inflation, fiscal consolidation, muted external sector concerns and rise in foreign exchange reserves, and the expectation that India's economic growth will outperform most peers. Barring a sharp depreciation of the CNY, we expect the INR to trade in a range of Rs. 64.5-66.0/USD over the near term. However, the weakening of the INR relative to the USD would increase the cost of servicing USD denominated debt.

### **Inflation**

The inflationary impact of the depreciation of the INR relative to the US dollar is expected to largely be offset by the decline in global commodity prices, which is beneficial to net commodity importers such as India, as well as the landed price of Chinese imports. For instance, prices of crude oil (Indian basket), steel, coal and gold corrected by 12%, 9%, 6% and 5%, respectively, in INR terms in July 2015 relative to the previous month. ICRA expects CPI inflation to undershoot the Reserve Bank of India's (RBI's) projection of 6.0% for January 2016, suggesting room for further monetary easing of 25 basis points (bps) in 2015. However, the RBI may chose to await further transmission of past easing as well as signs of stability in exchange rate markets before undertaking additional rate cuts.

## **CORPORATE SECTOR IMPACT**

In the following we have discussed the potential impact of Yuan devaluation on some of the more vulnerable corporate sectors. The sectors expected to be directly impacted by Yuan devaluation includes steel, tyres and auto component – as these sectors have a large overhang of Chinese capacity in the global market. This apart, the power & telecom sector would also be impacted indirectly by devaluation of rupee against USD, due to a combination of increase in input costs and foreign currency borrowings. The corporate sector however would stand to benefit from lower raw material costs resulting from lower commodity prices, which may sustain from any slowdown in the Chinese economy.

While the current analysis takes into account the recent Yuan and rupee devaluation, it may be noted, that in the event of any sharp devaluation of CNY in the future, the impact on several corporate sectors would need to be re-assessed.

# **Steel: NEGATIVE**

STEEL INDUSTRY Impact - NEGATIVE

Pricing pressures emanating from Yuan devaluation offset by the recent import duty hike and INR depreciation, but rising imports from Japan and South Korea remain a concern In comparison to a 28% growth in China's overall steel exports to the world during the period January-June 2015, growth in China's steel exports to India stood at 62% during the same period. India's HRC prices, which were about 25% costlier than imported HRC prices before the Yuan devaluation, became marginally more costly immediately after the event. India's steel imports, which grew by 71% in FY15, remain at elevated levels due to such a large price differential and grew by 53% during the period April-June 2015.

To protect the domestic steel makers from cheaper imports, the Government raised import duty on steel products by 2.5 percentage points in June 2015 and by a further 2.5 percentage points in the second week of August 2015. Despite this, ICRA feels that domestic steel industry would remain under pressure in the near term as imports from FTA countries including Japan and South Korea still attract negligible import duty of about one percent. This is also reflected from the fact that China's share in India's total imports has reduced in the current year to about 36% during Q1FY16 from 44% in FY15.

The weakening rupee following Yuan devaluation, coupled with a recent price cut of about Rs. 1000/MT effected by domestic steel players has resulted in a moderation in domestic HRC prices in USD terms. This has caused the domestic steel price premium to shrink to around 17% currently.

To summarize, pricing pressures emanating from Yuan devaluation have been offset by the recent import duty hike and INR depreciation, but rising imports from Japan and South Korea remain a concern in the near term at least. While the gap between the domestic steel price and landed cost of imported steel has narrowed recently, the same remains high on an absolute level. Overall pressure on realisations and margins of domestic players are therefore expected to continue

# **Tyre: NEGATIVE**

TYRE INDUSTRY Impact: NEGATIVE

China has traditionally dominated as the source market for tyre imports in India, largely for the replacement market.

Exhibit A: Trend in import of tyres from China (in USD Million)

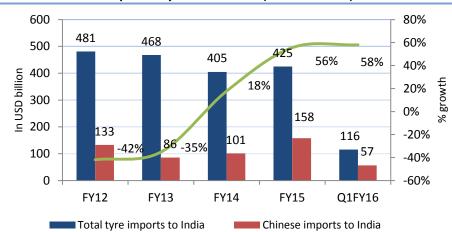
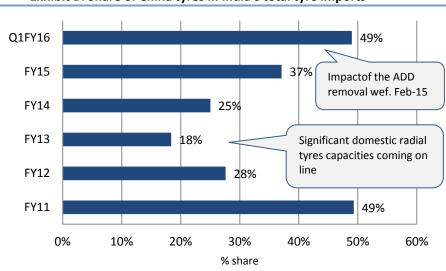


Exhibit B: Share of China tyres in India's total tyre imports



Source: ATMA, Industry reports, ICRA Research

Growth in Chinese tyre imports

The recent Yuan devaluation has exacerbated the price differential between Indian made and Chinese landed tyres.

During the past year, import of Chinese tyres into the Indian replacement market has increased sharply by 56% and by a further 58% during Q1, FY16. Imported Chinese tyres are used in the domestic after market space by the price sensitive Medium and Heavy Commercial Vehicle (M&HCV) and Passenger Vehicle (PV) fleet operators; and two wheeler (including cycles) consumers. While the sunset of an anti dumping duty (ADD) on Chinese M&HCV bias tyres in Feburary-2015 benefited Chinese tyres, the recent Yuan devaluation has exacerbated the price differential between Indian made and Chinese landed tyres.

# **Auto Component: NEGATIVE**

AUTO COMPONENT INDUSTRY Impact: NEGATIVE

The Indian auto component industry at ~US\$38.5 billion is a fraction of the Chinese auto component industry (US\$ 400 billion) – China also remains a very large exporter of auto components with exports of ~US\$ 100 billion in 2014.

Exhibit C: Trend in imports & exports to China (in USD Million)

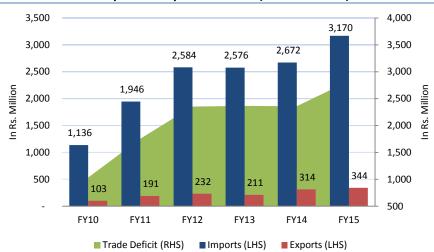
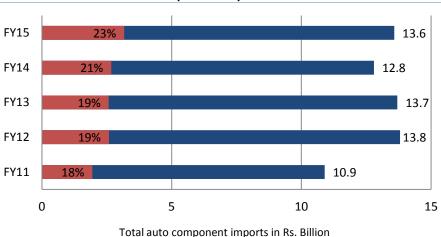


Exhibit D: Total auto component imports and the Chinese share



Source: ACMA, Industry reports, ICRA Research

During FY15, India imported auto components worth USD 3.17 billion from China, as against USD 344 million exports to China (EXHIBIT C). Consequently, India's trade deficit with China has widened from USD 1.03 billion in FY10 to USD 2.83 billion in FY15.

China accounts for about 23% of total auto component imports to India and this share has consistently increased over the past three years (Exhibit D) whereas exports to China (from India) have remained stagnant. The Indian automotive industry imports multiple products from China namely bearings, axle beams, knuckles, glass, wheel rims, steering products, rubber components, and electronic chips to name a few.

Considering cheaper and local raw material availability (as against imported raw material for India), lower financing cost and economies of scale, imports from China are priced-on an average-20%-25% cheaper than Indian components, posing a serious threat to domestic auto ancillaries.

AUTO COMPONENT INDUSTRY Impact: NEGATIVE

Exhibit E: Impact of the Chinese Yuan devaluation on the Indian auto component Industry

	Indian auto component manufacturers catering to:	% of Indian auto component demand	Impact
1.	Aftermarket (tyres, batteries)	17%	- Heightened price competition in the domestic aftermarket leading to margin erosion
2.	OE demand	54%	<ul> <li>While in the past, several major Indian OEMs have sourced components from China (wheel rims, steering components, axle beams), over the past three year, this trend has fallen due to increase in landed cost of these Chinese components; the current Yuan devaluation could lead to a product specific relook at these cost dynamics to some extent.</li> <li>Given the presence of localisation/sourcing centres in China, the continued devaluation of Yuan could lead to global OEMs continue using China as a sourcing point for India, instead of developing local Indian suppliers.</li> </ul>
3.	China	1%	<ul> <li>Though currently accounts for a small proportion of total business, a few exporters had started looking at this market as a vast opportunity going forward. Any further Yuan devaluation vis-a-vis rupee will make this opportunity more difficult.</li> </ul>
4.	Exporters competing with China in the global arena (USA, Germany among others)	~20%-25%	<ul> <li>This Chinese expansionary monetary policy is aimed at boosted the domestic economy, partly through exports. The devalued Yuan will make Chinese components cheaper than Indian components globally.</li> </ul>

Source: ACMA, ICRA Research

# **Power: NEGATIVE**

POWER Impact: NEGATIVE

While the direct linkages of the sector to Chinese Yuan is minimal, the sector would be impacted by rupee depreciation against the USD.

- ❖ INR depreciation against USD leads to a) cost escalation for the projects which have availed foreign currency debt funding¹ as well as b) higher variable cost of power generation due to dependence on the imported sources of fuel (both coal & R-LNG).
- ❖ ICRA's rated portfolio of thermal IPPs aggregating to 21 GW have foreign debt funding exposure to the tune of USD 7.3 billion in the form of foreign currency loans and foreign currency buyers' credit (as sub-limit of rupee term debt) in project cost for importing BTG equipments. Foreign currency debt exposure is estimated to account for about 35% of the project cost and INR depreciation against the USD since last 4-5 year period has also led to cost over-run by about 8-10% in majority of these projects. About 50% of the rated portfolio is operational and remaining is expected to be operational over next 1-3 year period.
- As shown in EXHIBIT F, for every 1 INR depreciation against US dollar at a given coal price, the variable cost of generation for an imported coal based IPP at a coastal location is estimated to increase by about 2.8 paise/unit and for domestic coal linkage based project (with 50% dependence on imported coal) at a hinterland location, the increase in variable cost is estimated to be about 1.1 paise/unit. Further, the fixed cost of generation for coal based power projects availing foreign debt (to the extent of 35-40% of project cost, primarily availed for funding imported BTG equipment) is estimated to increase by 1.4 paise/unit for every 1 INR depreciation against US dollar.

Exhibit F: Impact of INR depreciation against USD on Fixed and Variable Cost for an IPP

At current c	At current coal price level, for every 1 INR depreciation against USD				
Amount in Paisa/Unit	Imported Coal based IPP	Domestic Coal Linkage based IPP			
Variable Cost	2.8	1.1			
Fixed Cost	1.4	1.4			
Increase in Cost of Generation	4.2	2.5			

Source: ICRA Estimates

ICRA's rated portfolio of thermal IPPs aggregating to 21 GW have foreign debt funding exposure to the tune of USD 7.3 billion

- Coal based IPPs with foreign currency debt exposure and having competitively bid based PPAs wherein fixed capacity charge is quoted as non-escalable component in INR terms, remain exposed to risk of under-recovery due to risk of forex fluctuation which is not a pass-through. Even in cases, where IPPs were to avail hedging for forex exposures, cost of hedging is not allowed to be covered in such competitively bid PPAs. For IPPs having cost plus based PPAs, approval of cost over-run due to forex risk by SERC however remains critical to mitigate such risk of under-recovery on this front.
- Coal based IPPs with short term bilateral PPAs/merchant exposure remain exposed to forex risk associated with the sourcing of fuel, given that such projects would need to mainly depend upon the imported sources of fuel due to continuing shortages of domestic fuel.
- ❖ INR depreciation against USD would also impact the cost of generation for gas based power projects given that the pricing of domestic gas is denominated in USD. At the prevailing gas price of 4.66 USD/MMBTU, the variable cost of generation for a project using domestic gas would increase by 5 paise/unit for every 1 INR depreciation against USD. While majority of gas based IPPs would be able to pass on the escalation in fuel cost to the off-takers due to cost plus based PPAs with the state distribution utilities, their cost competitiveness would be affected. Also, viability of the scheme being implemented for allowing use of R-LNG for stranded gas based projects (for 8.1 GW capacity) would be affected in case of INR were to stay beyond the level of 63 INR/USD, even assuming that R-LNG price level were to remain soft (i.e. at delivered cost of 9.4 USD/mmbtu) and financial relief by way of moratorium for principal payment is in place for these projects.

# **Telecom: Moderately NEGATIVE**

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Cost of imported equipment to fall

Indian telecom industry has been saddled with a large debt burden for last few years. Elevated debt levels with sizeable proportion of foreign currency debt has impacted the telecom companies (telcos) given the significant rupee depreciation. However, the majority of the foreign currency debt on the books of the telcos is in USD or Euro and some proportion in African currencies (in case of Bharti Airtel Limited). While Reliance Communications Limited (RCom) has availed debt from Chinese Lenders including China Development Bank, the debt is USD denominated. Thus Indian telcos do not have any direct exposure to Chinese Yuan. However, the devaluation of the rupee vis-avis dollar would have an adverse impact on the overall indebtedness of the industry.

On the other hand, lots of equipments used in telecom infrastructure are imported from China, in addition to a large proportion of Chinese mobile handsets. The devaluation of Chinese currency would potentially lead to reduction in cost of imports and hence be beneficial for these importers – though the impact could be significantly offset by a corresponding depreciation of rupee.

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