



Operations Manual / Internal Governing Document

This document is updated once in a calendar year.

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Foreword

Credit rating is not just a high skill job. It is one of those jobs that require the highest degree of objectivity and transparency. While raters wield immense power of assessing the borrowers' ability and willingness to repay debt in a timely manner, the raters themselves must be willing to operate at the highest standards of corporate governance. Acuité' s Operations Manual ensures that integrity in the entire credit rating process is upheld.

The biggest challenge in arriving at high quality ratings is not intelligence or knowledge of an individual. It is applying intelligence and knowledge in a manner that is consistent and unbiased. Taking decisions under the influence of emotion, ego or bias can lead the most experienced people to take wrong decisions. The Operations Manual aims to provide a time-tested framework to ensure consistent and unbiased ratings. The rating analysts and rating committee members both must learn to meticulously and dispassionately apply the rating criteria and methodology adopted by Acuité, which is part of this document.

Apart from the criteria and methodology, this document also provides guidelines on how a rating agency employee must operate to keep conflicts of interest and biases away. The rating analysts and rating committee members must be willing to make it a way of life, to uphold the principles set by Operations Manual. And, not just for the individual employees, the Operations Manual also ensures that the Company itself is able to keep its profitability and growth target separate from the quality of rating it assigns.

We review and update this document every year to incorporate new best practices and better methodologies. All the policies, processes and guidelines must pass the test of 3 values of Acuité, namely Trust, Innovation and Excellence. The operational and internal auditors as well as the regulators, use this document as a base to test the integrity of various functions and processes.

Every Acuité employee takes the pledge of upholding this Operations Manual not just by the letter but also by the spirit of it.

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Operations Manual / Internal Governing Document

(Disclosure as per SEBI Circular SEBI/HO/MIRSD/MIRSD4/CIR/P/2016/119)

INTRODUCTION

SEBI vide its circular SEBI/HO/MIRSD/MIRSD4/CIR/P/2016/119 directed all Credit Rating Agencies to disclose their operating policies and guidelines. This document outlines the relevant policies, guidelines, rating process and criteria applicable to all rating assignments that fall within the purview of SEBI Regulations and Circulars (executed by Acuite Bond Ratings division).

Any rating product or service that meets all the three conditions mentioned below shall come under the purview of these guidelines:

- a. Ratings on public issues and right issue of securities (SEBI CRA Regulation, 1999), other securities / instruments and loans / facilities provided by banks (SEBI circular, 2012)
- b. Ratings assigned using a symbol standardized by SEBI (SEBI circular 2011)
- c. Ratings assigned through a rating agreement entered with the issuer (SEBI CRA Regulation, 1999)

In addition, Issuer Ratings, will also be subject to these guidelines.

POLICIES & GUIDELINES GOVERNING RATING PROCESS

Acuite follows stringent policies and guidelines to ensure independence, quality, timeliness and objectivity in assigning ratings that are unbiased.

- A. General Nature of Compensation Arrangements with Rated Entities
- B. Policy for Appeal by Issuers against the Rating being assigned to its Instruments
- C. Policy for Placing Ratings on Credit Watch
- D. Guidelines on What Constitutes Non-Cooperation
- E. Policy for Withdrawal of Ratings
- F. Gift Policy
- G. Confidentiality Policy
- H. Policy on Outsourcing of Activities
- I. Policy on Provisional Ratings
- J. FAQs on Ratings
- K. Disclosure on Managing Conflict of Interest
- L. Rating Process and Timeline
- M. Policy regarding Monitoring and Review of Ratings
- N. Rating Committee Composition, Responsibilities and Evaluation Criteria
- O. Guidelines on Minimum Information Required for Rating
- P. Guidelines on Seeking Information from External Entities
- Q. Policy on Internal Approvals

R. Role and Accountability of Rating Analysts

RATING CRITERIA

Acuite has well defined rating criteria and methodologies, models that form the analytical basis for all the ratings assigned. The rating criteria and methodology is reviewed once in a calendar year or earlier if regulations/ circumstances warrant. These criteria help the analyst to ensure that all ratings can be benchmarked against a common reference.

- A. Criteria for Rating of Manufacturing Entities
- B. Criteria for Rating of Trading Entities
- C. Criteria for Rating of Entities in Services Sector
- D. Criteria for Rating of Non-Banking Financing Entities
- E. Criteria for Rating of Banks and Financial Institutions
- F. Criteria for Rating of Entities in Infrastructure Sector
- G. Criteria for Default Recognition
- H. Application of Financial Ratios and Adjustments
- I. Criteria for Consolidation of Companies
- J. Criteria for Group and Parent Support
- K. Criteria for State Government Support
- L. Criteria for Rating of Securitized Transactions
- M. Criteria for Rating Commercial Paper
- N. Criteria for Fixed Deposit Ratings
- O. Complexity Levels of instruments

APPLICABLE REGULATORY GUIDELINES

- SEBI Regulations,
1999 http://www.sebi.gov.in/sebiweb/home/document_detail.jsp?link=http://www.sebi.gov.in/cms/sebi_data/docfiles/19524_t.html
- Coverage of other securities / instruments and loans / facilities provided by banks under purview of SEBI, March 01, 2012
http://www.sebi.gov.in/cms/sebi_data/attachdocs/1331706378217.pdf
- Standardization of Rating Symbols & Definitions, June 15, 2011
http://www.sebi.gov.in/cms/sebi_data/attachdocs/1308551826775.pdf
- Sharing of information regarding issuer companies between Debenture Trustees and Credit Rating Agencies, March 15, 2013
http://www.sebi.gov.in/cms/sebi_data/attachdocs/1363346395331.pdf
- Enhanced Standard for Credit Rating Agencies, November 01, 2016
http://www.sebi.gov.in/cms/sebi_data/attachdocs/147799998510

General Nature of Compensation Arrangements with Rated Entities

In case of rating of public debt issues, and bank facilities or commercial papers, the fee is paid by the issuer/borrower. The borrower/issuer has to pay initial rating fee along with the signed rating agreement for the rating exercise. On acceptance of the rating, the borrower/issuer has to pay an annual surveillance fee every year till the debt is fully repaid. In case, the quantum of debt increases under the same borrowing program, the borrower/issuer has to pay an additional initial rating fee and additional annual surveillance fee for the incremental borrowing.

Acuité may charge the borrower/issuer "Out of Pocket" expenses (OPE) at actuals for covering certain costs including but not limited to travelling for site visits, telecommunication, printing & stationery costs, subscription fees for various research and financial data & information services, credit information reports, website development & maintenance. OPE is applicable in fresh and review exercises.

Acuité begins a rating process (management interaction, rating analysis and rating committee) only after receipt of signed rating agreement and full payment of initial rating fee from the rated entity. Acuité has internal guidelines on fee structure for NCDs, Bonds, CP programs, and Bank Loan Ratings. The fee payable is largely dependent on the quantum of the debt being rated and to some extent on the complexity involved in the rating analysis. Acuité reserves the right to modify its fee structure.

Acuité and its employees do not accept cash payments for any reason whatsoever.

Acuité' s rating fee is not linked to the rating outcome or rating revisions or releases in any manner.

The rating is carried out by a separate team of personnel comprising analysts who are not in any way involved in business development and procurement. The compensation paid to members of the rating analytical team is not dependent on the rating outcome or rating fee received from the rated entities. This ensures that business pressures do not, in any manner, influence the teams involved in assigning the rating. Rating mandates are not solicited by promising specific ratings to issuers.

Acuité' s dissemination of credit rating of NCDs, Bonds, CP programs, and Bank Loan Ratings are accessible free of charge on its website, www.acuite.in.

Note: Under extant RBI norms (Prudential Framework for Resolution of Stressed Assets dated June 7, 2019), for Independent Credit Evaluation (ICE) of residual debt, wherever required, Acuité is directly engaged by the lender(s) and the payment of fee for such assignments (one-time exercise with no surveillance) is made by the lender(s).

Policy for Appeal by Issuers against Rating being assigned to its Instruments (Policy for Appeal)

A. *Appeal:*

The client can appeal for a reconsideration of rating, within five (05) days of communication of the rating, provided materially significant fresh / new information is submitted by the client, which was not provided earlier. A request for appeal will be accepted only once and acted upon at the discretion of Acuité.

B. *Appeal Process:*

For the purpose of appeal:

- i. Acuité shall carry out a critical review of the new data and developments, if any.
- ii. In case the exercise indicates a need for a revision in the ratings / outlook earlier assigned, the concerned rating analyst shall present an appeal note to the Rating Committee and the Rating assigned (revised or reaffirmed as the case may be) shall be communicated to the client.

Policy for Placing Ratings on Credit Watch

Subsequent to assignment of the rating, and before the scheduled review process, if any material changes in the rating drivers take place and if Acuité believes that such developments have a possible impact on the rating assigned then the rating shall be put on Rating Watch till the time the review takes place.

Acuité will inform the public by disseminating the Rating Watch through a press release.

Guidelines on What Constitutes Non-Cooperation

1. For the purpose of surveillance and review, Acuité calls for the information / data from the rated clients. In terms of the Agreement entered into by the client with Acuité, the client is required, inter alia, to:
 - i. Furnish on a continuous basis all information in a timely manner as may be required by Acuité during the lifetime of the facilities / instrument rated by Acuité and
 - ii. Pay the annual surveillance fee and all other charges billed by Acuité in full.
2. In case the rated entity does not provide the information called for by Acuité and does not respond to telephonic follow ups by Acuité' s executives, Acuité shall send a reminder through email / letter to the rated entity. Similarly, in case the annual surveillance fee and any other amounts payable to Acuité are not paid in full and on time, Acuité will remind the rated entity to pay the annual surveillance fee and all other amounts payable to Acuité through email / letter. If, in spite of reminder, the information required, or the annual surveillance fee is not received from the entity, the entity will be considered as a non-cooperating entity
3. With respect to chronic failure in submission of "No Default Statement" by a rated entity, Acuite will follow its internal guidelines on the action to be taken for flagging the entity as "Issuer Not Cooperating".
4. An instance where an issuer (whether or not flagged off as "Issuer not Co-operating") has failed to cooperate (please refer point 2 above), is considered by Acuité to be fraught with serious information risk. If Acuité is of the opinion that lack of cooperation by such an entity coupled with information risk makes the currently outstanding rating untenable, Acuité may take necessary rating action that may include a multi-notch rating transition. Acuité will also update the banker(s) with the rating action so taken.

Guidelines on Gifts

1. The code of conduct of Acuité requires that all employees demonstrate commitment to treating all people and organizations, with whom they come into contact or conduct business, impartially and professionally.
2. Gift constitutes, but is not limited to, receipt of cash/cheques, objects of value such as jewellery, consumables such as cigarettes, liquor bottle, statues of religious deities, movie tickets, holiday vouchers or third party sponsored off-site trips (foreign or domestic), passes to events, and memberships to clubs.
3. The employees of Acuité shall demonstrate the highest standards of ethics and conduct and practice and demonstrate equal treatment, unbiased professionalism, and non-discriminatory actions in relation to all clients, potential clients, potential employees, vendors, potential vendors or suppliers, government employees or agents and any other individual or organization.
4. Acuité, as a policy, does not give away gift as a means of securing business or any other reason.
5. No employee of Acuité shall extend any gift, money, or favour in any form to its clients, potential clients, vendors, potential vendors or suppliers, government employees or agents and any other individual or organization, in connection with any ratings-related or other work or service performed at Acuité, under any circumstances.
6. To avoid a conflict of interest, actual or perceived, Acuité and its employees shall not accept any gifts from clients, potential clients, potential employees, vendors, potential vendors or suppliers, government employees or agents and any other individual or organization.
7. In special circumstances, such as for speaking at seminars a speaker's memento, may be accepted by an Acuité employee subject to the condition that the monetary value of the gift is not more than Rs. 500/-.
8. Where the monetary value of the gift received is more than Rs. 500/-, the employee must return it to the giver immediately. If return of the item is not feasible for any reason whatsoever, the employee shall report the same to the Compliance Officer of Acuité. In the meantime, the gift shall be surrendered to the Administration Department by the recipient for its disposal.
9. Any breach of this policy should be brought to the notice of the Compliance Officer of Acuité.
10. Any attempt by any client, potential client, employee, potential employee, vendor, potential vendor or supplier, government employee or agent and any other individual or organization to give gift to an Acuité employee, with a view to influencing a decision, should be brought to the notice of the Compliance Officer of Acuité.

Confidentiality Policy

1. The objective of this policy is to protect confidential and/or material non-public information, including confidential information received from an entity rated/proposed to be rated and non-public information about a credit rating action (e.g., information about a credit rating action before the credit rating is publicly disclosed or disseminated to public).
2. Acuité and its access persons and employees are prohibited from using or disclosing confidential and/or material non-public information for any purpose unrelated to Acuité's credit rating activities, including disclosing such information to other access persons or employees where the disclosure is not necessary in connection with Acuité's credit rating activities.
3. Acuité and its access persons and employees shall take reasonable steps to protect confidential and/or material non-public information from fraud, theft, misuse, or inadvertent disclosure.
4. With respect to confidential information received from a rated entity, Acuité and its access persons and employees are prohibited from using or disclosing such information in violation of the terms of any applicable agreement or mutual understanding that Acuité will keep the information confidential.
5. Acuité and its access persons and employees are prohibited from selectively disclosing information about an unpublished credit rating action, except to the rated entity.
6. Acuité prohibits its access persons and employees who possess confidential and/or material non-public information to disclose such information to anyone other than an Acuité access person or employee involved in the rating process strictly on a need-to-know basis. Acuité access persons or employees are not allowed to use such information for personal gain.
7. Notwithstanding the above, Acuité and its access persons and employees reserve the right to disclose confidential/material non-public information, in their possession, to the Regulatory / Statutory authorities such as Securities and Exchange Board of India (SEBI), Reserve Bank of India (RBI) / Government, including, but not limited to, a Court of Law, when required to do so under any applicable law or regulation.
8. This policy is complementary to the Analytic Firewall Rules, Document Archival policy and the clear desk and clear screen policy currently in force and / or that may be adopted by Acuité from time to time.
9. This policy is location agnostic and applicable to access persons and employees whether working from office or remotely (such as working from home).

Policy on Outsourcing of Activities

In line with SEBI's circular CIR/MIRSD/24/2011 dated December 15, 2011, Acuite does not outsource its core activities related to rating execution and compliance functions.

Core activities related to Rating Execution:

1. Data entry (financial and non-financial)
2. Interactions / Discussions with the management
3. Preparation of the Rating / Review note
4. Presentation of the Rating / Review note to the Rating Committee
5. Administrative and secretarial work relating to Rating Committee Meetings

Non-core / non-analytical activities:

Acuite has appointed tele-calling / client servicing executives who are off-roll associates for the purposes of following up for information from rated entities for surveillance and review.

These associates are on a term contract with a third-party service provider purely from a payroll processing perspective. However, the training, monitoring / supervision and reporting is to an employee on the rolls of Acuite. These associates are bound by all the policies and guidelines of Acuite. Apart from processing payroll the third-party service provider has no role in the day to day management of these associates.

Policy on Provisional Ratings

A. *Provisional Ratings:*

- i. Provisional ratings are assigned by Acuité to debt instruments where certain important actions and/or execution of certain documents governing the ratings are yet to be completed. These actions / steps may comprise execution of the guarantee deed by the group / parent company or Government, appointment of debenture trustee, finer details regarding the structured payment mechanism and other factors based on which the rating is assigned.
- ii. Subsequently, upon execution of the requisite documents / completion of the required actions, the provisional ratings are converted into final ratings.

B. *Symbol for Provisional Ratings:*

In case of provisional ratings, Acuité prefixes such ratings with the word provisional e.g. **"Provisional ACUTE A (SO)"**.

C. *Conversion of Provisional Ratings into Final Ratings:*

Acuité shall convert the provisional ratings into final ratings as and when the terms such as execution of documents / complying with the conditions etc., as envisaged at the time of assignment of provisional ratings are fulfilled within the agreed time frame.

D. *Time frame for complying with the agreed terms, execution of documents and withdrawal of ratings:*

- i. Acuité shall disseminate the provisional ratings through its website and provide 335 days (for Bonds and Debentures) / 425 days (for Bank Loan facilities) for the issuer to execute various documents / complete the formalities for consideration of conversion to final rating.
- ii. Once the execution of documents / compliance with the conditions etc. (as mentioned in the provisional ratings when assigned) are in place, the provisional rating will be converted to final rating.
- iii. An issuer, who fails to comply with the documentation requirement / does not take the required action within the applicable time period [as stated above in D (i.)], may seek a suitable extension (in writing) of time for conversion of the Provisional rating to Final rating (i.e. to execute the documents / comply with the conditions) and pay the applicable surveillance fee to Acuite. As part of this request for extension by the issuer, Acuité will also seek necessary information to review the Provisional rating and complete the formal review process.
- iv. Acuite will initiate the process to withdraw the Provisional rating in cases where the issuer:
 - a. fails to comply with the documentation requirement / does not take the required action within the applicable time period [as stated above in D (i.)], and
 - b. also, does not seek an extension (in writing) of the Provisional rating to execute the documents / comply with the conditions, fails to submit necessary information for review and fails to pay the applicable surveillance fee to Acuite

- v. As part of the withdrawal process, Acuite will seek:
 - i. Updated business information, financial statements (Audited / Provisional as applicable) & any other information it considers important / critical and management interaction.
 - ii. Payment of dues, if any.

In case of non-cooperation by the rated entity with respect to any one or both of the above requirements, the rating(s) may be suffixed with "Issuer Not Cooperating" and simultaneously withdrawn.

Disclosure on managing conflict of interest

1. Acuité has operationally separated its credit rating analytical team from any other businesses of Acuité that present a conflict of interest
2. Acuité discloses the general nature of its compensation arrangements with the rated entities.
3. When Acuité receives compensation from a rated entity unrelated to its credit rating services, Acuité would disclose such unrelated compensation as a percentage of total annual compensation received from such rated entity.
4. Acuité would make a disclosure if it receives 10 percent or more of its annual revenue from a single rated entity.
5. Acuité would not trade in instruments presenting a conflict of interest with Acuité' s credit rating of the concerned entity, if rated by Acuité.
6. Acuité' s access person and/or employee who participates in a credit rating action with respect to an entity would not be compensated or evaluated on the basis of the amount of revenue that Acuité would derive from that entity.
7. Acuité' s access persons and/or employees who participate in a credit rating action would not participate in discussions with rated entities regarding fees or payments charged to such rated entity.
8. Acuité may review, where the compliance officer finds it so necessary, the past work of an analyst who leaves the employment of Acuité and joins an entity (subject to Acuite coming to know of its former employee taking up such an employment) where Acuite has an outstanding rating and the concerned analyst had participated in the rating exercise of that entity.
9. This policy is complementary to the gift policy and the policy for dealing with conflict of interest for trading and investment, which is currently in force and/or that may be adopted by Acuité from time to time.
10. The access person and/or employee has the onus to make reasonable efforts to inform and disclose to Acuité at the earliest of situation(s) and/or circumstances that may potentially or actually cause or be perceived to cause a conflict of interest in the discharge of his/her duties and obligations.

Policy regarding Monitoring & Review of Ratings

Any security / instrument / bank loan facility rated by Acuité shall be subject to continuous surveillance throughout the life time of the rated instrument. The following process/guideline shall be followed for the same:

1. The Rating, once accepted, is kept under constant surveillance throughout life of the instrument / facility (or until the rating is withdrawn) by monitoring developments within the rated entity, various economic and industry level factors that may influence the movement of the rating.
2. To facilitate the surveillance and the review process, the rating analyst will seek updated information (financial / non-financial) from the client periodically. A review is conducted in periodic frequency as per Acuité' s policies and prevalent SEBI / RBI guidelines. A review may also be conducted sooner, should there be a material event that warrants such a review on an out of turn basis.
3. In case the above data /information collected indicates the possibility of an impact on the creditworthiness of the rated entity, a view note is prepared and presented to the Rating Committee. Revision, if any, in the rating assigned by the Rating Committee is communicated to the rated entity and published on Acuité' s website.
4. At least one review should be conducted as under - For Bonds & Debentures: once every 365 days (i.e. the no. of days between the two rating committee meetings where the case is discussed should not exceed 365 days). For bank loan facilities: once every 455 days (i.e. the no. of days between the two rating committee meetings where the case is discussed should not exceed 455 days).
5. In case of non-cooperating rated entities where surveillance is not possible due to non-availability of requisite data or Acuité is of the opinion that the data is incorrect / not true, or non-receipt of surveillance fee, Acuité will conduct the rating review based on publicly available information and on best effort basis. In such cases, the suffix "Issuer not cooperating*" shall be added to the rating symbol. The asterisk mark shall be explained as "Issuer did not co-operate; Based on best available information".

Policy on Withdrawal of Ratings

Bank Loan Facilities

Acuite will withdraw the Credit Rating of bank facilities, subject to the following conditions:

1. Receipt of a written application for withdrawal from the rated entity
2. No Objection Certificate (NOC) from all the lending banks OR from the lead bank, in such capacity (in case of consortium banking) as applicable. In case of change of bank, Acuite may rely on "Satisfaction of Charges" available on the website of Ministry of Corporate Affairs (www.mca.gov.in) in lieu of NOC.
3. Full payment of all dues, if any, to Acuite

At the time of withdrawal, Acuite shall issue a press release as per the format by SEBI. The Press Release shall also mention the reason(s) for withdrawal

Bonds / Debentures

A. As per SEBI Circular SEBI/ HO/ MIRSD/ DOP2/CIR/P/2018/ 95 dated June 6, 2018, Acuite will withdraw the Credit Rating on Bonds / Debentures, based on a written request from the issuer and subject to the following conditions:

1. Acuite has rated the instrument continuously for 5 years or 50 per cent of the tenure of the instrument, whichever is higher.
2. Acuite has received an undertaking from the Issuer that a rating is available on that instrument.

B. Notwithstanding what is stated in point A. above, as per SEBI Circular SEBI/HO/MIRSD/CRADT/CIR/P/2020/2 dated January 03, 2020, in case of multiple ratings on an instrument (where there is no regulatory mandate for multiple ratings), Acuite will withdraw the Credit Rating on Bonds / Debentures, based on a written request from the issuer and subject to the following conditions:

1. rated the instrument continuously for 3 years or 50 per cent of the tenure of the instrument, whichever is higher; and
2. received No-objection Certificate (NOC) from 75% of bondholders of the outstanding debt for withdrawal of rating; and
3. received an undertaking from the issuer that another rating is available on that instrument.

At the time of withdrawal, Acuite shall issue a press release as per the format prescribed by SEBI. The Press Release shall also mention the reason(s) for withdrawal.

Commercial Paper / Short Term Instruments

Acuité will withdraw the Credit Rating on Commercial Paper / Short Term Instruments, subject to the following conditions:

1. Receipt of a written application for withdrawal from the rated entity
2. Written confirmation of 'Nil' outstanding on the rated instrument from the Rated Entity's Auditors OR Issuer and Paying Agent (IPA)
3. Full payment of all dues, if any, to Acuité

At the time of withdrawal, Acuité shall issue a press release as per the format by SEBI. The Press Release shall also mention the reason(s) for withdrawal

Fixed Deposits

Acuité will withdraw the Credit Rating of fixed deposits on receipt of a written request of withdrawal accompanied by a letter from statutory auditors of the rated entity certifying and a Board resolution confirming:

1. the deposits are fully repaid; or
2. the Rated Entity has set aside in an escrow account, an amount that is adequate for the payment of principal and interest with a commitment to service the depositors on the due dates; or
3. the Rated Entity has stopped using the Credit Rating to mobilize further deposits and has informed depositors about the same and has given an explicit option to prematurely withdraw the deposits

The Credit Rating is placed on 'Notice of Withdrawal' for six months, before being withdrawn.

Merger / Winding up / Amalgamation of Rated Entities

Acuité shall withdraw a Credit Rating in case the Rated Entity is wound up or merged or amalgamated with another entity upon receiving a copy of the court order that the rated entity is wound up / amalgamated / merged with another entity.

Provisional Ratings

If the proposed structure considered at the time of rating the transaction, is significantly different from the actual issuance, or when the issuer fails to comply with the documentation requirements stipulated at the time of assigning the provisional rating, Acuité may withdraw the provisional rating. Provisional ratings may also be withdrawn when the issue is not placed subject to availability of necessary supporting documents to that effect.

At the time of withdrawal, Acuité shall issue a press release as per the format by SEBI. The Press Release shall also mention the reason(s) for withdrawal

Applicable in all instances of Rating Withdrawals notwithstanding the rated instrument / facility:

Acuite will seek updated business information, financial statements (Audited / Provisional as applicable) & any other information it considers important / critical and management interaction.

In case of non-cooperation by the rated entity with respect to the above requirements, the rating(s) may be suffixed with "Issuer Not Cooperating" and simultaneously withdrawn.

Policy on Internal Approvals

1. With respect BD activities - Discount Approval on Rating Fee (Initial Rating, Enhancement or Surveillance) will have to be approved as per internal Delegation of Authority document.
2. With respect to Analytical Operations and Processes - Any deviation from laid down policies will have to be approved by an official at the level of Chief Rating Officer. Such deviations should not be in contravention of prevailing SEBI regulations for CRAs.

Functioning of Rating Committee Composition, Process, Responsibilities & Evaluation

Definition of Rating Committee

Regulation 2(1)(r) of the Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 defines a rating committee as follows:

'Rating Committee' means a committee constituted by a credit rating agency to assign rating to a security.

As per Acuite's credit rating process, a 'Rating Committee' assigns the credit rating at a meeting after duly considering all information, analysis and views presented by the rating analyst through a 'Rating Note'.

Constitution

1. A rating committee will comprise five (05) members including the Chairperson. A list of members of the committees is given in Annexure I. The composition of the Rating Committee may change at any point of time at Acuite's discretion.
2. The quorum for the meeting will be three (03) members, including the Chairperson.
3. The Appeal Committee at Acuite comprises three (03) members including the Chairperson and will have a quorum of three (03) including the chairperson. The Chairperson of the Appeal Committee is an independent member and majority of the members on the Appeal Committee will comprise members who were not part of the original decision.

Qualification of Rating Committee Members

- Internal Committee members:
 - Educational qualification: CA/ CFA / MBA / MMS / PGDBA / Cost Accounting / CAIIB / FRM/ MA (Econ.)/ M. Com./ M. Sc./ Ph. D/ Post Doctorate
 - Experience: A minimum post-qualification professional experience of 5 years, including 2 years of experience in a Credit Rating Agency/ Banks/ NBFCs/ Mutual Fund / Credit Research Firm / Bi-lateral Government Agency
- External Committee members:
 - Educational qualification: CA/ CFA / MBA / MMS / PGDBA / Cost Accounting / CAIIB / FRM/ MA (Econ.)/ M. Com./ M. Sc./ Ph. D/ Post Doctorate
 - Experience: Ex-Bankers / Professionals with Rating Agency experience.

Duties & Responsibilities

The Rating Committee shall deliberate on the rating notes submitted, hear the presentation of the rating analyst on the case and then assign the rating in line with the rating criteria / methodology of Acuite and the internal policies governing rating, by way of majority opinion of the Rating Committee members.

General Guidelines

1. Rating committee members will maintain independence and ensure that they do not let business considerations, political views or personal biases impact the individual

rating decision. Fees paid by the client should not be disclosed to the rating committee members. Social status of the promoters/directors, the quantum of the debt programme should also not influence the rating decision.

2. Clients will not represent their case directly to the committee or individual committee members, except in case of an Appeal where a personal representation with the members of the Appeal Committee may be permitted on a specific written request by the issuer (subject to the extant 'Policy for Appeal').
3. Committee members will immediately report to the Compliance Officer of any attempt by intermediaries, brokers, clients or anyone else to influence the rating by any means that may compromise the unbiased nature of the rating.
4. Committee members will keep themselves aware and updated of the rating criteria and methodologies (and the changes therein) and act in accordance with the same.
5. Committee members will not provide any advance indication of the rating to anyone in any form; they will only take a collective decision through voting.
6. **System of Voting and recording of Dissent:**
 - o The rating committee decision will be based on the majority vote and in case of a tie, the chairperson will have the casting vote.
 - o Note of dissent, if any, by any member of the rating committee shall be taken on record.
7. Committee members will be bound by Acuité's internal Code of Conduct and Non-Disclosure Agreement (for external members) and shall always protect the confidentiality of information obtained from clients, internal analytical notes, discussions / deliberations.

8. Conflict of interest:

For a Rating Committee member, conflict of interest can arise under one or more of the following circumstances:

1. Investment in securities issued by the entity being rated (including self, spouse, children and dependents)
2. Business dealings OR any form of pecuniary relationship with the entity being rated (including self, spouse, children and dependents)
3. Directorship / Employment (whole-time or part-time) with the entity being rated (including self, spouse, children and dependents)

In case, there exists conflict of interest with reference to any case/s, forming part of the above agenda, the Rating Committee member(s) is/ are advised to recuse oneself from participating in the discussions and voting on the relevant case/s.

9. A designated officer will arrange the committees, set the agenda, circulate the agenda along with rating notes and coordinate logistics (make arrangements for voice/video conferencing, send intimation to members). The same officer will also note the minutes of the proceedings, record the ratings assigned, keep signed records of such minutes and send updates to concerned teams (Finance, Operations) on the ratings assigned. The responsibilities of the Rating Administration team will be to ensure smooth operation of the committees and adherence to the following:
 - o Generally, on 'T-1' issue notice of RCM along with the list of cases to be presented on Day 'T'. However, there could be exceptions where a rating action is required to be taken based on a material event OR conversion of a rating from "Provisional" to "Final" basis the legal vetting of documents / structure as originally envisaged at the time of assigning the "Provisional" rating. In such exceptional

- circumstances, RCM (Day 'T') may be convened at a short notice by issuing the notice of such RCM on the same day (Day 'T').
- Ensure dispatch of rating notes to the committee members prior to the committee meetings.
 - Maintain list of attendees of the rating committee
 - Announcing each case before it is presented.
 - Taking note of the committee's final rating decision on each case.
 - Taking notes and tracking action on clarifications sought/action points specified by the committee.
 - Maintaining approved minutes duly signed by the Chairperson of the rating committee meetings. The minutes shall contain the details as given in Annexure II.
 - Ensuring that each meeting is assigned a serial number for easy future reference.
 - Collecting rating notes back from individual members after the committee decision.
 - Ensuring that hard copies of exhibits and rating notes are appropriately and securely destroyed after the meeting.
10. Expert Opinion:
- Chairperson of the committee may invite expert opinion from Acuité's panel of experts, should the need arise.
 - Such experts will not have voting rights in the committee.
 - Expert panellists will also be bound by confidentiality agreement and prevention of conflict of interest obligations.
11. Any non-ratings member shall take prior approval from the Chief Rating Officer / Compliance Officer (or as per the approval authority prescribed by extant regulation) for attending the RCM in listen-only mode.
12. Committee members and analysts may join the meeting through video or voice conference facility.
13. The bridge telephone number for conference, if any, should be secure and the password/PIN should be changed periodically.
14. Members of Business Development Team or Support Team will not attend the committee meetings except for training purposes through voice conferencing in 'listen-only' mode, in which case prior approval should be sought from the Chief Rating Officer / Compliance Officer (or as per the approval authority prescribed by extant regulation).
15. The Chairperson of the Rating Committee shall be responsible for orderly conduct of meeting in line with these guidelines.
16. The Chairperson of each of the Rating Committees shall on an annual basis undertake a review of the decisions taken by their respective committees in that financial year which would inter alia include:
- Ratings assigned by the rating committee including ratings assigned based on best available information in cases of non-cooperation by the issuer / rated entity.
 - Sharp changes in ratings.
- The review report as above shall be placed before the Board of Directors of Acuité.

Professional Conduct

The members of the committee (including expert panellists) will maintain decorum and conduct themselves professionally. This implies that:

- Use of foul language, show of temper or display of power or position should be avoided.
- Mutual respect for each other irrespective of age, seniority and designation will have to be observed.
- The rating recommendation/decision taken by a committee member should not be quoted outside the committee.

Annexure I

LIST OF COMMITTEE MEMBERS AND GUIDELINES FOR ITS CONSTITUTION

RATING COMMITTEE MEMBER POOL
1. A J Bose
2. Aditya Gupta
3. Pooja Ghosh
4. Pradeep K Jain
5. Sardendu K Singh
6. Suman Chowdhury
7. Vasant G Kamath
8. Vinayak Nayak

APPEAL COMMITTEE MEMBERS POOL
1. Asit Pal
2. Sachin Mathur
3. V Chandrasekaran
4. Members from the RATING COMMITTEE MEMBER POOL

Annexure II

The minutes of the rating committee meetings shall contain the following:

A. Preliminary Information

- Date of the RCM
- Names of all the persons attending the RCM

- Name of rating committee members present (only rating committee members will have voting rights)
- Name of the Chairperson of the meeting
- Any other special invitees (if any)

B. Information Relating to Rating Decision

Following information/ details of each rating decision shall be captured:

- Name of the rated issuer/entity
- Rating exercise i.e. whether it's a fresh rating or review/ surveillance case
- Rating outcome i.e. rating assigned, along with rating outlook and special rating symbol, if any.
- Summary of key issues discussed during the rating committee.
- Note of Dissent (if any) by any RCM member

C. Authentication and Maintenance of Rating Committee Summary

- The summary of the RCM shall be approved/ signed by the Chairperson either manually or digitally.
- The approved/ signed summary shall be maintained either manually or electronically.

Guidelines on Minimum Information Required for the Rating

To complete a rating assignment and to conduct surveillance and reviews, the Organization undergoing the rating process has to furnish, proactively, all details about past performance and future plans of the Organization even that of confidential nature. By signing a rating agreement, the Organization agrees to ensure availability of such information on a continuous basis. Access to such information forms the basis of timely and appropriate rating action. Acuité reserves the right to conduct the rating exercise / review with publicly available information, if the minimum requirement of information is not made available to Acuité. The rated entity will have to furnish the following:

1. Annual Reports / Audited Financial Statements for last 3 years (or since inception, if entity is incorporated within last 3 years)
2. Provisional Financial Statements (Quarterly / Half-yearly)
3. 'No Default Statement' in prescribed format and details of any past default / delay in meeting the debt obligations
4. Bank statement(s) for the last 6 months for the cash credit account/s and the term loan account/s

In addition, entities to be rated have to submit the following (if applicable) as and when Acuité calls for the same:

1. Financial projections for the next two years with relevant assumptions and Year to Date financials of the current financial year
2. Latest sanction letter from the bank
3. Details on project / capital expenditure
4. Top customers/suppliers' details
5. Future business plan or corporate actions (acquisition, mergers, business restructuring etc.)
6. Change in management
7. Reason and comments on status of non-co-operation or suspension with any previous CRA (if applicable)
8. Project wise cash flow statements (applicable to real estate firms)

Acuité will seek information (Points 1 to 4 and 1 to 9 mentioned above) through one or more modes including e-mail, letters and telephone calls.

Guidelines on Seeking Information from External Entities

The following are the external entities with whom the Analyst needs to interact / seek information regarding the entity being rated.

1. Banker(s) to the rated entity
2. Statutory Auditors (Optional)
3. Debenture Trustees to the proposed or past issues of the rated entity

The major points to be covered during the interaction with:

1. Banker(s):
 - a. Repayment track record
 - b. General conduct of the account
 - c. Pending / Proposed Enhancements, if any
 - d. Any other issue relevant to the entity being rated
2. Statutory Auditors (Optional):
 - a. Changes to the accounting policy, if any
 - b. Adherence to the accepted norms
 - c. Related party transactions

The Analyst shall obtain the required information, preferably in writing. However, if written feedback is not forthcoming, the analyst shall maintain a record of the discussions containing the date of interaction, name of the person interacted with and the synopsis of the interaction.

3. Debenture Trustees (DTs) to the proposed or past issues of the rated entity - The analyst shall share with and obtain from the debenture trustees information as contained in SEBI circular No. CIR/MIRSD/3/2013 dated March 15, 2013.

Acuite reserves the right to seek feedback from vendors / suppliers, buyers and other investors/lenders, if considered necessary.

Roles and Responsibilities of Credit Rating Analyst

The Analyst shall always uphold Acuité' s policies and values and shall be responsible for the following:

1. Explain the analytical process and information requirement to the client
2. Interact with client for information, data and documents needed for rating
3. Meet/interact with management team/promoters of the client at periodic intervals
4. Oversee the data entry process whereby data (Financial/Non-financial) is uploaded on Acuité' s rating workflow/databases and ensure highest quality
5. Prepare the rating note containing rating recommendation in a time bound manner by following:
 - A. Highest ethical standards, independence and objectivity
 - B. Acuité' s policies
 - C. Acuité' s rating criteria
6. Present the rating note to the Rating Committee
7. Inform the rating/rating changes to the client
8. Follow up with client for Letter of Acceptance
9. Provide clarification to clients on rating, reasons thereof
10. Process requests for appeal/withdrawal etc. as per Acuité' s policies
11. Keep himself/herself always updated with prevailing regulatory guidelines, Acuité' s rating criteria and policies
12. Keep himself updated on economic and industry level factors that may influence rating movement
13. Conduct surveillance and review as per Acuité' s policies
14. Analysts shall be responsible for undertaking the rating process and adhering to the timelines as specified in the Operations Manual/ Internal governing document.

Senior analysts shall, in addition, be responsible for training new analysts.

Acuité Ratings Code of Conduct (Code) based on the fundamental principles laid down by IOSCO

Introduction

As a credit rating agency, Acuité Ratings & Research Limited. (Acuité) is committed to observe highest standards of integrity and fairness in all its dealings. Acuité' s mission is to provide high quality, objective, independent, impartial, professional and rigorous analytical information to the marketplace. Acuité is committed to continuously reviewing and monitoring its policies and procedures in light of the contemporary developments. This Code will be available to public without charge on Acuité' s website at www.acuite.in. However, Acuité does not assume any responsibility or liability to any party arising out of or relating to this Code except as specifically agreed to by Acuité in an Agreement signed by Acuité with that party.

This Code shall not form a part of any contract with any third party and no third party shall have any right (contractual or otherwise) to enforce any of this Code's provisions, either directly or indirectly. Acuité in its sole discretion may revise this Code to reflect changes in market, legal and regulatory circumstances and/ or changes in Acuité' s policies and procedures.

Acuité requires all its employees to comply with this Code and the related policies and procedures. Any exceptions to this Code or the related policies and procedures should be approved in writing by the CEO of Acuité who shall be responsible for interpretation of this Code and the related policies and procedures. Failure to comply with this Code and the related policies and procedures could be sufficient reason for disciplinary action, including dismissal from service and possible legal action.

A. QUALITY AND INTEGRITY OF THE CREDIT RATING PROCESS

1. Quality of the Credit Rating Process

- i. Acuité would establish, maintain, document, and enforce a credit rating methodology for each class of entity or obligation for which Acuité issues credit ratings. Each credit rating methodology would be rigorous, capable of being applied consistently, and, where possible, result in credit ratings that can be subjected to some form of objective validation based on historical experience.
- ii. Acuité' s ratings would reflect all information known and believed to be relevant to Acuité, consistent with the applicable credit rating methodology that is in effect. Therefore, Acuité would establish, maintain, document, and enforce policies, procedures, and controls to ensure that the credit ratings and related reports it disseminates are based on a thorough analysis of all such information.
- iii. Acuité would adopt reasonable measures designed to ensure that it has the appropriate knowledge and expertise, and that the information it uses in determining credit ratings is of sufficient quality and obtained from reliable sources to support a high-quality credit rating.
- iv. Acuité would avoid issuing credit ratings for entities or obligations for which it does not have appropriate information, knowledge, and expertise. For example, where the complexity of a security or the structure of a type of security, or the lack of

robust data about the assets underlying the security raise serious questions as to whether Acuité can determine a high-quality credit rating for the security, Acuité would refrain from issuing a credit rating.

- v. In assessing creditworthiness, analysts involved in the credit rating action should use the credit rating methodology established by Acuité for the type of entity or obligation that is subject to the credit rating action. The credit rating methodology should be applied in a manner that is consistent across all entities or obligations for which that methodology is used.
- vi. Acuité would define the meaning of each category in its rating scales and apply those categories consistently across all classes of rated entities and obligations to which a given rating scale applies.
- vii. Credit ratings would be assigned by Acuité as an entity (not by an analyst or other employee of Acuité).
- viii. Acuité would assign analysts who, individually or collectively (particularly where credit rating committees are used), have appropriate knowledge and experience for assessing the creditworthiness of the type of entity or obligation being rated.
- ix. Acuité would maintain internal records that are accurate and sufficiently detailed and comprehensive to reconstruct the credit rating process for a given credit rating action. The records would be retained for as long as necessary to promote the integrity of Acuité's credit rating process, including to permit internal audit, compliance, and quality control functions to review past credit rating actions in order to carry out the responsibilities of those functions. Further, Acuité would establish, maintain, document, and enforce policies, procedures, and controls designed to ensure that its employees comply with Acuité's internal record maintenance, retention, and disposition requirements and with applicable laws and regulations governing the maintenance, retention, and disposition of Acuité records
- x. Acuité would establish, maintain, document, and enforce policies, procedures, and controls designed to avoid issuing credit ratings, analyses, or reports that contain misrepresentations or are otherwise misleading as to the general creditworthiness of a rated entity or obligation.
- xi. Acuité would ensure that it has and devotes sufficient resources to carry out and maintain high quality credit ratings.

When deciding whether to issue a credit rating for an entity or obligation, Acuité would assess whether it is able to devote a sufficient number of analysts with the skill sets to determine high quality credit ratings, and whether the analysts will have access to sufficient information in order to determine a high-quality credit rating.

- xii. Acuité would establish and maintain a review function made up of one or more senior managers with appropriate experience to review the feasibility of providing a credit rating for a type of entity or obligation that is materially different from the entities or obligations Acuité currently rates.

Acuité would establish and maintain a review function made up of one or more senior managers responsible for conducting a rigorous, formal, and periodic review, on a regular basis pursuant to an established timeframe, of all aspects of Acuité's credit rating methodologies (including models and key assumptions) and significant changes to the credit rating methodologies.

Where feasible and appropriate for the size and scope of its credit rating business, this function would be independent of the employees who are principally responsible for determining credit ratings.

- xiii. Acuité, in selecting the analyst or analysts who will participate in determining a credit rating, would seek to promote continuity and also to avoid bias in the credit rating process. For example, in seeking to balance the objectives of continuity and bias avoidance, Acuité could assign a team of analysts to participate in determining the credit rating - some for whom the rated entity or obligation is within their area of primary analytical responsibility and some of whom have other areas of primary analytical responsibility.
- xiv. Acuité would ensure that sufficient employees and financial resources are allocated to monitoring and updating all its credit ratings. Except for a credit rating that clearly indicates that it does not entail on-going surveillance, once a credit rating is published, Acuité would monitor the credit rating on an on-going basis by:
 - a. reviewing the creditworthiness of the rated entity or obligation regularly;
 - b. initiating a review of the status of the credit rating upon becoming aware of any information that might reasonably be expected to result in a credit rating action (including withdrawal of a credit rating), consistent with the applicable credit rating methodology;
 - c. reviewing the impact of and applying a change in the credit rating methodologies, models or key rating assumptions on the relevant credit ratings within a reasonable period of time;
 - d. updating on a timely basis the credit rating, as appropriate, based on the results of such review; and
 - e. incorporating all cumulative experience obtained.
- xv. If Acuité uses separate analytical teams for determining initial credit ratings and for subsequent monitoring of existing credit ratings, each team would have the requisite level of expertise and resources to perform their respective functions in a timely manner.
- xvi. Acuité would establish, maintain, document, and enforce policies and procedures that clearly set forth guidelines for disseminating credit ratings that are the result or subject of credit rating actions and the related reports, and for when a credit rating will be withdrawn.

2. Integrity of the Credit Rating Process

- i. Acuité and its employees would deal fairly honestly with rated entities, obligors, originators, underwriters, arrangers, and users of credit ratings.
- ii. Acuité's employees would be held to the highest standards of integrity and ethical behaviour, and Acuité would have policies and procedures in place that are designed to ensure that individuals with demonstrably compromised integrity are not employed.
- iii. Acuité and its employees would not, either implicitly or explicitly, give any assurance or guarantee to an entity subject to a rating action, obligor, originator, underwriter, arranger, or user of Acuité's credit ratings about the outcome of a particular credit rating action. This does not preclude Acuité from developing preliminary indications in a manner that is consistent with Section Nos. A 2(v) and B 2(i)(d) (below) of Acuité's Code under IOSCO.
- iv. Acuité and its employees would not make promises or threats about potential credit rating actions to influence rated entities, obligors, originators, underwriters, arrangers, or users of Acuité's credit ratings to pay for credit ratings or other services.

- v. Acuité and its employees would not make proposals or recommendations regarding the activities of rated entities or obligors that could impact a credit rating of the rated entity or obligation, including but not limited to proposals or recommendations about corporate or legal structure, assets and liabilities, business operations, investment plans, lines of financing, business combinations, and the design of structured finance products.
- vi. In each jurisdiction in which Acuité operates, Acuité would establish, maintain, document, and enforce policies, procedures, and controls designed to ensure that Acuité and its employees comply with Acuité's code of conduct and applicable laws and regulations.
 - a. Acuité would establish a compliance function responsible for monitoring and reviewing the compliance of Acuité and its employees with the provisions of Acuité's code of conduct and with applicable laws and regulations
 - b. The compliance function would also be responsible for reviewing the adequacy of Acuité's policies, procedures, and controls designed to ensure compliance with Acuité's code of conduct and applicable laws and regulations.
 - c. Acuité would assign a senior level employee with the requisite skill set to serve as Acuité's compliance officer in charge of the compliance function. The compliance officer's reporting lines and compensation would be independent of Acuité's credit rating operations.
 - d. Any employee of Acuité upon becoming aware that another employee or an affiliate of Acuité is or has engaged in conduct that is illegal, unethical, or contrary to Acuité's code of conduct, shall report such information immediately to the compliance officer or another officer of Acuité, as appropriate, so that proper action may be taken. The concerned Acuité's employees are not necessarily expected to be experts in the law. Nonetheless, Acuité employees are expected to report activities that a reasonable person would question. Upon receiving such a report from an employee, Acuité would be obligated to take appropriate action, as determined by the laws and regulations of the jurisdiction and the policies, procedures, and controls established, maintained, documented, and enforced by Acuité. Acuité would prohibit retaliation by Acuité or an employee against any employees who, in good faith, make such reports.

B. ACUITÉ'S INDEPENDENCE AND AVOIDANCE OF CONFLICTS OF INTEREST

1. General

- 1. Acuité would not delay or refrain from taking a credit rating action based on the potential effect (economic, political, or otherwise) of the action on Acuité, a rated entity, obligor, originator, underwriter, arranger, investor, or other market participant.
- 2. Acuité and its employees would use care and professional judgment to maintain both the substance and appearance of Acuité's and its employees' independence and objectivity.
- 3. Acuité's determination of a credit rating would be influenced only by factors relevant to assessing the creditworthiness of the rated entity or obligation.
- 4. The credit rating Acuité assigns to an entity or obligation would not be affected by whether there is an existing or potential business relationship between Acuité (or

its affiliates) and the rated entity, obligor, originator, underwriter, or arranger (or any of their affiliates), or any other party.

5. Acuité would operationally, legally, and if practicable, physically separate its credit rating business and its analysts from any other businesses of Acuité that may present a conflict of interest. For other businesses that do not necessarily present a conflict of interest, Acuité would establish, maintain, document, and enforce policies, procedures, and controls designed to minimize the likelihood that conflicts of interest will arise.

2. Acuité' s Policies, Procedures, Controls and Disclosures

- i. Acuité would establish, maintain, document, and enforce policies, procedures, and controls to identify and eliminate, or manage and disclose, as appropriate, any actual or potential conflicts of interest that may influence the credit rating methodologies, credit rating actions, or analyses of Acuité or the judgment and analyses of the Acuité' s employees. Among other things, the policies, procedures, and controls would address (as applicable to the Acuité' s business model) how the following conflicts can potentially influence Acuité' s credit rating methodologies or credit rating actions:
 - a. being paid to issue a credit rating by the rated entity or by the obligor, originator, underwriter, or arranger of the rated obligation;
 - b. being paid by subscribers with a financial interest that could be affected by a credit rating action of Acuité;
 - c. being paid by rated entities, obligors, originators, underwriters, arrangers, or subscribers for services other than issuing credit ratings or providing access to Acuité' s credit ratings;
 - d. providing a preliminary indication or similar indication of credit quality to an entity, obligor, originator, underwriter, or arranger prior to being hired to determine the final credit rating for the entity, obligor, originator, underwriter, or arranger; and
 - e. having a direct or indirect ownership interest in a rated entity or obligor, or having a rated entity or obligor have a direct or indirect ownership interest in the Acuité.
- ii. Acuité would disclose actual and potential conflicts of interest (including, but not limited to, those conflicts of interest identified in Section B 2(i) (above) in a complete, timely, clear, concise, specific, and prominent manner. When the actual or potential conflict of interest is unique or specific to a credit rating action with respect to a particular rated entity, obligor, originator, lead underwriter, arranger, or obligation, such conflict of interest would be disclosed in the same form and through the same means as the relevant credit rating action.
- iii. Acuité would disclose the general nature of its compensation arrangements with rated entities, obligors, lead underwriters, or arrangers.
 - a. When Acuité receives from a rated entity, obligor, originator, lead underwriter, or arranger compensation unrelated to its credit rating services, Acuité would disclose such unrelated compensation as a percentage of total annual compensation received from such rated entity, obligor, lead underwriter, or arranger in the relevant credit rating report or elsewhere, as appropriate.
 - b. Acuité would disclose in the relevant credit rating report or elsewhere, as appropriate, if it receives 10 percent or more of its annual revenue from a single

- client (e.g., a rated entity, obligor, originator, lead underwriter, arranger, or subscriber, or any of their affiliates).
- iv. Acuité would disclose in its credit rating announcement whether the issuer of a structured finance product has informed Acuité that it is publicly disclosing all relevant information about the obligation being rated or if the information remains non - public.
 - v. Acuité would not hold or transact in trading instruments presenting a conflict of interest with Acuité's credit rating activities.
 - vi. In instances where rated entities or obligors (e.g., sovereign nations or states) have, or are simultaneously pursuing, oversight functions related to Acuité, the employees responsible for interacting with the officials of the rated entity or the obligor (e.g., government regulators) regarding supervisory matters would be separate from the employees that participate in taking credit rating actions or developing or modifying credit rating methodologies that apply to such rated entity or obligor.

3. Independence of the Employees of Acuité

- i. Reporting lines for Acuité's employees and their compensation arrangements would be structured with a view to eliminating or effectively managing actual and potential conflicts of interest
 - a. Acuité's employee who participates in or who might otherwise have an effect on a credit rating action with respect to an entity or obligation would not be compensated or evaluated on the basis of the amount of revenue that Acuité would derive from that entity or obligor.
 - b. Acuité would conduct formal and periodic reviews of its compensation policies, procedures, and practices for Acuité's employees who participate in or who might otherwise have an effect on a credit rating action to ensure that these policies, procedures, and practices have not compromised and do not compromise the objectivity of Acuité's credit rating process.
- ii. Acuité's employees who participate in or who might otherwise have an effect on a credit rating action would not initiate or participate in discussions with rated entities, obligors, arrangers, or subscribers regarding fees or payments charged to such rated entity, obligor, arranger, or subscriber.
- iii. Acuité's employee would not participate in or otherwise influence an Acuité's credit rating action with respect to an entity or obligation if the employee, an immediate family member of the employee (e.g., spouse, domestic partner, or dependent), or an entity managed by the employee (e.g., a trust)
 - a. holds or transacts in a trading instrument issued by the rated entity or obligor;
 - b. holds or transacts in a trading instrument (other than a diversified collective investment scheme **like a Mutual Fund Scheme**) that itself owns an interest in the rated entity or obligor, or is a derivative based on a trading instrument issued by the rated entity or obligor;
 - c. holds or transacts in a trading instrument issued by an affiliate of the rated entity or obligor, the ownership of which may cause or may be perceived as causing a conflict of interest with respect to the employee or Acuité;
 - d. holds or transacts in a trading instrument issued by a lead underwriter or arranger of the rated obligation, the ownership of which may cause or may be

- perceived as causing a conflict of interest with respect to the employee of Acuité;
- e. is currently employed by, or had a recent employment or other significant business relationship with the rated entity or obligor or a lead underwriter or arranger of the rated obligation that may cause or may be perceived as causing a conflict of interest;
 - f. is a director of the rated entity or obligor, or lead underwriter or arranger of the rated obligation; or
 - g. has or had, another relationship with or interest in the rated entity, obligor, or the lead underwriter or arranger of the rated obligation (or any of their affiliates) that may cause or may be perceived as causing a conflict of interest.
- iv. Acuité's analyst would not hold or transact in a trading instrument issued by a rated entity or obligor in the analyst's area of primary analytical responsibility. This would not preclude an analyst from holding or trading a diversified collective investment scheme (like Mutual Funds Scheme) that owns a trading instrument issued by a rated entity or obligor in the analyst's area of primary analytical responsibility.
 - v. Acuité's employee would be prohibited from soliciting money, gifts, or favours from anyone with whom Acuité does business and would be prohibited from accepting gifts offered in the form of cash or cash equivalents or any gifts exceeding a minimal monetary value.
 - vi. Acuité's employee who becomes involved in a personal relationship (including, for example, a personal relationship with an employee of a rated entity, obligor, or originator, or the lead underwriter or arranger of a rated obligation) that creates an actual or potential conflict of interest would be required under Acuité's policies, procedures, and controls to disclose the relationship to the compliance officer or another officer of Acuité, as appropriate.
 - vii. Acuité would establish, maintain, document, and enforce policies, procedures, and controls for reviewing without unnecessary delay the past work of an analyst who leaves the employ of Acuité and joins an entity that the employee participated in rating, an obligor whose obligation the employee participated in rating, an originator, underwriter, or arranger with which the employee had significant dealings as part of his or her duties at Acuité, or any of its affiliates.

C. ACUITÉ'S RESPONSIBILITIES TO THE INVESTING PUBLIC, RATED ENTITIES, OBLIGORS, ORIGINATORS, UNDERWRITERS, AND ARRANGER

1. Transparency and Timeliness of Credit Ratings Disclosure

- i. Acuité would assist investors and other users of credit ratings in developing a greater understanding of credit ratings by disclosing in plain language, among other things, the nature and limitations of credit ratings and the risks of unduly relying on them to make investment or other financial decisions. Acuité would not state or imply that SEBI/ RBI endorses its credit ratings or use its registration status to advertise the quality of its credit ratings.
- ii. Acuité would disclose sufficient information about its credit rating process and its credit rating methodologies, so that investors and other users of credit ratings can understand how a credit rating was determined by Acuité.

- iii. Acuité would disclose a material modification to a credit rating methodology prior to the modification taking effect unless doing so would negatively impact the integrity of a credit rating by unduly delaying the taking of a credit rating action. In either case, Acuité would disclose the material modification in a non-selective manner.
- iv. Acuité would disclose its policies and procedures that address the issuance of unsolicited credit ratings.
- v. Acuité would disclose its policies and procedures for distributing credit ratings and reports, and when a credit rating would be withdrawn.
- vi. Acuité would disclose clear definitions of the meaning of each category in its rating scales, including the definition of default.
- vii. Acuité would differentiate credit ratings of structured finance products from credit ratings of other types of entities or obligations, preferably through a different credit rating identifier. Acuité would also disclose how this differentiation functions.
- viii. Acuité would be transparent with investors, rated entities, obligors, originators, underwriters, and arrangers about how the relevant entity or obligation is rated.
- ix. Where feasible and appropriate, Acuité would inform the rated entity, or the obligor or arranger of the rated obligation about the critical information and principal considerations upon which a credit rating would be based prior to disseminating a credit rating that is the result or subject of the credit rating action and afford such rated entity, obligor, or arranger an adequate opportunity to clarify any factual errors, factual omissions, or factual misperceptions that would have a material effect on the credit rating. Acuité would duly evaluate any response from such rated entity, obligor, or arranger. Where in particular circumstances Acuité has not informed such rated entity, obligor, or arranger prior to disseminating a credit rating action, Acuité would inform such rated entity, obligor, or arranger as soon as practical thereafter and, generally, would explain why Acuité did not inform such rated entity, obligor, or arranger prior to disseminating the credit rating action.
- x. When Acuité publicly discloses or distributes to its subscribers (depending on the Acuité's business model) a credit rating that is the result or subject of the credit rating action, it would do so as soon as practicable after taking such action.
- xi. When Acuité publicly discloses or distributes to its subscribers (depending on Acuité's business model) a credit rating that is the result or subject of a credit rating action, it would do so on a non-selective basis.
- xii. Acuité would disclose with a credit rating that is the result or subject of a credit rating action whether the rated entity, obligor, or originator, or the underwriter or arranger of the rated obligation participated in the credit rating process, if such a practice is followed by Acuité. Each credit rating not initiated at the request of the rated entity, obligor, or originator, or the underwriter or arranger of the rated obligation would be identified as such.
- xiii. Acuité would clearly indicate the attributes and limitations of each credit rating, and the extent to which Acuité verifies information provided to it by the rated entity, obligor, or originator, or the underwriter or arranger of the rated obligation. For example, if the credit rating involves a type of entity or obligation for which there is limited historical data, Acuité would disclose this fact and how it may limit the credit rating.
- xiv. Acuité would indicate in the announcement of a credit rating that is the result or the subject of a credit rating action when the credit rating was last updated or reviewed.

The credit rating announcement would also indicate the principal credit rating methodology that was used in determining the credit rating and where a description of that credit rating methodology can be found. Acuité would explain this fact in the credit rating announcement and indicate where to find a discussion of how the different credit rating methodologies and other important aspects factored into the credit rating decision.

- xv. When rating a structured finance product, at its sole discretion, Acuité would publicly disclose or distribute to its subscribers (depending on Acuité's business model) sufficient information about its loss and cash-flow analysis with the credit rating, so that investors in the product, other users of credit ratings, and/or subscribers can understand the basis for Acuité's credit rating. Acuité would also publicly disclose or distribute information about the degree to which it analyzes how sensitive a credit rating of a structured finance product is to changes in the assumptions underlying the applicable credit rating methodology.
- xvi. When issuing or revising a credit rating, Acuité would explain in its announcement and/or report the key assumptions and data underlying the credit rating, including financial statement adjustments that deviate materially from those contained in the published financial statements of the relevant rated entity or obligor.
- xvii. If Acuité discontinues monitoring a credit rating for a rated entity or obligation it would either withdraw the credit rating or disclose such discontinuation to the public or to its subscribers (depending on Acuité's business model) as soon as practicable. A publication by Acuité of a credit rating that is no longer being monitored would indicate the date the credit rating was last updated or reviewed, the reason the credit rating is no longer monitored, and the fact that the credit rating is no longer being updated.
- xviii. To promote transparency and to enable investors and other users of credit ratings to compare the performance of different CRAs, Acuité would disclose sufficient information about the historical transition and default rates of its credit rating categories with respect to the classes of entities and obligations it rates. This information would include verifiable, quantifiable historical information, organized over a period of time, and, where possible, standardized in such a way to assist investors and other users of credit ratings in comparing different CRAs. If the nature of the rated entity or obligation or other circumstances make such historical transition or default rates inappropriate, statistically invalid, or otherwise likely to mislead investors or other users of credit ratings, Acuité would disclose why this is the case.

2. The Treatment of Confidential Information

- i. Acuité would establish, maintain, document, and enforce policies, procedures, and controls to protect confidential and/or material non-public information, including confidential information received from a rated entity, obligor, or originator, or the underwriter or arranger of a rated obligation, and non-public information about a credit rating action (e.g., information about a credit rating action before the credit rating is publicly disclosed or disseminated to subscribers).
 - a. The policies, procedures, and controls would prohibit Acuité and its employees from using or disclosing confidential and/or material non-public information for any purpose unrelated to Acuité's credit rating activities, including disclosing such information to other employees where the disclosure is not necessary in

- connection with Acuité's credit rating activities, unless disclosure is required by applicable law or regulation.
- b. The policies, procedures, and controls would require Acuité and its employees to take reasonable steps to protect confidential and/or material non-public information from fraud, theft, misuse, or inadvertent disclosure.
 - c. With respect to confidential information received from a rated entity, obligor, originator, underwriter, or arranger, the policies, procedures, and controls would prohibit Acuité and its employees from using or disclosing such information in violation of the terms of any applicable agreement or mutual understanding that Acuité will keep the information confidential, unless disclosure is required by applicable law or regulation.
 - d. With respect to a pending credit rating action, the policies, procedures, and controls would prohibit Acuité and its employees from selectively disclosing information about the pending credit rating action, except to the rated entity, obligor, arranger, or their designated agents, or as required by applicable law or regulation.
- ii. Acuité would establish, maintain, document, and enforce policies, procedures, and controls designed to prevent violations of applicable laws and regulations governing the treatment and use of confidential and/or material non-public information.
 - iii. Acuité would establish, maintain, document, and enforce policies, procedures, and controls that prohibit employees that possess confidential and/or material non-public information concerning a trading instrument from engaging in a transaction in the trading instrument or using the information to advise or otherwise advantage another person in transacting in the trading instrument.

D. GOVERNANCE, RISK MANAGEMENT, AND EMPLOYEE TRAINING

- i. Acuité's Board of Directors (or similar body) would have ultimate responsibility for ensuring that Acuité establishes, maintains, documents, and enforces a code of conduct that gives full effect to the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies.
- ii. Acuité would establish a risk management function made up of one or more senior managers or employees with the appropriate level of experience responsible for identifying, assessing, monitoring, and reporting the risks arising from its activities, including, but not limited to legal risk, reputational risk, operational risk, and strategic risk. The function would be independent of the internal audit function (if practicable given Acuité's size) and at the sole discretion of Acuité make periodic reports to the Board of Directors (or similar body) and senior management to assist them in assessing the adequacy of the policies, procedures, and controls Acuité establishes, maintains, documents, and enforces to manage risk, including the policies, procedures, and controls specified in the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies.
- iii. Acuité would establish, maintain, document, and enforce policies, procedures, and controls requiring employees to undergo formal on-going training at reasonably regular time intervals. The subject matter covered by the training should be relevant to the employee's responsibilities and should cover, as applicable, Acuité's code of conduct, Acuité's credit rating methodologies, the laws governing Acuité's credit rating activities, Acuité's policies, procedures, and controls for managing conflicts of interest

and governing the holding and transacting in trading instruments, and Acuité's policies and procedures for handling confidential and/or material non-public information. The policies, procedures, and controls would include measures designed to verify that employees undergo required training.

E. DISCLOSURE AND COMMUNICATION WITH MARKET PARTICIPANTS

- i. Acuité's disclosures, including those specified in the provisions of the IOSCO CRA Code, would be complete, fair, accurate, timely, and understandable to investors and other users of credit ratings.
- ii. Acuité would disclose with its code of conduct a description of how the provisions of its code of conduct fully implement the provisions of the IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies and the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies (collectively, the "IOSCO provisions"). If Acuité's code of conduct deviates from an IOSCO provision, Acuité would identify the relevant IOSCO provision, explain the reason for the deviation, and explain how the deviation nonetheless achieves the objectives contained in the IOSCO provisions. Acuité would describe how it implements and enforces its code of conduct. Acuité also would disclose as soon as practicable any changes to its code of conduct or changes as to how it is being implemented or enforced.
- iii. Acuité would establish and maintain a function within its organization charged with receiving, retaining, and handling complaints from market participants and the public. The function would establish, maintain, document, and enforce policies, procedures, and controls for receiving, retaining, and handling complaints, including those that are provided on a confidential basis. The policies, procedures, and controls would specify the circumstances under which a complaint must be reported to senior management and/or the Board of Directors (or similar body).
- iv. Acuité would publicly and prominently disclose free of charge on its primary website:
 - a. Acuité's code of conduct;
 - b. a description of Acuité's credit rating methodologies;
 - c. information about Acuité's historic performance data; and
 - d. any other disclosures specified in the provisions of the IOSCO CRA Code as applicable given Acuité's business model.

F. DEVIATIONS WITH IOSCO CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES

Acuité's Code of Conduct is generally aligned with the Code of Conduct Fundamentals for Credit Rating Agencies issued by the Technical Committee of the International Organization of Securities Commissions with the exception of the following areas where there is a deviation with the provisions of the IOSCO Code:

1. **Operational and legal separation between ratings and other businesses:**
Acuité provides shared human resources, technology, finance and legal services across all its businesses. However, Acuité has also ensured that there are proper firewalls in place to prevent any conflict of interest, arising out of such sharing.

Acuité Code of Conduct in compliance with the SEBI (Credit Rating Agencies) Regulations, 1999

As a credit rating agency, Acuité Ratings & Research Limited. (Acuité) is committed to observe highest standards of integrity and fairness in all its dealings. Acuité' s mission is to provide high quality, objective, independent, impartial, professional and rigorous analytical information to the marketplace. Acuité is committed to continuously reviewing and monitoring its policies and procedures in light of the contemporary developments. This Code will be available to public without charge on Acuité' s website at www.acuite.in. However, Acuité does not assume any responsibility or liability to any third party arising out of or relating to this Code.

This Code shall not form a part of any contract with any third party and no third party shall have any right (contractual or otherwise) to enforce any of this Code's provisions, either directly or indirectly. Acuité in its sole discretion may revise this Code to reflect changes in market, legal and regulatory circumstances and/or changes in Acuité's policies and procedures.

Acuité requires all its employees to comply with this Code and the related policies and procedures. The CEO of Acuité shall be responsible for interpretation of this Code and the related policies and procedures. Failure to comply with this Code and the related policies and procedures shall be sufficient reason for disciplinary action, including dismissal from service and possible legal action.

In the conduct of its business, Acuité and/ or its employees shall:

- make all efforts to protect the interests of investors.
- observe high standards of integrity, dignity and fairness in the conduct of its business.
- fulfil its obligations in a prompt, ethical and professional manner.
- at all times exercise due diligence, ensure proper care and exercise independent professional judgment in order to achieve and maintain objectivity and independence in the rating process.
- have a reasonable and adequate basis for performing rating evaluations, with the support of appropriate and in-depth rating researches and maintain records to support its decisions.
- have in place a rating process that reflects consistent and international rating standards.
- not indulge in any unfair competition nor shall it wean away the clients of any other rating agency on assurance of a higher rating.
- keep track of all-important changes relating to the client companies and develop efficient and responsive systems to yield timely and objective ratings.
- monitor closely all relevant factors that might affect the credit worthiness of the issuers.
- disclose its rating methodology to clients, users and the public.
- wherever necessary, disclose to the clients, possible sources of conflict of duties and interests, which could impair its ability to make fair, objective and unbiased ratings.
- ensure that no conflict of interest exists between any member of its rating committee participating in the rating analysis, and that of its client.

- not make any exaggerated statement, whether oral or written, to the client either about its qualification or its capability to render certain services or its achievements with regard to the services rendered to other clients.
- not make any untrue statement, suppress any material fact or make any misrepresentation in any documents, reports, papers or information furnished to the Securities and Exchange Board of India ("Board"), stock exchange or public at large.
- ensure that the Board is promptly informed about any action, legal proceedings etc., initiated against it alleging any material breach or non-compliance by it, of any law, rules, regulations and directions of the Board or of any other regulatory body.
- maintain an appropriate level of knowledge and competence and abide by the provisions of the Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 ("Act"), regulations and circulars, which may be applicable and relevant to the activities carried on by the credit rating agency.
- comply with award of the Ombudsman passed under the Securities and Exchange Board of India (Ombudsman) Regulations, 2003.
- ensure that there is no misuse of any privileged information including prior knowledge of rating decisions or changes.
- not render, directly or indirectly any investment advice about any security in the publicly accessible media.
- not offer fee-based services to the rated entities, beyond credit ratings and research.
- ensure that any change in registration status/ any penal action taken by Board or any material change in financials which may adversely affect the interests of clients/investors is promptly informed to the clients and any business remaining outstanding is transferred to another registered person in accordance with any instructions of the affected clients/investors.
- maintain an arm's length relationship between its credit rating activity and any other activity.
- develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in the carrying out of their duties within the credit rating agency and as a part of the industry. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interests, disclosure of shareholdings and interests, etc. Such a code shall also provide for procedures and guidelines in relation to the establishment and conduct of rating committees and duties of the officers and employees serving on such committees.
- provide adequate freedom and powers to its compliance officer for the effective discharge of his duties.
- ensure that the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.
- ensure that good corporate policies and corporate governance are in place.
- not, generally and particularly in respect of issue of securities rated by it, be party to or instrumental for:
 - (a) creation of false market;
 - (b) price rigging or manipulation; or
 - (c) dissemination of any unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange, unless required, as part of rationale for the rating accorded.

Guidelines on debt servicing confirmations pertaining to unlisted debt instruments (Retail Debentures / Retail Deposits)

Acuite does not seek date-wise debt servicing confirmations for unlisted debt instruments (including but not limited to retail debentures and retail deposits) that it rates which do not fall under the purview of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 and Securities and Exchange Board of India (Issue and Listing of Debt Securities) Regulations, 2008. Notwithstanding the above, Acuite seeks 'No Default Statement' on a monthly basis from all issuers with outstanding ratings.

Guidelines on Key Financial Indicators in case of non-cooperation by the issuer (unlisted entity)

In cases of non-cooperation by issuers that are unlisted, where despite best efforts, issuers do not share financial statements / information, Acuite will rely on reliable sources to gather financial information. In cases, where Acuite is unable to gather financial information on such entities, Acuite will not publish the Key Financial Indicators in the press release (Rating Rationale).

Guidelines on interaction with Audit Committee of entities with listed NCDs

SEBI vide its Circular SEBI/HO/MIRSD/CRADT/CIR/P/2019/121 dated November 04, 2019 has made mandatory an interaction with the Audit Committee of the rated entity at least once a year on specific matters that may have a bearing on the rating of the listed NCDs. The matters to be discussed include related party transactions, internal financial control and other material disclosures made by the management of the rated entity with listed NCDs.

Given the logistical challenges of getting a common time from different members of the Audit Committee of the Board, Acuite will seek an interaction with the Chairperson of the Audit Committee of the Board. In an exceptional circumstance where the Chairperson is not available, the meeting or call may be conducted with another independent director in the Audit Committee.

The mode of such interaction with the Chairperson of the Audit Committee could include an in-person meeting OR video-conferencing OR telephonic interaction.

Guidelines for assigning non-‘D’ rating to entities with an outstanding ‘D’ rating by other credit rating agencies

Acuité Ratings adheres to SEBI guidelines for recognition of default in servicing of debt instruments. Nevertheless, there could be scenarios under which a non-‘D’ rating may be assigned by Acuité to some loans / debt facilities that carry an outstanding rating of ‘D’ from another credit rating agency (CRA):

- The outstanding rating of another CRA is in the "Issuer Not Co-operative" (INC) category, implying the rating is not updated for the latest business, financial and liquidity position. Therefore, there is a possibility that the credit profile of the entity along with its liquidity position has changed significantly.
- Even if the outstanding rating of ‘D’ from another CRA is not in the INC category, there is a likelihood that the past default has been cured and the client may be servicing debt in a timely manner for a considerable period extending from a few months to over a year.

Acuité follows its standardised mechanism to ascertain the liquidity position of an entity which involves analysing information on bank limit utilization, bank statements (to the extent available) and seeking banker feedback apart from a mandatory declaration from the client on its debt servicing status (No default statement-NDS).

In case of an existing ‘D’ rating from other CRAs, validation and checks are carried out to establish issuer’s clean track record of timely debt servicing for a consecutive period of 3 months. The minimum requirement for ascertaining the liquidity position of the entity in such cases include:

- Bank statements for the last 6 months (mandatory)
- Compulsory lender feedback covering all bank borrowings
- No Default Statement for the last 3 months

Generally, Acuité assigns a non-D rating, (but within the sub-investment grade) when it is confirmed that there has been no default in its debt servicing in the last 3 months. For assigning an investment grade rating, generally a curing period of 1 year is observed. However, Acuité may deviate from the above timelines in case of certain situations as outlined in the curing period section of default recognition criteria under extant regulatory guidelines.

Frequently Asked Questions: Credit Rating

- What is Credit Rating?

A credit rating is an independent, unbiased and objective opinion on future debt repayment ability and willingness of a borrower with respect to a debt instrument. In other words, a credit rating is a measure of risk of default in making timely repayment of principal and interest by a borrower for a particular debt instrument.

- What is the validity period of a credit rating?

Once the rating is accepted, it would be under surveillance over the tenure of the instrument. The rating is kept updated as required, through the surveillance process. Such ratings will be made public through Acuite's website www.acuite.in if the rating is available on the website it means that the rating is valid until it is changed.

- What are Structured Obligations (SO) ratings?

Structured Obligations (SO) ratings are ratings assigned to instruments that involve some mechanism for credit enhancement and/or structured payment mechanism to support the debt obligations of the issuer. Such ratings carry the suffix "SO".

- What is meant by the suffix 'CE' and when it is applicable?

CE stands for Credit Enhancement. The suffix 'CE' is used where the rating assigned to a debt / borrowing programme is supported by an Explicit Credit Enhancement mechanism. The suffix CE has been introduced by SEBI to help investors and lenders distinguish ratings from those based on a Structure Obligation that carry the suffix 'SO' (Please refer What are Structured Obligation (SO) Ratings? above).

All ratings where the credit enhancement is external (or from third party), but the rated instrument is not bankruptcy remote of the issuer/ originator, will carry the 'CE' suffix.

Some examples where the suffix 'CE' will apply include, Partially / Fully guaranteed bond/loan, Shortfall undertaking backed bond/ loan or other such third-party credit enhancement, Debt backed by pledge of shares or other assets, Debt backed by Payment Waterfall /Escrow, DSRA etc., but with Full Guarantee or DSRA Replenishment Guarantee from a third party, Standby Letter of Credit backed Commercial Paper or other instruments/ facilities, Letter of comfort etc.

- How does a Credit Rating help an investor?

A credit rating provides the investor with an independent and unbiased opinion and understanding of the credit risk in a particular debt instrument or a bank loan. Understanding credit risk is important for the investor to take an informed decision before

investment/lending and to determine the 'pricing' of such instruments. A credit rating helps eliminate information asymmetry thus helping market forces function more efficiently.

- Does Acuité have necessary approvals to rate debt instruments such as debentures/bonds/commercial papers and bank facilities?

Yes, Acuité is registered with the Securities and Exchange Board of India (SEBI) under the SEBI (Credit Rating Agencies) Regulations, 1999 and has received SEBI's permanent registration (IN/CRA/006/2011), to rate the debt instruments such as debentures/bonds/commercial papers, and accredited by Reserve Bank of India (RBI) as an External Credit Assessment Institution (ECAI) to undertake bank loan ratings for BASEL II requirements.

- What are the various fees payable for the rating exercise?

Acuité, upon receiving a request to rate an issue, charges Initial Rating Fee for carrying out the rating exercise for the first time. In subsequent years Acuité charges Annual Surveillance Fee. The Initial Rating Fee and the Annual Surveillance Fee amount is linked to the quantum of the debt instrument/Bank Loan and is usually calculated in basis points.

- Who pays the credit rating agency?

The fees are paid by the issuer/borrower. This model of rating is known as 'issuer paid' or 'issuer solicited' rating.

- Is it mandatory to sign a rating agreement?

Yes, it is mandatory to sign a rating agreement.

- If the rating is meant to be independent then why the issuer has to pay for/solicit the rating?

The rating is meant to remove information asymmetry in a debt transaction. Hence, two critical conditions need to be fulfilled for a credit rating opinion to serve its purpose:

- a. The rating has to be based on much more information than that is available in public domain. Access to confidential information such as company's management, future business plans, borrowing plans, debt repayment track record, list of suppliers and customers etc. are extremely crucial for arriving at a fair rating. This is not possible if the issuing/borrowing entity doesn't solicit the rating and signs an agreement to this effect.
- b. The rating has to be made freely available in public domain so that current and future investors/lenders can readily access such information. The issuer pays for the services so that the rating and its rationale can be made available in public domain. Hence, the issuer paid/solicited model of rating is a more commonly accepted standard.

- How does Acuité ensure that the rating is not biased, or ratings are not influenced?

Acuité manages the actual / potential conflicts of interests in line with the SEBI regulations / guidelines and the IOSCO Code of Conduct. The above guidelines are aimed to ensure that the analytical team is able to arrive at a rating opinion without being influenced by the fee. The measures adopted by Acuité in this regard, inter alia, include:

- a. The compensation of the members of analytical team at Acuité is not linked to the rating fee or the rating assigned.
 - b. The analytical team is firewalled and, therefore, does not have access to fee details of clients nor do they engage in fee negotiations with the client.
 - c. No one outside the analytical team has access to the rating assigned to an entity unless it is made public.
 - d. Acuité does not provide any advance indication about the rating to a client, before all information is received and analysed, and the rating is assigned by the Rating Committee.
 - e. Acuité employees are prohibited to trade in stocks/bonds/debentures of companies rated by Acuité. Strict disclosures of investment holdings and prior approval of sell/purchase of stocks/bonds/debentures is in place.
 - f. Employees of Acuité are strictly prohibited from accepting any gift, favour (in cash or kind).
 - g. Rating is assigned by a rating committee after necessary deliberations on the basis of voting and majority opinion, and only then the Rating is assigned. The Rating is not assigned by any individual.
 - h. Sales and other employees outside the analytical team don't have access to the Rating Committees.
 - i. The core analytical activities are conducted within Acuité and not outsourced.
 - j. The rating process cannot be conducted arbitrarily, and the rating process follows rating criteria / methodology. All rating criteria / methodology are publicly available on Acuité website.
 - k. The Rating assigned and the rationale behind the rating are also made public through the rating releases on Acuité website.
- Is a credit rating a recommendation to buy, sell or hold a rated debt instrument?

No, a credit rating is not a recommendation to buy, sell or hold a rated debt instrument.

- Does Acuité conduct an audit of a rated entity?

No, Acuité does not conduct any audit of a rated entity. Acuité's ratings are based on the audited/unaudited financials and other information / documents provided by the rated entity to Acuité and the information available in the public domain for assigning a rating.

- Is rating a one-time exercise?

No, a rating of a debt instrument is not a one-time exercise. Once an assigned rating is accepted by the client the Rating is kept under surveillance for the lifetime of the debt instrument.

- What kind of information is required for conducting a rating assignment?

The following information, inter alia, is required for a rating:

- Annual Reports for the last three years
- Financial projections for the next two years with relevant assumptions and Year to Date financials of the current financial year
- Details of the Bank Facility/ies to be rated along with photocopies of all sanction letter/s
- Timely Debt Repayment Letter (in the prescribed format) and details of any past default / delay in meeting the debt obligations
- Top customers/suppliers' details

Besides the above-mentioned documents, the Organization also has to furnish to Acuité any other relevant additional information (including, but not limited to, access to operating systems/ sites, facilities and key management personnel) as may be considered necessary by Acuité for carrying out the rating assignment.

The Organization shall also require to promptly inform Acuité, in writing of any other developments such as all corporate actions including but not limited to sell-off, acquisitions and mergers, restructuring or any proposal for re-schedulements or postponement of the repayment programs of the Organization's dues / debts with any lender (s) / investor(s).

- Can an issuer or his banker insist on disclosing or indicating a rating as a precondition of signing an agreement?

No. At Acuité, we follow a strict policy of not providing any advance indication of a rating or even a band of ratings. This is because it is not possible to arrive at a rating without completing the entire rating exercise step by step as per Acuité's policy and criteria.

- How can an investor get access to Acuité Ratings or know if Acuité has changed its rating?

Acuité discloses all its rating and its rating actions through its rating releases on its website www.acuite.in.

- How is a rating kept updated / Why do ratings change?

Acuité conduct surveillance and reviews for all accepted Acuité ratings of bonds/debentures/ CPs/ bank facilities/ FDs that are outstanding. This process involves tracking of developments in the business environment of the rated entities and an analysis of the audited annual and unaudited quarterly/half yearly results. The above factors are considered through a process of rating review based on which a rating committee affirms the existing rating or if necessary assigns a new rating, i.e. higher or lower, as the case may be.

- What is an Appeal?

During the initial rating process, once a rating is assigned and if the client, based on materially new information, is of the opinion that the rating can be better, the client can

appeal for reconsideration of the rating by submitting such materially new information to Acuité. Such an Appeal can be made only once and within 05 days of communicating the rating assigned to the client.

- What is Rating Watch?

A Rating Watch indicates that a particular rating may undergo a revision in the near term and the likely direction of such revision. A "Positive" Rating Watch indicates a possibility of an upgrade, a "Negative" Rating Watch, indicates a possibility of a downgrade. In case the impact of development or the development itself is uncertain then the Rating Watch advisory will mention "Developing". This implies that the ratings may be upgraded or downgraded. However, a Rating Watch does not necessarily mean a rating revision will have to take place.

- What is a Rating Outlook?

A Rating Outlook indicates the possible direction of change of a rating and is applicable to Long-term ratings. The rating outlook is communicated along with the rating symbols, "Positive" - for a possible upward revision, "Negative" - for a possible downward revision and "Stable" - for ratings that are expected to remain unchanged. However, a "Positive" or "Negative" Rating Outlook may not necessarily lead to an actual revision in rating. Conversely, a rating may be revised upward or downward, despite having a "Stable" outlook, if circumstances so warrant.

- What is investment grade and speculative grade?

Though there is no such formal category of investment grade / speculative grade, the investment community use these categorizations. Debt Instruments rated 'BBB-' and above are generally called investment grade. Instruments that are rated 'BB+' and below are known as speculative grade. Instruments rated in the speculative grade are considered to carry materially higher risk and a higher probability of default compared to instruments rated in the investment grade.

- Should an investor invest blindly based on the rating?

No. A credit rating is an opinion of a credit rating agency. An investor is expected to conduct his /her own due diligence before investing in an instrument.

- Who regulates rating agencies?

In India, Credit Ratings Agencies are registered with the Securities and Exchange Board of India (SEBI) under the SEBI (Credit Rating Agencies) Regulations, 1999 for rating of securities offered by way of a public or rights issue. A few of SEBI registered agencies are also accredited by the Reserve Bank of India for providing bank loan rating services to meet the requirements of New Capital Adequacy Framework (Basel II norms) of RBI.

- Can a rating agency charge a higher fee for providing a better rating?

In Acuité there are strict firewalls between the Business Development Team which finalizes the fee and the Rating Operations Team which assigns the rating. In Acuité, a rating is never linked to the fee charged to a client.

- What is suspension of a Rating?

Acuité does not suspend any ratings with effect from January 01, 2017 in compliance with prevailing SEBI guidelines for Credit Rating Agencies.

- Can an issuer ask for suspension of the rating?

No, an issuer cannot request for a suspension as the rating agreement signed by the issuer does not have any such provision.

- What is withdrawal?

When a debt instrument is fully repaid on schedule or before schedule, the rating will be withdrawn after following the laid down process.

- What happens if the issuer does not co-operate with the rating agencies for sharing information?

This will be a violation of the rating agreement between the rating agency and the issuer, and the existing SEBI regulations. Such ratings will be carried out based on publicly available information on a best effort basis. In such cases, a Press Release shall be made to this effect and the suffix "Issuer not cooperating*" shall be added to the rating symbol. The asterisk mark shall be explained as "Issuer did not co-operate; Based on best available information".

- How much time does it take to complete a rating assignment?

Once all information as per the requirement is received, the rating process is completed by Acuité in about 3 - 4 weeks.

- Can Acuité advise me how to get a better rating or help me structure an instrument for better rating?

No, Acuité will not provide any advice on a better rating or a better structure of an instrument. Acuité strictly follows the SEBI (CRA) Regulations and also IOSCO Code.

- What is a default?

A default is an instance of failure of the borrower to repay the principal and/or pay the interest in full and on the due date as per the terms of the issue/ debt. Thus, even a one-day delay and/or one-rupee shortfall in meeting the debt obligation will lead to assignment of (or a downgrade to) "D" rating signifying default.

- When is a "D" rating revised upwards?

A "D" rating may be revised to a higher (non-D) rating category after the borrower exhibits timely repayment of principal and/or payment of interest for three consecutive months and displays its commitment to continue to meet all future debt obligations in a timely manner. However, even in such cases the rating cannot be upgraded to 'BBB-' or above category unless a minimum of one year's conduct of timely debt repayment is established.

- Is an interaction with the Audit Committee of rated entities with listed NCDs mandatory?

Yes, SEBI vide its Circular SEBI/HO/MIRSD/CRADT/CIR/P/2019/121 dated November 04, 2019 has made mandatory an interaction with the Audit Committee of the rated entity at least once a year on specific matters that may have a bearing on the rating of the listed NCDs. The matters to be discussed include related party transactions, internal financial control and other material disclosures made by the management of the rated entity with listed NCDs. For more details [click here](#).

Rating Process Flow And Timeline

Description	Timeline
Reporting of Signed mandate with fee payment [^]	Day T
Case allocation to Analyst*	Day T+1
Send communication to seek required data and information	Day T+3
Receipt of Minimum Information (Timer is Reset)	Day T1
Management interaction from date of receipt of complete information	Day T1+7
Submission to RCM#	Day T1 + 12
RCM	Day T1 + 14
Communication of Rating and sending LoA template	Day T1+16
Receipt of Signed LoA (applicable for fresh cases)	Day T2*
Dissemination of Rating and publishing on website	Day T2+2
Surveillance & Monitoring - On-going process	As per SEBI requirements

'Day' refers to a working day and excludes weekends / public holidays / non-working or partial days / emergency holidays declared by government / municipal authorities.

[^] Reporting of Signed mandate with fee payment:

This refers to the stage after clearance by Quality Control (QC) team. Hence, Day 'T' is the day on which the QC team clears the mandate and the case is handed over to the analytical team for execution.

*** Case allocation to analyst:**

The Rating Desk, which is an independent team that is not involved in the execution of rating assignments, allocates the new cases received on the basis of multiple factors such as, region/geography of the issuer, industry/ sector, product (BLR/Bonds) debt quantum, case complexity, vintage and experience of the analyst, bandwidth of the analyst, group entity(s) of the issuers already rated etc. If need be, the Rating Desk may seek inputs from the Head – Ratings / President – Ratings in this matter.

Submission to RCM:

Wherever required, the rating note is reviewed by the Team Leader/ Head before submission to RCM.

Appeal

The client has an option to appeal against the rating assigned. If the client chooses to appeal against the rating assigned, Acuite will accept such a request at its discretion, only upon being provided with additional, material information not provided earlier. Such a request can be made within 05 days of communication of rating and shall be accepted only once.

***Disclosure of Unaccepted Rating:**

Acuité will disclose the unaccepted ratings on its website within a month from the date of communication of Rating to the client, as per prevailing SEBI guidelines.

Timeline

Once Acuité receives all required information from the client the rating process will be completed, and the case will be presented at the Rating Committee Meeting within 3 to 4 weeks.

Policy for Dealing with Conflict of Interest for Investment / Trading (Trading Policy)

A. Preamble:

- a) This Document contains the policy, procedures and restrictions to manage and prevent Conflict of Interest in trading / investment by Acuité, its Access Persons and other employees.
- b) Acuité and its Access Persons / Employees should ensure compliance with this Policy and also ensure compliance of:
 - i. The Securities and Exchange Board of India (Insider Trading) Regulations, 1992;
 - ii. The Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 and
 - iii. Other laws relevant to trading in securities.
- c) This Policy shall cover transactions for purchase or sale of securities either individually or jointly or in the names of their dependents or as a member of a HUF.

B. Definitions:

a) Securities

Securities for the purpose of this Policy shall have the meaning assigned to it under the Securities Contracts (Regulation) Act, 1956. This Policy does not apply to Investments in Government Securities, Mutual Funds, gold, real estate, Government Savings Schemes, investments made through discretionary wealth management service providers, investments which are not in the nature of securities like life insurance policies, provident funds, etc.

b) Access Persons

Access Persons means officials of Acuité appointed as Chief Executive or by any other designation (such as Chief Executive Officer / Managing Director / Executive Director / Whole-Time Director / President), all Business Heads in the Credit Rating Division, all employees performing the function of Rating Analysts, all employees providing assistance to the Ratings Operations team, Heads of the Departments or divisions, Compliance team members, and the members of the Rating Committee of Acuité. The Compliance Officer will have the authority to include any other employee / official / consultant as Access Persons, based on the business / regulatory / other requirements.

c) Immediate Family & Dependents

Immediate family & dependents shall mean and include spouse, minor children, dependent parents, other dependents and any entity (including Hindu Undivided Family) or trust owned or controlled by the Employees / Access Persons or their Dependents.

C. Trading / Investment by Acuité:

Acuité shall ensure that there is no conflict of interest while making investment in any Securities. Acuité shall not make any investments in Securities issued by companies which

have credit ratings outstanding from Acuite. No non-public and/or price - sensitive information about any company from its credit rating division shall be relied upon in its investment decision.

D. Securities Trading Approval Portal (STAMP):

With a view to facilitate the process of seeking approvals for transactions and making the disclosures under this Policy paperless and seamless, Acuite has developed an in-house trading and management portal called Securities Trading Approval Portal (hereinafter called the STAMP), through which Access Persons / Employees can comply with all the actions as required under the Policy.

E. Trading / Investment by Access Persons / Employees and their immediate family & dependents:

a) Disclosures

- i. Within seven working days from the date of joining every Employee must submit to the Compliance Officer a Holding Statement of the Securities held by him/her and/or his/her immediate family & dependents, in the format given in the enclosed Annexure A.
- ii. Thereafter, annually all the Employees including the Access Persons should submit his/her consolidated Statement of Holding of all securities (including the holding statements of their immediate family & dependents) as on 31st March every year, within 30 working days from the end of the financial year.
- iii. As regards, the CEO, he/she shall submit the Holding Statement/s, as stated above, to the Compliance Officer who shall place the same before the Board of Directors for their noting at the ensuing Board Meeting.
- iv. On completion of any and every transaction of Securities, all the Employees including Access Person shall upload the Transaction Statement on STAMP, within seven working days from the date of transaction for record. In respect of securities transactions in IPOs, Right Issues, Buy-back, etc., the Employees / Access Person shall upload the Transaction Statement on the Portal, within seven working days from the date of allotment of securities / receipt of communication of the transaction from the company/broker/R&TA/DP.

b) Prior Approval for Transactions

- i. Every Access Person is required to seek prior approval of the Compliance Officer for entering into a securities transaction (including those through initial public offerings (IPOs), corporate actions such as buy-back, rights issues, etc.) This includes all transactions of the Access Person and his/her immediate family & dependents. Normally, such prior approvals are to be sought through STAMP. However, in certain exceptional situations, the Compliance Officer may allow Access Person to seek prior written approval by submitting a request in duplicate, in the format given in the enclosed Annexure B.
- ii. The Compliance Officer shall, obtain prior approval from the CEO for entering into a securities transaction.

- iii. The Compliance Officer shall approve / reject the request raised by the Access Person through STAMP. However, in case of prior approval sought in writing through submission of Annexure B, the Compliance Officer shall convey the approval / disapproval, by returning to the Access Person, a duly signed duplicate copy of his/her request form.
- iv. As regards the Compliance Officer, he/she shall obtain prior approval of the CEO by raising a request through STAMP or in exceptional situations by submitting a written request in duplicate in the format given in the enclosed Annexure B.
- v. The CEO shall approve / reject the request raised by the Compliance Officer through STAMP or convey the approval / disapproval by returning to the Compliance Officer, a duly signed duplicate copy of his/her request form.
- vi. As regards the CEO, he/she shall obtain prior written approval of the Chairman of the Board of Directors by submitting a request in duplicate in the format given in the enclosed Annexure B. This approval may be obtained through circulation of the request over e-mail.
- vii. The Compliance Officer shall convey the approval / disapproval by the Chairman of the Board of Directors by returning to the CEO, a duplicate of his/her request form duly signed by the Compliance Officer, mentioning the date of approval / disapproval.
- viii. On receipt of the approval, the order must be executed within seven working days from the date of approval. If the order is not executed within the above period of seven working days, the Access Person must seek prior approval for the transaction again.
- ix. If the Access Person does not intend to utilize the approval already given, he/she should immediately inform the Compliance Officer of his/her decision to not utilize the given approval by updating the status as "Approval Not Utilised" on STAMP.
- x. Approvals granted herein shall be valid for seven working days from the date of approval but may be withdrawn earlier by the Compliance Officer, if the circumstances so warrant.

c) Restricted List

- i. To prevent trading in the Securities of a rated client of Acuité based on insider information, Acuité shall put such companies on the Restricted List which will be systematically updated on STAMP.
- ii. When a company is on the Restricted List, trading in Securities of that company by an Access Person shall not be allowed.

d) Other Restrictions

- i. An investment has to be held for a minimum period of 30 calendar days (after purchase before selling) by an Access Person in order to be considered as being

held for investment purposes. In case of securities acquired under IPOs, rights issue, etc. the holding period shall commence from the date of allotment of the Securities.

- ii. In personal emergencies, the holding period may be waived by the Compliance Officer in consultation with the CEO after receiving the request from the Access Person.
- iii. Further, the securities of a company which has been sold by an Access Person cannot be purchased again for a minimum period of 30 calendar days from the date of sale of such securities.
- iv. Analyst involved in the rating process shall not have ownership of the securities of the company they rate.

F. Members of the Rating Committee:

Members of the Rating Committee shall upfront disclose in writing their interest, if any, to the Compliance Officer in the Securities / instruments / facilities that are considered for rating by Acuité. Such member/s shall refrain from participating in such rating by Acuité.

G. Compliance, Violation:

- a) Compliance of this policy is a condition of continuance of employment with Acuité. Any violation will be viewed seriously by Acuité and shall be the ground for disciplinary action. This may include imposition of a monetary penalty for continuing default / non-compliance and/or termination from service with or without notice, as deemed fit by Acuité.
- b) Submission of the information as required under this Policy in no way authorizes or ratifies the transactions executed earlier by the Employees / Access Persons.
- c) The information submitted by the Employees / Access Persons is for record and Acuité is not responsible if they contravene the provisions of the -
 - i. Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015
 - ii. Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003
 - iii. Any other circular/regulation/guideline issued by SEBI from time to time.
- d) It is the policy of Acuité to proactively cooperate with all Regulators and Law Enforcement Agencies in their investigations / action against any Employee / Access Person of Acuité.

H. General:

- a) If an Employee / Access Person needs any clarification, he/she should seek in writing such clarifications from the Compliance Officer by giving all necessary details.
- b) The Management of Acuité reserves all rights to make necessary changes to this Policy and inform such changes in writing by a general circular / e-mail to all the Employees /

Access Persons. Such changes shall automatically form part of this Policy and shall be binding on all the Employees / Access Persons.

- c) All decisions taken by the Compliance Officer / CEO / Board of Directors shall be final and binding on all the Employees / Access Persons. In this regard, no correspondence shall be entertained. No Employee / Access Person shall challenge, in a Court of Law or otherwise, any decision taken under this Policy.
- d) All information provided to Acuite in compliance with this Policy shall be kept confidential and will not be shared, except on a “need-to-know” basis or as required by or under any law.

Anti-Money Laundering Policy (AML Policy)

A. Introduction:

Pursuant to the recommendations made by the Financial Action Task Force (formed for combating money laundering), Government of India had notified the Prevention of Money Laundering Act in 2002. SEBI had issued the Guidelines on Anti Money Laundering Standards vide their notification No. ISD/CIR/RR/AML/1/06 dated January 18, 2006 and vide letter No. ISD/CIR/RR/AML/2/06 dated March 20, 2006 had issued the obligations of the intermediaries registered under Section 12 of SEBI Act, 1992.

As per these SEBI guidelines, all intermediaries have been advised to ensure that proper policy frameworks are put in place as per the Guidelines on Anti Money Laundering Standards notified by SEBI.

Accordingly, the Company has laid down this Anti-Money Laundering Policy ("AML Policy").

B. Scope & Objectives:

This Policy shall be applicable to Acuité, its branches/franchises, its officers, employees, products and services offered by the Company whether existing or rolled out in future.

The key objectives of the Policy is:

1. To prevent Acuité's business channels / products / services from being used as channel for money laundering.
2. To establish a framework for adopting appropriate AML procedure and controls in the operations/business processes of Acuité.
3. To monitor and report suspicious transactions.
4. To ensure compliance with the laws and regulations in force from time to time.
5. To protect Acuité's reputation.
6. To assist law enforcement agencies in their effort to investigate and track money launderers.

C. Principal Officer:

The Senior Vice President – Centre of Excellence & Investor Outreach of Acuité shall be designated as the Principal Officer. The Principal Officer will be responsible for implementation of internal controls and procedures for identifying and reporting any suspicious transaction or activity to the senior management i.e. CEO/MD, Board of Directors of Acuité and the concerned authorities.

D. Designated Director:

The Whole Time Director of Acuite, shall be appointed as the Designated Director of the Company and details thereof will be intimated to FIU consequent to SEBI Circular CIR/MIRSD/112014 dated March 12, 2014. Designated Director will ensure overall compliance with the obligations imposed under chapter IV of the Act and the Rules. The Principal Officer will keep the Designated Director informed of all measures taken for anti-money laundering and all suspicious transactions reported to FIU. Designated Director will bring to the notice of the Board of Directors all important matters as may be deemed fit.

E. Monitoring and Reporting of Suspicious Transactions:

The Company shall ensure that a business relationship is commenced only after establishing and verifying the identity of the Client.

Ongoing monitoring is another essential element of an effective AML framework.

The PMLA place an obligation on the Company to furnish information in respect of suspicious transactions, thus it is clarified that employees should be vigilant and report all such attempted transactions to the Principal Officer as a Suspicious Transaction, even if not completed by Clients, irrespective of the amount of the transaction.

Employees (Analysts) should report any suspicious activities as listed below but not limited to, to the Principal Officer who will further investigate the issue and report to the Designated Director/ Board of Directors/ FIU based on the circumstances:

Client whose identity verification seems difficult or client appears not to cooperate.

Substantial increase in business without any apparent cause

Unusual activity compared to past transactions and unusually large cash deposits made by an individual or business.

Source of funds not clear or not in keeping with the apparent standing / business activity.

Payout/pay-in of funds and securities transferred to /from a third party.

Transfer of investment proceeds to apparently unrelated third parties

Unusual transactions / business undertaken by shell corporations, off shore banks / financial services, businesses reported in the nature of export-import of small business items.

Large sums being transferred from overseas for making payments.

F. Training of staff on AML:

The Company will conduct training of relevant staff members with an objective to:

Make employees aware of the laws relating to money laundering and terrorist financing

Regularly provide training on how to recognize and deal with transactions and other activities which may be related to money laundering or terrorist financing.

The frequency of training shall be annual with additional training if circumstances warrant (based on following triggers):

1. On-boarding / fresh hire
2. Internal Transfer / Promotion to an analyst role
3. Changes in legislation
4. Changes in level of risk

The Company will rely on internal and/or external resources and/or faculty for the training requirements.

G. *Record Keeping:*

The Principal Officer will be responsible to ensure that AML records are maintained properly. The Company shall maintain and preserve the records for the minimum period prescribed under AML Act and SEBI Act.

H. *Freezing of funds, financial assets or economic resources or related services:*

Any instruction from UAPA Nodal officers or SEBI or Stock Exchanges / Depositories or any government or regulatory authority for freezing of funds, financial assets or services provided to any client shall be complied with. Any unfreezing of such accounts, assets or services shall be done only on receipt of instructions from appropriate regulatory and / or government authority. The Company shall comply with all the obligations to be followed by intermediaries which has been issued vide SEBI Circular ref. no: ISD/AML/CIR-2/2009 dated October 23, 2009.

I. *Review:*

This policy will be reviewed by the Principal Officer and Designated Director for FIU (PMLA) from time to time to comply with the extant provisions of the Prevention of Money Laundering Act, 2002, Rules and Regulations issued thereon, and Regulations/ Circulars/ Directions issued by SEBI and Stock Exchanges). Views of concerned Business Heads, may be taken into account where the management finds it necessary. Revised versions of the policy shall be reviewed, approved and adopted by the Board of Directors.

RATING CRITERIA

Acuite has well defined rating criteria and methodologies, models that form the analytical basis for all the ratings assigned. The rating criteria and methodology is reviewed once in 3 years or earlier if regulations / circumstances warrant. These criteria help the analyst to ensure that all ratings can be benchmarked against a common reference.

Criteria for Rating of Manufacturing Entities

Business Risk

A. Industry Risk

The characteristics of an industry are common and applicable to all the entities operating within that industry. Accordingly, Acuite evaluates the Industry risk while evaluating credit profiles. A company needs to be assessed in the context of the industry it belongs to. Industry evaluation brings out the effect of various factors on business prospects and the general operating environment. Accordingly, this evaluation lays the ground work and reference point for the entity to be rated. Factors determining an industry's credit risk profile are explained in detail below.

a. Macro-economic Risk

A country's economic performance has a profound impact on the prospects of various industries and sub-industries. Key macro-economic variables considered are the economic growth rate, foreign exchange risk, interest rate risk and commodity risk as these factors have a direct bearing on the industry's profitability margins.

- i. **Economic Growth:** While assessing the fundamental or core drivers of demand for a product or service, it is necessary to consider growth in the consumer's disposable income and spending pattern for consumer and industrial products.
- ii. **Foreign Exchange Risk:** In a globalized economy, a sector relies on both, exports and imports. Accordingly, foreign exchange exposure has the potential to impact margins and eventually the credit profile. Even if the exposure is hedged, evaluation of effectiveness and/or complexity of the hedging mechanism are needed.
- iii. **Interest-Rate Risk:** It is necessary to analyse the impact interest rates have on the industry's prospects as interest rates impact both the supply and demand side. On the supply side, interest rates impact the ability to borrow to increase production while on the demand side interest rates impact consumer spending. Moreover, higher interest rates reduce profitability especially if new/ expansion projects are debt-funded.

b. Demand Supply Dynamics and Pricing

The current and future imbalance between demand and supply determines product price trends. This impacts realizations and hence industry profitability.

- i. **Current Demand Supply Gap:** Past price trends help gauge whether an industry is in excess supply or demand or an equilibrium situation. Price trends also need to be seen in the context of technical developments in product innovation, process improvements, substitutes and emerging substitutes.
 - ii. **Demand Drivers:** Demand drivers need to be assessed in order to identify the trends that are likely to affect the players within an industry. While demand estimation can be tricky, a combination of demand and supply dynamics, import export data, international price trends and end user industry usage are often used as surrogate measures to estimate prospects. Some of the drivers analyzed include:
 - **Product Life cycle stage:** nascent, growth, mature or declining
 - **Product Usage:** Whether a product has a single or multiple application
 - **Complimentary Products:** These are products that can be used in conjunction with other products. These increase market coverage of the original product.
 - **Products Substitutes:** Existence of high number of product substitutes can have an important bearing on the industry's prospects as switching becomes easy and pricing premium becomes difficult.
 - **Demand Cyclicity:** Certain products exhibit a cyclical effect, i.e. a predictable upside and downside that repeats in a few years. While projecting a demand supply scenario, it is necessary to make suitable adjustments for the product position in the cyclical curve.
 - iii. **Imports and Exports:** Cheaper imports are a perceptible threat to the industry's prospects especially in markets that are price sensitive. Accordingly, understanding dimensions of imports/exports such as quality, price and market segmentation is necessary.
 - iv. **Capacity Addition/New Projects:** While - assessing the projected supply demand gap, the magnitude of fresh capacity additions along with its timing is quite important.
- c. **Market Structure**
- Market Structure refers to the manner in which companies across an industry are organised and the competitive moves adopted by different players. It has a significant bearing on the pricing power and profit margins. The key points to be analysed are:
- The number of players in the sector both organized and unorganized
 - The basis on which different players compete - Price, Innovation or catering to specific customer segments, branding etc.
 - Extent of competition and its impact on price - For e.g. in the detergent market, competition is intense among the organized and unorganized players. This puts pressure on the pricing and hence margins
 - Entry barriers -Capital expenditure, marketing and distribution network, production facilities, branding, captive raw material sources, licensing etc
 - Elasticity of demand - the response of consumers to price changes (Do consumers switch to a competitor in response to price increase by a specific player? Do they reduce their purchase of a specific product if the price increase is across the industry? Are they indifferent to modest price increases?)
 - Presence of product substitutes and complements

- Manufacturing process - different product formats, technology used, availability of raw materials and price variation, pricing power of supplier, environmental and safety hazards

d. **Regulatory Environment**

The government influences the economy and its sub-segments by way of various policy measures to channelize resources based on the needs of a society. The present day policy measures include:

- Varying duty structure (Goods and Services Tax, import, export, countervailing, anti-dumping etc.)
- Providing fiscal incentives to certain sectors (tax holidays, setting up of special economic zones, increasing credit flow through policy prescriptions, permission to issue tax free bonds etc.)
- Price controls
- Distribution controls
- Regulating imports, exports, issue of licenses, FDI norms
- Promoting bilateral and multilateral trade with other nations

In assessing the regulatory framework, one must take into account the stability of these policies. Policy reversals can send confusing signals and create uncertainty for various industry participants. The overall impact of the regulatory environment can be gauged by its effect on competition, cost structure, growth prospects, profitability and ultimately on its sustenance in the near-to-medium term.

e. **Industry Profitability**

While evaluating an industry it also is necessary to assess its future profitability. An opinion on the same is a culmination of various factors mentioned before. Here's reiterating the salient ones:

- Is the current supply demand gap trend likely to reverse in the near future due to a change in demand or supply? Are the demand drivers that have influenced revenue growth so far still intact? Are there any trend breakers or new demand influencers? Are there any regulatory or macro-economic factors that inhibit/promote demand or supply?
- What is the current cost structure and profitability margin? How have costs and margins behaved in the past?
- Is the current cost structure likely to improve/deteriorate in the near term? Are there new unanticipated costs that are likely to impact margins (for e.g. litigation, compliance)?
- What is the likely profitability in the near future?

B. Market Position

This assesses the ability of the enterprise to sell its goods and services. This section examines the company specific analysis that covers risk drivers on the revenue side. The main emphasis is on analysing the competitive position of a company in the market place with respect to pricing and volumes. Key risk indicators include:

a. **Market Share**

A key factor affecting future volumes and pricing power is the current and projected market share of the company in its main product categories along with the size and

growth of those segments. It is necessary to ascertain customer preferences in each of the product segments and also to determine if growth drivers that were prevalent in the past continue to hold good in the future. Also, the competitive advantage of the company in the market in terms of brand, product quality, innovation, cost, customer service, and committed off-take in the form of long-term contracts with existing customers, sales to group companies etc. and their sustainability need to be gauged.

b. Diversification of Sources of Revenue

Revenue diversification can be gauged by analyzing revenue break-up by product, by geography, by customer and by industry to ascertain concentration or reliance on a particular revenue stream. A diversified revenue stream is likely to withstand shocks in a particular market or geographic segment.

c. New Product Introduction

An additional factor to be considered while assessing a company's future revenue is the introduction of new products and services. New product introduction can be an extension of the existing product line, compliments or in a completely new domain.

d. Pricing Power

It is necessary to ascertain whether the company can maintain/increase price realisation on its products and maintain/grow volumes. This is influenced by demand-supply factors and competitive pressures. Here, brand presence and size become important factors to guard against price erosion.

e. Pricing Power

One needs to analyse the presence and success of a company's market penetration efforts. Expanding the presence, new applications of existing products, ramping up delivery channels, entering into strategic alliances etc. are all important. Such factors help evaluate the sustainability of the company's projected revenue plan. Peer analysis with respect to the following factors can provide an insight into the relative position of the company and its market standing:

Market Share	Distribution network
Sales and Profit Growth	Innovation
Product Range	Geographic Spread
Brand Strength	

C. Operating Efficiency

Operating Efficiency takes into account the effectiveness and efficiency of different operational aspects of an enterprise in detail. Efficient operations apart from ensuring quality of product or service lead to cost competitiveness. The cost structure of the company is compared with the cost structure of competitors to identify key cost advantages or vulnerabilities. Trends of key costs elements are useful in analysing if the company is facing or is likely to face pressures on the cost front. The various factors to be examined are given below:

a. Current Cost Structure and Inter-Firm Comparison

Firms may adopt a high fixed cost-low variable cost or a low fixed cost-high variable cost strategy. To evaluate different production formats, it is necessary to compute the break-even point for each player and study the merits and demerits of each strategy. The overall cost is further broken down into constituent elements such as raw materials, power and fuel, wages and salaries, logistics cost, sales, general and administrative expenses etc. This is compared with its peer group. Operational strengths and weakness are assessed with such an analysis. While assessing input related risks one must consider the level of vertical integration, long-term sourcing arrangements for assured raw material supply, pricing power of suppliers, uninterrupted supply of utilities, labor relations etc and their cost implications. The cost of maintaining a logistics and distribution network is vital for perishables (retail industry), bulk goods (cement) and on-demand/customizable products (e-commerce).

b. Cost Modifiers

While projecting future financials it is essential to factor in the role of technical and process improvements in shaping cost structure. Quality improvements, use of enhanced information technology applications such as ERP, CRM etc, deployment of analytical tools in determining product-mix, procurement strategy, inventory and logistics management etc., - play a vital role in optimising the supply chain, minimising costs and sustaining operations in the long run.

c. Cost Trend

To forecast the cost structure, it is necessary to gain understanding of trends related to key cost elements. This is driven by supply-demand dynamics of the particular commodity, presence of captive sources, use of alternatives, long-term arrangements with suppliers, government policies etc. The likelihood and impact of unexpected shocks in the form of energy shortage, fuel cost spikes, unfavorable litigation outcome, environmental issues also need be factored in along with the firm's ability to withstand the same.

d. Sustainability Risk

Acuite also examines the sustainability of operations of the entity, compliance with pollution control norms and impact of the entity on the surroundings and environmental risks arising thereof.

Management Risk

This is a very important aspect of the evaluation. The quality of management has a crucial bearing on the performance of an enterprise. The assessment focuses on management quality, competence, governance and risk attitude. The risk framework for assessing the same has been laid down below:

A. Promoter

Promoters influence management selection, decision making and future course of the company. Before analysing the current management and its strategy, it is essential to understand certain aspects about the promoter:

- Promoter's background and previous business ventures undertaken
- Role of promoters and the management in the decision-making process, succession plan, intention to professionalise management
- Growth plans, risk appetite, style of conducting business (cautious or aggressive)
- Promoter's ability, intention and extent of dilution of stake and gearing philosophy

B. Leadership Capability

From a risk perspective the leadership potential of an organization is an important indicator of its credit risk as it influences strategy, execution and ultimately the ability and intention to fulfil financial obligations. In assessing leadership, it is necessary to focus on four aspects: competence, depth, stability and risk orientation. The Key Risk Indicators (KRIs) are shown below:

Competence	Depth	Stability	Risk Orientation
<ul style="list-style-type: none"> • Experience in related and unrelated business • Track record of managing important assignments/projects • Consistency of Performance • Experience in managing downturns or significant changes such as mergers, restructuring, asset sale, closure etc. 	<ul style="list-style-type: none"> • Extent of delegation of powers • Succession planning/presence of organisational back-ups for key organisational roles 	<ul style="list-style-type: none"> • Career growth of key personnel in the organisation • Presence of leadership opportunities • Attrition at top and mid-management level • Labour Relations 	<ul style="list-style-type: none"> • Track record of pursuing projects beyond firm's resources, unrelated diversification, ambitious acquisitions • Leverage and dividend policy • Focus on short-term strategies as against long-term goals

C. Management Integrity and Value System

Confidence of the various stakeholders of a firm is affirmed by the values of its leadership team. The manner, in which a company conducts business, has a bearing on perception of the customer (about the company) and its standing. In assessing a firm's risk, any deviation from expected and accepted norms with respect to management integrity has the potential to notch down its ratings based on the magnitude and severity of deviation. Key Risk Indicators (KRIs,) are as follows:

- Criminal proceedings against one or more members of the management team
- Raids conducted on the company/promoters/employees by statutory authorities.
- History of litigation
- Adherence to local laws and environmental norms
- Instances of default on statutory obligations (Wilful or otherwise)
- Adverse news about the company, reputation of management

D. Strategic Risk - Strategic Evolution, Track record of execution and Future strategic position

Strategic direction (or intent) refers to the position adopted by an organisation to differentiate itself from its competitors while simultaneously working on future plans. A firm may want to compete on cost, innovation or serve a niche segment to distinguish it from other market players. While assessing strategic risk, it is necessary to understand how a company's strategy has evolved over time in response to market forces and organizational priorities as set by its promoter and/or top management. This needs to be analyzed in conjunction with the various moves undertaken to achieve strategic objectives such as undertaking greenfield/brownfield projects, mergers and acquisitions, sell offs, tie-ups to name a few. This historical context helps place the current strategic intent and the future plans in perspective.

E. Management Processes and Corporate Governance Practices

Along with a capable management team and an effective strategy, it is necessary for the management team to adopt the best practices in corporate governance. This gets reflected in the composition and functioning of the board, attitude towards stakeholders and disclosures among others. It is also important for the management team to undertake a systematic planning exercise that sets organizational priorities and ensures that those priorities percolate to the middle and lower management helping the organization's review mechanisms and track progress of plans and re-evaluate strategies and goals.

The Key Factors - to be considered are:

- Independence of the board, their functioning
- Quality and adequacy of corporate disclosures
- Soundness of accounting practices
- Extent of non-transparent - group and parent transactions
- Presence of a planning team and a process that allows the firm to respond to market opportunities and threats
- Alignment of organizational goals with employee targets and remuneration
- Quality and adequacy of performance and market feedback to top management

Financial Risk

The financials of an enterprise are a clear indicator of its performance. A good business and management should ultimately reflect in the financial position of the enterprise. Financial evaluation assesses the enterprise's strength of cash flows vis-à-vis its debt obligations. The focus is on accounting quality, reputation of auditors, track record of the financial performance in terms of growth, profitability, break even, value addition, liquidity, cash flow adequacy, level of indebtedness, level of overall outside liabilities, quality of receivables, and quality of investments. Aspects such as contingent liabilities, auditor's qualifications and notes to accounts are studied in detail.

While a number of financial ratios are considered, important ones are debt/equity, return on capital employed, profitability margin, asset turnover, interest cover, debt service coverage, cash accruals to debt and the size of net worth. The relative importance placed on different ratios would depend on the nature of business. These ratios are compared with peers and bench marks for different ratings.

As the rating involves assessment of an enterprise's ability to meet future debt obligations, significant stress is laid on the projected performance in terms of assumptions, sensitivity to changes in assumptions, projected capital expenditure etc.

Acuite evaluates the financial flexibility of an enterprise in terms of its ability to generate additional funds from various sources if need arises. Its track record in raising funds from the banking community, institutions, capital markets and money markets is analysed. The relationship with the lender community is important. Availability of liquid, marketable securities and assets would also impart financial flexibility to an enterprise. In addition, postponing capital expenditure, may be for a limited period, would also provide certain financial flexibility.

Financial risk parameters are used to evaluate credit risk. While analysing financial performance, it is essential to factor in the firm's accounting and financial policies as these play a major role in arriving at comparable figures. Apart from accounting adjustments the analyst evaluates historical trends, future financial projections and the resource mobilization ability of the company.

A. Financial and Accounting Policies

While using a common yardstick to compare the financial performance of various firms, it becomes imperative to adjust published financial figures and factor in company specific policies. Some of the points considered are:

- Auditors comments and qualifications
- Changes in depreciation, write-off and reserving policy
- Off-balance sheet items such as contingent liabilities guarantees, use of operating leases etc.
- Dividend policy
- Quality of financial disclosures

B. Historical Financial Analysis

Historical financials provide a snapshot of the financial health of the company. Financial projections have to be assessed in the context of historical financial metrics as any sharp departure should have a macro-economic and business justification. Historical analysis should span 3-5 years or a complete business cycle. Sub-factors considered in the analysis are:

- **Trend:** sales, profitability (ROCE, operating profit, PAT), debt-equity, debt protection cover (interest coverage ratio, debt service coverage ratio).
- **Operating efficiency:** cost as a percentage of sales, productivity per employee etc.
- **Margins:** Operating profit margins, PAT margins etc.
- **Liquidity:** Current ratio, quick ratio, inventory days, receivable days, payable days, working capital days.
- **Return Measures:** Return on net worth, ROCE, Return on assets etc.
- **Solvency:** Debt / Equity mix, debt service coverage ratio, interest coverage ratio etc.

These factors are compared with the nearest peers to find the relative risk standing.

C. Future Financial Outlook

The analyst computes future financials (profit and loss, balance sheet, cash flow, ratios, break-even analysis etc.) based on future capacity expansion plans, funding strategy, industry outlook, sourcing arrangements, price trends of underlying raw materials etc.

Financials are stressed by varying key assumptions to study the impact on debt repayment ability as measured by critical metrics such as debt service coverage ratio and interest coverage ratio.

D. Resource Mobilization Ability

Resource mobilization ability reflects the firm's ability to access easy and cost-effective finance to fulfil obligations under normal and stressed conditions. Under normal conditions, cash inflows and planned outflows need to be matched.

Cash Inflows include	Cash Outflows include
Cash accruals from business	Debt repayment
Access to multiple sources of funding - equity markets, bank finance, institutional support, trade credit, asset sale etc.	Planned capital expenditure and investments
	Working capital requirements

Firms should also be in a position to raise resources under cash crunch situations that arise either due to poor firm prospects or external factors. Following factors need to be considered:

- Unencumbered liquid assets
- Ability to raise short term financing through banks/financial institutions/group companies/parent company/capital markets

Project Risk

Projects are important for growth. But, projects undertaken by an enterprise could significantly alter its risk profile. The nature of the project in terms of green field, brown field, diversification, expansion is examined. Unrelated diversification and taking up projects of very large size in relation to its existing operations increases risk. A view is taken on the project after considering all aspects of project appraisal such as the cost of the project, means of financing, financial closure, product, technology, implementation risk, time and cost overruns, raw material availability, market and demand supply analysis, financial projections, project implementation skills and track record of the management in project implementation. All assumptions are validated, and a sensitivity analysis is done to see the impact of different variables on the financial position.

An evaluation of the project risk is undertaken if the company embarks on a new project(s) either by way of expansion or acquisition or starts a new business. Projects involve considerable risk in terms of large cash outflow, tying up equity and debt funding, long gestation period for project completion, interplay of various external agencies such as regulators, vendors, shareholders, borrowers, uncertainty of revenues, mismatch of cash inflow and outflow etc. Factors to be considered while analysing project risk include:

A. Strategic Risk

There needs to be a clear rationale for the proposed project and the competitive advantages it offers. The project should provide synergies to existing businesses and must be commensurate with the size of the firm. The project may offer access to new markets, product technologies, customer base, access to raw materials, economies of scale or enhance market position.

B. Risk of Project Delay

Delayed or abandoned projects result in heavy sunk costs, loss of market share, lost opportunities and eventually cause a drain on cash flows. The chances of project delays are influenced by:

- Management track record and ability to manage large projects, size and complexity of current project in comparison with to earlier projects
- Robustness of project planning process - clarity of business goals, market-need assessment, comprehensiveness of project plan
- Land procurement, regulatory approvals and clearances.
- Firm product off-take committed supply of raw material and power
- Effectiveness of project supervision - external or internal supervision, use of modern management and information technology tools
- Technology risk - gestation period in procuring production technology especially if imported, commissioning delay, operational delay, suitability of technology, technology obsolescence etc.

C. Funding Risk

This refers to the ability of the firm to tie-up funds for the project both at the initial stage and on an ongoing basis. The sub-factors considered are:

1. **Total funding** - size of the project
2. External funds requirement based on cash accruals of the sponsor, restrictions on the use of cash accruals by existing lenders, commitment to other projects and the risk appetite of the management, and such factors needs to be ascertained
3. **Borrowing** - company philosophy regarding leverage, borrowing capacity of the firm, banking and institutional relationships, cost of borrowed funds, covenants, effect on overall leverage and rating
4. **Private equity** - promoter's contribution, strategic investors (number, terms, timing, control)
5. **Equity through market route** - condition of equity markets, perception of industry and company in specific, quantum of equity offering, management control

D. Risk of Project Sustenance

The ultimate viability of the project is dependent on how the company can drive revenues, manage costs, and generate cash flows to meet its financial obligations. Revenue is influenced by industry conditions, company's product positioning and market penetration efforts. Cost competitiveness is governed by economies of scale, synergies with existing businesses, control over raw material sources, location advantages etc.

Group and Parent Support

An enterprise belonging to an established business group or a company is on a different footing compared to a stand-alone enterprise. The former could benefit from the parent/group in terms of credibility, brand equity, managerial, business and financial support. Notching ratings of individual companies up or down is based on the assumption that a company's credit worthiness, apart from its own business and financial strengths and weaknesses is also dependent on the backing it enjoys with the group/parent/government.

The degree of linkage between the entity and its group companies/parent/government needs to be ascertained to decide the extent of notching. Some of the factors influencing the degree of association are usage of common name, size of investment and holding in the entity by its parent/group/government, past instances of support etc.

Please [click here](#) to access the criteria on "Group and Parent Support"

Criteria for Rating of Trading Entities

Executive Summary

Trading entities are firms / companies involved in distribution, bulk breaking, retailing and trading of basic commodities, as well as products / finished goods with little or no processing. This rating methodology explains the approach adopted by Acuité to evaluate the business and financial risk profile of Trading Companies.

Trading entities are known to face challenges such as commodity / product price risks, foreign currency fluctuation risks, low margins and a competitive environment with low entry barriers. Acuité's credit risk assessment is based on the entity's scale of operations, level of supplier and customer concentration, value addition, if any (in terms of logistics, branding, retailing among others), exposure to forex fluctuation and extent of mitigation, inventory holding policy and volatility in the commodities being traded.

While evaluating a trading entity, Acuité takes into consideration Business Risk, Management Risk and Financial Risk but in a different light as compared to the methodology adopted for manufacturing companies.

Business Risk Analysis

While evaluating a trading entity's business risk analysis, Acuité considers the following factors:

- Size of Business and Sustainability
- Supplier Risk
- Inventory Risk
- Customer/Debtor Risk
- Forex Risk
- Level of Value Addition
- Regulatory Risk

Detailed explanation of the above factors is given below:

A. Size of Business and Sustainability

Higher scale of business indicates a more sustainable business position that enables an entity to have a greater influence over business trends and pricing to withstand various economic cycles. Scale also highlights the entity's bargaining power with customers and suppliers, economies of scale, preferential tie-ups with vendors and customers. With greater scale, usually the trading entity's diversification over geographies, products, suppliers and customers is high.

B. Supplier Risk

While analysing a trading entity, Acuité also tries to understand the supplier profile, length of relationship with the supplier, credit terms and preferential tie-ups if any. Acuité believes

that the dependence on a few large suppliers could impact the business profile of the entity, although the same can be mitigated to some extent by the length of the relationship. Also, the fortune of the trading entity gets linked to the fortunes of the large supplier.

C. Inventory Risk

Acuité analyses a trading entity's inventory risk under three areas:-

- a. **Inventory Holding Policy:** The business model of the entity is analysed along with past trends, to understand the inventory holding requirements that a trading entity may have. Businesses involving low value addition such as bulk breaking and high seas sales of basic commodities generally have lower inventory holding requirements. Whereas, entities in retailing, distribution and trading of slightly more complex products with several stock keeping units (SKUs) are generally seen to have higher inventory holding requirements. For entities that have order backed trading operations, or back-to-back trading model, the inventory risk is low. However, for other entities, generally, higher the inventory holding requirement, higher is the inventory risk.
- b. **Volatility in the commodity being traded and hedging mechanism:** Acuité then goes on to analyse the volatility in commodity prices being traded along with the entity's inventory holding requirements. Thus, a jeweller (retailer) or a distributor of steel products will have more exposure to inventory risk. Acuité also evaluates the hedging mechanism the trading entity employs and the effectiveness of the same to mitigate price risks such as booking forward contracts on the commodity exchanges.
- c. **Ability to pass on the price increase to customers:** Acuité evaluates the trading entity's ability to pass on significant price increase to customers. Entities that have well defined price escalation clauses with their customers or arrangements with their suppliers to share the downward price movements in the traded commodities, generally have better stability in profit margins.

D. Customer/Debtor Risk

Generally, entities having low bargaining power with their customers tend to extend higher credit to enhance their competitive advantage. Also, concentration of debtors from a few large customers would lead to higher risk of working capital stretch or defaults in payments. In such cases, the credit profile of customers itself becomes a key input while assessing the business risk profile of a trading entity.

The entities with well laid out credit policies are more insulated from counterparty risks. Credit policies can broadly cover limits on credit lines extended to counterparties, method of computation of credit limits, limits on trade volume, to name a few. Acuité also analyses the mode of collection of payment, such as Letter of Credit, post-dated cheques, advance payment against supplies etc., to understand the counterparty credit risk associated with an entity.

E. Forex Risk

While analysing the trading entity's business risk profile, Acuité evaluates the entity's exposure to currency fluctuation risk. A trading entity's foreign currency risk is more acute when it imports goods on credit (either LC or clean credit) and sells the same domestically

or procures domestically and exports. Acuité also evaluates the effectiveness of the various hedging mechanisms employed by such entities to mitigate significant fluctuation in forex rates. Additionally, Acuité positively factors in any natural hedge that may exist in case the entity has forex earnings and spending of comparable levels.

F. Level of value addition

Lastly, Acuité evaluates the level of value addition of the trading entity in the entire value chain that would invariably lead to higher margins and better return indicators. Trading entities involved in packaging and retailing (both online and the conventional models), branding, distribution, logistics and basic levels of processing, would have higher margins and better ability to absorb price shocks.

G. Regulatory Risk

In India, the regulatory environment is fairly stringent for certain sectors, restricting free trade, sourcing, warehousing and even pricing of essential commodities. In an attempt to strike a balance between the welfare of the agricultural community and ensuring supplies at competitive rates, the government also engages directly in sourcing and pricing (by setting minimum support prices) of essential commodities. Given these considerations, Acuité carries out detailed analysis of the regulatory framework and factors it in the overall business risk profiles of the trading entities.

Financial Risk Analysis

The debt contracted by a trading entity is generally short term, self-liquidating in nature, to fund its inventory and debtor requirements, with minimal to nil long-term debt. Also, the reliance on non-fund based limits such as letter of credit forms a large part of the entity's liabilities, especially for those engaged in import of commodities. Acuité takes into account these factors while analysing the entity's financial risk profile.

Acuité assesses the entity's adequacy of cash flows to meet indebtedness, while also assessing the management's policies with regard to financial risk. The historical financials, fund and cash flow statements and financial projections provide essential information about the entity's operations. Some of the sub-factors considered in financial risk analysis are:

- **Trend:** Sales, sales returns, profitability, debt-equity, debt servicing cover
- **Margins:** Operating profit margins, PAT margins among others
- **Liquidity:** Current ratio, quick ratio, inventory days, receivable/payable/working capital days
- **Return Measures:** Return on net worth, Return on capital employed and Return on assets
- **Debt and Debt Coverage:** Debt equity mix, Total outside liabilities (TOL) to Net worth ratio, Interest coverage ratio.

Acuité's financial risk evaluation also includes trend analysis and peer comparison to understand the relative risk standing of the entity. Understanding an entity's financial and accounting policies is a must to ascertain the accounting quality. Several analytical adjustments are also required to evaluate financial risk.

A detailed review of the past financial statements is done to understand the influence of all business and financial risk factors on the entity's performance. While current and historical information is necessary to establish an entity's condition and financial track record, future financial projections are required to estimate the expected performance. Projections are sensitized to assess the future financials under conditions of stress.

Management Risk Analysis

Evaluating the quality, capability and stability of management is vital to an entity's long-term prospects. Accordingly, operational success, risk tolerance capacity and vision of the management is taken into account. Management integrity is an essential part of the rating process. Charting a definitive course of action and effectively executing various aspects of business form key functions of any management team. Acuite believes that management's track record, second tier management, formal succession plan, and high degree of expertise including corporate governance are vital to the long-term sustainability of the entity. A critical evaluation of the organisational structure, quality of systems and procedures is also essential for assessing management risk. Moreover, the management's philosophy with respect to leverage and aggressiveness is also assessed.

Criteria For Rating Of Entities In Services Sector

Executive Summary

Different business models of services sector entities and their unique characteristics make it imperative to put in place a separate framework for assessment of credit risk. Service sector entities typically include educational institutions, advertising agencies, IT and IT enabled services, as also other bodies in the hospitality and the healthcare sectors. Apart from these conventional services, new age services such as manpower supply and taxi fleet operators have contributed to the expansion of the service sector universe. From a credit rating standpoint, it is important to have a clear understanding of the business models of these entities, the risks involved therein and key risk mitigants. The two key factors of service sector entities are:

Firstly, the balance sheet of a service entity does not capture its most crucial asset - human resource. Secondly, unlike manufacturing/trading entities that have the flexibility of carrying unsold goods as inventory, service sector entities cannot store their services. The cost structure of a service enterprise mostly comprises period costs that vary with time rather than with level of activity for a certain period. Considering the high fixed costs of a service entity, stable revenue generation is more important as compared to a manufacturing/trading entity with relatively variable cost structure. From a credit perspective, working capital financing for most service sector entities is largely limited to receivables financing (i.e. post sale financing) as opposed to inventory financing which is also available to manufacturing and trading entities.

From a broader perspective, Acuite has identified the following common factors for analysis of service sector entities:

- Industry Risk
- Market Position
- Operating Efficiency
- Financial Risk
- Management Risk

Industry Risk

Given below are the risk factors that Acuite takes into account with regard to credit rating of service sector entities:

- Status of the industry - (Initial, consolidation, growth, maturity or decline), trends in each of the stages
- Outlook for the segment
- Organised/unorganised
- Entry barriers
- Capital or labour intensive
- Regulatory impact and price controls, if any
- Fiscal incentives, if any

Based on a critical analysis of the above factors, Acuité evaluates the industry risk of the entity and performance of the segment in which the entity operates. In case the entity's performance is divergent from industry trends, Acuité would recognise such divergence and factor in the same in the overall risk assessment.

Market Position

Acuité takes into account the following while evaluating the market position:

A. Revenue Visibility

The revenue visibility of entities such as schools and hospitals will be comparatively more stable than that of airlines, hotels and IT-enabled services. The divergence in revenue stability is essentially due to the insularity of entities like schools and healthcare from economic cyclicity. Acuité believes that relatively stable operating cashflows for such entities vis-a-vis other service entities (hotels and hospitality) support the former's ability to raise debt. From a debt servicing perspective, the lenders will prefer borrowers with stable stream of cash flows rather than a volatile cash flow stream and hence, as a corollary, entities which are relatively insulated from cyclicity will be a better credit risk.

B. Customer Profile

The profile of the customer base of a service entity is critical from a business resilience perspective. From a credit risk perspective, a diversified clientele profile is preferred to a concentrated one. Acuité, in addition to diversity of the clientele base, also evaluates other finer aspects such as nature of the relationship between the entity being rated and its customers. A higher level of integration between the service provider's business and that of the customer's will be critical in this regard. For e.g. a captive BPO of an investment bank will have customer concentration risk. However, if the credit quality of the investment bank is satisfactory and the dependency of the investment bank on the BPO is high, the captive BPO may be considered a low risk on the market assessment.

Similarly, for service entities with a retail focus such as schools/health care facility, higher the economic strata of the clientele, higher will be the pricing power and better will be the market position assessment. In the hospitality sector, it is important to ascertain whether a particular hotel is driven by business or tourism clientele. Tourism-dependent hotels are more prone to event risks whereas a hotel dependent on business traffic will be influenced by economic cyclicity. Similarly, in an ITeS segment, there could be focused concentration on the BFSI space. In such a scenario, downturns in the sector could impact the flow of business from the BFSI industry. Acuité recognises these aspects related to the market position of an entity.

C. Range of services/Revenue Streams

The range of services offered by an entity plays an important role in determining stability of earnings. For e.g. a logistics company providing end-to-end solutions has an advantage over one that has presence in only one/two segments of the logistics value chain. So is the case with an entity with regional presence vis-à-vis another with nation-wide operations. A hospital chain operating nationally with multi-specialty services and in-house diagnostic facilities would typically have a lower business risk compared to a hospital operating from a single location with limited services to offer. Accordingly, for such diversified entities, Acuité believes that diversity of revenues across sectors/geographies

mitigates risk of revenue fluctuations to a large extent and imparts resilience to the credit profile of the entity being rated.

D. Brand Image

The growth drivers of the services sector are brand image, track record and customer satisfaction. An entity with an established brand name definitely has an edge over others. Strong brands can facilitate business growth in terms of volumes/market share enabling easy market penetration resulting in improved financial performance. Acuite evaluates these factors based on the extent of premium in margins/higher growth in revenues vis-a-vis its peers. In certain industries, such as hotels the ability to attract franchisees is a strong indicator of the brand image.

Other things remaining the same, an entity with large portfolio of established brands will score higher on the market position assessment.

E. Distribution Network

The market position assessment of a service sector entity will also be influenced by its distribution network. A wider distribution network will enable the entity to service its customers efficiently. A wider distribution can be acquired by expanding to various geographies organically or inorganically. In case of inorganic growth route wherein, the service entity acquires an existing operation in a new geography and rebrands it, the distribution network would grow faster. Typically, an established cinema chain which has a strong urban presence and is trying to expand into rural geographies would try to acquire existing screens in Tier 2 and Tier 3 geographies rather than constructing these theatres all by itself. Other things remaining constant, an entity with a wide distribution network will score higher than the one with presence in one or two towns. The ability to scale up operations organically/inorganically is also crucial while assessing the credit profile.

Operating Efficiency

A. Cost Structure

Operating efficiency refers to an entity's ability to manage its cost structure efficiently so as to mitigate the impact of adverse revenue fluctuations on profitability margins. This can be done by containing fixed costs in the overall cost structure for a given level of output of services.

Different business models adopted by service entities to moderate the overall level of fixed costs would qualify for a higher rating on the Operating Efficiency parameter.

B. Human Resources

Manpower resource is one of the key factors that contributes to the success or failure of a service entity. Continued availability of skilled manpower is crucial for success of a service enterprise. Tie-ups with institutions such as colleges, academies ensure continued stream of talent. Apart from external tie ups, in-house training/skill development verticals in an organisation will have a positive impact from an operating efficiency perspective.

Acuité considers metrics such as manpower cost as a percentage of operating revenues, revenue per employee and profit per employee while comparing productivity across peers.

C. Operational Integration

Acuité observes that higher the level of integration across the value chain, more operationally efficient the service level entity is likely to be. For instance, a training institute which has a tie-up with a leading bank will benefit by way of key inputs such as training faculty, course content and practical training infrastructure which can be provided by the bank.

Hence, due to the operational benefits arising out of such integration, the training institute would qualify for a higher rating on the Operational Efficiency parameter. A health care facility with in-house diagnostic facilities will score more than a standalone hospital with limited ancillary facilities.

Financial Risk

While assessing financial risk, Acuité examines the capital intensity of the entity being rated. Certain entities such as airlines, educational institutions with relatively higher capital intensity will be evaluated on parameters applicable to manufacturing entities. For other entities with relatively lower capital intensity, Acuité will accordingly factor in the differences in the financial risk assessment.

Management Risk

Management risk shall be assessed on parameters such as integrity of the management, competence and risk appetite. Integrity assessment will cover known instances of defaults/delinquencies and serious transgression of laws. Competence will be assessed on the basis of the credentials of the management, their past track record and ability to manage the business and regulatory environment. Risk appetite refers to the policies of the management with regard to risk management.

Criteria For Rating Of Non-Banking Financing Entities

Executive Summary

Non-Banking Finance Companies (NBFCs) have played an important role in the Indian financial market in terms of extending financial services mainly to Tier II and Tier III cities across India apart from encouraging product innovation and customisation. NBFCs have historically bridged the gap between unorganised finance companies and banks. They can be broadly classified into asset finance companies, equipment leasing, hire purchase finance companies, investment companies, loan companies and residuary non-banking company. However, they operate in diverse segments such as commercial vehicle finance, loan against property or shares, housing finance, infrastructure finance, gold loans, and unsecured retail loans or micro-finance. NBFCs have also played a pioneering role in securities-based lending such as Loan against Shares (LAS), Margin Funding, Initial Public Offerings (IPO) Financing, securitization to name a few.

NBFCs have spread across the entire gamut of risk spectrum, including - personal loans, consumer durable loans, dealer or vendor financing and - segments such as home loans.

Acuite's rating criteria for NBFCs is similar to that of banks and financial institutions. However, difference in the risk matrix necessitates focus on certain parameters such as diversification in product portfolio and innovation, cost competitiveness, capital adequacy, access to low cost funds, resources mix, established brand equity and level of technological integration.

Market Position

A. Size, Asset profile and Market presence

The size of operations determines the benefits derived by an NBFC in terms of economies of scale, ability to service large clients and preference over smaller companies for alliances. It also determines the ability of the company to sustain the fierce competition and create entry barriers for new entrants. Also, the size of operations can be assessed based on the total assets under management vis-à-vis the total assets under management of overall NBFCs. Further, the year-on-year growth in size of assets under management against year-on-year growth in various asset classes is an important parameter in determining the market position of the company. Additionally, size of operations, the asset profile and segments in which an NBFC operates, sheds additional light on the market position. Large NBFC's that have been operating for a long time and serving diverse asset classes tend to enjoy better market position and brand equity. This translates into benefits such as lower establishment and promotional expenses, more predictable income stream, preferred financier status and lower risk perception by customers.

B. Product Portfolio

Product innovation and customisation has not only aided NBFCs in creating a niche position in urban and semi-urban areas but also in gaining an edge over banks. Thus,

product innovation and customisation are key determinants of the market position enjoyed by an NBFC.

The company's presence in various segments is required to be analysed in the light of segmented concentration and stability of earnings. Majority of the NBFCs operate as uni-product model companies to concentrate on their core competencies. However, the same also exposes these companies to business cycles within the segment. Further, high exposure to a single segment would also impact asset quality. Thus, diversification across segments assumes greater importance in the NBFC industry. A diversified portfolio helps them mitigate the impact of business cycle risk. However, certain NBFCs specialise in serving particular segments, grow large therein and are successful in defending their market positions despite competition from other financial institutions. Acuité also evaluates the strength and specialty an NBFC may have in serving a particular segment.

Acuité shall evaluate contribution of each segment in the company's revenue profile and history of delinquencies within the top-contributing segments. Higher contribution by a single segment or top three segments would translate into lower earnings stability and deterioration in asset quality.

C. Market Presence or Distribution Network

NBFCs particularly operating in retail financing are required to develop strong distribution network of branches, direct sales or marketing offices, dealers, sub-dealers to name a few. In addition to distribution network, strong origination skills are a pre-requisite for establishing strong market reach. However, larger geographical presence is associated with higher operating costs. Thus, it is essential for companies to employ expansion strategies that aid in optimisation of operating costs vis-à-vis growth. The company's ability to effectively utilise cross selling techniques, strong origination and sourcing abilities are key elements that provide an edge. Acuité shall review the geographical reach of the company in light of the cost-effectiveness of the growth strategy.

D. Customer Relations, Service Standards and Fair practices

NBFCs have been successful in gaining market share in urban and semi-urban areas on account of customer-oriented product innovation and superior customer service. Lesser turn-around time (TAT) compared to banks enables NBFCs to establish a strong market presence. Efficient customer service would in turn help build customer relationships. The presence of transparency and fair practice codes also assist NBFCs in a robust market position. Acuité shall review their track record in providing efficient customer service against industry standards.

Operating Efficiency

A. Appraisal and Monitoring Systems

Nature of operations of NBFCs demands strong appraisal as well as monitoring systems. Also, those operating in a competitive environment are required to monitor profitability, cost competitiveness and asset quality necessitating companies to incur large investments in IT infrastructure and information systems. Strong credit appraisal, monitoring and recovery systems enable companies to maintain risk and return profile.

Acuite shall evaluate systems and policies laid down by the company with respect to credit appraisal, extent of use of credit bureau information, data monitoring systems including frequency and finally integration of branch level data.

B. Adherence to Regulatory Requirements

Entities in the financial sector are subject to regulations of multiple regulators. Deficiency in compliance with regulatory requirement hampers the smooth functioning of the company and negatively impacts the image. Accordingly, consistent adherence to regulations is imperative for the smooth functioning of NBFCs. Acuite shall review the track record of the company in complying with the regulatory norms laid down by RBI, SEBI, IRDA or any other agency. Any deficiency in compliance shall have a negative impact on the rating of the entity.

C. Asset Quality

Asset quality, a critical parameter in assessing an NBFC's credit risk profile often acts as a mirror of overall operational performance and risk appetite of the entity. Asset quality is determined by studying the company's asset profile. The product and geographic diversification mix of loan portfolio (exposure to unsecured assets), average ticket size, customer profile and movement in each of these parameters can help understand the inherent risk that an NBFC's portfolio is exposed to. Acuite evaluates the NBFC's risk management policies once the inherent risk profile of the asset portfolio is established. This gives an insight into how the asset risk is being managed. Strong risk management policies manifest themselves in lower credit losses during the aftermath of weak economic cycles. The strength of underwriting mechanisms, early warning systems, control and recovery measures go a long way in building a company's asset quality.

Parameters such as GNPA (Gross Non-Performing Asset) and NNPA (Non-Performing Asset) percentages, track record of the delinquencies within each asset class are analysed. Finally, the recovery mechanisms for collection from delinquent accounts and the track record of recovery also help assess the NBFC's asset quality.

D. Resource Raising Ability

The company's access and ability to raise funds in a cost-effective manner ensures stability of its operations. The resources profile can be analysed based on the funding mix, support and access to funds in times of liquidity crunch, and growth in resources over the years vis-à-vis incremental cost of funds. Further, the resources profile should be studied against the nature of asset to be financed as well as the other uses of the resources and their nature. Diversified resources profile eases the liquidity position of an NBFC. Regulatory guidelines govern NBFCs' access to various resource-raising avenues. The company's access to capital markets or support from parent or group companies is also taken into account while evaluating resource raising ability.

E. Technology

Technology and IT infrastructure play an important role in the smooth operations of an NBFC. Retail financing implies smaller ticket size and large volumes, necessitating NBFCs to invest significantly in technology. Greater technological integration enables the company to remain cost effective.

Financial Risk

A. Capital Adequacy

NBFCs are required to maintain capital adequacy ratio as prescribed by the regulator from time to time. However, in addition to being a regulatory requirement, capital adequacy ratio gives an indication of the capital available to absorb losses arising from credit risk and market risks (in case of losses on marked-to-market portfolio). A higher capital adequacy can also indicate risk perception/tolerance of the NBFC. Most of the NBFCs operate in homogeneous product segments exposing them to higher business cycle risk demanding higher capital requirement. Thus, there is a greater need of inbuilt liquidity cover in the form of core capital to insulate the company in times of liquidity crisis.

Capital adequacy is also required to be studied in the light of past history of NPAs, additional provision required for the same and potential losses from stressed assets. Capitalisation levels also provide insight into the management's aggression with respect to growth of the portfolio and the extent of reliance on debt to grow the balance sheet.

Acuite also assesses the trends with regard to amount of capital, proportion of Tier I/Core capital, the management's capitalisation policy and extent of conformity to regulatory requirement.

B. Earnings Quality

Earning quality determines the stability, sustainability and growth in revenues. Studying an NBFC's income profile is essential to assess its earnings quality. Evaluating an NBFC's earnings quality involves analysing its asset portfolio as also its composition and diversity. The contribution to the top line from various segments and the trend in such contribution is particularly important to assess revenue stability. Contribution of each segment, once evaluated in relation to borrowing costs, gives a picture of the net interest spreads and net interest margins earned by the company in relation to the asset profile it carries. Riskier asset segments should ideally involve higher spreads. One way to improve spreads is to lower the borrowing costs while retaining the asset/investment portfolio. NBFCs usually rely on wholesale/bulk funds and are exposed to higher interest risks hence analysis of borrowing costs play an important role in evaluating earnings.

Administration costs and credit costs (provisions and write-offs) form the next pillar in ascertaining earnings quality. An NBFC's operational efficiency and strong risk management practices generally translate into lower operating expenses and credit costs. Endeavours to constantly protect interest spread; reduce credit and administration costs enable NBFC's to confidently navigate through economic and interest cycles without impairing the earnings quality. Acuite shall also compare trends in incremental interest spread, operating expenses ratio and return on total/average assets of the NBFC and compare the same with industry peers to better categorise earnings quality.

C. Liquidity

NBFCs and HFCs are exposed to relatively higher liquidity risks vis-à-vis banks due to the absence of structural liquidity support mechanisms as existing in the latter case.

The maturity profile of asset and liabilities and any mismatch thereof, has significant bearing on the liquidity profile of the company. While many NBFCs and HFCs consciously

run an asset-liability mismatch to ensure better funding and higher spreads, their ability to manage such mismatches during a difficult liquidity scenario is a critical element in their liquidity assessment.

Acuité shall study the maturity profile of assets and liabilities, board approved policies of the company with respect to liquidity management and its access to funds from diverse sources including its parent (if any) during any exigency.

D. Accounting Quality

Accounting quality to be assessed in terms of conformance with Generally Accepted Accounting Practices (GAAP). Standard accounting practices facilitate comparison across the industry. In India, NBFCs are required to follow the accounting standards prescribed by the Institute of Chartered Accountants of India (ICAI). Acuité shall review the company's accounting policies, notes to accounts, and auditors' qualification if any, thoroughly. Non-conformance with the prescribed guidelines could impact rating.

Management Risk

A. Corporate Governance

Corporate governance evaluation takes into account management risk in terms of performance and accountability of the management towards various stakeholders such as shareholders, employees, customers, suppliers and lenders. Acuité shall also analyse the qualitative and quantitative parameters that determine accountability of the management towards various stakeholders. In addition, Acuité appraises the management of NBFCs on the following parameters:

B. Competency

Competency of the management is assessed based on the management credentials, organisation structure, performance track record, strategies employed by the management in response to the change in environment and finally impact of the strategy implemented on the performance of the company.

C. Integrity

Integrity of the management is assessed on the basis of the track record of the management in adhering to statutory requirements by various regulatory authorities, litigation and such related issues. Management for this purpose includes senior management of the company, directors and promoters.

D. Risk Appetite

Risk Appetite of the management is an important parameter in determining management risk. It is ascertained on the basis of the tendency of the management to enter into risky business segments, exposure to risky segments in the past and management philosophy for mergers and acquisitions.

Acuité lays out a comprehensive framework to assess risks inherent in the NBFC industry that includes credit, liquidity and interest rate risks. Additionally, it also incorporates marketing, operational and financial risks to arrive at the credit risk profile. The framework integrates qualitative as well as quantitative assessment of an NBFC.

Criteria For Rating Of Banks And Financial Institutions

Executive Summary

Banks are systemically essential entities having a unique risk profile. Acuité follows an exhaustive CAMELO framework to assess the credit facility of banks. The broad parameters of this framework are:

- Capital Adequacy
- Risk Weighted Assets
- Asset Quality
- Management Risk
- Earnings Quality
- Liquidity
- Operational Environment

This process of assigning credit ratings to banks based on the CAMELO framework involves assessment of banking operations and taking into consideration the financial profile of the bank along with other qualitative factors. This is followed by a structural analysis which typically includes an analysis of the asset-liability management, sensitivity of the bank to the external environment and the overall approach of the banks towards mitigating risks. Based on the CAMELO framework, the risk of a bank comprises the following:

Capital Adequacy

All banks, under the Basel II and Basel III norms, are required to maintain a minimum level of regulatory capital (comprised of Tier I and Tier II capital) as a proportion of the Risk Weighted Assets. Higher levels of capitalisation - especially Tier I enable a bank to better absorb losses and provide stability in banking operations. Thus, apart from the Capital Adequacy Ratio, Acuité evaluates the Tier 1 capital to Risk Weighted Assets (RWA) Ratio and the quantum of Capital Conservation Buffer Maintained by the bank. Acuité also evaluates the indebtedness of a bank vis-à-vis its own funds, with higher indebtedness meaning that the incremental growth in loan book would have to be supported by increasing reliance on equity as a means of finance. While assessing a bank's capital levels and adequacy of the same, Acuité also evaluates the expected growth trajectory, outlook on asset quality, and ability of the bank to raise additional capital (Tier I and Tier II) in the short/medium term.

Risk Weighted Assets

While a bank's asset quality indicators measure its existing delinquency profile, the Risk Weighted Assets measure the propensity of such delinquency occurring in the first place. Acuité evaluates the Risk Weighted Assets to Total Exposure (all fund and non-fund-based exposures) ratio. This indicates the average risk weight associated with the bank's assets and off-balance sheet exposures enabling to ascertain the quality of assets which are yet to default.

Asset Quality

A study of the delinquency levels in the bank's asset portfolio, composition of assets into standard, sub-standard are some of the parameters that help evaluate a bank's ability to manage credit risk. It is also important to study the relationship between growth in assets and NPAs to ascertain whether the reduction in the GNPA ratio is due to an actual reduction in GNPA, or higher growth in assets. Acuite also evaluates the levels of geographical and sectoral diversification in the loan books to ascertain the degree of risk a bank would be susceptible to in case of adverse economic or regulatory changes in a sector or region. Further evaluates the segment wise NPA and advances levels to understand the composition and performance (revenue/profit) of the loan segments based on size, sector, geography especially for public sector banks that are required to lend to priority sectors areas. To understand the quality of lending to the corporate sector, Acuite takes into account the credit quality of the top loan exposures, along with concentration in the loan portfolio. A bank's ability to attract and retain high credit quality corporate borrowers is a key to ensure stable and healthy asset quality going forward. Acuite also evaluates a bank's provisioning and write-off policies, risk management practices.

Further, to develop a holistic view of the asset quality of the bank, Acuite believes that the rate of migration in the asset quality is an indispensable parameter to be evaluated. To this end, Acuite evaluates the Slippage Ratio of the bank's assets defined as a ratio of Fresh Accretions to the Gross NPA divided by the total standard assets at the beginning of the year.

Acuite evaluates the quantum of priority sector exposure by factoring in the risk diversification strategies adopted to mitigate high credit risk.

Management

Management Risk is evaluated at two levels. Firstly, it is a function of the competence and integrity of the top management. Secondly, it is a function of the checks and balances put in place to account for fraud prevention, supervision and oversight within the bank. Acuite appraises the management of the bank on the following parameters:

A. Competence

Competency of the management is assessed based on the management's credentials, organisation structure, performance track record, strategies employed in response to environment changes and finally impact of the strategy implemented on the performance of the company.

B. Integrity

Integrity of the management is assessed based on the track record of the management in adhering to statutory requirements, level of disclosures, transparency in reporting and analysis, litigation and related matters. Management, for this purpose includes senior management of the company, directors and promoters.

C. Risk Appetite

Risk appetite of the management is an important parameter in the evaluation of management risk. It is ascertained based on the tendency of the management to enter

riskier/newer business segments, exposure to risky segments in the past and management philosophy for mergers, acquisitions and aggressive growth plans.

D. Corporate Governance Structure

Acuité also believes that quality corporate governance is the key towards effective management of a financial institution. It facilitates compliance and enables the bank to better identify frauds, misappropriations and other personnel related operational issues.

E. Accounting Quality

Acuité lays much emphasis on accounting quality. The auditor's report, changes in auditors, accounting policies, periods as also comments of auditors are considered while arriving at the rating.

F. Systems & Procedures

Acuité believes that adherence to the laid down procedures and carrying out the transactions in line with the procedures and systems is an important aspect governing the operations of a bank. Accordingly, the control and monitoring mechanisms of the bank are also factored in by while arriving at/ assigning the rating.

G. Regulatory Compliance

Despite liberalisation, the banking sector continues to be a highly regulated industry. Thus, the level of compliance with RBI guidelines, maintaining daily and fortnightly balances in the form of Cash Reserve Ratio, Statutory Liquidity Ratio and meeting other regulatory requirements are parameters that are evaluated by Acuité.

Earnings

Earnings is a function of the operating efficiency. Evaluation of the quality of earnings is not only treated as a return variable, but also evaluated as a cost variable. Acuité adopts a three-pronged approach to understanding the Earnings Quality of a bank:

A. Profitability and return ratios

These ratios measure the efficiency and loan pricing ability of the bank and compute the pace and yield that help generate returns. Acuité analyses several ratios including Net Interest Income (NII), Net Interest Margins (NIM), Interest Spreads, Return of Assets etc. to ascertain profitability and return levels.

B. Operating Expenses as a Proportion of Total Assets

This ratio measures the operating efficiency of the bank by analysing the trend in operating expenses with a rise or fall in AUM. In well managed banks with increase in scale of operations, the ratio should ideally decline with realisation of economies of scale.

C. Ratio of Non-Interest Income to the Total Income

This ratio is aimed at measuring the fee-based income as a proportion of the total income generated by a bank. Typically, fee-based income is less risky than interest income for a bank as the former is generated without the fund outflow for the purpose. Nevertheless, it is important to consider the amount of development as a proportion to average non-fund based commitments. Acuité also evaluates the investment income to total income ratio.

This ratio is aimed at understanding the proportion of earnings from investments after accounting for mark to market adjustments. A higher ratio, to a limited extent, may indicate the risk appetite and business development efforts of the bank.

Liquidity

Acuité assesses the liquidity profile of financial sector entities based on the mismatches in the asset liability maturity profile, availability of steady state liquid assets, and the management's philosophy regarding its liquidity management.

Banks have a highly stable liquidity profile given the steady access to retail deposits. Most banks in India have a sizeable proportion of low-cost current account and savings account deposits as well as retail term deposits, which are highly granular and relatively sticky in nature. Hence, the assessment of the deposit profile is a critical aspect of its credit risk assessment. In addition, the assessment takes into account various liquidity support mechanisms for the banking sector such as access to liquidity through call money/repo markets, refinance limits from various institutions etc. Additionally, as per Basel III framework on liquidity standards, banks are required to maintain liquidity coverage ratio of 100% i.e. high-quality liquid assets (HQLA) should be equivalent of 100 % of the net cashflows over the next 30 calendar days (as defined in the RBI guidelines). The excess SLR holdings of a bank (over and above the statutory requirements) can also be a source of comfort during any sudden liquidity requirements.

For FIs, the assessment includes the availability of a fairly liquid investment portfolio which can be accessed quickly to meet any unforeseen funding requirements. The ability of FIs to mobilise resources from the market also enhances their liquidity profile and is factored in while assessing their liquidity profile.

Operating Environment

Acuité also evaluates the overall operating efficiency of the bank and its ability to gain from economies of scale by evaluating the operating processes. Acuité evaluates the bank's performance on four fronts:

A. Scale of Operations and Branch Spread

Acuité believes that sustaining a healthy earning profile along with a robust asset book depends on the bank's ability to diversify sources of cash flow. One of the key indicators is the geographical spread of operations. Acuité also evaluates the benefits derived from economies of scale by ascertaining the decline in operating expenses as a proportion of the spread.

B. Product Spread

Active product development and wide product spread are vital to ensuring a healthy earning profile and maintaining a competitive edge. In a changing business environment, a bank's ability to differentiate its products is the key to maintaining healthy returns on working funds. To this end, Acuité evaluates the exposure concentration of products and the bank's product innovation skills. Thus, history of active product innovation and market

development activities undertaken add significant buoyancy to the operating risk profile by enhancing stability in the growth of future cash flows.

C. Technological Prowess

The technological prowess of a bank lies in embracing the latest in technological developments with an aim to limit costs, increase market penetration and enhance customer satisfaction. Using the latest technologies coupled with an efficient Core Banking System and advanced services like RTGS and Mobile Banking enable banks to limit turnaround time, improve margins on transaction fees and exponentially enhance profitability per employee. Further, these guarantee a higher level of customer satisfaction and improve customer retention rate too.

D. Human Resource Management

The quality of a bank's service offering is determined by its human capital. With increasing competition in the sector, emphasis is to be laid on customer experience and having efficient processes in work-flow management. Acuité believes that the bank's recruitment policy and its human resource development practices along with the overall management of organisational culture are important aspects in maintaining a healthy operating risk profile.

Market Risk Profile

The market risk profile of a bank is evaluated at two levels. Acuité first ascertains the bank's exposure to systematic risk factors and subsequently evaluates its ability to access the market, raise resources and manage market risks.

A. Exposure to Systematic Risk Factors

Systematic risk factors are macroeconomic factors that affect the entire economic system at large. It is thus impossible for a commercial entity to avoid exposure to systematic risk. At the same time, systematic risk factors may have a differential impact on different borrower classes. However, exposure to these factors can be managed in such a way that the overall impact on the bank portfolio is minimal. Thus, measures the bank's exposure and ability to manage systematic risk in its portfolio by assessing the following parameters:

- a. **Assets under Management and concentration in the Loan Book**
Banks with large loan books with limited concentration are in a better position to guard against their exposure to systematic risk. Also, banks with large AUMs and diversified portfolio are less likely to be adversely affected by systematic risk factors as the overall probability of default in the portfolio will be much lower. However, Acuité also notes that banks with large AUMs having large exposure to a single party are more exposed to systematic risks as the ability to manage the impact of systematic risk factors significantly diminishes. Exposure to a wide range of financial products and catering to different types of financing requirement, limits revenue concentration from a borrower profile.
- b. **Nature of Contingent Liabilities and Assets**
Banks, through bank guarantees, co-acceptances, underwriting and merchant banking operations, derivatives exposures and other financial products, often take off-balance

sheet exposures on their books which are often triggered by macroeconomic and systematic factors. Thus, Acuite conducts a detailed evaluation of the gamut of contingent assets and liabilities held by the bank to better assess the probability of these contingencies arising in the short to medium term.

c. Gap Assessment

Systematic risk factors of a bank are its exposure to interest rate risk. This is evaluated by assessing the Rate Sensitive Gap (RSG) of the bank considering the current interest rate cycle. RSG is defined as the difference between the Rate Sensitive Assets (RSA) and Rate Sensitive Liabilities (RSL).

- i. Floating Rate versus Fixed Rate Lending: Acuite believes that banks with maximum exposure to floating rate assets tend to have higher degree of exposure to interest rate risk. Generally, in times of inflation and high interest rate cycles, floating rate assets improve the profitability of a bank.
- ii. Re-pricing & Refinancing Risk: While a bank may be able to maintain a healthy liquidity profile in case of assets with shorter maturity as compared to liabilities, it will be exposed to higher degree of interest rate risk. Such risk is more pronounced when interest rates are declining. When rolling over assets or sanctioning of new loans, the bank's issuing rate may decline whereas the cost of borrowing shall continue to remain fixed because of the long maturity of bank debt. On the other hand, a shorter maturity of its debt as compared to its assets in an environment of rising interest rate exposes the bank to a high degree of refinancing risk - wherein the cost of borrowing may increase substantially and adversely affect its Net Interest Margin.

d. Systemic Importance and Government Support

The banking sector is a systemically important economic intermediary. Therefore, while the RBI regulates the Indian Banking system, it also extends necessary support from time to time in the form of Liquidity Adjustment Facility (LAF) and Marginal Standing Facility (MSF), operational support and regulatory assistance. The degree of support varies with the scale, nature, size and scope of operations. Further, the extent of government holding, and the regional and socio-economic importance are other factors that play a major role. Acuite believes that a healthy degree of support from the government on these grounds further strengthens the credit risk profile of the bank.

e. Cost of Borrowing, Resource Mobilization Ability

A bank's resource mobilization ability is a function of its cost of borrowing, ability to raise resources from the market and availability of unutilized lines of credit. Expanding the Current Account & Savings Accounts' portfolio (CASA) is one of the ways to raise low cost high volume financial resources for banks and reduce the weighted average cost of funds. Acuite ascertains the trend related to the growth in the bank's CASA over a period and analyses the CASA Ratio of the bank.

B. Business Development, Business Channels

Acuite believes that growth in the scale of operations is driven primarily by two factors:

a. Market Presence and Distribution Network

The geographical distribution and the network of branches, marketing strategies and growth in CASA are key factors that determine the bank's ability to expand business operations in the short to medium term. However, the maintenance of a vast distribution network is typically associated with higher selling and distribution and fixed costs for the bank. Acuité therefore evaluates the expansion strategy of the bank in the light of its cost-effectiveness and economies of scale.

b. Customer Relations, Service Standards and Fair Practices

In a highly competitive business environment, adherence to service standards and healthy customer relations is imperative to maintain competitive edge. Therefore, Acuité also evaluates the grievance redressal systems, adoption of technology enabled processes and other operating processes to assess the overall quality and service standards of the bank.

Criteria For Rating Of Entities In Infrastructure Sector

The Infrastructure sector includes segments such as construction of roads, bridges, irrigation projects, power projects - generation, transmission and distribution, ports, airports, and other such projects of social importance such as waste management. Typically, infrastructure projects differ from regular projects in terms of their large investment, long gestation periods, strategic importance and significant entry barriers.

Types of Infrastructure Projects:

Government Projects: Government projects include ports, irrigation projects of strategic importance undertaken by the government.

PPP (Public Private Partnership) Projects: These are projects undertaken in Special Purpose Vehicles format (SPVs) in which the government and private parties hold stakes.

Private Projects: These are projects promoted by private entrepreneurs.

Generally, infrastructure projects are executed through Special Purpose Vehicles floated by the promoters/sponsors. These SPVs could be either wholly owned by the promoter or jointly with other stakeholders like Government/private equity investors. The SPV structure helps in ring-fencing the cash flows and assets of the project from the promoter's balance sheet. Debt is usually raised in the SPV against the strength of the cash flows. These cash flows could be toll charges for a toll-way company, transmission charges for a power transmission company or user development fees/rentals generated by an airport. Operational cash flows are generally collected in a separate account (Escrow Account) and a waterfall mechanism would be in place to decide priority of payments.

While each segment in the sector has its unique characteristics, there are certain factors which are common to most of the infrastructure projects. Acuite believes that focusing on these key factors common to most projects provides an appropriate evaluation of the risk profile of the project. This document details some of these common parameters and their importance from a credit rating standpoint.

The rating framework for infrastructure entities takes into account the Business Risk, Financial Risk and Management Risk. Given below are the factors examined under each of these:

BUSINESS RISK

Business risks associated with infrastructure entities can be bifurcated into two categories - risks associated with the project until commissioning and commercial operations thereafter

A. Risks associated with the project prior to commissioning Funding Risk:

Funding Risk analysis entails an evaluation of the financial closure of the project - both from an equity and debt perspective. The equity portion is to be brought in by the

promoter/sponsor and also supplemented by private equity investors and public offerings. The debt portion is usually raised from domestic banks, financial institutions, NBFCs, and international lenders such as multi-lateral institutions. Most infrastructure projects involve a consortium/syndicate of lenders. Besides, regular funding in the form of rupee/foreign currency term loans, Rupee-denominated bonds, External Commercial Borrowings (ECBs) etc., other avenues such as mezzanine debt and the like are the other avenues of funding available to the infrastructure players.

Infrastructure projects are generally long duration projects with long gestation periods. Hence, the funding profile of such a project has to be long term in nature, in order to align cash flows with debt servicing commitments. Acuité takes into account the maturity profile of debt while arriving at funding risk assessment.

Infrastructure projections are prone to time and cost overruns. Hence, the ability of the promoter/sponsor to infuse additional funds is a key factor that influences the funding risk assessment.

Execution Risk:

Acuité factors in the following while assessing Execution Risk:

- **Type of Project:** Acuité examines the nature of the project being undertaken - Greenfield project/ Expansion project etc. A greenfield project entails higher level of risk compared to a brownfield project.
- **Regulatory approvals:** The timely receipt of approvals from various government departments/ regulatory agencies is a critical factor influencing execution risk. In case of road projects, delays in approvals like 'Right of Way' may impact the timely execution.
- **Requisite raw material, labour, utilities:** Acuité examines the tie-ups for uninterrupted supply of key inputs. For instance, coal supply linkages would be a critical aspect examined by Acuité while rating a coal-based power generation company.
- **Dependency on overseas vendors:** Dependence on overseas vendors for capital equipment/raw material
- **Reputation:** Reputation of key vendors on timely delivery of equipment/track record with regard to after sales servicing is crucial. For instance, solar panels are one of the key equipment in solar energy projects. Tie up with an established vendor with track record of timely delivery, performance and after sales delivery will imply lower execution risk.
- **Terrain of the project:** Terrain of the project and availability of social infrastructure also play a vital role in execution risk. For instance, projects located in areas prone to natural calamities/events like floods, earthquakes will have typically higher execution risk.

Technology Risk:

Acuité examines the following aspects:

- Nature of technology (new or conventional)
- Extent of technological change in the sector

- Availability of ongoing technological support

Past track record of the technology provider

Legal Risk:

While infrastructure projects are mostly implemented by the Central/State Government, a large number of projects take the public-private partnership (PPP) mode. The PPP model envisages financial /nonfinancial/fiscal support from the government. Given the implications of the model, Acuité evaluates the roles and responsibilities envisaged in the partnership, rights, as well as the financial implications arising out of the agreements and contracts entered into between the parties.

B. Risks associated with the project after Commercial operations Offtake Risk

Offtake risk assessment entails a study of the adequacy of operating cash flows vis-a-vis debt servicing commitments. The following aspects will be examined:

- Revenue generation, volumes, tariffs (proposed as well for the future and escalation if any)
- Utility of infrastructure to users and the alternatives/substitutes available
- The ability and willingness of users to pay and their economic conditions
- Competition in the market
- Government/tariff regulations. Robustness of the revenue collection mechanisms, revenue leakage and mitigation measures
- Political risk in tariff fixation and its revision

Operating Risk:

Generally, the infrastructure facilities once developed, require ongoing maintenance. For instance, the toll-way developer is responsible for timely maintenance of the toll road which is assessed under Operating Risk. In case of wind energy projects, usually the original EPC contractor handles the operations and maintenance. The lack of proper maintenance on the part of the EPC contractor for say a Solar Energy project may impact the future plant load factor (PLF) of the project. The following are the factors evaluated with regard to operation and maintenance of infrastructure projects:

- The facilities not meeting the standards set and user dissatisfaction and impact on the revenue generation.
- Maintenance of safety standards, not meeting the quality requirement and resultant damages if any, claims and impact on revenue.
- Some of the examples in this regard include frequent non availability of power from generating stations, problems of distribution including low voltage, non-availability of berths in docks resulting in demurrages, non-availability of one/two lanes an expressway due to poor road quality and subsequent repairs.

Based on the specific characteristics of the concerned infrastructure projects, Acuité evaluates the risks associated with operations, the impact on revenue generation and debt servicing capabilities.

Counterparty Risk:

A key risk to be noted in an infrastructure project is the credit quality of the counterparty. A strong counterparty like NHAI or Government of India will significantly mitigate counterparty risk inherent in a project. However, in the event of a relatively weaker counterparty - for instance a State Electricity Distribution Company (Discom)- the counterparty risk is significantly elevated due to higher possibility of delays/defaults in payments or legal issues. A strong counterparty to a project increases the ability to raise funds at favourable pricing.

Risk arising out of Force Majeure Condition:

Force Majeure conditions arise due to earthquakes, fire, damages during construction/operations which can have an adverse impact on the project. Acuite ascertains whether adequate insurance cover exists to cover such unforeseen losses. Besides, emphasis is also laid on the provisions in the legal agreement on termination of the contract between the sponsor and the purchaser and compensation for the same.

Credit Enhancement Assessment:

Generally, the lenders to Infrastructure Projects stipulate covenants such as guarantees from promoter entities enjoying high investment grade rating and/or maintenance of adequate safeguards by way of DSRA (Debt Service Reserve Account), Escrow Account etc. In such cases Acuite may adequately factor in the credit enhancement while considering the rating.

FINANCIAL RISK

The financial risk analysis of an infra project takes into account the following factors:

- Reasonability of the assumptions underlying the cash flow projection
- The base case cash generation capacity of the project and its adequacy to meet the debt obligations. The debt coverage metrics such as interest coverage, debt service coverage ratio, ratio of net cash accruals to total debt are also evaluated. In case of infra projects involving foreign currency debt, risks such as currency movements, hedging etc. are considered.

A sensitivity of the debt coverage metrics is carried out to assess the debt servicing ability under various conditions of stress. The financial risk analysis of infrastructure projects focusses more on the cash generation potential and promoter's support in case of need.

MANAGEMENT RISK

The factors considered include:

- Track record of management with banks/financial institutions/capital markets. Relationships with banks/institutions from a future fundraising perspective
- Experience and track record of management with regard to implementation and successful operation of similar projects
- Stated/Implied stance of management on commitment to the project

- In case of more than one promoter, Acuite will examine the likelihood of ongoing financial support from each. In case of private equity investors, the expectations on exit and its impact on the project will be examined
- The ability to anticipate, withstand and manage challenges arising during the implementation of the infra project with long gestation and operating periods for repayments.

Criteria For Default Recognition

Acuité adheres to the following definition of default#:

Fund-based facilities & Facilities with pre-defined repayment schedule

Facilities	Rating Scale	Proposed Definition of Default
Term Loan	Long Term	A delay of 1 day even of 1 rupee (of principal or interest) from the scheduled repayment date.
Working Capital Term Loan		
Working Capital Demand Loan (WCDL)		
Debentures/Bonds		
Certificate of Deposits (CD)/ Fixed Deposits (FD)	Short Term/ Long term	Overdue/unpaid for more than 30 days.
Commercial Paper	Short term	
Packing Credit (pre-shipment credit)	Short Term	
Buyer's Credit	Short Term	Continuously overdrawn for more than 30 days
Bill Purchase/Bill discounting/Foreign bill discounting /Negotiation (BP/BD/FBP/FBDN)	Short Term	Overdue/unpaid for more than 30 days

Fund-based facilities & No Pre-Defined Repayment Schedule

Facilities	Rating Scale	Proposed Definition of Default
Cash Credit	Long Term	Continuously overdrawn for more than 30 days.
Overdraft	Short Term	Continuously overdrawn for more than 30 days.

Non-fund-based facilities

Facilities	Rating Scale	Proposed Definition of Default
Letter of credit (LC)	Short Term	Overdue for more than 30 days from the day of devolvement.
Bank Guarantee (BG)(Performance / Financial)	Short Term	Amount remaining unpaid from 30 days from invocation of the facility.

Other Scenario

Scenario	Proposed Definition of Default
When rated instrument is rescheduled:	Non-servicing of the debt (principal as well as interest) as per the existing repayment terms in anticipation of a favorable response from the banks of accepting their restructuring application/ proposal should be considered as a default.
	Rescheduling of the debt instrument by the lenders prior to the due date of payment will not be treated as default, unless the same is done to avoid default or bankruptcy.

Events of Default in case of Hybrid Instruments

Acuité believes that any delay in servicing the interest from the scheduled repayment date shall constitute an event of default. Acuité will recognize a default when the issuer of the instrument delays, even by one day, any interest payment (and/or principal in case of non-perpetual instruments) even if the terms of the instrument allow such delays in certain situations.

Curing Period

The following curing period shall be applicable for entities rated 'D' i.e. 'Default' category

- *Generally 90 Days - from 'Default' up to 'BB+'
- Generally 365 Days - from 'Default' to 'BBB-' and above

However, there could be situations where an entity that has defaulted in the past, witnesses one or more (list is indicative, not exhaustive) of the following:

- Change in management
- Acquisition by another firm
- Sizeable inflow of long-term funds
- Benefits arising out of regulatory changes
- Sharp improvement in liquidity brought about by debt restructuring
- Technical defaults

The aforementioned or similar such developments may structurally alter the credit risk profile of entities that have defaulted in the past. If Acuité is of the opinion that factor(s) that led to a

default earlier is unlikely to recur in the near term, Acuite may deviate from the curing period stated above.

*Cases of deviations from stipulated 90 days, if any, shall be placed before the Rating Sub-Committee of the board of the CRA, on a half yearly basis, along with the rationale for such deviation. This is in line with SEBI circular, "Review of Post-Default Curing Period for CRAs" (SEBI/ HO/MIRSD/ CRADT/ CIR/ P/ 2020/ 87) dated May 21, 2020.

Checklist for the Rating Note

The Rating Analyst should ensure that the points mentioned in the checklist below are applicable to all the outstanding instruments. The table below should form part of every rating note.

Details of the checklist	Yes / No
Has the issuer indicated that they have delayed or defaulted^ in debt service on any external debt (i.e. excluding debt from the promoters)?	
Has the company's auditor (typically in the annual report) indicated any delays/ defaults in debt service by the borrower?	
As part of the interactions with the borrower's bankers, have any of the bankers indicated any irregularity/ delays/ defaults in debt service by the borrower?	
For capital market instruments, have the debenture trustees indicated any delays/ defaults in servicing of the debt instruments by the issuer?	

With respect to recognition of default, Acuite will be guided by SEBI Circular SEBI/ HO/ MIRSD/ CRADT/ CIR/ P/ 2020/ 53 dated March 30, 2020. A note on the same is available on: <https://www.acuite.in/transitory-relaxation-from-compliance-with-certain-provisions-under-SEBI.htm>

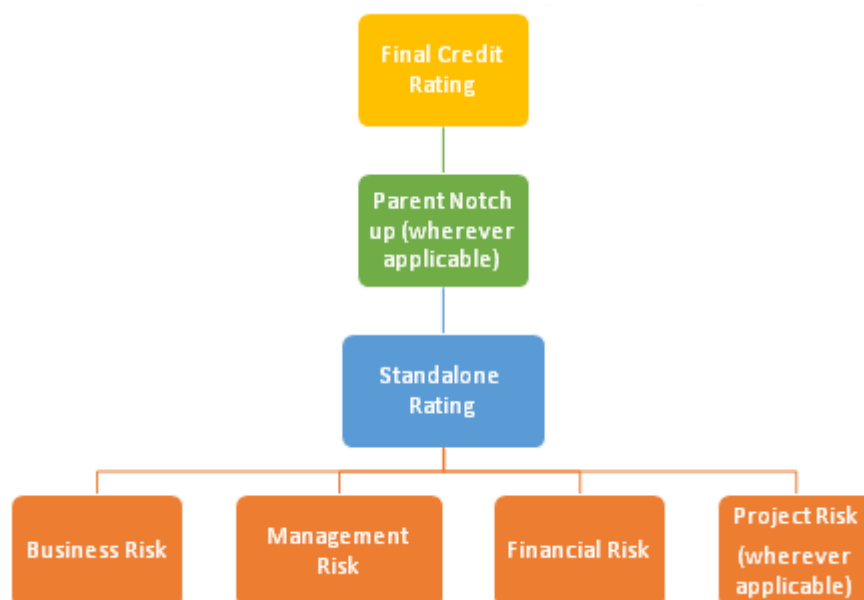
Application Of Financial Ratios And Adjustments

Acuite considers the following metrics for an appropriate assessment of an entity's financial health and performance:

1. Net worth
2. Capital Structure/Gearing
3. Profitability (Operating Profit Margin & Net Profit Margin)
4. Debt Protection Metrics and Coverage Ratios
 - a. Interest Coverage Ratio
 - b. Debt Service Coverage Ratio
 - c. Net Cash Accrual to Total Debt
 - d. Debt to EBITDA
5. Efficiency (Return on Capital Employed)
6. Liquidity (Current Ratio)

While certain business segments may require additional financial metrics to be examined, Acuite believes that credit risk assessment based on the above ratios reflect the credit quality of the issuers.

Acuite's approach to rating comprises an evaluation of the quantitative and qualitative aspects of an entity. Acuite takes into account the qualitative aspects through business and management risk analysis whereas financial risk analysis is quantitative in its approach. The table below explains the rating framework and its components:



As indicated in the diagram above, financial risk analysis is an essential part of the Rating Framework. It entails examining the various financial metrics and their movement over a period of time. Given below are the key metrics, method of calculation and explanation on their importance from the analytical standpoint:

1. Net worth

Net worth refers to the owner's stake in the business. In case of a company, tangible net worth means the aggregate of paid up Share capital and reserves and surplus, after excluding items such as revaluation reserves, intangibles, unamortized miscellaneous expenditure and accumulated losses. Acuité believes that a higher net worth base provides cushion against losses and contingencies. Net worth is indicative of the shock absorption capacity of an entity and its resilience to external conditions. Acuité observes that, other things remaining equal, higher the net worth base higher is the protection to lenders. Hence, size of the net worth assumes importance while assessing the financial risk profile of an entity.

2. Capital Structure/Gearing

The capital risk in an organisation is largely dependent on its capital structure and related decisions. Such decisions are often based on several factors including the cost of capital and at times the lenders' policies and the investor's preferences.

The above two parameters adequately describe the capital structure and the associated impact on the entity's credit risk profile.

Debt / Equity Ratio:

Debt / Equity Ratio = (Total Debt Long Term and Short Term)/Total Tangible Net worth

Acuité considers all on-balance sheet debt to arrive at the gearing. For purposes of gearing ratio, apart from regular debt like bank borrowings and non-convertible debentures, Acuité may also include other debt instruments. These include preference shares/debentures/bonds convertible into equity at the option of the holder and other such hybrid instruments. In certain cases, Acuité may also take into account off-balance sheet commitments such as guarantees extended to subsidiaries/group companies etc. while arriving at the gearing depending on the estimates of possible devolvment.

Tangible net worth includes equity share capital and reserves and surplus after excluding items of un-amortized miscellaneous expenditure and accumulated losses, revaluation reserves, other intangibles appearing on the balance sheet. Items such as compulsorily convertible preference shares may be treated as quasi-equity after examining relevant clauses. Unsecured loans from promoters may also be treated as quasi equity if Acuité is satisfied that these will be retained in business till the currency of the credit facilities. Acuité will consider factors such as subordination clause in the bank's sanction letter, the past trends in respect of such loans and the promoter's stated stance while treating it as debt or quasi equity. Acuité may also exclude items such as unrelated investments in/advances to outside entities, receivables that are long overdue from the tangible net worth.

A high debt-equity ratio (DER) is typically associated with higher credit risk. Acuité observes that high gearing magnifies the risk of default especially during a downturn in the economic cycle. Acuité notes that entities with steady revenue streams/stable operating cash flows can sustain higher debt levels than those exhibiting significant volatility in their cash flows across a cycle.

While comparison of gearing across peer entities could lead to insights on their relative credit risk, in case of certain categories of entities such as traders, a different approach is warranted.

Traders and EPC contractors rely more on non-fund based facilities such as letters of credit to fund their working capital requirements. In such cases, Debt / Equity ratio may not correctly reflect the indebtedness of the entity. Hence, Acuite generally examines the TOL/TNW (Total Outside Liabilities/Tangible Network) to gauge the correct level of indebtedness from a credit rating standpoint.

Total Outside Liabilities to Total Network:

$$\text{Total Outside Liabilities to Total Network} = (\text{Total Debt} + \text{Other outside liabilities}) / \text{Total Tangible Network}$$

This ratio expresses how well the owners'/promoters/shareholders' funds cover outside liabilities for the entity. Generally speaking, higher the TOL/TNW, more is the credit risk inherent in the entity. Nevertheless, even in such cases, Acuite examines the nature of business, sectoral trends and other related aspects while arriving at an opinion on the sustainable level of indebtedness.

3. Profitability (Operating Profit Margin & Net Profit Margin)

The operating profit margin represents the core earning capability and is unaffected by leverage or depreciation charges.

Operating Profit Margin:

$$\text{Operating Profit Margin} = (\text{Earnings Before Interest, Tax, Depreciation and Amortisation}) / \text{Operating Income}$$

Operating Income comprises items such as Net Sales (Gross sales net of sales tax, excise duty and other local taxes) from core operations and other related income of a recurrent nature such as scrap sales, job work income, commission income and export incentives. A consistently high operating margin (vis-a-vis peers/industry standards) implies higher pricing power with clients and efficient cost structure.

From a rating perspective, entities with relatively stable operating margins across a cycle would be preferred to those exhibiting high volatility. Companies with strong brands or operating in niche segments will generally command better operating margins than those in commoditised segments. Similar is the case with companies operating in higher value-added services segments such as high-end IT services vis-a-vis players at the lower end of the value chain.

The operating margin is essentially a measure of the ability of the entity to manage the competitive pressures, cost structure and maintain / improve profitability.

Net Profit Margin:

$$\text{Net Profit Margin} = \text{Net Profit after Taxes} / \text{Operating Income}$$

Net profit margin is calculated by dividing Net profit after taxes by Operating revenue of the company. It reflects the earnings after considering all operating costs, interest expenses, and depreciation, other items of income and expenditure and taxes. Generally speaking, net profit margins tend to be more volatile across time periods as compared to operating margins.

Apart from the operating cost structure, the net profit margin is also influenced by leverage levels, asset intensity, tax outgo and abnormal items of income/expenditure. Against this backdrop, the comparison of net profit margins across time periods/entities may be of limited utility to the analyst till he has an insight into the reasons for variations across time periods. For instance, an abnormally higher 'other income' of a non-recurring nature such as profit on sale of non-core assets will artificially boost net profit margins of an entity for a certain period vis-a-vis that of other years. Hence, comparability of net margins across periods from a future projection standpoint may be misleading unless the abnormal influences are evened out. Similarly, the net profit margin of an entity operating in a tax-free geography may not be comparable with an entity paying taxes at the highest marginal rates. Despite its limitations, the Net profit margin reflects a broad metric of the ability of an entity to generate internal accruals and to increase its net worth from internal generation. Other factors remaining constant, higher the net profit margin, better is the ability of the entity to support a high growth trajectory.

4. Debt Protection Metrics

Debt protection metrics help analyse the nature of interaction of various income statement items with the balance sheet structure of the entity. The analysis of these metrics evolves at three levels - Acuite first analyses debt protection by taking into account the coverage of interest payments, followed by the principal payment and eventually the entire quantum of debt on books.

Given the above approach, Acuite first analyses the **Interest Coverage Ratio of the entity**.

Interest Coverage Ratio:

$$\text{Interest Coverage Ratio} = \text{EBITDA} / \text{Interest Charges}$$

This ratio describes how well the operating profit covers interest payments made by the entity in a financial year. In addition to the interest charges, Acuite also considers preference dividend and other bank charges while calculating this ratio. A higher ratio implies better debt protection. However, this ratio does not provide a holistic picture with respect to the degree of debt protection as it considers only interest coverage. For term loans, Acuite relies on the **Debt Service Coverage Ratio (DSCR)** for the above.

Debt Service Coverage Ratio:

$$\text{Debt Service Coverage Ratio} = (\text{Net Profit} + \text{Depreciation} + \text{Interest Charges}) / (\text{Interest Charges} + \text{Current Maturity of Long Term Debt})$$

DSCR evaluates how well the cash accruals in the given year cover the quantum of debt servicing required. While Acuite believes a higher ratio indicates that an entity should be able to service its debt from current year cash accruals, DSCR below 1 time indicates that the issuer may face debt servicing pressures and hence has a higher risk of default. Higher the DSCR, better will be the ability to service debt in a timely manner. Acuite also believes that DSCR must be sufficiently above 1 time in order to reduce the susceptibility of the entity's debt servicing ability in light of the adverse industry or environmental factors.

Net Cash Accruals to Total Debt:

$$\text{NCATD} = (\text{PAT} + \text{Depreciation} - \text{Dividend}) / (\text{Total Debt Long term \& Short term})$$

Net Cash Accruals to Total Debt is a debt protection metric which links the total debt of the entity to its net cash accruals for any given period.

It is a rough surrogate for coverage of the debt with net cash accruals from a business. A NCATD of 25% would broadly indicate that the entity would need around four years of net cash accruals to liquidate its current levels of debt. This ratio does not make a distinction between different types of debt- short term or long term. Hence, its utility to gauge the debt servicing ability over a period is limited vis-a-vis the interest coverage ratio or DSCR discussed above. Nevertheless, despite its limitations, Acuite observes that generally speaking, entities with consistently higher NCATD levels have resilient credit profiles than those with lower NCATD.

Debt to EBITDA:

$$\text{Debt to EBITDA} = \text{Total Debt} / \text{EBITDA}$$

Apart from DSCR, Acuite believes that the **Debt to EBITDA Ratio** is also an important metric to assess default risk which comes along with the maturity profile of the existing debt.

This ratio is an indicator of the amount of time that the entity will need to repay the current amount of debt on its books by utilising operating profits. In case Debt to EBITDA is higher than the overall maturity of the debt, the entity will be required to refinance its debt or ensure timely infusion of capital by promoters. Irrespective of the recourse chosen, the high Debt to EBITDA is representative of a significantly greater degree of credit risk.

5. Efficiency (ROCE)

Return on Capital Employed:

Return on Capital Employed = EBITDA / Total Capital Employed

where, total capital employed is defined as:

Total Capital Employed = Total Networth + Total Debt

Acuité measures the efficiency with which capital employed in the business is utilised. It is typically measured by analysing the **Return on Capital Employed** of the entity. A key advantage of ROCE is that it is unaffected by leverage and is a metric which lends itself to comparability across sectors.

Acuité observes that ROCE ratios tend to be depressed particularly when the entity is on a growth trajectory or in case of commodity-based industries during the trough of a commodity cycle. Since there is often a time lag between capital expenditure and benefits accruing therefrom, the ROCE ratios will be low during the period of heavy capex. Acuité considers the trend of ROCE across a cycle to understand the overall efficiency of the unit rather than that for a specific period.

6. Liquidity (Current Ratio)

Liquidity refers to an entity's ability to meet its obligations (financial and commercial) in a timely manner. A strong liquidity profile implies ready availability of unencumbered cash and liquid assets to meet debt servicing commitments and day-to-day business related expenses as and when they fall due.

In Liquidity assessment, Acuité evaluates availability of unencumbered cash/liquid assets with the entity, unutilised bank lines and potential for timely liquidity support from group entities with stronger credit profiles. Acuité may also examine the refinancing ability of the entity while assessing liquidity profile especially in cases where the entity has significant debt repayment obligations.

Evaluation of the Current Ratio is an important tool to determine the liquidity position of an entity.

It is a metric of how the current assets of an entity are funded.

Current Ratio:

Current Ratio = (Current Assets) / (Current Liabilities)

A current ratio indicates how current assets of an entity have been financed. A ratio above 1 indicates that a portion of the current assets have been funded by long term sources. A ratio below 1 indicates that a portion of the short term funds have been used to support long term assets. Generally, current ratios below 1 are viewed as a sign of possible stress. In this context, Acuité believes that rather than relying on current ratios in isolation, it is

necessary to examine the ratio in conjunction with other metrics such as working capital cycle and the nature of activity.

Lenders have been traditionally examining trends in current ratio for assessing proposals for working capital financing. From a lender's perspective, higher the current ratio (i.e. higher the proportion of long term funds supporting current assets), higher is the protection available to the banker. Acuite believes that in addition to the Current Ratio and its trends, it is also necessary to factor in the quality of current assets. For instance, other aspects remaining the same, a unit dealing in a commodity business is likely to have a better liquidity profile than a unit dealing in customised products because of the former's ability to liquidate its inventory at a short notice.

A mere examination of the current ratio will not reveal these critical aspects. In most of the cases, along with the movement in current ratio, it is necessary to examine movements in working capital cycle. The working capital cycle in days is calculated as under.

Working Capital Days:

$$\text{Working Capital Days} = \text{Debtor Days} + \text{Inventory Days} - \text{Creditor Days}$$

Working capital days indicate the number of days it takes for an entity to realise cash from its production/trading cycle. Higher working capital days indicate that the company takes more days to realise its cash from operations. Also, it would mean higher external funding requirement for the entity. Here again, Acuite examines each item of working capital to understand the impact on the liquidity profile of the unit.

Cash Flow Analysis

Acuite's analysis focusses on profitability as well as cash flow. The ability of an entity to meet commitments to its lenders and other stakeholders depends on its internal cash generation ability. An entity with a robust operational cash flow will depend less on external funding to fund its growth.

Auditor Comments and Remarks

Acuite also examines the auditor's comments and remarks in detail and makes necessary adjustments, if required while calculating the ratio. In case of remarks such as lower provision for depreciation or un-recognised diminution in value of investments, Acuite may make necessary adjustments to the income statement/balance sheet figures while calculating ratios.

Criteria For Consolidation Of Companies

Executive Summary

Firms often find it economically valuable to establish separate legal entities - such as subsidiaries (for instance, in case of FMCG products), Special Purpose Vehicles (in case of Solar Power Projects) or as associate or group companies (as in the case of firms with multiple SBUs) - as against expanding its own scale of operations. The primary rationale behind such a trend is due to the onset of diseconomies of scale with larger size, more efficient tax planning & management and other regulatory issues. As the economy prospers, firms are bound to grow in size - resulting in both the birth of such legal entities and also in the consolidation of separate entities into merged entities.

This active process of forming complex inter-firm business networks results in a complicated stream of cash flows that transpires across group companies and along with the stream of cash accruals comes a myriad of uncertainty or risk. Thus, in order to better understand the risk involved in such economic-legal structures, Acuité consolidates the financials of the parent/group company with that of the holdings - in an attempt to unravel this complex web of cash flows and risk transmission.

Typically, Acuité believes in a necessary congruence between the accounting policies and financial analysis and to this end the method for consolidation followed is as articulated in the Accounting Standard 21 by the Institute of Chartered Accountants of India. Acuité also believes that these consolidated accounts are a necessary source of key information that enables the market to better deconstruct both the business and financial risks hidden in an enterprise.

Objectives of the Document

This document is fundamentally aimed at better understanding the need for consolidation of financial statements, and Acuité's own approach towards consolidation & the ensuing analysis of the same. It also sheds significant light on the larger study of the degree of support that a parent/holding/group company extends to its subsidiaries/SPVs/group company and Acuité's view on the same.

Method of Consolidation:

Acuité follows the following 3 stage method for consolidation:

- **Reciprocal pairs of assets & liabilities are identified and offset against each other.** Here, investments/interoperate borrowings or lending in related entities are negated against each other and only the net value is considered.
- **Adjusting the Net-worth with that of the Subsidiary/group Company.** Here, the net worth of the subsidiary is added to that of the parent and any investment by the parent in the subsidiary is deducted from the net worth of the consolidated balance sheet.

- **Offsetting Revenues and Costs.** Here, the inter-group transactions are offset - hence limiting transfer pricing related issues in inter-group transactions. By taking a net value, the financial ratios are re-calculated and analysed.

The most significant advantage of this method is that it does not necessitate the revaluation of the assets neither does it make it necessary for us to create goodwill to equilibrate the financial statements.

Cases Relevant for Consolidation

While the degree of impact of consolidation on the risk-return metrics varies significantly across firms and business models, however the need for consolidation as an exercise is well warranted in a large pool of cases - in order to ensure due diligence in the credit risk assessment exercise. Such a support mechanism may include significant holding, past track record of financial support or mutual collaboration of business interests.

At the same time, the actual impact on the cash accruals of the parent/group company varies from case to case and thus, to evaluate degree and nature of inter-linkages Acuité analyses the following six factors to the extent they are applicable:

- Identify the Business & Strategic Significance of the Entity being rated for the Parent/group company
- Degree of leakages and injections of funds along with ease of support to and from the parent/group company to the entity being rated
- Presence of statutory, legal or documentary assistance to establish track record and likelihood of support from the parent/group entity to the entity being rated. Acuité also factors in the management's stated posture while analysing this factor.
- Analyse the percentage shareholding/crossholding by the parent/group companies in the related entity - higher the shareholding, greater is the probability of the parent/group extending support to the latter
- Understand the Management's Attitude towards the role of the rated Entity in the Parent/Group. Acuité also analyses the degree of management control that the related entity wields over the rated entity
- Study the presence or absence of shared names, brands, business channels and other synergies

Once the related entity and the firm have been evaluated on these parameters, Acuité establishes the degree of integration of both the entities and this understanding drives the foundation for further analysis. Only in cases where strong levels of inter-linkages are established, Acuité follows the complete integration method, wherein the business, financial and management risk profiles of the related entity and the entity being rated are combined. In cases where all the entities in a group are consolidated, each of the entities may not qualify for the same credit rating or outlook. Based on various parameters, there may be deviation in the credit ratings assigned among the entities that have been consolidated. In cases where semi-strong or moderate levels of linkages are established, Acuité may apply a group/parent notch-up to the ratings of the entity being rated. (Please refer Acuité's criteria on Group and Parent Notch up).

Criteria For Group And Parent Support

Executive Summary

The rating of a company is enhanced when its credit worthiness, in addition to its individual strength and weakness is also dependent on the pedigree and backing it enjoys from its stronger parent or group companies. Acuité also factors in the ease and track record of support from the parent or group for rating. In case the cash flows of the parent or group entities are ring fenced, and unavailable to the company being rated, Acuité adequately factors in the same, and may not provide any notch up.

Although several parameters to determine the extent of parent/group support available to an entity exist, Acuité recognises that in case of parent-subsidary relationship, the support to the subsidiary will probably flow from only one strong entity. However, in case of group companies, the support could flow through multiple entities in the group, and it may be difficult to ascertain the single supporting group entity. Thus, Acuité considers group support notch up only if the the group has a relatively strong credit profile.

Firstly, Acuité would arrive at the group's overall rating after aggregation of business, management and financial risks of various group companies. In case, only parent company support is forthcoming, Acuité will evaluate the credit profile of the parent entity and also factor in the likely impact of the support on the subsidiary in the parent company's credit rating. Thereafter, the ability and willingness of the parent company to provide support to the company being rated in times of distress would be evaluated.

Acuité's analysis of group/parent support will be based on various factors including the nature of business relationship and the company being rated, quantum of shareholding by companies in the group/parent in the company being rated and the degree of management control. Based on the assessment of these factors, the level of linkage of the subsidiary being rated with the group/parent would be established. Thereafter, Acuité would suitably notch up the stand-alone rating of the company being rated. A fully-owned company with significant business synergies with the group/parent using a common brand name could get a higher notch up as compared to a company that has limited synergy in operations and limited likelihood of support. The parameters taken into consideration for such evaluation are elaborated below.

This approach will clearly identify the relationship between the individual company and the group companies/parent company and establish the extent of support likely to flow to the rated entity.

Factors to be considered while notching up of Ratings

- A. Nature of business relationship of the company being rated with the group/parent:
When substantial business synergies exist between the company being rated and other companies within the group/parent company or if the company is of strategic importance to the group/parent, appropriate weightage could be assigned to the relationship.

The following are taken into consideration to determine business synergies:

- The company could be providing critical inputs to the group's/parent company's operations
- The company could be contributing significantly to the group's/parent company's turnover, profit after tax and cash flows
- The company could be in a line of business that the group/parent company believes to have considerable growth potential

B. Use of common brand

The company being rated could be sharing a common brand name either in part or full with the group/parent company. In such a case the group /parent company could be under pressure to support the company in times of difficulty.

C. Quantum of holding by parent/group companies

Greater the percentage of shareholding of the group /parent company in the related entity, higher is the weightage that could be assigned. Further, due consideration is also given to future plans of the group/parent company with regard to increasing its holding.

D. Value of exposure of parent/group

Greater the value of exposure of group/parent company in the entity being rated as compared to size of operations of the parent/group, higher would the weightage.

E. Management control

The commitment of the group/parent in managing and controlling the company being rated in both strategic direction and operations should be one of the factors to be considered. A more involved management and control by the group/parent could be viewed favourably while notching up of ratings.

F. Management's written commitment and stated posture

The written assurances given by the group/parent company through letters of comfort, keep well agreements, contractual arrangements for supply of services/products could be viewed as increased commitment by the group/parent company to the company being rated. Also, in cases where the parent/group company has a clearly articulated, publicly stated intent to support, the likelihood of the same being honoured in times of financial distress is higher.

G. Track record in supporting the entity being rated and ease of support

Acuité will assess the support based on the management's articulated stance on the criticality of the business to the group/parent over the medium term and past demonstration of such support on a timely basis, where applicable. In this regard, the current financial flexibility and liquidity position of the group as well as the group management's philosophy/plans to maintain the latter at an appropriate level will be assessed and regularly reviewed while factoring in parent/group support into the rating of the subsidiary company.

Factors to be considered while notching down of Rating

In specific cases of parent-subsidary relationship, where the subsidiary's standalone credit profile is significantly stronger than the parent's, Acuite may also notch down the rating of the subsidiary (entity being rated). A stronger subsidiary could be supporting a weaker parent by ways of inter-corporate deposits (ICDs), dividends or preferential sale-purchase transactions providing preferential credit terms to the parent.

Criteria For State Government Support

Executive Summary

India has a large number of government entities and industrial growth to a great extent is attributed to these entities formed either by an act of parliament or by orders of the central/state cabinets. Such entities play a central role in the economic growth of the country.

These organisations, spread across sectors from Civil Supplies to State Road Transportation are the catalysts of socio-economic prosperity. They are systemically essential, and their perpetual existence enables the government to diligently discharge its key roles and responsibilities. To this end, their smooth functioning and subsistence is a significant policy interest of the respective state and central governments and, Acuité believes that a certain degree of support is generally extended towards such entities by state governments. Such support can be in any form - from unconditional guarantees to significant shareholding to letter of comfort. However, the impact of such support varies from case to case and thus, Acuité assigns a state government notch up to government entities - which is a function of the credit risk and ability of the state government to support the entity being rated.

Objective

The objective of this document is to describe the methodology used to assign government notch up to eligible public sector undertakings and other government entities in India.

Methodology to Identify the Nature and Degree of Government Support:

Acuité follows a three tier process to understand the nature, degree and likelihood of government support extended/to be extended towards various entities:

A. Constitution of the Entity:

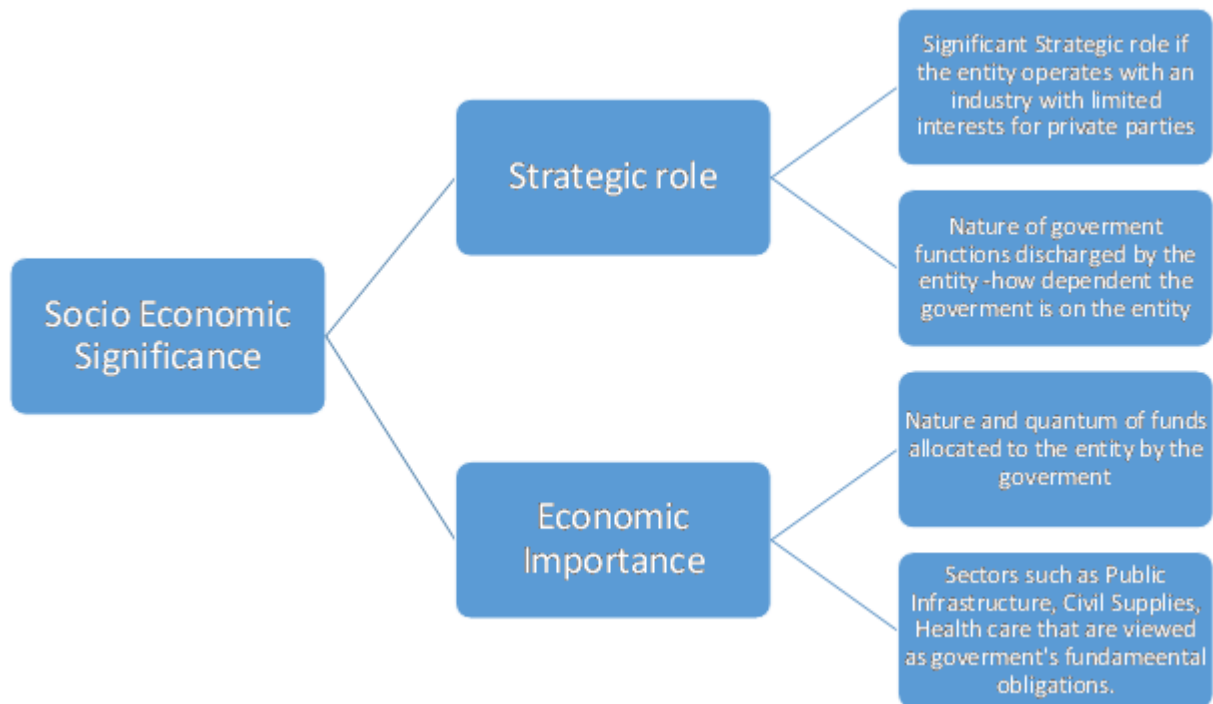
The degree of shareholding of the state government in an entity is an important parameter in ascertaining the nature of government support. Organisations formed by Acts of Legislature and departments of government are likely to enjoy substantial government support.

B. Socio-Economic Significance of the Entity:

Acuité takes into account the following criteria to evaluate the degree of systemic importance of an entity:

- The number of people impacted by the government entity
- Importance of the function discharged by the entity in the state/central government's policy
- Revenue contribution by the entity to the government

The significance of the entity is also evaluated on the basis of the strategic role and importance of the sector in the state/central government's policy. Schematically, the relationship may be summarised as follows:



C. Implications of Default

Acuité believes that the degree of support extended by the government to any related entity is a function of two key parameters:

- a. Degree of Contagion: If the failure/default of an entity is expected to create widespread cash flow issues across industries and firms (for example in case of insurance agencies and banks) or leads to a loss of public confidence that may adversely impact business environment, the expected support by the state/central government would be higher.
- b. Socio-Politico-Economic Implications of Default: If the failure of an entity results in loss of economic, social or political functioning of the state due to:
 - Number of employees of the entity along with the degree of unionisation amongst them
 - Political pressure arising out of the scope of possible failure of the entity
 - Amount of foreign currency debt - default of which may impact the inflow of foreign investments across the sector
 - Any other significant social, political or economic impact
- c. Impact on Public Perception: Acuité believes that if the default of an entity results in the loss of confidence with the government or increases the scope of geo-political unrest or political instability in the legislature, the government is more likely to extend support to it in order to prevent default and maintain public confidence.
- d. Posture of the Government: The posture of the government is determined by two things:

- **Stated Posture:** The government may create a structured obligation via an unconditional guarantee or a debt service repayment arrangement put in place externally or by other modes such as a letter of comfort, undertaking among others that can be factored in while arriving at the final rating.
- **Implied Posture:** The government support may be implicit wherein there exists public perception of such support thereby making it necessary for the government to avert any failure/default in order to maintain public confidence.

Determining the Degree of Government Notch Up

Acuité may follow a three dimensional approach to determine the degree of government notch up to be extended to any entity, as discussed below:

<u>Parameters</u>		<i>Significant Shareholding by the Government</i>	Implications of Default	
			<i>High</i>	<i>Low</i>
Socio Economic Significance	<i>High</i>	Yes	Such entities are extremely important for the smooth functioning of the government, and thus, Acuité equates the rating of such entities with the respective government ratings.	Such entities are expected to remain solvent through periodic support from the government. However, low implications of the entity defaulting is also adequately factored in the notch up.
		No	While such entities are systemically essential, the absence of significant shareholding induces some uncertainty with respect to the degree and nature of support	Low implications of default further dilutes the degree of support as a result of which, limited government support is assumed in such cases. The notch up in such cases is limited.

			expected from the government.	
	<i>Moderate</i>	Yes	Such entities, like certain financial institutions are expected to receive significant support from the government due to the goodwill they enjoy.	Only support such entities are expected to receive from the government is due to the role they play in discharging public policy objectives across the policy spectrum.
		No	The notch up in such cases is relatively lower as compared to the case discussed above due to the absence of significant government holding making it a largely private enterprise with limited government holding - ineligible for large budgetary allocations.	Low implications of default further dilute the degree of support. As a result, limited government support is assumed in such cases.
	<i>Low</i>	Yes	The singular motivation for any support is driven by the adverse implication of default, thus	Despite high government holding, the relatively limited economic and political significance of the

			limited support is expected and resulting in minimal benefit to the credit profile of the rated entity.	entity reduces the probability of government support in case of distress.
		No	While the entity is important for the government, there's limited statutory provision available to extend support. Thus, minimal notch up is extended by Acuite.	No notch up.

Criteria For Rating Of Securitized Transactions

Criteria for Rating of Securitized Transactions [assigning SO (Structured Obligation) ratings]

Primer on Securitization

Securitisation of assets entails the originator transferring the loan/asset to a bankruptcy remote Special Purpose Vehicle (SPV). The SPV would raise funds from the investor by issuing Pass Through Certificates (PTCs), having credit enhancements extended by the originator. The payments to the investor happen from the cash flow generated by this asset owned by the SPV. Alternatively, the investor and borrower can opt for a separate arrangement called direct assignment of method, wherein the underlying assets are directly assigned to the investor, with no need of an SPV. Securitisation of assets is popular primarily for transactions in which the underlying assets comprise residential and commercial mortgages, vehicle financing, gold loans, LAP (Loan Against Property), construction equipment loan, personal loans among others.

This section covers Acuite's approach to rating Asset Backed Securities (ABS) and Mortgage Backed Securities (MBS), which cover the major two type of securitization structures.

In order to understand the risks associated with a securitisation transaction, it is important to first familiarize oneself with the nature of such a transaction.

Key Steps in Securitisation	Risk Associated/ Factors Analysed
From its overall portfolio, the originator demarcates a pool of assets (loans) that it wishes to securitise.	Overall Portfolio Risk
The originator then sells this underlying asset pool to a separate SPV (Trust managed by a Trustee). This sale is typically made while ensuring that all risks and rewards associated with the particular asset is transferred to the SPV, thus delineating the performance of the asset pool from the changes in the credit profile of the originator.	Legal Risk
The SPV raises funds from investors by issuing them Pass through Certificates (PTC). These funds are in turn paid to the originator as consideration for sale of assets to SPV	Transaction Structure
The servicer is then responsible for ensuring timely collection of receivables and depositing the same in a designated Trust and Retention Account (TRA). In several securitisation transactions, the originator can also act as a servicer.	Servicer Risk

This cash flow generated from the underlying asset pool is deposited in the TRA. It subsequently flows to the investor as interest and principal components of the PTC issuances.	Credit Risk
The originator may provide additional credit enhancements to cover any shortfall in collections from the underlying pool and ensure that payments to the investor are in full and in a timely manner.	

Acuité evaluates individual risk elements acting at each stage of the securitisation transaction and the interplay among them.

Overall Portfolio Risk

Analysing the various practices and policies followed by the originator of the asset becomes important before ascertaining the overall health of the portfolio. Acuité analyses the robustness and soundness of the policies adopted by the originator for the entire gamut of lending activities, including lead generation, underwriting and credit policies, post disbursal monitoring of assets and collection efficiency. Acuité also gives due importance to the quality of MIS maintained by the originator and its risk management systems. Further, Acuité analyses the target market in which the originator operates, its geographical focus, and risk appetite. The delinquency rates and track record of managing portfolio of assets from which the asset pool has been carved out is also important to understand the portfolio risk associated with the originator.

Acuité analyses the characteristics of the originator's portfolio to understand delinquency risk, prepayment risk and collection efficiency. While doing this analysis, Acuité evaluates the entire portfolio of the originator, where new loans keep getting added while older loans are closed. Such analysis wherein newly disbursed loans get added regularly is called dynamic portfolio analysis.

A. Delinquency Risk

To analyse the overdue position in a given portfolio, Acuité bifurcates each underlying loan among several buckets such as 'On Time payment', '30+ DPD', '60+ DPD', till '180+DPD'. This bifurcation of individual loans acts as a starting point of the dynamic portfolio analysis. Acuité calculates the bucket wise delinquency rate. The outstanding value of loans as on date in each bucket is divided by the total portfolio outstanding as on that date. Acuité evaluates the trend in this delinquency rate over a period of time. However, in cases of rapidly expanding portfolios, this delinquency ratio may understate the delinquency risk. Thus, it may be prudent to consider lagged delinquency rates as well. Here, a historical (lagged) value of the outstanding portfolio is taken. Typically, the historical value of 6-12 months of the outstanding portfolio is taken depending on the asset class, seasoning, and original tenure among others. While analysing the performance of a portfolio over a period of time, it is also important to make sense of the movement in the delinquency transition rates for a portfolio.

B. Prepayment Rate

Acuité analyses the monthly historical prepayment rates for the portfolio, along with the expected interest rate and income level movements. Acuité also compares these prepayment rates with the benchmark rates for the same asset class.

C. Legal Risk

Analysis of legal risks associated with securitisation transactions is important to ensure that interest of investors is protected at times, when credit quality of the originator deteriorates significantly. Essentially, the analysis revolves around the de-linking of the underlying asset pool and credit enhancement to the pool from the credit quality of the issuer. Thus, in case the originator files for bankruptcy, the performance of the asset pool and its respective credit enhancement will remain unaffected with investors receiving their payments in a timely manner.

For this de-linking to uphold in the court of law, it is essential that the sale of assets from originator to SPV is free of any recourse and that all risks and rewards associated with the asset is transferred from the originator to the SPV. Acuité analyses not only the specific terms and conditions of the asset transfer agreement, but also other documents including the rights and obligations of all involved. Acuité may also seek third-party independent legal opinion to learn about the legal risks involved in a securitisation transaction, if deemed necessary.

While assessing the legal risk of a given securitisation transaction, Acuité also takes into account the competence and experience of the designated trustee in performing its duties and responsibilities.

D. Transaction structure

Acuité also analyses the transaction structure to determine the inherent protection to PTC investors. The two primary structural features built into the transaction are:

1. PAR v/s Premium Structure

Transactions wherein investors pay the outstanding principal of the underlying asset as a consideration towards the issue of the PTC is called a PAR structure, i.e. PTCs are said to be issued at PAR. In this structure, typically the yield from the underlying asset pool is higher than the yield payable to PTC holders. Thus, there will be excess interest spread (EIS) accumulated from cash flows generated by the underlying pool. This EIS would be wholly or partly available to meet any shortfall in funds generated from the underlying assets, thus providing an internal credit enhancement. Balance, if any, in the EIS account at the end of the PTC tenure is typically transferred back to the originator.

In Premium structures, on the other hand, investors pay a premium over and above the outstanding principal of the underlying asset pool. Here, the cash flows generated by the underlying pool go to PTC investors and thus, no internal credit enhancement by way of EIS is available for investors.

2. Waterfall Mechanism (Tranching)

A well-defined, legally enforceable waterfall mechanism involves slicing the entire PTC issuances into various layers or tranches, with one typically being senior and one or more subordinated tranches. The objective here is to relatively insulate the senior tranche from the delinquency and prepayment risks in the pool. Here, the first right of cash flows generated by the pool is with senior tranche investors with residual funds flowing to subordinates.

E. Servicer Risk

Since cash flow generation from the pool of underlying assets is primarily dependent on the performance of the servicer itself, analysing the profile of the servicer becomes important. The servicer's ability to adopt and adhere to policies and processes with highest level of efficiency and competence related to follow-up, collection, maintenance of MIS and operational risk mitigation become critical. For long tenure PTCs, the servicer's solvency risk becomes critical. Thus, Acuité also analyses the financial risk profile of the servicer, quality of its management and its track record. For servicers having relatively weaker credit profiles, stronger forms of credit enhancements may be mandated.

F. Credit Risk

The ability of the underlying asset pool to generate adequate and timely cash flows is analysed in this section. While analysing the credit risk in a securitisation transaction, Acuité evaluates the impact of several factors like characteristics of asset class, pool risk, macro-economic risk, interest risk and pre-payment risk.

a. Asset Class:

The end use of the underlying loans/assets is analysed to understand the inherent risk in the securitisation transaction. For instance, Acuité believes that a pool consisting of residential home loans would be significantly safer than that of credit card receivables.

b. Pool Risk:

Acuité believes that static pool analysis is crucial to forecast the estimated loss in the securitised pool. Static pool refers to a collection of loans to which no new loans are added. The underlying loans from the portfolio are clubbed together based on their time of origination to form discrete pools. Loans having originated during a certain time period are clubbed in one static pool. Similarly, several static pools are taken into consideration so as to compare their performance during multiple time periods. Acuité may also include past securitised pools in its static pool analysis. Acuité then analyses the delinquency curve for each static pool to understand delinquency trends with reference to seasoning of loans as well as to compare delinquency risks that may have originated during different time periods. Similarly, Acuité also analyses prepayment curves, recovery curves and collection efficiency for various static pools.

Additionally, Acuité also evaluates the following parameters of the pool while analysing the quality of the pool. The Pool is compared with the Portfolio on various characteristics such as:

- Loan to Value Ratio (LTV) - Lower LTV ratio indicates better future performance of the pool
- Geographic Distribution
- Seasoning of Pool - Higher the seasoning, lower the risk
- Borrower profile and concentration levels
- Asset class of the pool
- Interest rate charged to the borrowers in the pool
- Residual Maturity of the Pool

If pool risk is significantly different from the portfolio risk of the originator, it could mean cherry-picking while carving out the pool. The risk profile of the pool when compared against portfolio risk could be either better or worse. Thus, Acuité adequately factors in the same, while assessing credit risk for securitisation transaction.

c. Macro-Economic Risk

The ability of the underlying asset pool to generate adequate, stable and timely cash flows is also influenced to a large extent by the overall economic environment prevailing in the country or the geography in which the asset class is largely concentrated. Any significant but unforeseen volatility in the macro economic scenario can influence the value of collaterals of the underlying assets, thus influencing the credit risk associated with the pool. Income levels of the underlying borrowers and interest rates to be paid are certain key variables that impact the ability of the underlying asset pool to generate stable cash flows. Acuité factors in the expected economic conditions over the tenure of the asset pool to incorporate the likely impact of the same on the credit profile of the underlying assets.

d. Interest rate Risks and Pre-Payment risks

Interest rate risks primarily arise due to mismatch in the interest rate benchmarks for the underlying pool of assets and investors. For instance, in structures wherein loans in the pool are linked to floating rates and payouts to investors are on fixed interest rates, cash flows from the pool may be inadequate in a falling interest rate regime. While analysing the credit risk in a structure, Acuité takes into consideration the expected movement in interest rates, the cushion between cash flows being generated by the pool and payout to investors.

In cases wherein the pool is linked to floating interest rates, movement in benchmark interest rates also impact the expected prepayments in the pool. Prepayment risk arises when investors receive funds earlier than expected,

thus exposing them to risk of re-investing these funds at lower yields. Typically, decreasing interest rates and increasing income levels lead to higher prepayments in pools based on retail loans. While analysing prepayment risk for a given transaction, Acuite analyses the expected movements in interest rates and income levels with historical prepayment patterns for a given asset class.

G. Explicit/External credit enhancements

Based on the risk profile of the underlying pool and the transaction structure, the originator may employ additional credit enhancements (external) in the form of debt service reserve accounts (DSRA) and/or corporate guarantee. Acuite analyses the extent and quality of this additional support and its legal enforceability. Acuite may also analyse the legal structure to check whether cash collateral is available to investors even if the originator goes bankrupt. To be considered as an effective credit enhancement, Acuite believes that these enhancements should provide the required funds before due date so that payments too are made to investors on or before due dates.

As per recent SEBI guidelines, ratings where the credit enhancement/structure around cash flows lead to rated instrument being bankruptcy remote of the issuer/originator **will carry the 'SO' (Structured Obligation) suffix**. Acuite believes that 'SO' ratings shall be assigned to ratings of Securitization transactions entailing ratings assigned to PTCs (Pass Through Certificates). **The following categories of structures will be eligible for SO suffix.**

Type of Instrument / Structure	Rationale
ABS	<i>Bankruptcy remote structure</i>
MBS	Bankruptcy remote structure
CDO	Bankruptcy remote structure
Covered bonds, which have to be serviced primarily by the cash flows from the pool of loans housed in a trust, with secondary recourse to issuer	Bankruptcy remote structure
Capital protection oriented funds	<p>These are very similar to CDOs involving a pool of corporate debt exposures, and hence 'SO' suffix ensures consistency.</p> <p>The ratings would be on the regular rating scale for debt instruments and not on the mutual fund rating scale.</p>

Criteria For Rating Commercial Paper

Overview

Commercial Paper (CP) is an unsecured money-market instrument, issued by corporate borrowers, financial institutions and primary dealers to raise short-term funds (usually ranging between 7 to 365 days) for funding working capital requirements. In India, CP has traditionally been used as a low-cost instrument to replace working capital borrowings from the banking system. In recent years, highly-rated non-banking financial companies (NBFCs) have also started accessing CP in a large way to meet their short-term funding needs resulting in NBFCs and financial institutions accounting for around 60 per cent of CP issuers.

CP has several inherent risks. While some of these are specific to the instrument, many others are about the entity being rated. More often than not, entities have a tendency to rollover and refinance their CP Issue as a regular long term practice, warranting a long term view along with the short term.

To this effect, Acuite believes that the process of rating a CP Issue not only involves assessing the fundamental risks in the entity, but also ascertaining the structural (instrument specific) risks in the issue. This largely covers liquidity and refinancing risk apart from credit enhancement mechanisms (if any).

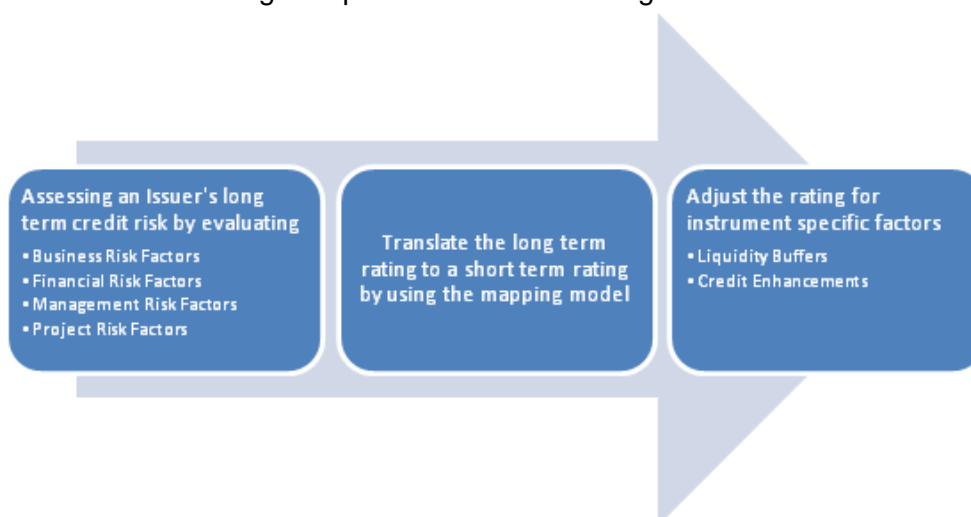
Scope

This document outlines Acuite's approach towards rating of Commercial Paper and covers the following.

- Part I: Understanding the fundamental risks of the entity being rated
- Part II: Translation of long term risk indicators onto a short term scale
- Part III: Evaluating the structural and instrument-specific risks with credit enhancement mechanisms, if any.

Methodology for Rating Commercial Paper Issues

The three stage process for rating CP Issue is given below:



A. Assessing Long Term Credit Risk

While CP is a short term instrument, since it is generally rolled over on maturity, it tends to remain afloat on a long term basis. In case the issuer fails to rollover the CP, the issuer's ability to refinance the CP is a function of its long term credit risk as the issuer must depend on fresh borrowings from Financial Institutions/banks or from the capital markets to prevent default on its CP related obligations. Therefore, the long term credit rating is indicative of the refinancing risk and the roll-over (or repricing) risk inherent to an issuing entity.

In order to assess the long term credit risk of the issuer, Acuité believes that an organisation needs to take into account three primary sources of risk:

- a. **Business Profile:** Business Risks are a function of the entity's market position and operating efficiency apart from being exposed to the systemic risks in the industry in which the entity operates.
- b. **Financial Profile:** The Financing mix, the strength and weakness of the financials and the financial structure of the entity along with stability of earnings, profitability and the margins, design of various sources of funding and the funding instruments along with the entity's liquidity and resource mobilization ability are evaluated to understand the financial risk inherent in the entity.
- c. **Management Profile:** The management's ability to adequately capitalize on its financial structure, the corporate governance practices adopted, competence, integrity and risk appetite are the factors that Acuité takes into consideration to evaluate the inherent management risk in the entity.
- d. **Project Risk:** Under Project Risk, the entity's ability to manage a significant project, in terms of funding requirements and implementation capabilities is analyzed. Acuité also evaluates the track record of the entity with regard to successful completion and commissioning of large projects.

Acuité places special emphasis on understanding the liquidity risk of the issuer, the long term resource mobilization ability and financial flexibility.

B. Long Term Liquidity Risk and Resource Mobilisation Ability

After arriving at the long term rating, Acuité believes that it is imperative to evaluate the issuer's liquidity position and stability in the periodic cash flows. To this effect, two key aspects are analyzed:

- The monthly working capital limit utilization during the last six to 12 months
- Projected cash flows in the short to medium term

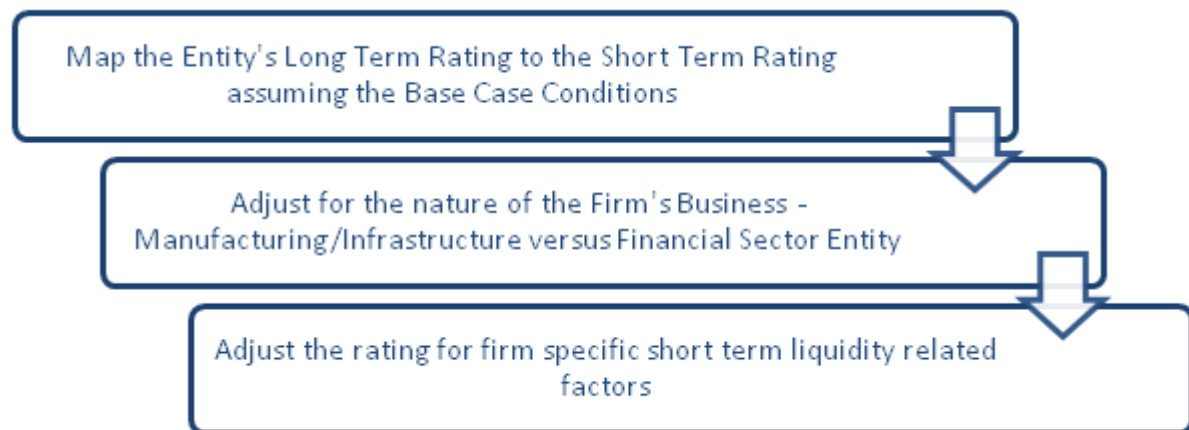
Commercial Paper issues tend to be refinanced and thus Acuité believes that it is imperative to analyze the entity's ability to refinance its CP issue on expiry – either by rolling over the issue or through alternative sources of funding. Acuité adopts a three stage approach to ascertain the same:

- a. **Assessment of the un-utilized working capital limits:** It is observed that entities with lower levels of utilization, on a consistent basis, warrant higher ratings especially if the un-utilized limit is sufficient to cover the size of the issue.

- b. **Assessment of the Issuer's ability to raise funds at a short notice:** Generally, entities that enjoy better relationships with banks/financial institutions (FIs) and have good repayment / financial track-record are able to raise funds at a short notice. Besides, the following factors also enable such entities to easily raise funds –
- Presence of high-quality / liquid assets that can easily be accepted as primary security or collateral by banks and FIs
 - Support and commitment from the promoters, group entities or any other entity
- c. **Assessment of the Current Liquidity Levels:** Historical presence of adequate high quality liquid assets and commitment to maintain them in future reduces the degree of liquidity risk in the entity.

C. Translating the Long Term Rating to the Short Term Scale

Acuité-assigned Short Term Ratings are dependent on the Long Term Ratings. Given below is the two-step process followed by Acuité to map the ratings.



D. Firm Specific Adjustments in Short Term Ratings

Acuité may assign a higher or lower credit rating as against the base case mapping model presented below, to account for substantial differences in an entity's liquidity profile. For instance, availability of comfortable short term liquidity in the form of cash collateral or liquid investments or any other similar factor reduces the short term liquidity risk of the entity. Acuité may take an upward deviation and assign a higher short term rating for a particular long term rating as indicated in the mapping model below.

E. Base Case Mapping Framework:

Long Term Rating	Short Term Rating
Acuité AAA	Acuité A1+
Acuité AA+	

Acuité AA	
Acuité AA-	
Acuité A+	Acuité A1
Acuité A	
Acuité A-	Acuité A2+
Acuité BBB+	Acuité A2
Acuité BBB	Acuité A3+
Acuité BBB-	Acuité A3
Acuité BB+	Acuité A4+
Acuité BB	
Acuité BB-	
Acuité B+	Acuité A4
Acuité B	
Acuité B-	
Acuité C	
Acuité D	Acuité D

F. Liquidity Back Up and Credit Enhancement Options

A Liquidity Back-Up facility is a mechanism that allows the CP Issuer to draw funds from a pre-arranged line if they choose not to roll over the issue. Such lines constitute lines of credits from banks and other financial institutions and are factored in assigning ratings to CPs. However, no credit enhancement is extended on account of the mere presence of such facilities. The reason behind the same is the possibility of such lines not being made available by banks, in case of a steep deterioration in the credit quality of the issuer.

CP Ratings are only enhanced by the presence of Credit Enhancement Options in the form of unconditional and irrevocable credit support facilities such as Back Stop Facilities, Guarantees by commercial banks or corporate entities. Such facilities are evaluated on three parameters:

- The distinction between the liquidity back up and standby credit facility;
- Whether the credit facility is irrevocable and unconditional and is available under all circumstances

- Whether the credit enhancement would be available before the maturity date (ideally a T minus structure with sufficient buffer to ensure that in case the issuer fails to arrange the funds, the credit enhancement can come in-force before the date of maturity)

In such cases, the rating is enhanced based on the credit risk profile of the entity providing the credit enhancement.

Fixed Deposit

Fixed Deposits: As an Instrument

The term Fixed Deposit refers to a certificate of deposit that pays a fixed rate of interest until a given maturity date. Funds placed in a Fixed Deposit usually cannot be withdrawn prior to maturity or they can be withdrawn only with advanced notice and/or by paying a penalty. Currently, deposits can be accepted by the following types of entities viz., (i) Banks (ii) Non-banking Financial Companies registered with RBI (referred to as NBFC-D); and (iii) Non-banking, non-financial companies.

Fixed Deposits: Credit Rating Parameters

Acuite believes that credit rating parameters to rate fixed deposits will depend on the inherent credit quality of the issuer. In other words, the criteria used to rate manufacturing/financial entities or respective industry specific criteria will be used for evaluation. Accordingly, the credit rating parameters will be linked to business, financial and management risk profiles.

Risk factors that may impact Credit Rating:

Business Risk: Credit rating analysis begins with an assessment of the company's environment. Acuite analyses the dynamics of business with respect to the industry in which the company operates, to determine the degree of operating risk that a company faces. The factors assessed include industry risk, competitive profile, market standing and operating efficiency of the enterprise.

Management Risk: Management risk takes into account the ability of the leader to guide, explore opportunities, develop, execute plans and react to market changes. Acuite considers the risk appetite, integrity and competence of the management and also evaluates its corporate governance principles.

Financial Risk: Financial risk analysis determines how the business manages the available funds, the risks it faces and the factors employed to mitigate the same. The balance sheet, income statement, sources and uses of funds statement and financial projections provide essential information about the company's initial and ongoing repayment capacity. Quantitative analysis of revenues, profit margins, income and cash flow, leverage, liquidity and capitalization help identify trends and anomalies that could affect the borrower's performance. While benchmarks vary greatly by industry, several analytical adjustments are required to calculate ratios for an individual company.

Analysis of audited financials entail reviewing accounting quality to determine whether ratios and statistics derived from financial statements can be used accurately to measure a company's performance and position relative to its peer group.

Additional Factors Considered

Along with the revolving nature of the FDs, large number of investors and smaller repayment amounts make this instrument different from mainstream debt instruments. Accordingly, due emphasis has to be accorded to factors such as risk management systems surrounding the

raising and repayment of FDs. For instance, stronger risk management policies such as using account transfer for FD (as against Cash and PDCs) go a long way in ensuring issuer ability and willingness to service instruments in a timely manner. The historical track record of raising and repayment of FDs and the extent of reliance on this type of instrument in the overall funding mix are also evaluated. Acuite may consider a differentiation between a rating for a Fixed Deposit vis a vis the ratings on the other plain vanilla debt instruments of the same borrower. The reasons are twofold. Firstly, borrowings under fixed deposit programme are granular in nature and maturities of the fixed deposits are spread across different points of time. Secondly, it is pertinent to note that while certain fixed deposits fall due for payment, the borrowing company could also be simultaneously accepting fresh deposits/ renewing existing deposits. The net impact on the borrower's cash flow is significantly moderated.

Acuite's Rating scale for Fixed Deposits

Symbols	Rating Definition
'Acuite FAAA' ("F Triple A") Highest Safety	Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such instruments carry lowest credit risk
'Acuite FAA' ("F Double A") High Safety	Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations. Such instruments carry very low credit risk
'Acuite FA' ("F Single A") Adequate Safety	Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk
Acuite FBBB ("F Triple B") Moderate Safety	Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk
Acuite FBB ("F Double B") Moderate Risk	Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations
'Acuite FB' Inadequate Safety	Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations
'Acuite FC' High Risk	Instruments with this rating are considered to have very high risk of default regarding timely servicing of financial obligations
'Acuite FD' Default	Instruments with this rating are in default or are expected to be in default soon

Note: Acuite may apply '+' (plus) or '-' (minus) signs to its ratings from Acuite FAA to Acuite FC category to indicate their relative standing within the category.

Complexity Level Of Financial Instruments

Introduction

Rating agencies have been assessing wide range of financing instruments with varied characteristics and intricacies. During the last few years, the Indian Capital Market has witnessed a scenario of newer and innovative financial instruments/issues being floated by the issuers. These instruments include structured bonds, asset/mortgaged backed securities, security receipts, convertible/non-convertible debentures etc.

In the context of the intricacies involved in the innovative instruments, the investors may not fully understand the implications arising out of the complexity involved in such instruments. In order to inform the investor about complexity of such instruments, Acuite has categorized such instruments in three levels: Simple, Complex and Highly Complex.

It has to be understood that complexity is different from credit risk and even an instrument categorized as 'Simple' can carry high levels of risk.

Simple Instruments

These instruments carry high degree of certainty regarding their risk-return relationships and are reasonably well understood by investors and other market players.

Complex Instruments

These instruments typically have variable risk return profiles and understanding of these instruments among market participants is lower vis-à-vis Simple instruments. These are mainly instruments with variable returns over time. The number of counterparties for such instruments can be more than one.

Highly Complex Instruments

These instruments are the highest in term of complexity and the understanding of their risk profile is usually more difficult than 'Complex Instruments'. The cash-flow, return and maturity characteristics are variable in nature and often involve large number of counterparties.

Classification of Instruments Based on their Complexity

CORPORATE AND BANK-DEBT			
	Simple	Complex	Highly Complex
BANK FACILITIES	ALL	-	-

FIXED DEPOSITS	FIXED RATE OF INTEREST	-	-
COMMERCIAL PAPER	FIXED RATE OF INTEREST	-	-
CORPORATE BONDS AND NON CONVERTIBLE DEBENTURES	FIXED COUPON RATE	FIXED COUPON WITH PUT/CALL OPTION. FLOATING RATE LINKED TO CERTAIN BENCH MARK RATE(WITH OR WITHOUT PUT/CALL OPTION)	-
CONVERTIBLE DEBENTURES	-	COMPULSORILY OR OPTIONALLY CONVERTIBLE	-

STRUCTURED INSTRUMENTS			
	Simple	Complex	Highly Complex
STRUCTURED BONDS/NCD'S	-	BACKED BY GOVT/GROUP COMPANY	PARTIALLY GUARANTEED
ASSET BASED SECURITIES(ABS)	-	FIXED RATES. BACKED BY SPECIFIED ESCROW OF CASH FLOWS OR FIXED DEPOSIT.	FLOATING RATES. BACKED BY LINKED TO CERTAIN BENCHMARK RATES.
MORTGAGE BASED SECURITIES(MBS)	-	-	MBS WITH RESET OF RATES
PASS THROUGH CERTIFICATES(PTC)	-	-	INSTRUMENTS BACKED BY ABS/MBS.
COLLATERISED DEBT OBLIGATIONS (CDO)	-	SINGLE ASSET	MULTIPLE ASSET

BONDS STRUCTURES FOR POOL FINANCING	-	-	BONDS STRUCTURED FOR POOL FINANCING
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HYBRID INSTRUMENTS			
	Simple	Complex	Highly Complex
LOWER TIER 2 BONDS	FIXED COUPON	FIXED COUPON WITH FEATURES (SAY A PUT/CALL OPTION)	FLOATING RATE WITH FEATURES(SAY PUT/CALL OPTION ,FLOORS/CAPS)
		FLOATING RATE(YIELD LINKED TO BENCHMARK)	
HYBRID DEBT INSTRUMENTS	-	-	INNOVATIVE PERPETUAL DEBT
			PERPETUAL PREFERENCE SHARES
			UPPER TIER 2 BONDS
OTHER HYBRID INSTRUMENTS	-	SEPARATE TRADING OF REGISTERED INTEREST AND PRINCIPAL SECURITIES(STRIPS)	SECURITY RECEIPTS(ISSUED BY ASSET RECONSTRUCTION COMPANIES)
			EQUITY LINKED DEBENTURES
			COMMODITY LINKED DEBENTURES

EQUITY & PREFERENCE SHARES			
	Simple	Complex	Highly Complex
EQUITY SHARES	EXCHANGE TRADED	-	-

	EQUITY SHARES		
PREFERENCE SHARES	-	PLAIN VANILLA	-
		CONVERTIBLE PREFERENCE SHARES	

MUTUAL FUNDS			
	Simple	Complex	Highly Complex
DEBT FUNDS	GILT FUNDS	FLOATING RATE FUNDS	-
		MONTHLY INCOME PLANS	
	LIQUID FUNDS		
	DEBT FUNDS		
	FIXED MATURITY PLANS		
	INTERVAL FUNDS		
STRUCTURED MUTUAL FUNDS	-	CAPITAL PROTECTED FUND-STATIC HEDGE	CAPITAL PROTECTED FUND-LEVERAGED
			CPPI (CONSTANT PROPORTION PORTFOLIO INSURANCE)
		ARBITRAGE FUNDS	DPI (DYNAMIC PORTFOLIO INSURANCE)
	PLAIN EQUITY FUNDS	DERIVATIVE FUNDS	ART FUNDS

MUTUAL EQUITY OTHERS	FUNDS- AND		FUND OF FUNDS	
		SECTOR BASED FUNDS		
			INTERNATIONAL FUNDS	
		BALANCED FUNDS	SPECIAL SITUATION FUNDS	
		GOLD FUNDS		
		EXCHANGE TRADED FUNDS		
		INDEX LINKED MUTUAL FUNDS		

DERIVATIVES			
	Simple	Complex	Highly Complex
EQUITY DERIVATIVES	-	BUYING INDEX/STOCK OPTIONS(LONG POSITION)	SELLING INDEX/STOCK OPTIONS(SHORT POSITION)
		INDEX/STOCK/CURRENCY FUTURES(BUYING AND SELLING)	
COMMODITY DERIVATIVES	-	COMMODITY FUTURES	-
FOREIGN EXCHANGE DERIVATIVES	-	SIMPLE SINGLE CURRENCY FORWARD RATE AGREEMENT WITHOUT ANY FEATURES (CAP, COLLAR, KNOCK IN, KNOCK OUT, ETC.)	FORWARD RATE AGREEMENT WITH CUSTOMISED FEATURES
			CROSS CURRENCY FORWARD RATE AGREEMENTS
			CURRENCY OPTIONS
			CURRENCY SWAPS

INTEREST RATE DERIVATIVES	-	-	INTEREST RATE SWAPS
			CROSS CURRENCY INTEREST RATE SWAPS
CREDIT DERIVATIVES	-	CREDIT DEFAULT SWAPS- PROTECTION BUYING-SINGLE ASSET	CREDIT DEFAULT SWAPS- PROTECTION SELLING-SINGLE ASSET
			CREDIT DEFAULT SWAPS-MULTI ASSET(BOTH BUYING AND SELLING)

Criteria For Rating Hybrid Instruments Issued By NBFCs & HFCs

Introduction

The recent changes in the regulatory framework governing the capital adequacy requirements for non-banking finance companies (NBFCs), including Housing Finance Companies (HFCs), have resulted in the introduction of several hybrid instruments aimed at strengthening the regulatory capital base for these financial institutions. Financial institutions have been issuing such instruments since FY2008-09 and the volumes have increased significantly over the last five years. These instruments have attributes of both - equity and debt-instruments and are differentiated based on their loss absorption characteristics.

These instruments typically carry higher risk mainly because the issuers could face restrictions on servicing the coupon on these instruments in case their capital adequacy below the levels stipulated by the Reserve Bank of India, National Housing Bank (in case of HFCs) or in case of losses incurred by the issuer.

Type of Instrument	Characteristics*				
	Maturity	Capital Treatment	Seniority	Discretion Regarding Coupon payment	Loss Absorption Capacity
Lower Tier II Debt Instruments (Sub-Debt)	Minimum 5 years	A portion of the Lower Tier II Debt forms a part of the Regulatory Capital of the issuer	These bonds are subordinated to other creditors/ senior debt	None	None
Upper Tier II Instruments	Minimum 15 years	Upper Tier II Capital and Lower Tier II Capital cannot be in excess of the total Tier I Capital	Subordinated to all creditors - excluding Tier I debt	Coupons may be deferred and are cumulative	Principal may be written down in case of shortfall in regulatory capital

Tier I Bonds (Perpetual Debt)	Perpetual	Part of the Tier I Capital upto a maximum of 15% of the total Tier I Capital. Excess quantum shall be included as a part of the Tier II Capital	Subordinated to all other creditors	Coupons are deferred if the regulatory capital falls below the statutory requirement ; or in case payment of the coupon results in the regulatory capital falling below the statutory requirement	In case of accumulation of losses/shortfall in regulatory capital requirements, principal amount may be written down
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Rating Framework

Acuité's evaluation of hybrid instruments is a three step process:

1. The long-term conventional bond rating of the issuer is evaluated in line with the relevant rating criteria. The criteria for rating NBFCs is available on: <https://www.Acuite.in/criteria-nbfc.htm>
2. Subsequently, the Resource Mobilisation Ability of the issuer is examined by considering the degree of parent/group support, shareholding pattern, funding profile and demonstrated ability to augment its capital structure from diverse sources.
The rating so arrived at based on step 1 and step 2 will be the upper cap for the rated hybrid instrument. Acuité believes that any instance of default on the senior debt or the Lower Tier-II debt shall inevitably lead to default on the issuer's hybrid instruments. Acuité may equate the rating of the subordinated debt instrument with that of the conventional debt due to the absence of significant loss absorption characteristics in such instruments.
3. The final rating for the Hybrid Instrument is then either equated or notched down based on factors like the issuer's:
 - a. Current Capital Adequacy Ratio (CAR) and the cushion available with regard to the regulatory requirement
 - b. Expected movement in CAR over the medium-term vis the expected growth rate in Risk Weighted Assets
 - c. Probability of Servicing the coupon/interest in the event of loss

Based on the above factors, Acuité may notch up the rating by up to three notches.

Acuité also notes that in the recent past, the financial sector regulators (RBI and NHB) have allowed issuers to service their interest/coupon commitments on hybrid instruments despite reporting losses - subject to complying with minimum regulatory capital requirements.

However, Acuité takes note that in certain unforeseen circumstances, such approvals may be withheld by RBI/NHB and thus the same constitutes an important risk factor in the evaluation of hybrid instruments.

Treatment of Preference Shares

Preference shares (Other than those issued to Promoters) shall be treated as debt unless they are compulsorily convertible into equity shares. Acuité shall also be guided by the coupon rate and the residual tenure of the preference shares while deciding the analytical treatment to be accorded. From a legal standpoint, a lender, in distress situation, is in a senior position vis a vis a preference shareholder about claims on the cash flows and the assets. Notwithstanding the legal position, an issuer of preference shares may find it difficult to renege on his commitments to the preference shareholders as such an event will be construed as indicative of deterioration in the credit quality of the issuer, thereby having implications for future fund raising and pricing of debt.

Preference shares issued to Promoters will be treated as equity only if the promoters furnish an undertaking that these shares will be not redeemed till the currency of the bank facilities & any redemption will be refinanced through promoter infusion of an equal amount through equity or equity like instruments

Default Risk Drivers

The default risk arising out of non-payment of coupon/interest on hybrid instruments is linked to the likelihood of the Capital Adequacy Ratio (CAR) of the issuer falling below the regulatory requirement.

Acuité evaluates two risk factors to ascertain the probability of occurrence of any of the above events of default:

- i. **Capital adequacy and historic volatility in CAR:** The CAR requirement varies across categories of issuer. NBFCs are required to maintain a CAR of 15% while HFCs need to maintain 12%. Acuité examines the individual components of CAR (such as Common Equity Ratio etc.) and how it compares to the regulatory requirements.

Acuité further assesses the available headroom between the current CAR of the issuer vis the regulatory requirement. The historical volatility in CAR enables Acuité to estimate the propensity of the issuer's CAR deteriorating below the regulatory requirement.

Acuité evaluates the expected movement in the internal accretion to the issuer's net worth and movement in the risk weights in the issuer's portfolio. An issuer's CAR may experience significant deterioration in case the issuer decides to take on relatively riskier lending practices or experiences a sudden spike in delinquency levels. Such movements in CAR are affected by the macroeconomic conditions, sectoral and geographic composition of the asset portfolio, collateralisation level, capital structure and interest spreads of the issuer. Acuité relies on expected movements in indicators such as Net Interest Margin and Return on Average Assets to assess the quality of internal accretions to the net worth of the issuer over the medium term.

- ii. **Likelihood of servicing the coupon on Hybrid Instruments in the event of loss:** The issuer must seek the approval of RBI/NHB in order to service the coupon due on such instruments in the event of loss - even if adequately capitalised in line with regulatory requirements.

Treatment of Default on Preference Shares

From a default perspective a slippage of a single dividend payment (even if the issue provides for cumulation of dividends) or slippage on redemption dates (whether a regular redemption or an early redemption through exercise of option by the preference shareholder) will be treated as default.

Criteria For Rating Instruments Issued By Urban Local Bodies

The Urban Local Bodies (ULBs) operating in the country have been vested with the authority and responsibility of rendering civic services to the residents of their jurisdiction. For effective discharge of its function, the municipality has to raise adequate resources from the various avenues, including but not restricted to budgetary supports.

The governmental character of the ULBs, their management, their objectives, roles, revenue streams and funding avenues differ significantly from commercial entities, hence making it imperative that the credit profiles of these players are evaluated on a different framework.

Acuite evaluates ULBs on the following mix of qualitative and quantitative parameters.

A. QUALITATIVE FACTORS

I. Governing Framework

- a. Methodology for deciding the key management personnel, key decision making committees, tenures of these committees and the processes laid down for critical decisions.
- b. Delineation of functional responsibilities into 'Obligatory' service and 'Discretionary' service. Obligatory service includes those which are mandatorily required to be discharged by the ULB as per its statute. Discretionary service means those functions which can be outsourced, or which can be discharged by private parties at the behest of the ULB individually or jointly. The bifurcation of the above services is necessary to understand the extent of future funding requirements. Since the pool of resources with a ULB is limited, it is expected that higher priority will be accorded for the revenue & capital expenditure regarding essential services like water supply or sewerage services rather than relatively non-essential services such as maintenance of gardens.

II. Revenue Generation Potential

The revenues generated from taxes and other sources of income and the stability of these revenue streams are examined here. The breakup of revenues into Own Revenues (Property Taxes, Water Taxes, etc.) & Other Revenues (Grants/Allocations) is critically examined under this parameter. Since the provision of services is based on cost recovery basis, the efficiency of recovery is also examined by studying the deficits.

The funds/ grants received from various governments are examined in terms of their (i) source i.e. the central and State Governments and (ii) their nature such as revenue grants, capital grants, recurring grants, one time grants and project oriented grants. Acuite also looks at the methodology for computing the quantum of such funds/ grants. The stability and other related factors are evaluated under this head. The performance of the ULB vis-a-vis the budgetary expectations and its near term plans are examined critically.

III. **Current Population Coverage**

The larger the population coverage of the ULB's services, lower will be its future capex requirements and larger will be the tax base for levying of various taxes. The demographic profile is also considered in the evaluation process. The per capita income is a useful metric in this regard as it indicates the level of affluence and the tax paying propensity.

IV. **Debt Raising Flexibility**

Under this head, Acuité will examine the debt raising plans, regulatory limits to borrowings and ability to raise funds through innovative instruments. The previous borrowing programs of the ULBs, adherence to the laid down/ accepted covenants, meeting the debt repayment schedules as well as the refinancing capabilities are also assessed.

V. **Drivers of Economic Activity**

The drivers of economic activity in a region depend on factors like size of the city, presence of SEZs, smart city/ies present/ identified, health of the State Govt. and its stage/ philosophy for development, incentives available for industrialisation, levels of industrial/commercial activity, level of value addition by the industry and commerce, job opportunities, availability and adequacy of social and other infrastructure availability and other such factors.

The sustainability of these economic drivers is critical as development of alternative pockets of economic activity can influence the level of activity in an existing place. For instance, the development of satellite towns on the periphery of existing metropolitan regions could cause a shift in residential and commercial activity due to reasons like affordability of real estate. This in turn has implications for the future earnings stream of the ULB.

B. FINANCIAL INDICATORS

1. Key Operating Metrics

The key aspects to be considered here are

Breakup into Tax Revenues & Non Tax Revenues Grants received from State Government and stability of the same.

2. Revenue Expenditures

Revenue expenditures and their rate of growth Nature of revenue expenditure-committed (wages, interest, etc.) or discretionary spends. Higher the proportion of Committed Expenditure lower is the flexibility available to the ULB.

3. Capital Account

Track record of Capital Receipts and their application for various asset creation uses.

4. Key Metrics

Operating Revenue Surplus/ Deficit as a percentage of Net debt Operating Revenue surplus/ Deficit + Interest as a percentage of Interest Expense Operating Revenue Surplus/Deficit+ Interest as a fraction of principal repayment and interest obligation.

5. Liquidity

The availability of unencumbered cash/ cash equivalents which can be easily tapped to meet certain operational/financial commitments. The quantum of such liquidity vis-a-vis the annual commitments is reckoned while arriving at the parametric assessment.

Real Estate Entities

The real estate sector comprises entities engaged in the construction and development of residential / commercial real estate. Acuite understands that entities engaged in real estate activities have to be assessed on a framework which differs from the conventional framework applicable to manufacturing entities primarily on account of the following reasons:

Firstly, there exists significant time lag between revenues and cash inflows from a project. Typically, in a residential project, advances from customers are received at the inception of a project whereas in case of a commercial project, revenues may be recognised at a later point after the project is sufficiently advanced. Hence, profit for a given period may diverge significantly from cash flows. Since timely servicing of debt obligations depends on adequacy of cash flows rather than profitability, it becomes necessary to focus on cash flow adequacy for real estate projects.

Secondly, real estate activity is project-based. Each project is unique in terms of size, profitability, time requirements etc. Since a real estate developer may be executing more than one project at a time, revenues will depend on the stage of completion of the project and sales effected. Resultantly, the revenue profile of a real estate developer may fluctuate widely from one period to another unlike that of manufacturing units, wherein revenues will typically exhibit a steady pattern. Hence, the operational and financial parameters applicable to manufacturing entities, cannot capture the nuances of that of real estate projects.

In view of the above difference, Acuite considers certain parameters specifically for the construction sector in its Risk Assessment Framework. The overall framework is based on Business Risk, Financial Risk and Management Risk assessment of the entity whose facilities are being rated.

1. Business Risk Assessment

MARKET POSITION

Geographical and Segmental Diversity

Higher the geographical diversity in operations, lower is the risk inherent in the business model. Since demand supply dynamics of each region is different, geographical spread in operations imparts resilience to the revenue profile. Apart from geographical diversity, Acuite also examines the segmental diversity in the business of a real estate developer. The demand drivers for residential and commercial segments vary. While residential real estate growth is influenced by factors such as increased affordability, demographic profile of the region/city, the large number of people in the employable segment and higher preference for nuclear families, residential projects by established developers attract advances from customers which provide a major part of the initial funding. Hence, residential projects are generally funded through a mix of customer advances and promoter funding. Again, in case of customer interest, the actual user's interest protected than that of the investor, since actual user demand is usually backed by housing loans which implies a steady flow of advances as construction progresses. As against this, in case of high investor interest, the flow of advances is generally linked to market conditions.

Commercial realty demand is influenced by demand from sectors such as Information technology, retail and services. Commercial projects generally attract customer interest as they approach the completion stage. Hence, cash flows from clients are usually back ended. It has been observed that residential real estate is generally sold off and hence has limited potential to generate recurring revenue streams for a developer. Commercial real estate segment on the other hand, has the potential to generate recurring streams of revenue like lease rentals wherever the property is given out on lease rather than an outright sale. In case the developer opts for a lease model, the developer may choose LRD (Lease rental discounting) loan which is used to replace the construction loan.

The advantage of the leasing option is that it allows the developer to generate liquidity at regular intervals by discounting the future receivables from time to time and also gain from any upside in property prices.

In case of assessment of real estate cases under the LRD model, certain other risks such as counter party credit risk, early exit risk, interest rate risk are also examined while conducting credit assessment.

Track Record

Longer the track record, better will be the score on the market position since prospective buyers are generally keen about an established track record of execution of projects.

Brand Equity of Real Estate Developer

The brand equity of a real estate developer is critical from a customer acquisition perspective and also from the stand point of attracting funding to support the project.

OPERATING EFFICIENCY

Status of major projects

Entities with major projects in the initial stages of construction will score low on this parameter primarily because the likelihood of high time and cost overruns is very high. Hence, cash flow forecasting becomes difficult. Delays in receipt of approvals from government authorities are common thereby translating to cost and time overruns.

Nature of Projects undertaken

While conventionally real estate developers own land parcels and develop projects on these land sites, more efficient models are also in vogue such as joint development projects/ redevelopment projects. Models such as redevelopment projects / joint development projects are asset light in nature and reduce capital requirements of the developer.

Again, projects with inherent modularity will score higher on this parameter. For instance, a developer developing independent villas on plots of land will have the flexibility to align the level of progress of construction undertaken to cash flows from clients. However, in case of multi storeyed structures, the builder has limited flexibility to slow down construction even in case of low demand owing to commitments made to buyers for handover the possession by specific dates. The enactment of legislation like RERA which stipulates penalties for non-adherence to commitments made to buyers of flats, adds to the risk.

Regulatory Framework

The enactment of RERA (Real Estate Regulatory Act) is a major step by the government in enforcing basic discipline among real estate players. RERA stipulates registration of existing / proposed projects on the website of the real estate regulator, restrictions on diversion of funds received as advances for a specific project, penalties for non-adherence to commitments etc.

Each state will have its own RERA which would be broadly based on the lines of the Central RERA. Other than legislations like RERA, the real estate sector will also be influenced by interest rates and policies of the banks/financial institutions in lending to real estate.

The changes in the regulatory environment will also have an impact on the business risk profile of real estate players. Acuite factors in the regulatory environment while assessing the real estate player.

2. Financial Risk Assessment

The financial risk assessment of real estate entities will be governed by cash flow measures as opposed to conventional measures like profitability, interest coverage and Net Cash Accruals to Total Debt. Acuite focusses on the internal cash flow generation potential of the project and external cash generation potential while assessing the cash flow forecast.

Acuite seeks basic data from the client in terms of project cost, funding mix, bookings and advances received, construction work in progress till date and expected date of completion.

The projected cash flow statement is constructed, and the Cash Flow Coverage Indicator is examined in this regard. The analyst may look at the base case scenario and also examine movements in the ratio under various scenarios.

Cash flow coverage Indicator = $\frac{\text{Cash inflows from customers} + \text{Infusion of additional promoter funds} + \text{Fresh term loan drawdowns}}{(\text{Cash outflows for construction} + \text{Taxes} + \text{Interest} + \text{Principal repayment})}$

This ratio is calculated for every year across the life of the project. Acuite examines the minimum and maximum ratio across the tenure of the loan. If the ratio is likely to go below unity for any given period, Acuite examines the refinancing ability / additional fund infusion to support the operational and financial commitments. Acuite also considers liquidity support like unencumbered cash balances and cash equivalents while formulating an opinion on the cash flow adequacy of the entity.

3. Management Risk Assessment

The key parameters of Integrity, risk appetite and competence are evaluated based on the following

- Integrity: Past credit history, instances of delinquencies, market perception as evidenced by articles in the print and electronic media
- Risk Appetite: Propensity to launch several projects over a short period which is likely to expose the balance sheet to considerable stress, excessive reliance on debt funding
- Competence: Demonstrated ability to execute projects across cycles, geographies and segments.

Rating Criteria for General Insurance Sector

Executive summary:

General insurance (Non-Life) companies play an important role in the financial services sector by offering risk cover against various non-life related risks through a wide range of products and services. They offer a wide range of products and services across business segments such as motor, fire, health, marine, aviation, engineering, liability, personal accident etc. Acuité assigns '**Financial Strength Rating**' (FSR) to the general insurance companies to reflect the ability of the insurance company to meet its claims related obligations towards the policy holders.

Acuité assesses the standalone credit risk profile of the general insurance company based on the evaluation of the industry risk, business risk, and financial risk profiles of the company. In addition, Acuité also factors parent/group/government support into the rating for companies backed by strong parent/promoter groups or the government, which are expected to provide regular support to the rated insurance company to meet its growth and regulatory capital requirements.

Rating Methodology:

Industry Risk:

Industry risk assessment includes evaluation of various factors impacting the general insurance industry including the market size and historical growth trend, future growth potential and drivers for the same, competitive dynamics of the various segments within the general insurance industry and the players therein, and impact of competition on the pricing strategy and business practices of the insurance companies. Acuité also analyses the impact of the economic conditions, government policies and regulatory environment for the industry and the various individual segments. Any material changes in regulations or industry practices in the underwriting norms, claims and investment pattern, solvency margin requirements or taxation may significantly impact the industry and alter the competitive positioning of the players.

Business Risk:

Market position

Market position assessment includes evaluation of the rated entity's presence across business segments within the industry, its competitive strength compared to other players within each business segment, franchise, distribution network, and growth enablers including assessment of business/operational linkages with the parent/group. Leadership position across one or more business segments provides competitive edge over peers in the industry and pricing flexibility. Diversity across business, customer, and geographical presence provides long-term business sustainability and flexibility during times of stress.

Underwriting policies and practices

Evaluation of the rated entity's underwriting policies and practices is a critical input to the business risk assessment, as it is the key to the long-term sustainability of the company in the industry. It reflects adequacy/inadequacy of the pricing of risks against the claims to be incurred in future. A separate business segment wise and an overall assessment is undertaken as the risk dynamics are different across the various business segments and can significantly impact the overall performance.

It involves assessment of the impact of the past and current underwriting policies and practices on the company's performance (past and future) as well as the management's future strategy. Underwriting policy and practices will be driven by the various factors including industry dynamics and management's strategy with respect to future growth plan and mix, market penetration, risk-based pricing, profitability etc.

India has seen emergence of single business segment focused insurers in recent times – several standalone health insurance companies are present in the market and competing with the diversified general insurance companies. The ability of these companies to have deep understanding of the business, and price the risks appropriately is critical for their growth.

Apart from qualitative factors, the evaluation also includes various quantitative factors of business performance such as underwriting margin, combined ratio, incurred claims ratio, among others.

Reinsurance strategy

Reinsurance is critical for any insurance business as it enables sharing of risks across the global insurance sector, especially in the event of any major catastrophic risks. It enables general insurance companies to limit the losses on the originally underwritten portfolio, thereby strengthening their underwriting capabilities. The assessment includes evaluation of the reinsurance strategies with respect to the proportion of the reinsurance undertaken through various reinsurance schemes across business segments, sharing of claims in excess of the retention limit, track record of reinsurance claims recoverability and the credit profile of the reinsurance companies. The assessment also includes evaluation of reinsurance accepted by the rated entity from the other insurance companies and the track record of claims payable from such reinsurance.

Investment management

General insurance companies invest policy holder funds surplus in line with the stipulated regulatory guidelines across various asset classes including equities, corporate debt and government securities. Consequently, investment management is integral part of the general insurance business and enables to boost the overall profitability (or helps in mitigating the pressure arising due to underwriting related losses). A well-diversified good quality portfolio with limits on single borrower and industry exposure concentration is expected to generate stable returns over the long term. To achieve this, disciplined investment management across economic and business cycles is critical. In addition to the historical performance, the assessment includes evaluation of the investment and risk management philosophy in relation to the insurance liabilities and the internal controls, especially with respect to credit risk, market risk, liquidity risk. Assessment also includes evaluation of the top exposures across asset classes including equities, corporate debt, and others.

Financial Risk:

Capitalisation

Evaluation of capitalisation is critical for assessing the Financial Strength Rating of an insurance company. General insurance companies must ensure compliance with minimum capital (Rs.100 Cr. currently) and solvency margin (1.5 currently) requirements.

Solvency margin of an insurance company is the size of capital relative to the risk taken, which is all liabilities subtracted from total assets. It indicates the soundness of the insurance company and ability to honour all the claims. Solvency ratio (defined as available solvency margin /required solvency margin) indicates adequacy of capital against underwriting risks and growth.

The analysis also includes assessment of the planned capital infusion and projected solvency margin. Furthermore, ability and willingness to bring in additional capital to meet any catastrophe or significant unforeseen underwriting losses is critical to sustain business operations. It will enable assessment of the availability of adequate capital for growth and insurance company's ability to honour claims to the policy holders.

General insurance companies are also permitted to raise other forms of capital (Preference Shares and Subordinated Debt), which helps them to diversify their capital base and also buttress their solvency margin. However, there are stringent requirements associated with this form of capital, especially to service the dividend/interest on these instruments.

Profitability

A general insurance company's business model assessment provides an indication of the quality and sustainability of its earnings profile and overall financial strength. A company with a healthy business risk profile will be able to achieve profitable growth despite high competitive intensity in the industry. Sound underwriting practices and good investment management philosophy will enable the insurance company to sustain a healthy earnings profile over the medium term. A detailed assessment of the underwriting practices across each business segment is undertaken to evaluate the inherent risks, claims ratio and underwriting performance and its impact on the overall underwriting profits. Underwriting profits are the core earnings of any insurance business and a reflection of its long-term sustainability. However, any volatility in the underwriting performance (even underwriting losses) can be offset by stable investment income. The investment portfolio including the mix of debt and equity also needs to be analysed to assess the stability of its returns and the extent of volatility in the same.

Liquidity and financial flexibility

Any insurance company needs to maintain adequate liquidity to meet its claims related obligations towards the policy holders on a timely basis. This will be primarily in the form of a highly liquid investment portfolio and the operating cashflows. Hence, the risk assessment of the underwritten portfolio, crystallisation of claims and the management's philosophy towards maintaining adequate liquidity on a regular basis in line with the emerging claim obligations is critical. Other sources include the financial flexibility of the promoters to facilitate funding in times of need.

Management Risk:**Corporate Governance**

Corporate governance evaluation takes into account management risk in terms of performance and accountability of the management towards various stakeholders such as regulators, shareholders, employees, customers and suppliers. Acuite shall also analyse the qualitative and quantitative parameters that determine accountability of the management towards various stakeholders. In addition, management is appraised on the following parameters:

Competency

Competency of the management is assessed based on the management credentials, organisation structure, performance track record, strategies employed by the management in response to the change in environment and finally impact of the strategy implemented on the performance of the company.

Integrity

Integrity of the management is assessed based on the track record of the management in adhering to statutory requirements by various regulatory authorities, litigation and such related issues. Management for this purpose includes senior management of the company, directors and promoters.

Risk Appetite

Risk Appetite of the management is an important parameter in assessing management risk. It is ascertained based on the willingness of the management to enter into riskier business segments, exposure to such segments in the past and management philosophy for mergers and acquisitions.

Parent/Group:

Acuite will also factor in parent/group or government support in case of general insurance companies which are promoted by strong parent/groups/government (please refer to the criteria '**Criteria For Group And Parent Support**' for details). It is based on the evaluation of various factors including the strategic importance of the insurance business to the parent/group, ownership pattern and management control, operational linkages and synergies, common branding, past and future financial support. Acuite also assesses the financial flexibility of the parent/group to provide support both for growth and to address the losses arising from any catastrophic events.

SECTION ON RATING OF HYBRID INSTRUMENTS ISSUED BY INSURANCE COMPANIES

The capital of insurance companies primarily comprises of equity capital from the shareholders. In November 2015, Insurance Regulatory and Development Authority of India (IRDA) allowed insurance companies to raise following other forms of capital to augment their capital position:

- Preference shares

- Subordinated debt

These instruments, also known as hybrid instruments, will help insurance companies to improve their Solvency Margin while growing their business and increasing insurance penetration.

The starting point for any hybrid debt rating of an insurance company is its 'Financial Strength Rating' (FSR), whether it is in general or life insurance sector. The parameters considered for arriving at FSR have already been covered in this document. Subsequently, the rating will be notched down to factor in the additional risks associated with these instruments. The risks include non-payment of dividend/interest if the Solvency Margin breaches regulatory requirements. Also, regulatory approval is required if the general insurance company reports a loss or the loss increases due to such payment of interest/dividend. Acuite will also factor in the articulation and demonstration of timely support by the parent/group to meet regulatory stipulations associated with the hybrid instruments.

Risk Features - Hybrid instruments issued by general insurance companies:

These instruments are akin to the Upper Tier II bonds issued by banks under Basel II regulations. The risk of principal and coupon non-payment on the Upper Tier II bonds is linked to the banks' overall capital adequacy ratio falling below the regulatory minimum (9 per cent). Servicing on these bonds also requires regulatory approval in the event of a loss.

Hybrid instruments issued by general insurance companies carry additional risks because of the restriction on debt servicing on the instrument if the solvency ratio of the insurance companies falls below the regulatory stipulation. Further, in case of insufficient profit or loss, approval from IRDA is required to service these instruments.

Features of the hybrid instruments issued by insurance companies

Instrument	Preference Shares Subordinated debt
Limits on the instruments	Total quantum of these instruments shall not exceed: 1. 25 per cent of total of paid up equity share capital and securities premium of the insurance company 2. 50 per cent of the net worth of the insurance company
Maturity period	Preference Shares and Subordinated debt shall be for a tenure as follows: - Minimum Ten years for Life, General Insurance and Reinsurance Companies - Minimum Seven years for Health Insurance Companies - Subordinated debt can be perpetual in nature as well.
Call/Put options	Call option after the instrument has run for at least 5 completed years. Solvency ratio to be met before and after the exercise of the call option No put option is permitted
Return	Dividend / Interest can be fixed, or floating rate linked to a market determined rupee interest benchmark rate

Servicing conditions for dividend/interest	<p>1. Solvency position of the insurance company being above the regulatory minimum at all times including after such payment of dividend or interest</p> <p>2. Prior approval of IRDA mandatory if such payment of dividend or interest results in a loss or increase the net loss of the insurance company</p> <p>3. No loss absorption feature, which may result in conversion of the instrument into equity</p>														
Dividend/ Interest discretion	Cancellation of dividend distribution on preference shares or servicing of the subordinated debt must not impose restrictions on the Insurer, except for distribution of dividend to equity shareholders														
Cumulative/ Non-cumulative	<p>Dividend on preference shares shall be non-cumulative</p> <p>Interest on subordinated debt not paid in a particular year may be paid in subsequent years subject to compliance with the servicing conditions for such instruments</p> <p>Insurance companies permitted to pay compound interest on the missed interest payment on the subordinated debt</p>														
Instrument amortisation	<p>Instruments shall be subjected to a progressive hair cut for computation of Solvency Margin on straight-line basis in the final five years prior to maturity. Accordingly, as these instruments approach maturity, the outstanding balances are to be reckoned for inclusion in capital as indicated below:</p> <table border="1"> <thead> <tr> <th>Years to Maturity</th><th>Included in Capital</th></tr> </thead> <tbody> <tr> <td>5 years or more</td><td>100%</td></tr> <tr> <td>4 years and less than 5 years</td><td>80%</td></tr> <tr> <td>3 years and less than 4 years</td><td>60%</td></tr> <tr> <td>2 years and less than 3 years</td><td>40%</td></tr> <tr> <td>1 years and less than 2 years</td><td>20%</td></tr> <tr> <td>Less than 1 year</td><td>0%</td></tr> </tbody> </table>	Years to Maturity	Included in Capital	5 years or more	100%	4 years and less than 5 years	80%	3 years and less than 4 years	60%	2 years and less than 3 years	40%	1 years and less than 2 years	20%	Less than 1 year	0%
Years to Maturity	Included in Capital														
5 years or more	100%														
4 years and less than 5 years	80%														
3 years and less than 4 years	60%														
2 years and less than 3 years	40%														
1 years and less than 2 years	20%														
Less than 1 year	0%														
Seniority of claims	<p>1. Claims of Preference Shareholders shall be superior to the claims of investors holding equity share capital but shall be subordinated to the claims of the policyholders and all other creditors</p> <p>2. Claims of the holders of subordinated debt shall be superior to the claims of the investors in preference shares and equity shares in that order but shall be subordinated to the claims of the policyholders and all other creditors.</p> <p>3. Instruments shall neither be secured nor covered by a guarantee of the Insurance Company or other arrangements that legally enhance the seniority of the claims as against the claims of the insurer's policyholders and creditors</p>														

Rating approach:

Acuite would first arrive at or analyse the Financial Strength Rating (FSR) of the general insurance company, as the claims of the policy holders are senior to the claims of these instrument holders as well as that of the equity holders. It would then notch down the FSR rating to reflect the risks associated with the hybrid instruments to arrive at its final rating on the hybrid instruments issued by the general insurance companies. Acuite would factor in the parent/group/government support based on the articulation of, and demonstration of, the support to the general insurance company.

Major risks associated with the hybrid instruments and its assessment:

Hybrid instruments issued by general insurance companies carry additional risks because of:

- Inability to service interest/dividend on the hybrid instruments in the event of breach of solvency margin regulatory threshold (current minimum requirement is 1.5) by the insurance company. This can be because of factors such as
 - significant growth in business and premiums, especially in segments with relatively high risks resulting in higher reserve requirements,
 - significant losses due to sharp increase in claims, or
 - Changes in regulations requiring higher reserve requirements
- Regulatory approval required if the payment of dividend or interest results in a loss or increase the net loss of the insurance company

Hence, the rating on the general insurance company shall be notched down to factor in the additional risk on the hybrid instrument as the non-payment of interest/dividend on a timely basis will be treated as an event of default.

While assessing the notch-down, Acuite will consider following factors to arrive at the final rating on the hybrid instruments:

- Historical trend in solvency ratio and the buffer maintained over the regulatory requirements
- Articulation and ability of the parent(s)/group to bring in additional capital and the demonstration of such support in the past to support the growth requirements and meet the regulatory requirements
- Historical trend and the future expectation on the insurance company's claims ratio, any vulnerability due to business concentration etc.
- For Preference shares, availability of distributable reserves to assess the ability to service the dividend payments

The extent of notch-down will be based on the assessment of the past track record of the Solvency Margin buffer and the future expectation.

The rating on the hybrid instruments will be very close to the financial strength rating of the general insurance company in a scenario of fairly high solvency margin above the minimum requirement and a strong likelihood of a sustainability in the existing buffer levels. On the contrary, lower the Solvency Margin buffer expectation, higher will the notch-down from the financial strength rating of the general insurance company. The rating on these instruments are expected to have higher transition intensity as compared to the financial strength rating on the insurance company as the rating is highly sensitive to the Solvency Margin levels and the earnings.

Please click here to access the previous version of the criteria on "Hybrid Instruments Issued By Insurance Companies"

Criteria For Rating Based on Explicit Credit Enhancement (CE)

SEBI circular dated June 13, 2019 has made it imperative for Rating Agencies to assign a suffix of (CE) in respect of Ratings, which are supported by Explicit Credit Enhancement. Acuité believes that this step will help in establishing a linearity across the methodologies adopted by various rating agencies. The increasing number of ratings based on such Credit enhancements especially in higher rating categories renders importance to such a uniformity; especially as mostly in such cases, there is a significant divergence between the standalone credit profiles of the borrowers vis-a-vis the ratings assigned based on such explicit credit enhancements. Such instruments/ structures shall have a suffix of 'CE' after the rating.

Acuité believes that the structures /instruments backed by Explicit Credit Enhancement shall mean and include any of the following. The list is inclusive and not exhaustive.

1. Bonds/ Loans backed by Debt Service Reserve Account (DSRA) and Escrow Arrangement/ Structured Payment Mechanism (SPM) where there is undertaking by a third party for replenishment of DSRA.

In case of a structure based on the creation of a DSRA, i.e. backed by liquid asset collateral such as FD, or G-sec bonds, the quantum of funds in the TRA (Trust & Retention Account)/ Escrow Account and the DSRA are to be evaluated in line with the total amount of debt to be serviced on each due date. The presence of an escrow account by itself does not guarantee the adequacy of funds for servicing. However, a strictly executed escrow arrangement can be useful for trapping the cash flows and utilising them as per the priority (waterfall mechanism) for meeting the debt servicing requirements.

Typically, a higher cover in the form of DSRA is representative of a high degree of safety & eligible for higher notch up. Acuité recognises the fact that funds placed in the DSRA are often associated with high opportunity costs, and thus increase the effective cost of borrowing for the issuer. The presence of a DSRA along with a SPM (which could be in the form of a T- n day structure) differentiates the instrument from other plain vanilla borrowings (without these features), as the likelihood of slippages in payments is mitigated due to such clauses. The presence of a corporate guarantee or a DSRA Replenishment Undertaking by a third-party acts as a credit support, so that in the event of the DSRA being utilised the third party shall replenish the DSRA or make the requisite payment (as per the guarantee/ undertaking document) after the demand/invocation notice by the lender or debenture trustee. Acuité will also conduct an independent credit assessment of the third party who has provided the undertaking/ guarantee. The ability of the third party to meet their obligations under the undertaking is assessed.

The ratings based on such structures is suffixed with the words CE in parenthesis to indicate that the rating factors in support in the form of external credit enhancement.

Loans & Borrowings with DSRA & Escrow mechanism without replenishment undertaking/guarantee by third party

In cases even where there is no replenishment undertaking by a third part, Acuité may still consider the presence of a DSRA & Escrow account (along with a T structure) as an Internal Credit Enhancement factor in the benefits accruing from such arrangements. The ratings in such cases will not consider the suffix CE. However, Acuité will mention in its analytical approach that it has relied on the presence of a structure while arriving at the final rating.

2. Bonds / Loans backed by Partial / Full Guarantees / Letters of Comfort from Corporates/ Banks/ Sovereign Governments/ State Governments/ Government backed Financial institutions

In such mechanisms, there exists an external entity (typically a corporate /bank or a government) that undertakes to fulfil the debt repayment obligations on behalf of the issuer of the instrument in case the necessary funds are not made available before the due date.

Acuité may examine the guarantee deed in to ascertain if the guarantee is unconditional and irrevocable. Besides, Acuité may also study the following aspects

- Whether the guarantee covers the entire tenure of the instrument and also cover the interest and principal part of the instrument/ loan
- Possibility of any operational/ regulatory risks that could inhibit the guarantor from discharging the obligations under the guarantee, should such a situation arise
- Legal opinion from an independent law firm to ensure that the above conditions are satisfied
- Acuité arrives at an internal estimate of standalone credit rating of the guaranteeing entity
- In case of unconditional and irrevocable structures, the rating of the structured obligation is mapped (not necessarily equated) to that of the guaranteeing entity, provided the expectation of support can be inferred from the document.

Acuité believes that ideally these dates of invocation and subsequent payment by guarantor should typically be before the upcoming due dates, (T minus x) structures. The forthcoming due dates defined as T. The typical preferred dates for the above conditions, to ensure timely availability of funds to investors, will vary depending upon the ease with which the guarantor can make the funds available. The prime consideration here is the operational ease with which the guarantor can make the funds available for investors after invocation of the guarantee. For instance, a guarantee from a bank in the form of a stand by line of credit (SBLC) would typically require less time to ensure fund availability to an investor after guarantee invocation, as compared to a state government guarantee.

Notwithstanding the expectation of (T-x) structure, Acuité has observed that the invocation of guarantees especially in case of bank debt is a post default event. Acuité focusses more on the post invocation timelines such as the date by which the funds will be made available post serving of invocation notice. Acuité also examines the time lines for intimation to the rating agency especially in case of debt with debenture trustees.

In such cases of Bank guarantee / SBLC backed structures, in addition to its own assessment, Acuité may rely on external ratings assigned by other rating agencies to

these banks/ financial institutions. In case of more than one rating, Acuité will generally consider the lowest of the rating. In case of overseas banks/ institutions, Acuité may map the international rating of the bank to the domestic scale and then assign a rating based on the domestic equivalent of the bank's rating. Acuité may suitably maintain a differential of 1-2 notches to the guaranteeing bank's rating /domestic equivalent rating. It is to be noted that such ratings are based on the credit quality of the guaranteeing bank and any revision in the credit rating of the said bank will result in a revision of the CE ratings assigned for the facilities/borrowings.

In respect of debt obligations (credit facilities availed from banks/ Capital market instruments) backed by Bank Guarantees/ Standby Letters of Credit from Banks/ Financial Institutions, the ratings will be linked to the credit quality of the Guaranteeing /SBLC issuing Bank. The ratings assigned to such credit facilities will be suffixed with the words (CE) i.e. Credit Enhanced, to indicate that these ratings do not reflect the standalone credit quality of the borrower/issuer and are based on certain forms of credit enhancement.

Acuité observes that Bank guarantees/SBLCs are issued by banks as per pre-defined standardized formats and are usually post default in nature i.e. the lender can invoke the guarantee /SBLC only after the occurrence of default. Besides, there are no predefined timelines for invocation or payment by guaranteeing bank after invocation. Notwithstanding these limitations of a bank guarantee, it needs to be recognised that a credit facility / capital market instrument supported by a bank guarantee is considered as an exposure on the guaranteeing bank. The risk weightage assigned to such exposures is also lower than other regular exposures, since the rating of the guaranteeing bank is reckoned by the lender for purposes of capital adequacy. The issuance of a guarantee is a part of a normal course of business for a bank and the guaranteeing bank has to set aside capital to meet this off-balance sheet exposure. Any failure /inability to honour the obligations under the guarantee / commitments can potentially impact the bank's credit worthiness and impair its trust and credibility from an external standpoint. Since the implications of a default under a guarantee / SBLC are severe, a bank will ensure that its commitments under any guarantee / SBLC are met even in the most difficult circumstances.

In cases where there are no explicit corporate guarantees (i.e. legally enforceable obligation), Acuité may rely on other supports such as Letter of Comfort. The key aspects to be reckoned here would be the intent of the counterparty's management in supporting the timely servicing of the debt obligations and the criticality of the arrangement to the counterparty's operations.

Such ratings will also be suffixed with (CE).

3. Structures Based On Pledge of Liquid Securities Including Shares

A. Structures based on Pledge of Shares

The increasing trend in offering security coverage in the form of shares/ liquid investments has prompted a need for looking at such structures differently as opposed

to structures based on a security of movable/ immovable assets. Generally, a rating is indicative of a probability of default and is generally unaffected by the collateral coverage. However, in cases of structures backed by liquid collateral, a right type of structure can mitigate the likelihood of default.

Against this backdrop, Acuité assesses such structures in a different manner as opposed to plain vanilla borrowings. Such structures are very common in case of borrowings by investment vehicles of promoters. It has been observed that generally promoters of listed companies prefer to hold their investments in their listed companies through a clutch of privately held companies. Typically, these private companies have moderate revenue streams mainly by way of dividends on the shares/ interest on investments. Such companies are structured as vehicles for promoter holding and typically do not have any other operations; their net worth and any debt requirements are for investments in promoter group companies. In the absence of any operations, these companies do not have any source of sustainable cash flow, they often must go in for refinancing of their debts/ infusion of funds by promoters. Hence, refinancing ability/ financial flexibility is critical in evaluating such companies. Their financial flexibility is directly linked to the market valuation of their investment portfolio.

Acuité 's approach to evaluation of such issuers is based on the standalone credit profile of the issuer which would then be notched up for the structure. The extent of notching up will depend on two broad platforms (i) Strength of the Structure (ii) Nature and Quantum of liquid collateral.

Strength of Structure

Timelines for funding the account are generally spelt out in the financing document in terms of T-n days (where T is the due date). Typically, n ranges between 3-5 days in most of the cases, since it provides adequate time to the lender/ debenture trustee to initiate the process for selling the securities and ensuring that the funds are received in the account on the due date.

Secondly, tolerance for any dilution in security coverage is also a critical factor in evaluation of such structures. In case of structures backed by pledge of equity shares, if the security coverage falls below the minimum acceptable coverage stipulated in the term sheet, then an immediate top up must be arranged. Acuité believes that for such structures, any significant tolerance below the stipulated coverage beyond five consecutive trading days will render the structure infructuous. Needless to say, monitoring by the lender of the asset coverage on a periodic basis and initiating action for topping up wherever necessary is crucial in such structures. Hence, Acuité will examine the financing documents for these clauses.

Nature & Quantum of Liquid Collateral

Among other factors, Acuité also examines the following aspects while arriving at a notching up:

- 1) Market Capitalisation & Financial performance of the companies, whose shares are being offered as collateral/
- 2) Volatility in the share prices

- 3) Financial Flexibility in the form of unencumbered shares available with the (borrower) promoter vis a vis pledge-based borrowing
- 4) Quantum of unencumbered promoter holding vis-a-vis encumbered promoter holding

The ratings on borrowings based on pledge of shares / securities/other liquid assets will be suffixed with CE in parenthesis after the rating.

B. Structures based on pledge of highly rated bonds/ debt Securities (both Government securities & Private bonds)

Acuite observes that certain instruments/ bank facilities secured by a pledge of Government Securities/ and highly rated bonds/ debentures issued by private corporate bodies and PSUs are increasingly gaining acceptance. The key borrowers under these instruments will be traders in government securities/ corporate bonds. These facilities are virtually credit risk free since the lender can easily liquidate the underlying securities without any significant price concession and recover the entire dues.

High credit quality of the Underlying security (i.e AA - & above)

The Securities issued by Government of India are almost risk free in terms of their AAA Rating due to the sovereign status of the issuer. However highly rated securities issued by other entities like private corporates / PSU undertakings/ State Governments are at an elevated risk of deterioration in credit quality (usually evidenced by downgrade in the rating) over a medium to long term. Hence the key aspect to be examined is the extent of exposure to Non- Central Government securities permissible under the borrowing arrangement.

Liquid nature of the Security

Generally, the market for government securities is highly liquid mainly on account of their risk-free status and significant market participation in the form of players like primary dealers , mutual funds and most importantly banks (for Statutory Liquidity Ratio requirements) . Within the government securities segments, certain segments have slightly higher liquidity than others depending on the tenor, pricing and quantum of paper available. As against government securities, the market for corporate bonds and other securities is relatively shallow since most of the long-term investors in these bonds/ Securities prefer to stay invested till maturity. Besides the shallow nature of the counter, the liquidity in a bond/ debenture can also be impacted by changes in the credit quality of the borrower. Sharp credit cliffs (i.e downgrade by several notches) can also trigger a liquidity issue on a counter.

Availability of adequate margin to mitigate the risk of volatility over a single time period

Generally, the lenders will prefer some "skin in the game" of the borrower , which will be stipulated by way of margin requirements. Typically, the margin will be at least equal to the volatility over a given time period based on past historical data. The volatility in prices of government securities is a function of factors like liquidity, interest rate announcements, size of borrowing programme, economy wise macro factors etc.

Since the list of securities eligible for drawing under such facilities, includes a mix of central government securities as well as other securities including private securities, the actual margin stipulation is higher keeping in mind the probability of higher credit losses under the private sector can portfolio. The availability of adequate margin is a critical factor to be considered in this aspect. Similar to ratings on share pledge-based facilities, the ratings assigned to the structures based on pledge of debt securities will be suffixed with the words (CE) indicating that the rating factors in support from the presence of high-quality liquid collateral available to the lender & the flexibility available to the lender to recover his dues at a short notice.

Besides the above mentioned four major categories, the ratings on following categories of instruments/ borrowings will also be suffixed with the words CE:

Type of Instrument / Structure	Rationale for CE suffix
CMBS-like structures	External credit enhancement
Covered bonds, which have to be serviced primarily by the issuer, with secondary recourse to the cash flows from the pool of loans housed in a trust	External credit enhancement
Partially guaranteed bond	External credit enhancement
Guaranteed bond/loan; Shortfall undertaking backed bond/ loan or other such third-party credit enhancement	External credit enhancement
SBLC backed CPs or other instruments/ facilities	External credit enhancement
Debt backed by pledge of shares or other assets	External credit enhancement
Guaranteed pooled loans issuance (PLI) / Pooled bond issuance (PBI), not through a trust	External credit enhancement
Obligor/Co-obligor structures or Cross-default guarantee structures	External credit enhancement

The long term and short-term rating scales are presented below:

Long Term Rating symbol	Descriptor	Short Term Rating Symbol	Descriptor
AAA (CE)	Highest Safety, Lowest Credit Risk	A1 (CE)	Very Strong degree of Safety, Lowest Credit Risk
AA (CE)	High Safety, Very Low Credit Risk	A2 (CE)	Strong degree of Safety, Low Credit Risk
A (CE)	Adequate Safety, Low Credit Risk	A3 (CE)	Moderate degree of Safety, Higher Credit Risk as compared to instruments

			rated in the two higher categories
BBB (CE)	Moderate Safety, Moderate Credit Risk	A4 (CE)	Minimal degree of Safety, Very High Credit Risk
BB (CE)	Moderate Risk, Moderate Risk of Default	D (CE)	Default / Expected to be in Default on Maturity
B (CE)	High Risk, High Risk of Default	Acuité may apply '+' (plus) sign for ratings from 'ACUITE A1 (CE)' to 'ACUITE A4 (CE)' to reflect comparative standing within the category.	
C (CE)	Very High Risk, Very High Risk of Default		
D (CE)	Default / Expected to be in Default soon		
Acuité may apply '+' (plus) or '-' (minus) signs for ratings from 'ACUITE AA (CE)' to 'ACUITE C (CE)' to reflect comparative standing within the category.			

Methodology For Resolution Plan Ratings

The increasing level of stressed assets in the balance sheets of Indian banks/financial institutions have been an area of concern for the bankers and regulator. The introduction of radical measures such as IBC (Insolvency & Bankruptcy Code) is expected to gradually result in an improvement in the credit culture and act as a deterrent to wilful defaulters. While the intent of the regulation is to nudge the banks towards weeding out structurally unviable cases, it does allow flexibility to the banks to resolve such potentially viable cases in certain cases through resolution plans, wherever lenders expect that the revised debt servicing requirements (as per resolution plan) can be aligned to cash flows generated from the underlying assets.

The Reserve Bank of India vide its circular of February 12, 2018 had announced that resolution plans (RPs) involving restructuring / change in ownership in respect of accounts where the aggregate exposure of lenders is Rs. 100 Cr and above, shall require independent credit evaluation (ICE) of the residual debt by credit rating agencies (CRAs) specifically authorised by the Reserve Bank for this purpose. While accounts with aggregate exposure of Rs. 500 Cr and above shall require two such ICEs, others shall require one ICE. Only such RPs which receive a credit opinion of RP4 or higher for the residual debt from one or two CRAs, as the case may be, shall be considered for implementation. Since the resolution plans pertain to distressed accounts, it entails a modification to the existing approach followed for regular Bank loan Ratings. Here the approach is reformative (futuristic) rather than punitive (focusing on past instances of delinquency). The RBI Circular of June 2019 made further modifications to the earlier circular of February 12, 2018 in terms of certain aspects of the Resolution plan such as timelines, specified period; however, the basic approach from a Rating Standpoint remains unchanged.

Acuité has developed a framework for RP ratings [also known as Independent Credit Evaluation (ICE)] to ensure a credible and consistent approach towards such cases. The RP rating methodology is based on an assessment of the following factors:

The Resolution plan typically entails splitting overall exposure as on a cut-off date into its sustainable and unsustainable components, and subsequently extending the maturity of the debt to align it with the operational cash flows. It is pertinent to note that Acuité will be rating only the Sustainable Portion of the exposure. The RP rating will not be applicable to the Unsustainable portion of the exposure. However, the commitments under all categories of debt (sustainable as well as unsustainable) will be reckoned while arriving at the debt service coverage indicators. Generally, the repayment of the unsustainable portion of debt (which could be in the debt instruments with equity like characteristics) is typically after the payment of sustainable debt. However, in certain cases, the payment of the unsustainable debt could also commence during the initial period of repayment. In such a case, the assumption is that the sustainable debt will have precedence over the unsustainable debt

ASSESSMENT OF REASONS FOR WEAKENING OF THE CREDIT PROFILE

In this case, Acuité shall primarily rely on the TEV report, Resolution Plan, and other related data furnished by the company in this regard along with discussions with management and

bankers. Acuité may also call other documents such as Annual Report, Latest stock audit report, Forensic Audit Report, Monthly Operational data, to arrive at the final decision.

The brief parameters to be looked at are as follows:

1. **Industry Risk** over the period of the resolution plan. The assessment of Industry Risk is more to understand the extent of cyclical, the competitive landscape, regulatory environment, risks emanating from emergence of new technologies, threats from overseas suppliers, and user sector performance among others during the period of the resolution plan. . The cyclical of the industry particularly becomes extremely relevant, since the operating cash flows of the units in a cyclical sector may vary significantly depending on whether the unit is operating at a trough or peak of the cycle.
2. **Market Position** – Current market position in terms of type of clientele, extent of pricing power, diversity in markets, among others. The market position assessment entails a study of the clientele profile, terms of payment, extent of pricing flexibility, extent of market coverage, threats from substitutes, among others.
3. **Operational Efficiency**: Operational efficiency benefits from factors such as integrated nature of operations, proximity to raw material supply, strategic location, tie-ups, access to proprietary technology.
4. **FINANCIALS**: Since most of the resolution plans pertain to stressed assets, the conventional measures of credit assessment will not be suitable for RP ratings. The key issue to be examined in such cases is of adequacy of cash flows to service the debt commitments. Hence, in RP resolution plans, the focus is on cash flows rather than profitability/gearing etc. The cash flow focus helps in understanding the cash flow buffers available keeping in mind the debt servicing commitments. Since the resolution, plans are long tenure plans (in some cases beyond 20 years) and the cash flow visibility beyond the initial 3-5 years is difficult. Acuité believes that the likelihood of the variance from base estimates significantly increases with very long tenor plans (> 7 years); hence, sensitivity analysis becomes an essential part of such plans. Other factors such as the presence of DSRA (Debt Service Reserve Account) help in mitigating the impact of temporary inadequacy in cash flows. Hence, these factors also have a bearing on the overall assessment.
5. **Resource raising capacity of Promoter**: The Promoter's ability to infuse additional funds (beyond the initial upfront contribution as required under restructuring guidelines) is assessed under this parameter. The promoter's ability to raise funds through disposal of non-core assets and personal assets becomes relevant. The key factor is the importance attached by the promoter to the distressed entity and the promoter's willingness to support the resolution plan.
6. **Management continuity and Professionalism**: Since the continuity of management is critical for the smooth revival of a company, the management succession is assessed. The nature of the ownership is also assessed. In certain cases, the lenders may decide to induct new promoters, or a new investor may come in with a majority stake. In such cases, the competence and background of the new investors assumes relevance.

Resolution Plan Rating

ICE SYMBOL	Definition
RP1	Debt facilities/instruments with this symbol are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such debt facilities/instruments carry lowest credit risk.
RP2	Debt facilities/instruments with this symbol are considered to have high degree of safety regarding timely servicing of financial obligations. Such debt facilities/instruments carry very low credit risk.
RP3	Debt facilities/instruments with this symbol are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such debt facilities/instruments carry low credit risk.
RP4	Debt facilities/instruments with this symbol are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such debt facilities/instruments carry moderate credit risk.
RP5	Debt facilities/instruments with this symbol are considered to have moderate risk of default regarding timely servicing of financial obligations.
RP6	Debt facilities/instruments with this symbol are considered to have high risk of default regarding timely servicing of financial obligations.
RP7	Debt facilities/instruments with this symbol are considered to have very high risk of default regarding timely servicing of financial obligations.

Methodology For Rating Of Security Receipts

Security Receipts (SRs) are instruments issued by Asset Reconstruction Companies as consideration for their purchase of distressed assets from banks/ NBFCs. A SR reflects an interest in the underlying distressed asset/ pool of distressed assets.

Evolution of SRs

The enactment of SARFAESI (Securities & Reconstruction of Financial Assets and Enforcement of Security Interest), & RBI also allowed the functioning of Asset Reconstruction Companies (ARCs) who would be authorised to buy stressed assets from banks for a consideration. Since the capital base of these ARCs was modest, RBI allowed the ARCs to pay a part of their consideration in the form of SRs. The scheme initially started with 5/95 configuration (i.e. 5% of the purchase consideration to be paid in cash and balance 95% by way of issue of SRs). The scheme was gradually modified to 15 /85 scheme to nudge the ARC to have more 'skin in the game' by way of cash investment. RBI also linked the valuation of the SRs and consequently increased the ARC's revenue linkages to the Recovery Ratings assigned by Rating Agencies on these SRs. RBI has also effected certain changes in the regulation pertaining to provisioning relief to the banks based on the SRs held by them in respect of an account.

The key methodology for assigning of RR rating hinges on following two factors:

1. Resolution methodology – Liquidation Approach or Restructuring Approach
2. Assessment of the Magnitude & Timing of Cash flows to arrive at the Present Value of Cash flows & Redemption of SRs.

Resolution Methodology

The approaches adopted by ARCs to resolve the distressed assets acquired by them can be broadly categorised as (a) Liquidation Approach & (b) Restructuring Approach.

The Liquidation approach, usually, is adopted in cases of structural unviability of the business. Often the viability of businesses is threatened due to factors such as changes in regulation, emergence of new technologies, changes in customer preferences among others. In such a scenario, the lenders (including SR holders) will be left with limited options such as sale of assets. The value of industrial assets, (more particularly land), can support the recovery efforts of the lenders. The nature of the assets is important in this case. For instance, assets with customised applications will have limited marketability than assets with standardised applications. The regulatory restrictions on usage can also affect the marketability of the assets. For instance, the land and building of a distressed unit in an electronics zone can be sold mostly to units operating in similar segments or allied areas. In case of certain assets, the maintenance of the assets is another factor, as the lenders may have to ensure the timely maintenance to preserve their market value.

The appreciation in prices of land (especially in and around urban centres) has imparted a buoyancy to the recovery efforts of the lenders. The valuation reports have to be obtained from

bank empanelled valuers to get a fair estimate of the expected proceeds from sale of property. The timing and quantum of cash flows will be critical in this case. The IBC (Insolvency & Bankruptcy Code) has put in place a mechanism for timely resolution of assets. The mooting of the ICA (Inter Creditor Agreement) to bring all lenders under a common umbrella is also a progressive step in this direction. While such initiatives are expected to augur well for the ARCs, the operational impediments such as legal hurdles by existing managements (who do not want to be dislodged) or operational creditor's issues will have to be ironed out.

Restructuring Approach

In most of the cases, the assets of the distressed entity have inherent economic potential. The entity in such cases could have faced distress because of transient setbacks such as cancellation of orders, build-up in receivables, labour strikes, raw material linkage issues, regulatory changes domestically or abroad among others. In such cases, the lenders pursuant to a techno-commercial viability study may decide to alter the terms of payment. The additional requirement of funds required for the smooth implementation of the scheme is also assessed while arriving at the restructuring scheme.

In such cases, the cash flows could be staggered over a period with payments to the lenders being made in a pro rata manner. The promoters of the distressed entity may also propose an OTS (One Time Settlement) with an upfront payment and balance, over a period, with some or all lenders. Acuite has observed that generally all the ARCs focus on consolidation of the debt in an entity by acquiring the stakes of various lenders. The ARCs ability to influence the resolution strategy is significantly enhanced by such aggregation of debt.

Acuite's stance in restructuring cases will be to arrive at stress case scenarios in addition to base case scenarios, to gauge the extent of variability in cash flows and consequently the impact on the recoveries and redemption of SRs.

Discount Factors

Generally, Acuite applies a 9% discount factor while arriving at the present value of the cash flows. Acuite also considers the priority payments, if any, such as management fees before arriving at the distributable surplus.

Acuite's Rating Scale and their respective interpretation is as under.

Recovery Rating	Implied Recovery	Rating Definition
ACUITE RR1+	> 150%	The rating of ACUITE RR1+ indicates that the present value of anticipated recoveries is more than 150% of the face value outstanding of the SRs.
ACUITE RR1	100% - 150%	The rating of ACUITE RR1 indicates that the present value of anticipated recoveries is in the range of 100%-150% of the face value outstanding of the SRs.
ACUITE RR2	75% - 100%	The rating of ACUITE RR2 indicates that the present value of anticipated recoveries is in the range of 75%-100% of the face value outstanding of the SRs.

ACUITE RR3	50% - 75%	The rating of ACUITE RR3 indicates that the present value of anticipated recoveries is in the range of 50%-75% of the face value outstanding of the SRs.
ACUITE RR4	25% - 50%	The rating of ACUITE RR4 indicates that the present value of anticipated recoveries is in the range of 25%-50% of the face value outstanding of the SRs.
ACUITE RR5	0% - 25%	The rating of ACUITE RR5 indicates that the present value of anticipated recoveries is in the range of 0%-25% of the face value outstanding of the SRs.

Infrastructure Investment Trust (InvIT)

Key Stakeholders in an InvIT

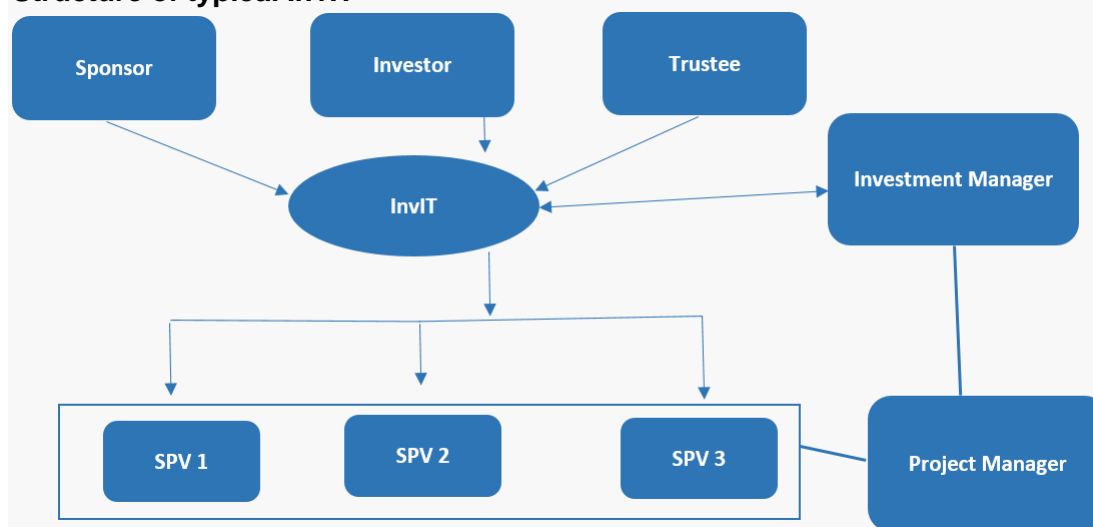
1. **Sponsors** – A sponsor sets up the InvIT. A sponsor at all times is required to hold a minimum of 15% of units of the InvIT for a period of three years from the date of issuance. There is no limit on the number of sponsors in such InvITs
2. **Trustee** – Trustee is responsible for acting as per the provisions of the trust deed of the InvIT
3. **Investment Manager** – The investment manager is responsible for the investment decisions made under the InvIT and will also oversee the project managers, who in turn, are responsible for the operations of the underlying assets in an InvIT

Key regulations stipulated by SEBI for InvITs

(Source: **SEBI/HO/DDHS/DDHS/CIR/P/2019/59**)

1. **Holding of Assets** – An operating asset can be held directly or through SPVs in an investment trust. The trust can invest in two-level SPVs through a holding company, subject to majority shareholding in the hold co and the underlying SPV.
2. **Allotment of Units** – The value of each allotment lot shall not be less than Rs 1 lakh for InvITs, where each lot shall consist of 100 units. Allotment to an investor shall be made in multiples of a lot. Allotment of Units – The value of each allotment lot shall not be less than Rs 1 lakh for InvITs, where each lot shall consist of 100 units. Allotment to an investor shall be made in multiples of a lot.
3. **Investment in Under Construction Assets** – InvITs can invest up to 10% in under-construction assets.
4. **Debt** – InvITs can raise debt at the SPV level or at the level of InvIT or it could also be a combination.

Structure of typical InvIT



The debt raised at the level of SPV can be credit enhanced through a guarantee from the InvIT to achieve the benefits of cash flow pooling.

Leverage Restrictions in investment trusts

A Credit rating is required to be obtained if the aggregate consolidated borrowings and deferred payments (net of cash and cash equivalents) of the investment trust are in excess of 25% of the asset value.

1. Aggregate consolidated borrowings and deferred payment of the investment trust net of cash and cash equivalents are typically restricted at 49% of the value of the investment trust
2. The aggregate borrowings can be increased to 70% on the satisfaction of the conditions mentioned below:
 - a. Approval from Unit Holders
 - b. credit Rating of 'AAA' post increasing the leverage
 - c. Minimum track record of six continuous disbursements
 - d. Capital released is used in acquiring new infrastructure assets

Investor protection and governance norms are relaxed for privately placed InvITs, key features are mentioned below:

1. No restrictions on leverage limits
2. No regulatory constraints on investment strategy
3. No regulatory guidelines on the distribution of free cash
4. No regulatory requirement regarding public disclosure on the performance of InvIT
5. Funds are to be raised through placement memorandum
6. Funds can be raised only through institutional investor and bodies corporate
7. Not accept from an investor an investment less than Rs. 1 crore
8. Not raise funds from more than 20 investors

Risk assessment framework for arriving at the credit rating of an InvIT

It is proposed that the framework for the assessment of risk in an investment trust be based on the following

1. Business Risks
2. Financial Risks
3. Presence of Structural Features
4. Regulatory Risks
5. Management Risk

Business Risk

Evaluation of business risk should be focused on the quality of the assets under the InvIT. The quality assessment should cover the following revenue risk associated with each of the projects, the tenure of the contract and the protection available to the issuer under the contract (including the termination clauses), the re-pricing risk associated with the contracts, demand and supply situations affecting the future cashflows.

For assets under pay and use model – viz. toll roads, airports and ports; in case of an existing asset, the track record of traffic movement may be well established, and historical traffic data is required for ascertaining the traffic trend. However, for a project with a limited operational track record, forecasting traffic volumes and measuring market risks can be challenging, given the absence of reliable and sufficient historical traffic data an estimate may be used to assess the future revenue potential for the asset.

Counterparty credit risk associated with the asset – This is more applicable to the assets which are not under use and pay model. In the situation of financial stress with the counterparty, there could be delays in realization of cash. Diversification of counterparty is likely to mitigate counterparty risk to a certain extent.

Operating Risk– Conformance with the desired performance levels over the period of concession or under the PPA as the case may be. Any delays in the timely maintenance and lack of provisioning for maintenance expenses could lead to the material weakening of the project and thus is likely to impair the revenue-generating capacity of the project.

Diversity of Asset base in the InvIT – A diverse asset base for an InvIT should have no single assets dominating the cashflow for the InvIT, should not have a major concentration in one geography, should not be dependent on a single revenue model (can be a mix of toll and annuity for road assets)

Financial Risk

Sustainability of cashflows – The lesser the variability of cash flow, the better is the sustainability of the asset (Annuity Road Assets have lower variability of cash flow compared to toll assets).

Stable Returns: An asset which has a defined cost structure and adequate provisions for routine maintenance is more likely to build in adequate buffers to counter any delays in receivables (annuity roads, lease rentals etc.). A thorough analysis of the cost structure, therefore, needs to be conducted to ascertain if all the major cost components are thoroughly covered while arriving at the profitability.

Assessment of liquidity: Cashflows from an asset should also be assessed from the perspective of the potential to generate adequate liquidity during its initial period of operations. The Debt Service Coverage Ratio (DSCR) is required to be evaluated by applying reasonable stress to the operating conditions. Acuite will assess asset level DSCRs over the life of the concession agreement as one of the critical inputs amongst others.

Presence of Structural Features

Any Asset/Investment Trust (when debt is raised at the level of the Trust) with a limited track record of operations may present itself with a reduced level of certainty for the prediction of cash flows. In such situations, the presence of structural features which provide adequate cushion for debt repayment becomes critical. A project shall be viewed favourably if the structuring of the debt provides for trapping of the cash generated, creation and maintenance of DSRA, ballooning of the repayment structure to tide over the initial period of the ramp-up of operations, creation of provisions for incurring large expenditures, ring-fencing of the cash flows.

The analysis of cash flows should also include the priority of application of cash flows so generated towards various requirements. For instance, a payment waterfall which prioritizes application of funds towards shortfalls in maintenance reserves over payment of dividends should be viewed more favourably vis-à-vis a project where cashflows are released directly post application of funds towards debt servicing.

Acuite also takes note of the controls that the lenders exercise in such transactions, such as the imposition of restrictive covenants on leverage, or defining the total permissible borrowings or restricting repayments on junior debt.

Regulatory Risks

A review of the regulatory risk is critical where the operating assets are subjected to high levels of government intervention from time to time. There have been instances in the past where government interventions such as stopping toll collections for passenger cars has led to a substantial reduction in the toll revenues for developers, while there are remedies available to the developer under such circumstances. The evaluation of the history of such interventions and the compensations awarded and the timeliness of such compensations assumes criticality in the assessment of regulatory risks.

Management Risk

The evaluation of management risk should be centred around the following:

1. Integrity – Instances of violations of regulations in the past by the sponsor or the group
2. Competence – Track record of operations of the sponsors in managing similar assets in the past
3. Risk Appetite – Asset acquisitions, frequency of such acquisitions, the leverage policy adopted by the group/sponsor

Framework for capturing equity prices and distance to default

Acuité has adopted Altman Z-score cases as an additional validation for the ratings recommended by the analyst in the investment grade category. The Z-score formula for predicting bankruptcy was published in 1968 by Edward I. Altman, who was, at the time, an Assistant Professor of Finance at New York University.

The Z-score is a linear combination of five ratios, weighted by coefficients.

Z-score component definitions variable definition

X1 = Working capital / Total assets

X2 = Retained earnings / Total assets

X3 = Earnings before interest and taxes / Total assets

X4 = Market value of equity / Total liabilities

X5 = Sales / Total assets

Z score bankruptcy model:

$$Z = 0.012X_1 + 0.014X_2 + 0.033X_3 + 0.006X_4 + 0.999X_5$$

Zones of discrimination:

- $Z > 2.99$ – “Safe” Zone
- $1.81 < Z < 2.99$ – “Grey” Zone
- $Z < 1.81$ – “Distress” Zone

Notes:

1. It is pertinent to note here that Acuité does not base its rating decision solely on the Z-score.
2. It may also be noted that one of the limitations of Z-score is that it was designed for publicly held, manufacturing companies. Consequently, Acuité computes Altman Z-score only for equity listed, manufacturing companies.
