

A background image showing a hand holding a silver pen, writing on a document. The document has several colorful sticky notes (blue, yellow, green) attached to it. The image is slightly blurred, giving it a professional and focused appearance.

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. Acuite'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 Acuite, 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 three values of Acuite, namely Trust, Innovation and Excellence. The auditors as well as the regulators, use this document as a base to test the integrity of various functions and processes.

Every Acuite 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.

1. [General Nature of Compensation Arrangements with Rated Entities](#)
2. [Policy for Appeal](#)
3. [Policy for Placing Ratings on Credit Watch](#)
4. [Guidelines on What Constitutes Non-Cooperation](#)
5. [Guidelines on Gifts](#)
6. [Confidentiality Policy](#)
7. [Policy on Outsourcing of Activities](#)
8. [Policy on Provisional Ratings](#)
9. [Disclosure on Managing Conflict of Interest](#)
10. [Policy regarding Monitoring & Review of Ratings](#)
11. [Policy for Withdrawal of Ratings](#)
12. [Policy on Internal Approvals](#)
13. [Functioning of Rating Committee](#)
14. [Guidelines on Minimum Information Required for the Rating](#)
15. [Guidelines on Seeking Information from External Entities](#)
16. [Roles and Responsibilities of Credit Rating Analyst](#)
17. [IOSCO Code of Conduct adopted by Acuite](#)
18. [SEBI Code of Conduct adopted by Acuite](#)
19. [Policy for Dealing with Conflict of Interest for Investment / Trading](#)
20. [Guidelines on debt servicing confirmations pertaining to unlisted debt instruments \(Retail](#)

- [Debentures / Retail Deposits\)](#)
- 21. [Guidelines on Key Financial Indicators in case of non-cooperation by the issuer \(unlisted entity\)](#)
- 22. [Guidelines on interaction with Audit Committee of entities with listed NCDs](#)
- 23. [Guidelines for assigning non-'D' rating to entities with an outstanding 'D' rating by other credit rating agencies](#)
- 24. [Guidelines for site visit](#)
- 25. [Independent Credit Evaluation: Fee Structure and internal controls](#)
- 26. [Rules for Acuite's Analytic Firewalls](#)
- 27. [Guidelines on rating a portion of lenders' bank facilities](#)

RATING CRITERIA & METHODOLOGY

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. Please find the list of criteria/ methodology for:

- 1. [Rating Process and Timeline](#)
- 2. [Rating of Manufacturing Entities](#)
- 3. [Rating of Trading Entities](#)
- 4. [Rating of Entities in Services Sector](#)
- 5. [Rating of Non-Banking Financing Entities](#)
- 6. [Rating of Banks and Financial Institutions](#)
- 7. [Rating of Entities in Infrastructure Sector](#)
- 8. [Default Recognition](#)
- 9. [Application of Financial Ratios and Adjustments](#)
- 10. [Consolidation of Companies](#)
- 11. [Group and Parent Support](#)
- 12. [Public Finance - State Government Support](#)
- 13. [Rating of Securitized Transactions](#)
- 14. [Rating Commercial Paper](#)
- 15. [Complexity Levels of Financial instruments](#)
- 16. [Rating of Fixed Deposit Programmes](#)
- 17. [Rating of Hybrid instruments issued by NBFCs & HFCs](#)
- 18. [Public Finance – Urban Local Bodies](#)
- 19. [Rating of Real Estate Entities](#)
- 20. [Rating of Insurance Companies](#)
- 21. [Explicit Credit Enhancements](#)
- 22. [Resolution Plan Ratings](#)
- 23. [Security Receipts Ratings](#)
- 24. [Infrastructure Investment Trust \(InvIT\)](#)
- 25. [Covered Bonds](#)
- 26. [Real Estate Investment Trust \(REIT\)](#)
- 27. [Asset Reconstruction Companies](#)
- 28. [Lease Rental Discounting \(LRD\)](#)

APPLICABLE REGULATORY GUIDELINES

- SEBI Regulations, 1999 <https://www.sebi.gov.in/legal/regulations/aug-2021/securities-and-exchange-board-of-india-credit-rating-agencies-regulations-1999-last-amended-on-august-03-2021-40619.html>
- Coverage of other securities / instruments and loans / facilities provided by banks under purview of SEBI, March 01, 2012
https://www.sebi.gov.in/sebi_data/attachdocs/1331706378217.pdf
- Standardization of Rating Symbols & Definitions, June 15, 2011
https://www.sebi.gov.in/sebi_data/attachdocs/1308551826775.pdf
- Sharing of information regarding issuer companies between Debenture Trustees and Credit Rating Agencies, March 15, 2013
https://www.sebi.gov.in/sebi_data/attachdocs/1363346395331.pdf
- Enhanced Standard for Credit Rating Agencies, November 01, 2016
https://www.sebi.gov.in/sebi_data/attachdocs/1477999985100.pdf

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.

Acuite 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.

Acuite 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. Acuite 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. Acuite reserves the right to modify its fee structure.

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

Acuite'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.

Acuite'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, Acuite 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. If an issuer has all the outstanding ratings as non-cooperative for more than 6 months, then Acuité shall downgrade the rating assigned to the instrument of such issuer to non-investment grade with INC status. If non-cooperation by the issuer continues for further six months from the date of downgrade to non-investment grade, no CRA shall assign any new ratings to such issuer until the issuer resumes cooperation with Acuité or the rating is withdrawn by Acuité.

4. If an issuer fails to submit monthly 'No Default Statement' for consecutive months (corresponding to applicable instruments) as specified in table below, Acuité will flag off the rated entity as "Issuer Not Cooperating". However, the above will not apply in cases where the issuer is able to establish (i) technical or procedural issues for NDS submission OR (ii) a track record of timely debt servicing for the period as stipulated above. It is pertinent to note that the above timeline is the longest gap that Acuité will consider for flagging a rated entity as "Issuer not cooperating" and does not preclude situations where flagging as "Issue Not Cooperating" is effected in a shorter timeframe, if specific circumstances so warrant.

Rated Instrument	Investment Grade	Sub-Investment Grade#
BLR and/or unlisted debt only	6 months	9 months
Listed Debt and/or FDs	3 months	3 months
BLR and/or unlisted debt + Listed debt and/or FDs	3 months	3 months

Note: Listed debt could include Bonds, Debentures, CP, Pref Shares, PTCs and any other listed instrument by any name.

- "These guidelines will not apply to outstanding ratings in the 'C' and 'D' categories as these issuers are expected to be delaying or defaulting on their debt servicing obligations. A monthly statement that confirms default is not expected to trigger any further rating action."

5. 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 activities related to rating execution and regulatory compliance functions.

On-Roll Employees:

Activities related to rating execution performed by full-time on-roll employees:

1. Interactions / discussions with the management
2. Preparation of the Rating / Review note
3. Presentation of the Rating / Review note to the Rating Committee
4. Maintaining records and incidental secretarial work related to committee meetings

Off-Roll Associates:

Activities performed by full-time associates (on payroll of a third party) who use the physical infrastructure, network systems and IT assets that are owned and in full control of Acuite:

1. Following up for information from rated entities for surveillance / review
2. Data entry activity

Acuite hires associates who are on a contract with a third-party service provider purely from a payroll processing perspective.

- a) The training, monitoring / supervision and reporting of these associates is to a supervisor / employee on the rolls of Acuite.
- b) These associates work using the infrastructure, network (including Virtual Private Network) and IT assets owned by and software licensed to and in full control of Acuite. The same restrictions that apply to a full-time on-roll employee using the IT assets of Acuite apply to these associates.
- c) 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.

None of the activities pertaining to rating is outsourced to any third-party organisation where Acuite has ceded control of its IT assets & infrastructure, network systems & processes.

Non-Core* activities outsourced by Acuite:

Activities that Acuite has outsourced include managing certain associates for business development, hiring candidates using the services of recruitment consultants, payroll processing & payroll compliance related activities.

Wherever necessary, Acuite will outsource the following activities (all based on publicly available information sources):

1. ESG background check
2. ESG data
3. ESG assessments
4. Early Warning System

*The classification of core and non-core activities is as approved by Ratings Sub-Committee.

Policy on Provisional Ratings

A. Applicability Of Provisional Ratings:

- i. Provisional ratings are assigned by Acuité to debt instruments, issuer ratings [corporate credit ratings (CCR)], where certain important actions and/or execution of certain documents governing the ratings are yet to be completed. These actions / steps may comprise, as applicable:
 - a) execution of letter of comfort, corporate guarantee, or other forms of explicit third-party support;
 - b) execution of documents such legal agreements/ opinions, representations and warranties, final term sheet;
 - c) assignment of loan pools or finalisation of cash flow escrow arrangements;
 - d) setting up of debt service reserve account;
 - e) opening of escrow account; or
 - f) For a proposed Real Estate Investment Trust (REIT) or Infrastructure Investment Trust (InvIT), only after receipt of SEBI Registration. However, the process of obtaining rating may commence at the stage of the sponsor filing with SEBI for the registration of the Trust, subject to a declaration from the sponsor to this effect being submitted to Acuite.
- ii. Subsequently, upon receipt and execution of the requisite documents / completion of the required actions, the provisional ratings are converted into final ratings.

B. Exceptions:

Acuité may assign a rating, including provisional rating, to a debt instrument / issuer evaluating strategic decisions, such as funding mix for a project, acquisition, debt restructuring, loan refinancing, except for assigning scenario-based ratings or advance ratings.

C. Symbol for Provisional Ratings:

In case of provisional ratings ('long term' or 'short term'), Acuité prefixes such ratings with the word "Provisional" e.g. in all communications like rating letter, press release / rating rationale, etc.

D. 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.

E. 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. The provisional ratings shall be converted into a final rating within 90 days from the date of issuance of the debt instrument. The final rating assigned after end of 90 days shall be consistent with the available documents or completed steps, as applicable.
- ii. On a written request from the issuer, Acuité may grant an extension of 90 days on a case-to-case basis, solely based on the decision by the Rating Committee.
- iii. Since CCRs for REITs / InvITs are not linked to placement of a specific debt instrument, the validity period for conversion from provisional rating to final rating shall be computed from completion of fund raising and issuance of units by the REIT / InvIT. The validity

period for conversion shall be within 90 days, along with an extension of up to 90 days granted on a case-to-case basis by the rating committee, similar to cases involving issuance of debt instruments.

- iv. Acuite shall not assign any provisional rating to a debt instrument upon the expiry of 180 days from the date of its issuance.
- v. Acuité will withdraw the Provisional rating in cases where the issuer fails to comply with the required actions / documentation within the applicable time period [as stated above in **E i.)** or **E ii.)**],
- vi. As part of the withdrawal process, Acuité will seek:
 - a) Updated business information, financial statements (Audited / Provisional as applicable) & any other information it considers important / critical and management interaction.
 - b) 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.

F. Effect on Rating Action in case of Material Changes:

- i. Acuité may withdraw the existing provisional rating, in case there are material changes in the terms of the transaction after the initial assignment of the provisional rating, where issuance is yet to happen.
- ii. In some cases, there might be material changes in the terms of the transaction after the initial assignment of the provisional rating and post the completion of the issuance (corresponding to the part that has been issued). Under those circumstances, Acuité may withdraw the existing provisional rating and concurrently, assign a fresh final rating in the same press release, basis the revised terms of the transaction. Such withdrawal and simultaneous assignment of fresh rating shall be subject to inspection or examination by SEBI / other regulators, as applicable. The regulators shall review the materiality of changes in the terms of the transaction as well as appropriate documentation of investor consent to the change in terms.
- iii. See Note 1 and Note 2 in the Annexure, where withdrawal and simultaneous assignment of fresh rating shall NOT apply.

G. Disclosures in the press release / rating rationale:

In addition to the disclosures already being made, Acuité shall include the following disclosures in press release / rating rationale while assigning provisional ratings:

- i) pending steps/ documentation considered while assigning provisional rating.
- ii) risks associated with the provisional nature of the credit rating, including risk factors that are present in the absence of completed documentation / steps.
- iii) rating that would have been assigned in absence of the pending steps/ documentation considered while assigning provisional rating. In cases where the absence of said steps/ documentation would not result in any rating being assigned by Acuité (for instance, in case of provisional rating for REIT/ InvIT – pending formation of trust), Acuite shall specify the same in the press release.
- iv) While assigning provisional rating to a debt instrument proposed to be issued, the press release shall specify that in case the debt instrument is subsequently issued, the provisional rating would have to be converted into final rating as per the validity period / time frame prescribed in **E i.)** or **E ii)** (as applicable) above.

- v) While assigning provisional rating to an issued debt instrument, the press release shall specify the rating and timeline implications as per the validity period / time frame prescribed in **E i.)** or **E ii)** (as applicable) above.

H. Disclosures in the press release / rating rationale in case of REITs and InvITs:

Furthermore, in case of provisional ratings for REITs and InvITs, the following disclosures shall also be required, wherever applicable:

- i) The broad details of the assets that are proposed to be held by the REITs/ InvITs, the proposed capital structure, etc.
- ii) The rating rationale should disclose that Acuité has taken an undertaking from the sponsor stating that the key assumptions (relating to the assets, capital structure, etc.) are in consonance with the details filed by the sponsor with SEBI.
- iii) In case of change in provisional rating due to change in aforesaid key assumptions, the press release shall state that the rating by Acuite is based on a declaration from the issuer that similar changes have been made in the filing with SEBI.
- iv) Acuité may approach SEBI for guidance as and when it faces any issues in obtaining such a declaration or if it feels that rating announcement should be made without waiting for the declaration.

I. Unaccepted Provisional Rating:

In case the issuer (or sponsor, in case of REITs/InvITs), does not accept the provisional rating assigned, Acuité shall provide the following as supplementary disclosures along with "Unaccepted Ratings" published on its website:

- i) The details of the steps taken for assigning the provisional rating [as per **G i)**]. For instance, in case of REITs/ InvITs, such disclosure shall contain the broad details of the assets to be housed under the Trust, the proposed capital structure, etc.
- ii) the rating referred to in Para **G iii)**, viz. rating that would have been assigned in absence of the said steps/ documentation.

Annexure:

NOTE 1: There could be situations that a rating (either provisional or final) is assigned after duly evaluating the fundamental credit factors as well as the terms of the structure. However, it is experienced later that the structure failed to work in the manner that it was designed to. Example: The beneficiary failed to invoke the corporate guarantee in a timely manner or the lender failed to dip into the Debt Service Reserve Account (DSRA) on or before the due date, leading to missed payments. Such instances of failures in the working of the structure are not proposed to be covered under this approach. Acuité intends to continue with the existing practice of 'downgrading' the rating of the rated instrument/ facility in such cases. This is because these instances do not involve any change in the transaction terms.

NOTE 2: There could be other instances of changes in the rating factors that are beyond the control of the Acuité, but these are not proposed to be covered under this approach. As an example, there could be changes in the regulatory policies including changes in the import duty structure etc. which could change the rating of an entity. Acuité intends to continue with the existing practice of 'upgrading/ downgrading' the rating of the rated instrument/ facility in such cases. This is because these instances/ events, even though beyond the control of Acuité, are related to an assessment of the fundamental credit drivers of an entity.

Disclosure on managing conflict of interest

1. Acuité Ratings & Research Limited has operationally separated its credit rating analytical team from any other businesses of Acuité Ratings & Research Limited that present a conflict of interest
2. Acuité Ratings & Research Limited discloses the general nature of its compensation arrangements with the rated entities.
3. When Acuité Ratings & Research Limited receives compensation from a rated entity unrelated to its credit rating services, Acuité Ratings & Research Limited would disclose such unrelated compensation as a percentage of total annual compensation received from such rated entity.
4. Acuité Ratings & Research Limited would make a disclosure if it receives 10 percent or more of its annual revenue from a single rated entity.
5. Acuité Ratings & Research Limited would not trade in instruments presenting a conflict of interest with Acuité Ratings & Research Limited's credit rating of the concerned entity, if rated by Acuité Ratings & Research Limited.
6. Acuité Ratings & Research Limited'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 Ratings & Research Limited would derive from that entity.
7. Acuité Ratings & Research Limited's access person(s) and/or employee(s) 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 Ratings & Research Limited may review, where the compliance officer finds it so necessary, the past work of an analyst who leaves the employment of Acuité Ratings & Research Limited and joins an entity (if Acuité Ratings & Research Limited comes to know of its former employee taking up such an employment) where Acuité Ratings & Research Limited 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, policy for dealing with conflict of interest for trading and investment, and rules for Acuité analytic firewalls which are currently in force and/or that may be adopted by Acuité Ratings & Research Limited from time to time.
10. Acuité Ratings & Research Limited and its employees do not engage in providing rating advisory services and/or help the issuer(s) in structuring / syndicating the debt programme or loan facility(s) with or without fee.
11. The access person(s) and/or employee(s) has the responsibility to make reasonable efforts to inform and disclose to Acuité Ratings & Research Limited 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 Acuite 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 Acuite'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 Acuite's website.
4. At least one review should be conducted as under - For Bonds & Debentures, CP & CD program (and all forms of listed debt, regardless of the instrument name): once every 365 days (i.e. the no. of days between two consecutive press releases / rating rationales should not exceed 365 days). For bank loan facilities: once every 455 days (i.e. the no. of days between the two consecutive press releases / rating rationales should not exceed 455 days). In cases where, Acuite has outstanding ratings on both, listed debt as well as bank loans, the review timeline shall not exceed 365 days from the date of publishing the previous press release / rating rationale.
5. In case of non-cooperating rated entities where surveillance is not possible due to non-availability of requisite data or Acuite is of the opinion that the data is incorrect / not true, or non-receipt of surveillance fee, Acuite 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".
6. In situations, where Acuite has:
 1. Not carried out a review as per the timelines stated in point 4 above AND
 2. Not suffixed "Issuer not cooperating*" as per point 5 above
 the details will be published under "Review Due but Not Conducted" under the disclosure requirements (Annexure A, point 4.B Disclosures - in case of delay in periodic review) as per SEBI circular SEBI/HO/MIRSD/MIRSD4/CIR/P/2016/119. The list of "Review Due but Not Conducted" is available through the link <https://www.acuite.in/review-due-date.htm>

This list is updated every working day and is kept current. The record pertaining to an issuer is excluded from the list only after the press release consequent to the latest rating committee is published.

Policy on Withdrawal of Ratings

Bank Loan Facilities

Acuité 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. a.) No Objection Certificate (NOC) from all the lending banks OR from the lead bank, in such capacity (in case of consortium banking) as applicable OR
b.) Where some form of correspondence from a bank(s) is available with Acuite, that (i.) states closure / extinguishment of bank loans and/or working capital facilities of the rated entity OR (ii.) refers to internal guidelines of a bank(s), citing there is no requirement for external credit ratings for sanctioned bank limits below a certain threshold amount, Acuite will rely on such correspondence, in lieu of a specific NOC, for withdrawing the rating(s) assigned to the facilities availed by rated entity from that bank(s) OR
c.) In case of change of bank or closure / extinguishment of bank loans and/or working capital facilities as intimated by the rated entity [and no correspondence is available from the bank(s)], Acuite will rely on "Satisfaction of Charges", wherever 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 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

Bonds / Debentures

- A.** As per SEBI Circular SEBI/ HO/ MIRSD/ DOP2/CIR/P/2018/ 95 dated June 6, 2018, Acuité will withdraw the Credit Rating on Bonds / Debentures, based on a written request from the issuer and subject to the following conditions:
 1. Acuité has rated the instrument continuously for 5 years or 50 per cent of the tenure of the instrument, whichever is higher.
 2. Acuité 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, Acuité 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 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.

Fixed Deposits

Acuite 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

Acuite 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, Acuite 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, Acuite 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)I 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/ MutualFund / Credit Research Firm / Bi-lateral Government Agency
- Independent 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:

- The rating committee decision will be based on the majority vote and in case of a tie, the chairperson will have the casting vote.
 - Note of dissent, if any, by any member of the rating committee shall be taken on record.
7. Committee members will be bound by Acuite's internal Code of Conduct and Non-Disclosure Agreement (for independent 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.

A. Committee members and/or access persons who have a conflict of interest in the entity being rated are expected to:

- i. Inform the desk executive in writing citing existence of interest. This has to be done at the earliest i.e. on receipt of the Committee agenda but before the committee proceedings begin. This is important to ascertain whether or not quorum will be met for the specific case. If quorum is unlikely, the case has to be withdrawn from the committee agenda and included in another committee that will have to be constituted afresh.
- ii. Completely recuse themselves from the committee proceedings for the duration of the deliberations in that specific case.

B. To recuse, one will be required to physically step out (in case of physical committee meetings) or log out of the calls (for virtual / online interactions).

C. Case deliberations must begin only after all access persons with interests exit the meeting.

D. In the "Other Attendees" section of minutes, besides noting down the names of persons attending the committee, the executive manning the desk will be required to explicitly mention the line: "The following person(s) recused himself / herself during the committee deliberations:

1. Mr. _____,
2. Ms. _____”.

- E. The rating desk executive manning the committee needs to be sensitive to the quorum requirement being met at all points in time for all cases.
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:
 - 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 Acuite’s panel of experts, should the need arise.
 - Such experts will not have voting rights in the committee.
 - Expert panelists 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. The Chairperson of the Rating Committee shall be responsible for orderly conduct of meeting in line with these guidelines.
 15. 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 Acuite.

Professional Conduct

The members of the committee (including expert panelists) 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

RATING COMMITTEE MEMBER POOL

1. A. J Bose
2. Aditya Gupta
3. Bhaskaran S
4. Kaustav Saha
5. Kesavadas Menon
6. Mohit Jain
7. Neha Agarwal
8. Pooja Ghosh
9. Sumit Pramanik
10. Sushant Kumar Mishra
11. Tonoy Banarjee
12. Vasant G Kamat
13. Vinayak Nayak

APPEAL COMMITTEE MEMBERS POOL

1. Asit Pal
2. Supriyo Basu
3. S Venkatraman
4. Select individuals from RATING COMMITTEE MEMBERS' POOL

Annexure II

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

A. Preliminary Information

- Date of the RCM
- Name 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 ratings 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

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. Sanction letter issued by the bank (preferably, the most recent)
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)
9. Bank statement(s) for the last 6 months for the cash credit account/s and the term loan account/s
10. Any other, entity-specific data point / information as required during the rating / review process.

Acuité will seek information 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

SEBI vide its circular SEBI/HO/MIRSD/MIRSD4/CIR/P/2016/119 dated November 01, 2016 had prescribed clearly laying out, in the operations manual / internal governing document, the roles and responsibilities of the rating analysts. This document specifies the roles and responsibilities at different levels within analytical operations.

1. A Rating Analyst shall:
 1. prepare the rating note (without the rating recommendation) as per internal policy guidelines
 2. submit the note to immediate superior for review
 3. communicate and follow up with rating clients to seek information, ensure information is received and complete
 4. seek and set up management meetings, meetings with Audit Committee Chairman, bankers, auditors when required
 5. communicate rating outcome to rated entity, orally and in writing
 6. provide analytical, policy and regulatory clarifications to rated entity
2. A Senior Rating Analyst/ Manager/ Senior Manager/ Associate Vice President shall:
 1. recommend the rating(s) to the rating committee
 2. verify and ascertain quality of the rating note
 3. present the case to committee along with analyst
 4. handle all escalations internal or external
 5. While a Senior Rating Analyst/ Manager/ Senior Manager/ Associate Vice President can perform the role of an analyst, the reverse is not allowed.
3. A Vice President / Senior Vice President shall:
 1. verify and approve all rating recommendations before the case is submitted to Rating Desk for inclusion in rating committee

Irrespective of levels/designations all members of the analytical team shall be responsible for governance and standards of compliance as per laid down policies under prevalent regulations from time to time.

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

Introduction

As a credit rating agency, Acuite Ratings & Research Limited. (Acuite) is committed to observe highest standards of integrity and fairness in all its dealings. Acuite's mission is to provide high quality, objective, independent, impartial, professional and rigorous analytical information to the marketplace. Acuite 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 Acuite's website at www.acuite.in. However, Acuite does not assume any responsibility or liability to any party arising out of or relating to this Code except as specifically agreed to by Acuite in an Agreement signed by Acuite 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. Acuite in its sole discretion may revise this Code to reflect changes in market, legal and regulatory circumstances and/ or changes in Acuite's policies and procedures.

Acuite 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 Acuite 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. Acuite would establish, maintain, document, and enforce a credit rating methodology for each class of entity or obligation for which Acuite 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. Acuite's ratings would reflect all information known and believed to be relevant to Acuite, consistent with the applicable credit rating methodology that is in effect. Therefore, Acuite 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. Acuite 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. Acuite 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. Acuite would disclose in its credit rating announcement whether the issuer of a structured finance product has informed Acuite that it is publicly disclosing all relevant information about the obligation being rated or if the information remains non - public.
 - v. Acuite would not hold or transact in trading instruments presenting a conflict of interest with Acuite'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 Acuite, 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 Acuite

- i. Reporting lines for Acuite's employees and their compensation arrangements would be structured with a view to eliminating or effectively managing actual and potential conflicts of interest
 - a. Acuite'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 Acuite would derive from that entity or obligor.
 - b. Acuite would conduct formal and periodic reviews of its compensation policies, procedures, and practices for Acuite'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 Acuite's credit rating process.
- ii. Acuite'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. Acuite's employee would not participate in or otherwise influence an Acuite'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 Acuite;
 - 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 Acuite;
 - 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 Acuite's credit rating. Acuite 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, Acuite 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 Acuite 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 Acuite's business model) as soon as practicable. A publication by Acuite 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, Acuite 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, Acuite would disclose why this is the case.

2. The Treatment of Confidential Information

- i. Acuite 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 Acuite and its employees from using or disclosing confidential and/or material non-public information for any purpose unrelated to Acuite's credit rating activities, including disclosing such information to other employees where the disclosure is not necessary in connection with Acuite's credit rating activities, unless disclosure is required by applicable law or regulation.
 - b. The policies, procedures, and controls would require Acuite 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 Acuite and its employees from using or disclosing such information in violation of the terms of any applicable agreement or mutual understanding that Acuite 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. Acuite would describe how it implements and enforces its code of conduct. Acuite 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. Acuite 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. Acuite would publicly and prominently disclose free of charge on its primary website:
 - a. Acuite's code of conduct;
 - b. a description of Acuite's credit rating methodologies;
 - c. information about Acuite's historic performance data; and
 - d. Any other disclosures specified in the provisions of the IOSCO CRA Code as applicable given Acuite's business model.

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

Acuite'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:** Acuite provides shared human resources, technology, finance and legal services across all its businesses. However, Acuite 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.

Guidelines for site visit

Acuite has the following approach with respect to site visit as part of rating exercise.

1. Acuite will endeavour to conduct site visits for entities undergoing ratings
 - a. A "site" could ordinarily mean to include an office / service delivery centre / factory / manufacturing unit / business centre / shared office unit, or any establishment called by any other name whatsoever, from where the key official(s)/ authorized representative(s) of the entity undergoing the rating exercise operate.
 - b. The "site" is where an interaction with the concerned representative from the management team of the entity is expected. However, this need not be necessarily the only interaction.
 - c. Acuite will endeavour to conduct a site visit for every rated entity in the:
 - i. investment grade (or an investment grade rating recommendation with respect to a new case) at least once in every two (02) review cycles, subject to points 2 and 3 below
 - ii. sub-investment grade (or such a rating recommendation) at least once in three (03) review cycles, subject to points 2 and 3 below
2. Given site visits involves additional time, effort and expenses, Acuite will request the entity to make arrangements (travel and/or accommodation, as applicable) for such a visit OR alternatively charge the expenses "on actuals" for such site visits to the concerned entity. While the reimbursement of such site visit expenses is included as a clause in the rating agreement, entities that express a lack of willingness or actually fail to honour the same will be excluded from the list of future site visits and will cease to be covered under these guidelines. Acuite will not conduct site visits in any subsequent period for such entities.
3. Site visits will be subject to the applicable rules and permissions of the local / municipal / district / state / central authorities. Understandably, any travel restrictions imposed by the relevant authority (s) in case of any pandemic or force majeure events or any other reason is expected to result in deviations from these guidelines.

Independent Credit Evaluation: Fee Structure and internal controls

A. Fee structure for ICE of residual (sustainable portion) debt:

Standard fee shall be 4 bps (0.04%) of the proposed amount of residual debt.

Minimum fee per evaluation: Rs. 400,000/- (Rupees Four Lakh) + applicable taxes

Maximum fee per evaluation: Rs. 8,000,000/- (Rupees Eighty Lakh) + applicable taxes

The actual fee (after discount, if any) quoted by Acuite is payable in advance before execution of the ICE and shall depend on:

1. Size of Resolution Plan
2. Complexity of the case

B. Under no circumstance shall:

1. the fee charged by Acuite depend on OR be linked to the outcome of the evaluation /rating.
2. compensation of any member of the analytical team be linked to the fee charged for any ICE

C. Other Conditions:

1. Acuite will accept a mandate which must be executed between Acuite and the lending institution for ICE of RP of a specific borrower.
2. The fee in the subsequent instance(s) shall not be higher than the fee charged for the first ICE mandate.
3. Acuite does not advise or prepare or recommend or suggest any structure or indicate the rating outcome for a structure (scenario rating) for the residual debt RP. Any violation of the same by any employee(s) of Acuite will result in termination of the concerned employee(s).
4. All ICEs of RPs will require an independent and unbiased Techno-Economic Viability (TEV) report accepted / forwarded to Acuite by the lending institution and / or the lending bank shall provide Acuite with the terms of the proposed Resolution Plan.

Rules for Acuite's Analytical Firewall

- A. Objective:
The aim of the Analytic Firewall Rules is to ensure that the Rating Analysts have the necessary independence to express their opinions objectively and independently, free from any influence that may raise questions about the integrity of the rating exercise.
- B. Analytic Firewalls:
What is an Analytic Firewall?
Analytic Firewall is a set of rules that governs the interactions between two sets of employees of Acuite to meet the above objective:
- Employees who have access to analytical process, rating notes, rating outcomes prior to public disclosure (Rating Analytical team, Rating Committee members, Rating Administration team and anyone who has access to rating notes and/or client confidential information.
 - All other employees not covered above (e.g.: Business Development)

These rules cover the following:

- People in category "b." shall not be provided access to physical workspaces of employees in category "a."
- People in category "b." shall not be provided access to virtual workspaces (i.e. emails / folders / databases or any other electronic or printed material) of employees in category "a."
- Employees in category "b." shall not send any emails to any employee in category "a." to convey any matter that may directly or indirectly influence the rating outcome.
- Employees in category "a." shall not have access to rating fee of individual clients / transactions and are prohibited from participating in any discussion or in rating fee negotiations for an issue or issuer.
- Employees in category "b." shall not have access to rating outcome or rating notes prepared by analysts or rating releases prior to public dissemination.
- Joint interactions of members from analytical and business development teams with clients, when undertaken, shall be reported to the Chief Analytical Officer (CAO). The senior most person in the meeting shall ensure that there is no breach of the analytic firewall during such joint interactions. In case, a breach takes place it must be promptly reported, and the CAO will take necessary action (e.g. inter alia reallocation of the case to a different analyst), as may be appropriate to ensure analytical integrity.
- Employees in category "a." shall not disclose any confidential information to any other individual who is not meant to have access to such information. They are prohibited from disclosing confidential information to other Rating Analysts who are not directly involved in the rating process for the rated entity to which such information pertains.
- The confidentiality of all non-public information provided to Acuite by an issuer pursuant to any rating exercise must be safeguarded. Information about a ratings action or potential ratings action is confidential and may not be shared with anyone other than employees in category "a." who need to know such information, and the issuer and persons authorised by the issuer to act on behalf of the issuer.

These rules are complementary to all the other Rules, Policies and Procedures currently in force and/or that may be adopted by Acuite from time to time.

Guidelines on Rating a Portion of Lenders' Bank Facilities

Acuite has noted that certain bank borrowers execute mandates for rating only a part of their overall sanctioned bank facility(s). Such a practice is highly discouraged by Acuite, as this may create unwarranted conflicts in the rating process.

In case a bank loan rating mandate is reported that doesn't include 100% of the total existing bank facilities, the following guidelines shall apply:

1. Acuite will accept such a mandate only if the quantum covered in the mandate is the highest of:
 - i. 25% of the overall sanctioned bank facility OR
 - ii. Rs. 25 cr OR
 - iii. complete exposure to at least one specific sanctioned bank facility in its entirety.
2. A cooling-off period of clear 45 calendar days (from the date of rating communication on the partial quantum of bank facilities) will be observed by Acuite before accepting an enhancement mandate.

Frequently asked Questions

- 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 Acuite 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:

- a. Annual Reports for the last three years
- b. Financial projections for the next two years with relevant assumptions and Year to Date financials of the current financial year
- c. Details of the Bank Facility/ies to be rated along with photocopies of all sanction letter/s
- d. Timely Debt Repayment Letter (in the prescribed format) and details of any past default / delay in meeting the debt obligations
- e. 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-scheduling 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 Acuite there are strict firewalls between the Business Development Team which finalizes the fee and the Rating Operations Team which assigns the rating. In Acuite, a rating is never linked to the fee charged to a client.

- What is suspension of a Rating?

Acuite 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?

The following curing period (upward revision from "D") 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, Acuité may deviate from the curing period stated above.

*Cases of deviations from stipulated 90 days, if any, shall be placed before the Ratings 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.

- 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.

Rating Process Flow and Timeline

26th February 2022 (Version 7)

Sr. No.	Description	Timeline
1	Receipt of information [minimum + critical information (may vary from case to case)]	Day T1
2	Management interaction; timer is reset	Day T2
3	Submission to Rating Desk for inclusion in a RC Meeting#	Day T2 + 5
4	RC Meeting	Earliest: Day T2 + 5 Latest: Day T2 + 7
5	Receipt of manually / electronically signed Letter of Acceptance (applicable for fresh cases); timer is reset	Day T3 ^{\$}
6	Dissemination of rating and publishing on website	Day T3 + 2
7	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.

#Submission to Rating Desk for inclusion in a RC Meeting:

Wherever required, the rating note is reviewed by the Team Leader/ Head before submission to Rating Desk for inclusion in a RC Meeting.

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

Acuite 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.

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 Acuité. 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, Acuité 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 calendar 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 calendar 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 calendar days from the date of approval. If the order is not executed within the above period of seven calendar 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 Utilized" on STAMP.
- x. Approvals granted herein shall be valid for seven calendar 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

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 Acuité 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 Acuité, 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.

D. *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:

1. Client whose identity verification seems difficult or client appears not to cooperate.
2. Substantial increase in business without any apparent cause
3. Unusual activity compared to past transactions and unusually large cash deposits made by an individual or business.
4. Source of funds not clear or not in keeping with the apparent standing / business activity.
5. Payout/pay-in of funds and securities transferred to /from a third party.
6. Transfer of investment proceeds to apparently unrelated third parties
7. Unusual transactions / business undertaken by shell corporations, off shore banks / financial services, businesses reported in the nature of export-import of small business items.
8. Large sums being transferred from overseas for making payments.

E. *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.

F. *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.

G. *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.

H. *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

Acuité 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

PREAMBLE

Acuité's approach to rating of the credit facilities/ instruments of a manufacturing entity is broadly based on three pillars: Business Risk Assessment, Financial Risk Assessment and Management Risk Assessment. In certain cases where entity is undertaking large projects, Project Risk Assessment is also a part of the rating exercise. The framework provides for evaluation of an entity based on quantitative and qualitative parameters. The rating approach based on the said framework is essentially forward looking and provides a robust basis for any lending/ investing decision.

The following sections discuss the framework in detail

Business Risk

A. Industry Risk

The credit profile of any business entity has to examine in the context of the industry in which it is operating. Hence assessment of industry risk is a primary step during overall credit rating exercise. Generally, industries tend to exhibit significant differences in their risk profiles in longer time frames due to various externalities like demand supply dynamics, technological and regulatory shifts. Any business entity is a subset of its industry and the industry is a subset of the economy. The changes in the macro-economic landscape impinge on the performance of various industries. It is generally observed that units in specific sector/industry will exhibit a similar response to changes in economic environment. Hence, evaluation of the macro-economic environment is the crucial pre requisite for the assessment of any industry. The various macro-economic variables like GDP growth rates, level of interest rates in the economy, level of consumer spending capex by corporate sector, exchange rate stability etc. have a bearing on the performance of various industries in general. The extent of impact of these economic factors differs from industry to industry and from cycle to cycle. This adds to the complexities in arriving at an estimate of industry risk. Acuité has identified four broad parameters which together give a fairly reliable estimate of any industry risk. These variables are discussed at length below:

a. Macro-economic Risk

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 of supply or demand or is in 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 difficult, 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 analysed include:

- **Product Usage:** The volumes in the user sector influence the demand for the raw materials/ intermediates. Hence it is critical to understand the applications i.e., whether a product has single or multiple applications. In certain cases, the product is complementary to some other product. In such cases, the demand for the product will be linked to the demand for the other products. Similarly, products with substitutes can exhibit higher demand variability.
- **Demand Cyclicity:** Certain products exhibit a cyclicity in their demand i.e., volumes may increase or contract depending on the stage of the cycle. For instance, if the industry is at a peak and the volumes are likely to start tapering off then the demand estimates should factor these nuances. It is critical to understand and identify the inflexion points in the cycle so as to arrive at a realistic estimate of the demand over the medium to long term.
- iii. **Imports and Exports:** Threats to domestic industry from imports can influence the volumes of the domestic players. The pricing policies of the overseas suppliers, exchange rates and the government policies on protection to domestic industry become critical in this regard. Similarly, an excessive focus on exports by domestic players to benefit from higher international prices may impact the domestic supply of the product. 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.

b. Extent of Competition

Market Structure refers to the manner in which companies across an industry are organised and the competitive positioning of the different players. It has a significant bearing on the pricing power and profitability margins. The key points to be analysed are:

- The number of players in the sector both organized and unorganized- Competition, Monopoly, Duopoly, Oligopoly etc.
- The competitive strategies of different players- Price, Innovation or catering to specific customer segments, branding etc.
- Extent of competition from overseas players (imports) and its impact on price.
- 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.
- 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.

c. 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.

d. **Input Price Risk**

While evaluating an industry it also is necessary to assess its input profile i.e., availability of key inputs, volatility in prices of inputs etc. In a competitive environment, any single player has only a limited influence on the final selling price, hence input price assessment is necessary to understand the profitability levels.

- What are the key inputs & how is their availability?
- Is the availability steady or seasonal?
- Is the supplier base diversified or concentrated?
- Does the unit have the flexibility to change suppliers without impacting its operations?
- Is the pricing of inputs market determined or through regulatory intervention?
- Is there a dependence on imports or are all the inputs domestically available?
- Are the prices of inputs volatile or relatively stable?
- Any frequent instances of shortages in key inputs?

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. Sustained profitability of any enterprise broadly depends on the three Cs- Customers, Competitors & Costs. Customers & Competitors are externalities on which an individual player will have limited influence over the medium terms. Hence it is imperative that any business entity should continuously strive for staying cost competitive vis a vis its peers. The relevance of this can be understood in the context of a commodity like metals during periods of economic downturn. In such industries during a trough, the volumes and realisations decline and in this operating environment, only the low cost players tend to survive, whereas the high cost players have to scale down their operations to curtail their losses. Various factors to be examined for arriving at a rating on the Operating Efficiency parameter are given below:

a. Current Cost Structure

The study of the cost structure of any entity can be understood by a breakup of cost into fixed and variable components. Ceteris paribus, the lower the fixed costs, the lower will be the break-even volume & higher the resilience during an economic downturn. Secondly in order to understand the cost competitiveness of any unit, it is critical to understand key costs in the overall cost structure. These key costs differ from industry to industry. For instance, in a cotton yarn spinning unit, raw material and power would be major drivers of the overall cost structure whereas in a tea unit labour costs would be a major item of cost. In a cement unit, besides the input costs, power & freight also has a bearing on the cost. Any business unit can gain in terms of cost competitiveness due to factors like location (proximity to ports, access to cheap power, availability of cheap labour etc.) or backward linkages with raw material suppliers or forward linkages to an established distribution network. Such traits confer significant cost advantages to the players which has a bearing on their overall competitiveness and profitability etc. Generally, a player who is able to

manufacture any product at a significantly lower cost than peers due to aforementioned factors or other factors like regulatory exclusivity will tend to gain in terms of business strength.

b. Future Cost Drivers

While projecting future cost structure and cost competitiveness, it is necessary to factor in the impact of technological and market changes. 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.

For instance, if the business is generally carried in a physical format, through a network of stores, the real estate costs become relevant and large differentials between rentals/ establishments costs can impact the player's relative competitive positioning. However, once the business gradually moves to the online mode, the real estate costs assume a lower relevance in the overall cost structure. The likelihood and impact of unexpected shocks in the form of energy shortage, fuel cost spikes, unfavourable litigation outcome, environmental issues also need be factored in along with the firm's ability to withstand the same.

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.

FINANCIAL RISK ASSESSMENT

The ultimate barometer of success of any business entity is its financial performance and position. From a credit rating standpoint, the assessment of the financial risk profile is critical both on a historical as well as futuristic basis. The assessment covers various aspects such as revenue growth, margins, capital structure, coverage indicators, working capital management resource raising ability and liquidity management. It also entails other aspects such as Quality of accounting, Auditor's comments, disclosures, contingent commitments etc.

Ratio analysis is an essential part of financial assessment on any unit. While a number of financial ratios are considered, key ones are size of net worth, profitability ratios, coverage ratios, capital structure, efficiency ratios, inventory and debtors turnover ratios and liquidity ratios. The relative importance placed on different ratios would depend on the nature of business. These ratios are compared with peers /industry benchmarks to arrive at the relative standing of the rated entity vis a vis other units.

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 the 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. Historical Financial Analysis

Historical financials provide a snapshot of the financial performance of the company over the past 3-5 years & the current financial health of the company. Understanding of the historical financials is necessary to understand the business resilience demonstrated in the past and also to arrive at a realistic set of financial projections over near to medium term. The analysis of historical performance of a business unit is also done to understand how it performs in comparison with its peers.

The key variables covered as a part of historical financial assessment are:

- a) Size of Net Worth
- b) Debt Equity Ratio/Debt to EBITDA
- c) Interest Coverage Ratio
- d) NCATD (Net Cash Accruals to Total Debt)
- e) DSCR (Debt Service Coverage Ratio)
- f) Movement in profitability margins (Operating margins/ Net profit margins)
- g) Working capital parameters (Gross working capital days)
- h) Current Ratio
- i) ROCE

Besides the above mentioned ratios which are examined over 3-5 year time frame, the analyst may examine other ratios specific to the industry.

B. Future Financial Outlook

Based on the historical financial assessment and the discussions with the management regarding the future plans, the analyst estimates the projected Profit & Loss Account, Projected Balance sheet & Cash flow statements for near to medium term. Generally, the projections factor in the medium term capex plans, funding mix and the impact of these plans on the operating performance over the next 2-3 years.

Based on the projected figures, the analyst studies the various ratios (mentioned above) on a futuristic basis from the standpoint of a lender. Sensitivity analysis is a part of the exercise to understand the impact on the key ratios in case of changes in underlying assumptions. The impact on debt repayment ability as measured by critical metrics such as debt service coverage ratio and interest coverage ratio is calculated as a part of this exercise.

C. Resource Mobilization Ability

Resource mobilization ability reflects the firm's ability to access funding conveniently and competitively. The financial flexibility/liquidity assessment is looked at under this parameter. Liquidity essentially refers to ability to meet the various business obligations in a timely manner.

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

Management of liquidity is critical to the sustenance of any business entity. Acuite generally examines the following aspects to arrive at an opinion on liquidity profile/financial flexibility:

- Unutilised bank lines
- Unencumbered liquid assets
- Access to short term funding support from parent/ group companies
- Demonstrated ability to access capital markets for short term funding

D. Financial and Accounting Policies

While using a common yardstick to compare the financial performance of various firms, it becomes imperative to adjust for stark differences in accounting practices/policies. With the introduction of Ind AS accounting framework, which is generally applicable to most of the corporate entities in the country, the chance for any significant differentiation is reduced. Even otherwise, the auditor's opinion on adherence to established accounting standards is examined. However, some aspects considered are:

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

MANAGEMENT RISK ASSESSMENT

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 integrity, competence, governance and risk appetite. The risk framework for assessing the same has been laid down below:

A. Integrity

The integrity and credibility of the management is a key aspect influencing the decisions of any lender or investor. In the absence of credibility, the management will always face a certain level of trust deficit which will have a bearing on its access to credit and pricing of loans. The manner, in which a company conducts business, has a bearing on perception of the market's perceptions about the company and its standing. Key aspects examined here are:

- Instances of delays/defaults/compromises with lenders/investors.
- Legal proceedings against key promoters of key management personnel.
- Instances of frequent investigations by regulatory authorities
- History of litigation of a material nature
- Recurrent instances of non-adherence to local laws and environmental norms triggering regulatory action.
- Instances of significant default on statutory obligations
- Adverse news about the company / management regarding serious non-compliance with any laws.

B. Competence

Promoters influence management selection, decision making and future course of the company. The promoter's demonstrated ability in navigating the business across various business cycles is examined under this parameter. The various points examined are as under:

- Ability to maintain growth along with profitability across a cycle
- Ability to attract and retain marquee clients and skilled employees at senior level
- Ability to initiate course corrective measures in response to changing business landscape
- Ability to lead the company into different segments and successfully execute diversification/expansion initiatives
- Ability to balance and manage the expectations of various stakeholders including customers, employees, lenders, creditors, channel partners investors, society and government.

C. Risk Appetite

The management's risk profiling is extremely critical from a lender's perspective. The key aspect to be examined and understood here is whether the management is a risk seeker, risk averse or risk neutral. This can be gauged from the management's approach to debt (gearing), hedging of currency/ commodity exposures etc. The management's approach to growth vs profitability is to be understood from the risk standpoint. An aggressive management will pursue growth at any cost irrespective of its impact on profitability whereas conservative management will be focused on profits and cash flows. Again, some managements may prefer organic growth rather than inorganic initiatives which reflects their risk disposition.

D. Corporate Governance Practices

Along with a capable management team and an effective strategy, it is necessary for the management team to adopt 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. Key Factors to be considered are:

- Independence of the board, functioning of various committees
- Quality and adequacy of corporate disclosures
- Soundness & Stability of accounting practices
- Extent of intra group transactions /related party transactions
- Perceptions regarding governance practices
- Stability of top management
- Alignment of organizational goals with employee targets and remuneration.
- Quality and adequacy of performance and market feedback to top management.

PROJECT RISK ASSESSMENT

In case the rated entity is undertaking a large project, (vis a vis its current scale and size of operations) the analyst will consider the impact of this project on the credit profile of the entity over the near to medium term, in such cases the project risk assessment becomes important. Such projects may be crucial for the survival /growth of the entity and beneficial over long run, however they could impact the near term liquidity and the credit profile of the unit. 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 based on the following broad parameters.

A. Funding Risk

The funding mix and the financial closure is one of the major milestones of any project. Any significant delays in tying up the equity/ debt portion will have implications for the project risk assessment and ability to meet the project deadlines.

B. Implementation Risk

Any significant delays in project execution vis a vis scheduled timeframes may result in cost overruns and higher funding requirements.. Some factors influencing project delays are as under

- Management track record and ability to manage large projects, size and complexity of current project in comparison with earlier projects.
- **Delays in receipt of regulatory approvals**
- **Delays in tying up with contractors/ machinery vendors**
- Delays in utility setups

- Availability of land / labour
- Logistical issues/ Natural events etc.
- 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.

C. Technology Risk

In case of an existing technology, the risk is relatively low. However, in case on new technology which is still to be adopted on a large scale, the technology risk is on an elevated level.

D. OFF take risk

The ultimate viability of any expansion project is dependent on how the said project can contribute to the overall profits/ cash flows. The cash generation from the project should be commensurate with the expectations of its lenders/investors. The project should be able to demonstrate optimal capacity utilisation so as to meet the expectations of the stakeholders. Any likely challenges in achieving the offtake levels will result in higher project risk assessment.

Group and Parent Support

The rating based on analysis of above mentioned parameters is a standalone rating. However, it is commonly observed that an enterprise belonging to an established business group or a company is on a different footing compared to a stand-alone entity. The former could benefit from the parent/group in terms of credibility, brand equity, managerial, business and financial support. Notching the standalone ratings of individual companies up 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"

Assessment of Environmental, Social and Governance (ESG) Risks

In addition to the above mentioned Rating Framework, Acuite also comments on the ESG parameters in case of certain listed entities in its Rating Rationale.

The primary goal of any commercial entity is to maximize the value for its owners/ shareholders through profit maximization. However, it has to be recognised that besides profit maximization any business entity has certain responsibilities towards the society in which it is operating and towards the environment. Hence, an ESG assessment of a business entity assumes importance. ESG is a framework for measuring the performance of the company across three specific categories: Environmental, Social and Governance. ESG as a concept has been around for more than a decade. However, it has recently gained in prominence with large international investors tracking the ESG scores before taking the investment decisions. The regulators have also recognised the importance of the ESG framework. A SEBI circular on Business Responsibility and Sustainability Reporting dated May 10, 2021, requires the top 1,000 listed corporates to disclose significant non-financial information voluntarily in fiscal 2022 and compulsorily from fiscal 2023.

Acuite believes that the current trend among institutional investors of considering ESG scores along with the other conventional parameters like the credit rating will gain in importance over the near future.

Criteria for Rating of Trading Entities

PREAMBLE

Trading entities are engaged in distribution, bulk breaking, retailing and trading of basic commodities, as well as products/ finished goods. These entities differ from manufacturing entities primarily in two aspects- degree of value addition & profitability margins. Typically, a trading entity will have low degree of value addition and low profitability margins vis a vis a manufacturing entity. Hence, it is imperative that the trading entities be evaluated on a distinct framework which addresses these nuances of a trading activity. This rating methodology explains the approach adopted by Acuite to evaluate the credit profiles of trading entities.

BASIC APPROACH

Trading entities are exposed to risks such as commodity / product price risks, foreign currency fluctuation risks, low margins and a competitive environment with low entry barriers. Acuite'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, Acuite takes into consideration the Business Risk Assessment, Financial Risk Assessment and Management Risk Assessment but in a different light as compared to the methodology adopted for manufacturing companies.

I. BUSINESS RISK ASSESSMENT

While evaluating a trading entity's business risk analysis, Acuite 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 elaboration of the above factors is given below:

A. Size of Business and Sustainability

Generally, it is observed that units with higher scale of operations exhibit higher resilience to changes in various economic cycles. Higher scale adds to the entity's negotiating power with its customers and suppliers adding to its ability to navigate the business successfully across a cycle. With greater scale, usually the trading entity's diversification over geographies, products, suppliers and customers is high.

While size and wide distribution network of existing players is difficult to replicate for newer players, the recent increase in digital commerce has become a great disruptor for the existing players operating in the physical mode. The online initiatives of the manufacturers and the increasing penetration of e-commerce players has increased the competitive intensity in trading activity. Hence, sustainability of a physical presence over the medium term has to be examined against this backdrop.

B. Supplier Risk

Under this parameter, Acuite assesses the supplier profile, length of relationship with the supplier, credit terms etc. Acuite believes that the dependence on a few large suppliers could impact the business profile of the entity, although the same is mitigated to a large extent by the length of the relationship and criticality of the relationship to the supplier. Hence for a clear evaluation of the risk, it is more important to understand the nature of the relationship. For instance, in case of an auto dealer, invariably there will be 1-2 suppliers. However, in such cases, the auto dealer becomes a critical part of the principal distribution network in that geography and with regard to competition in the industry, the principal will also support the dealer wherever necessary. For instance, the support may be in the form of inventory funding line of credit under channel financing tie-ups with banks/NBFCs. On the flip side, the key risk here is that if the trader's business prospects are linked to the principal's market performance & if the principal loses market share then the auto dealers may also exhibit a subdued performance.

C. Inventory Risk

Acuite 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. The nature of the inventory assumes importance here. A trading entity engaged in trading of standard products with limited variants, procured domestically will generally tend to have lower requirements whereas entities in retailing, distribution and trading in products with wide variations are generally seen to have higher inventory holding requirements. For instance, a footwear dealer will typically have a large inventory to cater to the varied requirements of its clients. Similarly, a franchisee of a reputed retail jewellery chain will typically have a higher inventory holding requirement in order to attract clients with a wide variety of designs. On the flip side, entities that have order backed trading operations, or back-to-back trading model, the inventory risk is low. In case of entities with imports, players with large proportion of high seas transactions tend to have lower inventory levels vis a vis other importers.
- b. **Volatility in the commodity being traded and hedging mechanism:** Acuite also attempts to understand the volatility in commodity prices being traded along with the entity's inventory holding levels. Higher the volatility higher is the risk of inventory holding. Any significant adverse movements in the commodity prices can result in mark to market losses for the existing players holding large inventory. Acuite also evaluates the hedging mechanism the trading entity employs such as booking futures contracts on the commodity exchanges /back to back pass-through arrangements with clients.
- c. **Ability to pass on the price increase to customers:** Acuite 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, trading entities are required to extend significant credit to their customers in line with the industry practices to retain their competitive advantage. Hence, the trading entities

are exposed to the risk of counterparty risk i.e., risk of the customers not paying in time. This results in a build-up in receivables translating into liquidity pressures for the trading entity. Hence, in this context, Acuite understands the clientele profile and the extent of customer concentration risk. Besides the risk of non-payment, the trading entity is also exposed to the risk of non-acceptance/delayed acceptance of goods. For instance, a trading entity engaged in import of goods may have back to back arrangements with its domestic customers. In such cases, if a large customer delays taking delivery of his order due to reasons like liquidity stress, business slowdown etc. then the trading entity may be required to find alternate buyer for these goods. This may not always be feasible and could affect its cash flows and profitability. Hence, the credit profile of customers becomes a key input while assessing the business risk profile of a trading entity.

Acuite observes that the trading entities generally follow policies such as setting single party exposure limits to mitigate the counterparty risks. In this regard, Acuite also assesses the payment terms, such as Letter of Credit, post-dated cheques, etc. Generally, in case of sales under LC, the trading entity will be insulated from the credit risk since the LC opening bank is committed to making the payment on fulfilment of certain conditions.

E. Forex Risk

While analysing the trading entity's business risk profile, Acuite evaluates the entity's exposure to currency fluctuation risk. A trading entity is exposed to exchange fluctuation risk when it has payables in one currency and receivables in another currency. For instance, foreign currency risk is pronounced, when it imports goods on credit (denominated in USD) and sells the same domestically (denominated in INR) or procures domestically (denominated in INR) and exports (denominated in USD). In such cases, the trader is exposed to the exchange rate fluctuation risk in the time lag between procurement and ultimate sale. Acuite evaluates the various hedging mechanisms employed by such entities to mitigate significant fluctuation in forex rates.

F. Level of Value Addition

Acuite evaluates the level of value addition of the trading entity in the entire value chain that would 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 vis a vis other trading players.

G. Regulatory Risk

In India, the regulatory environment has a significant bearing on the future growth plans of the existing players. The Government rules regarding FDI in retail will have a bearing on the performance of existing retail players. Similarly, for certain products such as essential commodities, the government may frame rules for the inventory levels to be maintained by the traders, in order to ensure smooth domestic supplies, thereby affecting the performance of the traders. The government also engages directly in sourcing and pricing (by setting minimum support prices) of essential commodities. Given these considerations, Acuite carries out detailed analysis of the regulatory framework and factors it in the overall business risk profiles of the trading entities.

II. FINANCIAL RISK ASSESSMENT

The operations of a trading entity are characterised by high working capital intensity and low

fixed asset intensity. Hence, the debt contracted by a trading entity is generally short term, self-liquidating in nature, to fund its inventory and debtor requirements with minimal long-term debt. Besides fund based limits, the reliance on non-fund based limits such as letter of credit forms a large part of the entity's indebtedness. Acuite takes into account these factors while analysing the entity's financial risk profile.

Acuite assesses the entity's adequacy of cash flows vis a vis its overall 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 Networth & Return on Capital Employed
- **Debt and Debt Coverage:** Debt equity mix, Total outside liabilities (TOL) to Net worth ratio, Interest coverage ratio.
- **Risk Coverage Ratio:** The risk coverage ratio attempts to understand the impact of a 5-10% adverse variation in inventory/ receivables on the Net worth.

Acuite'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.

III. MANAGEMENT RISK ASSESSMENT

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 integrity, competence, governance and risk appetite. The risk framework for assessing the same is laid down below:

A. Integrity

The integrity and credibility of the management is a key aspect influencing the decisions of any lender or investor. In the absence of credibility, the management will always face a certain level of trust deficit which will have a bearing on its access to credit and pricing of loans. The manner, in which a company conducts business, has a bearing on perception of the market's perceptions about the company and its standing. The key aspects examined here are:

- Instances of delays/defaults/compromises with lenders/investors.
- Legal proceedings against key promoters of key management personnel.
- Instances of frequent investigations by regulatory authorities
- History of litigation of a material nature

- Recurrent instances of non-adherence to local laws and environmental norms triggering regulatory action.
- Instances of significant default on statutory obligations
- Adverse news about the company/ management regarding serious non-compliance with any laws.

B. Competence

Promoters influence management selection, decision making and future course of the company. The promoters' demonstrated ability in navigating the business across various business cycles is examined under this parameter. The various points examined are as under:

- Ability to maintain growth along with profitability across a cycle.
- Ability to attract and retain marquee clients and skilled employees at senior level.
- Ability to initiate course corrective measures in response to changing business landscape.
- Ability to lead the company into different segments and successfully execute diversification/expansion initiatives.
- Ability to balance and manage the expectations of various stakeholders including customers, employees, lenders, creditors, channel partners, investors, society and government.

C. Risk Appetite

The management's risk profiling is extremely critical from a lender's perspective. The key aspect to be examined and understood here is whether the management is a risk seeker, risk averse or risk neutral. This can be gauged from the management's approach to debt (gearing), hedging of currency/ commodity exposures etc. The management's approach to growth vs profitability is to be understood from the risk standpoint. An aggressive management will pursue growth at any cost irrespective of its impact on profitability whereas conservative management will focus on profits and cash flows. Again, some managements may prefer organic growth rather than inorganic initiatives, which reflects their risk disposition.

D. Corporate Governance Practices

Along with a capable management team and an effective strategy, it is necessary for the management team to adopt 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, the functioning of various committees
- Quality and adequacy of corporate disclosures
- Soundness & Stability of accounting practices
- Extent of intra group transactions /related party transactions
- Perceptions regarding governance practices
- Stability of top management
- Alignment of organizational goals with employee targets and remuneration.

- Quality and adequacy of performance and market feedback to top management.

Group and Parent Support

The rating based on analysis of above mentioned parameters is a standalone rating. However, it is commonly observed that an enterprise belonging to an established business group or a company is on a different footing compared to a stand-alone entity. The former could benefit from the parent/group in terms of credibility, brand equity, managerial, business and financial support. Notching the standalone ratings of individual companies up 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"

Assessment of Environmental, Social and Governance (ESG) Risks

In addition to the above mentioned Rating Framework, Acuité also comments on the ESG parameters in case of certain listed entities in its Rating Rationale.

The primary goal of any commercial entity is to maximize the value for its owners/ shareholders through profit maximization. However, it has to be recognised that besides profit maximization any business entity has certain responsibilities towards the society in which it is operating and towards the environment. Hence, an ESG assessment of a business entity assumes importance. ESG is a framework for measuring the performance of the company across three specific categories: Environmental, Social and Governance. ESG as a concept has been around for more than a decade. However, it has recently gained in prominence with large international investors tracking the ESG scores before taking the investment decisions. The regulators have also recognised the importance of the ESG framework. A SEBI circular on Business Responsibility and Sustainability Reporting dated May 10, 2021, requires the top 1,000 listed corporates to disclose significant non-financial information voluntarily in fiscal 2022 and compulsorily from fiscal 2023.

Acuité believes that the current trend among institutional investors of considering ESG scores along with the other conventional parameters like the credit rating will gain in importance over the near future.

Criteria For Rating of Entities In Services Sector

PREAMBLE

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 nuances of service sector entities distinguishing them from manufacturing entities are asset profile and cost structures. First, the most crucial asset of any service entity would be its human resource, which cannot be quantified on its balance sheet. Second, 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 high fixed costs (employee costs and other committed overheads) in the overall cost structure of a service entity, the operating leverage tends to be higher vis a vis a manufacturing/ trading entity which have relatively variable cost structures.

APPROACH

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 Assessment
- Management Risk Assessment

I. INDUSTRY RISK

Acuite's assessment of the industry risk is based on four broad parameters- Demand Supply Balance, Extent of Competition, Regulatory Environment and Input Price Risk. Within these four parameters, Acuite examines the following aspects in a detailed manner.

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.

II. 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 insularity of entities like schools and healthcare from economic cyclicity. Acuité believes that relatively stable operating cash flows 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 instance, 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-speciality 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.

III. 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.

Acuite 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

Acuite 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.

IV. FINANCIAL RISK ASSESSMENT

While assessing financial risk, Acuite examines the capital intensity of the entity being rated. Certain entities such as airlines, educational institutions, health care etc. with relatively higher capital intensity will be evaluated on parameters applicable to manufacturing entities. The conventional metrics like size of network, gearing, interest coverage, debt service coverage ratio, margins etc. are evaluated a historical basis (past 3-5 years) as well as on a projected basis. The resource raising ability is also examined from the standpoint of financial flexibility. It may be noted that certain other entities may have steady cash flow visibility and its ability to raise additional debt will be linked to the quantum of these steady cash flows. In such cases, the relevance of conventional measures like Network will get diluted in the overall assessment.

Acuite will accordingly factor in the differences in the financial risk assessment.

V. MANAGEMENT RISK ASSESSMENT

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 integrity, competence, governance and risk appetite. The risk framework for assessing the same has been laid down below:

A. Integrity

The integrity and credibility of the management is a key aspect influencing the decisions of any lender or investor. In the absence of credibility, the management will always face a certain level of trust deficit which will have a bearing on its access to credit and pricing of loans. The manner, in which a company conducts business, has a bearing on perception of the markets about the company and its standing. The key aspects examined here are:

- Instances of delays/defaults/compromises with lenders/investors.
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- Recurrent instances of non-adherence to local laws and environmental norms triggering regulatory action.
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Promoters influence management selection, decision making and future course of the company. The promoter's demonstrated ability in navigating the business across various business cycles is examined under this parameter. The various points examined are as under:

- Ability to maintain growth along with profitability across a cycle
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The management's risk profiling is extremely critical from a lender's perspective. The key aspect to be examined and understood here is whether the management is a risk seeker, risk averse or risk neutral. This can be gauged from the management's approach to debt (gearing), hedging of currency/ commodity exposures etc. The management's approach to growth vs profitability is to be understood from the risk standpoint. An aggressive management will pursue growth at any cost irrespective of its impact on profitability whereas conservative management will be focused on profits and cash flows. Again, some managements may prefer organic growth rather than inorganic initiatives which reflects their risk disposition.

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Group and Parent Support

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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.

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Assessment of Environmental, Social and Governance (ESG) Risks

In addition to the above mentioned Rating Framework, Acuité also comments on the ESG parameters in case of certain listed entities in its Rating Rationale.

The primary goal of any commercial entity is to maximize the value for its owners/ shareholders through profit maximization. However, it has to be recognised that besides profit maximization any business entity has certain responsibilities towards the society in which it is operating and towards the environment. Hence, an ESG assessment of a business entity assumes importance. ESG is a framework for measuring the performance of the company across three specific categories: Environmental, Social and Governance. ESG as a concept has been around for more than a decade. However, it has recently gained in prominence with large international investors tracking the ESG scores before taking the investment decisions. The regulators have also recognised the importance of the ESG framework. A SEBI circular on Business Responsibility and Sustainability Reporting dated May 10, 2021, requires the top 1,000 listed corporates to disclose significant non-financial information voluntarily in fiscal 2022 and compulsorily from fiscal 2023.

Acuité believes that the current trend among institutional investors of considering ESG scores along with the other conventional parameters like the credit rating will gain in importance over the near future.

Criteria For Rating Of Non-Banking Financing Entities

Executive Summary

The domestic financial sector landscape has evolved considerably over past decade in terms of increased diversity of financial sector participants, emergence of newer and more complex products, increasing trend towards adoption of digital technology amongst the existing players and emergence of a new class of players based on digital platforms. These developments resulted in better penetration of financial products across the economy. The gradually increasing role of the NBFC (Non-banking Finance Companies) segment in catering to the credit needs of a growing economy puts the focus on this important segment of the financial sector. As per a recent RBI report on Trend and Performance in Banking, December 2020, the credit intensity as measured by NBFC' s Credit to GDP increased from 8.8% in 2014 to around 12.2% in 2019 before moderating to 11.6% in 2020. The NBFC credit growth rate outstripped SCB Non-food credit growth over the period from 2014 to 2019.

In terms of sectoral deployment, Industry was the largest recipient of credit by NBFC sector followed by retail loans and services. Within Industry, the MSME segment has been a focus area with the players targeting niche areas and developing their business models and expertise the chosen segments. In service segment, sectors like commercial real estate and retail trade have been key target segments whereas in retail segment, housing loans, consumer durable loans and vehicle loans have been the major product categories

As of July 2020, based on an assessment of ~ 9618 NBFCs, it has been observed that the NBFC-ND-SI (Non-Banking Finance Company-Non Deposit taking-Systemically Important) segment comprising 292 entities contributed more than 85% of the total assets of the segment (An NBFC with assets size exceeding Rs.500 cr is categorised as Systemically Important). The NBFC segment comprises a wide spectrum of activities. Based on activity wise classification, there are currently 11 categories of NBFCs which primarily include –NBFC-Investment & Credit Company (ICC), NBFC-Infrastructure Finance Company (IFC), NBFC Systemically Important Core Investment Company, NBFC-Infrastructure Development Fund, NBFC-Micro Finance Institution etc. As on September 2020, of the total assets of Rs.30.87 trillion of NBFCs-ND-SI, around 47% of the assets were held by ICC & around 39% held by Infrastructure Finance Companies.

On the resources side, besides the capital base, NBFCs have been traditionally relying mostly on capital market instruments and bank borrowings to support their business growth. As on September 30,2020, debentures and bank borrowings contributed around 39% and 31% of the borrowings of NBFCs respectively. Besides conventional long term and short term borrowings, from banks, institutions and capital market investors, NBFCs have also been raising resources by borrowing from other NBFCs and through instruments such as Securitization & Direct Assignment transactions.

NBFCs have increasingly positioned themselves as a segment well equipped for last mile credit delivery - i.e. a bridge between unorganised lenders and banks. Their strength lies in the ability to consistently develop and deliver unique financial solutions to their borrowers in an efficient and effective manner. This has placed them at an advantage over conventional banks who may not be able to respond to client's needs to intrinsic differences in the style of operations. Besides competing with banks to meet the credit requirements of the conventional salaried borrowers, it has been observed that most of the NBFCs (especially in the retail NBFC segment) have been largely identified

the unserved/ underserved borrower like self-employed businessmen, unorganised workers etc. as a target segment which has traditionally encountered challenges to access credit from traditional banking channels due to factors like higher operational / documentation requirements. In order to cater to such borrower segments, the NBFCs have developed credit capabilities based on alternate / surrogate measures and extensively relied on digital technology to sharpen their credit processes. Apart from the growth in the retail segment, the NBFCs catering to the corporates mid to medium to large segment especially in segments like real estate & services have been fairly successful in offering innovative financial products to meet the requirements of the borrowers across various segments depending on their business requirements and cash flow profiles.

Acuite's rating criteria for assessment of for NBFCs is largely in consonance with its rating criteria for banks and institutions in view of the considerable degree of alignment in the risk profiles of these two segments. While the financial and non-financial parameters to be assessed are similar, there are certain nuances that need to be considered in respect of any NBFC. These nuances currently stem from factors like differentiated regulatory framework, resource profile, differentiated product offerings etc. Acuite observes in this regard that recent high profile credit incidents in the NBFC sector has triggered a radical relook at the regulatory arbitrage between banks and NBFCs. Against this backdrop, it is expected that going forward, the regulatory and supervisory dispensation especially for larger NBFCs will be closely aligned to banks. Hence, it is envisaged some of the players may have to revisit their business models in view of these changes in the overall environment.

Market Position

- A.** Scale of operations & Asset class Acuite believes that the ability of the management to scale up the assets under management (AUM) in a prudent, profitable and sustainable manner is one of the major performance indicator of an NBFC. Size confers a resilience to business in terms of its ability to absorb external shocks and hence Acuite considers size of AUM as an important parameter in its assessment of NBFCs.

Size of AUM and its growth rate is dependent on factors such as asset class, tenure of loans, management approach to growth, etc. The business model of the NBFC is relevant in this regard. An NBFC engaged in wholesale lending wherein the loan book comprises a few large exposures may be able to scale up quickly. Such business models require moderate physical and human infrastructure to scale up, however on the flip side there are elevated risks since delinquencies in respect of one or two large exposures can impact the profitability and performance metrics. Conversely, an NBFC with a presence in granular retail asset classes such as vehicle loans, microfinance loans, small ticket LAP, MSME lending, etc. is able to scale up only gradually as it entail extensive branch and establishment network for an organic growth. Management may in addition to the organic growth options, prefer to adopt inorganic growth opportunities through buyout of asset pools from other NBFCs or entering into arrangements such as business correspondent relationships/ co-origination, etc. In a nutshell, more granular the loan portfolio, the lower is the risk profile of the NBFC.

The advent of fintech based lending especially in areas of unsecured personal loans has reduced the requirements of extensive establishment network as most of the underwriting and monitoring is generally based on digital apps. Most of these apps rely on credit surrogates to arrive at the credit decision. Within the granular asset classes, each asset class may display different risk return behaviour. A MFI, which typically lends in low ticket sizes on unsecured basis to the lowest economic strata may be more influenced by the local factors such as natural calamities, lockdowns, etc than may be an NBFC with a presence in MSME lending

against security of property. The nature of the security and buffers available (LTV ratios at origination) also has a bearing on the risk profiles of the lenders. A housing finance company with large portfolio of retail housing loans typically will display lower delinquency rates vis a vis other asset classes, even in periods of high economic stress, due to high economic involvement of the borrower (Lower LTV ratios at inception) as also the moral pressure of avoiding defaults on the housing loans. In case of a gold loan company, the liquid nature of the collateral and the ability to auction of the gold jewellery to recover the dues, has a bearing on the level of delinquencies. In a vehicle finance company, the nature of the vehicle i.e., cars, two wheelers, LCV MCV or HCV will have exhibit differential risk dynamics. The asset quality performance of an NBFC engaged in financing heavy commercial vehicles will be more influenced by the level of economic activity vis a vis a player engaged in two wheeler financing.

B. Geographical & Product Diversity

Higher the geographical diversity of the underlying asset portfolio, the higher is the risk mitigation. Typically in the initial stages, any NBFC will develop in its core area of operation and then gradually expand to other areas after gaining the initial experience. By ensuring adequate diversification of the loan book across geographies, the NBFC will effectively diversify its risk. Since the credit profiles of the borrowers are largely linked to the level of economic activity in their region, achieving a geographically dispersed portfolio is a sound de-risking strategy. An MFI with an excessive concentration to 3-4 districts in one state, will be more vulnerable to business shocks vis a vis a diversified MFI. From risk assessment standpoint, a product diversity is more preferred than a dependence on a single product line is vulnerable to business shocks than an NBFC with presence across multiple lines. The external shocks can be in the form of regulatory changes, disruptive changes in markets with emergence of newer players/newer technologies, increased competition, etc. Dependence on a single product line exposes the NBFCs to the cyclicity in the product cycle. A diversified product portfolio with synergies across products imparts a stability to the earnings profile and also supports mitigation of possible asset quality pressures in any specific segment. Acuite observes that while product diversity is desirable from a risk standpoint, the success of the diversification strategy depends on the ability to develop the requisite capabilities across diverse product lines keeping in mind the specificities of each product vertical.

C. 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 the cyclical dynamics of the segment. A vehicle finance company with proven capabilities in pre-owned commercial vehicle financing over a long period may be a preferred lender for most of the SRTTO (Small Road Transport Operator) segment a factor which will support their business volumes during an economic boom. Similarly, an established gold loan financier who is able to offer competitively priced credit products with a quick turnaround to their clients by virtue of their systems and processes will see great business prospects in times of rising gold prices. Their unique product based capabilities support their competitive positioning vis a vis generalist players like banks who are more universal in their suite of product offerings. However, the flip side is that in the event of a sharp contraction in

economic activity or events like declining trend in gold prices, the business profiles of such players are more vulnerable. The business profiles impact them in terms of their volumes, asset quality and earnings. A moderate degree of diversification across segments helps them mitigate the impact of business cycle risk.

D. Market Presence or Distribution Network

The conventional NBFCs operating in retail segment operate through a network of branches in their area of operations. Most of the credit related functions of loan origination, monitoring and collection efforts are at the branch level under the overall supervision OF & inputs from zonal/ head office level. The advancements in technology has shifted the model towards a "phygital" approach (physical + digital), however, the importance of having a wide physical branch network for retail NBFCs is expected to continue over the foreseeable future especially considering the current level of digital penetration. In this regard, Acuite also attempts to understand the branch expansion policy, hierarchy and functions carried out at a branch target time expected for a branch to attain break even business volumes, policy on continuation of suboptimal branches etc. vintage of the branches and the dependence or otherwise on a few legacy branches. Ideally, for a growing business, it is expected that the newer branches start contributing to the overall AUM & disbursements, thereby de-risking the dependence on the earlier established legacy branches. The contribution of AUM from newer recently opened branches determine the efficacy of the branch expansion network. The opex intensity of the branches vis a vis the business generation from branches has a direct bearing on the profitability of the operations. The ability of the branches to achieve break even business volumes in an optimal time frame is critical. An excessive churn in branches will be evaluated in terms of its potential impact on future business growth. Besides the business generated from other branches, the volumes of business generated through alternate channels like Direct Selling Agents (DSAs) and other channels like business correspondents is also assessed. A high dependence on outside channels like Business Correspondent relationships with other entities, to grow the business, reduce opex intensity, It has been observed that generally companies try to strike a balance between self-originated (own branch) and externally generated business from a business stability standpoint.

Operating Efficiency

A. Appraisal and Monitoring Systems

Acuite's assessment and understanding of the credit and underwriting processes of the NBFC is a part of the overall rating process. In this regard, Acuite attempts to understand the overall credit philosophy, credit policies, procedures, and other attendant aspects like sanctioning architecture, monitoring and collection systems, recovery and provisioning policies and dependence on in house and external expertise etc. Especially in case of an NBFC operating in retail segment, the dependence on IT systems for origination, monitoring and collection is assessed to understand the robustness of the processes. The flip side of having efficient systems – both physical and human structure is high operating expenses. The opex cost as a percentage of the average AUM and other related metrics like cost to income ratio are monitored over a period of time to understand the extent of operational efficiency. These metrics are compared with other peers to understand the relative operating efficiency. Adherence to Regulatory Requirements & Disclosures.

The extent of regulation and supervision of entities in the financial sector has been increasing over the recent past especially after a few high profile credit incidents entailing some large

entities. From a rating standpoint, a continued adherence of the NBFCs to the regulatory prescriptions by the various regulators like SEBI, RBI, IRDA or others becomes important. The extent of compliances may be with regard to operational, accounting, financial or legal aspects. The disclosures in the financial statements (including auditor observations) along with discussions/undertakings of management become important inputs in appreciation of these compliance aspects. Acuite's view is that compliance with regulation is a hygiene factor which is expected of any entity, hence any instances of continued noncompliance of a material nature is more likely to have an impact on the final rating outcome.

Asset Quality: The ability to maintain a healthy asset quality on a consistent basis is among the most critical parameters influencing the profitability and overall credit profile of a well performing NBFC. Besides credit risk, the NBFCs in general are required to manage a wide gamut of risks like liquidity risk, interest rate risk, ALM risk, legal risk, operational risk, etc. However, among all these risks, credit risk assumes importance in terms of an NBFC's on profitability and financial health. It has been observed that the management of credit risk i.e. asset quality parameter stands out as A SINGLE MOST critical variable which has a high bearing weightage in the overall rating process. It is intuitive to expect moderation in asset quality, with gradual scaling of operations and seasoning of the loan book. The key point is the extent of credit costs vis a vis the scale. Acuite's approach in this regard is to understand the movements in the non-performing asset levels (GNPA & NNPA) or the Stage 2 & Stage 3 levels (under Ind As). Acuite also examines the incremental slippages, segment wise slippages etc to understand the historical asset quality movements and possibility of future trends. The write-offs also have an impact on the GNPA/NNPA levels hence policy regarding write-off is also assessed. Acuite observes that the adoption of an eclectic approach has become imperative in the current operating environment wherein traditional credit appraisal and monitoring mechanisms are complemented with an extensive use of technology driven tools so as to contain asset quality pressures. Besides the underwriting architecture & processes followed by the NBFC, other extraneous factors having a bearing on the long term asset quality trends include the nature of asset class, client profile, refinancing environment and the overall legal environment for recovery of dues. The strength of underwriting mechanisms, early warning systems, control and recovery measures go a long way in building a company's asset quality.

B. Resource Raising Ability

The growth potential of any NBFC is inextricably linked to its resource raising ability. The resource mix of the NBFCs & their capital structure assume relevance in this regard. From a resource profile standpoint, the level of gearing & cost of debt are two major variables which have a significant bearing on any NBFC's profitability & performance. The funding profile has to be aligned to the asset profile of the NBFC from an ALM perspective. An NBFC engaged in providing long term finance like housing finance will necessarily have a long term funding/borrowing profile as any attempt to fund long term assets with short term funding may result in mismatch risks which will have to be managed. These aspects make resource raising ability a critical monitorable.

Acuite observes that resource raising ability of NBFCs generally moves in tandem with their track record and their scale. An NBFC with limited track record may have to rely on equity funding in its initial stages before the prospective lenders develop the requisite comfort in initiating exposure to the NBFC. Such challenges may constrain their growth in initial stages.

The nature of the business also has a bearing on the resource raising ability. An NBFC engaged in high risk unsecured personal lending may initially have to depend more on equity funding as lenders may not be forthcoming considering the high risk perception, at least in the initial stages. On the contrary, larger established NBFCs with a presence in secured products and a seasoned loan book, with the benefit of an established track record of performance may enjoy higher resource raising ability. Such an NBFC may have a wide choice of funding options such as additional equity issuance, private equity, domestic borrowings from banks, capital market instruments like NCDs (both long term and short term), ECBs and other off balance sheet options like securitization, direct assignment transactions, structured products, etc. Besides the standalone profile and performance of the NBFC, the resource raising ability may also be influenced by factors like association with a large group corporate/financial services.

C. 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. In the context of fintech based lending wherein the underlying application is owned by some other entity. Acuite assesses the nature of the arrangement between the NBFC & the entity owning the application and the extent of investment.

Financial Risk

A. Capital Adequacy

The need for lending institutions like NBFCs to have a strong capital base emanates from their requirement to have adequate buffers to absorb any potential losses. The underlying principle is that any lender is exposed to various risks like credit risk, market risk, operational risk etc & higher the level of risk assumed by the NBFC, higher should be the capital base maintained by the lender. The concept of risk weighted exposures is critical to understand in this regard. The current regulatory prescription is 15% of risk weighted assets for NBFCs as the minimum threshold. The extant regulatory dispensation for adherence to capital adequacy norms is quite elaborate and covers various aspects such as nature of capital eligible for consideration as Tier 1 capital, distinction between Tier 1 & Tier 2 capital, the sub limits between these categories of capital, the risk weightages to be assigned to the exposures, etc. From a rating standpoint, Acuite assesses the existing level of capital & also compares it with its future capital requirements keeping in mind the growth plans of the NBFC. The evaluation of capital position is not only based on the current capital adequacy levels of the rated entity but will also factor in the ability to bring in equity capital through its parent or other stakeholders.

Besides assessing the adequacy of capital in normal scenarios, Acuite assesses the capital adequacy in stress scenarios and the possibility of reduction in buffers due to high asset impairment charges. In case of a significant reduction in buffers vis a vis regulatory thresholds, Acuite discusses with the management the plans to augment the capital base in such scenarios. Acuite observes that NBFCs also adopt an off-balance sheet approach to business growth to keep their capital requirements at optimal levels considering the return expectations of the stakeholders.

B. Earnings Quality

Earning quality assessment essentially focusses on the stability and sustainability of the earnings and the building blocks of the earnings profile. The assessment includes movements

in Net interest margins, trends in Pre-Provisioning Operating Profits, contribution of fee based income, non-recurrent incomes, trends in credit costs, etc. At a granular level the earnings quality assessment focusses on movement in average yields on various product lines, and its comparison with the average cost of funds, segment wise operating expenses and credit costs. Such granular assessment helps in better appreciation of the contribution of each segment.

C. Liquidity

The assessment of liquidity parameter in case of NBFCs focusses around the ALM statement and extent of mismatches across various time buckets. While mismatches are to be expected, the quantum of mismatch and availability of adequate credit lines to plug the gaps is an aspect to be studied. The quantum of on balance sheet liquidity and unutilised bank lines/fresh sanctions in hand are key monitorables. The ability to enter into securitization/structured asset sale transactions to manage the liquidity is also studied in this regard. The possibility of equity infusion is also discussed.

Acuité shall study the maturity profile of assets and liabilities, board approved policies of the company with respect to liquidity management, minimum unencumbered liquidity buffers 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 IGAAP/Ind AS. 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.

Management Risk

A. Integrity

Integrity of the management is a qualitative trait indicated by track record with lenders, investors, government authorities, other stakeholders. Any instances of defaults/delinquencies of a continuing nature will have a bearing on the parametric assessment of promoters. Any perceptions regarding integrity of the promoter can impact the funding plans as the bankers have been adopting a cautious approach to this sector especially after certain high profile defaults in the financial sector.

B. Competency

Competence of the management is assessed based on the management credentials, and its track record across a cycle to navigate and scale up the business in an increasing volatile operating environment.

C. Risk Appetite

Risk Appetite of the management is an important parameter in determining management risk. The management's philosophy on lending /investing and its approach towards other aspects such as gearing, hedging of forex exposures are the key variables which are reckoned. Besides these, the management's approach to growth – aggressive or conservative is also considered in risk appetite assessment.

Criteria For Rating Of Banks And Financial Institutions

Executive Summary

Banks are systemically essential entities having a unique risk profile. Acuite 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, Acuite evaluates the Tier 1 capital to Risk Weighted Assets (RWA) Ratio and the quantum of Capital Conservation Buffer Maintained by the bank. Acuite 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, Acuite 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. Acuite 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. Acuité 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, Acuité 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. Acuité 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, Acuité believes that the rate of migration in the asset quality is an indispensable parameter to be evaluated. To this end, Acuité 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.

Acuité 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. Acuité 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. Acuite 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. Acuite 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, Acuite 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:** Acuité 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. Acuité 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. Acuité 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

Acuité 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.

Treatment of Banks' Additional Tier I (AT1) Bonds under Basel III

One of the key differentiators of Basel III regulations vis a vis the previous versions has been its high emphasis on 'quality of capital' held by banks / institutions besides the 'quantity of capital'. The presence of several instruments in the bank's capital base with differentiated loss absorption characteristics has made it imperative that the rating of these instruments factors in these differences.

One of the key instruments for augmenting the capital base of banks/ institutions is the AT1 Bonds (Additional Tier 1 Bonds). An AT 1 bond is essentially a hybrid instrument with higher loss absorption characteristics (i.e. higher risk to investor) vis a vis other Tier 2 instruments such as Subordinated Debt instruments. The term 'hybrid instrument' indicates that it has attributes of both equity and debt. From an investor standpoint, the characteristics of these bonds are similar to Tier 2 bond instruments as long as the issuing bank's financial and capital position is at healthy levels; however, in case of a sharp deterioration in their performance (such as reduction in capital adequacy below certain thresholds), the issuing bank has the option of skipping the payments due under these bonds without affecting its going concern status.

The three broad characteristics of AT 1 bonds which differentiates these instruments is

- 1) Discretion in coupon payment
- 2) Thresholds for likely coupon payment
- 3) Principal Loss absorption

The presence of these additional risk factors makes these bonds attractive "yield kickers" for the investors seeking slightly higher yields (albeit by assuming higher risk). The key point to be noted is that breach of capital adequacy triggers below certain levels (pre specified triggers) magnifies the risk of non-servicing/ write down in respect of AT1 bonds. The concept of PONV (Point of Non Viability) is also relevant here. PONV will be decided by the regulator bank as the point at which the operations of the bank become unviable unless it effects a write down of the bonds / conversion to equity/ additional capital infusion.

Against the above background, Acuite assesses the risk associated with AT1 bonds differently from other regular bonds issued by the same issuer. Usually, these bonds are rated between 1-2 notches below the ratings assigned to the regular bond instruments issued by the bank to factor in the higher risks of both interest and principal losses. The extent of notch down will be limited for stronger banks with a robust capital position and importantly those who also have the demonstrated ability to raise equity capital from its shareholders. This may also cover the public sector banks who have been supported significantly by the Government of India through consistent capital infusion which has helped the latter to tide over longer high NPA cycles in the past. Clearly, the notch down needs to be greater extent for relatively weaker banks particularly in the private sector whose capital position is uncertain due to asset quality risks. The notch down is linked to the capital buffers available vis a vis the regulatory thresholds in case of additional stress scenarios with regards to asset quality and also factors such as management's stance on maintaining the buffers over the regulatory levels through timely mobilisation of equity capital.

Acuite may also adopt different notch down for AT1 bonds in banks where senior bonds are in the same rating levels, based on its assessment of the differential risk in terms of asset quality, profitability and therefore capital stability. The current / expected performance of the banks across the various parameters like profitability, asset quality, fund raising plans and more importantly, the impact of these on capital adequacy levels i.e. CET 1 & Tier 1 levels, are guiding principles in this regard.

It may also be noted that the equity like characteristics associated with AT1 instruments imparts a moderately higher volatility to the ratings of AT1 bonds as against ratings of regular Tier 2 Bonds. Whenever there is a significant deterioration in the financial performance of the bank which typically involves increased pressures on asset quality and profitability, a rating action on senior tier II bonds may be followed by a stronger action on AT1 bonds. The risk of default on AT1 bonds increases in an accelerated manner for a bank whenever there is an unexpected stress on asset quality along with an inability to raise capital in a timely manner.

Acuité, however, will incorporate its expectation of strong support from the Government of India in the AT1 bond rating criteria for public sector banks. Acuité has noted that there has been no incidence of default in AT1 bonds issued by these banks since the adoption of Basel III despite the continuing high level of stress on banking sector asset quality. While the standalone performance parameters of some of these banks have been severely impacted due to high level of loan provisions and write offs, consistent capital infusion over the last few years have enabled them to mostly keep their capital adequacy above the minimum levels. It has also been observed that wherever banks were under prompt corrective action (PCA) with a potential risk of non-payment of coupons for AT 1 bonds, the latter were prepaid through the available call option. While many market investors understand the inherent risks in such hybrid debt instruments, any default on them for public sector banks may build a perception of sovereign default. Therefore, Acuité will take into account a significant expectation of support even for AT1 bonds for government banks while applying the corresponding rating criteria.

Criteria For Rating Of Entities In Infrastructure Sector

PREAMBLE

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. Typically, infrastructure projects differ from regular projects in terms of their large investment, long tenures, and significant contribution of these projects to social goals and benefits. Besides these key differentiators, it has to be understood that infrastructure sector is wide in terms of the spectrum of industries and hence the nuances of the specific segment have to be appreciated while rating any entity. For instance, a thermal power project will differ significantly from an airport project in terms of its risk profile, regulatory environment, funding pattern, operational challenges etc.

Types of Infrastructure Projects:

Government Projects: Government projects include ports, irrigation projects of strategic importance, roads, bridges, school /office buildings etc. 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.

Overview of the Business Model- EPC Contractors & SPVs

Generally, infrastructure projects are awarded by the government departments/ quasi government bodies/ ULBs / private parties etc through tenders. The various EPC (Engineering, Procurement and Construction) players participate in these tenders subject to fulfilment of certain technical and financial criteria stipulated in the tender documents. Among the bidder, the bidder with the least cost quoted is usually selected as the winner.

In an EPC contract, the contractor executes the contract and as per the milestones, raises running account bills from time to time, which are paid by the counterparty after the necessary due process. Besides plain vanilla EPC contracts, in certain cases like roads, the contracts are also awarded by way of BOT contracts. Under this model, the EPC contractor floats a separate SPV for each project. The EPC contractor invests in the initial equity of the SPV (i.e., sponsor of the SPV) and also arranges for debt funding. The EPC contractor thus has a dual role towards the PROJECT SPVs- as a contractor and as a shareholder. Generally, it is quite common for one large EPC contractor to have multiple SPVs. The SPV enters into a concession agreement for 15-20 years with the counterparty, which gives the right to receive annuity to collect toll. These concession agreements could be of different basis like toll or annuity or HAM.

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.

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 Assessment, Financial Risk Assessment and Management Risk Assessment. Given below are the factors examined under each of these:

I. BUSINESS RISK ASSESSMENT

Business risks associated with infrastructure entities can be bifurcated into two categories- risks associated with the project until commercial operations (EPC stage) and risk associated with commercial operations thereafter.

A. Risks associated with the project prior to commissioning

Funding Risk:

Typically, an EPC Contractor's major expenses include raw materials, labour expenses and other ancillary overheads. Since the larger EPC contractors often sub contract a portion of their work to other smaller subcontractors, it is fairly common to rely on trade credit (raw material suppliers) and credit from sub-contractors. The EPC contractor may also rely on advances received from customers for supporting the working capital requirements. Since the bills are raised from time to time based on project milestones and realised subsequently, the dependence on fund based working capital line is fairly limited except in case of exceptional growth situations or significant spike in working capital requirements. However, it is pertinent to note that EPC contractors require large non-fund based limits in the form of Bank guarantees at each stage in the revenue generation business- for bidding, performance, retention money etc. These guarantees need to be unwound in a timely manner through timely execution of projects. Any delays /disputes in execution may result in invocation of guarantees / rollover of guarantees thereby contributing to a stress and higher finance charges.

In terms of fixed assets requirements, the EPC contractors rely on mix of owned equipment as well as rented equipment to meet their business requirements.

Order Book (Revenue Visibility) Risk

An EPC contractor needs to have a healthy order-book of executable projects to maintain revenue visibility. It has to be understood that the progress of each project may vary from period to period due to factors like availability of land/ right of way, regulatory clearances, labour issues, delays in receipt of machinery, environmental factors etc. In such a situation, a well-diversified order book of 2-3 times the annual revenues provides healthy revenue momentum. The diversity of the order book across counterparties and across geographies is the key aspect to be examined. In certain cases, where the player has a presence across various segments, a wider segmental diversity is preferred to an order book focused on a single segment.

Execution Risk:

It is fairly common to assume that projects will undergo time overruns due to a wide variety of reasons. These execution challenges can result in erosion in project profitability, reputational losses, claims for liquidated damages etc. Acuite factors in the following while assessing Execution Risk:

- **Type of Project:** Acuite examines the nature of the projects being undertaken, Greenfield project/ Expansion project etc. A Greenfield project entails higher level of risk compared to a Brownfield project.
- **Regulatory Approvals:** 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:** Acuite examines the tie-ups for uninterrupted supply of key inputs.
- **Dependency on Overseas Vendors & their credibility:** 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 a 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.

Counterparty Risk

The nature & credit profile of the counterparty also has a bearing on the credit profile of the EPC contractors. Since infrastructure development is mostly a domain of the governments, the counterparties typically include departments of Central Government, State Governments, Public works departments, Urban local bodies, NHAI etc. It has to be understood that most of the infrastructure projects are projects of strategic importance and governments are expected to provide these infrastructural facilities within their fiscal constraints. Against this backdrop, timely progress & execution of any project depends on its relative strategic importance vis a vis other projects and also on the availability of adequate fiscal flexibility with the government. It is quite common to encounter delays in execution and delays in realisation of bills even in case of certain government projects in times of fiscal stress. It is pertinent to note that usually these projects are awarded to the larger contractors on a tender basis and they in turn sub contract a part of their contracts to smaller EPC companies. In such cases, the credit profile of the immediate counterparty and the final counterparty becomes relevant. In case of contracts awarded by private parties, the credit profile of the company and its past track record in honouring commitments may be considered as a surrogate for assessing counterparty risk.

Legal Risk:

In any infrastructure project, the scope for litigation/disputes always exists. These disputes could be with subcontractors, vendors, joint venture partners, clients etc. Hence, it is quite common to find disclosures regarding claims/counter claims/penalties/liquidated damages etc. in the financial statements of the infrastructure players. While there are detailed agreements such as PPAs (in case of power projects) or Concession Agreements (in case of road projects), the possibility of litigations in infrastructure projects always exist. Any significant adverse outcome of these litigations, can have a bearing on the financial health of the company. The analyst examines the impact of these litigations on the financial health of the entity.

B. Risks associated with the project after Commercial operations

Offtake Risk

Once the project attains COD, the cash flows generated from the project is a function of the

offtake levels. The nature of the project becomes important here. For instance, in case of a road SPV (toll) project the revenue streams over the concession period will largely be exposed to the volume of traffic whereas if the developer has opted for an annuity model, the revenue projections would be insulated from traffic volumes. Similarly, for a green energy project, the revenue profile could either be based on long term PPAs (Power Purchase Agreements) or in case there are no long term PPAs, the revenues will be linked to movement of merchant power rates on the energy exchanges.

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

O & M Risk (Operations & Maintenance) 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 extent of O & M required depending on nature of the asset.
- The periodic provisions for routine maintenance and major maintenance provisions made by the SPV.
- Track record of the EPC contractor in adhering to O & M standards.
- Ability to identify new O & M contractors in case existing players are unable to offer required services.
- Likely stance of the counterparty (NHAI, Government department) in case of continued non adherence to laid down O & M standards.

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

Counterparty Risk:

The counterparty risks exist even after the project has attained COD, depending on nature of the project. 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.

II. FINANCIAL RISK ASSESSMENT

The Financial Risk analysis of an infrastructure entity takes into account the existing financial position, future financial position and resource raising ability.

The existing financial position examines aspects like size of Net worth, Debt/ Equity or TOL/TNW, Interest Coverage Ratio, NCATD (Net Cash Accruals to Total Debt), DSCR (Debt Service Coverage Ratio), GCA days, Current Ratio & profitability margins.

The projected income statement and balance sheet is drawn based on discussions with the client and the likely movement in the above ratios over the near to medium term is assessed.

Notwithstanding the importance of the above mentioned ratios, Acuite notes that timeliness and adequacy of cash flows vis a vis debt servicing commitments is crucial while rating an infrastructure entity, hence high emphasis is placed on cash flow assessment and adequacy while assessing an infrastructure proposal as opposed to the conventional metrics of Networth, gearing, etc.

The financial flexibility in terms of unencumbered cash balances, unutilised bank lines and adequacy of non-fund based lines is assessed.

III. MANAGEMENT RISK ASSESSMENT

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 infrastructure project with long gestation and operating periods for repayments.

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 integrity, competence, risk appetite and governance. The risk framework for assessing the same has been laid down below:

A. Integrity

The integrity and credibility of the management is a key aspect influencing the decisions of any lender or investor. In the absence of credibility, the management will always face a certain level of trust deficit which will have a bearing on its access to credit and pricing of loans. The manner, in which a company conducts business, has a bearing on the market's perceptions about the company and its standing. Key aspects examined here are:

- Instances of delays/defaults/compromises with lenders/investors.
- Legal proceedings against key promoters or key management personnel.
- Instances of frequent investigations by regulatory authorities.
- History of litigation of a material nature
- Recurrent instances of non-adherence to local laws and environmental norms triggering regulatory action.
- Instances of significant default on statutory obligations
- Adverse news about the company/management regarding serious non-compliance with any laws.

B. Competence

Promoters influence management selection, decision making and future course of the company. The promoters' demonstrated ability in navigating the business across various business cycles is examined under this parameter. The various points examined are as under:

- Ability to maintain growth along with profitability across the cycle
- Ability to attract and retain marquee clients and skilled employees at senior level
- Ability to initiate course corrective measures in response to changing business landscape
- Ability to lead the company into different segments and successfully execute diversification/expansion initiatives
- Ability to balance and manage the expectations of various stakeholders including customers, employees, lenders, creditors, channel partners investors, society and government.

C. Risk Appetite

The management's risk profiling is extremely critical from a lender's perspective. The key aspect to be examined and understood here is whether the management is a risk seeker, risk averse or risk neutral. This can be gauged from the management's approach to debt (gearing), hedging of currency/ commodity exposures etc. The management's approach to growth vs profitability is to be understood from the risk standpoint. An aggressive management will pursue growth at any cost irrespective of its impact on profitability, whereas conservative management will be focussed on profits and cash flows. Again, some managements may prefer organic growth rather than inorganic initiatives, which reflects their risk disposition.

D. Corporate Governance Practices

Along with a capable management team and an effective strategy, it is necessary for the management team to adopt 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.
Key Factors to be considered are:

- Independence of the board, functioning of various committees
- Quality and adequacy of corporate disclosures
- Soundness & Stability of accounting practices
- Extent of intra group transactions /related party transactions
- Perceptions regarding governance practices
- Stability of top management
- Alignment of organizational goals with employee targets and remuneration.
- Quality and adequacy of performance and market feedback to top management.

Group and Parent Support

The rating based on analysis of above mentioned parameters is a standalone rating. However, it is commonly observed that an enterprise belonging to an established business group or a company is on a different footing compared to a stand-alone entity. The former could benefit from the parent/group in terms of credibility, brand equity, managerial, business and financial support. Notching the standalone ratings of individual companies up, 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"

Assessment of Environmental, Social and Governance (ESG) Risks

In addition to the above mentioned Rating Framework, Acuite also comments on the ESG parameters in case of certain listed entities in its Rating Rationale.

The primary goal of any commercial entity is to maximize the value for its owners/ shareholders through profit maximization. However, it has to be recognised that besides profit maximization, any business entity has certain responsibilities towards the society in which it is operating and towards the environment. Hence, an ESG assessment of a business entity assumes importance. ESG is a framework for measuring the performance of the company across three specific categories: Environmental, Social and Governance. ESG as a concept has been around for more than a decade. However, it has recently gained in prominence with large international investors tracking the ESG scores before taking the investment decisions. The regulators have also recognised the importance of the ESG framework. A SEBI circular on Business Responsibility and Sustainability Reporting dated May 10, 2021, requires the top 1,000 listed corporates to disclose significant non-financial information voluntarily in fiscal 2022 and compulsorily from fiscal 2023.

Acuite believes that the current trend among institutional investors of considering ESG scores along with the other conventional parameters like the credit rating will gain in importance over the near future.

Criteria For Default Recognition

Acuite 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	
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

Acuite believes that any delay in servicing the interest from the scheduled repayment date shall constitute an event of default. Acuite 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 due to replacement / refinancing of existing lender's debt with debt of longer tenor i.e., elongation of the liability profile from a new lender (and not from the existing lender)
- Technical defaults

The aforementioned or similar such developments may structurally alter the credit risk profile of entities that have defaulted in the past. If Acuite 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?	

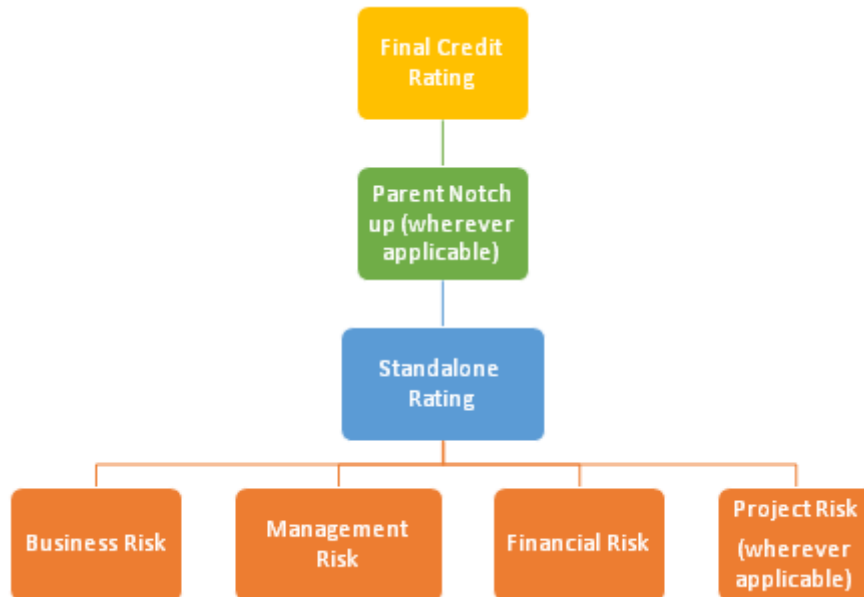
With respect to recognition of default, Acuite will be guided by SEBI Circular SEBI/ HO/ MIRSD/ CRADT/ CIR/ P/ 2020/ 53 dated March 30, 2020. A note on the same is available on: <https://www.acuite.in/transitory-relaxation-from-compliance-with-certain-provisions-under-SEBI.htm>

Further, Acuite will also be guided by SEBI Circular SEBI/ HO/ MIRSD/ CRADT/ CIR/ P/ 2020/ 160 dated August 31, 2020 with respect to "Relaxation from default recognition due to restructuring of debt".

Application Of Financial Ratios And Adjustments

PREAMBLE

Acuité's approach to rating comprises a holistic evaluation of the Business, Financial and the Management related parameters of the entity. The Business and the Management parameters comprise a qualitative evaluation whereas the Financial Risk assessment follows a quantitative approach based on a study of the various ratios. Financial Ratios give a general understanding about the fundamentals of an entity. These ratios are applied on the past financial statements as well as for the future projections of an entity. 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 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. It is pertinent to note that Acuité's Ratio Analysis is primarily based on the financial statements furnished by the clients. However, Acuité may make necessary analytical adjustments wherever required for the purposes of maintaining consistency/ uniformity.

Acuité observes that generally the following ratios/ financial parameters provide a sound understanding of the financial strength and performance of an entity.

1. Network:

Network 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. Network 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 network base higher is the protection to lenders. Hence, size of the network 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:

$$\text{Debt / Equity Ratio} = (\text{Total Debt Long Term and Short Term}) / \text{Total Tangible Network}$$

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 development.

Tangible network includes equity share capital and reserves and surplus after excluding items of un-amortized miscellaneous expenditure and accumulated losses, revaluation reserves and 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, past trends in respect of such loans and the promoters' 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 network.

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, Acuité generally examines the TOL/TNW (Total Outside Liabilities/Tangible Net worth) 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 Ratios (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:

$$\text{Operating Profit Margin} = (\text{Earnings Before Interest, Tax, Depreciation and Amortisation}) \times 100 / \text{Operating Income}$$

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 the 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 service 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:

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

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:

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 less than 1 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 greater than 1 in order to reduce the susceptibility of the entity's debt servicing ability in light of the volatility of the external Operating environment. It is to be noted that certain entities may go in for refinancing of their debt on a regular basis and hence a low DSCR need not necessarily indicate a critical situation if the company/ promoter has a track

record of timely refinancing of debt.

The calculation of Cash DSCR:

In certain cases, Acuité may also consider calculation of the Cash DSCR ratio as under:

$$\text{CDSCR} = [\text{profit after tax} + \text{depreciation} + \text{interest charges} - 25\% \text{ of incremental net working capital}] / [\text{debt payable within one year} + \text{interest and finance charges}]$$

The difference in the Cash DSCR as calculated above and the regular DSCR ratio is that in case of Cash DSCR the analyst assumes that a portion of the accruals will be required to fund the incremental margin towards the working capital and hence the cash DSCR is a slightly stringent version of the Regular DSCR.

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, Acuité observes that generally speaking, entities with consistently higher NCATD levels have resilient credit profiles than those with lower NCATD.

Debt to PBDIT:

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

Apart from DSCR, Acuité believes that the **Debt to PBDIT 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 PBDIT 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 PBDIT is representative of a significantly greater degree of credit risk.

5. Efficiency (ROCE)

Return on Capital Employed:

$$\text{Return on Capital Employed} = \text{PBDIT} / \text{Total Capital Employed} \text{ where, total}$$

capital employed is defined as:
Total Capital Employed = Total Networth + Total Debt

Acuité measures how efficiently a business is utilising its capital to generate profits. 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 greater than 1 indicates that a portion of the current assets have been funded by long term sources. A ratio less than 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. Acuité 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. It has to be understood that the current ratio has to be calculated based on a nuanced understanding of the underlying components. For instance, the analyst may be required to exclude debtors beyond 180 days from the figure of overall debtors while arriving at the current asset figures. Similarly, loans and advances to group companies/ outside parties (without any business relationship) may be excluded from current assets.

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 Gross Current Assets (GCA) and working capital cycle.

Gross Current Assets:

**Gross Current Assets (GCA) = Total Current Assets Related to Operations/
Operating Income**

Acuité also examines the Gross Current Assets (GCAs) days as a measure of Gross working capital requirements. It is also an important financial indicator of the working capital intensity.

Working Capital Days (Net):

Working Capital Days (Net) = GCA Days – Creditors Days

The net working capital cycle indicates the working capital requirements after considering the trade credit.

Cash Flow Analysis

Acuité'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

Acuité also examines the auditors' 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, Acuité may make necessary adjustments to the income statement/ balance sheet figures while calculating ratios.

Criteria For Consolidation Of Companies

PREAMBLE

Promoters often establish separate legal entities for varied considerations such as difference in markets/ customers/ products or regulatory/ tax/ legal considerations or other factors such as lenders/ investor preferences. It is not uncommon for a promoter to have a presence across the value chain but through different legal entities. For instance, a steel manufacturer may have one unit manufacturing TMT Bars in one entity and another unit manufacturing billets (raw material for TMT bars) in another entity. Similarly, a hospitality player may decide to have separate entities for each hotel property geography wise which will facilitate financial flexibility in case of a decision to monetize any or some of the assets. A gems and jewellery manufacturer may have its manufacturing operations in India but decide to have marketing subsidiaries geography wise in overseas markets.

In view of the structuring of the activities across various entities and significant operational and financial linkages between these entities, it becomes imperative that a consolidated approach is adopted. A consolidated approach will result in a more appropriate assessment of the overall profitability, cashflows, capital structure and debt protection indicators of the business as a whole. In cases where the entities are significantly aligned to each other, the consolidated approach will result in a more accurate assessment of the overall risk and credit profile.

Generally, Acuité relies on consolidated financials prepared by the issuer/ borrower entity or group. These consolidated financials typically provide a holistic view of a parent company along with its subsidiaries/ associates. These financials provide an overall view of the profitability, capital structure, borrowings, etc. In certain cases, Acuité may consolidate the business and the financial risk profiles of the issuer entity with other group entities including associates if such a consolidation is necessary for an adequate assessment of the business position and performance of the issuer/ borrower.

Objectives of the Document

This document is fundamentally aimed at understanding Acuité's own approach towards consolidation, the need for consolidation of financial statements and 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/ intercorporate 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, by limiting transfer pricing related issues in inter-group transactions. By taking a net value, the financial ratios are re-calculated and analysed.

Cases Relevant for Consolidation

While the degree of impact of consolidation on the risk-return metrics varies significantly across firms and business models, the need for consolidation as an exercise is well warranted in a large pool of cases. In order to adopt a consolidated approach, it becomes necessary to ensure presence of significant operational/ financial linkages between the entities being consolidated, besides common management. The operational linkages could be through significant sale/ purchase transactions, common clientele base etc. The financial linkages could be due to reasons like corporate guarantees for borrowings, significant loan/ investment transactions etc. The stance of the management is one of the key factors influencing the decision to adopt a consolidated approach or otherwise.

Acuite 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 linkages 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. Acuite 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 opinion of the role of the rated Entity in the Parent/Group. Acuite also analyses the degree of management control that the related or parent 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, Acuite 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, Acuite 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 of consolidation generally, all the entities are rated at similar levels given the expectation of high cash fungibility. However, in certain cases, Acuite may adopt a differential approach when some of the entities diverge significantly from other entities in terms of size, scale of operations or contribution to overall profits etc.

In cases where semi-strong or moderate levels of linkages are established, Acuite may apply a group/ parent notch-up to the ratings of the entity being rated instead of a consolidation approach.

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

Criteria For Group And Parent Support

Executive Summary

The rating of the credit facilities/debt instruments issued by any issuer (i.e. obligor) primarily revolves around a holistic assessment of its industry, business, financial and management profile. The rating is based on obligor's standalone credit profile as evaluated under the aforementioned parameters, i.e. wherever the obligor entity is not associated with any larger group or company, i.e. the standalone credit profile is the driver of the rating.

There are certain cases where the obligor is a subsidiary of another company with a strong credit profile or an associate of an established corporate group with a demonstrated track record of performance and established credibility. In such cases, the final rating factors in not only the standalone credit profile of the obligor entity but also the benefits it derives from being associated with a larger group or parent. The benefits are in the form of a notch up over the standalone rating, which reflects the expectation of support from the group both on a going basis and also in distress. The rating exercise in such cases will broadly entail the following three steps:

- Assessing the standalone credit Rating of the obligor
- Assessing the credit quality (i.e., Rating) of the parent or group (if not already rated by Acuité)
- Arriving at the extent of notch up over the standalone credit profile

The credit quality of the parent company is arrived at after considering the assessment under business, financial and management parameters. In case of a direct parent-subsidary relationship or a stepdown relationship (i.e. parent holds the majority stake in one company which in turn holds majority stake in our obligor company), it is the ultimate parent company which will be considered for the rating notch up. The key aspects to be examined are the ability and management's willingness to extend timely support to the obligor, i.e. firstly, the parent or group itself has to be rated higher than the standalone obligor and in the investment-grade category. Secondly, a majority holding does not necessarily qualify for parent notch up unless there is an implicit or explicit understanding based on management discussions, past track record, documentation through guarantee or letter of comfort etc. that the parent will continue to extend necessary support (financial and non-financial) to the obligor in future.

In case of a Group Notch up (i.e. cases wherein the majority shareholding in obligor is held by multiple entities controlled by same promoter), the flagship operating entity of the group may be considered as a surrogate for the Group. Acuité observes that in certain situations, the support could also flow from other group entities besides the flagship entity based on their free cash flow generation. Hence, under group assessment, Acuité also examines the various entities in the group to understand their financial strength and their debt burden. This is important since some of the entities may not be consolidated in the flagship entity but still may be pivotal to the group in terms of their cash flow generation and overall debt position.

The extent of notch up is essentially based on broadly two parameters (a) Economic importance of the obligor to the parent or group & (b) Moral obligation to support the entity. Under each of these parameters, there are sub-parameters for which objective scores are assigned. Based on the scores arrived at under these two factors, an aggregate notch up score is computed. The gap between the parent and standalone rating is compared with the percentage notch up score to decide extent of notch up. Acuité will mention in its analytical approach section of the Rating Rationale that the rating

factors in support from parent or group. It may be noted that the mere presence of a Corporate Guarantee or Letter of Comfort (particularly in case of non-sovereign corporate entities) does not necessarily qualify for equation of the rating with the guarantor's credit rating unless there is an associated payment structure which can ensure timeliness of the support.

The following section dwells on the specific sub parameters which are considered for determining the notch up:

I. Business Rationale

Strategic importance to Parent / Group

The criticality of the rated entity to the parent/group is one of the most important factors in the parent notch up framework. The importance of any entity will emanate from factors like significant operational and/or financial linkages with the parent/ group. An entity supplying a significant proportion of the raw material requirements of its parent company or providing critical job work services to its parent is an example of such operational linkage. Similarly, if the major part of distribution of the products/ allied services of the parent are handled in a separate entity, such an entity will be critical to the parent/group. A related example is a captive BPO unit of a large bank handling its back-office functions. Such a unit will be critical to the bank's operations and ongoing managerial and financial support to the entity can be expected from the bank. A typical example is of an Indian subsidiary of a multinational group. The scale of operations of the subsidiary could be modest relative to the group. However, if the management has significant expansion growth plans for India, the lenders/ investors can expect significant ongoing support from the overseas parent.

In a nutshell, the scoring under this parameter will be based on the extent of operational and/or financial linkages, both present and expected, with the parent /group and the way the business of the entity is correlated with the growth strategies of the group.

Magnitude of parent's investment in company

The investment of the parent in the subsidiary/associate entity also has a bearing on the likelihood of support which can be expected by the investee entity. A significant investment by the parent in its subsidiary indicates a high level of commitment to the subsidiary and its operations. The significance of the investment has to be evaluated both in terms of the absolute amount of fund infusion and in relation to the net worth of the investing entity. A subsidiary/associate entity which contributes significantly to the overall consolidated performance will continue to get ongoing as well as distress support from its parent. It has to be understood in this context that besides equity investment, a parent/ group can support the subsidiary/group entity through other measures such as extending unsecured loans, guarantees for raising debt or lenient terms of trade credit. The overall exposure has to be reckoned by considering the magnitude of investment.

Extent of share holding

The shareholding pattern is an important factor influencing the decision to extend support to an entity. A wholly owned subsidiary can be expected to receive higher support from its parent vis a vis a subsidiary with a high proportion of minority interest. The likelihood of timely support is also influenced by factors like the nature of the non-controlling shareholder. A shareholding pattern with 2-3 dominant/institutional shareholders besides the parent may require the concurrence of these shareholders for any major decisions such as equity infusion, etc. Certain

decisions may entail a special resolution, in which case the shareholder holding 75% stake becomes important. However, a parent or group entity with less than majority (51%) stake may also support the rated entity (associate company) if there are strong business linkages. If the parent or a group entity is the largest shareholder (less than 51%) and the other shareholders have significantly smaller stake, the group may have management control and therefore, support may need to be built in.

Ease of support

The ease of support is also a key parameter in the parent/ group notch up framework of Acuite. In certain cases, the parent company or group may be willing to extend support to the borrowing entity. However, the ability to provide timely support could be impeded due to factors like regulatory restrictions or some other factors. This may be particularly relevant for multinational companies bringing in funds from offshore where necessary approvals need to be taken. In case of 100% ownership by a domestic parent entity, the ease of support is relatively established. However, in case of a shareholding structure involving 2-3 dominant shareholders besides the parent (which can also be the Government), the ability of the parent to take a decision and provide support to the entity can sometimes be relatively challenging. In case of entities governed by special acts of Parliament/ Legislature, certain regulatory compliances may be required prior to infusion of funds. In such cases, timely support can be impeded.

II. Moral Obligation

Level of management involvement and control

An entity in which there is a high degree of involvement of the parent company in the day to day operations and the management is more likely to receive support than an entity in which the parent is just a passive investor. The parent company's association in the day to day management can be by way of appointment of senior management officials of the parent on the Board of the subsidiary company, involvement in decisions regarding appointment of senior managerial personnel and particularly the MD/CEO. The parent company's ability to influence the subsidiary's key metrics such as profitability, capital structure, etc. is evaluated under this parameter. In certain cases, the management of the parent company may influence the pricing of the transactions between the parent and subsidiary or decisions like payment of royalty to parent or group. In certain cases, the lenders of the parent company may have stipulated covenants regarding consolidated gearing, and debt protection indicators. The adherence to these covenants may require the parent to ensure that the financing decisions of the subsidiaries do not cause any breach of covenants at group level. The management's involvement in the operations of such subsidiaries becomes critical since the subsidiaries have to be ensured adequate funding support without reneging on the commitments to the parent/ subsidiary's lenders.

Shared name/ brands

The sharing of common names or common brands among various group entities indicates a common corporate umbrella which effectively indicates to the external stakeholder, i.e. lender or investor that the entity shares an association with a larger group. These common brands enjoy a high degree of credibility in the investor and lender fraternity and reflects a high degree of integration among the group companies. Any lender or investor initiating exposure to a relatively weak entity from the group assumes a certain degree of support from the parent or group. Any credit event relating to even one such a group entity may have implications for the

brand's perception and the future borrowing programme for the group as a whole and therefore, the expectation is the group will make an effort to ensure financial stability in these companies with shared brand names.

Written Commitments and Pronouncements, Management's Stated Posture

In certain situations, the parent company explicitly supports the fund-raising initiatives of the subsidiary by extending Corporate Guarantees or Letters of Comfort/ Letters of Undertaking/ Letters of Awareness in favour of its lenders. While certain documents like Letters of Comfort/ Letters of Awareness are not legally enforceable documents like Guarantees, however, lenders or bankers rely on these written commitments while considering the credit decisions. A 'Letter of Comfort' casts a moral responsibility on the issuer i.e. parent company to ensure that the debt obligations are met in a timely manner. While most of the guarantees are post default in nature, the expectation is that the corporate guarantor will arrange for timely funding support to avoid a credit event. The parent company may also provide additional documents like equity commitments and Non-Disposal Undertakings to lenders which provide an additional source of comfort. The existence of cross default clauses in the parent company's borrowing programmes also acts as an additional comfort since any serious default on the subsidiary debt, if not cured can trigger an acceleration of the parent's debt. The management's stated posture also becomes important in this case. The articulated stance to support the borrowing entity and ensure timely debt servicing will result in a higher score under this parameter.

Track record of support

Acuité will assess the future support also based on the parent's approach in the past. The demonstration of timely support to the borrowing subsidiary or other group entities will result in high score under this parameter. The timeliness and magnitude of support are critical aspects to be examined in this regard. An equity infusion or issuance of a corporate guarantee over the past 2-3 years qualify for a higher score than an equity infusion in the distant past.

Scenario of a Rating Notch Down

In specific cases of parent-subsidiary relationship, where the subsidiary's standalone credit profile is significantly stronger than the parent's credit profile, Acuité may also notch down the rating of the subsidiary (entity being rated). The rationale behind the notch down approach is that the subsidiary's cash flows could be regularly up streamed to the parent by way of ICDs, dividends etc., thereby impacting the subsidiary credit metrics.

Criteria For Public Finance - State Government Ratings

Executive Summary

The conundrum faced by governments of developing nations like India revolves around achieving an optimal balance between fiscal push required to support growth vis-a-vis adherence to fiscal discipline. In the Indian context, the targets as per the FRBM (Fiscal Responsibility and Budget Management) Act and the Finance Commission recommendations assume the importance in this regard. The federal structure makes it imperative that States as stakeholders also share the commitment to maintain the fiscal discipline along with the Central Government. Hence the individual states are expected to balance the socio-economic commitments while maintaining adherence to fiscal parameters. India is still in the process of recovery from the pandemic and the debilitating economic impact of the same; hence, attainment of the previously envisaged fiscal targets appears difficult over the near to medium term. The fiscal targets have been presently relaxed for the states in view of the exceptional circumstances & as per the current dispensation; the State governments have been allowed to increase the fiscal deficit for 2020-21 from earlier benchmark of 3.0% of GSDP to 5.0% of GSDP (3.5% unconditional +0.5% on states going in for Option 1 of GST compensation from Centre+ 1% additional based on achievement of four-mile stones(one nation one ration card+ EODB (Ease of Doing Business), Power utility reforms and ULB reforms). In order to ensure adequate resource availability to the states, the 15th Finance Commission has recommended that the 'normal' net borrowing limit for the states for FY22 & FY23 be fixed at 4% & 3.5% of GSDP and 3% for subsequent years till FY26.

The framework adopted by Acuite for assessing the overall fiscal health of the states is primarily based on two platforms, i.e. Fiscal Parameters & Economic Structure. Acuite tracks and monitors five key fiscal parameters and five economic indicators for assessing the financial health of a state relative to its peers. In this regard, it is pertinent to mention that the fiscal and economic performance of each state varies from year to year due to factors like the overall level of economic activity, spending on infrastructure, political developments like state and central elections, natural calamities etc. Besides the regular spending on revenue account like salaries, establishment overheads, interest payments and capital expenditure, the state governments are required to invest in infrastructure, which is necessary for provision of basic amenities to its citizens. A healthy infrastructure network is also a prerequisite for attracting private sector investments and creation of employment opportunities. Since the infrastructure projects are medium to long term projects, the impact of these initiatives on the per capita incomes and the overall standard of living is visible after a time lag. Hence, a state on an aggressive infrastructure campaign may exhibit a deterioration in fiscal metrics, though the government may be preparing the ground for sustainable development in future. Besides high level of planned expenditure, the state's fiscal Parameters for any given period are also impacted by the occurrence of events like natural calamities, which will require the government to augment the spending. In view of the aforementioned factors, we believe a methodology based on relative benchmarking for any given period will provide sharper insights into fiscal health of a state vis-a-vis a methodology based on historical comparison.

Acuite's methodology for State Rating is based on a relative comparison of the various parameters for a given common period. Acuite relies on the fiscal and economic performance of a static sample of 18 states in the non-special category for deciding the parametric benchmarks. The Special States are also rated on these benchmarks, albeit with certain adjustments.

The various economic and fiscal parameters reckoned by Acuite in its framework are as under

Fiscal Parameters

- a) **Revenue Deficit/ Surplus as a Percentage of GSDP (Gross State Domestic Product):** The Revenue Deficit refers to be excess of Revenue Expenditure over Revenue Receipts. The focus of any state government should be to optimise the trade-off between the Revenue deficit and the attainment of socio-economic objectives. A continued and persistent high revenue deficit inhibits the ability of the state to invest in infrastructure and other socially relevant projects, thereby impacting its future growth trajectory.
- b) **Fiscal Deficit as a Percentage of GSDP:** The fiscal balance as percentage of GSDP is a function of the performance on the revenue deficits/ surplus and the capital account deficit / surplus (i.e. state's development plans). For instance, states on a high growth trajectory with aggressive plans to develop infrastructure or states recovering from natural calamities like floods are more likely to end up with a higher fiscal deficit in some cases beyond the benchmark of 3% as per the finance commission recommendations. The key point to be monitored is the "quality" of the deficit rather than the amount of deficit. A large fiscal deficit arising out of continued infrastructural development will give a fillip to future economic growth, thereby translating better quality of life for its citizens. The concept of a Primary Deficit assumes relevance here. Primary Deficit is arrived at by deducting interest payments from fiscal deficit. Since interest payments are committed in nature, the state has limited flexibility in skipping on these payments. A higher fiscal deficit (vis-a-vis previous period) along with a lower primary deficit indicates that interest payments are contributing to the increase in fiscal deficit. Higher the interest component of total expenditure lower is the fiscal flexibility. Conversely, if a higher fiscal deficit is accompanied by higher primary deficit, it indicates that non-interest expenditure is increasing as a proportion of total expenditure.
- c) **Interest Expense/ Revenue Receipts:** The interest expense to Revenue Receipt ratio is a key metric in understanding the proportion of revenue receipts utilised for defraying the interest on the debt. Any ratio significantly beyond 10% indicates that there is scope for improvement in terms of the tax/ non-tax revenue.
- d) **Debt to GSDP:** In this case, Acuite looks at the magnitude of borrowings of the State Government in relation to the size of its GSDP. The higher the ratio (i.e. say >25%) riskier is the fiscal profile. Besides the ratio, more important is the debt profile in terms of nature of debt, maturity profile etc. A state required to borrow to meet its operating requirements is a much risky proposition than a state borrowing for capital asset creation, i.e. infrastructure. Besides direct borrowings, the guarantees extended by the State to public sector enterprises such as power utilities and other off-balance sheet commitments are also to be considered while reckoning the overall indebtedness
- e) **Own Tax Revenues/ Total Revenues:** The state government's ability to control its revenue base has undergone a radical change post the introduction of the GST regime. Under GST regime, most of the state taxes have been subsumed under the GST which falls within the purview of GST council. This limits the state government's ability to control its revenues from taxes. Nevertheless, Acuite considers Own Tax revenues to Total Revenues as a major indicator of the relatively steady revenue generation ability of the state government. The key components of the Own tax revenues include SGST, Stamp duty, property taxes etc.

Economic Structure

- a) **Size of GSDP:** The focus of successive governments has always been on balanced regional development and the various policy initiatives such as fiscal and tax incentives for investments in lesser developed geographies is reflective of this philosophy. However, it has been observed

that certain states like Maharashtra, Gujarat, Karnataka & Tamil Nadu account for a major contribution to overall GDP. These larger states have demonstrated the ability to attract investments, thereby leading to a large industrial and service sector base. The ability to attract investments from various sectors emanates from a combination of factors like geographical location, well developed infrastructure, investor friendly government policies, availability of skilled labour etc. These states also generate significant employment opportunities and are leading contributors to the national exchequer. The policy initiatives of the central government recognise the importance of these states and ensure adequate fiscal support to them whenever necessary. Acuite believes that on a relative basis, the resilience of the fiscal profile is directly linked to the size of GSDP, i.e. the higher the GSDP more resilient is the fiscal profile.

- b) **Per Capita Income:** Generally speaking higher the per capita income, the better the standard of living of the citizens. The focus of infrastructural development results in attracting higher investments in the state, which in turn, translates to higher incomes and a better standard of living for its citizens. The per capita income of the state is compared with the national average. Higher the contribution of secondary and tertiary sector to the GSDP, higher the probability of a sustainable improvement in per capita income.
- c) **GSDP Growth Rate:** A high GSDP growth rate while desirable is examined in conjunction with other Qualitative factors such as urbanisation, size of the state vis a vis other peers, reasons for high growth and source of growth. The understanding of growth drivers is necessary to understand the sustainability of growth in future. Acuite generally consider a CAGR (Compounded Annual Growth Rate) over past 3 years for arriving at a realistic estimate of growth.
- d) **GFCF / GSDP:** The extent of Gross Fixed Capital Formation in a state is an indicator of the spending on the infrastructure and other social amenities. Besides the magnitude of spending on infrastructure, it is also important to assess that the nature of spending, i.e. how productive is the investment in terms of its ability to contribute to economic development.
- e) **SDG Score:** The SDG (Sustainable Development Goal) scores of Niti Aayog captures a state's performance on around 17 sub-parameters like hunger eradication, climate impact, education etc.

CRITERIA FOR NOTCH UP BASED ON STATE GOVERNMENT SUPPORT

The rating of entities owned by governments needs to be looked at differently from other privately owned commercial entities for two reasons. Firstly, most of the government owned entities exist to meet broader social objectives such as state-owned power utilities, civil supplies corporation, state finance corporations etc. These entities are of strategic importance to the state. Hence, the government's approach in respect of support to such entities is governed by social considerations rather than commercial motives. Secondly, even in respect of the entities which have a limited social footprint, the implications of a default by a state government owned entity are high. Hence the state-governments ideally will maintain at least distress capital support to these entities

Acuite's extant rating methodology for assessment of State Government owned /controlled entities factors in likelihood of support from the respective Governments. The support could be 'explicit' and documented in the form of a Letter of Guarantee/ Letter of Comfort or 'implicit' based on majority ownership and strategic importance of the entity to the state. The underlying premise for factoring in such support is that a default by such an entity could have significant socio-economic implications

and impact the state's perception among lenders/investors. A rating of a state government owned/ supported entity depends on standalone rating of the entity based on its business and financial parameters & an appropriate notch up for the state government support, based on various economic and other non-economic factors. The notch up depends on (i) the gap between the standalone rating of the entity and state's credit rating (as per Acuite's internal assessment) (ii) the importance of the entity to the state based on various economic & non-economic factors. These factors include extent of ownership of the state in the entity, magnitude of investment, strategic (socio-economic) importance of the entity to the state, implications of default, past instances of demonstrated support, ease of extending support by the state etc. The details of the key parameters assessed by Acuite in rating of such entities is as under

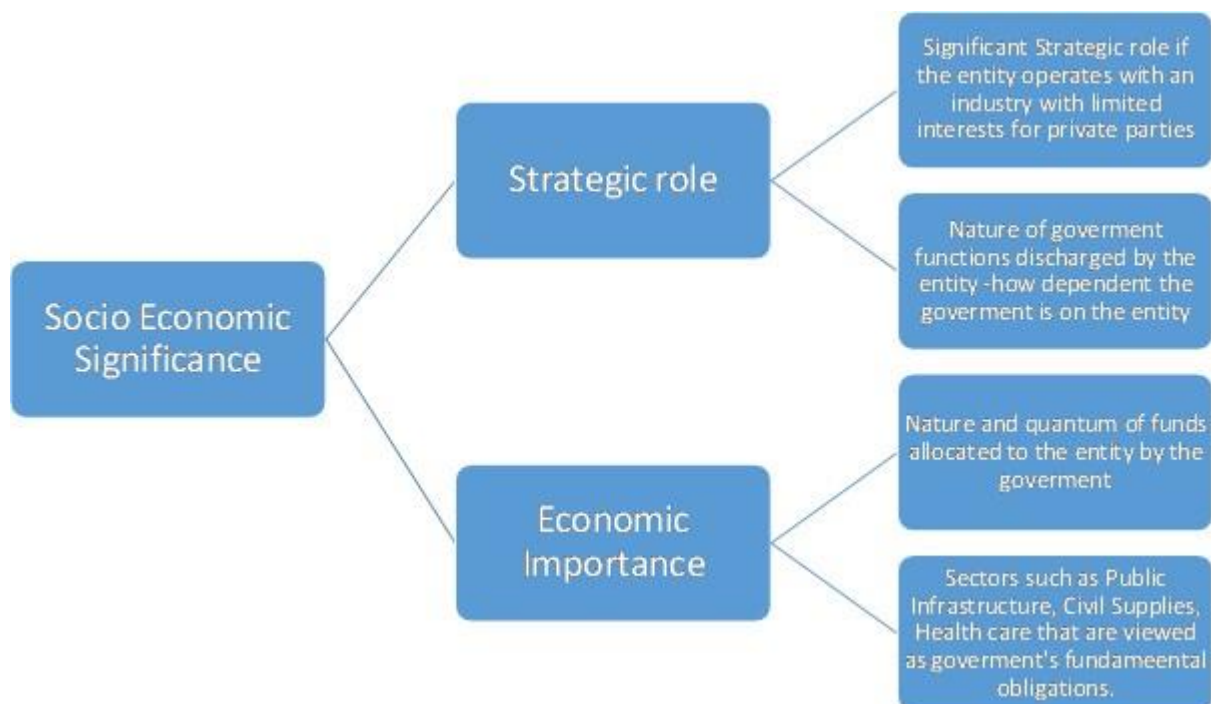
A. Constitution of the Entity:

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:

Acuite 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 exchequer



C. Implications of Default

Acuite 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 factors like
 - Large employee base of the entity and social disruption likely from potential loss of employment following the corporate failure
 - Default on existing debt may impact the future flow of investments
 - Impact on Public Perception: Acuité believes that if the state government believes that a default will have significant implications for the state's credibility it will ensure timely distress support to avoid a default and maintain public confidence.
- 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 notchup 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	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

			government ratings.	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 expected from the government.	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.
	Moderate	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.
	Low	Yes	The singular motivation for any support is driven by the adverse implication of the default, thus limited support is expected and	Despite high government holding, the relatively limited economic and political significance of the entity reduces the probability of government support in

	No	<p>resulting in case of distress.</p> <p>minimal benefit to the credit profile of the rated entity.</p> <p>While the entity is important for the government, there's limited statutory provision available to extend support. Thus, minimal notch up is extended by Acuité.</p>	No notch up.
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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) or Special Purpose Entity (SPE). The SPV would raise funds from the investors by issuing Pass Through Certificates (PTCs) on the strength of the underlying receivables & further credit enhancements extended by the originator. The payments to the investor are made from the cash flows generated by these receivables owned by the SPV. Securitization 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. Securitization transactions essentially involve a transfer of credit risk from the originator to the investor of the PTCs by repackaging of credit risk into various classes of tradeable securities with pre-defined risk profiles.

Securitization transaction volumes saw a significant spurt around FY19 following the failure of few large NBFCs around that period. Post these major credit events, the banks became increasingly selective in lending to NBFC segment. The NBFCs on the other hand were also exploring various other options to diversify their funding base. This led to many NBFCs tapping the securitization market for the first time. The banks were also more comfortable buying a pool of retail receivables from a NBFC rather than taking a balance sheet-based exposure to the NBFC. The securitization route was a tool for the NBFCs to manage their liquidity, asset liability mismatches and capital requirements. From the bank's perspective it was an expedient way to increasing their exposures to various retail segments – both in the PSL (Priority Sector Lending) and Non PSL category. As per Industry estimates, the securitization volumes in FY19 were at ~ Rs.1.9 trn. Subsequently the volumes moderated in FY21 largely due to the pandemic impact. Securitization transactions have again picked up in FY22 at ~ Rs.1.5 trn (industry estimates). It is pertinent to note that the securitization volumes include PTC structures as well as bilateral transactions between the buyer/investor and the seller (Originator) which are very common. Such sell down transactions are called Direct Assignment transactions wherein the underlying assets are directly assigned to the investor, with no need of an SPV.

RBI has been regulating this segment through guidelines for Securitization transactions from time to time. The latest RBI Directions on September 24, 2021, i.e., Reserve Bank of India (Transfer of Loan Exposures) Directions 2021 & Reserve Bank of India (Securitization of Standard Assets) Directions 2021 lay down a framework governing these transactions.

Analytical Framework of Acuité

This section covers Acuité'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 buyer identifies and cherry picks a pool of receivables based on specific parameters such minimum seasoning, overdue status, minimum credit score, geographical diversity etc. The intent is to ensure that the possible delinquencies are minimised and credit risk is effectively mitigated.	Credit 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
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.

Acuite's approach

Step 1

Acuité believes that it is extremely important to understand and assess the credit policies and various underwriting practices and policies followed by the originator both at pre-sanction & post disbursement stages. 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 disbursement monitoring of assets, collection efficiency & recovery /write-off policies. Acuité seeks data on various aspects of the portfolio which are called Portfolio Cuts based on parameters like such as Geographical diversity, Borrower profile (Occupation wise), Interest rate wise classification, Seasoning, Original maturity, LTV at origination, Credit score wise classification, etc. The attempt is to understand the characteristics of the portfolio. In case of an originator with presence across different asset classes, the delinquency patterns of each asset to class will vary. In such cases, Acuité will seek granular historical data on each asset class to assess the overall risk profile.

Step 2

Acuité analyses the characteristics of the originator's overall portfolio as well as the relevant product's portfolio to understand delinquency risk, prepayment risk and collection efficiency. Acuité may usually rely on static pool analysis or Dynamic Portfolio Analysis to understand the delinquency patterns over a period of time. Under Static Pool analysis, all loans originated during a given period are examined for their performance across a cycle. Generally, the larger the static pool sample, the sharper will be insights regarding delinquency patterns. 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 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. The analysis of prepayment curves, recovery curves and collection efficiency for various static pools provides an insight into the potential delinquencies. In the absence of static pool data, Acuité may examine the portfolio on a dynamic basis wherein the delinquency patterns are observed over a period of time with the underlying portfolio undergoing a change due to closures of existing loans and additions of new loans.

Step 3

The pool being assigned is then examined for the various parameters and these pool parameters are compared with the overall portfolio parameters of the same asset class. This is essentially to understand the extent of qualitative difference between the pool and the overall portfolio. The rating assigned to the PTC is based on the risk profile of the pool, industry risks, vintage risks, and other factors such as the extent of credit enhancement available. Besides analysing the pool characteristics and pool cash flows, the rating process also looks at the structure type, waterfall mechanism and extent of credit enhancement available.

Transaction Structure:

- a. 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.

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.

Besides the above structures, in certain cases, the TIUP structure (Timely Interest Ultimate Principal) is followed which provides a flexibility of pay-outs to the PTC investors. Hence in the event of intermittent shortfalls from the pool collections, the pay-outs to the investors are not significantly affected. Additionally, the feature of fast amortisation (Turbo-amortisation) can also be present in TIUP structures. In another form of structure, TITP (Timely Interest Timely Principal), the timely payment of PTC interest/ principal obligations is involved.

b. Credit enhancements (Internal as well as External)

Generally, any Securitisation transaction (i.e., PTC transaction) will have various layers of credit enhancement which support the notched-up ratings assigned to these structures as they provide additional comfort to the investors. These credit enhancements could be internal as well as external credit enhancement.

The major forms of Internal Credit Enhancements are EIS (Excess Interest Spread), OC (Overcollateralization) and Junior/ Subordinate tranches. Excess Interest Spread refers to the difference between the pool interest pay-outs received by the originators and the interest pay-outs made to the PTC investors. Overcollateralization refers to the additional pool receivables made available to the investors over and above the pool principal. Junior or Subordinate tranching refers to the tranche which bears the initial shortfalls in pay-outs (if any) as per the waterfall mechanism laid out & the claims of the investors in this tranche will be junior or subordinate to the Senior PTC holders.

In addition to the above, the originator may also furnish additional Cash collateral mostly in the form of fixed deposits with an established bank on which the lien of the PTC trustee is marked. The trustee can dip into this collateral in case the pay-outs from the pool are inadequate to meet the pay-outs to the PTC investors. The extent of cash collateral to be provided will be based on various factors like pool quality, internal credit enhancement available etc. In certain cases, a corporate guarantee may be offered from a third party in place of a cash collateral. Acuite analyses the extent and quality of such external enhancement and its legal enforceability. Acuite may also analyse the legal structure to check the bankruptcy remoteness of the PTC transaction. 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.

Step 4

Acuite shall initially assign a Provisional Rating based on the pool data and inputs furnished by the client based on the above steps. The Conversion of Provisional to Final rating will be subject to fulfilment of certain documentation formalities as stipulated by Acuite.

Step 5

The outstanding ratings are subject to periodic surveillance on the pool performance based on feedback and inputs received from the trustee and client.

Key Risks

A. Delinquency Risk/ Credit Risk

The understanding of credit/counterparty risk is critical to the securitization transactions. Since the PTCs are issued on the strength of the underlying receivables, any weakness in performance of the underlying receivables will affect the cash flow profiles and returns of the PTC investors. Hence arriving at an estimate, the estimate of potential delinquencies in the pool is a critical point of the exercise.

Acuite examines the trends in historical delinquency rates across various periods to understand the overall asset class performance. The portfolio outstandings are categorized across time buckets such as 'On Time payment', '30+ DPD', '60+ DPD', till '180+DPD'. Higher the "on time" portfolio, better is the performance. While it is common to have occasional slippages from On Time to 30/60 DPD time buckets, the near-term time buckets, a higher proportion of the portfolio in longer term time buckets of 90+ DPD could indicate a structural decline in credit quality. Acuite evaluates the trend in this historical delinquency rate over a period of time. However, in cases of rapidly expanding portfolios, this delinquency ratio may understate the delinquency risk & it may be prudent to consider lagged delinquency rates as well.

It has to be understood that temporary delinquencies are to be distinguished from structural credit weaknesses. There are certain classes like Commercial Vehicle loans wherein the pool performance could indicate temporary delinquencies which eventually get rectified over a period of time. This is primarily due to uneven nature of cash inflows of the borrower and variations in fleet utilisation. The asset class and nature of security also has a bearing on the credit risk inherent in the pool. Typically, it has been observed that delinquency rates are significantly low in asset classes like housing finance vis a vis other asset classes like unsecured loans/credit card receivables. This could be attributed to factors like nature of the asset, high proportion of owner's equity embedded in the asset and the social implications associated with such defaults. In certain other asset classes like gold loans too, the lender can immediately recover his dues by disposing of the liquid collateral. Hence the incidence of credit losses in such asset classes.

B. Legal Risk

Analysis of legal risks associated with securitisation transactions is important to ensure that interest of investors is protected at times, especially when credit quality of the originator deteriorates significantly and if the originator's lenders stake their claim on the pool receivables. 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 i.e. the transaction satisfies the requirements of a "true sale". It is pertinent to note that in the event of a situation wherein the conditions of a true sale are not met and the originator faces actions from his creditors, such transactions could be derecognised and the investor's interests in such cases could be compromised. Acuite may analyse the specific terms and conditions of the asset transfer agreement, but also other documents including the rights and obligations of all involved. Acuite 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, Acuite also takes into account the competence and experience of the designated trustee in performing its duties and responsibilities.

C. 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. Usually in most of the cases, the originator is the servicer in most of the securitization transactions. Since the collections are directly linked to the servicer's ability to monitor and follow-up with the borrowers, the servicer's ability to adopt and adhere to high standards of servicing i.e., follow-up, collection, timely depositing in pay out accounts etc. become critical. For medium to long tenure PTCs, the servicer's credit profile becomes critical since any sharp deterioration in the servicer's credit quality could impact its ability to discharge its obligations under the servicing agreement. Hence in all the securitization transactions, Acuite also analyses the financial risk profile of the servicer, quality of its management and its track record.

D. Commingling Risk

It has to be understood that in any securitization transaction there is a time lag between the periodic collections from the pool borrowers and the depositing of these collections in the escrow account of the PTC investors. The risk that the pool collections may get commingled with the originator's funds in the interim period is always present. In times of distress faced by the originator (who is usually the servicer), it will be necessary to isolate the pool collections from the regular collections of the originator.

E. 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. Acuite 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.

F. Regulatory Risk

Any changes in regulatory framework will have a bearing on the performance of the existing pools. For instance, a moratorium allowed by the regulator on certain categories of loans due to instances like pandemics will affect the pool pay-outs affecting their overall returns.

G. 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, Acuite takes into consideration the expected movement in interest rates, the cushion between cash flows being generated by the pool and pay-out to investors. In cases where in 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.

Rating Scale

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
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

PREAMBLE

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. The RBI guidelines on CP issuances of August 2017 cover the entire gamut of CP related issues such as eligibility to issue, credit rating requirements, reporting, appointment of IPA, roles and responsibilities of IPA, etc.

CP as a short term unsecured instrument has to be essentially evaluated from the standpoint of the near term liquidity profile of the issuer. It has been observed that depending on the conditions in the money market, certain issuers may prefer to rollover/ refinance their CP Issue as a regular long-term practice, thereby warranting a medium term view along with the short term. As per extant SEBI guidelines, the minimum rating for a CP shall be A3. In respect of eligible issuers with issuances of Rs.1000 cr. or above in a calendar year, CP ratings shall be obtained from at least two Credit Rating Agencies (CRAs) registered with SEBI and the lower of the two ratings shall be used. In case of same ratings, the lower of the two amounts shall be used for which ratings are obtained.

Acuite believes that the process of rating a CP Issue entails the assessment of the fundamental risks in the entity and also ascertaining the structural (instrument specific) risks in the issue. This largely covers liquidity and refinancing risk apart from credit enhancement mechanisms (if any).

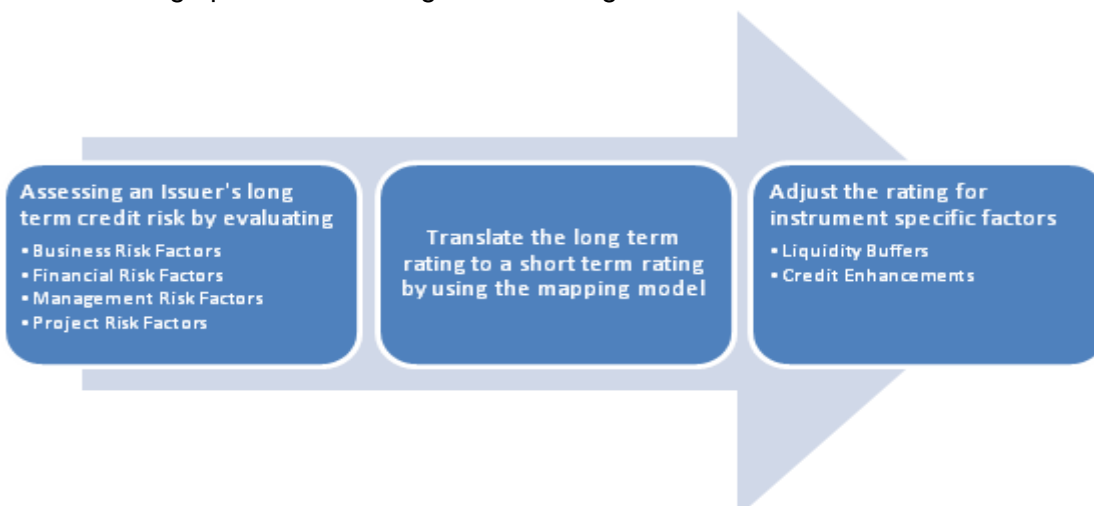
Scope

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

A CP is a short term instrument which may be rolled over on maturity thereby imparting a medium/ long term character as it tends to remain outstanding on a long term basis. In case the issuer faces challenges in rollover of the outstanding CPs, the issuer may have to rely on alternate sources of financing such as fresh borrowings from banks/ institutions or through other short term capital market instruments to meet its CP related commitments. Hence the assessment of the long term credit risk also becomes relevant. 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.

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 analysed:

- 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 analyse the entity's ability to refinance its CP issue on maturity— 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 also consider other arrangements such as liquidity back stop arrangements etc. while arriving at the rating for the CP. 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

Definition of Fixed Deposit

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.

Acuité's Rating scale for Fixed Deposits

Symbols	Rating Definition
'Acuité AAA' ("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
'Acuité AA' ("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
Acuité A ("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
Acuité BBB ("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
'Acuité BB' ("Double B") Moderate Risk	Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations
'Acuité B' ("Single B") High Risk	Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations
'Acuité C' ("Single C") Very High Risk	Instruments with this rating are considered to have very high risk of default regarding timely servicing of financial obligations
'Acuité D' ("Single D") Default	Instruments with this rating are in default or are expected to be in default soon

Acuité may apply '+' (plus) or '-' (minus) signs for ratings from 'ACUITE AA' to 'ACUITE C' to reflect comparative 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. Acuite's categorisation of the instruments across the three categories is based on factors like variability of the returns to the investors, uncertainty in cash flow patterns, number of counterparties and general understanding of the instrument by the market.

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.	FLOATING RATES.
		BACKED BY SPECIFIED ESCROW OF CASH FLOWS OR FIXED DEPOSIT.	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	-	BASEL III COMPLIANT SUBORDINATED DEBT INSTRUMENTS	INNOVATIVE PERPETUAL DEBT
			UPPER TIER 2 BONDS
			BASEL III COMPLIANT TIER 1 INSTRUMENTS
OTHER HYBRID INSTRUMENTS	-	SEPARATE TRADING OF REGISTERED INTEREST AND PRINCIPAL SECURITIES(STRIPS)	SECURITY RECEIPTS(ISSUED BY ASSET RECONSTRUCTION COMPANIES)
			PRINCIPAL PROTECTED MARKET LINKED DEBENTURES
			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	PERPETUAL NON-CUMULATIVE PREFERENCES SHARES (PNCPS)

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
		ARBITRAGE FUNDS	CPPI (CONSTANT PROPORTION PORTFOLIO INSURANCE)
			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 regulatory framework governing the capital adequacy requirements for banks and non-banking finance companies (NBFCs), including Housing Finance Companies (HFCs), have resulted in introduction of hybrid instruments aimed at strengthening the regulatory capital base for these financial institutions. Financial institutions have been issuing such instruments since FY 2008-09 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 is below the levels stipulated by the Reserve Bank of India, 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	Subordinated to all other creditors	Coupons are deferred if the regulatory capital falls below the statutory requirement;	In case of accumulation of losses/shortfall in regulatory capital requirements, principal

		Capital. Excess quantum shall be included as a part of the Tier II Capital		or in case payment of the coupon results in the regulatory capital falling below the statutory requirement	amount may be written down
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*Under Basel-II

Rating Framework

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

1. The long term conventional bond rating (Senior Bond rating) of the issuer is evaluated in line with the relevant rating criteria. The various operational & financial parameters like capital adequacy, asset quality, earnings quality etc. are examined while arriving at the rating for the Senior Bonds. Subsequently, the Resource Mobilisation Ability of the issuer is examined by considering various aspects like current funding profile, likelihood of parent/ group support, shareholding pattern, and demonstrated ability to augment its capital structure from diverse sources. The criteria for rating NBFCs is available on: <https://www.acuite.in/view-rating-criteria-44.htm>

The rating so arrived at, based on step 1 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 in case of an absence of significant loss absorption characteristics in such instruments.

2. 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 factoring in the expected capital mobilization vs 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 maintain a differential up to three notches. It is pertinent to note that the differential is not linear & the standalone rating of the bank (in case there is a notch up for any government or parent support) is a key factor in deciding the differential. In case of banks at the higher end of the rating band (i.e., stronger banks), the difference between senior bonds and AT1 instruments could be lower vis a vis a relatively weaker bank.

In this context the differences between the Basel II & Basel III dispensation needs to be appreciated. It has to be understood that under Basel III, the loss absorption characteristics of Additional Tier 1 (AT1) instruments are higher vis a vis under Basel II dispensation. An AT1 instrument under Basel III issued by a bank shall have loss absorption features (conversion/ write-down/ write-off) on breach of Common Equity Tier 1 (CET 1) triggers or at PONV (Point of Non-Viability). The coupons in respect of these instruments may be paid out of distributable items & free reserves (in the event of

inadequate profits during current year) subject to compliance with CET 1, Tier I & Total Capital ratios and interest shall not be cumulative. The claims of the holders of these AT1 instruments are senior only to the claims of equity shareholders and Perpetual Non-Cumulative Preference Shareholders. These instruments do not have a put option, however they may have call option after 5 years from issuance to be exercised subject to RBI approval.

Basel III compliant Tier II instruments have a feature to be invoked at the PONV thereby providing a buffer to depositors and senior creditors. While they may not have an interest deferral clause, these instruments are designed to absorb losses on PONV triggers through write-downs/ conversion to equity as per the regulatory directives. The rating of Tier II instruments under Basel III will be generally aligned to the Lower Tier II instruments under Basel II for banks at the higher end of rating spectrum. Based on past experience, in respect of PSU Banks, the Government has been proactive in ensuring capital infusion to ensure that the capital buffers remain above the PONV levels. It has to be understood that the likelihood of reaching PONV is much lower than the possibility of breach of overall capital adequacy. Hence, the probability of default on Upper Tier II instruments (Under Basel II) will be higher than the Tier II instruments (under Basel III).

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 can also be issued by banks for meeting their capital adequacy requirements. While Preference Shares carry fixed dividends (as opposed to equity dividends which may vary from year to year), however it has to be noted that dividend payments on preference shares are discretionary i.e., at the option of the issuer. For all practical purposes, the issuers will prefer to maintain their dividend payouts on the preference shares even during periods of extreme profitability stress as any skipping of dividends will be construed as a signal of credit weakness among investors and external stakeholders. The payouts during years of weak profitability performance could require the concurrence of the regulator especially if the capital adequacy levels are close to regulatory thresholds and the payouts could exacerbate the pressure of the capital adequacy front. Typically, PNCPS (Perpetual Non-Cumulative Preference shares) issued by banks are treated as a part of Tier I capital within the overall AT1 limit of 1.5% of RWAs subject to these instruments satisfying certain regulatory requirements. Also, RCPS (Redeemable Cumulative Preference Shares), PCPS (Perpetual Cumulative Preference Shares) & RNCPS (Redeemable Non-Cumulative Preference Shares) are to be treated as Tier II capital of banks.

Acuité's approach will be similar to the approach followed in respect of other hybrid instruments depending on the seniority status of these 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 are expected

to gradually move towards 15% in a phased manner. 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. 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 may be required to seek the approval of regulator in order to service the coupon due on such instruments in the event of loss- even if adequately capitalised in line with regulatory requirements.

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 taxpaying propensity.

IV. Debt Raising Flexibility

Under this head, Acuite 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

PREAMBLE

The real estate sector comprises entities engaged in the construction and development of residential/commercial real estate. Acuite understands that the 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, among others. 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 differences, 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.

I. 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 is protected than that of the investor, since actual user's demand is usually backed by housing loans that 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 such as 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 standpoint 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 of the possession by specific dates. The enactment of legislation such as 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 Authority) 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, among others.

Each state will have its own RERA, which would be broadly based on the lines of the Central RERA. Other than legislations such as 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.

II. 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 = (Cash inflows from customers + Infusion of additional promoter funds+ Fresh term loan drawdowns) ÷ (Cash outflows for construction+ Taxes+ Interest+ 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. The refinancing ability has to be examined in the context of the prevailing operating environment. Typically, NBFCs are the key lenders to real estate sector, the occurrence of events which impedes the lending ability of the NBFCs will impact the financial flexibility of the lenders. The presence of marquee real estate focused private equity players as majority shareholders tends to be viewed positively from a financial flexibility standpoint especially if such players are able to demonstrate the willingness to support the ventures. Acuite also considers liquidity support like unencumbered cash balances and cash equivalents while formulating an opinion on the cash flow adequacy of the entity. The emergence of REITs (Real Estate Investment Trust) as an investment option provides the real estate developers an avenue to raise fresh resources by transferring certain income yielding assets to the trust.

III. 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.

Assessment of Environmental, Social and Governance (ESG) Risks

In addition to the above mentioned Rating Framework, Acuité also comments on the ESG parameters in case of certain listed entities in its Rating Rationale.

The primary goal of any commercial entity is to maximize the value for its owners/ shareholders through profit maximization. However, it has to be recognised that besides profit maximization any business entity has certain responsibilities towards the society in which it is operating and towards the environment. Hence, an ESG assessment of a business entity assumes importance. ESG is a framework for measuring the performance of the company across three specific categories: Environmental, Social and Governance. ESG as a concept has been around for more than a decade. However, it has recently gained in prominence with large international investors tracking the ESG scores before taking the investment decisions. The regulators have also recognised the importance of the ESG framework. A SEBI circular on Business Responsibility and Sustainability Reporting dated May 10, 2021, requires the top 1,000 listed corporates to disclose significant non-financial information voluntarily in fiscal 2022 and compulsorily from fiscal 2023.

Acuité believes that the current trend among institutional investors of considering ESG scores along with the other conventional parameters like the credit rating will gain in importance over the near future.

Rating Criteria for Insurance Companies

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. Acuite 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.

Acuite assesses standalone credit risk profile of the general insurance companies based on the evaluation of the industry risk, business risk, financial risk and management risk profiles of the company. In addition, Acuite also factors support by parent/group/government 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. Acuite also analyses the impact of the economic conditions, government policies and regulatory environment for the industry and 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 present) 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 case 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 and 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 honor 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 honor 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 highly 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 cash flows. 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 track record of the management in adhering to statutory requirements by various regulatory authorities, litigation, and such related issues. The

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:

Acuité 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 evaluation of various factors including 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. Acuité 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. Acuité 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 and 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; and 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	1. Solvency position of the insurance company being above the regulatory minimum at all times including after such payment of dividend or interest. 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. 3. No loss absorption feature, which may result in conversion of the instrument into equity.														
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	Dividend on preference shares shall be non-cumulative 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. Insurance companies permitted to pay compound interest on the missed interest payment on the subordinated debt.														
Instrument Amortisation	<p>Instruments shall be subjected to a progressive haircut 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. Acuité 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, Acuité 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 be 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.

Assessment of Environmental, Social and Governance (ESG) Risks

In addition to the above mentioned Rating Framework, Acuité also comments on the ESG parameters in case of certain listed entities in its Rating Rationale.

The primary goal of any commercial entity is to maximize the value for its owners/ shareholders through profit maximization. However, it has to be recognised that besides profit maximization any business entity has certain responsibilities towards the society in which it is operating and towards

the environment. Hence, an ESG assessment of a business entity assumes importance. ESG is a framework for measuring the performance of the company across three specific categories: Environmental, Social and Governance. ESG as a concept has been around for more than a decade. However, it has recently gained in prominence with large international investors tracking the ESG scores before taking the investment decisions. The regulators have also recognised the importance of the ESG framework. A SEBI circular on Business Responsibility and Sustainability Reporting dated May 10, 2021, requires the top 1,000 listed corporates to disclose significant non-financial information voluntarily in fiscal 2022 and compulsorily from fiscal 2023.

Acuité believes that the current trend among institutional investors of considering ESG scores along with the other conventional parameters like the credit rating will gain in importance over the near future.

Explicit Credit Enhancement (CE)

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. Acuite 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.

Acuite 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. Acuite 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. Acuite 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 subject to the presence of a 'T'- 'n' structure in the Undertaking besides the other factors like irrevocability and unconditionality. ('T'- 'n' indicating that if 'T' is the due date for any payment of interest/ principal, then the issuer of the Undertaking commits to ensure funding in the account if the account is not funded 'n' days before the due date). The CE suffix indicates that the rating factors in support in the form of external explicit credit enhancement. Even in the absence of 'T'- 'n' structure in the undertaking, Acuite may still factor in support from the

guaranteeing entity (albeit without a CE suffix). The understanding is that the entity issuing the undertaking may still continue to support the borrowing entity though there is no explicit clause in the undertaking for timely support.

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 party, Acuite 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, Acuite 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 exist an external entity (typically a corporate / or a government/or a Bank) that undertakes to fulfil the debt repayment obligations on behalf of the issuer of the instrument/borrower in case of an invocation of the guarantee, the necessary funds are not made available before the due date /

In this regard, if considered necessary, Acuite may, examine the guarantee deed in to ascertain the following aspects

- Unconditional & Irrevocable Nature of Guarantee
- Guarantee is Continuing in nature. Whether the guarantee covers the entire tenure of the instrument and also covers the interest and principal part of the instrument/ loan
- Clause providing for payment on first demand without any protest
- Possibility of any operational/ regulatory risks that could inhibit the guarantor from discharging the obligations under the guarantee, should such a situation arise
- Timelines for invocation & payment upon receipt of invocation notice
- Legal opinion from an independent law firm regarding the various aspects such as enforceability, unconditional & irrevocable nature etc.

A. Borrowings/ Instruments supported by Corporate/ Government Guarantees

- In case of borrowings supported fully by Corporate Guarantees/Government from a strong parent/Group entity/ Government, the final rating will depend on standalone rating of the borrowing entity, rating of guarantor & notch up over the standalone rating of the borrowing entity/issuer. Acuite arrives at an internal estimate of the shadow credit rating of the guaranteeing entity wherever there is no outstanding rating from Acuite. In case of unconditional and irrevocable structures, the rating is mapped (not necessarily equated) to that of the guaranteeing entity, based on a notch up framework. The presence of a Corporate Guarantee by itself does not necessarily qualify for equating the rating of the borrower with the corporate guarantor. Certain other aspects such as strategic interest to the Corporate Guarantor, magnitude of investment of guarantor in the borrower etc. will be examined while deciding the notch up.
- Since the rating in such cases does not reflect the standalone credit profile of the borrowing entity, the analytical approach in the Rating Rationale will mention the presence of a Corporate Guarantee. However, it has been observed that, in most of the cases of

Corporate Guarantee, estimating the timeliness of support could be a challenge. In the absence of any T-n structure in the Guarantee, it is not plausible to assume that the Guarantor is committed to a timely support. Hence in such cases, Acuite does factor in support of the Guarantor in the rating but does not suffix (CE) to the rating. In case of Corporate / Government guarantee cases with a T-n structure, Acuite uses the suffix (CE) to the rating

B. Borrowings /Instruments supported by Bank Guarantees/ SBLCs

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. 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 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.

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 generally invokes the guarantee / SBLC only after the occurrence of default. There is no T-n Structure in such guarantees. Notwithstanding the absence of T-n clauses, the ratings assigned to such credit facilities will be suffixed with the words (CE) i.e., Credit Enhancement 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 from the bank. The reason for adopting this approach in respect of bank guarantee supported borrowings (vis a vis borrowing supported by Corporate/ State Government Guarantees as above) is that such guarantee/SBLC issuances are part of bank's core activity. Typically, under these guarantees, the bank undertakes to pay the amount within a pre-agreed time after invocation. Any instance of non-payment by the bank/delays in payment after receipt of invocation notice, can have adverse implications for the issuing bank's credibility. As opposed to such guarantees, the presence of corporate guarantee does not ensure that ultimate payment will be received in a timely manner even after invocation.

In view of such stringent clauses, the lending Bank/investor reckons such exposures as an exposure on the guaranteeing bank & the risk weightage assigned to such exposures will be based on the rating of the guaranteeing bank.

Acuité has observed that, the invocation of guarantees especially in case of debt availed from banks/financial institutions 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 timelines for intimation to the rating agency especially in case of debt (NCDs etc.) with debenture trustees.

C. Borrowings/Instruments supported by Letters of Comfort

In cases where there are no explicit corporate guarantees (i.e., legally enforceable obligation), Acuite 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 structures will not be suffixed with a CE since there are no (T-n) structures and even if the management decides to incorporate such structure, the legal enforceability of the LoC presents a challenge.

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, Acuite 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.

Acuite'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. Acuite 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, Acuite will examine the financing documents for these clauses.

Nature & Quantum of Liquid Collateral

Among other factors, Acuite 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.

C. 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 wide 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
Guaranteed pooled loans issuance (PLI) / Pooled bond issuance (PBI), not through a trust	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	Acuite 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		
Acuite 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 willful 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.

Based on RBI's "Prudential Framework for Resolution of Stressed Assets" dated June 7, 2019, Acuite 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 Acuite 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, Acuite 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. Acuite 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 cyclicity, 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 cyclicity 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 cashflow visibility beyond the initial 3-5 years is difficult. Acuite 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 mooted 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+	More than 150%	Present value of expected recoveries is more than 150% of the face value of outstanding SRs
ACUITE RR1	More than 100% and upto 150%	Range of present value of expected recoveries is more than 100% and upto 150% of the face value of outstanding SRs
ACUITE RR2	More than 75% and upto 100%	Range of present value of expected recoveries is more than 75% and upto 100% of the face value of outstanding SRs
ACUITE RR3	More than 50% and upto 75%	Range of present value of expected recoveries is more than 50% and upto 75% of the face value of outstanding SRs
ACUITE RR4	More the 25% and upto 50%	Range of the present value of expected recoveries is more than 25% and upto 50% of the face value of outstanding SRs
ACUITE RR5	Upto 25%	Range of the present value of expected recoveries is 25% of the face value of outstanding SRs

Infrastructure Investment Trust (InvIT)

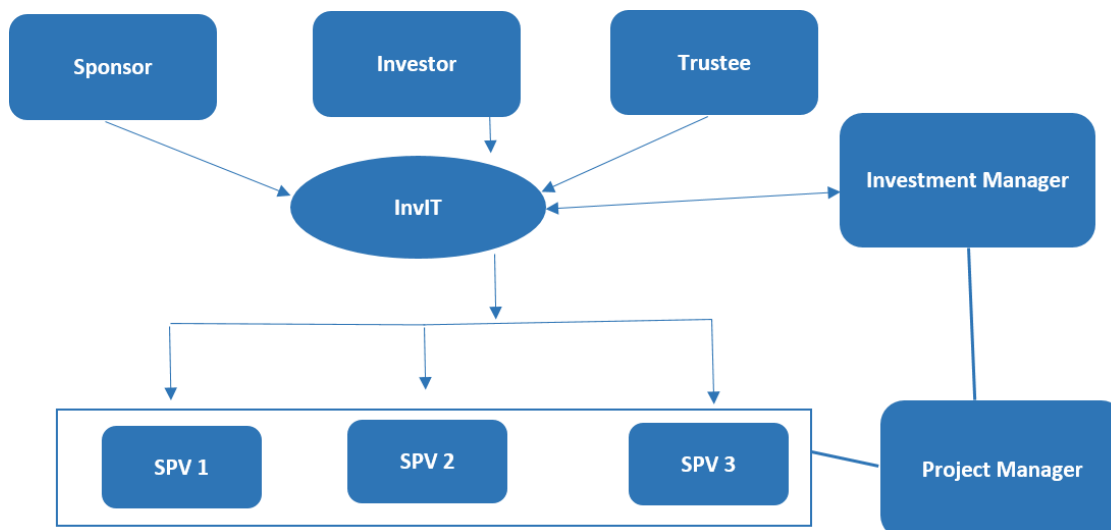
Key Stakeholders in an InvIT

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 records,

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

Covered Bonds

Covered Bonds are hybrid instruments combining the characteristics of a PTC (Pass through certificates) and NCD (Non-convertible Debenture) as it provides dual recourse to the investor, i.e. recourse to (i.) cover pool assets that are held in a bankruptcy remote Special Purpose Vehicle distinct from the originator and (ii.) unlimited recourse on the Issuer. A PTC holder's returns are largely dependent on the underlying pool performance, i.e. mostly detached from the standalone credit profile of the issuer/originator. The originator's role in PTC transactions is limited to the servicing and the credit enhancement related obligations, which are decided upfront. Hence, a covered bond partakes the traits of a PTC and a bond. Generally, in a covered bond transaction, the identified pool of receivables is transferred to a trust formed by the originator. The trust is a special purpose vehicle, which guarantees the obligations to the bondholders. It is to be noted that notwithstanding the fact that the underlying pool has been isolated from a legal standpoint, the transaction continues to be reflected on the books of the issuer like an NCD transaction. The difference between such a Covered Bond transaction and NCD transaction is that, unlike a bond investor, a covered bond transaction is legally structured to ensure that the investors can access the underlying pool of assets (say receivables), especially in case of trigger credit events like sharp rating downgrades, bankruptcy, etc. One more factor favouring covered bonds is that the deals are generally over collateralised, i.e. value of receivables transferred is higher than the issue size. From an issuer standpoint, it results in a lower cost of funds, whereas from an investor perspective, the dual recourse results in an improvement in recovery prospects.

It is to be understood that the mismatch between the maturity profiles of the underlying assets and the maturity profiles of the covered bonds make asset liability management important. Due to factors like occurrences of defaults/delinquencies, pre-payments and foreclosures, the collateral coverage may fluctuate, making it imperative that the collateral coverage envisaged at inception is adhered to at all times.

From a Covered Bond rating standpoint, Acuite will be guided by the following factors

- **Standalone Credit Profile of the Issuer:** As Covered Bonds are hybrid instruments combining the characteristics of NCD (Non-convertible Debenture) and a PTC (Pass through certificates), the credit assessment of the issuer to determine its repayment capacity is the initial step of the rating process for evaluating such transactions. Thus, Acuite analyses the financial risk profile of the servicer, quality of its management and its track record.
- **Characteristics of the Underlying Pool:** The characteristics and credit quality of the underlying pool is taken into consideration for assessment of such transactions. Acuite evaluates the impact of several factors like characteristics of asset class, delinquency level, geographical concentration, interest risk and pre-payment risk. Accordingly, Acuite lays stress on the pre-defined pool eligibility criteria and its adherence by the issuer.
- **Extent of credit enhancement:** Based on the credit quality of the issuer and risk profile of the underlying pool, the issuer may employ additional credit enhancements (external) in the form of Over Collateralization (OC), Cash Collateral (CC), Excess Interest Spread (EIS). Acuite analyses the extent and quality of this additional support and its legal enforceability.
- **Legal risks in the transaction:** Analysis of legal risks associated with such 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. 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. Acuite 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. Acuite may also seek third-party independent legal opinion to learn about the legal risks involved in a securitisation transaction if deemed necessary.

- **Extent of mismatch between maturity of the pool and covered bond maturity:**

Acuite will decide the extent of notch up over the issuer's standalone credit profile based on its assessment of the above parameters. **The rating will be suffixed with (CE) to indicate that the rating is driven by the structure.**

Real Estate Investment Trust (REIT)

The need for managing the risk-return trade-off while achieving optimal diversification among various asset classes has led to the emergence of several investment structures across various asset classes such as real estate, infrastructure and distressed debt. The nature of these instruments and the complexity involved makes them ideal investment options for the more evolved investor categories like high net worth investors and institutional investors. In the Indian context, an instrument that has been gaining in popularity that also witnessed the listing of the first Real Estate Investment Trust (REIT) on 1-April-2019.

The regulatory foundation for REITS was laid with the enactment of SEBI (Real Estate Investment Trust Regulations) in 2014. Subsequently, SEBI has issued amendments to these regulations from time to time.

A Real Estate Investment Trust is a trust formed under the Indian Trusts Act 1882. It is structurally comparable to a mutual fund which mobilises funds from a large pool of investors for investing in a basket of securities (debt or equity). The key differentiator is that REIT as an investment vehicle raises funds from various investors (unitholders of the REIT) for investing primarily in a portfolio of completed and income-generating real estate assets. Besides investing in completed income-generating assets such as shopping malls, workspace and warehouses, REITs are also permitted the flexibility to invest in other assets like equity/debt of listed/unlisted companies engaged in real estate, mortgage back securities and also under construction properties (subject to regulatory restrictions). A REIT can either own the assets directly or through an SPV (Special Purpose Vehicle) or even through a holding company structure which in turn owns the SPVs. REIT are usually promoted /floated by real estate developers/ owner of commercial assets, which can also be private equity or real estate focussed funds (Sponsors of the REIT).

Key Aspects of the Regulatory Landscape

- Investments by a REIT can be either directly in real estate assets or through SPVs (Special Purpose Vehicles) or even through a holding company structure. The floor of 80% for completed and income-generating assets and ceiling of 20% in respect of under-construction properties, TDRs, mortgage-backed securities etc., are to ensure that the REIT cash flows are well defined, predictable and table.
- Investment in under-construction properties are allowed to the extent of 20% (ceiling) of overall assets and subject to minimum holding of 3 years from completion.
- Regulations stipulate eligibility of sponsor group such as a minimum net worth of Rs.100 Cr for the sponsor group along with specific track record criteria for real estate developer sponsors.
- Maximum leverage (on consolidated basis) including deferred payments and net of cash not to exceed 49% of the aggregate value of assets, effectively implying a consolidated leverage of less than 1.0x. The debt can be availed both at SPV level or REIT level.
- An external Credit Rating is required if the debt levels exceed 25% of the REIT assets.
- In case of listing of REITs, Sponsors, Sponsor Group & associates to hold a minimum 25% of units outstanding, on a post offer basis for 3 years.
- Minimum size of investment in a REIT by an investor is Rs.0.5 lacs. Minimum 200 investors required for listing (excluding sponsor group).
- Regulations also stipulate the conditions required for related party transactions.
- Investors in REITs include mutual funds, insurance companies, banks, multilateral institutions,

FPIs etc. Certain categories of investors may have some regulatory restrictions on their investment quantum.

- 90% of the distributable surplus (NDCF) to be paid out by way of dividends to unitholders.

Advantages to Sponsor

- Avenue for Monetisation of real estate assets
- Cheaper source of funding due to inherently higher rating of a REIT vis a vis the balance sheet based borrowing of the real estate developers
- Diversity of funding profile
- Ability to leverage further to support under-construction assets

Advantages to Investor

- Low ticket exposure to real estate
- Higher & steady yields vis a vis other asset classes: mandatory distribution of 90% of NDCF as dividends
- Professional management

Key stakeholders in a REITs & their Primary Role

Sponsor: Generally, a real estate developer/ real estate focussed investor with significant experience in developing and managing real estate assets/ properties (For eg: Embassy Group, K. Raheja Group, Brookfield)

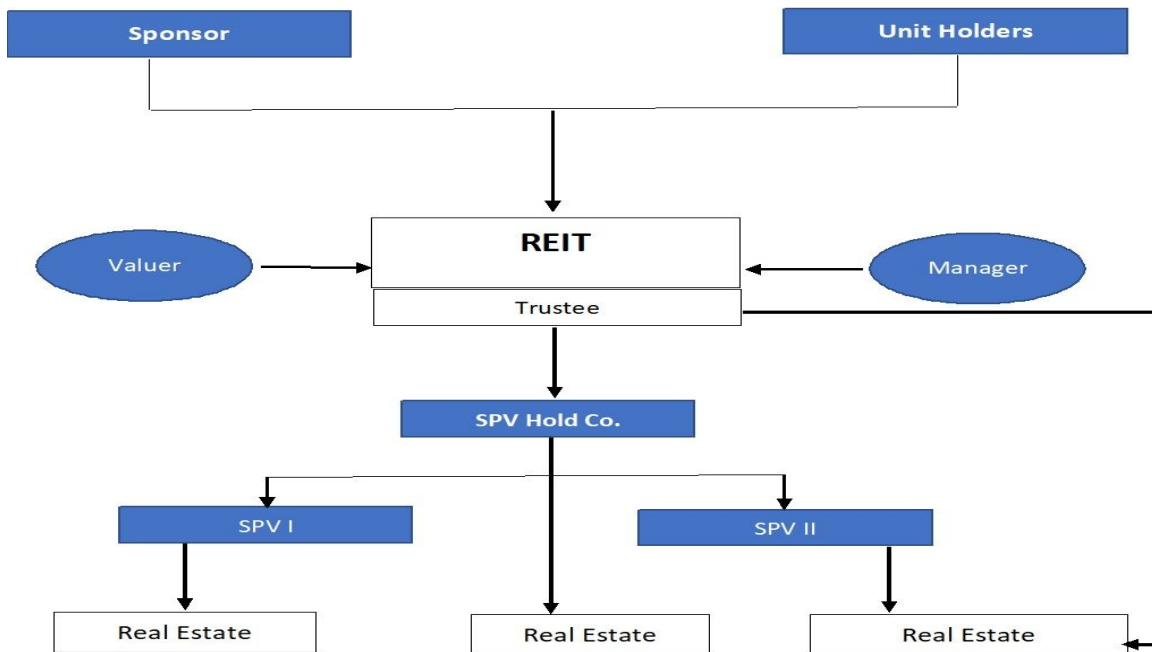
Unitholder: The investors in a REIT who are allotted units as per the quantum of their investment, indicating their pro-rata ownership of the net assets.

Manager: Entity vested with operational responsibility of managing the real estate assets

Trustee: Managing the trusteeship functions for the unitholders (akin to a debenture trustee for debenture holders)

Valuer: A registered valuer responsible for the valuation of the assets under the REIT

REIT DIAGRAMMATIC REPRESENTATION



Assessment Methodology

Since a REIT function as a conduit (pass through) structure between the unitholders on one side and real estate and related assets on other, the focus of assessment is on cash flow adequacy and asset coverage (valuation). Acuite's rating on REIT instrument indicates its opinion on the ability of the trust to meet the debt servicing commitments to external lenders in a timely manner. It does not indicate likely return potential to the investors (unitholders) or future valuation of the REIT or viability of its underlying projects.

The key parameters to be considered while rating a REIT are group under Business Risk Analysis, Financial Risk Analysis & Management Risk Analysis are as under

BUSINESS RISK ANALYSIS

1. **Counterparty Risk:** The quality of the key counterparties (anchor tenants of a mall/ office/warehouse etc) is a key factor to be considered in any REIT structure. Higher the credit quality of the counterparty, lower is the credit risk of delay /delinquency. The assessment of counterparty profile is relatively straightforward in case of office space segment where the clientele would be limited and likelihood of churn over the medium term is also low. However, in case of a larger number of lessees (i.e. in case of malls/ large commercial complexes) the assessment becomes slightly complex. In case of a mall, typically there would be 4-5 anchor clients such as a multiplex, reputed multibrand retail players etc., who generally provide long term stability to the rental stream. Due to their large area requirements and their ability to attract large client footfalls, these anchors enjoy a concessional pricing vis a vis the other multiple smaller lessees occupying smaller areas. The anchor clients are relatively stable vis a vis smaller lessee who may witness a churn based on market wide and unit specific factors. In a multiple lessee situation, the top 5/ 10 clients (in terms of revenues) can be evaluated to gauge the overall clientele profile and also extent of client concentration risk. The granularity of the lessee portfolio, whether in the office or commercial space, is an important element in the REIT consolidated business profile. While excessive dependence on 2-3 clients for rental revenues

may be perceived to be risky, it has to be evaluated from the credit quality of these clients and the expected stability of the revenues from these clients. In view of the recent trend of having a minimum rental plus a variable revenue sharing model, the cash flow projections may need to factor in the inherent volatility in that scenario.

2. **Revenue Stability, Early Exit Risk & Renegotiation Risk:** From a lending perspective, the steady revenue stream associated with the lease rental based term loans transactions differentiates them from other project-based term loans. In order to assess the revenue stability, Acuite seeks to understand the underlying lease contracts with existing clients such as start date & end date of lease agreement, area occupied, rental to be paid, security deposit, step up provisions etc. Usually, the lease agreements for retail space, especially in non-anchor category are initially entered for tenures of 3-5 years with renewal clauses. The revenue stability could be impacted on account factors like non-renewal of agreements, sharp decline in the credit quality of existing clients and unanticipated early exits due to lower than expected business levels. All lease agreements usually have clauses which stipulate an initial lock in and early exit clauses which provide the lessee to seek an exit prior to the expiry of the regular lease term. Since early exits cause a disruption in the revenue streams of the lessor, as a risk mitigation, the lessees are required to pay a pre-agreed amount in case of early exits. The security deposits placed by the lessees can also be adjusted against such payments. The key risk to the lessor (borrower) in case of early exits by an existing lessee is of identifying a suitable alternative lessee within a reasonable time span to minimise the impact on revenue streams. The concept of WALE (Weighted Average Lease Expiry) assume importance as a metric in REIT structures for tracking revenue stability from existing clients. These risks are accentuated in an economic downturn when more clients may opt for early exits due to challenging business conditions and it may be difficult to find alternative lessees, thereby impacting the overall occupancy levels of the property.

From an analytical standpoint, the aspects to be evaluated are (i) length of association of the lessee, (ii) extent of lessee's investment in fitouts/ infrastructure at the said property, and (iii) criticality of the said space to the overall operations of the lessee. Generally, the longer the association, lower are the chances of early exit by the lessees. Similarly, a significant investment in fitouts and infrastructure by the lessee will act a deterrent to early exits. The nature of operations carried out at the leased facility also has a bearing on decision to seek an early exit. For instance, in case of a highly profitable branch of a retail jewellery company or a bank or a branch of an IT company with a large headcount of highly skilled personnel working out of that space, any change in location could be disruptive to the lessee's operations.

3. **Demand Supply Dynamics & Location:** The demand supply dynamics of real estate market depend on several factors like level of economic activity in the region, retail spending patterns, current projects in the pipeline, government policies. Again within real estate, the dynamics of the retail segment will diverge from the demand for office space. For retail space, the location of a property is a critical factor influencing its revenue profile and ability to maintain optimal occupancy levels. A mall in a central location of a city with developed infrastructure like adequate parking spaces and well connected to surrounding residential localities will be an attractive option for the retailers. Such a mall may, in fact, command a premium in its rentals in view of the high footfall expectancy and large catchment area in the initial stages of development of the city/town. However, with the gradual development of the city/metro in its satellite regions and across the periphery, these properties will face competition from newer properties. In case of office space, key factors influencing demand are connectivity, availability of supporting infrastructure like parking spaces, proximity to government offices and banks, proximity to clients

and suppliers and quality of common clients like restaurants etc. Shifts in pockets of economic and commercial activity could impact the demand for office space in any given region. The demand supply dynamics could also be influenced by slowdown in level of economic activity which could result in lower demand for office space forcing corporates to go in for rationalisation of headcount, shifting to low cost locations, outsourcing or streamlining processes by bringing them under one location etc.

These macro aspects have a bearing on the valuation of the real estate assets and the future rental streams. The rental dynamics and occupancy levels, in turn, influences REIT's stability of cash generation and its ability to meet its debt commitments in respect of its external lenders and its dividend distributions.

FINANCIAL RISK PROFILE

In a REIT structure, the prime focus is on valuation and cash flow coverage. The regulations stipulate the maximum leverage and the distribution of net distributable cash flows. The adequacy of the cash flows will be critically examined and sensitivity to future rental movements will be examined. The key metrics will be LTV ratio, Interest coverage, Net Debt/ EBITDA and adequacy of cash flows vis a vis debt servicing commitments. In case of longer tenor debt with bullet amortisation structures, Acuite will assess the mechanism to ensure adequate cash flows for redemption.

As is normally the approach followed in case of real estate projects, cash flow based approach (rather than a Profit and loss approach) is preferred wherein periodic cash inflows (net rentals & allied inflows like parking charges, CAM recoveries) are compared with cash outflows (operating expenses, interest costs and principal repayment obligations) to assess the debt servicing ability. In view of the steady rental cash flows from a diversified basket of completed income generating real estate assets and safeguard mechanism such as escrow accounts in place, a lower DSCR (vis a vis a realty business with ongoing construction projects) is acceptable in such cases. Since a significant proportion of the cash flows at the SPV level / holding company level are up streamed to the REIT and the debt levels are also monitored at a consolidated level, Acuite will consider the consolidated approach while assessing the cash flow adequacy. The financial flexibility in terms of (existing debt vis a vis existing value of assets) is also assessed to understand the buffer available to raise additional debt to support under construction properties/ fresh asset acquisitions.

Presence of DSRA mechanism

In certain transactions, Debt Service Reserve Account is stipulated, which could be a fixed deposit on which the lender has a lien. Typically it would be comprising debt servicing obligations for a period of say 3-12 months. The DSRA serves as a liquidity buffer. In the event of a shortfall in inflows due to factors like delays in rental payment by some of the lessees, the lending institution can utilise the amount under DSRA for making good the shortfall in debt servicing obligations. Subsequently, the DSRA will have to be replenished. The presence of a DSRA is a strong positive from a rating standpoint, especially if the DSCR metrics are subdued.

Management Risk Analysis

Integrity

Any past instances of defaults/ delinquencies/ composition with lenders by the sponsor management. Any instances of serious punitive action by Real Estate Regulator.

Competence

- Demonstrated expertise in real estate activities across geographies, number of properties developed and managed across various segments (i.e. malls, office space, commercial complexes, warehouses etc.) both in terms of volume (million sq.ft.) and value.
- Demonstrated ability to attract and retain marquee clients across various sectors in existing properties
- Track record of repayment in LRD debt of the sponsor in the past
- Ability to raise funding at competitive rates through diverse sources

Risk Appetite

Propensity to grow aggressively by overleveraging (Maximum LTV ratio to be maintained will be the key determinant)

Criteria for Rating of Asset Reconstruction Companies

The business models of ARCs are built around their expertise in acquiring distressed assets (NPAs) from banks and financial institutions and successfully resolving these assets. 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. Security Receipts (SRs) are instruments issued by Asset Reconstruction Companies as consideration for their purchase of distressed assets from banks/NBFCs. An SR reflects an interest in the underlying distressed asset or pool of distressed assets. The consideration for acquiring these assets is generally a combination of Security Receipts & upfront cash. SRs are issued by separate trusts which are formed by the ARC to represent a distressed asset or a combination of distressed assets.

RBI's initial guidelines envisaged a 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 subsequently modified to 15/85 scheme to nudge the ARCs to have more "skin in the game" by way of a minimum 15% cash investment. The proportion of the cash/SRs currently is largely a function of the negotiation between the buyer of the asset (ARC) & Seller of the Asset (Lender). Pursuant to regulatory changes, the lenders have been showing a distinct preference for more cash deals which have resulted in increased capital requirements for the ARCs. The investments in SRs are also currently permitted for QIBs, which has increased the flexibility of the ARCs in acquiring more assets. The regulator has been mulling avenues to improve liquidity in SRs through options like listing.

Factors considered while assessing the performance of an ARC

1. Promoter support:

Acuite will evaluate the extent of available promoter/s support, the financial strength of promoter and the interlinkages in the form of capital, managerial and/or operational support. Regular capital support from the promoters will ensure that company has resources for scaling up the business, while managerial support will aid in framing various risk management policies, resolution strategies, etc. This is a key parameter and more so in the event of nascent stage of operations of an ARC where the track record of operations is yet to be established.

Many ARCs, however, have a distributed shareholding from financial institutions and mostly banks. The promoter support in such a case may be assessed either from the largest shareholders (if they hold a material stake, say over 30%) or on a collective basis if there is a track record of collective support. Further, in case of a distributed shareholding of public sector banks, the indirect consolidated government holding is also assessed and the extent of support from the government, if of a material nature, is evaluated.

2. Company management and expertise:

Acuite will understand the background of the management in terms of their experience, expertise, their ability to add value to the overall resolution process and the resource raising ability. The overall organisational profile, decision making philosophy regarding acquiring new assets, valuation, recovery mode etc. will be assessed under this parameter. The ability to attract marquee investors and QIBs is also an important aspect to be examined under this parameter.

3. Capital Structure:

The capital structure/gearing is also an important factor in determining the credit quality of the ARCs. Typically ARCs have been modestly leveraged up to 2-3 times since a large portion of their acquisitions have been through issuances of SRs. The nature of the assets to be offered as collateral has also been a challenge in raising funds, especially from the conventional banks. Nevertheless, besides banks, the ARCs have raised funds through sources like debentures, ECBs etc. The higher the dependence on external debt, the more the susceptibility of the credit to any external shocks.

4. Acquisition/ risk management policies:

Acuite will understand the asset acquisition policy of the ARC in terms of the preferred size of the acquisition, sectoral preferences etc. This will help in understanding the diversity and granularity of the AUM. The more granular & sectorally diverse the AUM, the more resilient is the credit profile & earnings profile across business cycles. Besides the diversity across sectors, sizes, top exposures etc. Acuite will also examine the approach to consolidation/aggregation of debt. This is because aggregation confers certain advantages to an ARC in terms of speed of decision making and influence on the approach to resolution.

5. AUM Analysis:

The AUM profile is understood in terms of their sectoral diversity and their recovery rating diversity. As regards recovery ratings, more the proportion of high rated Security Receipts, higher is the possibility of future earnings improvement through recoveries/redemption of SRs along with the timely realisation of management fees. Since the trusts are usually established for 5 years (extendable to 8 years) the vintage of the assets acquired is also considered important here. The higher the vintage beyond 5 years, more likely is the possibility of certain write-downs over the near future. Acuite seeks granular data on the top 5/10 exposures, rating wise/ seasoning/ industry wise bifurcation of AUM in order to understand the resolution of the top exposures and AUM construct.

6. Track Record of Resolutions:

An improving trend of cumulative redemptions of SRs to cumulative issuances is indicative of positive developments in area of recoveries/ resolutions. A consistent track record of resolutions suggests healthy operational efficiency. In certain cases, resolution of a few large ticket cases can also influence the results for a given period. Acuite also examines the resolution across the portfolio by way of the ratio of cumulative recovery/total SR's, Recovery % of AUM or ATA, Yearly recoveries and Turnaround time.

7. Operating Efficiency:

The ratio of Operating Expenses to the Average Assets Under Management & Operating Income is also examined to identify any trends of strengths and weaknesses. Typically, the ratio will be high in the initial stages and will stabilise once the AUM acquisition reaches an optimal level.

8. Earnings Quality:

Acuite will evaluate the strength of earnings by way of trend and consistency of management fees. Typically, an ARC derives its revenues from three sources, i.e. management fees, redemption of the SRs held by it in the various distressed assets & upside fees. The Management fees are the relatively steady portion of the revenue streams. The other two revenue streams are generally lumpy and depend to a large extent on the resolution of the

assets. As a result, the consistency of a portion of fee component lends some cushion to earnings profile. Trends in composition of fee income in the total revenues, profit on the redemption of security receipts, PAT as % of average total assets are evaluated.

ARC with limited or no track record

In the event that an ARC is a newly formed one with limited or no track record of operations, the following parameters will assume significant importance:

- ARC parentage and promoter support
- Board Composition and independent directors profile
- Capitalization level and Net worth
- Resources raising ability & investors base
- Co tie-ups/ Co-investment partners
- Business plans detailing growth strategy, threshold capitalisation and gearing levels to be maintained, capital raising (both equity and debt), exposure levels and risk management/ acquisition/ valuation policies etc.

Lease Rental Discounting (LRD)

PREAMBLE

The increasing prices of real estate and a propensity towards maintaining asset light business models have been the twin drivers of preference for 'leased' real estate properties as opposed to outright purchase of properties. The trend is more pronounced especially in certain sectors like Organised Retail, IT & IT enabled services. The lease option converts 'capex' into 'opex', thereby obviating the need for raising long-term resources to support the growth plans of the corporates. The realtors, especially those operating in the malls and office space segment have also reoriented their business models to meet the changing requirements of their clients. From the realtor's (lessor or asset owner) standpoint, a sale results in a one-time cash flow, whereas a lease model results in a stream of lease rental inflows and the realtor gets to capture the capital appreciation (upside) especially in a rising real estate market.

Usually, the process starts with the real estate developer availing a construction loan to develop a property. While the construction is still in progress, the developer initiates talks with potential lessees for the property. Once the property is ready for possession, the construction loan is replaced by a lease rental discounting loan (LRD Loan) based on the agreements signed with the lessees. After adjusting the LRD loan against the outstanding construction loan, any surplus is available to the realtor for investment in his other ventures. The LRD transactions usually have an escrow mechanism under which rental inflows are required to be deposited in a designated account and the debt obligations are recovered from the said account after allowing permissible debits like property taxes/ operating expenses, as per the agreed arrangement. Thus, from a credit monitoring standpoint, the LRD structures are far more amenable to monitoring by the lender vis a vis other credit facilities. The lending banker is usually secured by the hypothecation of the underlying rent receivables and mortgage of the property.

Against the above backdrop, the rating methodology for evaluating LRD based structures should factor these above nuances which differentiate these structures from plain vanilla balance sheet based loan products. Acuite believes that the following factors need to be considered while rating a LRD transaction:

I. BUSINESS RISK ANALYSIS

A. Counterparty Risk:

The profile of the lessees (counterparties) is a key factor to be considered in any LRD structure. Higher the credit quality of the counterparty, lower is the risk (Probability of Default) to the lender. The assessment of counterparty profile is relatively straightforward in case of a single lessee situation, however in case of multiple lessees (i.e., in case of malls/ large commercial complexes) the assessment becomes slightly complex. In case of a mall, typically there would be 3-4 anchor clients such as a multiplex, reputed multi-brand retail players etc. generally, provide long term stability to the rental stream. Due to their large area requirements and their ability to attract large client footfalls, these anchors enjoy a concessional pricing vis a vis the other multiple smaller lessees occupying smaller areas. The anchor clients are relatively stable vis a vis smaller lessees who may witness a churn based on market wide and unit specific factors. In a multiple lessee situation, the top 5/10 clients (in terms of revenues) can be evaluated to gauge the overall clientele profile and also extent of client concentration

risk. While excessive dependence on 2-3 clients for rental revenues may be perceived to be risky, it has to be evaluated from the credit profile of these clients and the expected stability of the revenues from these clients.

B. Revenue Stability, Early Exit Risk & Renegotiation Risk:

From a lending perspective, the steady revenue stream associated with the LRD transactions differentiates them from other project based term loans. In order to assess the revenue stability, Acuite seeks details of the agreement with existing clients such as start date & end date of lease agreement, area occupied, rental to be paid, security deposit, step-up provisions etc. Usually, the lease agreements for retail space are initially entered for tenures from 3-5 years with renewal clauses. The revenue stability could be impacted on account factors like non-renewal of agreements, sharp decline in the credit quality of existing clients and unanticipated early exits. All lease agreements usually have clauses which stipulate an initial lock in and early exit clauses which provide the lessee to seek an exit prior to the expiry of the regular lease term. Since early exits cause a disruption in the revenue streams of the lessor, as a partial risk mitigation, the lessees are required to pay rentals for three months/ six months in case they exercise this option. The security deposits placed by the lessees can also be adjusted against such payments. The key risk to the lessor (borrower) in case of early exits by an existing lessee is of identifying a suitable alternative lessee to minimise the impact on revenue streams. These risks are accentuated in an economic downturn when more clients may opt for early exits due to challenging business conditions and it may be difficult to find alternative lessees thereby impacting the overall occupancy levels of the property.

From an analytical standpoint, the aspects to be evaluated are, length of association of the lessee, extent of lessee's investment in fitouts/ infrastructure at the said property, and criticality of the said operation to the overall operations of the lessee. Generally, the longer the association, lower are the chances of early exit by the lessees. Similarly, a significant investment in fitouts and infrastructure by the lessee will act as a deterrent to early exits. The nature of operations carried out at the leased facility also has a bearing on decision to seek an early exit. For instance, in case of a highly profitable branch of a retail jeweller or a bank or a branch office of an IT company with a large headcount of highly skilled personnel working out of that office, any change in location could be disruptive to the lessee's operations.

C. Demand Supply Dynamics & Location:

The demand supply dynamics of real estate market depend on several factors like level of economic activity in the region, retail spending patterns, current projects in the pipeline, government policies. Again, within real estate, the dynamics of the retail segment will diverge from the demand for office space. For retail space, the location of a property is a critical factor influencing its revenue profile and ability to maintain optimal occupancy levels. A mall in a central location of a city with developed infrastructure like adequate parking spaces and well connected to surrounding residential localities will be an attractive option for the retailers. Such a mall may in fact command a premium in its rentals in view of the high footfall expectancy and large catchment area in the initial stages of development of the city/ town. However, with the gradual development of the city/ metro in its satellite regions and across the periphery, these properties will face competition from newer properties. In case of office space, key factors influencing demand are connectivity, availability of supporting infrastructure like parking spaces, proximity to government offices and banks, proximity to clients and suppliers, etc. Shifts in pockets of economic and commercial activity could impact the demand for office space in any given region. The demand supply dynamics could also be influenced

by slowdown in level of economic activity which could result in lower demand for office space forcing corporates to go in for rationalisation of headcount, shifting to low cost locations, outsourcing or streamlining processes by bringing them under one location etc. A thumb rule to assess the location advantage and demand supply dynamics of the property would be to assess the extent of churn in the clientele and the average occupancy levels over the past 2-3 years.

Acuite notes that technological advancements and increasing trend of online model both in B2B and B2C segments has made it easy for companies to operate with smaller size offices especially those companies embracing new age practices like flexi-timings and Work From Home (WFH). This trend is expected to result in more 'location agnostic' business models thereby optimising the overheads.

II. FINANCIAL RISK PROFILE

DEBT SERVICE COVERAGE RATIO (DSCR)

In a standalone LRD based structure, the inflows will be from lease rentals and recovery of CAM (Common area maintenance charges) from clients. The outflows will comprise operating expenses (maintenance and electricity overheads, salaries of operating staff etc.) and interest costs on the LRD loan. Since most of operating expenses are borne by clients (lessees), the EBITDA margins in a LRD structure are high.

As in case of real estate projects, cash flow based approach based on comparison of cash inflows (net rentals & allied inflows like parking charges, CAM recoveries) with cash outflows (operating expenses, interest costs and principal repayment obligations) is more appropriate while arriving at the DSCR metric (instead of the P&L approach). In view of the steady cash flows and the escrow mechanism in place, a lower DSCR is acceptable in LRD based structures.

In case where the borrower has other project related debt besides the LRD debt, it would be appropriate to calculate the DSCR both at the company level and for the LRD, for a holistic analysis. In such cases, Acuite does not make any distinction between the LRD & Non LRD debt from a rating perspective. The understanding is that any delays/ delinquencies on non LRD debt, if not cured in time, could trigger an action from those lenders, impeding the smooth functioning of operations which in turn could affect the timely servicing of the LRD debt.

Presence of DSRA mechanism

In certain LRD based transactions, Debt Service Reserve Account is stipulated which could be a fixed deposit on which the lender has a lien. Typically, it would be comprising debt servicing obligations for a period of say 1-3 months. The DSRA serves as a liquidity buffer. In the event of a shortfall in inflows due to factors like delays in rental payment by some of the lessees, the bank can utilise the amount under DSRA for making good the shortfall in debt servicing obligations. Subsequently the DSRA will have to be replenished. The presence of a DSRA is a strong positive from a rating standpoint, especially if the DSCR metrics are near unity.

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

A = Working capital / Total assets

B = Retained earnings / Total assets

C = Earnings before interest and taxes / Total assets

D = Market value of equity / Total liabilities

E = Sales / Total assets

Z score bankruptcy model:

$$Z = 1.2(A) + 1.4(B) + 3.3(C) + 0.6(D) + 1.0(E)$$

Zones of discrimination:

- $Z > 2.99$ – “**Safe**” Zone
- $1.80 \leq Z \leq 2.99$ – “**Grey**” Zone
- $Z < 1.80$ – “**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, private sector manufacturing companies.

Policy for Credit Rating Models

Credit rating models can be fairly effective tools for prediction of credit defaults. They can be deployed by Credit Rating Agencies (CRAs) to support their existing rating processes that seek to arrive at an appropriate rating outcome. While Acuite had been earlier using a specific rating model for smaller entities with less than Rs 25 Cr of debt, it took a decision to develop a comprehensive and statistically validated set of rating models in FY21 which will be primarily anchored around objective data, and which will facilitate better quality of rating decisions. Accordingly, due processes were followed for the appointment of an independent and professional entity who had the requisite experience and expertise to develop statistically robust rating models.

Acuite appointed an external consultant with a track record of fifteen years and have provided risk management solutions to over 150 clients in the banking and the insurance sector. They have assisted Acuite Ratings in the development of separate models for the manufacturing, trading, services, banking and the NBFC sectors.

About the rating model:

The rating models are being developed based on empirical dataset i.e. both financial and non-financial information for entities rated by Acuite as well as by other Credit Rating Agencies (CRA). The statistical tool deployed is logistic regression in R-studio with help of the package "Caret". It uses the log odds of the outcome and models the same as a linear combination of the predictor variables.

The log-odds (the logarithm of the odds) for the value labelled "1" is a linear combination of one or more independent variables ("predictors"); the independent variables can each be a binary variable (two classes, coded by an indicator variable) or a continuous variable (any real value).

Assumptions of Logit Regression: Following are the key assumptions of the logit regression model

1. The dependent variable should be dichotomous in nature.
2. There should be no outliers in the data

The regression equations and the estimates are used to attain a financial score, a non-financial score and a combined score. The R-Library of "Caret" is used to find the most optimised equation. The script runs multiple iterations of the data till the most optimised equation is obtained as output. The method used in this script is called Fisher's iterations. Thus, the results are optimised till the lowest p-values and highest AICs are obtained.

In the service sector and financial model (NBFCs and Banks), statistical models are not a good fit and we cannot get an optimum regression equation. P-values for all variables are very high. In such cases, we have opted for judgmental models. On the basis of standard industry practices and keeping in mind the key principles of corporate finance, each variable is classified in various buckets/classes. Each class/bucket is further provided a score, which is used to calculate the final score for the model, based on the respective weightage, as provided to the variable.

Rating Tool

Acuite has developed excel based tools which are in line with the models developed and will be used for ratings done by it. The tool has been developed based on empirical dataset for entities rated by Acuite as well as other Credit Rating Agencies (CRA).

Following models and rating tools are created:

Sr. No	Rating Model	Exceptions (if any)
1.	Manufacturing entities with op income less than Rs. 500 cr.	None
2.	Manufacturing entities with op income less equal to or greater than Rs. 500 cr.	None
3.	Trading entities	None
4.	EPC & Construction sector entities	i. Real-estate Developers ii. Builders iii. Toll road companies
5.	Service sector entities	i. Real-estate Developers ii. Builders iii. Toll road companies
6.	Non-Banking Finance Companies (NBFCs)	I. Broking firms II. Investment / Merchant Banking
7.	Banks	None

Tool Override:

The tool provides a financial rating and then a final rating. An option of a subjective override on the final rating with a 3-notch or 2-notch upgrade or a 3-notch or 2-notch downgrade is provided (3-notch upgrade/downgrade for a statistical model and 2-notch upgrade/downgrade for a judgemental model). The analytical team will endeavour to limit the instances of such override. For every override, a rationale should be provided by the analyst on why the override has been considered.

It is however advised that the analyst should use the override option judiciously and keeping in mind the organisational policy for the same. The respective team leader should be aligned while using an override.

Points to ensure:

1. All the financial and non-financial values should be entered correctly.
2. All the financial and non-financial values entered should be from same year.
3. Complete year financial (actual or provisional) should be used.
4. If the financial and non-financial variables change drastically due to major events happening mid-year, annualised financials can be used after aligning the same with supervisor / TL instead of using the financials of the previous year.
