

CARE'S RATING METHODOLOGY

For Non Banking Finance Companies (NBFCs)

CARE's ratings are an opinion on the relative ability and willingness of an issuer to make timely payments on the specific debt obligations over the life of the instrument, CARE has developed a comprehensive methodology for credit rating of debt instruments issued by NBFCs. Some of the factors considered in CARE's rating analysis are described below:

QUANTITATIVE FACTORS

The starting point in reaching a rating decision is a detailed review of key measures of financial performance and stability:

a) Capital Adequacy

Capital Adequacy Ratio (CAR) is a measure of the degree to which the company's capital is available to absorb possible losses; High CAR indicates the ability of the company to undertake additional business. Debt equity ratio is also examined as a measure of gearing. CARE examines the conformity of the Company to the regulatory guidelines on capital adequacy norms and further examines the capital adequacy on the basis of expected erosion of capital arising as a result of additional provisioning for NPAs etc.

The impact of mark to market gains/losses from investment portfolio on capital adequacy is also examined.

b) Asset Quality

Asset Quality review begins with the examination of the company's credit risk management framework. The overall asset quality is assessed by evaluating the asset class wise exposures. The historical recovery rate of annual demands of principal and interest and the company's experience of loan losses and write-off/provisions are studied. The proportion of assets classified into standard, substandard, doubtful or loss and the track record of recoveries of the company is examined closely. The portfolio diversification and exposure to vulnerable sectors is evaluated to

arrive at the level of weak assets.

c) Resources

Resource base of the NBFC is analyzed in terms of cost and composition. Deposits form an important funding source for many NBFCs. Proportion of deposits /loans/bonds in funding mix is examined. Deposit growth rates and their rollover rates are also analyzed. Average as well as incremental cost of funds is examined in the context of prevailing interest rate regime. Ability of the company to raise additional resources at competitive rates is examined critically.

d) Liquidity

Lack of liquidity can lead an NBFC towards failure, while, strong liquidity can help even an otherwise weak company to remain adequately funded during difficult times. CARE evaluates the internal and external sources of funds to meet the company's requirements. The liquidity risk is evaluated by examining the assets liabilities maturity (ALM) profile, collection efficiency, deposit renewal rates and proportion of liquid assets to total assets. The short term external funding sources in the form of unutilized lines of credit available from banks etc along with directed and other investments if any are important sources of reserve liquidity.

e) Earning Quality

CARE analyzes the composition of income of the company by segregating it into fee based and fund based activities. Core earnings are also identified by excluding non-recurring income from total income. Each business area that contributes to the core earnings is assessed for risks as well as for its earning prospect and growth rate.

Profitable operations are essential for NBFCs to operate as an ongoing concern. Yield on business assets and investments are viewed in conjunction with cost of funds to arrive at the spreads earned by the company. Interest cover is also an useful indicator of the extent of cover over the interest paid by the company. Operating efficiency is examined in terms of expense ratios. Quality of company's earnings is also influenced by the level of interest rate and foreign exchange rate risks that the company is exposed to.

Finally, the overall profitability is examined in terms of, return on Capital employed, return on assets and return on shareholders' fund.

Evaluation of quantitative factors is done, not only of the absolute numbers and ratios, but

their volatility and trends as well. The attempt is to determine core measures of performance. CARE also compares the company's performance on each of the above discussed parameters with its peers. Detailed inter-company analysis is done to determine the relative strengths and weaknesses of the company in its present operating environment and its prospects.

QUALITATIVE FACTORS

Some of the qualitative factors that are deemed critical in the rating process are:

a) Ownership

Ownership pattern and track record of the promoters/group companies is examined. Strong promoters are more likely to provide support to the company in times of crisis.

b) Management quality

The composition of the board, credentials of the CEO and the organisational structure of the company are considered. The company's strategic objectives and initiatives in the context of resources available, its ability to identify opportunities and track record in managing stress situations are taken as indicators of managerial competence. Adequacy of the information systems used by the management is evaluated. CARE focuses on modern practices and systems, degree of computerisation, capabilities of senior management, personnel policies and extent of delegation of powers.

c) Risk Management

The management stance on risk and risk management framework is examined. Credit risk management is evaluated by examining the appraisal, monitoring and recovery systems and prudential lending norms of the company. The company's policy and exposure to interest rate and foreign currency risk is examined. Interest rate risk arises due to differing maturity of assets and liabilities and mismatch between the floating and fixed rate assets and liabilities. Foreign currency risk arises due to difference in currency denomination of assets and liabilities. The derivatives and other risk management products used in the past and implication of these deals are also analysed.

d) Compliance with statutory requirements

CARE examines track record of the company in complying with regulatory requirements of RBI.

e) Accounting Quality

Rating relies heavily on audited data. Policies for income recognition, provisioning and valuation of investments are examined. Suitable adjustments to reported figures are made for consistency of evaluation and meaningful interpretation.

f) Size and Market Presence

The fund base and network of the NBFC may have a bearing on the company's competitive position. In the rapidly changing competitive environment, the niche strategy of smaller companies against the scale advantages of larger players/banks would be carefully examined to understand the business model of each company.

All relevant quantitative and qualitative factors are considered together, as relative weakness in one area of the company's performance may be more than adequately compensated for by strengths elsewhere. However, the weightage assigned to factors are different for short term ratings and long term ratings. The intention of long term ratings is to look over a business cycle and not adjust ratings frequently for what appear to be short term performance aberrations. The quality of the management and the competitiveness of the company are of greater importance in long term rating decisions.

The rating process is ultimately a search for the fundamentals and the probabilities for change in the fundamentals. The assessment of management quality and the company's operating environment are used to interpret current data and to forecast how well the company is positioned for the future. The final rating decision is made by the Rating Committee after a thorough deliberation on the rating report on the company.

HEAD OFFICE - MUMBAI
CREDIT ANALYSIS & RESEARCH LTD
 4th Floor, Godrej Coliseum,
 Somaiya Hospital Road,
 Off Eastern Express Highway,
 Sion (East), Mumbai - 400 022.
 Tel: +91-022- 6754 3456
 email:care@careratings.com
 Website:www.careratings.com

| <u>Regional Offices</u> | <u>Branch Offices</u> |
|--|---|
| Unit No. O-509/C, Spencer Plaza, 5th Floor, No. 769, Anna Salai, Chennai 600 002 Tel: (044) 2849 7812/2849 0811 | 401, Ashoka Scintilla 3-6-520, Himayat Nagar Hyderabad - 500 029 Tel.: (040) – 40102030/31, 91600 04563 |
| 3rd floor, B-47, Inner Circle, Near Plaza Cinema, Connaught Place, New Delhi - 110 001. Tel: +91- 011- 2331 8701/ 2371 6199 Cell: 98117 45677 | Unit No. 8, I floor, Commander's Place No. 6, Raja Ram Mohan Roy Road, Richmond Circle, Bangalore - 560 025. Tel.: (080) - 2211 7140/41, 9886024430 |
| 3rd Floor, Prasad Chambers (Shagun Mall Building), 10A, Shakespeare Sarani, Kolkata - 700 071 Tel: (033)- 2283 1800/ 1803/ 2280 8472 | |
| 32 TITANIUM Prahaladnagar Corporate Road, Satellite, Ahmedabad - 380 015. Tel.: (079) 4026 5656 | |

Disclaimer

CARE's ratings are opinions on credit quality and are not recommendations to sanction, renew, disburse or recall the concerned bank facilities or to buy, sell or hold any security. CARE has based its ratings on information obtained from sources believed by it to be accurate and reliable. CARE does not, however, guarantee the accuracy, adequacy or completeness of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. Most entities whose bank facilities/instruments are rated by CARE have paid a credit rating fee, based on the amount and type of bank facilities/instruments.