

Rating Methodology for Rating of Alternative Investment Fund (AIF)

Background –

SEBI had notified regulations on alternative investment funds (AIFs) in May 2012. AIFs are funds established or incorporated in India for the purpose of pooling in capital from Indian and foreign investors for investing as per a pre-decided policy.

The intent behind the AIF regulations was to create a mechanism where regulatory framework is available for all shades of private pool of capital or investment vehicles so that such funds are channelized in the desired space in a regulated manner. AIF Regulation has replaced the existing SEBI (Venture Capital Funds) Regulations, 1996.

The regulations created three categories of registrations for all private pools of capital.

- **Category-I AIFs** consist of VCFs, Small and Medium Enterprises (SME) funds, infrastructure funds and social venture funds (SVFs).
- **Category-II AIFs** consist of private equity funds, debt funds and
- **Category-III AIFs** are in the nature of domestic hedge fund structures.

The AIF Regulations are an attempt to extend the perimeter of regulation to hitherto unregulated funds, so as to ensure systemic stability, increase market efficiency, encourage formation of new capital and provide investor protection. In light of the above developments, CARE has developed the rating methodology for rating of the AIF schemes. The AIF rating methodology involves comprehensive analyses of sponsor and asset manager's experience and expertise in the respective segments or asset classes they manage, investment-related processes, risk management systems and operations & technology-related parameters. ***Detailed rating methodology for AIF rating is presented below.***

A. Definition and Rating Process

CARE's ratings of alternative investment fund (AIF) schemes are an opinion on the asset selection ability and asset management capabilities in their respective segments. Respective segments mean industry / sub-industry / asset class in which AIF intends to invest (MFI segment, healthcare industry etc.).

What AIF Ratings are not?

These AIF ratings are not a recommendation to purchase, sell or hold a security / fund. Also these ratings do not comment on the prospective performance of the fund with respect to appreciation, volatility of net asset value (NAV), or yield of the fund. The ratings also do not address the fund's ability to meet the payment obligations to the investors.

Rating Process

- The rating process will start on signing of the rating agreement and initial information from the client. The rating team will analyze the information, interact with the client and conduct visits of their offices and branches to evaluate the systems. CARE will also take feedback from the auditors of the client. The rating team would prepare a note for consideration of the Rating Committee. The rating as decided by the committee will be communicated to the client along with the rationale for the same. The rating accepted by the clients will be published.

¹Third party guarantees are not allowed for capital protection oriented schemes as per SEBI guidelines.

Ongoing Review, Monitoring / Surveillance and Withdrawal of Rating

- CARE would review relevant scheme information on an ongoing basis. CARE would rely on information obtained from the AMC and/or from publicly available sources.
- CARE would require quarterly reports from AMC on operational and other parameters and the latest scheme portfolio. In addition a detailed annual review considering the annual accounts of the fund would be undertaken.

B. Detailed Methodology

- **Sponsor Evaluation** – Evaluation of the sponsor of the AIF is one of the key rating factors. Factors considered include sponsor's financial & business strength, commitment of the sponsor towards AIF, experience of the sponsor in the segments in which AIF proposes to invest and management quality of the sponsors.
 - **Financial and Business strength of the sponsor:** The various factors examined would include sponsor's business profile, capitalization and gearing levels, resource raising ability, profitability track record, asset quality and liquidity profile.
 - **Extent of Sponsor's commitment towards fund / scheme:** A higher level of commitment by the sponsor to the fund / scheme would be viewed positively. The commitment of sponsors in terms of funding and level of involvement by sponsors' management in the AIF and business linkages with segments in which AIF proposes to invest would also be taken into consideration.
 - **Experience of the sponsor in the targeted segments:** Track record of the sponsor in the segment in which AIF proposes to invest and its market presence in that particular segment is a key consideration.
 - **Management quality of sponsor:** Qualification and past experience of the top management of the sponsor company would also be carefully evaluated. Sponsor group with record of sound credentials and integrity would be considered positively.
- **AMC Evaluation** – CARE would assess the management of the AMC, in terms of their professional skills and track record in fund management. CARE would also consider the AMC's overall size, organizational structure and general business practices.
 - **Experience in fund management:** Experience of the key staff in fund management in different asset classes, investment strategies, client types, geographies, particular asset class in which scheme proposed to invest and total experience in fund management will be evaluated. Experience of key staff in particular segment in which AIF proposes to invest will also be reviewed.
 - **Size of the overall assets under management:** The size of the AMC in relative to its peers is an indication of the AMC's ability to mobilize funds for investments. CARE would also look at the quantum of funds under management dedicated to a particular segment in which the AIF proposes to invest in.
 - **Organizational structure:** CARE would review the AMC's board of directors and its composition including presence of independent directors, the composition of the AMC's investment committee and the presence and quality of third party vendors such as R&T Agent, Custodian, Valuation Agencies etc. CARE would also consider whether the AMC's investment committee consists of any external members or investor's representative.
 - **Liquidity analysis:** Liquidity analysis of AMC would primarily cover the AMC's ability to cover expenses, sufficiency of cash in hand to meet unexpected contingencies and operating expenses in a period of severe stress. This is particularly important for open-ended schemes as they may face redemption pressure on a regular basis.

²Refer to the section on SEBI guidelines

- **Investments (Portfolio) Related Processes** – CARE would examine the investment process at specific scheme level to assess the various factors that affect the investment decisions taken.
 - **Portfolio selection process** - Robustness of internal appraisal systems to evaluate prospective/existing investments would be looked into. Periodicity of investment committee meetings and access to information and research to support investment decisions are assessed. A sound internal investment research outfit would lend a greater credence compared to investment research that is outsourced.
 - **Investment objectives** – Clearly defined objectives and limits in terms of selection of investment, internally defined exposure limits to limit concentration risk as well as compliance of the regulatory guidelines will be viewed as positives.
 - **Maturity profile of the investments** - Maturity profile of the investments is looked into to ensure that it is in tandem with the tenure of the fund so as the liquidity risk at the time of maturity of the fund is adequately managed. In case an AIF has been recently launched and has no constructed investment portfolio, the maturity profile of the proposed investments would be discussed with the AIF and considered.
 - **Process for reviewing portfolio performance** – Periodicity of analysis of portfolio, performance of fund and methodology used for valuation of illiquid investments would be considered.
 - **Underlying portfolio quality** - CARE would examine the credit rating of the investments made by the AIF to assess the overall average credit quality of the portfolio. CARE would also evaluate the proportion of externally credit rated investment portfolio, the credit rating of such portfolio and direction of rating migrations.
- **Risk Management Systems**
 - **Risk identification and measurement** – CARE would review the AMC's framework for identifying and measuring of the various risks including market, operational, credit and liquidity risks. CARE would review the various risk estimation techniques used by the AMC such as value at risk, scenario analysis, default risk etc. Operational risk assessment includes the 'key man risk', which is to identify the number of key personnel in the AMC, their responsibilities, incentive structure and whether they have invested in AIF.
 - **Risk monitoring and control** – CARE would assess the various processes employed by the AMC to monitor the various risks such as scenario analysis and stress testing, internally defined limits in term of exposure by obligor, geographical region and industry. Once a risk is identified and measured, CARE believes it is important to analyze the levels of acceptable risk to an AMC and the measures taken to mitigate them once those levels of acceptable risk are breached.
- **Operations / Technology**
 - **Internal controls and adequacy of the information systems used by the management:** The quality of back office systems and control systems which ensure segregation of trading and back office operations, compliance with stated policies is important. Adequacy, quality and timeliness of the information systems used by the management, and in-built checks and balances are seen closely. Robustness of the information system is critical for regular portfolio monitoring and monitoring various risks.
 - **Corporate governance and Regulatory compliance:** CARE examines the composition and functioning of the Board as well as various committees of the Board, such as Audit Committee, Risk Management Committee, Investment Committee, and Valuation committee constituted in accordance with SEBI guidelines, Ownership

³Risk factors are discussed in the section on "CARE's Rating Methodology for Capital Protection Schemes".

and Organization Structure, Shareholder Relationship, Disclosure and Transparency, Litigation status, Financial Prudence and Statutory and Regulatory Compliance in assessing the quality of corporate governance.

- **Staffing** – CARE would assess whether the AMC is adequately staffed. CARE would examine whether there are distinct team / department for different activities like front office activities, operations, investment team, risk management etc.
- **Client servicing** – CARE would examine the timeliness and quality of the investor reporting by the AMC.
- **IT resources** – Adequacy of the physical and IT infrastructure is examined from the purview of information storage & data integrity, security, adequacy of physical infrastructure in relation to the size of the entity etc.

C. III] Rating Scale and Definitions

Rating	Definition
CARE AAA (AIF)	The asset selection ability and asset management capabilities in their respective segments for these schemes are expected to be excellent.
CARE AA (AIF)	The asset selection ability and asset management capabilities in their respective segments for these schemes are expected to be good.
CARE A (AIF)	The asset selection ability and asset management capabilities in their respective segments for these schemes are expected to be adequate.
CARE BBB (AIF)	The asset selection ability and asset management capabilities in their respective segments for these schemes are expected to be moderate.
CARE BB (AIF)	The asset selection ability and asset management capabilities in their respective segments for these schemes are expected to be inadequate.
CARE B (AIF)	The asset selection ability and asset management capabilities in their respective segments for these schemes are expected to be poor.
CARE C (AIF)	The asset selection ability and asset management capabilities in their respective segments for these schemes are expected to be very poor.

Modifiers {“+” (plus) / “-”(minus)} can be used with the rating symbols for the categories CARE AA (AIF) to CARE C (AIF). The modifiers reflect the comparative standing within the category.

Disclaimer

CARE’s alternative investment fund rating is not a recommendation to purchase, sell, or hold a security / fund. It neither comments on the current market price, suitability for a particular investor nor on the prospective performance of the fund with respect to appreciation, volatility of net asset value (NAV), or yield of the fund. The ratings do not address the fund’s ability to meet the payment obligations to the investors.

The ratings are based on current information furnished to CARE by the issuer or obtained by CARE from sources it considers 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. CARE does not perform an audit in connection with any rating and may, on certain occasions, rely on. The ratings may be changed, suspended, or withdrawn as a result of changes in, or unavailability of, such information, or based on other circumstances. Funds rated by CARE have paid a rating fee.