CARE Ratings' criteria – Project Stage Entities

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Background:

Project implementation encompasses different types of projects undertaken, e.g., Infrastructure (road, power, port, etc.), Urban infrastructure (irrigation, metro rail, stadium, etc.), and Industrial projects (setting up facilities for manufacturing different goods, viz., cement, fertiliser, consumable food and drink, chemicals, automobiles, etc.). CARE Ratings Limited (CARE Ratings) has developed separate rating methodologies for different types of projects under various sub-sectors of Infrastructure sector as well as for Urban infrastructure projects (refer our website www.careratings.com). This paper explains the aspects generally considered while rating Project-stage companies in the manufacturing sector.

CARE Ratings has a standard methodology for the rating of companies belonging to the manufacturing sector. Furthermore, CARE Ratings has also developed methodologies specific to various industries within the manufacturing sector. For operational companies, the sector-specific methodologies are applicable, which describe various factors that are considered by CARE Ratings while evaluating project-stage manufacturing entities. Although it is not an exhaustive description of all the factors that are considered, this methodology explains some of the key qualitative and quantitative factors that are important for rating such project-stage companies.

The operational cash flows from the projects, post its commissioning, are expected to service its debt obligations. The ratings get constrained due to the inherent risks associated with project execution/construction, funding, and stabilisation among others. Accordingly, the ratings assigned to the project stage entities are generally not placed at the higher end of the rating scale, unless it is a part of a very strong parent/group, for which there is very strong economic incentive and moral obligation to support the project-phase entity.

Rating methodology:

CARE Ratings assesses various risks while conducting credit risk assessment of project stage entities, as mentioned below:

I. Promoter and management risk:

- Financial strength of the promoter group: The promoter group having strong financial and credit profile is viewed positively as it exhibits its capacity to support the project in a timely manner during construction phase as well as during stabilisation stage. The promoter's articulation of providing timely need-based support is duly factored.
- Operational linkage with the promoter: If the project has direct forward or backward linkages with the existing operations of promoter entities, it underscores importance of the project for the promoter entity and is hence considered positively. For analysing this, the strategic importance of the project to its promoter, the level of economic integration and extent of shareholding of the parent are factored.
- Experience of executing similar project in the past: Experience in the similar sector adds to the comfort; however, any unrelated diversification is examined from long-term strategic perspective and support articulated by the promoter group.
- Key management team: Project execution team with relevant sector expertise provides comfort for smooth implementation. CARE Ratings looks into details of key management team.

II. Construction risk:

- Physical status of project: The status of land acquisition, availability of resources like water, power, and arrangements for pollution control are looked into. The construction status and progress are driven by mobilisation of adequate manpower and machinery for the same. Any cost and time overruns are viewed negatively.
- Status of statutory clearances: The availability of necessary statutory clearances or advanced stage of the same is viewed positively. CARE Ratings analyses the preparedness and track record of management in arranging such clearances in the past to assess the risks in the projects at a nascent stage.
- EPC contractor: The relevant track record of contractors and their favourable credit profile provide comfort on timely execution of the project. Also, the presence of fixed-time fixed-price agreements with contractors involved in project execution and availability of performance guarantees/warranties from equipment suppliers are expected to mitigate construction and post implementation risks to a large extent and are thus viewed positively.

III. Financial risk:

- Reasonableness of project cost with respect to benchmarks wherever feasible is taken into consideration. CARE Ratings also relies on techno economic viability reports prepared by third parties, wherever available.
- Extent of financial closure, tie-up of funds: The projects with full or substantial financial closure are viewed positively.
- Visibility with respect to timely infusion of equity: The status of equity already infused and resource raising capability of the promoters to fund required balance equity (including cost overrun, if any) in a timely manner is considered. Sometimes, equity is proposed to be raised through capital market. Due to uncertainties of capital markets, tie up of such equity is viewed with caution till it is raised.
- Project leverage/ proposed funding mix: CARE Ratings looks at the project leverage to assess long-term viability of the project. It is also compared to similar other projects, wherever available. Typically, the projects financed in lower debt to equity mix are viewed positively.
- Project DSCR: CARE Ratings analyses the ability of the projects to generate sufficient operational cash flow to service its debt obligations over the entire tenor of the debt. CARE Ratings considers sensitised debt-service coverage ratios (DSCRs) after factoring negative deviations with respect to various assumptions underlying the project cash inflows and outflows with reference to changes in interest rates, among other things.

IV. Industry risk:

- Demand-supply position: The market or industry data are examined to assess revenue visibility post completion of the project to the extent possible. The nature of the product to be manufactured and extent of competition for the same is analysed.
- Technology: CARE Ratings relies on third-party reports wherever available for technological assessment. A long-standing commercially-proven technology minimises the risk of stabilisation, whereas new technologies which are yet to be commercially proven increase the stabilisation and operating risk of the project.

V. Business risk:

- Location: Geographical location of the project is taken into consideration. Proximity to raw material or market, existing facilities of the promoter group company with which forward or backward linkages are proposed, provides comfort.
- The ability of the company to stabilise operations and generate envisaged realisations / cash flows is considered in the post project implementation period.

VI. Environmental, Social and Governance risk

Over the last few years, Environmental, Social and Governance (ESG) risks have started gaining importance across the globe and are increasingly influencing investment decisions. The companies may have to incur operational or capital costs towards mitigating these risks. CARE Ratings analyses the impact of ESG risks on the credit profile of an entity by assessing the expected impact of these costs on the future earnings/revenue/cash flows of rated entities including project stage entities. The considerations with respect to ESG aspects are an integral part of assessing credit risk and get addressed under various parameters wherever relevant. The importance of each risk may vary from sector to sector.

Environmental risk is factored in the credit risk assessment of polluting sectors wherein the expected cost to be incurred towards mitigants in the form of pollution control certifications, effluent treatment measures, etc. and the impact of those on future cash flows is evaluated. Furthermore, CARE Ratings also analyses the various aspects related to environmental and forest clearance including issues faced in getting such clearances or delays in receipt of such clearances.

Social risk would play out prominently in a labour/manpower intensive service industry like education, hospitality, mining, etc., where social issues like employee policies or customer relationships are important factors. Similarly, governance parameters like transparency, adherence to applicable regulations, public disclosures, and costs towards these objectives form part of the credit risk analysis.

The rating process is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. The rating, however, does not factor any force majeure events that may lead to cash flow mismatches. The rating determination is a matter of experience and holistic judgement of the Rating Committee, based on the relevant quantitative and qualitative factors affecting the credit quality of the issuer.

[For previous version please refer 'Rating Methodology – Project Stage Companies" issued in January 2021**]**

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About:

CareEdge is a knowledge-based analytical group that aims to provide superior insights based on technology, data analytics and detailed research. CARE Ratings Ltd, the parent company in the group, is one of the leading credit rating agencies in India. Established in 1993, it has a credible track record of rating companies across multiple sectors and has played a pivotal role in developing the corporate debt market in India. The wholly-owned subsidiaries of CARE Ratings are (I) CARE Advisory, Research & Training Ltd, which offers customised advisory services, credible business research and analytical services (II) CARE Risk Solutions Private Ltd, which provides risk management solutions.