CARE Ratings' criteria for rating of Short-Term Instruments

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Background

CARE Ratings Limited (CARE Ratings) assigns ratings on a short-term rating scale for instruments and facilities with original maturity of upto one year. The short-term ratings are usually mapped to the long-term ratings in conjunction with evaluation of liquidity profile of the issuers which entails analysis of working capital management, variations in the working capital cycle and adequacy of internal accruals for meeting the short-term financial obligations. The long-term fundamental credit quality assessment by CARE Ratings essentially consists of analysing the operational and financial characteristics of the entity being rated. Besides quantitative factors, qualitative aspects like assessment of management capabilities play a very important role in arriving at the rating for an instrument. The relative importance of qualitative and quantitative components of the analysis varies with the type of entity. Rating determination is a matter of experienced and holistic judgment, based on the relevant quantitative and qualitative factors impacting the credit quality of the entity.

Rating criteria for short-term instruments:

CARE Ratings' approach for rating a short-term debt instrument is similar to the one followed for assessing credit risk for long-term instruments. Though the time horizon of a short-term instrument is up to one year, the time horizon for arriving at the rating normally extends beyond this period since the attempt is to arrive at the ratings which do not change frequently.

Assessing liquidity and financial flexibility of the entity gains more prominence while arriving at the short-term ratings apart from its basic fundamental credit analysis.

- **Liquidity:**
  Analysing liquidity is crucial for arriving at the short-term rating. This involves analysing the cash flows, working capital management, and examining the availability of any unencumbered liquid investments or unutilised committed lines of credit from banks. The entity's cash flows are examined to assess the liquid sources for repaying debt maturing in the short term. The assumptions underlying the cash flow projections are analysed to make a realistic assessment of short-term liquidity. Examination of asset-liability maturity (ALM) profile across various maturity buckets becomes important for assessing the liquidity position of companies in the financial sector. Within financial sector entities, the banks usually command superior liquidity profile attributable to better access to capital and money markets including financing options from the Reserve Bank of India (RBI), such as repo and liquidity adjustment facility. Please also refer to CARE Ratings' criteria on Liquidity Analysis of Non-financial Sector entities as well as the section on Liquidity Ratios under the criteria for Financial Ratios – Non-financial/ Financial/ Insurance sectors on our website www.careratings.com for more insights on this aspect.

- **Financial flexibility:**

  Financial flexibility refers to alternative sources of liquidity available to the entity as and when required. While low level of leverage provides basic flexibility to raise additional borrowings, alternative sources of liquidity can be:

  a) General line of credit from strong parent or group company.
  b) Strong group profile which could implicitly mean the possibility of group support in times of stress. It may be noted that high levels of pledged shareholding of promoters could, however, affect the entity's financial flexibility, and may even affect its own liquidity position and ability to raise fresh funds.
  c) Back-up lines of credit from banks, etc. Short-term debt issued in the form of commercial paper (CP) is often carved out of the working capital limits of the entity thus implicitly creating back-up liquidity facilities. Though this type of arrangement reduces the chances of default in repayment of CP, it does not fully eliminate it. Inability or unwillingness of the bank to restore the limits or shortfall in drawing power could lead to inadequacy of back-up liquidity at the time of CP maturity. The extent of utilisation of working capital facilities and likely variation in drawing power is hence studied in detail to assess the nature of cushion available.
  d) Implementing large projects usually involves periods of strain on the entity's liquidity position. CARE Ratings analyses factors like financial closure, stage of the project, draw-down schedule of funds and the various milestones of implementation of capital expenditure programme. In this context, flexibility to defer capital expenditure or implement project in phases eases the strain on liquidity of the entity and thus provides comfort in terms of financial flexibility.

Short-term – Long-term mapping framework:

Even though short-term factors may tend to skew the short-term rating, the long-term credit quality assumes a pervasive role in determining short-term ratings. An entity with favourable long-term fundamentals will find it much easier to fulfil its short-term commitments on account of its strong operating cash flows and its ability to leverage upon its strengths to refinance, if required. This implicitly establishes a link between long-term and short-term ratings. Moreover, many of the short-term instruments tend to get 'rolled over', and though short term by design, they virtually behave like long-term instruments. In the eventuality of the entity facing difficulties to rollover the short-term instrument, it may have to leverage its long-term rating to get funds in the absence of any other short-term funding sources. Thus, an entity's long-term credit quality cannot be ignored while assigning short-term ratings.

Although the short-term ratings are correlated to the long-term ratings, the assessment of an entity's liquidity provides some flexibility in determining the mapping of a given long-term rating into the short-term scale. Essentially, the long-term ratings have a wider scale, while short-term rating scale is much shorter due to which there may not be a one-to-one mapping between the two scales. Moreover, the mapping considered for the financial sector entities may be different from that for entities in the non-financial sectors, chiefly due to better liquidity and easier access to funds by the former. CARE Ratings may differ from its general mapping framework (refer table below) if it has reasons to attribute a superior or an inferior short-term credit quality and accordingly assign a higher or lower short-term rating based on evaluation of present and envisaged liquidity position of the issuers.

CARE Ratings' indicative mapping of short-term ratings to long-term ratings: -

Long-term ratings^	Corresponding Short-term rating^ mapping (indicative)								
	A1+	A1	A2+	A2	A3+	A3	A4+	A4	D
AAA									
AA+									
AA									
AA-									
A+									
A									
A-									
BBB+									
BBB									
BBB-									
BB+									
BB									
BB-									
B+									
B									
B-									
C									
D									

^'CARE' Prefix to be used with rating symbols.

Note: Indicative mapping with 'teal colour' background in the above table reflects mapping generally used by CARE Ratings, while indicative mapping in 'grey colour' background shows certain situations arising from superior liquidity-related aspects for the issuer.

[For previous version please refer to "Criteria for Short Term Instruments" issued in February 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.