

Rating Methodology for Rating of Mutual Fund- Infrastructure Debt Funds (MF-IDF)

[In supersession of earlier “Rating Methodology –[MF-IDF](#)”]

Definition and Rating Process

CARE’s ratings of infrastructure debt fund schemes through mutual fund route (IDF-MF) are an opinion on the asset selection ability and asset management capabilities in infrastructure sector for these schemes.

What IDF Mutual Fund Ratings are not?

This IDF Mutual fund scheme rating is not a recommendation to purchase, sell or hold a security. 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 rating also does not address the funds’ ability to meet the payment obligations to the investors. This rating is different from the credit ratings assigned by CARE to debt instruments and bank facilities of corporate entities.

Rating Process

The rating process will start on execution of the rating agreement and receipt of 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.

CARE reserves the right to suspend, withdraw, revise or reaffirm the rating at any time based upon any new event or information or on unavailability of information or any other circumstances, which CARE believes may impact the rating. CARE shall also be entitled to publicize/disseminate such suspension/withdrawal/ revision/ reaffirmation of the rating in any manner considered appropriate by CARE.

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 specifying the latest scheme portfolio. In addition a detailed annual review considering the annual accounts of the fund would be undertaken.

Detailed Methodology

A] Sponsor evaluation: Evaluation of the sponsor of the IDF is one of the key rating factors. The experience of the sponsor in the financial sector and infrastructure space in particular and its financial profile are key determinants in ascertaining the sponsor strength.

- **Experience of the sponsor in the infrastructure sector and financial sector:** The past performance of the sponsor in the financial sector in general and infrastructure space in particular, is of key significance. The sponsors' participation in the sector could be in different roles primarily as sponsor for various infrastructure projects, as financier of infrastructure projects/companies, project debt syndication, projects advisory role, maintenance operation of various infrastructure projects etc. In cases where the promoters have acted as financiers for the infrastructure companies/projects, their asset quality is likely to be an indicator of their project selection capabilities and ability to appraise infrastructure projects. In cases where the promoters/sponsor of the mutual funds have acted as sponsor of infrastructure projects then the performance of the special purpose vehicles is likely to be an indicator of the project execution and implementation capabilities. It would also help in evaluation of the sponsors' abilities to make timely/successful exits from the projects. Track record of the promoters, directly or through its subsidiaries, across the various stages of project development right from conceptualization, funding to maintenance /operations of projects is considered favourably as participation across the various stages is expected to enhance their understanding of the key risks in the infrastructure projects at different stages of the project life cycle. This would also be an indication of the ability of the sponsor to turnaround the infrastructure projects conceptualized/managed by them and make timely and successful exits.
- **Extent of Sponsors commitment in the fund:** A higher level of commitment by the sponsor to the fund would be viewed positively.
- **Financial Strength:** The various factors analysed under 'Financial Strength' would include the profitability track record, asset quality, liquidity profile, financial flexibility, capitalisation and gearing levels of the sponsor.
- **Management quality:** 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.

B] Evaluation of the Asset Management Company: CARE believes that the management of the AMC serves as a catalyst for establishing the future trajectory of the fund and therefore a critical variable in assessment. The investment by IDF requires thorough understanding of several processes involved in implementation of the infrastructure Projects (e.g. Environment clearance, land acquisition, regulatory regime etc., to name a few). Given the above intricacies, the

management of investment in infrastructure projects is critical from the perspective of investors. Key factors which are examined to assess asset manager's effectiveness include:

- **Management skills in the infrastructure segment:** Management's past track record in managing/executing projects in the infrastructure space across various segments like roads, ports, power etc. would be an added advantage as it is expected to help in prudent selection and management of investments. Senior management's track record, if any, in turning around and monetizing troubled exposures would assume significance on account of the intricacies involved in operation of long gestation infrastructure projects and the rising weakness observed in the performance of assets in the sector.
- **Fund Management skills of the Asset Management Company:** The experience and expertise of the fund management team are useful aspects in gauging the probability of achieving the debt fund's investment goals and observance to stated policies. Due diligence exercised in selection of the fund managers is also looked into. Performance with regard to returns in various schemes managed by the asset management company or by the group in the past is also examined as it could serve as an indicator of the asset selection and management skills within the group or fund.
- **Evaluation of the Risk evaluation policies and processes:** Through the investment and risk management policy, the Board lays down the broad framework within which the investment committee and fund managers prudently conduct the investment activities. CARE examines various quantitative and qualitative parameters incorporated in the investment and risk management policy. The various areas to be assessed include:
 - **Processes & criteria for selection of projects:** Robustness of Internal appraisal systems to evaluate prospective/existing projects would be looked into. Adequacy of processes for ongoing monitoring of the investments/projects would also be examined.
 - **Risk mitigation structures:** CARE would also examine the policies and measures on various credit risk mitigation techniques incorporated in the investment proposals such as: Minimum level of security cover in respect of debt instruments/loan exposures, Controlling stake in the project SPVs either directly or through companies in the group, credit risk mitigation structures like credit enhancements, corporate guarantees etc. Presence of credit risk mitigant clauses in project-specific agreements, such as any guaranteed payments on project termination, annuity structures etc. Investment valuation methodology, frequency of valuations and presence of Stop loss Limits would also be evaluated. The independence of risk management function would also be carefully examined.

Operational & Regulatory Factors

- **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 and compliance with stated policies are important. Adequacy of the information systems used by the management, quality and timeliness of the information made available to the managers and built in checks and balances are evaluated. 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 such as Audit Committee, Risk Management Committee, Investment Committee, Valuation committee in accordance with SEBI guidelines, Ownership and Organization Structure, Shareholder Relationship, Disclosure and Transparency, Litigation status, Financial Prudence and Statutory and Regulatory Compliance are useful for assessing the quality of corporate governance.
- **Physical & IT Infrastructure:** 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] Portfolio Quality

- **Investment composition framework** in terms of investments in revenue generating operational projects and projects yet to achieve COD, form and extent of investment – equity (listed/ unlisted), debt (senior, subordinated), policy on take-out finance from banks, extent of liquid investments and borrowing lines from bank, policy on investments in securitized debt instruments and policy on rating wise composition of the loan portfolio.
- **Concentration risk:** Diversification results in reduction in risk concentration on particular projects/sectors/issuers. SEBI has laid down certain broad guidelines providing for the various investment options and maximum project exposure limits. CARE would look into the investment policy to examine the internally defined exposure limits as well as to the compliance of the regulatory guidelines. Diversification in the asset book acts as credit positive for the rating of an IDF as its increases the resilience of the asset book in the scenario of a particular project facing adversities.
- **Maturity profile of the investments:** Maturity profile of the investments is also looked into to evaluate if it is in tandem with the tenure of the fund to ensure that liquidity risk at the time of maturity of the fund is adequately managed.

- Relative average credit quality of the investments within infrastructure sector:** CARE would examine the credit rating of the investments made by the debt fund and compare it with the universe of rated infrastructure entities in similar sector to assess the overall relative average credit quality of the scheme’s investments in infrastructure sector. CARE would also evaluate the proportion of externally credit rated investment portfolio. Rating migration towards lower rating bands is likely to be an indication of weakness in the asset book. CARE would also analyze these migrations by comparing them with industry performance.

Infrastructure Debt Fund Schemes – Rating Symbols and Definitions Rating Definition

Rating	Definition
CARE AAA (MF-IDF)	The asset selection ability and asset management capabilities in infrastructure sector for these schemes are expected to be excellent.
CARE AA (MF-IDF)	The asset selection ability and asset management capabilities in infrastructure sector for these schemes are expected to be good.
CARE A (MF-IDF)	The asset selection ability and asset management capabilities in infrastructure sector for these schemes are expected to be adequate.
CARE BBB (MF-IDF)	The asset selection ability and asset management capabilities in infrastructure sector for these schemes are expected to be moderate.
CARE BB (MF-IDF)	The asset selection ability and asset management capabilities in infrastructure sector for these schemes are expected to be inadequate.
CARE B (MF-IDF)	The asset selection ability and asset management capabilities in infrastructure sector for these schemes are expected to be poor.
CARE C (MF-IDF)	The asset selection ability and asset management capabilities in infrastructure sector for these schemes are expected to be very poor.

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

[Reviewed in January 2020, next review due in January 2021]

Disclaimer
<p>CARE’s infrastructure debt 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 funds 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 occasion, rely on unaudited information. 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.</p>