Rating Methodology – Infrastructure Investment Trusts (InvITs)

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Overview:

India is a developing country and in order to get back on a higher and firmer growth trajectory in the years to come, availability and existence of modern infrastructure becomes essential. Infrastructure sector has a significant role because of its multiplier effect on overall economy. Also, infrastructure projects are capital intensive and with long gestation period, require long-term capital and India suffers from a severe shortage of long-term capital. In India, infrastructure has limited funding options and traditionally financing has been met through bank finance with tenure of 10 to 15 years. In this backdrop, Union Budget in February 2014 introduced Infrastructure Investment Trusts (InvITs) in India, and subsequently in September 2014, SEBI had notified InvIT regulations. InvITs provide long-term capital and unlock developer's capital, which can be deployed for further growth.

InvITs are similar to mutual funds; they utilize the pooled capital of investors to buy and manage income-generating infrastructure assets such as roads, transmission towers, wind, solar, ports, airports, telecom, etc. InvITs are permitted to issue units (equivalent to equity) that are listed and traded on the bourses. Public InvITs invest not less than 80% of the value of InvIT assets in revenue-generating infrastructure assets. InvITs must distribute not less than 90% of the net distributable cash flows to the unit holders. The aggregate consolidated borrowings and deferred payments of the InvIT, net of cash and cash equivalents is restricted to 70% of the value of the InvIT assets. However, private InvITs (i.e., not listed on the bourses) are exempt from restrictions on leverage and mandatory distribution. If leverage exceeds 25% of the value of the InvIT assets, InvIT requires a credit rating from an accredited credit rating agency like CARE Ratings. Furthermore, if the leverage is beyond 49%, InvIT requires a credit rating of "AAA" or equivalent for its consolidated borrowing and the proposed borrowing exceeding 49%, from a credit rating agency. So also, InvIT must have a track record of minimum six distributions on a continuous basis and capital released will be used in acquiring infrastructure assets.

Scope:

The rating of consolidated debt of InvIT is an opinion on the capacity of InvIT to repay its debt in a timely manner. The rating neither signifies the returns to unit holders nor does it signify any potential yield levels to the unit holders, and thereby should not be construed as a rating of InvIT's units. It is also not an indicator of the credit quality of individual assets which are part of the InvIT's portfolio. The ratings neither predict a specific level or range of performance of an InvIT (measured in terms of the net asset value or otherwise) over any given time period nor do they opine on the suitability or otherwise of an InvIT for investment or any other purposes. Finally, it is to be noted that InvIT rating is not a measure on the adequacy of market value or address the extent to which trust expenses and costs may reduce distributions to unit holders.

Salient Features of InvITs (listed)

Particulars	Description
Entity style	Trust under Indian Trusts Act 1882
Underlying asset type	Majority operational
Lock-in period for sponsors and strategic investors	Three years for minimum of 15% stake and 1 year for holding exceeding 15% One-year lock-in for strategic investor
Shareholding by the sponsors	15% collectively as sponsors on a post issue basis for not less than three years
Aggregate consolidated borrowings and deferred payments net of cash and cash equivalents	Cap at 49% of the asset's valuation Cap at 70% of the assets valuation (AAA rated entities and track record of six distributions on a continuous basis)
Distribution	At least 90% of the net distributable cash flow
Frequency of dividend distribution	Minimum of once in a half year for public InvITs/ once in a year for privately placed InvITs
Investments	Listed/unlisted debt of companies in infrastructure sector, government securities, money market instruments, liquid mutual funds, equity share of companies which derive not less than 80% of their operating income from infrastructure sector
Requirement of credit rating	Consolidated borrowings and deferred payments net of cash exceeds 25% of the assets value

Source: SEBI

Other important features of listed InvITs:

I. The InvITs are to hold controlling interest and not less than 51% of the equity share capital or interest in the special purpose vehicles (SPVs) except in case of PPP projects, where acquiring or holding is disallowed by government or under any provisions of the concession agreement.

II. InvITs are allowed to invest in two-level structure through holding company (holdco) wherein the holdco holds controlling interest, and not less than 51% of the equity share capital or interest in underlying SPVs such that the ultimate holding interest of the InvIT in the underlying SPVs is not less than 26%.

III. InvITs shall have the right to appoint majority of the board of directors in the underlying SPVs.

IV. Mandatory sponsor holding of not less than 15% of the total units of the InvIT after initial offer on a post-issue basis for at least three years.

V. Mandatory distribution of at least 90% of the net distributable cash flows by SPVs and 100% of the net distributable cash flows by holdco to the InvIT.

VI. The pass through is provided in respect of income by way of interest received by the InvITs from SPV, i.e., there is no taxation of such interest income in the hands of the trust and no withholding tax at the level of the SPV. However, interest income received by non-resident unit holders attracts 5% of tax, and for the resident unit holders, it attracts 10% of tax.

VII. The dividend received by the trust is exempt from dividend distribution tax at the level of SPV if InvIT holds 100% stake in the SPV and is exempt in the hands of the trust, and the dividend component of the income distributed by the trust to the unit holders is also exempt.

VIII. All related party transactions must be on an arm's length basis

IX. A full valuation shall be conducted by the valuer not less than once in every financial year and within two months from the end of the financial year and no valuer shall undertake valuation of the same project for more than four years consecutively.

X. A half-yearly valuation of the assets of the InvIT shall be conducted by the valuer for the half-year ending September 30, for a publicly offered InvIT for incorporating any key changes in the previous six months and such half-yearly valuation report shall be prepared within one month from the date of end of such half year.

Responsibilities of the investment manager as listed under SEBI guidelines

I. The investment manager must make the investment decisions with respect to the underlying assets or projects of the InvIT including any further investment or divestment of the assets.

II. The investment manager must oversee activities of the project manager with respect to revenue streams from the projects and the project management agreement and must obtain compliance certificate from the project manager on a quarterly basis.

III. The investment manager must ensure that the infrastructure assets of the InvIT or the SPV have proper legal titles, if applicable, and that all the material contracts are legal, valid, binding and enforceable.

IV. The investment manager has to appoint the valuers, auditor, registrar and transfer agent, merchant banker, custodian and any other intermediary or service provider or agent as may be applicable with respect to activities pertaining to the InvIT in a timely manner.

V. The investment manager must ensure that the valuation of the InvIT assets is done by the valuers in accordance with regulations.

VI. The investment manager has to ensure that the computation and declaration of NAV of the InvIT based on the valuation done by the valuer (shall be disclosed to the stock exchanges) not later than fifteen days from the date of valuation.

VII. The investment manager must declare distributions to the unit holders in accordance with regulations.

VIII. The investment manager must submit to the trustee: -

a. quarterly reports on the activities of the InvIT including receipts for all funds received by it and for all payments made, compliance with regulations, performance report, status of development of under-construction projects, within thirty days of end of such quarter;

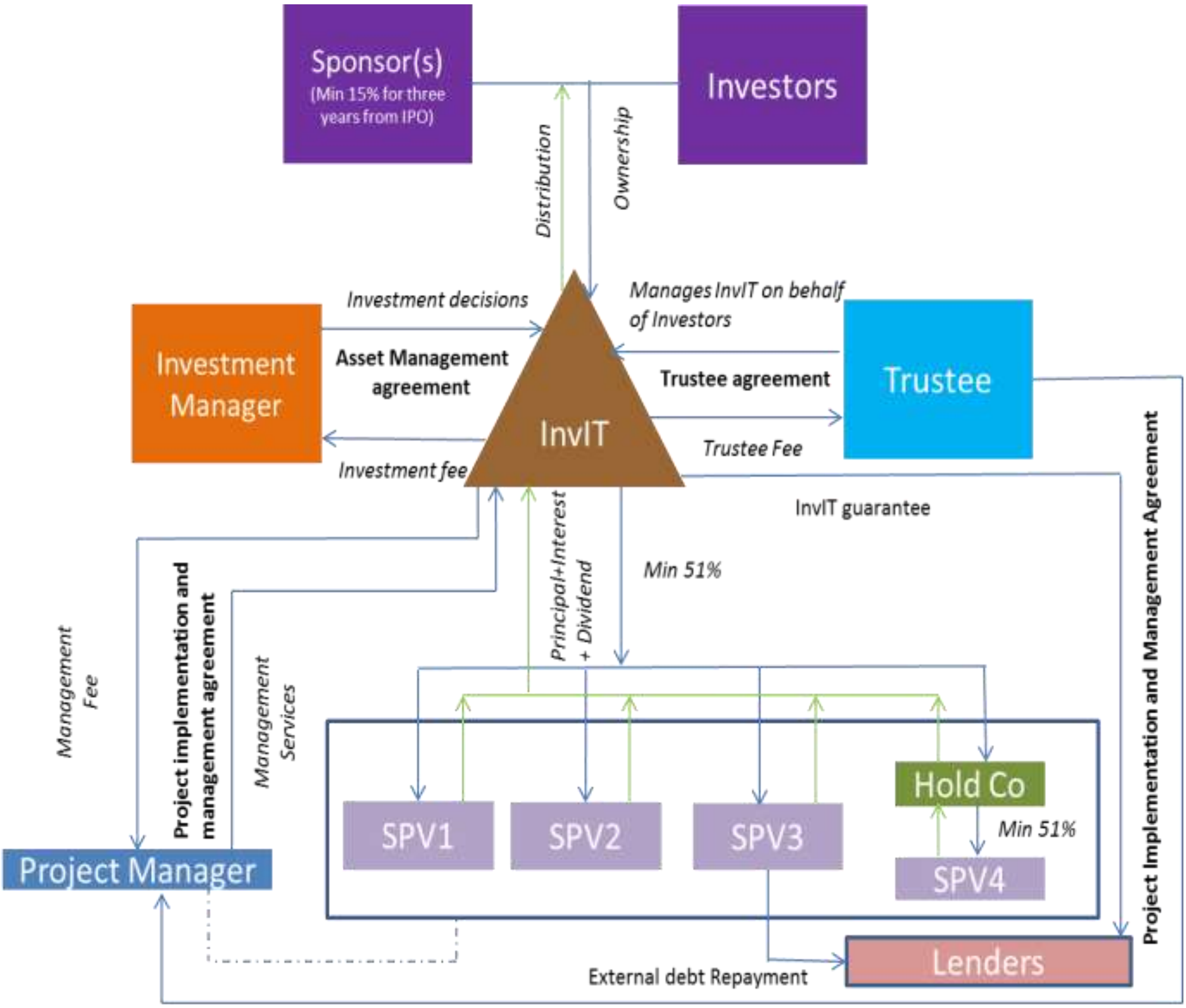
b. valuation reports within fifteen days of the receipt of the valuation report from the valuer;

c. reports on investment decisions to acquire or sell or develop or bid for any asset or project or expand existing completed assets or projects along with rationale for the same;

d. details of any action which requires approval from the unit holders; and

e. details of any other material fact including change in its directors, change in its shareholding, any legal proceedings that may have a significant bearing on the activity of the InvIT, within seven working days of such action.

Typical structure of InvIT



Source: CARE Ratings

Rating Methodology

Credit rating of borrowings of InvIT involves evaluation of broadly three key rating factors: (a) credit quality of portfolio of assets (b) financial risk and (c) management risk.

Credit quality of portfolio of assets:

The most important driver of the InvIT's credit rating is the credit quality of the assets it owns. CARE recognizes that the entire cash flow which is available to the InvIT to service its debt (that of both holdco and the SPVs) is to be generated by its investments in infrastructure assets. Accordingly, the credit risk associated with these cash flows is best assessed at the individual asset level. Therefore, the credit quality of the individual assets in the portfolio would be the most important driver of the InvIT's credit rating. The credit quality of the portfolio of assets is assessed using the sector-specific criteria applicable to the entity. Homogeneous assets (assets in same sector) under InvIT will be assessed based on applicable sector-specific criteria after pooling of cash flows. However, if there are any restrictions with respect to fungibility of cash flows of any SPV, the same will be excluded from pooling of cash flows. For heterogeneous assets, each SPV will be assessed separately using sector-specific criteria which are available on our website www.careratings.com . For example, toll roads housed under InvIT will be assessed using Rating methodology – Toll Road Projects and transmission assets housed under InvIT will be assessed using Rating methodology – Power Transmission Projects. Similarly, for solar, wind, ports and airports respective sector-specific criteria will be used to assess credit quality of assets.

InvIT ratings are derived from the cash flows of the underlying assets. The ratings consider the risks that infrastructure projects housed under InvIT are generally expected to face, including stresses to revenues due to the effects of macroeconomic cycles, short-term external shocks, and likely renegotiation of contracts (Power Purchase Agreements), operating and cost stresses. Credit quality of portfolio of assets would be assessed based on predictability of revenues from its contracts with counterparties, proportion of revenue generating assets compared to under-construction assets, diversification in terms of geographical and counterparties. The ratings under the InvITs criteria and related-sector criteria do not cover fundamental change of law or change of regulations; fundamental changes in demand due to the disruptive technology or otherwise; or extreme events, such as terrorism, the long-term effects of global warming, or the collateral consequences of extreme events. The analytical process often includes reviews of third-party reports, including studies prepared to assess design, technology, maintenance costs and demand risks or forecast availability of important resources for, e.g., traffic studies for toll roads. Though they may form a basis for reaching reasonable conclusions about the relevant risks, such studies have inherent limitations in methodology and actual outcomes can vary significantly from forecast.

CARE would be reviewing the rating whenever a new significant asset is added or divested from the portfolio. The rating will normally correspond to the current portfolio of assets and any new additions or deletions will be treated as events triggering a rating review. However, CARE may include known prospective investments in its analysis. CARE expects the InvIT's stated investment philosophy will endure over a relatively long period of time and that there is a high likelihood that the fund maintains a given credit quality over time. Any new acquisitions would be separately evaluated by CARE after/at the time of acquisition, and if it denotes a deviation from the stated investment policy, the asset acquisition may impact the InvIT's credit quality.

Financial risk:

Financial risk of InvITs is assessed based on debt service protection metrics, stability of cash flows, overall leverage of InvIT, its headroom for further debt raising and liquidity reserves. InvIT regulations allow InvITs to raise debt at InvIT level or the SPV level. If InvIT has entire external debt at InvIT level, debt protection metrics at InvIT level will be looked at. In case, debt is raised at SPVs, CARE evaluates debt service coverage ratio at the SPVs as well as InvIT level and CARE also evaluates extent of distress/need-based support to any weaker SPVs. Analysis also includes definition of distributable cash flows to investors and liquidity reserves available as a cushion to manage cash flow mismatches. Since InvIT distributes minimum of 90% of net distributable cash flows, liquidity buffers such as debt service reserve, major maintenance reserve provides cushion against cash flow mismatches. Lower overall gearing is seen positively for toll roads, whereas for annuity and transmission projects with stable & predictable cash flow with longer repayment period tend to mitigate the high gearing to an extent, provided the counterparty making annuity payments is strong. Accordingly, availability-based projects can sustain on the lower debt service coverage ratio given the certainty attached to the cash flows of the project. Furthermore, the foreign exchange variation risk is also assessed in case of un-hedged foreign currency exposure. CARE adjusts interest rate assumptions in the financial model throughout the life of the debt to evaluate the impact of changes in interest rates. Further, debt structure, tail period, refinancing risk and financial flexibility of InvIT are also assessed.

Management risk:

The experience of investment manager and project manager is reviewed based on their track record of performing similar tasks in the past, as well as in terms of adherence to the standards of corporate governance. It is also noted that the experience of the project manager and investment managers may be considered as a key driver for the individual rating of under implementation projects which are in the portfolio. CARE would also consider the investment strategy detailed in the offer document. CARE will also ensure that its assumptions appropriately confirm to the specifics, if any, of the investment strategy, such as minimum cash holding or a voluntary debt ceiling. Moreover, CARE takes cognizance of the level of support provided by sponsor to the InvIT. Support could be by way of infusion of equity or sourcing of credit. Strong sponsor will have higher financial flexibility to refinance existing debt facilities and attract equity investments from private equity players, pension funds, etc.

Conclusion:

InvIT is a vehicle to invest in the infrastructure assets. InvITs are governed by SEBI guidelines. Listed InvITs are governed by stringent regulations. Guidelines have been revised over a period to attract interest of investors and recently not listed private InvITs have been exempted from restriction on leverage, mandatory distribution, etc. The rating outcome is ultimately an assessment of credit quality of portfolio of assets housed under InvIT, stability of cash flows and debt protection metrics, refinancing risk, financial flexibility and management risk.

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