Criteria for Short Term Instruments

[In supersession of "Short Term Instruments" issued in March 2020]

Background:

The framework of CARE's rating methodology essentially consists of analyzing 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's 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 ratings which do not change frequently.

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

- **Liquidity:**

  Analyzing liquidity is crucial for arriving at the short term rating. This involves analyzing the cash flows, working capital management and examining the availability of any unencumbered liquid investments or unutilized lines of credit from banks. The entity's cash-flows are examined to assess the liquid sources for repaying short term debt. The assumptions underlying the cash flow projections are analyzed to make a realistic assessment of short term liquidity. Examination of asset-liability maturity (ALM) profile becomes important for assessing the liquidity position of companies in the financial

sector. Please refer to CARE's criteria on Liquidity Analysis of Non-financial Sector entities 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. Extent of utilization 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 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 Link:

Even though weighed by short term factors which may tend to skew the short term rating, the long term credit quality assumes a pervasive role in determining such short term ratings. An entity with favorable long term fundamentals will find it much easier to fulfill 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 not being able 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.

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