Brickwork Ratings General Criteria

Scope of Criteria

The criteria document identifies and briefly addresses some of the specific factors considered by Brickwork Ratings (BWR) in analysing the credit profile of entities. Credit rating criteria enable analysts to analyse and interpret information using a consistent approach. Ratings are subjective credit opinions based on various qualitative and quantitative risk factors that companies are exposed to. The scope of this document is to capture the key risks assessed by BWR while arriving at the rating of an entity. These attributes are mainly business- and industry- related factors in which the entity operates, which help ascertain the debt servicing capability, as against cash flow generation. The key risks that companies may face are industry, business, financial and management risks. These primary risks and the way in which they are incorporated in the rating framework are discussed in detail below.

Distinguishing Companies by Business Classification:

At BWR, we have broadly classified debt issuer segments as follows:

1. Manufacturing Sector
2. Services/ Trading Entities
3. Financial Sector
4. Infrastructure Sector
5. Government and Local Bodies

Within each of the segments, there could be further classifications. For example: Financial Sector may include Banks, NBFCs, Financial Institutions, Micro-Finance Institutions, Insurance companies and Mutual Funds.

Distinguishing between Issuer and Issue Ratings

BWR assigns two types of credit ratings, one to issuers and the other to specific debt issues or other financial obligations. The first type is called 'Brickwork's Counterparty Credit Rating'. These ratings are not specific to any instrument and do not reflect any priority or preference among obligations. It is a current opinion of an issuer's overall creditworthiness. This opinion focuses on the issuer's ability and willingness to meet its financial commitments on a timely basis, even in adverse conditions. This is also an indicator of an entity's fundamental creditworthiness.

Credit ratings are also assigned to specific issues and are called Issue ratings; these refer to financial commitments towards a specific issue of an entity and its willingness to pay those specific obligations. Issue-specific rating is a forward-looking opinion of an entity's overall debt servicing capacity to meet its debt obligations in a timely manner. In fact, the vast majority of credit ratings pertain to specific debt issues. Junior debt may be rated below the counterparty credit rating, while well-secured debt can be rated above. It provides additional comfort to investors that the obligation would be honoured by an additional external collateral, guarantee or insurance.

Distinguishing between Long- and Short-term Ratings

Long-term ratings are forward-looking credit opinions over a longer period, designed to remain stable over the course of normal business cycles and valid till the tenor of the debt instrument, whichever is earlier. They range from 'BWR AAA' for the highest quality obligations to 'BWR D' for the lowest. Ratings from 'BWR AA' to 'BWR C' may be modified by the addition of a plus or minus sign to distinguish the relative credit standing within the major rating categories.

Short-term ratings evaluate the likelihood of a borrower's timely repayment of obligations considered short-term in relevant markets. It measures the ability of an organisation to pay-off any obligation with an original maturity of one year or less, money market instruments such as Commercial Paper (CP) and bank facilities such as short-term loans, Bank Guarantees (BGs), Letters of Credit (LCs), packing credit and bill discounting. They range from 'BWR A1' for the highest quality obligations to 'BWR A4' for the lowest, and the details can be seen in Rating Scale. BWR uses modifier '+' from A1 to A4.

BWR assesses the issuer's long-term credit profile, arrives at the long-term rating and maps the short-term ratings with the long-term rating. The short-term rating so arrived at, among other variables, factors in the analysis of the company's liquidity profile and financial flexibility. Typically, short-term ratings are linked to long-term ratings, and the rating mapping is available in BWR's short-term debt criteria. However, based on the type of entities being rated, their liquidity profiles and available credit enhancement, BWR may assign a different rating from the typically suggested mapping.

Distinguishing between Solicited Vs Unsolicited Ratings

The major distinction between an unsolicited and a solicited rating is that the latter is requested and is therefore, paid for by the rated firm, while the former is neither of the two. Consequently, unsolicited ratings are based on publicly available information only and are also based on internal research on the industry and peer group.

The credit rating symbol for an unsolicited rating is accompanied by the word UNSOLICITED in bold letters to differentiate the same from solicited ratings.

Common Thread Across Ratings

At BWR, a common thread for rating all Issuers or Issues, Long-term or Short-term, Solicited or Unsolicited, and Individual or a Pool of Assets, consists of broad factors, including Business Risk, Industry Risk, Management Risk and Financial Risk. Each of these broad risk factors will have a list of parameters, and these parameters may be different for different types of segments.

In this document, the broad risk factors are discussed, and the discussion on parameters is included in the segment-wise criteria.

- **Business Risk**

  Business risk focuses on the entity's ability to sustain its business and generate consistent cash flow over the long run. This includes risks related to the environment that the entity operates in, which affect its turnover, margins, position within the industry and operational efficiencies, along with the relation between the client and suppliers or buyers. Each credit rating analysis begins with an assessment of the company's business environment in which the entity operates. To determine the degree of operating risk, the factors assessed include prospects for growth, stability or decline in its operations and the pattern of business cycles, technological change, labour unrest, and the impact of government regulations. Industries that have long lead times in building production capacity or that require fixed plants of a specialised nature face heightened risk. The implications of increasing competition are obviously crucial.

  Generally, the company has diversification in terms of products and geographical locations, which is looked at favourably as it helps minimise the demand–supply gap and any economic issue. Irrespective of the size, scale, or number of years of experience in the industry, every organisation faces risks right from the start of the project to its completion. These risks are mainly associated with factors specific to the sector that the entity operates in. For example, a real estate entity faces cyclicality risks due to the close linkages of the sector with the economy. These risks can hamper an entity's profitability, in addition to affecting its expansion plans. These include risks related to the environment that the entity operates in, which affect its turnover, margins, position within the industry and operational efficiencies.

  BWR assesses the multiple business segments that an entity functions in. An entity present in multiple segments would likely be rated higher than an entity focusing on one product line on account of expected higher ability to sustain economic shocks. That said, the capex plans of the management and adequacy of resources for tying-up the same are crucial factors while evaluation.

Additionally, the risks associated with different processes for diversified products are factored in the assessment.

Generally, companies enter long-term contracts with suppliers, as well as with buyers, to enjoy benefits such as better prices and constant raw material/commodity supply. Depending on market conditions, such agreements may or may not be favourable to companies.

BWR analyses the customer and supplier concentration risk arising out of dependence on a limited number of customers or suppliers, or the company having to rely on spot purchases to cater to its customer commitments, exposing it to the price volatility risk. Reliance on a few customers or suppliers for the sales and purchase of raw material, respectively, also limits the company's bargaining power.

BWR assesses the stability and sustainability of the business. BWR assesses the ability of an entity to correctly identify, measure and minimise such risks. Furthermore, to keep an organisation running, it is imperative to have stability in revenues and expected cash flows. These cash flows also take care of the organisation's fixed interest obligations. BWR assesses the revenue generation capability of entities by analysing their market position and scale of operation, level of competition and relation with customers, among others.

A stronger market position gives an entity bargaining power among its suppliers and customers. BWR assesses in detail factors such as market reputation, brand recognition, and demand and supply scenario, contributing to a market position that would help an entity profitably sell its products. Invariably, the size of the entity plays an important role while assessing its market share.

- **Industry Risk**

  The purpose of an industry analysis is to understand the conditions in which a business operates and the changes - cyclical, competitive, and technological - that it is likely to experience. Most industries exhibit some degree of cyclical volatility, and some industries are exposed to seasonal variances too. Such volatility affects a company's operating performance and financial condition. Technological changes and new competitors, or substitute products can also affect performance.

  Industry risk is identified by factors such as demographic presence, presence in the highly competitive markets, capital-intensive nature of industry, and barriers to entry. Furthermore, industry risks involve factors that are external to an organisation, such as changes in government policies and markets. BWR assesses the nature of industry, state and central government support, and regulatory risk. The operations of some entities are affected by the general economic and political environment. Anxiety among the general public about the economic scenario can further lead to decline in demand for an entity's services.

  BWR identifies the relative position of an entity in comparison with its peers. Such an industry analysis helps analyse the ability of an organisation to identify the threats and opportunities it is faced with and take appropriate measures to use it to its full advantage. Apart from the above-mentioned factors, BWR assesses the impact of technological challenges, resource availability, demand-supply scenario, price trends, product substitution availability, the investment plans of the major players in the industry, industry-wide financial position, gross margins and the availability of substitutes, to arrive at rating for the entity.

- **Management Risk**

  The importance of management competency and integrity cannot be overstated. The ability of a commercial entity's managers to guide it, utilise opportunities, develop and execute plans and react to market changes is extremely important to its financial well-being. The unexpected loss of one or two key employees can be detrimental to a company, particularly a small or mid-size firm. BWR considers the company's corporate governance while assessing management risk.

  A strong, dedicated and highly experienced board of directors helps the organisation achieve its profitability and operating efficiency targets and helps improve the company's financial and liquidity position. BWR assesses the consistency of performance demonstrated by the management, and the quality of corporate governance adopted by the entity as also the performance of other group concerns. Red flags, if any, highlighted by internal or external stakeholders, would negatively reflect in the rating. The financial flexibility of the management, tested by the empirical evidence of successfully supporting the group companies/manufacturing units, past track record of successfully running manufacturing units, and quality of corporate governance practices followed by the entity are factored in while assessing the company's overall credit profile.

- **Financial Risk**

  The balance sheet, income statement, sources and uses of funds/cash flow statement, and financial projections provide essential information about the company's initial and ongoing repayment capacity. The quantitative analysis of revenues, profit margins, income and cash flow, leverage, liquidity and capitalisation are other factors that may affect borrower performance. Financial risk is portrayed largely through quantitative means, particularly by using financial ratios.

  BWR assesses a company's financial risk through the evaluation of the previous, current and projected future financials, particularly the availability of cash flow and debt servicing capability. BWR also carries out sensitivity analysis on some of the key variables to assess the impact on their financials. For a more detailed description of ratios, the reader may refer to BWR's approach to Financial Ratios. Financial accounting policies, especially those related to inventory, and liquidity analysis are additional characteristics considered for rated entities. Liquidity analysis is an integral part of the company's assessment, which identifies its liquidity availability in the form of unencumbered liquid investment, cash available with the company and the utilisation of bank limits as against meeting its short-term debt servicing obligations. Unutilised banking limits or low utilisation of the banking limits is viewed favourably from a credit perspective and provides an additional liquidity buffer with the company, in case need arises. While higher funds from operations denote a stronger debt servicing ability, the cash flow from operations indicates an entity's ability to efficiently manage its suppliers and debtors. Keeping in mind the stability of revenue generation, leverage ratios help ascertain the level of debt held by entities to gauge their ability to pay-off their interest and principal debt obligations and their track record of debt servicing. These ratios aim to measure important credit, liquidity, market and operational risks, which vary from one industry to another. Furthermore, they help identify trends in the business so that appropriate managerial action can be taken. The presence of various macroeconomic forces, changes in interest and exchange rates and default in payments further exacerbate such risks.

- **Analysis of Projections**

  While current and historical information is necessary to establish a company's current position and financial track record, projections estimate the expected performance.

Parent/Group Support

A rating of a subsidiary, or an affiliate that is controlled by a dominant shareholder, involves the examination of its parent company's credit quality, which could enhance or detract from the subsidiary or affiliate's stand-alone rating.

It may be noted that ratings are generally assigned based on best available information and BWR's professional judgment regarding certain expectations and assumptions about entity-specific factors and business environment that impact the entity's performance. Hence, in addition to applying the general rating criteria stated above, changes in the business and economic environment and their impact on the rated entity would also be considered, on a case-to-case basis, while assigning the ratings.

Conclusion

BWR's overall credit assessment entails the comprehensive analyses of the entity's financial, industry, operational and business risks. The assessment also includes the entity's management quality, track record, financial flexibility, parent/group support and corporate governance practices. BWR analyses an entity by assessing the impact of each of the above-mentioned risks and attributes to arrive at the overall assessment of a company's credit quality. While the general methodology comprises the comprehensive analyses of various risks associated with the regulatory aspects; financial, industry, operational and business risk; and the market position, the final rating is assigned based on the entity's overall credit assessment and applicable industry-specific criteria as available on BWR's website.

The criteria will be generally reviewed once in three years, and as and when necessary. All the revised criteria are disclosed on the BWR website with the hyperlink to the original criteria (before revision).

The previous version of this document can be found in
www.brickworkratings.com/download/Criteria-GeneralCriteria.pdf

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