

## Rating Criteria for Infrastructure Sector

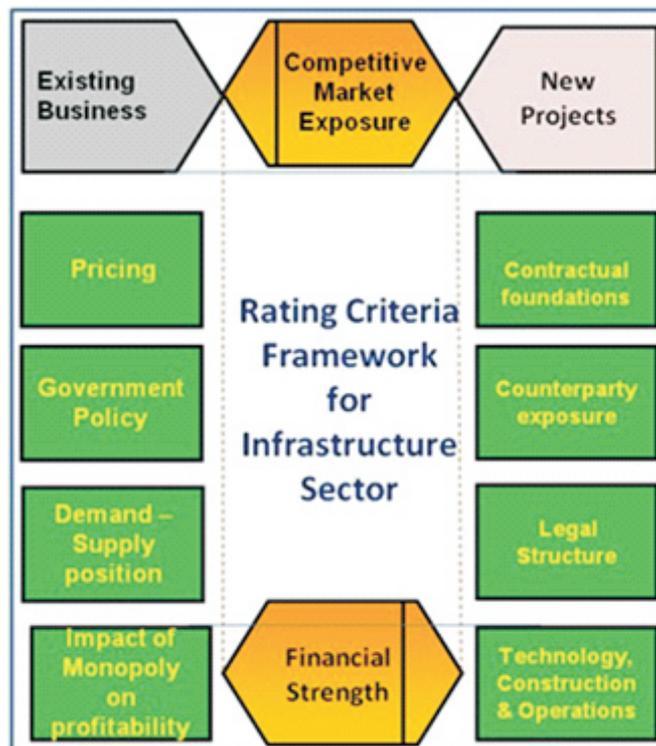
The term 'Infrastructure' (as defined by GOI) typically refers to the technical structures that support a society, such as Roads & Bridges, Energy (Power, Oil & Gas), Utilities including water supply, Transportation (Rail, Road & Sea), Social Infrastructure (Municipalities and Local bodies) Telecommunications, Mining, Ports – Air & Sea and so forth.

The companies engaged in the infrastructure sector include:

- a) Belonging to private sector or Government related entities.
- b) Already engaged in the operations of the implemented projects or may be in the process of implementing or the combination of both.

The revenue streams are expected over a longer-term as compared to other companies as some infrastructure projects normally take a longer period for implementation / gestation.

Brickwork considers the following framework for Rating Infrastructure companies.



## Pricing

It may be observed that the pricing of goods & services in the infrastructure sector are quite often regulated by government in the form of tariffs. However, within the infrastructure sector, different segments adopt different practices. The highly regulated tariff regimes could be witnessed in the areas of Oil & Natural Gas, Aviation, Water Sewerage services, etc. Brickwork considers such government interventions as both positive and negative. On the one hand, it is positive because regulators determine financial returns favourably for infrastructure companies in order to balance the interest of consumer and the company. On the other hand, it is negative in view of the absence of pricing flexibility.

## Government Policy

Brickwork classifies the Infrastructure companies in three broad categories:

- a) Public-policy-based institutions, which play a central role in meeting political and economic objectives.
- b) Commercial enterprises, which play a smaller or no public policy role.
- c) Commercial enterprises that include corporate or financial institution that are likely to receive extraordinary government assistance.

The assessment of an entity is a function of the level of influences of the government policies for the independent functioning of the entity. The government influences come in the form of direct & indirect taxes, funding support, providing government guarantees, etc.

## Demand and Supply Position

Unlike other sectors, the infrastructure sector has a favourable demand and supply position. In other words, the demand outstrips the supply in most of the cases. Brickwork considers this phenomenon as favourable in the short to medium term.

## Impact of Monopoly on Profitability

The monopoly position helps companies to generate more profits and at the same time the government interventions by way of having social, political and economic objectives will make entities inefficient.

## Contractual Foundation

The contractual foundation covers the whole range of relevant Project Agreements (which exclude the finance agreements and other documents that set out the financial structure). Summary of such agreements are considered to assess the benefits and risks.

## Competitive Market Exposure

An evaluation of how a project would perform when faced with competitive market exposure is important for all projects, not only those that currently face market risks. The analysis of a project's competitive market position may consider factors below as applicable:

- Industry fundamentals
- Commodity price risk
- Supply and cost risk
- Foreign exchange exposure
- Project's source of competitive advantage
- Potential for new entrants, disruptive technologies, or exiters

## **Counterparty Exposure**

Assessment of the soundness and legality of the contractual framework needs to be supplemented by an assessment of the ability and the willingness of the contracting parties to fulfil their obligations. The willingness of counterparties to perform might stem from economic incentives, business relationships, market position, reputation, ownership, and relationship with government, rather than from contractual arrangements.

## **Technology, Construction and Operations**

The choice of technology and construction risk present significant concerns to project finance financiers / investors. Brickwork considers the technical and operational evaluation of project finance transactions.

## **Financial Strength**

One of the most visible and quantifiable measures of project risk is the sufficiency of cash flow to cover obligations. The companies must generate adequate revenues to cover principal and interest payments after meeting mandatory charges such as operations and maintenance expenses, nonrecurring items, capital replacement expenditures, and taxes. The company cash flows must be able to contend with risks such as interest rate fluctuations, inflation risk, liquidity risk, and in some cases funding risks and foreign exchange fluctuations. Fundamentally, the key financial issue is a company's ability to generate adequate cash flow to cover its debt obligations.

## **Legal Risk**

Because of the non-recourse, single-asset nature of project financing, the legal structure of the project needs to provide comfort to the financiers / investors.

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### **Disclaimer:**

*It must be clearly understood that a Rating opinion is based on various factors/aspects which includes application of certain Rating criteria. The particular criteria applied depends on a number of factors, inter alia, sector/Industry, historical performance, cyclical trends, prevailing economic condition, group support etc. Rating opinions factor many assumptions and the application of any particular criteria or a set of criteria may be full or partial depending upon peculiarity of each case. Application of any Rating criteria should not therefore be considered as rendering finality or completeness to a Rating assessment. A reference to criteria needs to be perceived in broad terms, only as an aid to a rating decision.*