Rating Criteria for Infrastructure Debt Funds under Mutual Funds Scheme

Executive Summary

Infrastructure forms the backbone of an economy, playing a key role in providing connectivity, employment and education. The quality of infrastructure dictates the extent of development in a country. Infrastructure projects by their nature are long-term and returns on the same can be seen only after they have been in operation for a few years. Companies in the infrastructure sector have a long gestation period and are highly capital-intensive in nature. Their revenue streams are expected over a longer term as compared to other sectors as infrastructure projects normally have a higher gestation period and longer project life.

Given the strategic importance of the sector, there is a need for adequate and timely financing to bolster the development of infrastructure projects in the country. The Government of India and Reserve Bank of India (RBI) have undertaken various measures to improve infrastructure financing in India. However, a vast demand-supply gap still remains to be bridged. In light of the same, Infrastructure Debt Funds (IDFs) have been introduced through Public-Private Partnerships (PPPs) in the sector to provide an impetus to these projects and ease the funding process.

IDFs are investment vehicles that can be created in the form of a mutual fund or NBFC for channelizing investment into the infrastructure sector. An IDF in the form of a mutual fund is regulated by the Securities and Exchange Board of India (SEBI), whereas an IDF-NBFC is governed by the RBI. According to the RBI, IDFs essentially serve as vehicles for refinancing the existing debt of infrastructure companies, creating fresh headroom for banks to lend to fresh infrastructure projects.

Brickwork Ratings (BWR) assigns ratings to IDFs on the long-term rating scale. The rating is followed by an "idf mfs" suffix to indicate that the ratings have been assigned to IDFs. It should be noted that a rating assigned to an IDF is not indicative of the probability of default of the fund; it is indicative of the credit quality of the fund considering the underlying portfolio, management and sponsorship of the fund. At no time should the rating assigned by BWR be construed as an advice to buy, sell or hold the instrument.

The Asset Management Company (AMC) of the fund manages the funds of various IDF schemes in accordance with SEBI guidelines. Some characteristics of IDFs are as follows:

- These are close-ended mutual funds with a focus on long-term infrastructure debt.
- They require a minimum investment of Rs. 1 Cr with a face value of Rs. 10 lakh/unit.

- The maturity period is usually up to 5 years with the option of structuring for longer tenures.

Scope of the Criteria

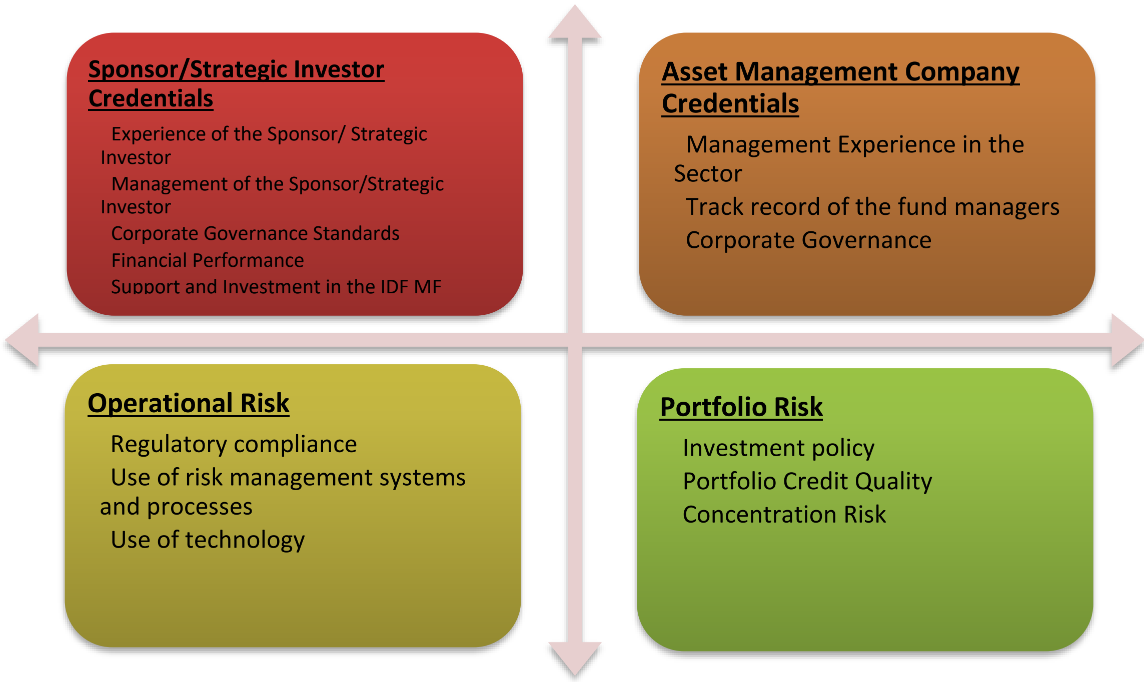
The document is an assessment of the qualitative and quantitative parameters considered by BWR to arrive at the rating of an IDF-MF. These parameters range from the assessment of the track record and expertise of sponsors to the effectiveness of AMC, as well as the ability to identify the right investments and measure the risks involved in each project.

Risk Assessment and Rating Criteria for Rating Infrastructure Debt Funds

BWR's rating criteria for f IDFs captures four main parameters:

a) Sponsor Credentials
b) Asset Management Company Credentials
c) Operational Risk
d) Portfolio Risk

The criteria are captured in the figure below:



Sponsor Credentials

Sponsors with relevant experience in the infrastructure sector help an IDF identify the right investments and successfully achieve its objectives. An IDF could have more than one sponsor; multiple sponsors using their knowledge and experience in the sector add to the strength of the fund. The sponsors' participation in the sector could be in different roles, primarily as a sponsor for various infrastructure projects or financier of infrastructure projects/companies, or in project debt syndication, project's advisory role and maintenance operations of various infrastructure projects, among others.

IDF-MF schemes can be launched by either an existing mutual fund or as a separate mutual fund that only caters to the infrastructure segment. For an existing MF, the presence of strategic investors becomes essential to launch such schemes. Strategic investors may be SI-NBFCs/ infrastructure finance companies registered with the RBI, scheduled commercial banks or international multilateral financial institutions, FIIs or as defined by SEBI regulations from time to time. In cases wherein the IDF MF is launched as a new mutual fund, the track record of the sponsor with respect to the sector, experience of the management in financing and tracking the sector will be inputs used while assigning a rating. In the case of existing MFs that launch IDFs, the presence of strategic investors, their contribution towards the corpus of the fund and their experience in the sector will be considered.

BWR assesses the financial strength of a sponsor by analysing a healthy track record of profitability ratios, asset quality, liquidity profile, financial flexibility and gearing levels as an indicator of the sponsor's financial strength. Sponsors having the insight and required skills and abilities to identify critical factors responsible for driving the success of infrastructure projects are viewed positively. Strong sponsor credentials not only help identify attractive investment opportunities, but also help eliminate projects that may result in financial stress in the future.

Asset Management Company Credentials

The management of the AMC serves as a critical variable in assessing an IDF. The management of the AMC will influence the overall investment policy and processes. Investments in the infrastructure sector require specialised knowledge of project finance and management. The track record of the fund managers in the management of specialised IDFs and adherence to governance standards is considered in the rating process.

Key parameters in assessing the management's effectiveness include the following:

- **Past Track Record and Experience:** The past track record of the management in carrying out projects in the infrastructure sector is seen as a positive as it helps in the prudent selection and identification of vulnerable projects in terms of the expected gestation period, location-related intricacies and access to funding. Usually, a highly experienced AMC management team is viewed positively.
- **Fund Management Skills:** An asset manager possessing the requisite skills in fund selection so as to realise the fund's investment goals is critically assessed by BWR. The management of specialised IDFs within the group adds to the fund management skills. Various past scheme returns are also being assessed to identify the management skills and asset selection of the group or fund.
- **Fund Manager Background:** Fund managers with knowledge of day-to-day movements in financial markets and the general economic scenario are seen positively and help in the identification of profitable projects. Fund managers must do a thorough analysis of companies by assessing their financial statements and making the same available to the general public to engage new and existing customers. It is a responsibility of the fund managers to provide people with appropriate financial recommendations, which helps them make investment decisions.
- **Risk Mitigation Procedures:** The presence of internal appraisal systems to evaluate projects and techniques to mitigate the various credit risks involved in each project is assessed by BWR. Such techniques related to the minimum level of security cover as against loan/debt exposure, controlling stake of promoters in the SPV, credit enhancement in the form of corporate guarantee, agreements, investment valuation and its frequency and stop loss arrangements, among others, help assess the risk management policies of the AMC. Risk mitigant clauses to prevent payment defaults at the time of contract termination are also critically assessed.

Operational Risk

BWR assesses the issuing company's operational efficiency through a thorough analysis of the systems and processes followed in risk management and mitigation, compliance with regulatory requirements and the use of technology in carrying out operations. Separate front and back offices, a well-established organisation structure to avoid any conflict of interest and a provision for the adequate training of personnel further indicates a superior operational efficiency. The broad parameters to assess operational risk are as follows:

- **Regulatory Compliance:** The presence of committees performing audit, investments, valuation, risk management, litigation and various other statutory and legal functions is useful to assess the degree of corporate governance practices followed.
- **Comprehensive Information System:** A robust control system ensures and plays an important role for the smooth monitoring of portfolios, security, storage and data integrity, and various risks. Data being the most precious asset of any organisation, it is imperative to have adequate IT infrastructure to ensure its security.
- **Internal Controls:** The quality of internal controls being assessed thoroughly at BWR, such as the segregation of front-office and back-office operations and compliance followed, and the robustness of the process followed by the management.

Portfolio Risk

The underlying credit quality of the portfolio, including counterparty credit risk, risk of concentration due to exposure in one of the specific segment or borrowers in the infrastructure space, investment policies and adherence to the same, recovery prospects due to the structuring of the instruments invested in influence the rating assigned to the IDF. Further, maturity of investment in instruments should match the final maturity of the funds or scheme. BWR assesses the following parameters to gauge portfolio risk:

- **Diversification of Portfolio:** A well-diversified portfolio of projects helps reduce reliance on specific projects or sectors. Therefore, even if one sector is exposed to certain macro risks, due to its diversified investment in other sectors, the credit quality of the portfolio remains either unaffected or is affected to a limited extent.
- **Liquidity Risk:** The degree of liquidity risk can be ascertained by comparing the maturity profile of the portfolio with the maturity profile of the IDF investments.
- **Counterparty Risk:** At the time of assessment of the credit quality of the IDF, it is imperative to look into the counterparty risk that it is exposed to, emanating from credit default swaps, interest rate futures and swaps, account bank for cash deposits and so on. Mitigation of counterparty risk requires a strong track record of key counterparties.
- **Industry risk associated with Investment in Infrastructure projects:** Companies in the infrastructure sector have a long gestation period and are highly capital-intensive in nature. Their revenue streams are expected over a longer term as compared to other sectors, as infrastructure projects normally have a higher gestation period and longer project life. Since the sector is capital-intensive and has a long gestation period, it is imperative for the entity to have sustained cash flows over a longer term, and access to capital markets and banks for funding. The risk of investment in these assets is being assessed separately for entities engaged in greenfield or brown field projects.
- **Assessment and validity of Investment policy:** BWR considers the investment policies and processes that are in place at the AMC/investment strategies for the schemes. Internal documentation as well as detailed discussions allow BWR to understand how aligned the

investment process is with regard to the stated investment objective of the scheme such as Investment Policies, Operational policies and procedures, Risk Management Policies and Systems in place as well as internal and external audits.

- **Environmental Risk:** BWR assesses the environmental risk and economic prevailing conditions such as Covid pandemic, where debts in which investments are done may require restructuring/rescheduling by the lender/investors and may have benefit of force majeure and change in law, the corresponding rescheduling of maturity date to MF investors will lead to credit quality dilution of fund.

Periodic Review of the Portfolio:

BWR reviews and monitors ratings assigned on an on-going basis. In cases where there is a change in the portfolio, the credit quality is evaluated and discussed with the investment team at the AMC. In the case of changes in the management, policies and processes, among others, BWR will consider the effect of the same on the rating assigned and may revise the assigned ratings.

IDF Rating Scale at Brickwork Ratings

The IDF rating scale is similar to the long-term rating scale used by Brickwork Ratings for rating the debt funds of mutual funds. The "idf mfs" suffix is added to indicate that the fund rated is an infrastructure debt fund.

BWR AAAidf mfs	Schemes with this rating are considered to have **the highest degree** of safety regarding the timely receipt of payments from the investments that they have made.
BWR AAidf mfs	Schemes with this rating are considered to have a **high degree** of safety regarding the timely receipt of payments from the investments that they have made.
BWR Aidf mfs	Schemes with this rating are considered to have an **adequate degree** of safety regarding the timely receipt of payments from the investments that they have made.
BWR BBBidf mfs	Schemes with this rating are considered to have a **moderate degree** of safety regarding the timely receipt of payments from the investments that they have made.
BWR BBidf mfs	Schemes with this rating are considered to have a **moderate risk** of safety regarding the timely receipt of payments from the investments that they have made.
BWR Bidf mfs	Schemes with this rating are considered to have a **high risk** of safety regarding the timely receipt of payments from the investments that they have made.
BWR Cidf mfs	Schemes with this rating are considered to have a **very high risk** of safety regarding the timely receipt of payments from the investments that they have made.

Modifier {"+" (plus) / "-"(minus)} can be used with the rating symbols for the categories AAidf mfs to Cidf mfs. The modifiers reflect comparative standing within the category.

Conclusion

BWR analyses each parameter after measuring the impact of the aforementioned risks and attributes, along with the credentials of the AMC's management and investment portfolio, to arrive at the overall credit assessment of the IDF-MF. Due to the capital-intensive nature of infrastructure projects, emphasis is laid on the AMC's investment portfolio, along with the investors' maturity profile. While the methodology comprises a comprehensive analysis of various risks associated with the regulatory aspects, investment risk, portfolio risk and operational risk, the final rating is assigned based on the overall credit quality of the fund, considering the underlying portfolio of investment, management and sponsorship of the fund.

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

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