Rating Criteria for Market / Equity Linked Debentures

Executive Summary

Principal Protected Market / Equity Linked Debentures (PPMLDs) constitute debt instruments whose returns are generally linked to market indices and specific entity stocks, etc. The terms of such instruments usually include a promise from the issuer to pay back the face value /principal on the instrument at maturity subject to the issuer's credit risk profile. However, the return/coupon on these instruments is not fixed and are normally linked to external market indicators such as equity share price, an equity index or the movement of an index, volatility of the stock, the interest rate or commodity prices to capture the market upside. Structures of these bonds are fixed initially at the time of issue, along with initial and final redemption dates. The performance and valuation of underlying assets is tracked regularly/periodically. The coupon is determined at the time of redemption, based on the performance of the initial and final levels of underlying assets. The complexity of the structures varies depending on the instrument, appetite of the investors and returns associated with it. Various option pricing models are used. In essence, the investor has recourse to the issuer's credit profile (depending on the credit quality of the issuer) and the assets acting as collateral (such as equity shares), thus providing a dual recourse. However, return on debentures may vary based on the performance of the external market indicators/ benchmarks, which is linked with return as compared to a traditional bond and is normally predefined. The main benefit of PPMLDs is that even if the index to which the instruments are linked provide low or negative returns, the initial capital remains protected. These debentures are specifically designed for risk neutral investors who want to participate in the upside of equity markets, without the fear of losing out on the initial capital.

In PPMLD bonds which are linked to specific stocks, the risk emanates from the borrower's credit profile (measured through evaluation of industry, business, financial, liquidity and management risks), the credit risk of the underlying securities for the transaction (such as equity shares), legal risk in terms of robustness of transaction and market risk. Therefore, the evaluation of PPMLD transactions requires a rating framework different from that for traditional debt instruments. This criteria document covers the rating methodology adopted by Brickwork Ratings (BWR).

Scope of the Criteria:

This document provides an assessment of the risks considered by BWR while arriving at the rating of Market/ Equity Linked Debentures. The overall rating assigned is indicative of the credit quality of the issuer, performance of the external market indicator/benchmark to which the returns are linked, and various aforementioned risks associated with it.

Risk Assessment and Rating Methodology:

BWR considers the following attributes and risks to assess the credit profile of Market/Equity Linked Debentures. While some of these attributes are market specific, others assess the credentials of the issuer and management quality.

Broadly, the factors assessed by BWR are as follows:

- Credit Risk
- Legal Risk
- Market Risk
- Management Risk

Credit Risk

An issuer's ratings and credit quality have a direct implication on the ratings of the debentures. Although the payoff depends on the market conditions, PPMLDs are ultimately debentures carrying a certain credit risk associated with the issuer's credit profile. These debentures are mostly issued by corporates/NBFCs. The credit risk of a corporate entity is broadly assessed through the evaluation of industry, business, financial, liquidity and management risks. In case of NBFCs, an issuer's financial health is assessed through metrics such as capitalisation, asset quality, liquidity, and collection efficiency, track record of performance and ability to raise funds in a timely manner.
Further, the issuer's liquidity position is an important parameter, where the issuer's ALM profile is assessed to understand the entity's long- and short-term liquidity management mechanism. MLDs do not allow premature exits and all benefits are subject to the investment being held till the redemption/maturity date. The principal amount invested is usually locked in for a period of two to three years which exposes investors to a high degree of liquidity risk. Therefore, investors must be prepared to hold onto their investments till the end of the maturity period.

Legal Risk

From a legal standpoint, the legitimacy of the issue of debentures is an important risk factor to be considered. As part of its rating process, BWR studies relevant transaction-related legal documents and assesses legal risks from the perspective of robustness of enforcement of the structure. BWR obtains opinion from an internal legal expert to confirm that the recourse mechanism can be achieved through the transaction structure.

Market Risk

In addition to the risks inherent to the transaction structure, there are external risks that could elevate risk in the transaction. Payment of coupons on debentures is contingent upon a certain underlying market condition or volatility of pre-defined indicators/benchmarks such as the Nifty 50 index or government securities (10-year G-sec). Macroeconomic risks can impact the performance of specific asset classes and lead to a downgrade in the performance of underlying securities. A highly volatile market scenario that is highly dependent on the economic, market and political conditions makes these securities a risky investment which is appropriately factored in the ratings assigned by BWR. PPMLDs are specifically designed for risk neutral investors who want to participate in the upside of equity markets, without any fear of losing out on the initial capital and who are expected to take an informed decision, after considering the risks associated with the instruments.

Macroeconomic risks: The state of the economy or of specific sectors and their impact on the performance of the issuer and on the linked returns is incorporated in various scenarios such as no/low return on debentures at the time of bearish market conditions.

Event risk: The occurrence of unforeseen events, failure of the system, political interference, change in laws and regulatory frameworks that can further exacerbate the risk of transactions in market/equity linked bonds and thus impact the existing rating of PPMLDs.

Management Risk

A strong, dedicated and highly experienced board of directors, along with competent promoters possessing a strong market experience helps the issuing entity instil investor confidence and helps improve the entity's financial and liquidity position. BWR assesses the overall track record of the management and the quality of corporate governance adopted by the issuer as well as the performance of other group concerns. Red flags, if any, highlighted by internal or external stakeholders, would negatively reflect in the rating.

Rating Scale

In the case of Principal Protected Market Linked Debentures (PPMLDs), BWR prefixes such ratings with the symbol "PP-MLD". As per SEBI guidelines on PPMLD dated 15 June 2011 and 28 September 2011, credit rating agencies shall prefix 'PP-MLD', followed by standardised rating symbols while assigning ratings for long and short-term PPMLD issues.

These instruments are rated as per the scale given below.

Long-term debt instruments - instruments with original maturity exceeding one year

BWR PP-MLD AAA	Instruments with this rating are considered to have the highest degree of safety regarding the timely servicing of financial obligations. Such instruments carry the lowest credit risk.
BWR PP-MLD AA	Instruments with this rating are considered to have a high degree of safety regarding the timely servicing of financial obligations. Such instruments carry very low credit risk.
BWR PP-MLD A	Instruments with this rating are considered to have an adequate degree of safety regarding the timely servicing of financial obligations. Such instruments carry a low credit risk.
BWR PP-MLD BBB	Instruments with this rating are considered to have a moderate degree of safety regarding the timely servicing of financial obligations. Such instruments carry moderate credit risk.
BWR PP-MLD BB	Instruments with this rating are considered to have a moderate risk of default regarding the timely servicing of financial obligations.
BWR PP-MLD B	Instruments with this rating are considered to have a high risk of default regarding the timely servicing of financial obligations.
BWR PP-MLD C	Instruments with this rating are considered to have a very high risk of default regarding the timely servicing of financial obligations.
BWR PP-MLD D	Instruments with this rating are in default or are expected to be in default soon.

Modifier {"+" (plus) / "-"(minus)} can be used with the rating symbols for the categories BWR PP-MLD AA to BWR PP-MLD C to reflect comparative standing within the category.

BWR assigns a rating "outlook" for ratings from 'AAA' to 'B'. The rating outlook indicates the direction a rating is likely to move in over a period of time and may be classified as Positive, Stable or Negative.

Short term debt instruments- instruments with original maturity of/up to one year

BWR PP-MLD A1	Instruments with this rating are considered to have a very strong degree of safety regarding the timely payment of financial obligations. Such instruments carry the lowest credit risk.
BWR PP-MLD A2	Instruments with this rating are considered to have a strong degree of safety regarding the timely payment of financial obligations. Such instruments a carry low credit risk.
BWR PP-MLD A3	Instruments with this rating are considered to have a moderate degree of safety regarding the timely payment of financial obligations. Such instruments carry a higher credit risk as compared to instruments rated in the two higher categories.
BWR PP-MLD A4	Instruments with this rating are considered to have a minimal degree of safety regarding the timely payment of financial obligations. Such instruments carry a very high credit risk and are susceptible to default.
BWR PP-MLD D	Instruments with this rating are in default or expected to be in default on maturity.

Modifier {"+" (plus)} can be used with the rating symbols for the categories BWR PP-MLD A1 to A4. The modifier reflects comparative standing within the category. The mapping of long to short-term ratings has been explained elsewhere in the criteria.

Conclusion

BWR arrives at the final rating after factoring in the aforementioned risks and attributes. Although these securities are relatively safer from the perspective of principal protection, significant emphasis is laid on the credit risk related to the issuing entity. PPMLDs issued by an entity with a high rating are seen positively. The parameters mentioned do not constitute the entire framework for the rating process and in fact, are to be considered as a basic approach for understanding the issuer's credit quality.

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

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