This methodology note stands superseded and is now subsumed under the applicable methodology notes for the corporate, public finance and financial sectors. Readers may refer to ICRA's website www.icra.in to view the above methodology notes.

ISSUER RATING—A NOTE ON METHODOLOGY

Introduction

ICRA's recently launched service of Issuer Ratings seeks to provide an opinion on the fundamental creditworthiness of the rated entities in relation to their senior unsecured[1] obligations. An ICRA Issuer Rating focuses on the rated issuer's ability and willingness to meet its financial commitments in general as and when they arise, and is not specific to any particular obligation. In launching this service, ICRA has been prompted by the increasing need among market participants to have an informed and objective opinion on the fundamental credit quality of companies that may not have a concrete or immediate debt issue plans.

A conventional credit rating, on the other hand, is assigned to a specific debt obligation of an issuer and is thus an opinion (expressed as a symbol) on the relative credit risk associated with that particular financial obligation.

To differentiate Issuer Ratings from its conventional issue-specific Credit Ratings (referred to here-in-after as "Issue Ratings"), ICRA prefixes the letters "Ir" to its Issuer Rating symbols. Besides, the Issuer Rating definitions also specifically mention that the ratings are not specific to any debt instruments issued by the rated entities. Refer Annexe for ICRA's Issuer Rating definitions.

Rating Methodology

ICRA's analytical framework for Issuer Ratings is broadly similar to that for its conventional Issue Ratings. The difference arises mainly from the fact that while an Issuer Rating is more akin to a general purpose "corporate credit rating", an Issue Rating takes into account the terms of the specific debt being rated.

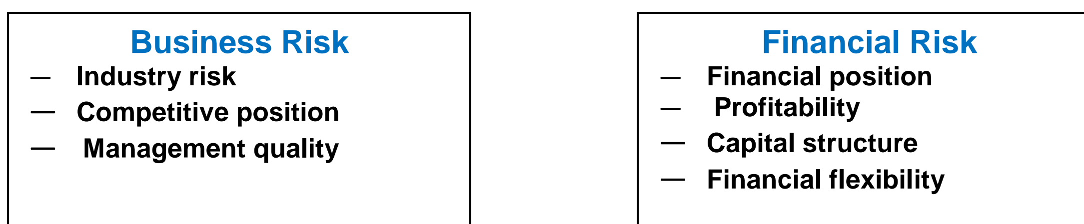
This methodology note first provides an overview of ICRA's general rating methodology. It then discusses the broad principles of notching, which could, under certain circumstances result in a difference between the issuer and issue ratings.

[1] Senior unsecured obligations refer to claims that rank lower than the claims of the Secured Creditors, but which have higher priority compared with the claims of, say, Preference Shareholders, Subordinate Debt Holders and, of course, Equity Shareholders.

OVERVIEW OF ICRA'S RATING METHODOLOGY

The methodology for assigning Credit Ratings entails a comprehensive evaluation of the risks that could impact an issuer's ability to generate cash flows. This risk analysis is complemented by a cash flow analysis that seeks to capture the adequacy of the issuer's projected cash flows vis-à-vis its debt servicing obligations.

The risk analysis framework for a typical manufacturing company may be depicted as follows:



Some of the key risk factors that ICRA analyses while arriving at a Credit Rating are discussed in the following sections.

1.1 Business Risk

The business risk that an issuer is exposed to is a combination of the industry risk in its major product segments and its competitive position within the industry.

- ***Industry Risk***

The objective here is to understand the attractiveness of the industry in which the issuer operates. The aspects examined include:
- Existing and expected demand-supply situation
- Intensity of competition
- Vulnerability to imports
- Regulatory risks
- Outlook for user industries
- Working capital intensity
- Overall prospects and outlook for the industry

- ***Issuer's Competitive Position***

An assessment of the issuer's competitive position within an industry is made on the basis of its operating efficiency as well as its market position. Some of the factors assessed are:
- Scale of operations
- Vintage of technology used
- Capital cost position
- Location advantage in terms of proximity to raw material sources as well as markets
- Operating efficiencies (yields, rejection rates, energy consumption, etc)
- Market position as reflected in trends in market share, ability to command premium pricing, extent of distribution network, and relationship with key customers

Usually, a peer comparison is carried out to evaluate each of the above factors.

1.2 Financial Risk

The objective here is to determine the issuer's current financial position and its financial risk profile. Some of the aspects analysed in detail in this context are:

Operating profitability: The analysis here focuses on determining the trend in the issuer's operating profitability and how the same appears by peer comparison.

Gearing: The objective here is to ascertain the level of debt in relation to the issuer's own funds and is viewed in conjunction with the business risks that the issuer is exposed to.

Debt service coverage ratios: Here, the trends in the issuer's key debt service coverage ratios like Interest Coverage and Net Cash Accruals/Total Debt are examined.

Working capital intensity: The analysis here evaluates the trends in the issuer's key working capital indicators like Receivables, Inventory and Creditors, again with respect to industry peers.

Accounting quality: Here, the Accounting Policies, Notes to Accounts, and Auditor's Comments are reviewed. Any deviation from the Generally Accepted Accounting Practices is noted and the financial statements of the issuer are adjusted to reflect the impact of such deviations.

Contingent liabilities/Off-balance sheet exposures: In this case, the likelihood of devolvement of contingent liabilities/ off-balance sheet exposures and the financial implications of the same are evaluated.

Financial flexibility: The issuer's financial flexibility—as reflected by it unutilised bank / credit limits, liquid investments, and the nature of its relationship with banks, financial institutions and other intermediaries—is assessed.

1.3 Strength of Promoters/Management Quality

All debt ratings necessarily incorporate an assessment of the quality of the issuer's management, as well as the strengths/weaknesses arising from the issuer's being a part of its "group"[2]. Also of importance are the issuer's likely cash outflows arising from the possible need to support other group entities, in case the issuer is among the stronger entities within the group. Usually, , a detailed discussion is held with the management of the issuer to understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the issuer's industry. Some of the other points assessed are:

- Experience of the promoter/management in the line of business concerned
- Commitment of the promoter/management to the line of business concerned
- Attitude of the promoter/management to risk taking and containment
- The issuer's policies on leveraging, interest risks and currency risks
- The issuer's plans on new projects, acquisitions, expansion, etc
- Strength of the other companies belonging to the same group as the issuer
- The ability and willingness of the group to support the issuer through measures such as capital infusion, if required

1.4 Adequacy of Future Cash Flows

Since the prime objective of the rating exercise is to assess the adequacy of the issuer's debt servicing capability, ICRA draws up projections on the likely financial position of the issuer under various scenarios. These projections are based on the expected operating and financial performance of the issuer, ICRA's outlook on the industry concerned, and the issuer's medium/long-term business plans. Sensitivity tests are also performed on certain key drivers, such as selling prices, input costs, and working capital requirements. Also of particular importance are the projected capital expenditure and debt repayment obligations of the issuer over the projection horizon.

2. Notching Principles

The broad principles applied for notching, which could result in differences between Issuer Ratings and Issue Ratings, are discussed in the following sections.

- At the higher end of the investment grade[3], since ICRA generally does not distinguish between ratings based on the security offered, Issuer Rating is likely to be at par with Issue Ratings. In any case, at the higher end of the investment grade, where the probability of default is low, ICRA applies a

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[2] Not applicable for stand-alone entities

[3] However, currently ICRA's investment grade issue ratings are only based on probability of default and do not factor in post default recovery prospects

significantly higher weight to timeliness of debt servicing, and the rating is unlikely to vary on the basis of the security offered or the priority of claims.

- At the lower end of the investment grade[3] and in the case of speculative grade entities, where the probability of default is significantly higher, the assessment of post default recovery prospects assumes greater importance. This includes an assessment of the differences, if any, among the claims priority for the different classes of debt, and also of the values of the corresponding collateral that may be realisable.

- In case ICRA is of the view that the debt is well-secured with highly liquid and marketable collateral that has a well defined mechanism for realisation and is likely to have a higher priority of claims in case of default, such debt could be rated higher (generally not more than one notch) than the Issuer Rating.

- For "junior" obligations[4] whose priority of claims is lower (for instance Subordinated Debt and Preference Shares), Issue Ratings would generally be lower (typically by one notch) than Issuer Ratings. Again, this distinction is usually not made at the higher end of the investment grade, where timeliness of payments, as discussed, assumes far greater importance than post default recovery prospects.

Like all other ratings, ICRA's Issuer Ratings also call for the exercise of judgement, and there is thus no room for a "one-size-fits-all" approach. Every case is analysed objectively and solely on its merits.

[4] The Companies Act, 1956, does not specifically impose any restriction on declaration of dividend by a company even if it is defaulting to a creditor as long as the dividend is paid out of profits. However, generally loan documents/trust deeds as well as the SEBI (Disclosure & Investor Protection) Guidelines, 2000 have covenants/ provisions that restrict declaration / distribution of dividend (on both equity and preference shares) in case of default to lenders and/or bondholders. Thus, it is reasonable to assume that the priority of claims for Preference Shareholders will be lower than that for senior unsecured creditors.

Annexe

ICRA's ISSUER RATING SCALE

IrAAA: The highest-credit-quality rating assigned by ICRA. The rated entity carries the lowest credit risk. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

IrAA: The high-credit-quality rating assigned by ICRA. The rated entity carries low credit risk. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

IrA: The adequate-credit-quality rating assigned by ICRA. The rated entity carries average credit risk. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

IrBBB: The moderate-credit-quality rating assigned by ICRA. The rated entity carries higher than average credit risk. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

IrBB: The inadequate-credit-quality rating assigned by ICRA. The rated entity carries high credit risk. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

IrB: The risk-prone-credit-quality rating assigned by ICRA. The rated entity carries very high credit risk. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

IrC: The lowest-credit-quality rating assigned by ICRA. The rated entity carries extremely high credit risk. The rating is only an opinion on the general creditworthiness of the rated entity and not specific to any particular debt instrument.

Note:
For the Rating categories IrAA through to IrC the sign of + (plus) or – (minus) may be appended to the Rating symbols to indicate their relative position within the Rating categories concerned. Thus the Rating of IrAA+ is one notch higher than IrAA, while IrAA- is one notch lower than IrAA.

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