Investor Caution Required for India Corporate Perpetual Securities

India Ratings: Mumbai 27 July 2011: India Ratings says that the recent issuances of perpetual debentures by select Indian corporates have brought to the fore a relatively new class of instrument for both corporate issuers and investors, although banks have been regular issuers of such instruments for a number of years. India Ratings notes that these instruments invariably have equity-like features, which contribute to financial flexibility and support the ongoing viability of the organization, and could therefore be eligible for equity credit based on its criteria. However, they are also inherently riskier than other debt obligations, and should therefore be treated with considerable caution by investors.

India Ratings notches down corporate perpetual security ratings from the issuer's National Long-Term rating (reference rating for instrument ratings) in accordance with its criteria for such instruments. The additional risk is typically a function of heightened risk of non-performance in a going concern which has not defaulted on any other obligations but also reflects increased loss severity if it were to default.

"The aim of perpetual instruments is often two-fold for a corporate, (i) to access cost-effective financing, and (ii) to benefit from any equity credit, which can help improve financial leverage metrics for the issuer. However from a debt ratings perspective, there is a need for notching to reflect the equity like-characteristics in the instrument", says Rakesh Valecha, Senior Director, India Ratings and Research Private Limited. Further, some recent issuances were not found eligible for equity credit as they had debt-like characteristics such as look-back features, which reduce an issuer's ability to defer payments, and/or a call option with a step-up coupon in excess of 1% which even with a replacement language reduces permanence in the capital structure. As per India Ratings' criteria, equity credit is either 0%, 50% or 100%, the continuum reflecting the ability of the instrument to behave as equity when activation triggers are breached.

India Ratings' methodology for rating perpetual bonds and debentures issued by corporates in the domestic market is consistent with its criteria for rating such instruments. Its rating approach does not factor in different levels of recovery expectations for different classes of creditors because India's legal environment - although somewhat improving - is extremely time consuming and still skewed in favour of the debtors. As a result, there is not enough data to conclusively demonstrate that senior secured creditors (which are majority creditors) to corporates are better off than unsecured and/or subordinated creditors. Therefore, India Ratings does not distinguish between secured and unsecured ratings in the Indian context which are both rated at the same level.

India Ratings' rating on perpetual securities takes into account risks of coupon deferrals, which are therefore rated at least one notch lower than the issuer's National Long-Term rating. While this remains the guiding principle across the rating scale, the probability of a deferral may be higher for entities exhibiting deterioration in their overall credit profile, which may necessitate lowering the instrument rating further. India Ratings may also lower the instrument rating by more than one notch if it has features that materially increase the likelihood of the activation of the loss absorption mechanism as may be the case of certain mandatory loss absorption triggers.

India Ratings presently does not differentiate between cumulative and non-cumulative deferral triggers for perpetual bonds which are rated at the same level. However, there is a possibility that non-cumulative instruments with better loss absorption features may be rated at levels lower than cumulative instruments.

Contacts:
Rakesh Valecha
Senior Director
+ 91 22 4000 1740
India Ratings and Research Private Limited
Wockhardt Towers, 4th Floor, West Wing,
Bandra Kurla Complex, Bandra East,
Mumbai - 400051

Tahera Kachwalla
Director
+91 22 4000 1705

Additional information is available at www.indiaratings.co.in

Applicable criteria, "Treatment of Hybrids in Corporate and REIT Credit Analysis", dated September 2012, and "Criteria for Indian National Ratings of Bank Hybrids and Subordinated Debt", dated September 2012, are available at www.indiaratings.co.in