Rating Criteria for Partial-Credit Guarantee Backed Debt

Cross-Sector Criteria

Scope

This report outlines India Ratings & Research's (Ind-Ra) analytical approach to rating partial credit guarantee (PCGs, or partial guarantees) backed debt issuances. It identifies the nature of a partial guarantee as a credit enhancement, rather than a credit substitute, as well as the impact of differences in PCG structures on the rating outcome. This report covers Ind-Ra's analysis of PCGs in debt issuances by corporate entities, project finance vehicles and public finance issuers.

Key Rating Drivers

Borrower Credit Quality (BCQ): This is captured by the rating of an instrument without PCG. In case of corporate entities, BCQ would refer to Long Term Issuer rating (LTIR), while for issuances by SPVs that domicile infrastructure assets, BCQ would refer to the stand-alone credit quality of the project. A full guarantee substitutes the credit risk of an underlying instrument with that of its guarantor for any default in the payment of interest or principal. However in a partial guarantee, investors remain exposed to some level of underlying instrument's credit risk (typically between 10% and 90%). This makes the borrowers' credit quality and the nature of its cash flows important rating drivers.

Guarantor's Credit, Guarantee Structure: Ind-Ra will differentiate among guarantee providers depending on their credit quality and relationship with the underlying obligor. Guarantees can take a variety of forms, and it is important to analyse each guarantee on a case-by-case basis, as its economic value and effect on a transaction rating will vary. The agency assigns all ratings based on the timely payment of contractual obligations. Guarantees, conversely, may be structured to reduce the probability of default or reduce loss given default.

Ind-Ra carefully analyses guarantee structures and considers only those components which support timely payment of debt service (both principal and interest). Recovery analysis is restricted to the guarantor's potential for topping up used PCG and to the extent to which PCG is restored to its original level before a default occurs. The PCG's ability to prevent the occurrence of a default would be the key consideration since the agency's ratings reflect the probability of default.

Sizing the Credit Enhancement: The extent of PCG required for a single-notch rating uplift depends on several factors. These include the standalone rating of the obligor, the rating of the guarantor, the nature of cash flows of the obligor, especially the ability of the used-up guarantee to be topped up in a short time and the nature of the guaranteed debt. A lower extent of PCG support would be required when the standalone rating of the guaranteed instrument is low, the nature of the cash flows allow for a quick topping of the used-up guarantee and the amortisation schedule is spread out.

Usually, the extent of PCG support required for a single-notch rating uplift can range from 7% to 15% but there may be circumstances where the limits can be breached on either side. This should be read along with the approaches detailed out below in this document. If the rating without the PCG is in the non-investment grade category, it is very unlikely that it would benefit significantly, if at all, from a partial guarantee since the presence of many other risks could constrain the ability to avoid a payment default.

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Application of Criteria

The methodology of rating PCG-backed transactions specifically focuses on the effect of a PCG on a transaction's rating, where the PCG is designed to reduce the probability of default depending upon the structural features of the guarantee and the legal constitution and characteristics of the issuer.

The product has been used infrequently in the Indian markets to benefit entities with a rating uplift, enabling these issuers to achieve greater access to a wider investor base such as insurance companies and pension funds.

Ind-Ra's Methodology

Reduction in the Probability of Default

When analysing an asset-backed securitisation, a bankruptcy-remote fixed pool of loans or project finance issuers, Ind-Ra believes that a PCG can act as supplemental credit enhancement and be effective in reducing the probability of default. The partial guarantee can be structured in many ways, and fees associated with PCGs are paid out of transaction cash flows, so it is essential to understand the cash flow waterfall of the transaction. Ind-Ra's rating approach for partial guarantees associated with SPVs and bankruptcy-remote type entities is the same as its traditional rating approach for asset securitisation or project financing.

The number of notches benefit depends upon a combination of (i) the extent of guarantee (ii) the percentage of issuer's total outstanding debt covered by the PCG (iii) the guarantor's subordination in the event of invocation of guarantee and (iv) the impact of insolvency proceedings on the PCG debt. The number of notches benefit is usually capped, unless the PCG covers all outstanding senior debt; is sufficiently bankruptcy remote; and assigns a subordinated role to the guarantor

A PCG can provide liquidity or absorb a certain level of losses on the underlying pool of assets and thereby reduce the probability of default on the issued notes. Similarly, in the case of a project SPV, working as a sizeable liquidity reserve, a PCG is available during the periods of financial stress. In Ind-Ra's view, such a facility would add most value to projects with demand risk, where revenue is subject to cyclical variations or ramp-up uncertainties. In such situations, a substantial PCG will support a rating uplift since the project cash flows acquire greater resilience to absorb shocks, unless qualitative factors are otherwise considered by the agency to constrain the rating – for example, a single asset energy project constrained by the low credit rating of the off-taker utility.

A PCG should be absolute, unconditional and irrevocable, and be accompanied by a strong payment mechanism to effectively address the probability of default. Ind-Ra also assumes that the guarantor's claims on underlying cash flows would be subordinate to those of the guaranteed senior debt i.e., bond covenants would permit access to cash flows only after senior debt/bonds are paid in full. Furthermore, since the guarantee does not cover 100% of the principal and interest payments, it will not result in a credit substitution but only an enhancement.

Partial Guarantee for a Project SPV – An Illustration

To determine the number of notches of a rating uplift that a transaction can gain from a PCG, Ind-Ra will test the resilience of the cash flow analysis to absorb stresses – commensurate to the proposed rating level. This is done by analysing the impact of variations in key parameters identified by the agency. While variables could differ across various infrastructure assets, they would revolve around revenue – both volume and price – and operating costs – both periodic and routine. Alternatively, a PCG can be viewed as improving debt service coverage (DSCR) ratio, thereby enhancing the transaction's credit quality. The following illustration will help elucidate this concept in the case of a project SPV:

Ind-Ra has carried out certain stress scenarios on a sample toll road project to illustrate the extent to which the project can absorb additional stress, due to the credit enhancement of a partial (assumed to be 40%-50% of project debt) guarantee. For each scenario, the maximum stress under various parameters that the project can absorb without defaulting (i.e., break even DSCR of at least 1.0x being achieved) on debt both with and without the guarantee support is shown.

The sample project has assumptions in line with the roads rated in the indicative 'IND BBB' category, with typical traffic growth assumptions. The interest rate for bondholders is assumed to be 11% (commensurate with relatively high investment grade ratings) over a 10- year amortisation period. Toll rates are assumed to grow at 5% yoy as are operating costs, including both routine and major maintenance expenditure. Traffic is assumed to grow at 6% yoy for all vehicle categories.

Figure 1
Cash Flow Impact of Guarantee

Factor	Break even stress without guarantee	Break even stress with 40%-50% guarantee
First year traffic underperformance	A 12.5% dip in the first year traffic compared with the base case	Around a 35% dip in the first year traffic compared with the base case
Traffic and toll rate growth	0% yoy traffic growth for the first three operational years, then 6% for the remainder of the loan tenor- for all vehicle categories	0% yoy traffic growth for all vehicle categories for the entirety of the debt tenor; and 0% yoy toll rate growth for the first six operational years, then 2%-5% yoy for the remainder of the loan tenor
Combination stress 1	A 5% dip in the first year traffic and 4% yoy toll rate growth for the next three operational years; then 5% yoy for the remainder of the loan tenor 3% yoy traffic growth rate for the first three operational years; then 6% yoy growth for the remainder of the loan tenor - for all vehicle categories	A 8%-10% dip in the first year traffic and 0% yoy toll rate growth for the next three operational years; then 5% yoy growth for the remainder of the debt tenor A 3%-5% yoy decline in traffic growth rate for the first three operational years; then a 3%-6% yoy growth for the remainder of the debt tenor - for all vehicle categories

Source: Ind-Ra

In the illustration, by virtue of enhancing the minimum DSCR from 1.2x in the base case (project rated in the 'IND BBB' category) to the 1.7x-1.8x range, a PCG can enable the transaction to be rated potentially much higher.

While Ind-Ra does not expect such severe downside scenarios depicted Figure 1 above to materialise in the normal course, the fact that the partial guarantee allows the project to withstand more severe stress scenarios and still meet debt service obligations in a timely manner is the key driver for a rating upgrade.

Individual Projects May Have Qualitative Constraints

Often, rating levels are not primarily dictated by the quantitative measures of credit risk but by other aspects that may be purely qualitative. Such constraints could, in theory, limit the extent to which liquidity support increases a project's rating. Some factors that could constrain the ratings of operational projects are as follows:

Off-taker or Grantor Risk

The entities that are the primary source of revenue for a project can significantly impact, or even constrain, a project's debt rating, especially when it is unlikely that they could be replaced at economically viable rates.

Ramp-up Risk

For green-field projects with demand risk, there may be a less solid basis for operational revenue forecasts than for existing projects with a proven track record. Depending on the basis and degree of conservatism in the expert forecasts, such inherent uncertainty may limit a project's debt rating until ramp-up is completed.

Operational Risk

Some projects have a high level of operational risk, in terms of either cost or their ability to generate expected revenue. In such cases, a replacement operator may be difficult to secure, due to a lack of alternatives. This may create a link between the operator's rating and that of the project. However, this is not typically the case in most projects rated by Ind-Ra to date.

Sizing the Guaranteed Amount

The size of a guarantee governs the degree of potential rating uplift. Therefore, a progressive reduction in the guaranteed amount under stress scenarios would decline the benefit of a guarantee to cash flows and hence the potential ratings uplift would be limited to that degree. The nature of cash flows will determine how quickly the used-up guarantee can be topped up for reuse.

The amortisation schedule determines the debt related outflow in a single year; the longer the amortisation schedule, lower the amount to be covered in a year. Thus long amortisation schedules provide longer time for cash flows to recover and longer time for used up PCG to be restored and would therefore be favourable to PCG structuring. Debt with longer amortisation schedules typically would require lower PCG for a single notch uplift.

The probability of default associated with a rating level increases exponentially when it moves down the rating scale. Therefore, other factors remaining the same, the extent of guaranteed amount required for a single-notch rating uplift will be lower, when the guaranteed entity has a lower standalone rating.

When finally notching up the rating of a transaction for a PCG structure, rating committees will consider the extent of guaranteed amount, the guarantee structure, the credit rating of the guarantor, the standalone rating of the guaranteed entity and most importantly the nature of the cash flows of the guaranteed entity and possible stress scenarios.

Consequently, it also follows that the rating of a partially guaranteed instrument will continue to move upward or downward with its LTIR. Since the guarantee is partial, it is not meant to be bankruptcy remote from the issuer and in case of any missed payment on the PCG debt it would be classified as being in default in accordance with transaction documentation.

Legal Opinion

Ind-Ra would expect the transaction counsel to opine on a) the timely enforceability of the guarantee b) the strength and adequacy of the structured payment mechanism, which should enable the trustee to ensure that bondholders receive their dues on time and c) applicability of the guarantee under the insolvency laws.

Guarantee Provider

A guarantee provider has a direct effect on the total amount of the guarantee required. Key factor is the credit quality of the guarantor and the issuer being guaranteed. Ind-Ra's methodology assumes that the credit quality of the guarantor is significantly better than that of the Issuer. In Indian transactions, PCG providers have largely been rated at 'IND AAA' which means that there is little default risk of the PCG provider when a demand for draw-down is made.

Conditionality and Claims Processing

In general, any conditionality to a guarantee should be limited. Ind-Ra may penalise proposals with ongoing requirements to maintain coverage. Certain clauses that are now less common, but seen before, such as a change in ownership, fulfilment of capital-expenditure programs, or even a failure to pay coverage premium, are viewed negatively by the agency. On a case-by-case basis, Ind-Ra would review the credit implications of any conditionality and penalise the value of guarantees as necessary. In some instances, the conditionality may preclude the agency from giving any credit to the partial guarantee.

Processing a claim under a partial guarantee should also be straightforward and without major conditions. In the best structures, cash is available on a payment date in DSRA to help maintain timely payments on bonds. Under this scenario, bond payments are typically required to be deposited in trust accounts up to five days prior to the payment date. If cash is not available at that time, the trustee is able to draw on the partial-guarantee facility to supplement the payment.

Scope and Limitations

This criteria report describes Ind-Ra's criteria and approach towards analysing PCG transactions in India. The report outlines the general framework of Ind-Ra's analytical approach, and addresses the rating analysis when a PCG is present and quantifies the impact of differences in PCG structures and their application to issuances.

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