Rating Mutual Fund Schemes of Infrastructure Debt Funds

Special Report

Key Rating Considerations

Qualitative and Quantitative Factors: In assigning ratings to individual schemes launched by mutual funds pursuant to the Securities and Exchange Board of India (SEBI) guidelines on infrastructure debt funds (IDFs), India Ratings & Research (Ind-Ra) will assess a number of factors including the underlying credit quality of the investment portfolio, the experience and expertise of the sponsors and the asset management company, sponsor commitment to the scheme and the robustness of the investment identification, evaluation and risk management processes and systems employed.

Ind-Ra also recognises that the IDF concept has been evolved by the government of India (GoI) to augment the supply of much-need long-term capital for meeting India's ambitious infrastructure development programme. The GoI has actively facilitated the creation of a regulatory framework and establishment of an enabling environment (for e.g., the creation of the model tripartite agreement for operating toll road projects) that could reduce risk perception on certain projects.

Significance of Ratings: While Ind-Ra will use its traditional long-term credit rating scale ('IND AAA' to 'IND C') with an idf-mf suffix to assign ratings to IDF schemes, it should be noted that the ratings do not measure the expectation of default risk for the scheme itself, as a fund/scheme generally cannot default. Rather, the ratings should be interpreted as an opinion regarding the strength of the credit protection factors embedded in the fund's investment policies, expertise and experience of the sponsors and investment managers and vulnerability to losses and prospects of ultimate recovery as a result of defaults in the fund portfolio.

Sponsor Strength and Experience: Ind-Ra views the presence of a strong sponsor as an important factor for IDF schemes to successfully achieve its objectives**.** Although the market size is large, an experienced sponsor with a deep, well-rounded understanding of and expertise in the infrastructure sector will enable IDFs identify the right investment opportunities. This attribute assumes particular importance against the background of the stress facing the sector presently.

The quantum of a sponsor's investment as a proportion of the total fund size is important in judging its commitment to and confidence in the prospects of IDFs.

Asset Manager Credentials: To evaluate the asset management company's investment management capacity and vulnerability to operational and investment management failures, the agency will examine five key parameters – (a) company, financial condition (not to be confused with an explicit financial evaluation) and staffing; (b) risk management and controls; (c) portfolio management; (d) investment administration and (e) technology.

Underlying Credit Quality: An important driver of the IDF's rating is the actual and prospective average credit quality of the fund's invested portfolio. The agency would incorporate an element of rating momentum embedded and therefore also capture the likelihood that the fund maintains a given credit quality over time. Concentration (or conversely, diversification) and counterparty risk, as applicable, would also be assessed. Recovery prospects and structural enhancements would be accorded due weightage.

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Background

The Finance Minister in his budget speech for FY12 had announced setting up of IDFs to accelerate and enhance the flow of long-term debt into infrastructure projects for funding the government's massive programme of infrastructure development, estimated at around USD1trn during the 12th Five-Year Plan. The GoI expects IDFs to act as a medium for channelising much-needed long-term debt for financing infrastructure projects and also to help in the migration of project loans for operating assets from banks to the fixed income markets.

The following broad structure has been envisaged:

- An IDF may be set up either as a trust or as a company. A trust-based IDF would be a mutual fund (MF) that would issue units while a company-based IDF would be in the form of a non-banking finance company (NBFC) that would issue bonds to raise resources.
- An IDF would have to be registered in India. A trust-based IDF (MF) would be regulated by SEBI; and an IDF set up as a company (NBFC) would be regulated by the Reserve Bank of India (RBI). Both sets of regulations have been issued and are operational.
- The GoI expects IDF investors to be domestic and off-shore institutional companies, especially insurance and pension funds which have long-term resources.

Around 10 applications have been made for approval to launch IDFs, primarily through the MF route. Sponsors include infrastructure finance companies, insurance companies, fund houses and banks.

Scope and Limitations

This special report deals with Ind-Ra's approach to rating specific schemes floated by IDFs via the MF route.

The ratings should be interpreted as an opinion regarding the strength of the credit protection factors embedded in the fund's investment policies, expertise and experience of the sponsors and investment managers and vulnerability to losses and prospects of ultimate recovery as a result of defaults in the fund portfolio. They are an opinion on the relative ranking of the IDF on the aforesaid attributes and are not an absolute measure.

While Ind-Ra will use its traditional long-term credit rating scale with an idf-mf suffix ('IND AAAidf-mf', 'IND AAidf-mf' and so on) to assign ratings to IDF schemes, it should be noted that the ratings do not measure the expectation of default risk for the scheme itself, as a fund / scheme generally cannot default.

These ratings also do not address the risk of loss due to changes in prevailing interest rates, credit spreads and other market conditions, nor do they comment on the adequacy of market value or address the extent to which fund expenses and costs might reduce distributions to shareholders. The ratings do not predict a specific level or range of performance of a scheme / fund (measured in terms of the net asset value or otherwise) over any given time period nor do they opine on the suitability or otherwise of a fund for investment or any other purposes.

Appendix 1 lists the rating symbols and definitions. In assigning ratings to newly launched IDFs, the agency recognises that the fund's initial portfolio may not be fully representative of its longer-term or target portfolio. Therefore, subject to a satisfactory legal and regulatory review and manager assessment, Ind-Ra may base its ratings on a conservative analysis of the fund's agreed investment guidelines.

Ind-Ra reviews portfolios periodically to monitor outstanding ratings. The agency requests individual portfolio holdings level information as well as summary statistics on the fund's portfolio and investment activities. It typically requests monthly performance data from the fund's administrator or custodian, as parties independent of the investment manager/asset management company (AMC).

Related Criteria

Rating Criteria for Infrastructure and Project Finance, September 2012

Bond Fund Rating Criteria, September 2012

Key Rating Factors

Sponsor Assessment

The financial position of the IDF's sponsor along with its track record in the infrastructure sector will be an important determinant of the ratings assigned to the scheme. Where an IDF has more than one sponsor, the quality of each of them will be evaluated separately. Multiple sponsors that can offer complementary skills and resources would be viewed as a rating positive.

Profitability, funding, liquidity and capitalisation are the key measures of evaluating the financial position. Public credit ratings provide useful guidance in this regard.

A sponsor's track record in the infrastructure sector could have been accumulated in one or more of the following roles:

- Financing – debt and/or equity
- Intermediation – financial advisory/syndication
- Conceptualising, developing, constructing and/or operating projects
- Policy advisory

The sponsors that score strongly on these parameters are likely to enjoy deep relationships with different stakeholders and also possess the requisite skills to identify the critical factors that drive successful infrastructure projects in India.

Ind-Ra believes that an IDF scheme will benefit from both of the aforesaid attributes of its sponsor. The benefit of the sponsor's expertise in the sector will likely be transferred through the AMC in the form of:

- early identification of attractive investment opportunities
- ability to weed out investment proposals where lack of sponsor discipline might have led to aggressive bids resulting in potential stress in the future
- rigorous evaluation of credit risk
- monitoring performance
- managing an orderly and profitable exit

Asset Manager Evaluation

To rate an IDF scheme, Ind-Ra performs an assessment of its fund manager or AMC. With this assessment, the agency seeks to establish that the manager is suitably qualified, competent and capable of managing the fund.

A manager assessment is based on a meeting between senior management and the agency at the fund manager's offices. The agency will evaluate management's effectiveness in organising and implementing specific steps to achieve its stated investment goals. The manager assessment considers:

- experience and track record in portfolio management
- quality and stability of credit selection and monitoring processes
- the extent and quality of internal controls, operating policies, systems and risk management guidelines
- infrastructure

Ind-Ra attaches particular importance to: (a) governance, organisational structure and third-parties involved; (b) integration of risk management with portfolio management processes and (c) portfolio management coordination and processes relating to the generation and implementation of top-down macro views.

To the extent feasible, for assessing the AMC, Ind-Ra will rely on the five-point (listed earlier in the report), multi-faceted approach detailed in Fitch Ratings' (Ind-Ra's 100% parent company) criteria for Reviewing and Rating Asset Managers.

The key objective is to secure a measure of the AMC's investment management capacity and vulnerability to operational and investment management failures.

In general, Ind-Ra prefers managers to have a track record in the relevant asset class, for example three or more years. Where a manager does not have a track record, for instance in the case of start-up managers, the agency may consider the experience and/or track record of investment teams or management, gained by managing funds at the sponsor/a predecessor or competitor asset manager, as well as the depth of funding and operational infrastructure available and necessary for a well-run, stable asset management platform.

Furthermore, the assessment of the manager's quality is also a function of its style, typically the degree of active portfolio management. Generally, Ind-Ra expects stronger processes and resources when the portfolio is actively managed (relative to the liquidity). In the event of a material change in the composition of the management team, Ind-Ra will need to immediately perform an updated assessment of the fund manager.

Ind-Ra will also verify if the organisation and operations of the AMC are structured in compliance with the duties specified in the SEBI guidelines (please see Appendix 2).

Portfolio Credit Quality

Ind-Ra notes that actively managed funds typically follow a set of investment guidelines – the relevant SEBI guidelines are in Appendix 3. The agency considers whether the investment guidelines (where applicable) are consistent with its rating criteria at the relevant rating level.

Besides an evaluation of the credit quality of assets in the IDF scheme's portfolio, a review of other credit considerations, such as the fund's concentration risk and the credit quality of key counterparties is also undertaken. Modifiers ('+' and '-') may additionally be applied to the category rating implied by Ind-Ra's rating analysis to reflect the relative risk of the fund within the rating category.

In most cases, Ind-Ra imposes a cap on the scheme's rating to reflect the presence of low-rated securities in the fund's portfolio. Rating caps are primarily applied to highly rated funds where Ind-Ra views a maximum rating differential of two rating categories between the fund credit rating and the rating of newly purchased securities. This is an appropriate means to limit the risk of individual underlying asset performance being inconsistent with the rating assigned to the fund. As an example, a fund rated 'IND AA' is not likely to invest in assets rated below the 'IND BBB' category.

Ind-Ra always uses issue-specific ratings in its analysis, which consider relative subordination. The agency starts with its own ratings. Where this is not available, the lowest of other ratings assigned by recognised national agencies is applied.

For assets that are not publicly rated by one or more nationally recognised rating agencies, Ind-Ra would expect most of the assets to be analysed internally by its relevant analytical team, in the form of a credit opinion. In only very limited circumstances, the agency may consider the fund manager's own credit assessment, subject to a review of the internal credit assessment by a relevant Ind-Ra's analyst covering substantively the same sector. This would, however, only be on a case-by-case basis and the agency would expect securities with ratings obtained in this manner to make up an extremely small percentage of credits.

Concentration Risk

Concentrated portfolios carry greater tail risk and are more likely to exhibit higher vulnerability to losses than those of funds of similar credit quality, but that are more highly diversified. This is due to the fact that concentration can increase idiosyncratic risk and loss severity. Ind-Ra's analysis of diversification primarily focuses on issuer concentration. For example, a portfolio with a majority of the assets in a single sub-sector may be exposed to changes in policy.

One could argue, for example, that at some point a government authority may adopt a policy to be more stringent on deductions on availability payments for certain projects (annuity-based road projects, for instance). This may result in a declining credit quality and/or recoveries for some projects in that sub-sector. Since the risks in question are likely to be portfolio specific, Ind-Ra will identify areas of systemic risk and implement stress scenarios through a committee process on a case-by-case basis.

The agency assesses exposure with particular focus on the percentage of the portfolio attributed to the largest issuers in the portfolio (among other measures). Conversely, an IDF's rating may benefit if its investments are well diversified across one or more of sub-sectors, geographical regions, issuers / sponsor groups, etc. Portfolios with a small number of assets or those where individual asset balances represent a disproportionate exposure within the portfolio, carry the risk that portfolio performance may be adversely impacted by a few assets that may underperform relative to the statistics suggested by their ratings.

Asset Recovery Rates

Although handicapped by lack of reliable data on recoveries in the infrastructure sector post a default, Ind-Ra will nonetheless attempt to make estimates of asset-specific recovery rates for each investment by the IDF. These are calculated as part of the credit analysis and represent the recovery expectation of the asset.

The recovery rates take into account the type of project, the security package, enforceability of security in the jurisdiction in question and whether the project is in construction or in operation.

Typical security packages (for senior debt) could include:

- First ranking legal mortgage over properties (including shares of the SPV), assignment over all contractual rights, direct agreements with all parties, etc
- Charge overall project cash flows and/ or project bank accounts
- Sometimes during construction phase: parent company guarantees from contractors

If the creditors have security over the project company's shares, this will give them the option to sell the project company in its entirety rather than going through the, perhaps, painful and expensive route of security enforcement. Another added advantage of security over a project company's shares is that the lenders may be able to secure for themselves the right to remove directors of the project company and appoint substitutes.

The industry of the obligor is important - tangible asset-intensive industries, especially utilities, have higher recovery rates than service sector firms'. Default scenarios in the demand-based transportation projects (post completion) are more likely to result from revenue underperformance which could translate into lower ultimate recoveries than in similar projects with availability-based revenue structures.

In addition, Ind-Ra will consider project-specific agreements, such as debt tenors in relation to the term of the project concession and any guaranteed payments on project termination. Where a default leads to a concession termination, the counterparty for the termination payment is usually the procuring authority, so exposure to credit default following the termination is linked to the counterparty's credit quality. As an illustration, Appendix 4 has a summary of usual termination events and payments for typical National Highways Authority of India (NHAI, 'IND AAA'/Stable) toll road concessions. Usually, termination provisions stipulate the time frame in which the procuring authority can repay termination sums.

Creditors' step-in rights and speed of process (although this could vary by sector and is perhaps more closely linked to the legal structure, bankruptcy laws, etc of the country) are important in assessing time to recovery.

Given the chronic and acute infrastructure deficits facing India, the long-term economic value of several projects in the sector could be retained even though there could be short-term volatility in performance/cash flows. The recovery estimates will analyse to what extent the financing benefits from this value. That being said, there could be situations where the economic value of individual projects is impaired or completely eroded.

Counterparty Risk

IDFs could be exposed to counterparty risk stemming from different sources, including the use of derivatives for hedging such as credit default swaps, interest rate futures and swaps, as well as the account bank for cash deposits. Ind-Ra will look into the rating of the counterparty and the quality of the collateral and margining policy, when relevant, when assessing the overall credit quality of the IDF. At higher rating levels, the agency would expect key counterparties, such as the trustee and the custodian, to possess a sound track record.

Structural Enhancements

While individual investee projects/companies might have a certain credit rating, Ind-Ra recognises that prior to an investment by the IDF, weak financial structures could be re-engineered or credit enhanced to improve their ultimate credit quality. Two examples of financial re-engineering would include substituting a fixed-rate bond (which the IDF's investment could represent) for an existing floating rate bank loan and better sculpting of debt amortization to more accurately reflect an asset's useful life and revenue generating capacity. Both of these could result in an improvement in debt service coverages. The rating of underlying investments could also receive uplift from external wraps such as the partial credit guarantee issued India Infrastructure Finance Company Limited (IIFCL).

Appendix 1

Rating Definitions and Symbols

In assigning ratings to specific schemes floated by IDFs via the MF route, Ind-Ra will use its traditional long-term credit rating scale with an idf-mf suffix (for example, 'IND AAAidf-mf', 'IND AAidf-mf' and so on). It is important to recognise that the ratings do not measure the expectation of default risk for the scheme itself, as a fund/scheme generally cannot default. Rather, they should be interpreted as an opinion regarding the strength of the credit protection factors embedded in the fund's investment policies, expertise and experience of the sponsors and investment managers and vulnerability to losses and prospects of ultimate recovery as a result of defaults in the fund portfolio. They are an opinion on the relative ranking of the IDF on the aforesaid attributes and are not an absolute measure.

These ratings do not also address the risk of loss due to changes in prevailing interest rates, credit spreads and other market conditions, nor do they comment on the adequacy of market value or address the extent to which fund expenses and costs might reduce distributions to shareholders. The ratings do not predict a specific level or range of performance of a scheme/fund over any given time period nor do they opine on the suitability or otherwise of a fund for investment or any other purposes.

Given below are the symbols and the corresponding rating definitions:

IND AAAidf-mf: Highest fundamental credit quality

The rating category denotes the highest strength of the credit protection factors embedded in a fund's investment policies; the sponsors/investment managers are vastly experienced and their expertise is judged to be of a very high degree; vulnerability to losses is expected to be the lowest and prospects of ultimate recovery as a result of defaults in the fund portfolio deemed to be the highest.

IND AAidf-mf: Very High fundamental credit quality

The rating category denotes very strong credit protection factors embedded in a fund's investment policies; the sponsors/investment managers are well experienced and their expertise is judged to be of a high degree; vulnerability to losses is expected to be very low and prospects of ultimate recovery as a result of defaults in the fund portfolio deemed to be very high.

IND Aidf-mf: High fundamental credit quality

The rating category denotes strong credit protection factors embedded in a fund's investment policies; the sponsors / investment managers are moderately experienced and their expertise is judged to be moderate; vulnerability to losses is expected to be low and prospects of ultimate recovery as a result of defaults in the fund portfolio deemed to be high.

IND BBBidf-mf: Good fundamental credit quality

The rating category denotes comfortable credit protection factors embedded in a fund's investment policies; the sponsors/investment managers have some experience and their expertise is judged to be average; vulnerability to losses is expected to be moderately low and prospects of ultimate recovery as a result of defaults in the fund portfolio deemed to be moderate.

IND BBidf-mf: Speculative fundamental credit quality

The rating category denotes moderate credit protection factors embedded in a fund's investment policies; the sponsors/investment managers have limited experience and their expertise is judged to be low; vulnerability to losses is expected to be high and prospects of ultimate recovery as a result of defaults in the fund portfolio deemed to be weak.

IND Bidf-mf: Highly speculative fundamental credit quality

The rating category denotes weak credit protection factors embedded in a fund's investment policies; the sponsors/investment managers have extremely limited experience and their expertise is judged to be very low; vulnerability to losses is expected to be very high and prospects of ultimate recovery as a result of defaults in the fund portfolio deemed to be very weak.

IND Cidf-mf: Exceptionally high levels of fundamental credit risk

The rating category denotes extremely weak credit protection factors embedded in a fund's investment policies; the sponsors/investment managers have no experience or expertise; vulnerability to losses is expected to be extremely high and prospects of ultimate recovery as a result of defaults in the fund portfolio deemed to be extremely limited.

Note:

The modifiers "+" or "-" may be appended to a rating to denote relative status within major rating categories. Outlooks are not assigned although at any point in time, a scheme's position and prospects may have underlying trends, for example improving, deteriorating or stable.

Appendix 2

Duties of asset management company as listed under SEBI Guidelines

- The asset management company shall lay down an adequate system of internal controls and risk management.
- The asset management company shall exercise due diligence in maintenance of the assets of an infrastructure debt fund scheme and shall ensure that there is no avoidable deterioration in their value.
- The asset management company shall record in writing, the details of its decision making process in buying or selling infrastructure companies' assets together with the justifications for such decisions and forward the same periodically to trustees.
- The asset management company shall ensure that investment of funds of the Infrastructure Debt Fund schemes is not made contrary to provisions of this chapter and the trust deed.
- The asset management company shall obtain, wherever required under these regulations, prior in-principle approval from the recognized stock exchange(s) where units are proposed to be listed.
- The asset management company shall institute such mechanisms as to ensure that proper care is taken for collection, monitoring and supervision of the debt assets by appointing a service provider having extensive experience thereof, if required.

Appendix 3

Permissible investments as listed under SEBI Guidelines

- Every infrastructure debt fund scheme shall invest at least ninety percent of the net assets of the scheme in the debt securities or securitized debt instruments of infrastructure companies or projects or special purpose vehicles which are created for the purpose of facilitating or promoting investment in infrastructure or bank loans in respect of completed and revenue generating projects of infrastructure companies or special purpose vehicle:

Provided that the funds received on account of re-payment of principal, whether by way of pre-payment or otherwise, with respect to the underlying assets of the scheme, shall be invested as specified in this sub-regulation:

Provided further that if the investments specified in this subregulation are not available, such funds may be invested in bonds of Public Financial Institutions and Infrastructure Finance Companies.

- Subject to sub-regulation (1) above, every infrastructure debt fund scheme may invest the balance amount in equity shares, convertibles including mezzanine financing instruments of companies engaged in infrastructure, infrastructure development projects, whether listed on a recognized stock exchange in India or not; or money market instruments and bank deposits. The investment restrictions shall be applicable on the life-cycle of the infrastructure debt fund scheme and shall be reckoned with reference to the total amount raised by the infrastructure debt fund scheme.
- No mutual fund shall, under all its infrastructure debt fund schemes, invest more than thirty per cent of its net assets in the debt securities or assets of any single infrastructure company or project or special purpose vehicles which are created for the purpose of facilitating or promoting investment in infrastructure or bank loans in respect of completed and revenue generating projects of any single infrastructure company or project or special purpose vehicle.
- An infrastructure debt scheme shall not invest more than 30% of the net assets of the scheme in debt instruments or assets of any single infrastructure company or project or special purpose vehicles which are created for the purpose of facilitating or promoting investment in infrastructure or bank loans in respect of completed and revenue generating projects of any single infrastructure company or project or special purpose vehicle.
- The overall investments by an infrastructure debt fund scheme in debt instruments or assets of infrastructure companies or projects or special purpose vehicles, which are created for the purpose of facilitating or promoting investment in infrastructure or bank loans in respect of completed and revenue generating projects of infrastructure companies or projects or special purpose vehicles, which are rated below investment grade or are unrated, shall not exceed 30% of the net assets of the scheme:

Provided that the overall investment limit may increase up to 50% of the net assets of the scheme with the prior approval of the trustees and the board of the asset management company.

- No infrastructure debt fund scheme shall invest in –
  - Any unlisted security of the sponsor or its associate or group company;
  - Any listed security issued by way of preferential allotment by the sponsor or its associate or group company;
  - Any listed security of the sponsor or its associate or group company or bank loan in respect of completed and revenue generating projects of infrastructure companies or special purpose vehicles of the sponsor or its associate or group companies, in excess of twenty five per cent of the net assets of the scheme, subject to approval of trustees and full disclosures to investors for investments made within the aforesaid limits; or

- any asset or securities owned by the sponsor or asset management company or their associates in excess of 30% of the net assets of the scheme, provided that
  a) such investment is in assets or securities not below investment grade;
  b) the sponsor or its associates retains at least 30% of the assets or securities, in which investment is made by the scheme, till the assets or securities are held in the scheme portfolio; and
  c) approval for such investment is granted by the trustees and full disclosures are made to the investors regarding such investment.

Appendix 4

Review of Demand-Based Infrastructure Termination Events and Payments (from a typical NHAI toll road concession)

Figure 1

Termination event *	Termination payment
Due to a force-majeure (FM) event that is a non-political event	90% of the debt due and the entire subordinated debt less due insurance claims, if any. Provided that in the event some insurance claims are not admitted, then 90% of such claims shall qualify for being included in the computation of debt due.
Due to an FM event, which is a political event	Total debt due, plus 120% of the subordinated debt plus 150% of the equity
Due to an FM event, which is an indirect political event	Total debt due, less due insurance claims, if any plus the outstanding subordinated debt, plus 110% of the equity.
Concessionaire event of default post-COD	90% of the debt due less insurance claims, if any.
NHAI EOD post-COD	Total debt due, plus 120% of the total subordinated debt, plus 150% of the equity.

Source: Ind-Ra
***** Termination events are defined in detail in the concession agreements, available on the Authority's web site.