

Revenue-Supported Rating Criteria

Master Criteria

This criteria report updates and replaces the previous version, dated 11 September 2015

Scope: This report presents India Ratings and Research's (Ind-Ra) master criteria for assigning credit ratings to revenue-supported obligations and entities in the public finance sector (public sector entities of central and state governments, central government special purpose vehicles, among others). The report discusses the key qualitative and quantitative factors that influence a borrower's expected ability to meet financial obligations in full and on schedule.

Five Categories of Focus: The criteria are organised into five broad categories of analytical focus: governance and management; operational profile; debt profile; financial profile and liquidity. While the report describes Ind-Ra's general approach for assigning revenue-supported ratings, not all the credit factors discussed may pertain to every rating situation.

Extremely Diverse Borrowers: Public finance borrowers that issue revenue-supported debt represent an extremely diverse set of organisations that include municipal enterprises, educational and cultural institutions, non-profit hospitals, and utilities. Even among entities of similar size, scope, and purpose, these businesses are predominantly localised enterprises, each of whose creditworthiness is tightly linked to local demographic, economic, political, and/or competitive characteristics.

Credit Factors Will Vary: As a result of the diversity among borrowers, the degree to which certain credit factors are emphasised – especially non-financial factors – will vary depending on the levels of credit stability and competitiveness observed within the sector and for individual borrowers. Each specific rating action commentary or rating report will discuss those factors most relevant to the individual rating action. This report highlights the credit factors reviewed by Ind-Ra that are most common across revenue-supported borrowers.

Variations from Criteria

Ind-Ra's criteria are designed to be used in conjunction with experienced analytical judgment, exercised through a committee process. The combination of transparent criteria, analytical judgement applied on instrument-by-instrument or issuer-by-issuer basis, and full disclosure via rating action commentary (RAC), strengthens Ind-Ra's rating process while assisting market participants in understanding the analysis used in the ratings.

A rating committee may adjust the application of criteria to reflect the risks of a specific instrument or entity. Such adjustments are called variations. All variations will be disclosed in the respective RACs, including their impact on the rating where appropriate.

A variation can be approved by a rating committee where the risk, feature, or other factors relevant to the assignment of a rating and the methodology applied to it are both included within the scope of the criteria, but where the analysis described in the criteria requires modification to address factors specific to the particular instrument or entity.

Related Research

[Rating of Public Sector Entities Criteria \(December 2018\)](#)

[Tax-Supported Rating Criteria \(December 2018\)](#)

[Local and State Government Rating Criteria \(December 2018\)](#)

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Governance and Management

The effectiveness of governance and management is an important factor in assessing an organisation's creditworthiness, as management's decisions and initiatives – subject to the oversight and strategic direction of the governing body – can ultimately determine an entity's long-term financial viability. Ind-Ra generally focuses its commentary on management and governance practices where their effectiveness materially influences the rating decision.

Governance

With a level of analysis tailored to the structural characteristics of the sector, Ind-Ra reviews the effectiveness of the governing body (or board) in setting objectives, establishing principles and implementing the organisation's policies. Ind-Ra's assessment may include but is not confined to developing an understanding of the governing body's mission and strategy, ensuring business continuity, structure, composition, interaction with and oversight of management, knowledge of industry issues, and performance standards.

Management

Ind-Ra also examines the track record of senior management in implementing the governing body's policies and providing capable day-to-day management. Ind-Ra analysis is qualitative in nature and will assess management's history of successfully meeting the goals defined in a strategic plan and its ability and willingness to adjust to a changing operating environment. While a failure to meet specific goals may not be viewed negatively in all cases, Ind-Ra expects management to explain significant deviations from planned, expected, or budgeted results and to articulate its contingency plans.

Management effectiveness may also be judged through a review of planning processes. Leadership teams that possess a strong understanding of their markets and capabilities, effectively articulate goals and objectives, and are organised to operate consistent with industry best practices are viewed more favourably.

Operational Profile

Ind-Ra rating methodology includes a review of the operating characteristics of a borrower. Measured in a variety of ways depending on the borrower's sector, Ind-Ra's operations review may include investigations of business strategy, operational effectiveness, competitive position and environment, and capital planning and management processes. An examination of internal processes and procedures designed to maximise asset productivity and a review of an organisation's ability to maintain operating strength in a variety of economic and business conditions are core to this analysis. Ind-Ra views favourably those organisations that demonstrate stability in their performance level over time.

Business Strategy

To assess business strategy, Ind-Ra examines an organisation's position within the markets served and ability to meet the needs of its constituents. While Ind-Ra reviews historical market position trends in the context of current industry characteristics, close attention is paid to the flexibility an organisation retains to deal with potential changes in its competitive or operating landscape.

Ind-Ra looks to overall trends in demand and financial metrics to judge the effectiveness of an organisation's business strategy. As part of the analysis, Ind-Ra reviews the institutionalised processes that facilitate effective strategic planning, with an emphasis on aspects that provide operating flexibility to adjust for variations in demand. Even within the same industry, Ind-Ra recognises that no single business strategy is appropriate for all organisations. The plan should fit the mission of the borrower, the needs of its customers and other constituents, and its specific marketplace.

Operational Effectiveness

The efficient deployment of capital assets to generate surplus funds to cover debt service requirements and on-going repair and replacement of assets is a key credit consideration for all revenue-supported sectors. Ind-Ra examines the productivity or utilisation levels of existing physical plant assets in the context of a borrower's industry. Borrowers with elevated excess capacity and limited means to recoup their fixed costs are viewed negatively. While growth prospects and assumptions are carefully considered as part of a proposed expansion, Ind-Ra may negatively view such plans when excess capacity or organisational inefficiencies have historically plagued a borrower's operation.

An organisation's ability to generate cash flow from its operations sufficient to fund capital renewal and expansion and service debt obligations is evaluated through an analysis of revenue and expense trends. Changes in revenue are analysed by reviewing an organisation's pricing strategies; regulatory, political, or market limitations on its ability to influence price levels; and volume or demand patterns. An organisation's expense structure is similarly reviewed, with additional consideration given to cost containment efforts and industry-specific factors that may affect the cost and availability of inputs, whether raw materials, supplies, or labour, going forward.

Competitive Profile

In sectors where marketplace competition is a potential rating concern, an organisation's position relative to its peers is a major area of analytical focus. In such cases, Ind-Ra analysis may include reviews of market share trends, rate competitiveness, industry reputation, geographic coverage or footprint, and product differentiation. Aspirations to achieve higher industry standing or ranking, support service area economic development, or significantly change market share concentration are evaluated in conjunction with the practical realities of the organisation's current competencies and ability to secure additional resources to fund such initiatives.

Regulatory Issues

For sectors subject to external regulation, Ind-Ra combines a review of the current and expected regulatory climate with an assessment of the organisation's ability to maintain stable operations in the face of regulatory change. Ind-Ra may review responses to prior regulatory mandates, identifying financial and operational effects. Ind-Ra examines the potential for future regulatory initiatives and assesses whether the organisation, through its systems, practices, and resources, will have the ability to manage potential downside risks. In sectors where external regulation is prevalent and has a bearing on creditworthiness, an organisation's proactive response to regulatory developments and effective participation in the regulatory and legislative processes help support solid investment-grade ratings.

Capital Planning and Management

Ind-Ra assesses the feasibility of significant investment in physical plant capacity by reviewing the borrower's capital improvement plan (CIP). Plans that are dynamic, address facilities needs over multiple time spans, and specify funding sources are viewed more credibly in the rating process. In general, modular CIPs are viewed more favourably by Ind-Ra because they provide an organisation the flexibility to modify its planned capital investment should business or market conditions prove unfavourable.

Ind-Ra review focuses on current capacity constraints and limitations, the assumptions that underlie volume projections, and the capital budgeting process. In addition, funding sources, which may include a combination of debt proceeds, cash on hand, governmental appropriation, and other sources, are reviewed for reasonableness. For sectors that have large CIPs, Ind-Ra may also evaluate the overall terms and provisions of construction contracts (such as liquidated damages, early completion incentives, and labour contracts and cost adjustments), as well as the experience of the development team.

Ind-Ra reviews an organisation's process for and financial ability to make annual routine investment in asset maintenance and equipment acquisition. The amount of deferred maintenance an organisation has will be assessed in the context of its physical plant size and the plan for addressing the most critical needs.

Relationship with Government

For certain public finance credits that are an enterprise or component unit of a general government, the rating of the revenue-backed security may be tied to or influenced by the credit quality of the general government. In addition to sharing common management and service area characteristics, there are situations where significant legal or operational connections may exist between the two (for example where credit agreements cross-default or if one fund is drawing upon the cash of the other). In these cases the revenue-supported rating may be closely tied to the government's long-term rating. Ind-Ra details any direct relationship between the government's credit quality and related revenue-supported securities within the appropriate rating action commentary.

Debt Profile

The level and structure of a borrower's debt strongly affect Ind-Ra's overall assessment of creditworthiness. The purpose of a planned financing, the total amount of debt outstanding, and various characteristics of a borrower's debt structure are all components of Ind-Ra's review. Ind-Ra's approach may also consider the likely consequence of debt market fluctuations and a borrower's ability to meet obligations under such stressed conditions.

Purpose

Ind-Ra debt profile analysis begins with a review of the rationale to issue debt. For new money issues, Ind-Ra seeks to determine if planned capital investments are justified by capacity constraints, projected market growth, or competitive opportunities. In addition to Ind-Ra's own research and analysis, Ind-Ra considers a borrower's methods for monitoring industry growth patterns and their relative market position, if appropriate. Ind-Ra looks favourably on organisations that soundly demonstrate a need for their CIP by employing a variety of techniques to assess service area dynamics, such as econometric analysis and consultations with regional economic development and planning agencies and local businesses, as well as timely economic research and valid surveys. Ind-Ra is specifically interested in the most significant variables that affect increases and decreases in demand for an organisation's goods and/or services.

A borrower's ability to service planned debt from existing operations is viewed favourably. Alternatively, if debt repayment depends on the incremental revenue to be generated by new capital assets, the evaluation of project completion risk and feasibility becomes an important aspect of Ind-Ra analysis. For debt issued to refinance or restructure existing obligations, Ind-Ra analysis focuses on the rationale for the issuance and the options available to the borrower for that purpose.

Magnitude

Ind-Ra evaluates the actual and expected amount of debt outstanding by comparing debt and debt service levels to a comparable group of borrowers and examining future debt service requirements in relation to historical and expected revenue streams and the borrower's overall cost structure. Ratios relevant to the sector capture the financial flexibility afforded by an organisation's assets and operations relative to outstanding and expected long-term debt.

The inability to meet periodic debt service requirements with operating cash flows is viewed negatively. However, in certain cases, these concerns may be mitigated when a borrower's non-operating revenues (or those of an affiliate or other related entity that support the borrower) show a long and stable history or its liquid assets are several times greater than debt obligations (particularly for the higher education and healthcare sectors).

Investment-grade ratings (higher than 'IND BBB-') generally require coverage of debt service by earnings before capital costs, with higher ratings correlating strongly with higher coverage ratios. However, the presence of extraordinary pricing flexibility or available liquidity can mitigate occasional deficiencies in coverage.

Structure

The characteristics of a borrower's debt instruments and capital structure have a strong bearing on Ind-Ra assessment of creditworthiness. The establishment and composition of the obligated entity or entities, the nature of the security pledge, interest rate mechanisms, demand features, performance covenants, and principal amortisation are all components of Ind-Ra's review.

A high proportion of fixed-rate debt is viewed positively by Ind-Ra. Moreover, fixed-rate debts with amortising principal within the expected life of the assets financed provide the most stable debt configuration.

Ind-Ra examines the ability of borrowers that use variable-rate debt to manage interest rate and liquidity risk. Factors that can mitigate the risks involved, such as large cash reserves, are also considered. Generally, variable-rate borrowers that cannot absorb dramatic interest rate increases or address any failure to remarket variable-rate demand obligations (VRDOs), without materially damaging their overall financial profile, are viewed negatively.

The amount of variable-rate debt a borrower can manage (hedged or not) is a function of its operating risk profile, quality of cash flows, amount of available funds, and ability to manage interest rate exposure and financial hedges. To determine if a borrower can manage its variable-rate and short-term debt exposure at its given rating level, Ind-Ra may perform stress tests to determine the resilience of a borrower's financial metrics (e.g. cash flow and liquidity adequacy), compared with its peer group. Typically, borrowers rated 'IND A' or higher have greater financial flexibility, including market access, to manage the various risks associated with variable-rate debt than their lower rated counterparts.

Legal Provisions

Ind-Ra analyses several legal factors, which may include indenture provisions such as security pledges, rate covenants, events of default, additional bonds tests, and reserve requirements. While Ind-Ra believes bond covenants are clearly important to overall investor security, the degree to which they influence ratings varies. Operating performance will have a greater effect on the rating than legal provisions for most highly rated borrowers. However, legal provisions become increasingly important as a borrower moves down the rating scale.

Indirect Risks and Contingent Liabilities

In looking at an issuer's debt obligations, Ind-Ra examines not only liabilities directly incurred and payable by the issuer but also outstanding debt for which the issuer may in the future have an obligation. Examples include moral obligations, where the issuer may support but is not legally obligated to support – the debt upon failure of the primary security, and needs of related governmental entities that may require financial resources of the rated issuer. Such obligations are monitored but typically excluded from direct debt calculations unless the issuer's resources have been relied on to cover the obligation during the past three years.

Event Risks

Where relevant to the sector and material to the rating, Ind-Ra explicitly considers the potential event risks that may adversely affect the issuer's ability to repay the debt. Event risks arising from natural hazards as well as human error or mechanical malfunctions are identified and the management of the relevant risks evaluated. Ind-Ra also evaluates issuers' ability to safeguard itself from such unforeseen events. Where it is determined that a credit has vulnerability to event risk, mitigating factors will be evaluated. Some issuers have multiple assets and analysis may consider a single event unlikely to affect all assets to such an extent that it would hurt timely payment of debt. The debt will not be affected so long as there is sufficient liquidity

to get through the immediate impact of the event. In these cases where operating characteristics and revenue frameworks provide mitigation of risk, self-insurance may be a common option for an issuer. In some cases, risk mitigation will not be sufficient and the rating may be capped below an investment-grade threshold depending on vulnerability to the uninsured risk.

Financial Profile

A borrower's overall financial profile contributes materially to the rating determination. Ind-Ra analysis includes quantitative assessments of operating performance, liquidity, and debt load, as well as the historical trends in such measures. Comparisons with the borrower's sector-specific rated peers are often a component of the analysis.

Ind-Ra believes the financial profile is a product of the qualitative and strategic factors discussed herein and that the credit rating should be supported by well-founded expectations for such factors. Additionally, qualitative factors can often modulate the risk level that may be indicated by a narrow review of financial metrics, contributing to additional credit strength or weakness. Finally, absent the development of a clear trend, a certain amount of variability in financial performance should not affect the rating on the debt, as long as a borrower's underlying strategic position remains stable.

Performance Metrics

Both historical and projected financial results are considered. The best indicator of future financial performance is the recent track record of the borrower, its management team, and its market. If future performance is expected to track differently from historical results due to major project plans, environmental changes, or management initiatives, Ind-Ra examines the assumptions that drive projected results. Forecasts that rely on aggressive volume growth, market share capture, price increases, or expense reductions are viewed with analytical conservatism in the rating process. Ind-Ra may request sensitivity analyses stressing major forecast assumptions to gauge their importance in achieving projected results.

Using audited and interim financial information and statistics, Ind-Ra assesses the organisation's financial profile, reviewing trends in operating performance and non-operating results, absolute and relative levels of balance sheet assets and liabilities, and statistical information relevant to the sector. Financial forecasts, if available, are included in Ind-Ra review.

An organisation's ability to generate resources from its operations sufficient to fund capital renewal and comfortably meet expected debt service obligations is a key rating consideration. Demonstrated stability or consistent improvement is viewed positively. Where variability is observed, Ind-Ra's analysis seeks to identify the reasons for such changes and management's response to internal and external factors that may have resulted in negative movements. Although Ind-Ra approach considers non-operating revenues, performance analysis emphasises core operating results.

For sectors such as healthcare and education, whose credit characteristics call for relatively large cash reserves to support investment-grade ratings (higher than "IND BBB-"), the level of balance sheet assets held as cash, or that can be expeditiously converted to cash, is a key credit factor. Unrestricted cash and investments are measured absolutely and relative to operating performance and debt levels, whether such assets are used to quickly pursue market opportunities, counter market threats, absorb unexpected declines in operating performance, generate income to support operations, or simply serve as a backup reserve to meet debt service requirements.

The actual and expected debt a borrower carries – its amount, amortisation, and servicing requirements – is a key component of the financial profile. While specific metrics vary depending on the sector, Ind-Ra analysis includes the computation of several ratios that describe the relative amount of debt used to capitalise the enterprise, the magnitude of debt service requirements in relation to the scope of the entity's operations, and the ability of operations to generate funds to meet debt service requirements.

Peer Comparisons

Ind-Ra analysis also considers how a borrower's financial profile matches up with the profiles of other entities with similar market, operational, financial, and credit characteristics. Depending on the sector, one or more analytical tools may be used to compare a borrower's actual or pro forma financial performance with peer group benchmarks or rating-specific median financial ratios.

Liquidity

Ind-Ra analyses the ability of the issuer to timely receive dues and make payment of the debt obligation as per schedule. The analysis of the issuer's liquidity position includes revenue collection schedules, the timing of transfers received, the timing of disbursements, the quality and timing of receivables and payables, and any committed undrawn bank lines. Liquidity position highlights the ability of an issuer to make resources available to meet revenue requirement during a slump in demand or an increase in costs. Available cash position determines the strength of the liquidity profile and strong to moderate cash position ensures minimum liquidity risk.

Note on Sources

Ind-Ra analysis and rating decisions are based on relevant information available to its analysts. The sources of this information include the borrower and/or the obligor and the public domain. This includes relevant, publicly available information on the borrower, such as financial statements and regulatory filings. The rating process may also incorporate information provided by other third-party sources. If this other third-party information is material to the rating, the specific rating action will disclose the relevant source.

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