

Short-Term Ratings Criteria for Non-Financial Corporates

Sector-Specific Criteria

This criteria updates the Short term Ratings Criteria for non-financial corporates dated 4 April 2016.

Definition and Scope

A Short-Term Issuer Rating is based on the short-term vulnerability to default of the rated entity and is assigned to those financial obligations whose initial maturity is typically up to 12 months.

This report describes India Ratings and Research's (Ind-Ra) approach to short-term ratings for Short-Term Issuer Ratings (IRs) and issue ratings. The short-term money market obligation most commonly rated by Ind-Ra remains commercial paper (CP).

Highlights

Short-Term Rating Scale: Short-term ratings are generally assigned on a scale comprising 'A1', 'A2', and 'A3' in investment grade and 'A4', and 'D' in speculative grade. Additionally, a '+' modifier is used to further nuance the differentiation leading to 'A1+', 'A2+', 'A3+', and 'A4+' ratings.

Link to Long-Term Ratings: While there are a large number of discrete factors that drive short-term ratings, a linkage has always existed between short-term and long-term ratings. This reflects the inherent importance of liquidity and near-term concerns within a longer-term assessment. Additionally, it ensures that the two scales do not intuitively contradict each other for a given issuer. This linkage is outlined in Figure 1 on page 2.

Short-Term Time Horizon: The time horizon of the short-term rating extends nominally to 12 months although, as discussed below, this is an intrinsic rather than a "time-limited" view.

Asymmetry: Figure 1 also displays a certain asymmetry in that higher relative short-term default risk implies an elevated risk of default in the near term that cannot be separated from the long-term default assessment, but lower relative short-term default risk, perhaps through factors that lend the issuer's profile temporary support, may coexist with higher medium- or longer-term default risk.

This "mapping" table thus limits the potential for a combination of a particularly weak short-term rating with a high long-term rating. The other asymmetry – stronger short-term rating but weaker long-term rating – is addressed conceptually. The short-term rating within investment grade is a measure of intrinsic or sustainable liquidity, which excludes temporary or unsustainable support.

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Figure 1
Rating Correspondence

Long-Term IR	Short-Term IR
IND AAA	IND A1+
IND AA+	IND A1+
IND AA	IND A1+
IND AA-	IND A1+
IND A+	IND A1+ or IND A1
IND A	IND A1
IND A-	IND A1 or IND A2+
IND BBB+	IND A2+ or IND A2
IND BBB	IND A2 or IND A3+
IND BBB-	IND A3
IND BB+ to IND BB-	IND A4+
IND B+ to IND B-	IND A4
IND C	IND A4
IND D	IND D

Source: Ind-Ra

Assessing Short-Term Ratings – Sustainable Liquidity

The time horizon of short-term ratings does not explicitly relate to the 12 months immediately following a given date. Instead, it relates to the continual liquidity profile of the rated entity that would be expected to endure over the time horizon of the Long-Term IR, typically one economic cycle of the issuer under review. This approach places less emphasis on favourable or unfavourable features of the liquidity profile that may be regarded as temporary. Examples include high cash balances that would not be expected to be maintained or a high degree of contractual certainty on revenues/cash flows for the next 12 months that will then roll off with a lower likelihood of replacement.

Ind-Ra's initial view on the Short-Term rating generally considers the issuer's long-term ratings based on the mapping in the Rating Correspondence Table. Where the long-term IR can link to either of two ST ratings, the short-term rating may be clarified by means of a detailed review of the liquidity position, stability, and contingency programmes used to manage liquidity based on any criteria relevant to that sector. While deciding a short-term rating at the cusps, Ind-Ra also uses tools such as liquidity ratio/score to determine the final rating. Where an issuer demonstrates strong, specific liquidity-related features with no major deficiencies, the higher of the two short-term ratings may be assigned.

As a result, it is possible that the sustainable liquidity profile on which the short-term rating is based could depart from the actual, stronger but temporary liquidity profile of an issuer over the next 12 months. Thus, investment-grade short-term ratings benefit from more stability over time since they link to Ind-Ra's view of the issuer's sustainable liquidity profile. As such, short-term ratings will not reflect the volatility associated with increases or decreases in liquidity due to temporary factors. Liquidity is judged by assessing a mixture of the operational or internal cash flow, capital structure, available resources including unutilised committed lines from banks/FIs or tied-up long-term debt, and other factors, relative to demands on liquidity that conform to the stresses deemed to be appropriate for that sector and rating category.

Given the lower granularity of the scale within speculative grade, and the greater focus on liquidity in the analysis of the issuer's long-term prospects, a simpler mapping approach is used to derive speculative-grade short-term ratings. Actual short-term changes in liquidity profile are more likely to be reflected in movements in the Long-Term IR, particularly for issuers with Long-Term IRs in the 'BB' rating categories and below.

Issuer Ratings and Issue Ratings

Issuer Ratings

Most issuers will be assigned only long term issuer ratings though there might be instances where short term issuer ratings are also assigned.

Issue Ratings

Short-term ratings are assigned to issues with an original maturity of up to 1 year.

Where explicit enhancement is provided along with a pre-default payment mechanism (stand-by letters of credit-backed commercial paper, for example), the short-term rating on the instrument will be the higher of the direct-pay letter of credit (LOC) or similar guarantee provider or the short-term rating of the issuer itself.

Commercial Paper

Liquidity is an important part of Ind-Ra's overall corporate analysis. If a company's liquidity provisions are inadequate, it affects both the long-term and short-term credit ratings.

Applicable Criteria

[Corporate Rating Methodology](#)
(September 2012)

An excessive reliance on CP and other liquidity-sensitive short-term funding can heighten liquidity risk for a company. For corporate industrial companies, the appropriate amount of total short-term debt, including CP, is determined in relation to net working capital and seasonal borrowing needs or to an amount that can be determined by targeting the appropriate liquidity ratio. For example, where an issuer relies on a permanent layer of CP unrelated to its normal cash conversion cycle or inflated outstanding CP to fund acquisitions without sufficient contingency planning, it increases its liquidity risk.

Maturing long-term debt can also expose corporates to liquidity stress if the term of the debt is not matched to internal cash flows or maturing assets. Again, this would get reflected in the liquidity score. Staggering debt maturities and limiting maturities by month and year can help limit liquidity strains. Repayment of material debt maturities would usually be planned in advance, with contingency plans in case capital market conditions interfere with any expected funding.

Liquidity Risks

Corporate CP issuers need sufficient liquidity reserves (including liquid assets, unutilised committed bank lines or liquidity from a parent or third party) to withstand two types of liquidity challenges: systemic risk and credit, or event risk.

Systemic Risk

Systemic risk is the possibility of a broad market disruption affecting the entire CP market or a whole market tier. The Indian CP market can be considered as composed of two market sectors. These are the tier 1 CP market (encompassing issuances with ratings equivalent to IND 'A1+'), and the tier 2 market (CP with ratings equivalent to IND 'A1'). During periods of stress, the tier 1 CP market might be substantially more liquid than the tier 2 market.

There can be factors that can combine to shrink either the pool of buyers or the range of investments deemed attractive to an existing pool of investors suddenly and on a systemic basis.

Credit Risk

Credit risk for CP issuers is less related to default risk than to rating migration risk (i.e. the possibility of an issuer-specific event – such as a hostile takeover offer announcement, an unexpected adverse decision in a law suit, or an unfavourable earnings announcement – warranting a credit downgrade that makes investors unwilling to buy new CPs of that issuer). Although any corporate CP issuer can experience a reduction or loss of liquidity due to individual credit events, credits in the A1 category typically face a higher liquidity impact, since a downgrade would greatly reduce or eliminate CP market access. Market access for tier 2 issuers can also be impaired by adverse news about another company in the same industry sector, even if the issuer is not directly affected.

An adverse credit event or downgrade is likely to have a more modest impact on 'A1+' corporate CP issuers, since they have better financial resources and market reputations at the outset. However, not even blue-chip corporations are immune from event risk. On rare occasions, tier 1 corporate CP issuers can also experience such rapid deterioration in creditworthiness that they fall below investment-grade status.

The credit rating is not the only factor affecting market access. Very large issuers offering CP continuously in the market and issuers whose products and brand identities are well known tend to have better market access than do sporadic issuers with small CP programmes and a lower public profile. However, credit ratings generally correspond with levels of market access, systemic risk, and credit risk.

Why Liquidity Back-Up is Important

The immediacy of CP settlement, coupled with shorter-dated tenors, makes CP a potent short-term funding tool and also increases potential liquidity risk for issuers, who must fund their maturing paper with immediately available funds.

If a corporation's CP funding does not match its normal asset conversion cycle or operational free cash flow, the issuer must refund CPs already in the market either with new CPs or by issuing long-term bonds or accessing CP-specific or "general corporate purpose" bank lines, if they enable same-day funding. If the issuer does not have such immediate funding, the company may not be able to repay maturing obligations. To mitigate liquidity risk, Ind-Ra considers liquidity back-up for outstanding CP and other short-term debt obligations an important element in assigning instrument-level ratings as well as an element in assessing the Long-Term IR.

Buyers of corporate CP backed by bank liquidity commitments should not rely on these as direct credit enhancement. Liquidity back-up exists primarily to protect the issuer's overall credit against the risk of default or insolvency caused by unsuccessful CP market rollovers, not to protect creditors. A default or insolvency by the issuer would in nearly all cases prohibit drawing under the credit lines. The rating of corporate CP backed by liquidity arrangements is therefore linked to the issuer's credit standing and is not tied to the ratings of liquidity providers.

Liquidity back-up is either adequate or inadequate. "More than adequate" liquidity back-up does not justify a higher short-term credit rating. On the other hand, when CP is explicitly enhanced – for example, if it is backed by a direct-pay LOC or similar form of guarantee, with a pre-default payment mechanism – the ultimate CP rating will be the higher of the direct-pay LOC or similar credit enhancement or the short-term rating of the issuer itself.

Ind-Ra typically expects CP issuers to have full (100%) liquidity back-up available for its outstanding CP and other short-term obligations throughout their tenor, regardless of the credit rating of the entity. In case of issuers rated at 'IND AA- or below, Ind-Ra usually requires CP to be carved out of the entity's fund-based working capital limits. In case of higher rated entities, back-up may not only be in the form of bank commitments but may also include unutilised committed bank lines, long-term debt already tied-up, cash and cash equivalents, expected operational cash flow sources, tangible support from a parent with a strong credit profile, or other alternative forms of liquidity support. Tangible parental support would typically mean any arrangement whereby cash is made available by the parent at a short notice to prevent default on the CP. In such cases, Ind-Ra would seek a well-defined contingency plan from the parent to support the timely payment of CP as well as mention it clearly in the rating rationale.

Calculating Sufficient CP Back-Up Coverage for Corporates

Ind-Ra calculates corporate CP back-up coverage as the sum of all forms of liquidity support listed above – divided by the sum of CP and other short-term financial obligations (including interest and the principal repayments coming up within the year. For this purpose, special funding programmes and securitisations that have dedicated liquidity back-up are removed from the numerator and their dedicated back-up is removed from the denominator.

In case Ind-Ra assigns an investment grade ST rating despite less than 100% back-up, it would be noted as a deviation in the rating rationale and an issuer-specific rationale would be given to explain the same. Furthermore, a deficiency in an entity's liquidity profile will also be considered when evaluating its default risk.

Limitations

Please also see the Limitations in the Master Criteria [Corporate Rating Methodology](#).

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