

Alternative Rating Products



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Credit ratings have been an effective tool widely used to make investment and lending decisions. The sound, rigorous, systematic and analytical methods adopted by credit rating agencies in the conduct of their credit rating exercise which encompasses a wide and diverse set of entities across sectors, makes them well equipped to conduct an independent assessment of the

various market facilities. This assessment essentially pertains to the value, reliability, fundamentals and performance of the facilities all of which become critical in the (informed) decision making process of the potential users like investors and other stakeholders.

While credit rating provides an assessment and opinion of the credit worthiness and debt servicing ability of the entities/borrowing debt funds, thereby facilitating informed decision making by stakeholders viz. lenders and investors, there are in the market various facilities – physical and services alike, that require an independent assessment to gauge their various attributes, necessary for decision making by the stakeholders. This is where the necessity of having alternative rating products arises.

Such assessments can be carried out for a wide and diverse range (in some cases unique range) of physical and service facilities/offering, ranging from the grading of educational institutions, shipyards, equities and initial public offering (IPO) of companies, micro-finance institutions, real estate projects, real estate invest trust funds to energy audits and implementation of energy efficiency.

The need for rating or grading products stems from the information asymmetry prevailing in the markets/system pertaining to the various services and products. Lack of information or fragmented information, regional dynamics, small size players, lack of benchmark etc. necessitate the need for an independent evaluation of the stated attributes, the strengths and weaknesses of the facilities on offer.

The independent evaluation of the facilities i.e. ratings and grading, done by qualified rating agencies such as CARE Ratings bring about transparency and enables all users, investors and stakeholders make informed decisions. It also promotes the adoption of best practices, increases credibility, visibility and thereby prompts overall improvement in the quality of products and services offered. From a business standpoint, alternative rating

products also help the rating agencies diversify and thereby further develop and strengthen their understanding and expertise in assessing and evaluating varied products & services in the system. However, most of these products are market determined ones and are not mandated by the system, as in debt rating or bank loan ratings which are mandatory.

Covered here is a brief about the various alternate rating products CARE Ratings offers, catering to a gamut of diverse sectors and segments. Herein, we have enumerated the product offering and the methodology using in the evaluation/assessment of the same.

1. EQUIGRADE

CARE's Equi Grade is essentially an independent research of equities of listed companies carried out by CARE Ratings. The need for such an assessment emerges from the dearth in retail participation in India's capital markets (less than 10% of household investments). Despite the market capitalization of the domestic stock exchanges exceeding its GDP, retail participation here is limited owing to the lack of in-depth analytical information and independent professional assessment of the equity markets and its valuation. With active research available for only 5% of the listed companies, retail investors do not have adequate information for the majority of the listed companies. They are thus restricted to investing in bigger companies, thereby missing out on many smaller but fundamentally sound companies with attractive valuations.

Equi Grade entails an analytical and unbiased review and study of the (i) fundamentals of the company & industry (including management quality & corporate governance) and (ii) the valuation of its equity i.e. price of the scrip. Such an assessment is beneficial for the investors and the company alike. Stock exchanges too benefit from such independent studies as it increases investor awareness/education and thereby trading volumes.

Normally for the large companies, there exists a lot of equity research which is provided by investment banks and brokerage firms. However, for the others, there are research limitations. For the investor, this assessment could serve as a beneficial and at times critical input in their decision making. It can also serve as a shield for retail investors against speculative activity as an independent and professional assessment of the fundamental price making the investors prudent and prevent them being trapped in certain equities. It however needs to be borne in mind that Equi Grade does not comment on the suitability of the investment for the investor nor of the timing of the investment as these factors are unique to the investor and the market conditions. It thus does not guarantee any return or down-side of the stock and is not a recommendation to buy/sell or hold securities.

From the perspective of the listed company, Equi Grade adds immense value to the credibility and reliability of the company as the assessment is done by an independent agency bound by the regulations of the market regulator i.e. SEBI. Additionally, it also improves the company's visibility and thereby liquidity for its equity shares in the market as the assessment reports are widely disseminated to the investing community. It also supplements and provides an edge to the company's investor information dissemination initiatives, creating and boosting the investor friendly image of the company. The enhanced credibility and improved liquidity would serve to be beneficial in the fund raising activity of the company. It can also serve as a key input i.e. a credible third party view point, for the top management of a company in making strategic internal and business decisions.

2. Real Estate Star Grading

Given the fragmented nature of the real estate industry, the regional dynamics and the presence of small players, the sector is marred by low levels of investor trust. Even with the large corporate houses venturing into this sector and the transparency that they bring along, there is a lack of benchmarks to differentiate them.

There is thus a pressing need to evaluate and distinguish real estate projects on various parameters such as developer quality, track record, timeliness of project completion, construction quality, financial prudence, amenities provided, legal aspects, etc. CARE Real estate star grading addresses these issues and assesses the ability of the developer to construct the real estate project within specific timelines adhering to agreed specifications, thereby facilitating informed decision making by investors and buyers. The grading analyses the projects on various quality related parameters and are city specific and covers residential, commercial, retail, township, mix use development, SEZ, and IT parks.

Besides enabling buyers and investors in their decision making, the real estate star grading helps the real estate projects to showcase their abilities, create awareness, marketing, sales and improving its branding. Such a grading can serve/ complement the entry strategy for a developer in a new location. It also enhances the credibility amongst customers as well as play a crucial role in the process of approval of loans from banks/NBFCs. The banks also benefit from the periodic assessment (surveillance) by the rating agency. The gradings also provide value insights with regard to the due diligence activities conducted by private equity (PE) Investors and banks during funding of the projects.

The grading of real estate projects involves a thorough multi-layered evaluation to determine the quality of the project. Foremost, an extensive assessment of the project is undertaken based on information and documents provided by the client. In addition, meetings are held with the project management and operations team, site visits are conducted, evaluation of the past

projects done, assess the city and the project location along with project financial/ break-even analysis. The projects are under surveillance for its entire tenure even after the gradings are assigned.

3. Edu-grade

This product assesses the quality of the various courses offered by educational institutes. Here the effectiveness of resources provided and processes followed in achieving the course objectives is closely evaluated. Educational institutes by getting themselves graded by an independent agency would create greater visibility for themselves, awareness about the institute and improve their credibility. The institutes would be able to benchmark with peers. It will also boost student confidence in the institute and thereby aid in their decision making of enrolling in the institute. In addition to these, prospective employers and executive search firms also benefit from such an assessment. Likewise, banks and financial institutions, can use the grading as an aid in their student loan appraisal process. Lastly, investors in the sector could use grading as a tool for selection of institution they would like to fund.

The grading exercise is based on information provided by the institute which consists of both course-specific and college-specific information. The assessment is carried out course-wise. The grading exercise focuses on the evaluation of the quality of infrastructure & faculty, academic & non-academic activities and teaching methodology & assessment. In addition, the student quality mix, overall performance of outgoing students and the quality of management & financials is also evaluated.

4. IPO Grading

IPO grading facilitates the assessment of equity issues offered to public. It is an independent and professional opinion on the fundamentals of the issuer and the grades assigned to an issue represents a relative assessment of the 'fundamentals' of that issuer.

The Indian capital markets entail high levels of disclosures thereby making them transparent and efficient. However appropriate interpretation of these requires fairly high levels of analytical sophistication of the reader. The IPO grading helps simplify the meaning of the disclosure to the retail investors to the extent that they affect its fundamentals. It thus helps the investors in their decision making process. Such grading is particularly useful for assessing the offering of companies accessing the capital markets for the first time and have no track record of market performance. An IPO grading however does not take cognizance of the price of the security nor is it a recommendation to buy, sell or hold securities. It is not a comment of the offer price or listed price of the scrip.

An assessment of the overall fundamentals of an issue is undertaken based on business fundamentals & prospects, financial position, management quality, corporate governance practices, project risk and

compliance and litigation history. A time horizon of 3 years is usually taken for this analysis. The IPO grading would involve an in-depth assessment of the various quantitative and qualitative parameters of the issuer. Quantitative parameters include growth prospects of the industry, financial strength & operating performance of the issuer whereas, qualitative parameters primarily include management capability, promoters' evaluation, accounting policies and corporate governance practices.

5. ITI Grading

Given the importance of Industrial Training Institutes (ITIs) constituted under Directorate General of Employment and Training (DGE&T) for the Indian economy as a provider of skilled manpower, the quality of these institutes gains importance. The grading of these institutes serves as a quality assurance system.

The grading can serve as an input tool to compare relative strengths and weaknesses across institutes and the trades offered therein thus aiding DGE&T in identifying specific problem areas and designing appropriate policy interventions, thereby promoting excellence in vocational training, in turn producing quality labour for employment. Institutes can gain insights into their strengths and weaknesses and the scope to capitalize/improve on the same. The grading provides students with a benchmark for comparison between various institutes and trades and aid in their course selection. Corporates will also benefit from the grading by way of skilled manpower.

ITIs are graded at the Trade & Institute level. The institute level parameters evaluated include qualification of principal, overall upkeep & hygiene, availability of power, safety equipment's & adoption of safety norms, record of timely maintenance etc. The trade levels parameters include availability of space, tools & equipment, machinery and staff. Student intake and job record as per norms is also assessed.

6. Maritime Grading

Maritime Training Institute (MTI) grading is an opinion on the relative quality of the course conducted by the institute i.e. whether it achieves the specified objectives of the course. The analytical framework of CARE's grading methodology is divided into two interdependent segments (1) overall strengths of the institute and (2) course specific. For course assessment parameters such as course equipment, faculty assessment, teaching methodology and student quality are analyzed, in case of institute assessment parameters like financial strength, management quality and sustainability are looked into.

7. RESCO Grading

Ministry of New and Renewable Energy (MNRE) had launched Jawaharlal Nehru National Solar Mission with an objective to promote the use of renewable sources of energy and setting up an environment which will facilitate increased penetration of solar technology in the country. The mission envisages providing capital and interest

subsidy to make the solar off-grid projects commercially viable and workable on a sustainable basis. To scale up the said program, increase participation of capable entities and reduce transaction time, the mission has envisaged that RESCOs and System Integrators obtain an accreditation from rating agencies like CARE Ratings.

The grading is being done to enable participation of only credible channel partners in the project implementation. It also serves as a tool for promotion of best practices in the sector and to monitor performance capability over time and incentivize the efficient channel partners. In addition, it facilitates faster access to capital and interest subsidy, provides scope for self-correction and improvement on capability performance and financial soundness. It also encourages participation of startups and innovative entrepreneurs with requisite technical skills.

Other grading products

We also have some innovative products such as MFI grading which is a one-time assessment of a Micro Finance Institution's (MFI) operational and financial capability to undertake and sustain the targeted level of operations. Further, ESCO Grading has been initiated by Bureau of Energy for evaluating energy efficiency programs executed by "Energy Service Companies" or ESCOs. Shipyard Grading, another product involves assessment of the financial strength of shipyard companies and enables them to participate in numerous contracts for various types of ships given out by the Indian Navy. Construction grading of entities is another opinion on the ability of the respective entity to carry out the stated objectives like project management and execution, design and engineering, within a specified time frame. This helps users in short-listing superior entities which in turn can reduce the time involved in the tendering/bidding. Graded construction entities can get themselves empanelled with government departments such as PWD, Municipal Corporations, Urban Bodies, etc. Grading would aid potential investors in making an assessment of the entity while the entity can secure long-term finance at competitive rates.

CARE's first

A major innovation from our side more recently has been with Real Estate Investment Trusts (REITs) rating. The rating of REITs Fund, is an independent opinion on the REIT's investment quality, based on the fundamental assessment of the REIT and evaluates parameters such as - business Risk (analysis of underlying quality of assets), financial Risk (analysis of liquidity, financial flexibility and operating margins & earnings) and management/sponsor evaluation. REIT rating would serve as a valuable tool for investors and issuers. In case of investors, it would aid in choosing among REITs in terms of fundamentals and for the issuers, it would help in better showcasing the investment quality of the REITs.

Concluding remarks

The concept of alternative grading products is an extension of rating to any product or service which requires an unbiased view so as to guide decision making. Being market driven and not by regulation, these products need to be explained to potential users so that their value can be unlocked. The market has been receptive to such

products gradually and those entities going in for such a grading are deriving value. We can see further evolution in this market as rating agencies try and bring more innovative products to the table in a world that is getting more competitive with information asymmetry also widening as companies try and stay ahead.
