

Credit Rating: Assessment and Impact



Resurgent India Limited

We are a young & fast growing Investment Bank offering services in the fields of Mergers & Acquisitions, Private Equity, Venture Capital, Debt solutions, Working Capital, Project Finance and Business Consulting.

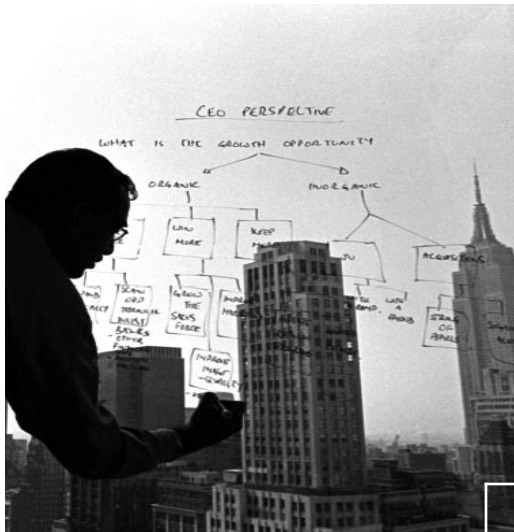
Our team acts as product and industry specialists with deep domain knowledge and research driven approach. With our business built on strong relationships and uncompromising ethical standards, we aim to create significant value for entrepreneurs and stakeholders by engaging with them at an early stage of ideation and partnering with them all the way, in order to execute the right growth strategies.

Our service offerings include :

Equity Solutions

Debt Solutions

Advisory, Enterprise Risk Management & Tax



Highlights:

- Closed more than 150 transactions across various sectors
- Successfully advised on transactions worth more than USD 500 million in 2012
- Dedicated team of specialists in key instruments (Equity, Domestic Debt, Structured Finance, ECBs, FCCBs) with rich transaction experience
- Business partners in Israel, Middle East, Europe, United Kingdom and Australia
- Actively running several cross border Mergers & Acquisitions and Private Equity transactions in sectors like Logistics, Consumer Goods, Industrial Goods, Auto, Healthcare etc.
- Strong research focus to ideate several cross border opportunities
- Offices in Gurgaon/Delhi, Mumbai, Kolkata and Bengaluru

Credit Rating: Impact & Assessment

Introduction:

Indian Banking sector, witnessed an extensive transformation in 1990s due to emergence of a large number of private as well as foreign banks in India due to economic reforms. This resulted in increase of banking activities, thus affecting a large number of activities, primarily lending. The facility of extending credit signifies the changing economic condition in which the bank operates. The increase in bank credit was due to a growing need for bank credit which was largely on account of the investments that were made to boost industrial production. In such a situation there was a danger of a party obtaining financial accommodation from various banks to an extent which made the company over leveraged and consequently leading to a severe pressure on the repayment capacity of the company. This necessitated the need to have a structured and reliable data base of companies on their credit history to enable lenders take a considered opinion on lending to companies.

Further, with the increasing market orientation of the Indian economy, investors needed to assess two types of risks to evaluate their investment options. One risk was “business risk” and other was “payments risk”. The latter to some extent was mitigated if there was a robust, reliable credit rating mechanism available to the investors.

India was perhaps the first amongst developing countries to set up a credit rating agency in 1988. The function of credit rating took a concrete shape as RBI made it mandatory for the issue of Commercial Paper (CP) to be rated before issue and subsequently by SEBI, when it made credit rating compulsory for certain categories of debentures and debt instruments. Further, in June 1994, RBI made it mandatory for Non-Banking Financial Companies (NBFCs) to be rated and fixed deposits of manufacturing companies also come under the purview of optional credit rating.

India was first among the developing country to set up a credit rating agency in 1988. Further, the function took a concrete shape as the Indian Central Bank made it compulsory for issue of Commercial Paper (CP)

Origin:

The first mercantile credit agency came into existence in 1841 in New York, to rate the ability of merchants to pay their financial obligations. Further, the modern rating system dates back to 1909 when John Moody started rating US railroad bonds. Going ahead, in the 1920s credit rating industry witnessed expansion as Poor's Publishing Company published its first rating guide. In line with this, Fitch Publishing Company and Standard Statistics Company were set up in 1924 and 1922 respectively. Post that, until 1970, no major rating agency was established, post which numerous credit rating agencies were established all over the world including countries like Malaysia, Thailand, Korea, Australia, Pakistan and Philippines etc.

Globally, modern credit rating era begun in 1909, when John Moody started rating US railroad bonds. Further, in India Crisil was the pioneer in rating arena

On the domestic front, CRISIL (Credit Rating and Information Services of India Ltd.) was setup in 1987 as the first rating agency followed by ICRA Ltd. (formerly known as Investment Information & Credit Rating Agency of India Ltd.) in 1991, and Credit Analysis and Research Ltd. (CARE) in 1994. All these agencies were promoted by the All-India Financial Institutions. The rating agencies have established their creditability through their independence, professionalism, continuous research, consistent efforts and confidentiality of information.

Meaning and Definition:

Credit rating is the opinion of the rating agency on the relative ability and willingness of the issuer of a debt instrument to meet the debt service obligations as and when they arise. Rating is usually expressed in alphabetical or alphanumeric symbols. These symbols are simple and an easily understood tool which assist the investor to differentiate between debt instruments on the basis of their underlying credit quality. Further, rating companies also publish explanations for their symbols used as well as the rationale for the ratings assigned by them, to facilitate deeper understanding.

In simple words, a rating is an opinion on the future ability and legal obligation of the issuer to make timely payments of principal and interest on a specific fixed income security. The rating quantifies the probability that the issuer will default on the

security over its life, which depending on the instrument may be a matter of days to thirty years or more.

Further, the credit rating is a symbolic indicator of the current opinion of the relative capability of the issuer to service its debt obligation in a timely fashion, with specific reference to the instrument being rated. It can also be defined as an expression, through use of symbols, of the opinion about credit quality of the issuer of security/instrument.

Need of Credit rating

Credit rating acts as a link between risk and return, besides comparing it with a benchmark. Besides, it also provides an opportunity for the investor to evaluate risk involved and also compare the offered rate of return against the expected risk of default.

Credit rating acts as a link between risk and return, besides, they also offer a benchmark, against which the risk is measured inherent in any instrument. An investor can use the rating to evaluate risk involved and can also compare the offered rate of return against the expected risk of default. The risk perception of a common investor, in the absence of a credit rating system, will largely be based on the familiarity with the names of the promoters or the collaborators. Further, it is not feasible for the corporate issuer of a debt instrument to offer every prospective investor the opportunity to undertake a detailed risk evaluation. Besides, it is unrealistic to expect different classes of investors to arrive at some uniform conclusion as to the relative quality of the instrument. Moreover they do not possess the requisite skills of credit evaluation.

Thus, the necessity of credit rating in the present scenario cannot be over emphasized. It would be of great help to the investors in making their investment decisions and also will assist the issuers of the debt instruments to price their issues correctly and to reach out to new investors. Regulatory bodies such as Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI) use credit rating to determine eligibility criteria for some instruments. For instance, RBI has fixed a minimum credit rating by an approved agency for issue of commercial paper. In general, credit rating will result in improving the quality consciousness in the market and establish over a period of time, a more meaningful relationship between the quality of debt and the yield from it. Further, Credit Rating is also a valuable input in establishing business relationships of various types. However, credit rating by a rating agency is not a recommendation to purchase or sale of a security.

Finally, the increase in repayment defaults, has led to a growing importance of crediting rating. The other factors for the increasing importance of credit rating are:

- i. The growth of information technology.
- ii. Globalization of financial markets.
- iii. Increasing role of capital and money markets.
- iv. Lack of government safety measures.
- v. The trend towards privatization.
- vi. Securitization of debt

Functions of Credit Rating Agency:

Primary attribute of a Credit Rating Agency is to provide unbiased opinion and quality and dependable information at low cost. Functioning of a Credit Rating Agency involves gathering of information that are interpreted and summarised for simple understanding of the investor.

- 1. Provides unbiased opinion:** An independent credit rating agency is expected to provide an unbiased opinion as to relative capability of the company to service debt obligations because of the following reasons:
 - i. It would not have any vested interest in an issue unlike brokers, financial intermediaries etc.
 - ii. Its own reputation could be at stake.
- 2. Provides quality and dependable information:** A credit rating agency is in a position to provide quality information on credit risk which is more authenticated and reliable because:
 - i. It has highly trained and professional staff that has better ability to assess risk.
 - ii. It has access to a lot of information which may not be publicly available.
- 3. Provides information at low cost:** Most of the investors rely on the ratings assigned by the rating agencies while taking investment decisions. These ratings are published in the form of reports and are available easily on the payment of negligible small price. It is not possible for the investors to assess the creditworthiness of the companies on their own.
- 4. Provide easy to understand information:** Rating agencies first of all gather information, and then analyze the same. Thereafter they interpret and summarize complex information in a simple and readily understood formal

manner. Thus in other words, information supplied by rating agencies can be easily understood by the investors. They need not go into details of the financial statements.

5. **Provide basis for investment:** An investment rated by a credit rating enjoys higher confidence from investors. Investors can make an estimate of the risk and return associated with a particular rated issue while investing money in them.
6. **Healthy discipline on corporate borrowers:** Higher credit rating to any credit investment enhances corporate image and builds up goodwill and hence it induces a healthy discipline on corporate.
7. **Formation of public policy:** Once the debt securities are rated professionally, it would be easier to formulate public policy guidelines as to the eligibility of securities to be included in different kinds of institutional port-folio.

Ratings are generally expressed in the form of alphabetical or alphanumeric symbols. The rating is issued on considering various facts such as nature and terms of the issue, willingness of issuer to make payment in time and probability of a default.

Assessment of Credit Rating: As said earlier, the rating is usually expressed in alphabetical or alphanumeric symbols. Further, the rating symbol assigned to each security issue symbolizes following aspects:

- i. The nature and terms of the particular security being issued;
- ii. The ability and the willingness of the issuer of a security to make payments in time;
- iii. The probability that the issuer will make a default in payments

Going ahead after knowing what symbolizes the rating assigned to a security issue, it is important to know the factors affecting the assignment of ratings:

- i. The security issuer's ability to service its debt. In this regard, they calculate past and expected future cash flows and compare these with fixed interest obligations of the issuer.
- ii. The volume and composition of outstanding debt.
- iii. The stability of the future cash flows and earning capacity of company.

- iv. The interest coverage ratio i.e. how many number of times the issuer is capable of meeting its fixed interest obligations.
- v. Ratio of current assets to current liabilities (i.e. current ratio (CR)), this determines the liquidity position of the issuing firm.
- vi. The value of assets pledged as collateral security and the security's priority of claim against the issuing firm's assets.
- vii. Further, market position of the company products are evaluated by the demand for the products, competitor's market share, distribution channels etc.
- viii. Operational efficiency is judged by capacity utilization, prospects of expansion, modernization and diversification, availability of raw material etc.
- ix. Track record of promoters, directors and expertise of staff also affect the rating of a company

Ratings are beneficial to the investors, as it gives an outlook to the investors and also recognises risk and return of the issue. Besides, it also provides an opportunity to the investors to make an independent decision without consulting an advisor.

Advantages of Credit Rating:

Benefits to Investors

1. **Safety of investments:** Credit rating gives an outlook to the investors about the degree of financial strength of the issuer company. On the basis of rating, the investor decides about the investment. Further, highly rated issues give an assurance to the investors of safety of Investments and minimize risk.
2. **Recognition of risk and returns:** Credit rating signifies both the returns expected and the risk attached to a particular issue. It makes the task of the investor easier in knowing the worth of the issuer company just by looking at the symbol because the issue is backed by the financial strength of the company.
3. **Freedom of investment decisions:** Investors need not seek advice from the stock brokers, merchant bankers or the portfolio managers before making investments. This provides freedom for small investors to take investment decisions by themselves. They decide on the basis of rating symbols attached to a particular security, which signifies the creditworthiness of the investment and indicates the degree of risk involved in it.

Investor is provided a wider choice of investment avenues and also he can compare among the given options and choose the best suitable option for himself. It also makes job of the investor easy in understanding the investment proposals.

4. **Wider choice of investments:** As it is mandatory for every issuer to rate the debt obligations, at any particular time, this will offer wide range of credit rated instruments for investments. Considering his ability to bear risk, the investor can make choice of the securities in which investment is to be made.
5. **Dependable credibility of issuer:** Non Existence of any link between the rating agency and the rated firm ensures dependable credibility of issuer and attracts investors. As the rating agency has no vested interest in issue to be rated, and has no business connections or links with the Board of Directors it will operate independent of the issuer company, the rating given by it is accepted by the investors.
6. **Easy understanding of investment proposals:** Investors require no analytical knowledge on their part about the issuer company. They can decide, depending upon the rating symbols assigned by the rating agencies and can proceed with decisions to make investment in any particular rated security of a company.
7. **Relief from botheration to know company:** Credit agencies relieve investors from botheration of knowing the details of the company, its history, nature of business, financial position, liquidity and profitability position, composition of management staff and Board of Directors etc. Credit rating by professional and specialized analysts reposes confidence in investors to rely upon the credit symbols for taking investment decisions.
8. **Advantages of continuous monitoring:** Credit rating agencies not only assign rating symbols but also continuously monitor them. The rating agency downgrades or upgrades the rating symbols following the decline or improvement in the financial position respectively.

Benefits of Rating to the Company: A company which has got its credit instrument or security rated is benefited in the following ways:

1. **Easy to raise resources:** A company with highly rated instrument finds it easy to raise resources from the public. Even though investors in different sections of the society understand the degree of risk and uncertainty attached to

a particular security but they still get attracted towards the highly rated instruments.

2. **Reduced cost of borrowing:** Investors always like to make investments in such instrument that guarantee safety and easy liquidity rather than high rate of return. A company can reduce the cost of borrowings by quoting lesser interest on those fixed deposits or debentures or bonds, which are highly rated.
3. **Reduced cost of public issues:** A company with highly rated instruments has to make less effort in raising funds through public, thus reducing the overall issue cost.
4. **Rating builds up image:** Companies with highly rated instrument enjoy better goodwill and corporate image in the eyes of clients, shareholders, investors and creditors. Clients feel confident about the goods or services offered, shareholders assured of high returns and investors are guaranteed about the safety of their investments and creditors are assured of timely payments of interest and principal.
5. **Rating facilitates growth:** Rating motivates the promoters to undertake expansion of their operations or diversify their production activities thus leading to the growth of the company in future. Moreover highly rated companies find it easy to raise funds from public through new issues or through credit from banks and FIs to finance their expansion activities.
6. **Recognition to unknown companies:** Credit rating provides recognition to relatively unknown companies going for public issues through wide investor base. While entering into market, investors rely more on the rating grades than on 'name recognition'.

It helps the issuer to reduce the cost of borrowing as the investors' looks for safety and liquidity. And an favorable rating ensures this, thus making the task of the issuer lot simpler.

Benefits to Intermediaries: The rating will reduce the effort by stock brokers in persuading their clients to select an investment proposal. Thus rating enables brokers and other financial intermediaries to save time, energy costs and manpower in convincing their clients.

Disadvantages of Credit Rating: Credit rating suffers from the following limitations

The purpose of rating fails if the firms hide the fact that would adversely affect the investor's decision. Further, the study is conducted at a particular point of time, any alternation in the factors affecting the rating, may result in rating being not effective in the altered situation.

1. **Non-disclosure of significant information:** The firms that are rated may not provide sufficient information, which is likely to affect the investor's decision as to investment, to the investigation team of the credit rating company. Thus decisions made in absence of such significant information may put investors at a loss.
2. **Static study:** Rating is a static study of present and past historic data of the company at a particular point of time. Various factors such as economic, political, environment and government policies have its impact on the operation of the Company. Any alteration after the assignment of rating symbols may defeat the very purpose of rating.
3. **Rating is no certificate of soundness:** Rating is only an opinion about the capability of the company to meet its repayment obligations. Rating symbols do not pinpoint towards quality of products or management or staff etc. In other words rating does not give a certificate of the complete soundness of the company. Users should form an independent view of the rating symbol.
4. **Rating under unfavorable conditions:** Rating grades does not always represent the true image of a company. The Company might be given low grade because it was passing through unfavorable conditions when rated. Thus, misleading conclusions may be drawn by the investors which hamper the company's interest.
5. **Difference in rating grades:** Same instrument may be rated differently by the two rating agencies, on the basis of the judgment of the investigating staff. This may lead to confusion among the investors.

Conclusion:

It is a fact that Credit Rating Agencies play a vital role in the financial market by assisting to reduce the informative unevenness between lenders and investors, on one side, and issuers on the other side, about the creditworthiness of companies (corporate risk) or countries (sovereign risk). An investment grade rating can put a security, company or country on the global radar, attracting foreign money and boosting its performance. Indeed, for emerging market economies, the credit rating is key to showing their worthiness of money from foreign investors. Credit rating helps the market regulators in promoting stability and efficiency in the securities market. Ratings make markets more efficient and transparent.

RESURGENT INDIA LIMITED

EQUITY I DEBT I ADVISORY

Resurgent India is a full service investment bank providing customized solutions in the areas of debt, equity and advisory. We offer independent advice on capital raising, mergers and acquisition, business and financial restructuring, valuation, business planning and achieving operational excellence to our clients.

Our strength lies in our outstanding team, sector expertise, superior execution capabilities and a strong professional network. We have served clients across key industry sectors including Infrastructure & Energy, Consumer Products & Services, Real Estate, Metals & Industrial Products, Healthcare & Pharmaceuticals, Telecom, Media and Technology.

In the short period since our inception, we have grown to a 100 people team with a pan-India presence through our offices in New Delhi, Kolkata, Mumbai, and Bangalore. Resurgent is part of the Golden Group, which includes GINESYS (an emerging software solutions company specializing in the retail industry) and Saraf & Chandra (a full service accounting firm, specializing in taxation, auditing, management consultancy and outsourcing).

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