Rating Criteria for Infrastructure Sector Companies

Introduction

ACER Credit Rating Private Limited (ACER), a SEBI-registered credit rating agency, is committed to delivering independent and transparent opinions on issuer and credit ratings. ACER credit insights aim to empower investors, lenders, and businesses with opinions on ratings. With a clear vision to support India's economic growth story, ACER upholds the highest ethical and analytical standards, combining deep domain expertise, advanced analytics, and rigorous processes to ensure every rating is objective and insightful.

The Company reserves the right to amend this policy from time to time in accordance with the applicable regulations, circulars, and directives issued by the Securities and Exchange Board of India. This rating criteria will be reviewed annually.

This Credit Rating Criteria clearly outlines the structured approach adopted by ACER Credit Rating to evaluate the creditworthiness of entities operating generally within the infrastructure sector. Infrastructure entities fundamentally differ from typical corporate entities; their projects are profoundly capital-intensive and characterised by long gestation periods. Their revenue streams are typically generated over an extended operational lifespan. A distinct Criteria is required because key rating drivers, such as revenues, are often determined by tariffs set by regulators or the government. Consequently, significant changes in government policy can materially impact the credit profile of entities in this segment.

Objective

The primary objective of this Criteria is to establish a clear, structured, and transparent framework that enables the consistent, objective, and forward-looking assessment of credit risk specifically for infrastructure entities and projects in India.

Industry Overview

The infrastructure sector plays a crucial role in stimulating economic growth, fostering connectivity, facilitating trade, and employing a substantial proportion of the population. The sector's inherent risk profile is unique; for instance, demand-related risks are typically minimal in many infrastructure segments due to traditionally high demand-supply gaps. However, due to the sector's capital-intensive nature and complex revenue models, the assessment must be sensitive to complex cash flow dynamics and enduring contractual obligations.

Scope & Criteria

This Criteria applies to the rating of debt programmes issued by entities across various infrastructure sub-sectors. Given that projects are typically undertaken through distinct entities known as Special Purpose Vehicles (SPVs), which possess specific contractual lives and revenue models, the risk assessment is fundamentally divided. Risks are assessed separately for the project implementation phase (focusing on funding and completion risks) and the operational phase (focusing on revenue risk and the regulatory policy framework).

In infrastructure, a direct comparison of financial performance across different players may not be meaningful due to varying revenue recognition policies, the potential for profits to differ significantly from cash flows, and wide fluctuations in revenue booking based on the stage of project execution. Therefore, ACER places greater emphasis on evaluating operational parameters and a cash flow-based approach over an accrued income perspective.

ACER Credit Rating's framework focuses on four critical risk factors for evaluation:

1. Business Parameters Assessment

2. Management Quality Evaluation

3. Financial Assessment

4. ESG and Legal Risk Assessment

1. Business Parameters Assessment

This assessment evaluates the inherent operational, industrial, market, and contractual risks specific to the infrastructure project or entity.

1.1 Project Implementation Risk

For projects under implementation (greenfield projects), the risk of time and cost overruns is paramount, as they can significantly impact project viability and the entity's credit profile.

- **Project Location and Resource Availability:** Difficult geographical terrain may create challenges in physical progress, potentially increasing project costs. ACER evaluates the availability and mobilisation of essential resources, including land (latest status of acquisition or Right of Way/Use – RoW/RoU), water, construction equipment, and skilled manpower, which are essential for smooth implementation.
- **Regulatory Clearances and Approvals:** Timely receipt of all necessary permits, licenses, approvals, and statutory clearances (including environmental, mining rights, land acquisition, and pollution) is crucial. Delays in obtaining these clearances often hamper progress according to the scheduled timeline.
- **Mitigation of Time and Cost Overrun:** ACER assesses mechanisms designed to minimise cost increases or schedule delays. Mitigating factors such as fixed-price sub-contracting or contracts allowing for inflation-linked cost escalations are viewed favourably as they transfer risk to the contractor. ACER relies on reports from third-party experts, such as Lender's Independent Engineers (LIE), to confirm technical viability and monitor physical progress against envisaged milestones.
- **Contractual Foundation (EPC Contract):** The terms of the Engineering, Procurement, and Construction (EPC) contract are rigorously examined. A contract that is fixed-time and fixed-price is highly favourable, as it commits the contractor to a set timeline and

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cost, providing cost certainty for the client and transferring the majority of project risks to the contractor.

- **Contractor Track Record:** The experience, capability, and credit quality of the main contractors and sub-contractors in executing similar kinds of projects are evaluated, alongside provisions for performance guarantees and liquidated damages.

1.2 Market, Industry, and Contractual Risk (Operational Stability)

The assessment shifts to revenue certainty, risk allocation, and management of operational elements once the project is commissioned.

- **Pricing and Regulatory Risk:** Infrastructure projects typically have low pricing flexibility because tariffs or prices are driven by regulatory bodies or the government. Higher levels of government intervention that scrutinise pricing decisions and imply less independent flexibility are generally viewed negatively. Entities relying solely on merchant sales (no contractual off-take) are highly exposed to price fluctuations.
- **Demand Risk and Competitive Exposure:** Demand risk is usually low for availability-based infrastructure projects (e.g., annuity roads, transmission). For projects exposed to demand fluctuations (e.g., toll roads), ACER reviews third-party viability reports, such as traffic studies, to confirm the adequacy of projected revenues. Competitive exposure analysis includes industry fundamentals, commodity price volatility, supply costs, and the potential impact of new entrants or disruptive technologies.
- **Contractual Risk Allocation (Concession/PPA):** The key contractual agreements, such as Concession Agreements and Power Purchase Agreements (PPAs), define the risk allocation framework for project life (including force majeure and off-take arrangements). These contracts are evaluated for clarity, completeness, and enforceability, ensuring optimum risk allocation. For PPAs, ACER confirms approval by the State Electricity Regulatory Commission (SERC).
- **Counterparty Risk:** The financial stability, operational history, and ability of all critical parties—including contractors, suppliers, and off-takers—to meet their obligations, especially timely payments, are paramount. The willingness of counterparties to perform may stem from economic incentives, market position, or relations with the government, beyond just the contractual arrangements.
- **Operation and Maintenance (O&M) Arrangements:** The viability of O&M contracts is reviewed. Fixed-price O&M contracts are viewed favourably as they transfer operational and maintenance risks to the contractor. The financial profile and operating experience of the maintenance contractor are assessed.

2. Management Quality Evaluation

Given the capital-intensive nature and extended life cycle of infrastructure projects, the quality, commitment, and track record of the promoters and management team are critical.

- **Sponsor Experience and Track Record:** Significant importance is placed on the experience of promoters/management in the infrastructure business, particularly their track record in executing similar projects, adhering to time schedules, and maintaining quality standards. The history of the sponsor, including their track record of supporting distressed projects in the past, is evaluated.

- **Resourcefulness and Financial Support:** The financial strength and current financial position of the promoters are essential to judge their ability to infuse funds or raise capital promptly, particularly in the event of cost overruns or cash flow shortfalls. The continued strategic importance of the project to the sponsor group influences the likelihood of need-based support.
- **Organizational Structure and Group Linkages:** Since projects are often executed through Special Purpose Vehicles (SPVs), ACER assesses the ownership structure, the ability of the majority owner to complete the project, and any explicit guarantees provided. While SPVs are typically analysed on a standalone basis, ACER generally considers the risks and cash flows at the group level when significant financial and operational linkages or cash flow fungibility exist. Ratings may be notched up/down based on the credit standing of the parent and the strength of this linkage.
- **Corporate Governance and Integrity:** ACER evaluates the management's overall competence, risk appetite, and integrity. Key considerations include the quality of corporate governance practices, board composition, and the adequacy and transparency of disclosures and financial reporting. Inexperienced sponsors engaging in aggressive bidding, leading to significant cost overruns, are viewed negatively. The legal constitution of the entity is also evaluated; entities like partnerships carry an inherent risk of capital withdrawal, which is factored appropriately.

3. Financial Assessment

Financial risk assessment covers cash flow stability, liquidity, leverage, and financial flexibility. Given the sector's reliance on long-term cash generation, ACER places significant emphasis on a cash flow-based approach.

3.1 Cash Flow Analysis and Adequacy

The analysis focuses on the stability and adequacy of projected cash flows to service debt obligations over the life of the asset.

1. **Debt Service Metrics:** Key ratios are computed under both base-case and stress scenarios to determine repayment capacity and the cushion against cash flow fluctuations.
    a. **Debt Service Coverage Ratio (DSCR):** This fundamental metric assesses the entity's capacity to meet interest and principal obligations.
    b. **Loan Life Coverage Ratio (LLCR):** ACER uses the LLCR to assess the ability of the project to meet debt obligations over the life of the loan, comparing the present value of future cash flows to outstanding debt.
2. **Profitability and Efficiency:** Profitability ratios (such as Net Profit Margin, ROCE, and ROE) are evaluated to assess the efficiency with which the project generates returns relative to costs or assets. A sustained track record of maintaining margins similar to, or better than, peers is viewed favourably.

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3. **Financial Covenants:** Operational and financial covenants stipulated in financing agreements, such as cash sweep, restricted payments, escrow waterfall, and minimum D/E ratios, are evaluated for their impact on financial flexibility and risk mitigation.

3.2 Liquidity, Funding, and Structural Support

The availability of adequate liquid funds is essential for protecting the entity against unforeseen economic downturns or contingencies.

- **Liquidity Buffer:** ACER assesses cash reserves, investments in liquid assets, available bank credit, unused/standby credit lines, and the promoters' ability to inject funds in case of shortfalls. The ratio of liquidity coverage (which determines the buffer available to cover debt obligations due in the following year) is considered.
- **Debt Structural Features:** Structural elements provide vital liquidity support. These include the presence of a Debt Service Reserve Account (DSRA) adequate to cover several months' debt servicing, escrow mechanisms, Trust Retention Accounts (TRA), ring-fencing of cash flows, and major maintenance reserves.
- **Funding Pattern and Financial Closure:** The overall project cost, the means of financing, and the adequacy of financial closure are evaluated. The sponsor's equity contribution and the status of funding tie-up are critical, as delays in funding under-construction projects can lead to significant time and cost overruns.

3.3 Leverage and Financial Flexibility

Leverage measures the proportion of debt financing used, impacting the entity's resilience during economic stress.

- **Overall Leverage:** An entity with low overall debt compared to project costs is viewed positively, as it implies better financial flexibility and the capacity to avail additional debt if needed. ACER assesses ratios such as overall gearing and gross debt to collections, comparing results to peer firms. Subordinated debt provided by the promoter is adjusted appropriately during the analysis.
- **Regulatory Impact on Provisioning:** ACER incorporates the impact of regulatory guidelines, such as those from the RBI, regarding increased provisioning requirements for projects that defer the Date of Commencement of Commercial Operations (DCCO) beyond a specified period.

4. ESG and Legal Risk Assessment

ACER recognises that Environmental, Social, and Governance (ESG) risks, along with comprehensive legal compliance, are critical factors influencing an issuer's sustainability and credit profile.

4.1 Environmental Risk

ACER assesses the environmental impact of infrastructure construction and operation, focusing on mitigation efforts and compliance costs.

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- **Mitigation and Compliance:** The assessment covers efforts towards sustainable operations, such as fostering eco-friendly buildings, increasing green spaces, and using sustainable energy sources.
- **Financial Impact:** ACER analyses the cash-flow implications of adhering to environmental standards, the cost related to recycling and waste management, and the potential risk of fines for non-compliance with environmental regulations. Specific environmental issues relevant to infrastructure, such as delays in obtaining environmental or forest clearances, or issues related to tree felling, are also considered.

4.2 Social Risk

Social issues in the infrastructure sector often arise due to the requirement for large tracts of land and RoW(Right of Way)/RoU(Right of Use) approvals.

- **Land Acquisition and Community Relations:** The assessment covers issues related to land acquisition, compensation, and adherence to Resettlement and Rehabilitation (R&R) protocols. The effective management and smooth settlement of issues with local communities regarding land acquisition are factored in.
- **Labour and Stakeholder Accountability:** ACER evaluates the developer's policies concerning employee welfare, labour relations, and adherence to stringent health and safety standards, as these factors impact reputation and future earnings.

4.3 Governance and Legal Risk

This component assesses internal structures, regulatory adherence, and external legal exposure.

- **Governance Structures and Transparency:** Governance is evaluated based on board composition, adherence to governance rules, the complexity of the organizational structure, and transparency in financial reporting and disclosures. The track record of compliance with regulations is scrutinised.
- **Regulatory and Compliance Track Record: Given** the heavy regulatory involvement, ACER assesses the entity's track record of compliance with regulatory stipulations and approvals, including the management of any ongoing litigations. The legal risk associated with land titles is also carefully scrutinized.
- **Policy Influence:** ACER assesses the level of influence of government policies on the entity's independent functioning, including funding support or guarantees.
- **Contractual Enforcement and Force Majeure:** The entity's ability to manage legal risks arising from the project's complex contractual foundations is evaluated. ACER may assess the adequacy of insurance covers and in-built contractual remedies to mitigate the impact of unforeseen force majeure events (such as natural disasters or political upheavals) on operations and cash flows.

Conclusion

The final rating assigned by ACER reflects a holistic judgment based on the comprehensive analysis of the already stated quantitative and qualitative factors affecting the credit quality of

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the infrastructure issuer. Given the capital-intensive nature of this sector, ACER places significant weight on the entity's ability to raise funds, ensure the stability and adequacy of cash flows for debt servicing requirements, and effectively navigate the complex regulatory and policy environment. ACER incorporates future estimations concerning competition, industry trends, economic conditions, and the company's strategies to ensure a forward-looking assessment.

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