



This methodology note stands superseded. Refer to ICRA's website [www.icra.in](http://www.icra.in) for the corporate credit rating methodology note or other sector-specific methodology notes to understand ICRA's rating approach. Also, refer to the note titled "Mapping of ICRA's Long-Term and Short-Term Ratings" on ICRA's website.

## ICRA'S APPROACH FOR RATING COMMERCIAL PAPERS

The analytical method that ICRA follows for rating short-term instruments such as Commercial Paper is almost similar to the one it uses to assign long-term credit ratings. The main distinction between the two is that ICRA's rating methodology for Commercial Paper programmes focuses primarily on evaluating the short-term liquidity position of the issuer, which in turn is determined by the business and financial risks that the issuer is exposed to. Although ICRA ratings are specific to the instruments rated, the short-term ratings in general have a linkage with the assigned or implicit long-term ratings of the issuers concerned. Besides the fact that short-term instruments like Commercial Paper are usually on-going programmes—thus warranting a longer-term rating view—refinancing risk or an issuer's access to other sources of funding is also largely influenced, in ICRA's opinion, by the issuer's longer-term credit profile.

Thus, apart from focusing on short-term factors like near-term business risk drivers and liquidity position of the issuer, ICRA also factors in the issuer's long-term credit profile while assigning short-term ratings to debt instruments issued by it. The following *table* presents a broad guidance to the linkage between ICRA's short-term and long-term ratings. The linkage shown is not rigid but only indicative. Significantly, an issuer with a speculative grade long-term credit rating will in most cases be rated in the speculative grade in the short term too.

	Long Term	Short Term			
Investment grade	AAA	A1+	A1	A2	A3
	AA+				
	AA				
	AA-				
	A+				
	A	A1	A2	A3	A4
	A-				
	A-				
	BBB+	A2	A3	A4	A5
	BBB				
	BBB-				
Non-Investment grade	BBB+	A4	A5	A6	A7
	BBB				
	BBB-				
	BB+				
	BB				
	BB-				
	B+				
	B				
	B-				
	C+				
	C				
	C-				
	D				

The key factors ICRA considers while assigning a rating to a Commercial Paper programme are discussed in the following sections.

## Business Risk

The business risk that an issuer is exposed to is a combination of the industry risk in its major product segments and its competitive position within the industry.

### (A) Industry Risk

The objective here is to understand the attractiveness of the industry in which the issuer operates. The aspects examined include:

- Existing and expected demand-supply situation
- Intensity of competition
- Vulnerability to imports
- Regulatory risks
- Outlook for user industries
- Working capital intensity of the business
- Overall prospects and outlook for the industry

### (B) Issuer's Competitive Position

The issuer's competitive position within an industry is determined by both its operating efficiency as well as its market position. Some of the areas assessed are:

- Scale of operations
- Vintage of technology used
- Capital cost position
- Location advantage in terms of proximity to raw material sources as well as markets
- Operating efficiencies (yields, rejection rates, energy consumption, etc.)
- Market position as reflected in trends in market share, ability to command premium pricing, distribution network, and relationship with key customers

Usually, a peer comparison is carried out to evaluate each of the above factors.

## Financial Risk

The objective here is to determine the issuer's current financial position and the adequacy of its future cash flows vis-à-vis its debt servicing obligations. Some of the aspects analysed in detail in this context are:

- **Operating profitability:** The analysis here focuses on determining the trend in operating profitability and how the same appears by peer comparison.
- **Gearing:** The objective here is to ascertain the level of debt in relation to own funds, and is viewed in conjunction with the business risks that the issuer is exposed to.
- **Debt Service Coverage ratios:** Here, trends in key debt service coverage ratios like Interest Coverage and Net Cash Accruals/Total Debt are examined.
- **Working Capital intensity:** The analysis here evaluates the trends in the issuer's key working capital indicators like receivables, inventory and creditors, again with respect to peers in the same industry.
- **Accounting quality:** Here, the accounting policies, notes to accounts, and auditor's comments are reviewed. Any deviation from the Generally Accepted Accounting Practices is noted and the financial statements of the issuer are adjusted to reflect the impact of such deviations.
- **Contingent liabilities/Off-balance sheet exposures:** In this case, the likelihood of devolvement of such exposures in the short term and the consequent financial implications are evaluated.

## Liquidity and Financial Flexibility

In the short term, debt obligations such as Commercial Papers are generally refinanced. Thus, the ability of the issuer to get the Commercial Paper refinanced is assessed by examining:

- The availability of unutilised working capital limits or lines of credit with the issuer from banks/financial institutions. Typically, issuers that are assigned A1+/A1 ratings for Commercial Papers by ICRA are generally expected to have unutilised limits to fully cover the size of Commercial Paper programme.
- The quality and nature of the issuer's current assets.
- The support/commitment available to the issuer from promoters/group entities.
- Other sources of financial flexibility for the issuer like liquid investments.

These factors apart, in determining an issuer's liquidity position and financial flexibility, its ability to raise funds at short notice are also examined. Such ability, in turn, is determined by the issuer's standing in, and relationship with, banks, financial institutions and other intermediaries.

## **Adequacy of Future Cash Flows**

Since the key objective of a rating exercise is to assess the adequacy of the issuer's debt servicing capability, ICRA draws up projections on the likely financial position of the issuer under various scenarios. These projections are based on the operating and financial performance of the issuer over the past three to five years, ICRA's outlook on the industry concerned, and the issuer's medium-term business plans. Sensitivity tests are also performed on certain key drivers, such as selling prices, input costs, and working capital requirements. Also of particular importance are the projected capital expenditure and the debt repayment obligations of the issuer in the short term, since they directly impact its liquidity position.

Since Commercial Papers are short-term instruments, the rating emphasis, as discussed, is primarily on liquidity and cash flow related parameters. Thus, the projected parameters, which are of critical importance are:

- Profitability levels and stability of coverage indicators
- Gearing levels
- Overall liquidity position
- Expected trends in free cash flows, retained cash flows, cash flow surplus/gap, use of committed lines of credit in relation to drawing power, and sanctioned limits.

## **Strength of Promoters/Management Quality**

Commercial Paper rating being a short-term rating, the analysis here focuses on evaluating the group strength available to the issuer (which can provide back-up support if need be), besides its business plans in terms of the likely level of capital expenditure and investments. Also of importance are the issuer's likely cash outflows entailed by the need to support other group entities, in case the issuer is among the stronger entities in the group. In examining this aspect, a detailed discussion is held with the management of the issuer to understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the issuer's industry. Some of the other points assessed are:

- Experience of the promoter/management in the line of business concerned
- Commitment of the promoter/management to the line of business concerned
- Attitude of the promoter/management to risk taking and containment
- The issuer's policies on leveraging and management of asset-liability matching, interest rates, and currency risks
- The issuer's plans on new projects, acquisitions, expansion, etc.
- Strength of the other companies belonging to the same group as the issuer
- The ability and willingness of the group to support the issuer through measures such as capital infusion, if required.

In conclusion, for a Commercial Paper programme, while the primary emphasis is on assessing the issuer's liquidity and financial flexibility as reflected in the availability of lines of credit, liquidity of investments, availability of group support, and such other factors, ICRA's rating approach places a high importance on the business and financial fundamentals of the issuer.



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