

RATING METHODOLOGY – CEMENT

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Table of Contents:

Overview	1
Business Risk Assessment.....	3
Financial Risk Assessment.....	4
Other Elements of Credit Risk Assessment.....	8
Management Quality & Corporate Governance Assessment.....	9
Summing Up	9
ANNEXURE.....	12

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This rating methodology document describes ICRA's approach to assess the credit quality of entities in the cement industry and supersedes ICRA's earlier methodology document on this subject, published in August 2019. While this revised version incorporates a few modifications, ICRA's overall approach towards rating entities in the sector remains materially similar.

Overview

The Indian cement industry is the second largest in the world, with a total installed capacity of around 516 million metric tonnes (MMT) as on March 31, 2021 and cement production of 296 MMT in FY2021. The production declined by 11% in FY2021 from 334 MMT in FY2020, due to the Covid-19 pandemic-led disruptions in Q1 FY2021. The industry occupies an important place in the national economy because of its strong linkages to other sectors such as housing and infrastructure.

The cement sector exhibits high cyclicity, driven by the lumpiness in the capacity additions on the supply side. Cement production has witnessed moderate growth, largely in the range of 4%-7% during FY2011-FY2021, except for a year of double-digit growth and three years of contraction in FY2017 due to demonetisation and in FY2020-FY2021 due to Covid-19 pandemic-led disruption. The industry is relatively insulated against global trends as the large freight component makes imports unviable. Thus, the competition in the Indian cement industry is largely restricted to domestic manufacturers. In addition to industry risks, ICRA's rating methodology analyses entity-specific drivers such as scale of operations, market position, geographical diversity, locational attributes such as the extent of proximity to consuming markets, cost efficiencies arising out of access to key inputs at competitive prices, and operating efficiencies for assessing the business risk profile.

For analytical convenience, the key factors are grouped under the following broad heads—Industry Risk Assessment, Business Risk Assessment, Financial Risk Assessment, Management Quality, and various other elements of credit risk assessment.

Industry Risk Assessment

- Regional demand-supply scenario
- Government policies

Business Risk Assessment

- Scale
- Market position
- Operational efficiencies

Financial Risk-Assessment

- Profitability Metrics
- Leverage and Coverage indicators
- Cash Flows and Liquidity Profile
- Foreign currency-related risks
- Tenure mismatches, and risks relating to interest rates and refinancing Contingent liabilities / off-balance sheet exposures

Other Elements of Credit Risk Assessment

- Parentage
- Financial Flexibility
- Debt Servicing Track Record
- Contingent Liabilities and Off-balance Sheet Exposures
- Event Risk

Management Quality

Assessment of Environmental, Social and Corporate Governance Risks

Industry Risk Assessment

Regional demand-supply scenario

Cement, being a bulky low-value commodity, is highly freight sensitive. A bulk of the cement produced within a region is usually consumed within the region itself, with only the excess transported to adjacent regions. Thus, price trends and capacity utilisation levels in the cement industry are determined more by regional supply-demand dynamics than by the national supply-demand balance. Therefore, while rating a cement manufacturer, ICRA focuses on assessing the likely demand-supply scenario in the region in which the entity operates.

While projecting demand, ICRA takes into account past trends, the underlying economic growth drivers, and the housing and infrastructure projects planned and being implemented in the region. The Government policies relating to rural and urban housing and infrastructure development have a direct impact on the cement demand.

On the supply side, ICRA attempts to project the likely supply position by looking at greenfield and brownfield expansion plans of manufacturers, besides low-cost supply additions through debottlenecking of existing capacities and blending¹. Given the long gestation period for a greenfield capacity addition, the cyclicity in the sector mainly arises due to the bunching up of the capacity addition on the supply side, whereas the fluctuation in demand may not be significant.

The domestic cement industry, which has traditionally been fragmented, has seen some consolidation of late, following several mergers and acquisitions. Such consolidation has also brought in a degree of supply rationalisation among manufacturers. As a result, cement prices tend to be steady, despite supply pressures over the past few years. Thus, while rating a cement manufacturer, ICRA also takes into consideration the degree of consolidation that exists in the region(s) concerned, as that determines the extent of supply rationalisation and the intensity of pricing pressures.

Government policies

The Government's direct role in the sector is limited and primarily relates to enabling access to the key raw material, limestone and key fuel, coal. The auction of limestone and coal mines is governed by the respective states, whereas royalty rates² are notified by the Central Government. Also, the Government policies relating to rural and urban housing and infrastructure development have a direct impact on the cement demand.

Business Risk Assessment

Scale

The scale of operations for cement companies is measured in terms of sales volumes. Larger capacities offer benefit of economies of scale for players.

Market position

ICRA looks at the market share of an entity across geographies while assessing its brand strength and market presence. The price trends and capacity utilisation levels in the cement industry are determined by regional supply-demand dynamics and the exposure to supply-demand volatility for a cement entity catering to one region would be high. ICRA takes a favourable look at manufacturers with plants in different regions along with a strong distribution network, as the geographical diversification usually allows players to better cope with the regional demand-supply volatility.

Operational efficiencies

One of the key metrics to measure a cement entity's operational efficiency is 'operating profits per unit of sales volumes' or OPBIDTA/MT. The value of this parameter is dependent on the net cement realisation and the cost structure of an entity. Cement being a commodity item does not allow much premium pricing and thus most manufacturers are price takers in the markets they operate in. In such a scenario, control over operating expenses is essential not only to maintain cost competitiveness and maximise profitability, but also withstand cyclical downturns, and is, therefore, one of the most important rating determinants. The cost structure of a cement entity is driven by locational economics, freight costs, power and fuel costs and blending ratio. Further, ICRA looks at the trade and non-trade sales mix, which also has an impact on the profitability.

Locational economics, logistics and freight costs - The bulk of India's cement production capacity is concentrated in a few clusters, which are essentially regions where limestone is widely available, however, the major consumption centres are often

1 Clinker capacity is often a constraint in the production of cement. Blended cements are a blend of portland cement and a combination of any one or more supplementary cementing materials, such as slag cement, silica fume, or fly ash.

2 Paid by the cement companies to State Government

states that are located far from these production centres. ICRA favourably views the entities that optimise the distance of the cement plants from the source of raw materials and the major consumption centres, and this supports the profitability over the long term on the strength of lower freight expenses.

In analysing the locational economics, ICRA also evaluates the strategies adopted by individual entities to offset their locational disadvantages, if any. One strategy, for instance, is to set up standalone grinding units close to the consuming markets and the clinker unit near the limestone quarry. This helps the manufacturers save the freight cost as clinker can be transported in open wagons or trucks. The benefit of this arrangement is even more marked in case the grinding unit is located close to a source of additive such as fly-ash or slag. Thus, ICRA assesses the entity’s policy on setting up an integrated cement plant vis-à-vis having grinding units and clinker units at different locations and the cost versus benefits of the entity’s approach.

Cement manufacturers use a mix of rail, road and coastal sea transport to distribute their products. While rail transportation is more economical over longer distances, for shorter hauls road transportation is more cost-effective and reliable. Coastal sea transportation of cement, as on date, is limited in India because of the limited availability of infrastructure and is largely confined to supplies by shore-based manufacturers in Gujarat to Mumbai and its neighbourhood.

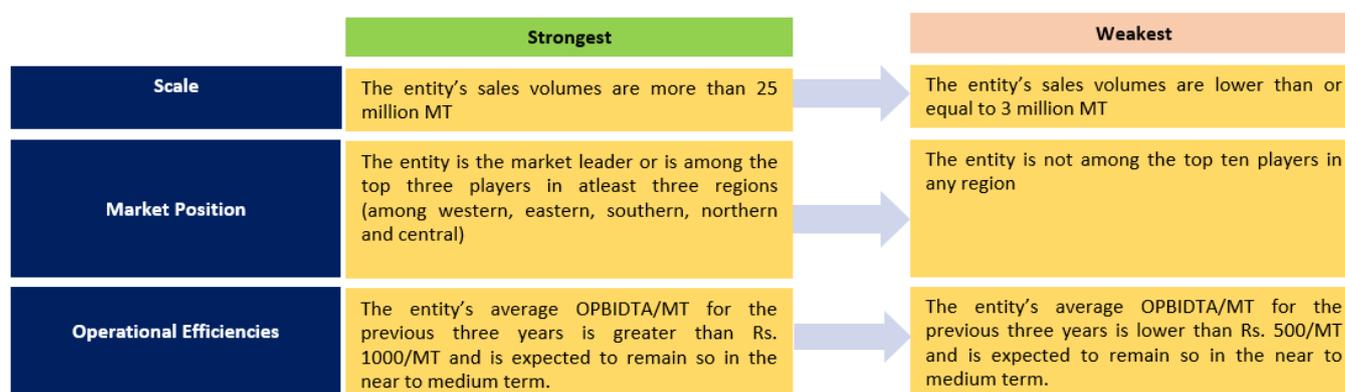
Power and fuel costs - The major operating cost head for cement companies (apart from freight) is power and fuel. ICRA assesses the manufacturer’s efforts at reducing input costs through measures such as setting up captive power plants which include thermal and renewable power plants. For major sources of fuel, namely, coal and pet coke, ICRA assesses the adequacy of the fuel supply arrangements.

Vintage factor of the plant – The vintage of a cement plant also influences its cost structure significantly. While an older plant enjoys the advantage of lower capital cost, such benefit is usually offset by higher power and fuel costs, significant repair and maintenance expenses, and generally higher manpower expenses.

Blending - Ordinary Portland Cement (OPC) accounts for around 30% of India’s cement production and is widely used in the construction industry. Recently, cement companies have been popularising the use of blended cement/ Portland Pozzolana Cement (PPC), with the result that the proportion of PPC in the total production has increased over the years. The cost of production of PPC is lower vis-à-vis OPC as the cost of additives such as fly-ash and slag (which are used in the production of PPC) is usually lower than the cost of clinker. Further, PPC allows a manufacturer to produce more cement using the same amount of limestone and clinker capacities. Therefore, ICRA views favourably those entities with a demonstrated ability to develop and sell blended products, in addition to the OPC.

Other parameters – The capacity utilisation of a cement entity is important given the high fixed costs. ICRA assesses the capacity utilisation of the cement unit in comparison with the peers in its region of operations. While high capacity utilisation is a positive attribute which results in a better cost structure, it is seen in relation to the regional average.

Summary of the Salient Business Risk Factors



Financial Risk Assessment

Since the primary objective of the rating exercise is to assess the adequacy of the entity's debt-servicing capability, ICRA draws up projections on the likely financial position of the entity under various scenarios. ICRA also considers the commitments of the entity towards other Group entities, new ventures and its investments in subsidiaries. These cash flows are then used to determine the entity's future debt-servicing capability under various scenarios.

The various financial metrics assessed by ICRA could be divided into four categories—profitability, leverage, coverage and liquidity. This document provides a summary of why ICRA considers these ratios to be important. For a more detailed description, readers may refer to the note titled – ‘*Approach for Financial Ratio Analysis*’, published on ICRA's website. In case of groups consisting of entities with strong financial and operational linkages, various parameters such as capital structure, debt coverage indicators and future funding requirements are assessed at the consolidated / Group level.

Profitability Metrics

Profitability metrics are a measure of an entity's efficiency and return on investments. It is imperative for most businesses to invest regularly in physical assets, product development, marketing and human capital to sustain or improve their competitive position. Entities that have superior profitability are able to do so through internal accruals with low dependence on external financing. Moreover, such entities are able to generate sufficient surplus for not only meeting their debt servicing obligations, but also to reward equity investors. This improves their ability to attract fresh capital for future business requirements. Moreover, entities with higher profitability have better resilience to economic downturns and are more likely to generate adequate internal cash flows for re-investment and debt servicing.

Given the commoditised nature of cement and market participants being price-takers, the profitability of a cement manufacturer is primarily a function of its cost structure and product mix. Also, since cement is a cyclical industry the profitability of the companies in this industry varies significantly along the cycle. Nevertheless, producers having cost structures better than the industry median level can generally be expected to better withstand the profitability pressures arising from demand-supply cycles. The key profitability metrics that ICRA evaluates include the OPBITDA³ margins and the PAT⁴ margins, seen in relation to changes in OPBDITA/MT of cement sold. The revenue and various cost items are analysed based on per MT of cement sold to ascertain the reasons for changes in the profitability and these parameters. They are also compared with relevant peers in the market to ascertain the reasons for efficiency/inefficiencies.

Higher OPBDITA margins are also seen in relation to the RoCE⁵. While the entity may have an OPBDITA margin similar to or better than the industry average, but in case the RoCE is lower, then the reasons for the same are analysed, which could be a lower fixed asset turnover than the industry average.

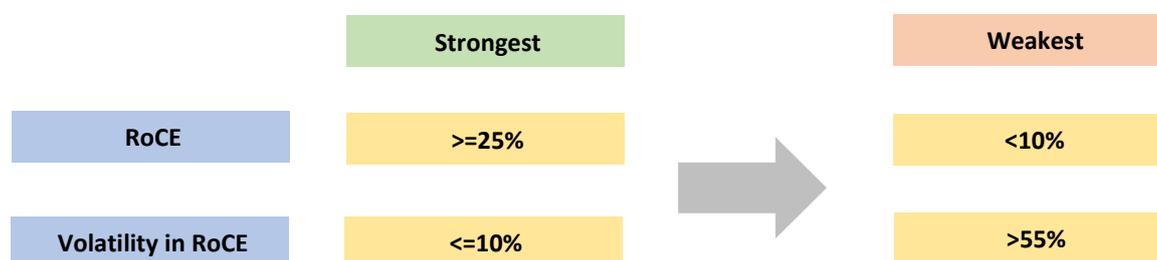
³ Operating profit before interest, tax, depreciation and amortisation

⁴ Profit after tax

⁵ Return on capital employed

Validation of Business Risk through Profitability Metrics

[Indicative Metrics⁶]

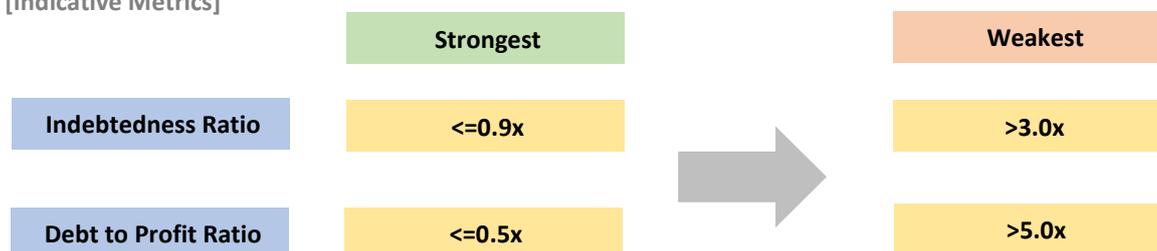


Leverage and Coverage indicators

Leverage ratios measure the indebtedness of an entity. The cement industry is highly fixed capital intensive in nature and the entities that pursue an aggressive financial policy, including heavy reliance on debt financing, are likely to be more vulnerable to cyclical downturns than entities which employ conservative financial leverage in their business. Low leverage ratios reflect low reliance on debt funding and imparts greater financial flexibility to raise incremental external capital (debt or equity) for re-investment in business or to tide over temporary funding shortfalls. ICRA also notes that the extent to which an entity leverages its balance sheet is, in addition to business requirements, also a function of the philosophy of the management towards growth and funding mix.

Assessment of Leverage

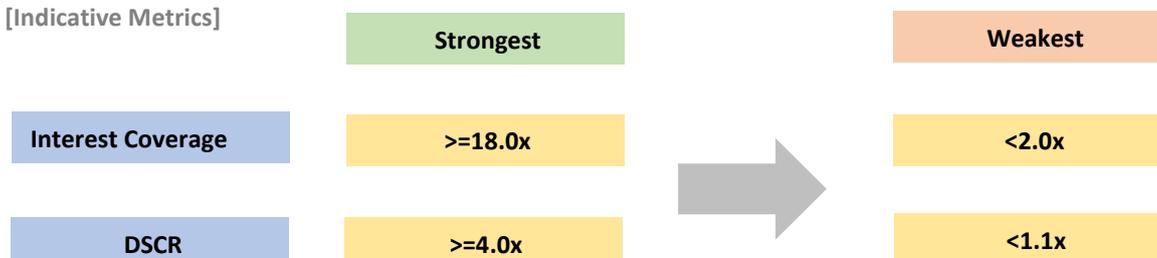
[Indicative Metrics]



Apart from the capital structure, ICRA also pays attention to the coverage indicators, including interest coverage and debt service coverage, while evaluating the financial health of a cement entity. The more robust an entity's performance is during downcycles, the better it is from a credit evaluation perspective.

Assessment of Coverage

[Indicative Metrics]



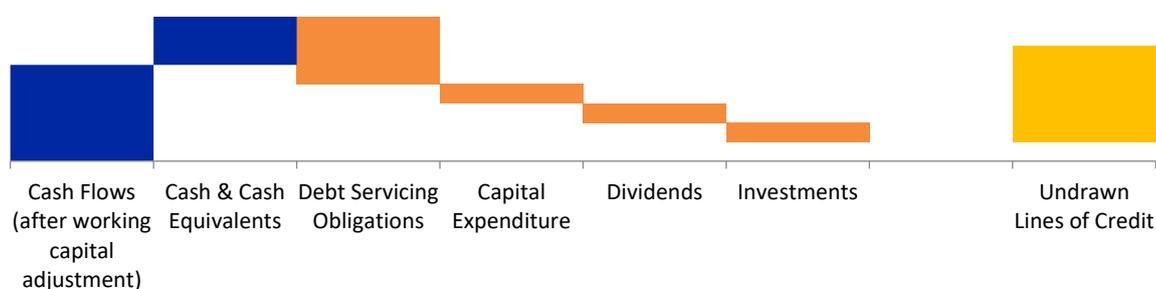
⁶ The indicative financial metrics mentioned here and elsewhere in the document are intended to provide a broad overview to the readers regarding what ICRA generally considers as 'relatively strong' or 'relatively weak' metrics. It is, however, possible that an entity has relatively weaker metrics on one or more financial parameters, but its credit risk is assessed to be low because of other mitigating factors, including (but not limited to) stronger metrics on other financial parameters, a healthy business risk profile, strong financial flexibility or a strong promoter group that is willing to extend distress support to it.

Cash Flows and Liquidity Profile

The rating exercise is primarily focused on assessing the future debt servicing capabilities of a company. With the necessity for cash to service the debt obligations, it is imperative that a cash flow analysis is undertaken to evaluate the external funding requirements and likely financial position of the company, going forward. A cash flow statement represents the sources from which cash is generated, as well as its deployment. Analysed here are the trends in an entity’s funds flow from operations, cash consumed to fund the working capital, the retained cash flows after paying out dividends or carrying out share buybacks, and the free cash flows after meeting debt repayment obligations and capital expenditure and investment needs.

Liquidity is the measure of an entity’s ability to meet its short-term cash obligations from various internal or external resources. Internal resources include cash flows from operations, unencumbered cash and cash equivalents on balance sheet and cash inflows expected from the monetisation of physical and financial assets. External resources include undrawn lines of credit or equity capital. The short-term obligations include both the committed as well as the contingent claims on an entity’s cash, including the debt servicing obligations, working capital requirements, capital expenditure and other investment outlays, dividend and share buyback-related outflows, besides the sudden demand arising from crystallisation of discrete events such as unfavourable outcome of an ongoing litigation. The higher the cushion available between the resources available (especially internal resources) and the obligations, better is the liquidity profile of an entity. Liquidity is generally assessed in conjunction with the vulnerability of an entity to timely refinancing / renewal of short-term sources of funding. Depending upon the circumstances, an entity that has a relatively modest liquidity profile, but a strong refinancing ability may not be viewed too unfavourably. ICRA also notes that the liquidity available with an entity may be for a temporary period and hence an entity’s overall policy towards maintaining adequate liquidity (given the trade-off between returns and liquidity) is accorded due importance in the analytical approach⁷.

Liquidity snapshot over any defined period



Foreign currency-related risks

For companies in the cement industry, while the revenues and costs are mostly denominated in Indian rupee, however, they can still have risks arising because of foreign currency movements where there is forex borrowing and also where the entities depend on imported coal / pet coke. The entities with high dependence on a single source of fuel (especially the imported) may see volatility in costs not only because of volatility in international coal prices but also because of currency vis-a-vis other players having access to diversified fuel sources. Additionally, the plant and machinery of the project could be funded through foreign currency loans. An unhedged foreign currency liability in the absence of corresponding foreign currency revenues may expose companies to foreign currency risk. The focus here is on assessing the hedging policy of the entity concerned in the

⁷ For more details on how ICRA assesses liquidity, readers may refer to the document titled, “Liquidity Analysis of Entities in the Non-Financial Sector” published on ICRA’s website

context of the tenure and the net foreign exposure and the extent of the timing difference in expected receipts vis-à-vis scheduled outflows is also assessed.

Tenure mismatches and risks relating to interest rates and refinancing

Large dependence on short-term borrowings to fund long-term investments can expose an entity to significant re-financing risks, especially during periods of tight liquidity. Existence of adequate buffers of liquid assets / bank lines to meet short-term obligations is viewed positively. Similarly, the extent to which an entity could be impacted by movements in interest rates is also evaluated.

Other Elements of Credit Risk Assessment

Parentage

Apart from standalone credit considerations, the likelihood of extraordinary support coming in from the parent/ Group to an entity, or the support that an entity is likely to extend to the other Group companies, is factored in while assessing the entity's credit profile. This process involves an assessment of the ability and willingness of the parent/ Group to extend support to the entity (and vice-versa), the strategic importance of the entity to the Group to which it belongs, along with the financial strength of Group entities, among others⁸.

Financial Flexibility

An entity's financial flexibility (or the lack thereof) is reflected in its ability to access capital or money markets at short notice and enjoy the confidence of banks, financial institutions, and intermediaries. A strong financial flexibility allows an entity to raise fresh borrowings or refinance existing ones in quick time, whenever required. Financial flexibility could arise from factors such as an entity's large scale of operations with strong financials, large, unencumbered cash flows, unencumbered assets and the flexibility to borrow against such assets, or strong parentage or linkages with a strong group.

In contrast, among the various measures of an entity's depleting financial flexibility, one relates to a high share of pledged promoter shareholding. A sign such as this may imply that the entity might be persuaded to distribute high dividends or support the promoter group through other means to the detriment of its own credit profile. If the promoters fail to repay their loans (availed by pledging of shares) or top up collateral when required, the lenders could sell the pledged shares. In some cases, this could trigger a change-of-control clause in the rated entity's bond indentures or loan documents and require it to redeem its debt ahead of schedule, creating a liquidity squeeze, besides affecting fresh capital-raising ability.

Debt-Servicing Track Record

The debt-servicing track record of the company forms an important rating consideration. Any history of past delays or defaults in meeting interest and principal repayment obligations reduces the comfort level with respect to the company's future debt servicing capability and willingness. Nevertheless, the reason behind past defaults is also analysed, which could also be due to adverse demand situations in the underlying industry. The company's ability to honour its debt obligations during the period of cyclical stress is also factored in.

⁸ For more details on this, readers may refer to the document titled, "Impact of Parent or Group Support on an entity's Credit rating", available on ICRA's website

Accounting Quality

ICRA reviews the accounting policies, notes to accounts, auditors' comments and other disclosures that are parts of the Annual Report of a rated entity. Deviations, if any, from the accounting standards/ practices are assessed and the financial statements of the entity are adjusted to reflect the impact of such deviations.

Contingent Liabilities and Off-balance Sheet Exposures

ICRA reviews the contingent liabilities and off-balance sheet exposures as disclosed by the entity in its Annual Report and evaluates the likelihood of their devolvement and the financial implications of the same.

Event Risk

ICRA recognises the possibility of events, such as unrelated diversification, mergers and acquisitions, business restructuring, asset sales and spin-offs, capital restructuring and litigations, which could have a material impact on the credit profile of a company. Incorporating the impact of such discrete events in the credit rating, from the beginning, is often difficult. Depending on whether and when such events occur, the rating opinion could be substantially different. To take rating decisions in such cases, ICRA applies its analytical judgment based on the rated entity's track record, the credibility of the management and the experience of having seen similar situations play out in other entities. However, given the nature of such events, it is possible that the rating may undergo a material change later, upon the occurrence of the event.

Management Quality

In addition to the business and financial risk analysis, all debt ratings incorporate an assessment of the quality of the entity's management and its financial policies.

In addition, the likely cash flow impact on the rated entity, from the possible need to support other group entities are of importance, in case the rated entity is among the stronger ones within the group. Usually, a detailed discussion is held with the management of the rated entity to understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the rated entity's industry.

Some of the points assessed are:

- Experience of the promoter/ management in the industry
- Commitment of the promoter/ management to the concerned line of business
- Risk appetite of the promoter/ management and risk mitigation plans
- The rated entity's plans regarding new projects, acquisitions, and investment in non-core business segments
- The rated entity's policies on leveraging, interest risk and currency risks

Periodic interactions with the management also help to estimate the possibility of the management's tendency to deviate from its core philosophy in times of stress.

Assessment of Environmental, Social and Governance Risks

The assessment of the Environmental, Social and Governance (ESG) risks by ICRA involves a broad range of considerations that pertain to the sustainability of an entity, with focus on aspects that can have a material impact on its credit quality. While the Environmental (E) & Social (S) risks tend to be both sector-related as well as entity-specific and could be driven by external factors such as regulations or demographic changes, the G risks are largely entity-driven. The impact of the E&S risks on an entity's credit profile tends to be asymmetric. If the ESG risks are material but unmitigated, these generally translate into pulling down the rating, but generally the ratings are not pushed up even when the ESG context is favourable.

Environmental and Social Risks

While undertaking credit assessment of entities, ICRA seeks to incorporate all relevant credit considerations into its rating decisions while taking a forward-looking view on the risks and the mitigation. The relevant credit considerations include (sometimes overtly, sometimes covertly) the E&S factors that could affect the rated entity/ transaction.

While ICRA's analytical approach does not explicitly disaggregate these risks to assess their impact on the rating, these risks are often assessed broadly. Further, it is not always feasible to fully or precisely disaggregate the sub-components of E&S risks in credit analysis since these considerations often tend to overlap. That said, the materiality of the E&S risks and the time horizon over which they are expected to crystallise differ widely across sectors and entities. In some cases, while the E&S risks could be material, their effect on the credit profile may be muted because of other fundamental strengths of the entity. In other cases, the adverse impact of the E&S risks is expected to play out in the future and hence these considerations do not necessarily weigh on the rating today with the expectation that by then they would possibly adapt themselves by realigning their business model.

While evaluating the E&S risks, ICRA's objective is only to assess the direct and indirect risks that an entity faces and how it already is or is intending to mitigate the impact of such risks on its credit profile. As an example, ICRA only assesses whether an entity is exposed to physical climate risks, or carbon transition risks such as those arising from changes in regulations or other environmental and social risks; and seeks to understand the various mitigation and adaptation approaches that the entity is implementing to mollify these risks.

Cement manufacturing is an energy intensive process which, given its process flow (typically crush and move raw materials to produce the end-product i.e. cement), requires a substantial use of fuel and results in greenhouse gas emissions, waste generation, and pollution. The cement industry is also one of the highest consumers of fuel, specifically coal. Increasing regulatory requirements to reduce greenhouse gas emissions and stricter air pollution standards may lead to higher costs for cement producers. The profitability and cash flow generation could face pressures if the higher compliance costs cannot be passed on to the customers.

Domestic cement companies in recent years have been investing in alternative/renewable energy sources, replacing hitherto known sources such as fuel (in the form of coal) as well as thermal power generation which has afforded the players multiple benefits apart from reducing carbon dioxide footprint. The usage of renewable sources of energy such as solar energy, wind energy and waste heat recovery system (WHRS) have been gaining momentum, in particular, the latter has emerged as one of the cheapest sources of power generation given the negligible input costs. Further, the cement companies are focusing on increasing the usage of alternate fuels and improving the share of production on blended cement and consequently reduce the clinker consumption. In addition, the industry is exposed to physical climate risks which could adversely impact the business continuity given the dependence on limestone mines for raw material.

The social risks relate to the health and safety of employees involved in the mining of limestone and production of clinker and cement. The sector is exposed to labour related risks and risks of protests/social issues with local communities, which might impact expansion/modernisation plans.

Governance Risks

A sound corporate governance structure attempts to make clear the distinction of power and responsibilities between the Board of Directors and the management. The constitution of an entity's Board and the Board of Directors' participation in strategy formulation, besides the entity's adherence to legal and statutory compliance requirements are factored in during credit assessments. ICRA seeks to gain a qualitative understanding of an entity's commitment to following transparent and credible practices depending on the way its financial statements are reported, the level of disclosures, consistency in communication and the openness about sharing information during the credit rating exercise. Besides, the corporate group

structure (whether simple or complex), the rated entity's related party transactions and instances of supporting group entities at the expense debt holders are also assessed.

Summing Up

ICRA's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the instrument being rated. This opinion is arrived at following a detailed evaluation of the issuer's business and financial risks, its competitive strengths, its likely cash flows over the life of the instrument being rated and the adequacy of such cash flows vis-à-vis its debt-servicing obligations. As the note has highlighted, for a cement player, special attention is also paid on the market position, an entity's scale of operation and operational efficiencies as well as management strategies for managing cyclical downturns and an overall approach towards investment and growth.

ANNEXURE

Summary of rating factors and an example to illustrate the key building blocks of a credit rating

		Strong			Comfortable			Adequate			Moderate			Weak						
Industry Risk	Industry Position																			
	Scale of operations																			
Business Risk	Market Position																			
	Operational Efficiencies																			
	Leverage																			
Financial Risk	Coverage																			
		Enhance					Support/ Neutral					Hinder								
Do these factors enhance or hinder the credit profile?	Diversification																			
	Refinancing Dependence, Liquidity and Financial Flexibility																			
	Currency Risk																			
	Financial Policy																			
	Management, Governance & Reporting																			
	Very High					High					Moderate					Low				
Parent Support	Likelihood of Parent Support																			
	Rating of Parent	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B/ C category					
	Final Rating	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B/ C category					

The above graphic is only for illustration purpose and does not represent a rating output from a formulaic model. The ratings assigned by ICRA are determined by Rating Committees based on both quantitative and qualitative considerations.

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