RATING METHODOLOGY - ALTERNATIVE INVESTMENT FUNDS (AIFs) November 2022

Click to Provide Feedback

Table of Contents:

Overview 1
Sponsor/Promoter Analysis 2
Portfolio Risk Analysis..........................2
Structural Analysis: Assessment of Capital Protection 3
Structural Analysis: Cash Flow Modelling 3
Environmental and Social Risks 5
Summing Up 5

ANALYST CONTACTS

Abhishek Dafria
Vice President
+91 22 6114 3440
abhishek.dafria@icraindia.com

Samriddhi Chowdhary
Vice President
+91 22 6114 3462
samriddhi.chowdhary@icraindia.com

Sohil Mehta
Senior Analyst
+91 22 6114 3449
sohil.mehta@icraindia.com

Overview

ICRA's rating for alternative investment funds (referred to as AIFs or the fund) reflects its opinion on the capital protection available to the unitholders of the AIF. This methodology document explains the analytical approach of ICRA to assess the credit risk associated with AIFs and involves an evaluation of the underlying investments of the rated AIF, the structural features, besides the investment philosophy.

As per the Securities and Exchange Board of India (SEBI), AIFs are defined as any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate, which is a privately pooled investment vehicle that collects funds from investors, whether Indian or foreign, for investing the same in accordance with a defined investment policy for the benefit of its investors and is not covered under the SEBI (Mutual Fund Regulations), 1996, SEBI (Collective Investment Schemes) Regulations, 1999 or any other regulations of SEBI to control fund management activities. AIFs, which came into existence in India in 2012, are regulated by the SEBI (Alternative Investment Fund) Regulations, 2012.

ICRA's ratings for AIFs reflect the adequacy of the cash flows from the debt instruments in which the AIF has invested to repay the principal amount to the investors while covering the operating expenses for managing the scheme. For this assessment, all cash flows available to the investor from the AIF, which could be principal redemption (principal/capital repayments), prepayments and redemption from one or more portfolio investments etc in the form of returns or income (including interest, cash dividends, premium, capital gains, prepayment penalties or other forms of cash receivable as permitted, net of expenses), gross of taxes, are considered to be available for principal or capital redemption to the investor.

The ratings, however, do not factor in market risks and hence should not be construed as an indication of the expected returns and the prospective performance of the scheme. These ratings are an assessment of the capital protection available in the scheme and should not be interpreted as a measure of the quality of the fund's management or its financial performance, reputation and other business practices including investment strategies, pricing, marketing, and distribution activities. Furthermore, the ratings are not a reflection of the adherence of the fund to the regulatory requirements. AIF ratings are assigned on a 20-point scale with the rating symbol accompanied by the (SO) suffix.

ICRA's rating methodology for AIFs involves an analysis of the following key risks:

1. **Sponsor/Promoter Analysis**
2. **Portfolio Risk Analysis**
    a) Credit quality of the underlying instruments
    b) Concentration risk
    c) Liquidity and reinvestment risk
3. **Structural Analysis**
    a) Assessment of capital protection
    b) Cash flow modelling

Sponsor/Promoter Analysis

ICRA analyses the profile of the sponsor/promotor and investment manager/asset management company (AMC) of the AIF schemes. AIFs backed by large institutions or groups with a sizeable track-record are expected to have adequate internal controls and processes and are thus expected to provide a higher level of comfort. ICRA reviews parameters like the sponsor's track record in financial services and the alternative investments space, its risk appetite, investment strategy, underwriting/investment processes, quality of management, internal systems & controls, financial profile etc while assessing the sponsor's quality. ICRA also takes into account the investment manager or AMC's experience, prior track record, investment objective, and operational and financial profile.

Portfolio Risk Analysis

AIF schemes can invest their corpus in different kinds of securities including debt (loan, debt securities, securitised debt instruments) and equity (listed/unlisted/equity-linked instruments etc.). ICRA's analysis of an AIF scheme's portfolio involves the assessment of the scheme's investment strategy, portfolio composition and credit quality. The key parameters considered include:

a) **Credit quality of the underlying instruments**: Typically, for the objective of capital protection, the AIF scheme could invest a part or the AUM in debt instruments and money market instruments across the rating spectrum. The remaining portion of the scheme's AUM, if any, can be invested in equity and equity-related instruments to achieve capital appreciation. The objective is to structure the scheme in such a manner that the interim cash flows and the maturity value of the debt investments are adequate to repay the principal to the investors while covering the operating expenses for managing the scheme.

    The ability of the AIF scheme to repay the capital to the investors in a timely manner is dependent on the timeliness of the receipt of the payment from the underlying investments made by the scheme. Hence, ICRA assesses the credit quality of the investments made by the scheme in debt instruments to evaluate the risk related to the timeliness of the payments. In case the investments are not yet made by the fund, the assessment is conducted based on the expected portfolio composition or the boundary conditions as described in the investment scheme/criterion. The boundary conditions are an important part of the rating assessment since the redeployment of funds received through prepayments or scheduled repayments should meet the set conditions and thereby not weaken the risk profile of the AIF.

b) **Concentration risk**: ICRA considers the portfolio composition to assess the possible portfolio concentration, which could be in terms of exposure to select entities, sectors, geographies etc. A high concentration in the portfolio could render the scheme vulnerable to adverse developments in a particular entity, sector or geography. Thus, a well-diversified portfolio is typically expected to be more favourable for an AIF's rating.

c) **Liquidity and reinvestment risk**: AIFs invest in a range of instruments, depending on the investment criteria, having varying maturity profiles. On the liability side, payouts to unitholders are to be made periodically as per the schedule. Hence, investments in instruments, which have a buffer between the redemption of the investments and the payouts to be made to the investors, provides cushion in case of any delays due to operational reasons and is thus viewed positively. In case of embedded put options in the debt instruments, the put option date is assumed to be the maturity date for such instruments. Any asset-liability mismatch (investment in instruments with maturity date later than the maturity date of the scheme) exposes the fund to the risk of insufficient cash flows available at the time of redemption and is hence viewed negatively. Furthermore, tenure mismatch between the invested instruments and the maturity of the fund in addition to potential prepayments could lead to reinvestment risk. The reinvestment of funds at a rate below the yield assumptions considered at the time of the initial assessment could alter the risk profile of the AIF.

Structural Analysis: Assessment of Capital Protection

ICRA's methodology for rating AIF schemes considers the extent of capital protection available to the unitholders. The fund would deploy the corpus raised into different asset classes/instruments in accordance with its investment strategy. The fund, in turn, would receive income, which could be in the form of interest, dividend, capital gains etc, over the life of such instruments and would recoup the capital (redemption or repayment) on maturity. Both these streams of funds, i.e. return as well as redemption, form the cash inflows for the fund, which, in turn, are used to make the payouts to the investors. The cash outflows, i.e. investor payouts, of the AIF are distributed to the unitholders in accordance with a predefined waterfall. AIF schemes can be designed to incorporate various structural features, which provide a fillip in case of a shortfall in redemption. These structural features could include:

a) **Principal subordination**: The cash flow waterfall for the scheme may prescribe a certain order for making payments to various categories of unitholders. In certain scenarios, certain categories or classes of unitholders may have a lower priority in claims from the fund compared to senior unitholders for the distribution of redemption proceeds, which results in principal subordination. This provides a cushion to the senior investors since the subordinated investors receive residual payments only after all the payments to the senior tranche and all the expenses for the scheme have been met. The presence of principal subordination provides protection to the senior classes of unitholders, in case of a shortfall in the overall inflows.

b) **Support available through returns**: The cash inflows to the fund also include the return or income generated on the underlying investments. These cash flows are distributed to the unitholders in accordance with the waterfall mechanism prescribed. As discussed earlier, for this analysis all cash flows available to the unitholders, be it in the form of returns or redemption, are considered to be available for capital protection. Thus, the availability of this income also provides capital protection to the unitholders. The order of distribution for such income would remain a key criterion for determining the extent of support provided by such income.

Structural Analysis: Cash Flow Modelling

The final step in rating the AIF transaction is modelling the projected cash inflows (from debt instruments till the fund maturity date) and outflows. ICRA's approach for modelling the cash inflows (the asset side) is based on the following inputs:

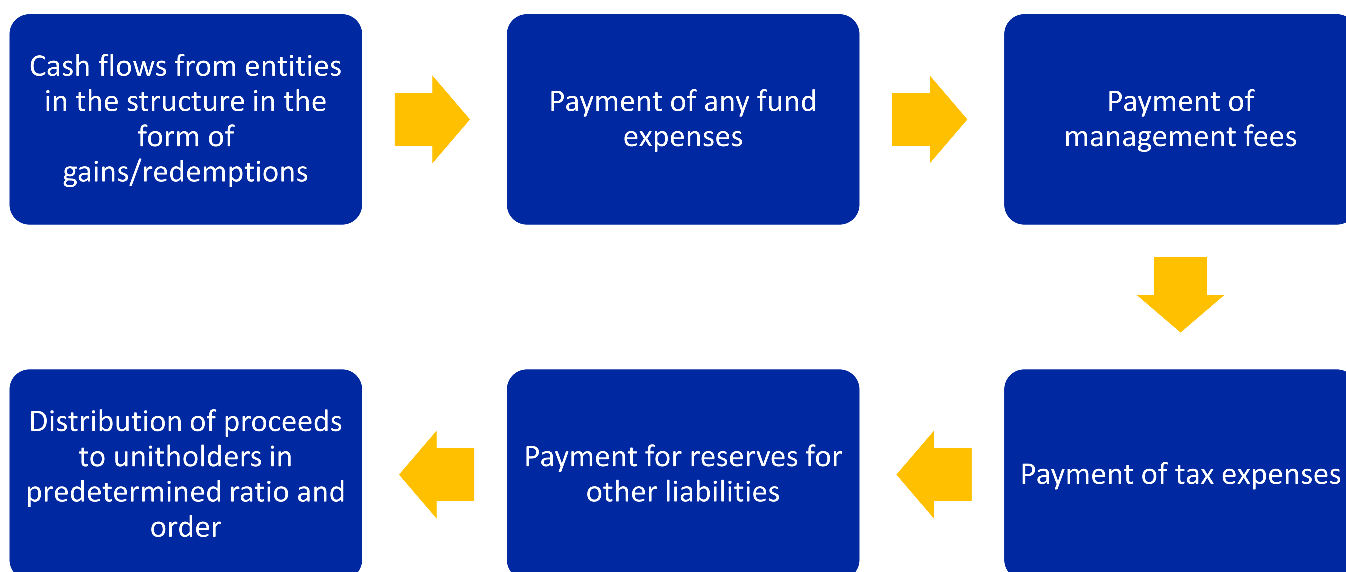
- **Composition of AIF structure**: This considers the boundary conditions/ allowable nature of investments for the AIF.
- **Scheduled repayments to investors/lenders**: The scheduled principal and interest repayments of each underlying investment is taken into consideration.
- **Correlation between entities**: The likely correlation between the borrowing entities in the AIF structure, based on business diversification (in terms of asset class and geographical presence in case of non-banking financial

companies/microfinance institutions), is taken into consideration. The higher the correlation between the entities, the higher is the probability of multiple entities defaulting at the same time.

- **PD of each borrower**: The probability of default (PD) of each borrower in the AIF structure is driven by its credit profile and the tenure of the debt being rated. The longer the tenure of the debt and the weaker the credit profile, the higher would be the PD of the borrower.
- **Build-up of PD**: All the underlying debt instruments are not expected to default simultaneously if the borrowers are not highly correlated. Some debt instruments may pay for a certain period and default later. Thus, another input in the model is the timing of the default. ICRA's assumption on the PD build-up typically depends on historically observed trends and market/economic conditions.
- **LGD**: The loss-given default (LGD) is based on the seniority of the debt and the nature of the security against the loan sanctioned. While evaluating the LGD, ICRA factors in the possibility of actual recovery through the sale of the underlying security during the tenure of the loan.
- **Recovery probability**: This factors in the probability and the estimated time frame (i.e. months) by when the entity in the structure would be able to recover, post default.

Based on the above inputs, ICRA simulates the various possible scenarios of cash flow collections. For modelling the outflows (the liability side or the investor payouts), the simulated collections are allocated as per the structure of the transaction and the 'cash flow waterfall' stipulated in the transaction documents. The quantum and timing of cash outflows are driven by the terms of the transaction, including the number, yield and *inter se* seniority among the various tranches and incidence of expenses, etc. A typical cash flow waterfall is given below:

Exhibit 1: A typical cash flow waterfall mechanism



The objective of cash flow modelling is to assess the adequacy of the capital protection in the structure for a particular rating. Thus, through a simulation exercise, the default probability and the expected loss for the AIF scheme, after factoring in the structural features, is determined and used to assess the corresponding rating.

Environmental and Social Risks

While AIFs do not face material physical climate risks, they are exposed to environmental risks indirectly through their portfolio of assets. If the entities or businesses on whom AIFs have an exposure face business disruption because of physical climate adversities, or if such businesses face climate transition risks because of technological, regulatory, or customer behaviour changes, it could translate into credit risks for the AIFs. However, the risk tends to be mitigated via adequate portfolio diversification. Further, the AIFs' investment exposure is typically over a short-to-medium time horizon that could allow them to adapt and take incremental exposure only on businesses that face relatively lesser downside environmental risks. Likewise, the exposure of AIFs to social risks depends on the nature of the sectors and/ or entities in the AIFs' portfolio and the relative concentration of investments.

Summing Up

The methodology being used by ICRA evaluates the adequacy of cash flows to repay the principal to the investors while covering the operating expenses for managing the scheme. This methodology document explains the general considerations which are applicable for rating these AIF transactions; however, depending upon the nuances of each transaction, other factors may be incorporated to effectively evaluate the risk associated with the transaction. The approach being used by ICRA to evaluate the risk and the principal protection offered by the fund incorporates the stress case scenarios coupled with statistical techniques to assess the adequacy of the cash flows to repay the investors. Further, ICRA assesses the presence of structural features such as tranches of different seniority to provide capital protection to the senior investors, if applicable. The underlying modelling assumptions may change from time-to-time based on market or economic conditions, the specific structure of a transaction, issuer-specific characteristics or even some new factors that may be observed.

Contact us for any feedback or comments at: methodologies@icraindia.com

RELATIONSHIP CONTACT

L Shivakumar
+91 22 6114 3406
shivakumar@icraindia.com

MEDIA AND PUBLIC RELATIONS CONTACT

Ms. Naznin Prodhani
+91 124 4545 860
communications@icraindia.com

Helpline for business queries

+91-9354738909 (open Monday to Friday, from 9:30 am to 6 pm)

info@icraindia.com

About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

For more information, visit www.icra.in and www.icraresearch.in

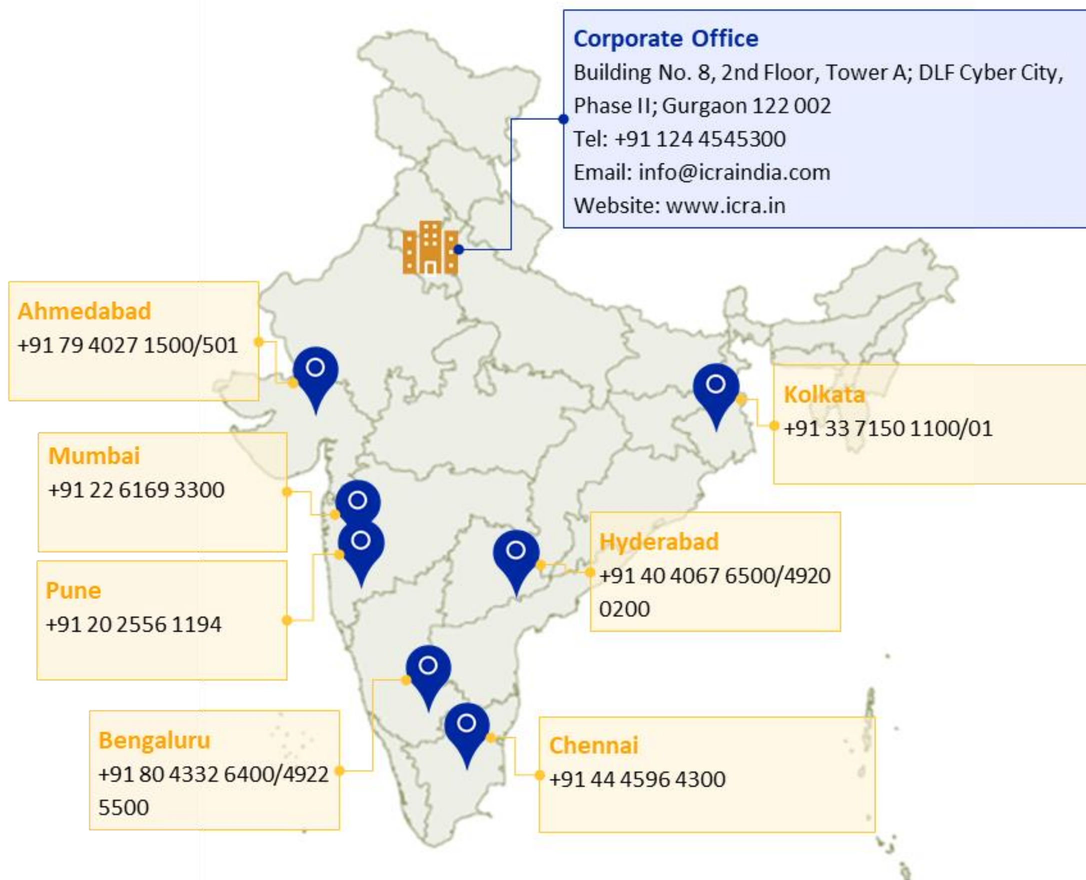
ICRA

ICRA Limited

Registered Office

B-710, Statesman House, 148 Barakhamba Road, New Delhi-110001
Tel: +91 11 23357940-45

Branches



© Copyright, 2022 ICRA Limited. All Rights Reserved.

Contents may be used freely with due acknowledgement to ICRA.

ICRA ratings should not be treated as recommendation to buy, sell or hold the rated debt instruments. ICRA ratings are subject to a process of surveillance, which may lead to revision in ratings. An ICRA rating is a symbolic indicator of ICRA's current opinion on the relative capability of the issuer concerned to timely service debts and obligations, with reference to the instrument rated. Please visit our website www.icra.in or contact any ICRA office for the latest information on ICRA ratings outstanding. All information contained herein has been obtained by ICRA from sources believed by it to be accurate and reliable, including the rated issuer. ICRA however has not conducted any audit of the rated issuer or of the information provided by it. While reasonable care has been taken to ensure that the information herein is true, such information is provided 'as is' without any warranty of any kind, and ICRA in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness or completeness of any such information. Also, ICRA or any of its group companies may have provided services other than rating to the issuer rated. All information contained herein must be construed solely as statements of opinion, and ICRA shall not be liable for any losses incurred by users from any use of this publication or its contents.