CRISIL Ratings

CRISIL Ratings approach to recovery risk ratings of security receipts

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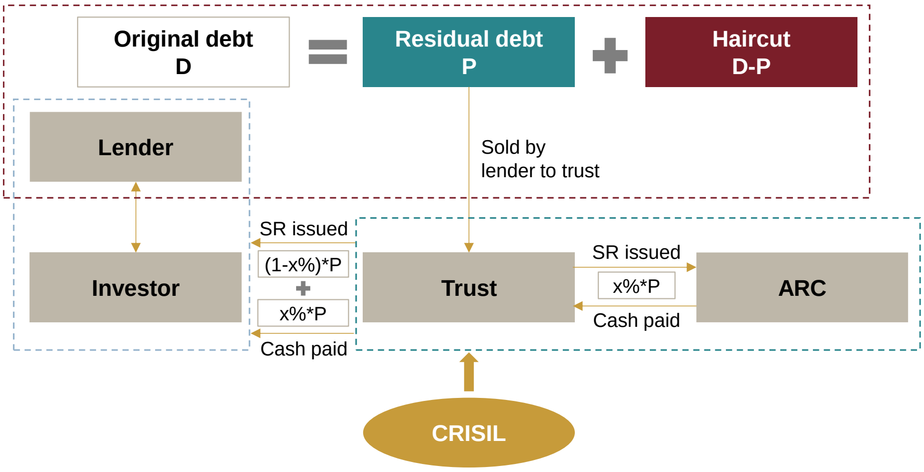
Executive summary

CRISIL Ratings has been assigning recovery risk ratings to security receipts (SRs) issued by trusts set up by asset reconstruction companies (ARCs) since more than a decade.

For distressed assets, lenders take a haircut on the principal due. The asset is sold at the residual amount to the ARC-floated trust, which issues SRs to investors (typically, ARCs and lenders). The Reserve Bank of India (RBI) guidelines stipulate a 15:85 structure for such transactions, wherein the ARC is required to subscribe to a minimum of 15% of the SRs and the balance by the lenders. The recovery risk rating assigned to the SRs is used by the ARC to arrive at the net asset value (NAV) of the SRs, which, in turn, is used by investors to value the SRs in their books.

Chart 1: Illustration on ownership and transaction involved in trust structures



The recovery risk rating reflects the present value of the anticipated future cash flow from the asset in relation to the outstanding face value of the SRs. It indicates the extent of recovery expected within the timeframe stipulated in the RBI guidelines (five years; extendable to eight). Please refer to Table 1 in the annexure for the rating scale.

CRISIL Ratings has evolved its criteria for rating SRs over the years in consultation with various stakeholders, including regulators. It factors in all the modes of recovery and provides a holistic picture of the extent of expected recovery.

Scope of the criteria

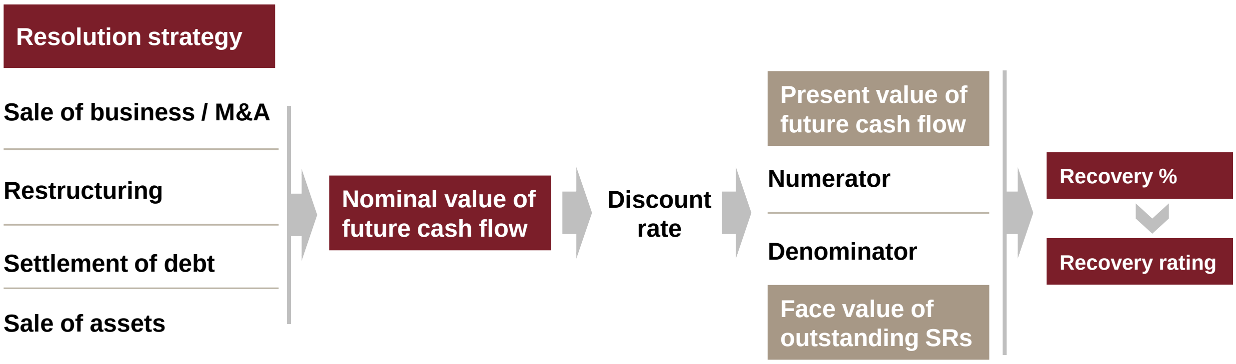
The criteria is applicable for rating SRs issued by ARCs[1]. The rating is valid over the tenure of the instrument. In line with the RBI guidelines, CRISIL Ratings reviews the recovery risk rating bi-annually (in June and December).

[1] The previous version of the criteria was published in April 2022 can be accessed here: https://www.crisil.com/content/dam/crisil/criteria_methodology/financials/archive/criteria-for-assigning-recovery-risk-ratings-to-security-receipts-april2022.pdf

Methodology

CRISIL Ratings assesses the expected future cash flow/recoveries from the asset within the stipulated resolution timeframe under the most feasible resolution strategy. The projected cash flow is then discounted to arrive at the present value. The discount rate should reflect the variability associated with the projected recovery, and hence depends on the external environment and the inherent risks of the underlying assets.

Chart 2: Methodology for assigning recovery risk rating



The choice of resolution strategy depends on several factors, including the cash flow potential of the asset, the competence of the promoters, reasons which led to the distress, the ability of the ARC to implement various resolution strategies, the external environment, security available, and the expected time frame of recovery and yields.

For example, an ARC which expects low cash flow-based recovery from an asset may opt to sell the asset, if readily realisable, for a quick exit and upfront returns. The evaluation of the expected recovery and its relative likelihood through multiple resolution plans form the core of the recovery risk rating.

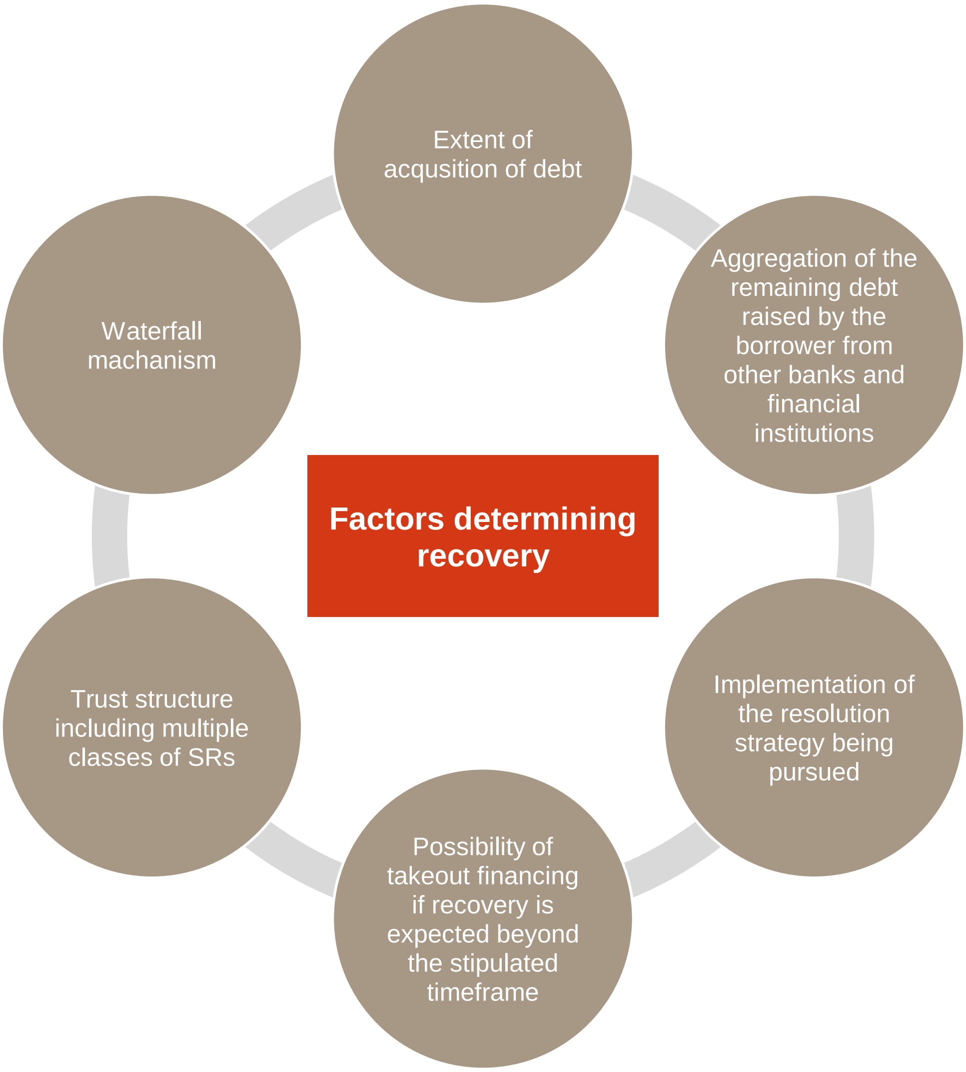
Chart 3: Assessment parameters for resolution strategies

Sale of business/M&A	Restructuring
• Likelihood of the acquisition/merger going through	• Probability of completing the restructuring exercise
• Quantum of down payment already received	• Business, financial and management risks of the underlying business
• Financial flexibility of the acquiring entity	• Sustainability of debt post restructuring
• Business, financial and management capabilities of the acquirer	• Likely equity valuation
• Assessment of Ebitda of the merged entity and likelihood of honouring periodic commitments	• Free cash flow vis-à-vis obligations to all secured lenders

Settlement of debt	Sale of assets
• Likelihood of the settlement going through • Quantum of down payment and adherence to the agreed periodic payment till date • Sources of funds outside the company, wherever available, and the alternatives • Stipulated deterrents through covenants • Assessment of Ebitda and likelihood of honouring periodic commitments, if payments are expected from the company's cash flow	• Block sale vs sale of individual assets • Details of assets on which lenders have charge; list of lenders and collaterals • Understanding of prevailing market/actual quotes received by the ARC/asset valuation report received from the valuer • Assessment of cash flow by applying the applicable depreciation rates for building and plant and machinery

Recovery depends not only on the chosen resolution strategy, but on several other factors, as illustrated below, including the seniority of SRs in the waterfall. These factors are evaluated during each rating review.

Chart 4: Factors determining recovery for a given class of SRs



Conclusion

CRISIL Ratings has experience of over a decade in rating SRs. Its ratings centrally factor in various modes of recovery available — restructuring, sale of asset/business and settlement of debt — and indicate the extent of recovery (on a present value basis). ARCs use these ratings to determine the NAV of the trust, which is a critical input for ARCs as well as for investors/lenders.

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Annexures

Annexure 1: Rating scale

Table 1: Recovery risk rating scale

Recovery rating	Implied recovery	Rating definition
RR1+	More than 150%	Present value of expected recoveries is **more than 150%** of the face value of outstanding SRs
RR1	More than 100% and up to 150%	Present value of expected recoveries is **more than 100% and up to 150%** of the face value of outstanding SRs
RR2	More than 75% and up to 100%	Present value of expected recoveries is **more than 75% and up to 100%** of the face value of outstanding SRs
RR3	More than 50% and up to 75%	Present value of expected recoveries is **more than 50% and up to 75%** of the face value of outstanding SRs
RR4	More than 25% and up to 50%	Present value of expected recoveries is **more than 25% and up to 50%** of the face value of outstanding SRs
RR5	Up to 25%	Present value of expected recoveries is **up to 25%** of the face value of outstanding SRs

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