CRISIL Ratings

The infrastructure sector: Unique rating drivers

February 2024

Criteria contacts

Somasekhar Vemuri
Senior Director, Regulatory Affairs & Operations and
Chief Criteria Officer
somasekhar.vemuri@crisil.com

Ramesh Karunakaran
Director
Rating Criteria and Product Development
ramesh.karunakaran@crisil.com

Geeta Makkar
Senior Executive
Rating Criteria and Product Development
geeta.makkar@crisil.com

In case of any feedback or queries, you may write to us at criteria.feedback@crisil.com

Contents

Executive summary

The infrastructure sector comprises entities ranging from service providers in power, telecommunications (telecom), mining, and transport; to state governments and urban local bodies (ULBs). The rating drivers of these entities are different from those applicable to companies in the corporate sector. For instance, government policy influences entities in the infrastructure sector much more than others. Again, unlike the corporate sector, the infrastructure sector has supply-side constraints in many segments. Also, in a few instances, the tariff charged for services provided is not driven by market conditions but by decisions of the government or regulator. Demand-related risks are minimal in power, telecom, and urban infrastructure, whereas demand growth is a key credit driver in the manufacturing sector.

Such divergences in key rating drivers warrant a separate framework for evaluating infrastructure sector companies (refer Box 1: Categories of CRISIL Ratings-rated entities) vis-à-vis their counterparts in other sectors. This article details the key rating drivers impacting the credit quality of entities in the infrastructure sector, and also explains how they differ from those of companies in the manufacturing and service sectors.

Categories of CRISIL Ratings-rated infrastructure sector entities

- Basic infrastructure service providers with moderate commercial viability: These include water and sewerage service boards, state transport corporations, and state government power generators, transmitters, and distributors.
- Commercial service providers: These comprise telecom service providers, aviation infrastructure providers, toll road operators, central/independent power generators and transmitters, and oil and natural gas companies.
- Special-purpose vehicles (SPVs) floated by state and local self-governments: These include municipal corporations and municipalities, and SPVs in the irrigation and roads segments with minimal commercial viability, seeking ratings that are supported by guarantees from the state governments.

CRISIL Ratings

Scope

The broader criteria of manufacturing companies[1] apply to entities in the sector. However, this article[2] highlights some of the common features that are unique to the infrastructure sector. It also outlines how CRISIL Ratings views each of these risk issues. The detailed criteria documents that capture the sector-specific nuances for the following sub-sectors within infrastructure are published separately and are available on *www.crisil.com*

- Criteria for rating the power sector
- Rating criteria for mobile telephony services
- Criteria for rating municipal and ULBs
- CRISIL Ratings criteria for rating annuity road projects
- Rating criteria for toll road projects

The criteria document highlights the parameters that are relevant for assessing the credit profile of issuers within the sector. These parameters serve as illustrative guidelines. The relevance of specific parameters varies based on the issuer's unique circumstances. For instance, if the liquidity of the company is weak, industry risk or other business-related factors may exert minimal influence on the final rating. Likewise, business parameters that hold substantial importance for one issuer may be less pertinent for another, potentially being encompassed within the broader category of industry risk.

Business risk

These include pricing flexibility and government policy, which have a significant bearing on the viability of operations.

Pricing flexibility

In the corporate sector, prices tend to be market-driven and players enjoy greater pricing flexibility. In the infrastructure sector, however, pricing flexibility is relatively limited because the government determines much of the tariff. The power and telecom sectors are, nevertheless, better off as prices in these (partially in case of telecom) are determined by regulatory commissions, not the government.

The goods and services offered cover basic needs such as water, power, telecom and transport. Revisions in the prices of these tend to have a significant impact on large sections of the population. Price revisions, therefore, constitute a sensitive issue and come under heavy scrutiny from political parties and the media. As a result, government influences the tariff to be charged for state transport, petroleum products, aviation, and water and sewerage services. Hence, the pricing flexibility of players in these sectors is very limited, a factor CRISIL Ratings views unfavourably.

In the case of power and telecom, regulatory authorities influence or determine tariff. This ensures a better balance between the interests of the service provider and the consumer. The State Electricity Regulatory Commissions

---

[1] The detailed criteria document is on the CRISIL Ratings website under the 'Criteria and Methodology' section – Rating criteria for manufacturing and services sector companies and 'CRISIL's approach to financial ratios

[2] For accessing previous published document on 'The infrastructure sector: Unique rating drivers', kindly follow below mentioned the link: https://www.crisilratings.com/content/dam/crisil/criteria_methodology/infrastructure/archive/CRISIL-Ratings-crieria-infra-unique-rat-drivers_2007-feb2021.pdf

(SERCs), for instance, determine tariff for the power sector after giving due consideration to the interests of the various user segments, while at the same time ensuring fair returns to licensees. Therefore, CRISIL Ratings favourably views entities whose tariff structures are determined by regulators as such entities tend to have healthy financial returns and their tariff is generally independent of government intervention. In case of entities with government-influenced prices, the credit view would be driven by the extent of the influence.

In the corporate sector, prices are market-driven and determined by factors such as the demand-supply situation and import parity. Pricing flexibility is, therefore, a significant differentiator between the credit quality of an infrastructure entity and a corporate sector player.

Government policy

Government policy is a central rating driver. At times, government intervention strengthens credit profiles, while at others, it constrains them.

Traditionally, government policy has played an important role and this is centrally factored in the assessment of players' credit profiles. However, the impact of the government role may vary. There have been instances where government influence has been a positive factor driving the ratings; for example, petrol and diesel cess passed on to entities such as the National Highways Authority of India, or tax exemptions to investors on borrowing programmes of infrastructure entities.

There are also instances when government intervention has proved to be a bane. These include the following:

- Lack of clarity in telecom sector regulations in the past had resulted in increased risk perceptions for the sector as a whole.
- Water and waste-water services provided by the ULBs are usually priced uneconomically; there are many instances when tariff for the domestic segment has not been revised for over 10 years.

The government offers no fund-based or non-fund-based support to entities that are not in the infrastructure sector. Its role is largely limited to making policies for various industries. Consequently, the credit profiles of corporate sector entities are not impacted by government influence. The credit profiles of several infrastructure sector entities, however, have close linkages with government policies.

In assessing their creditworthiness, CRISIL Ratings views government influence on the business and financial risk profiles of the rated entities on a holistic basis.

Demand risk

Generally, there is a favourable demand-supply situation in the infrastructure industry; in most cases, demand outstrips supply. In sectors such as water supply, airports, and urban infrastructure, the demand-supply gap is significant. Though the government encourages private investment in these sectors, a considerable portion of demand remains unmet. Demand risks are likely to remain low over the medium term, which has a positive impact on the credit profiles of the players.

In the corporate sector, demand risks play a significant role in ascertaining business risks. Industries with unfavourable demand-supply situations come under considerable stress: they face either a reduction in operating rates or decline in realisations. This, in turn, impacts the overall financial risk profile.

CRISIL Ratings factors in the low demand risks in the infrastructure sector favourably in its credit risk assessment framework.

Monopoly

Monopoly alone does not improve credit profile; the ability to earn profits is critical. The government has, in the past, created several monopoly entities such as the Airports Authority of India (AAI), Bharat Sanchar Nigam Ltd, and state electricity boards (SEBs) that were intended to be both economically viable and socially responsible. At times, the government uses these entities to further its own social, political, or economic objectives. Hence, despite being in a monopoly business, these entities often suffer losses due to government interventions in pricing. For instance, till the late 1990s, the state governments determined the power tariff of the respective SEBs, and rational increases in tariff were not allowed; consequently, the SEBs incurred huge losses. On the other hand, some monopolies registered robust profits. For instance, the increasing congestion at airports led to a sharp deterioration in the service quality of AAI, which, nevertheless, booked large profits. The capability to effectively use the monopoly status to generate high profits is key to ensuring a favourable credit profile.

The corporate sector is largely competitive, barring a few exceptions such as the petrochemicals sector where specific entities command a large market share. Prices in the petrochemicals sector are, however, linked to import parity prices, thereby ensuring rational pricing. Therefore, a sizeable market share is generally viewed favourably in the corporate sector.

The CRISIL Ratings view is contingent upon the impact of the monopoly status on the profitability of players.

Financial risk

With the exception of state governments and ULBs, the financial risk analysis framework for all entities in the infrastructure sector is similar to that of entities in the corporate sector. It has four components:

- Existing financial position
- Future financial risk profile
- Cash flow adequacy
- Financial flexibility

The key financial parameters analysed include trends in revenue from operations, an analysis of cost and profitability, management of receivables and payables, coverage ratios, return on capital employed, and debt analysis. The parentage, track record in raising funds, and trends in cash generated from operations are analysed to ascertain financial flexibility. To ascertain the future financial risk profile, CRISIL Ratings analyses operational and financial projections, and predicts the adequacy of projected flows to meet financial obligations after adjusting for expected capital expenditure, operational expenses, and working capital requirement.

Unlike the corporate sector, where making profits is a key objective, sub-sovereign and local governments are not primarily driven by financial and economic objectives but by larger social objectives. Attaining these entails significant expenditure. However, their financials are not comparable with those of the corporates given their ability to raise funds either through borrowings or taxes. Therefore, CRISIL Ratings uses a different financial risk assessment framework for ULBs and state governments (covered separately).

Management risk

CRISIL Ratings follows the standard criteria used for all manufacturing companies. This is presented in detail in the CRISIL Ratings publication, 'Rating criteria for manufacturing and services sector companies'.

Conclusion

The CRISIL Ratings rating criteria for the infrastructure sector are unique because entities in this sector have attributes quite unlike those in the corporate sector. The dominant roles that governments play in policymaking, pricing flexibility, and management are key to determining the credit profiles of government-controlled entities. At times, governments use the entities to further their own social, political and economic objectives, which constrains the rating.

About CRISIL Ratings Limited (A subsidiary of CRISIL Limited, an S&P Global Company)

CRISIL Ratings pioneered the concept of credit rating in India in 1987. With a tradition of independence, analytical rigour and innovation, we set the standards in the credit rating business. We rate the entire range of debt instruments, such as, bank loans, certificates of deposit, commercial paper, non-convertible / convertible / partially convertible bonds and debentures, perpetual bonds, bank hybrid capital instruments, asset-backed and mortgage-backed securities, partial guarantees and other structured debt instruments. We have rated over 35,000 large and mid-scale corporates and financial institutions. We have also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and infrastructure investment trusts (InvITs). CRISIL Ratings Limited ("CRISIL Ratings") is a wholly-owned subsidiary of CRISIL Limited ("CRISIL"). CRISIL

Ratings Limited is registered in India as a credit rating agency with the Securities and Exchange Board of India ("SEBI").

For more information, visit www.crisilratings.com.

About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better.

It is India's foremost provider of ratings, data, research, analytics and solutions with a strong track record of growth, culture of innovation, and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers through businesses that operate from India, the US, the UK, Argentina, Poland, China, Hong Kong and Singapore.

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

CRISIL Privacy

CRISIL respects your privacy. We may use your personal information, such as your name, location, contact number and email id to fulfil your request, service your account and to provide you with additional information from CRISIL. For further information on CRISIL's privacy policy please visit www.crisil.com/privacy.