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EMPOWERING TIMES

THINKING ALOUD

The Ratings Industry: Time to put the House in Order

Jay

PODIUM

Sankar Chakraborti

CEO & Executive Director, Acuité Ratings & Research Limited

WE RECOMMEND

Big Billion Start up – The Untold Flipkart Story

Mihir Dalal

Dear Reader,

World renowned credit rating agency, Moody's Corporation celebrates its 110th birthday. Credit rating agencies help in evaluating the creditworthiness of firms, in particular of bond issuers. Moreover, from an investor's perspective, it helps in key investment decisions. High credit rating assures investors about the safety of the instrument and enables them to save time and effort in analysing the financial strength of an issuer company. For companies, it improves their corporate image, strengthening borrowing capacity and enabling companies to grow and expand.

Over the years, the global financial system has changed, and important issues have been raised about credit rating agencies. Even though Moody's, Standard & Poor's and other agencies have had a successful story, following the financial crisis and the European debt crisis, criticism of credit rating agencies have risen.

ET this month looks at the **'The Value of Ratings.'** On the **Podium**, we speak to industry expert, **Sankar Chakraborti** - CEO & Executive Director, Acuité Ratings & Research, who explains the role of ratings agencies and its importance in the functioning of the financial market.

In the **Thinking Aloud** segment, **Jay** shares his views on the current landscape of the ratings industry. In the **We Recommend** section, we review **The Big Billion Start up** authored by Mihir Dalal, a book which summarises Flipkart's journey and the entrepreneurial journey of how the Bansals re-defined the e-commerce landscape.

In **Figures of Speech**, **Vikram's** toon bears the brunt of a bad rating!

As we start 2020, team ELS would like to wish our readers a Happy New Year!

As always, we value your opinion, so do let us know how you liked this issue. To read our previous issues, do visit the Resources section on the website or simply **Click Here**. You can also follow us on **Facebook**, **Twitter** & **LinkedIn** - where you can join our community to continue the dialogue with us!

THINKING ALOUD

The Ratings Industry: Time to put the House in Order

Jay

Inter-company competition is expected to bring out the best in an industry. So says conventional wisdom. But if there is one industry where this axiom was turned on its head, it is the Credit Rating industry. The ILFS fiasco (or a scam; call it what you want) brought to fore a number of issues and it is well known that the Non-Banking Financial Companies (NBFCs) sector is still reeling from the blow it received. No one has come through this crisis with their head held high. In fact, virtually everyone associated with this crisis has been tainted, and it will take a long time for all concerned to regain credibility. This includes so-called professional managers, Board Directors, Auditors, Banks, the regulators, government and most important of all, Rating Agencies.

How did the Ratings industry get into trouble in this story, one may well ask. After all, aren't they just outsiders who are independent in company processes? Not so, says the forensic audit by Grant Thornton when they examined the dealings between various Ratings firms and the different arms of ILFS. While the legal processes are still underway, heads have already rolled in some firms, and the stench has spread, vitiating the entire industry. What it also did was to put the spotlight on an industry which has lived in the shadows since the first Rating firm, CRISIL, was established in 1987 in India.

Ratings reflect the considered judgement of experts who take an independent view of the firm and study it under a microscope. Well, not quite that, as they depend on the information supplied to them by the client firm. Having been invited for this self-examination, and paid by the client for their professional services, the Ratings firm uses its proprietary processes, techniques, tools, and the wealth of experience that they possess, to come to a conclusion on the health of the subject firm. This Rating is typically made public so that those dealing with the firm know what to expect.

Besides, ratings of financial instruments (for instance, bonds) reflect the strength of the firm and transmits a strong message to the market and to all those who wish to deal with them.

The global majors of this industry include Moody's, Standard & Poor's and Fitch, whose verdict of firms & countries is often the last word for Institutional Investors. In India too, they are present through investments in the established players like CRISIL, CARE, etc.

The current crisis of credibility that the industry faces offers a wonderful opportunity for deep introspection to the six ratings firms registered with SEBI. While some of the actions are mandated by external demands of SEBI and the government, it is important to set their house in order by reinforcing the ethical and moral fibre of the firm. While fixing processes is easy, addressing the people element is not a quick fix. It is also widely anticipated that the industry in India will see consolidation in the coming days.

To my mind there is an even more important task: widening the market for Ratings. The Medium & Small Enterprises Sector (MSME) in India is extremely large but lags in professionalisation in various respects. While many are addressing manufacturing and quality challenges, this is the sector that is weak in financial management. Part and parcel of this is waking up to the power of Ratings. As the Indian economy lumbers to the ambitious goal of USD 5 Trillion, the need for raising capital will be a common requirement. Creating awareness of good enterprise-wide practices from the early stages of the entrepreneurial cycle will be a boon to both the MSME unit and to the Ratings industry. Educating firms about Ratings will demystify the concept and create demand too, and perhaps a joint effort from all the industry players on a common platform is overdue now (a la Mutual Fund and the Insurance sector).

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Podium

Sankar Chakraborti

CEO & Executive Director, Acuité Ratings & Research Limited

At Acuité, Sankar is leading Acuité's transformation from being world's first SME focused credit rating agency to a technology and innovation driven global knowledge company. Acuité has completed rating of over 58,000 entities.

Prior to Acuité, Sankar has worked for CRISIL, Centre for Monitoring Indian Economy (CMIE) and Capital Market Magazine. He was part of the founding team of CRISIL Research and CRISIL's Bank Loan Rating businesses. He was also deputed to S&P's Tokyo office in 2006.

Sankar is a sought-after speaker at universities, seminars and thought leadership forums.

Sankar aims to assist businesses make informed and better decisions to achieve profitable growth, and to help bring in transparency to financial transactions, through independent & unbiased opinion. He firmly believes that trust, innovation, and excellence are the three values of a rating agency which is going to keep it relevant and meaningful in the coming decades.

Sankar holds a Masters in Business Management and is a Graduate in Physics.

ET: What is the importance of company ratings from the stakeholders' point of view?

SC: Ratings are provided on a uniform rating scale (as prescribed by regulation) for a common, shared understanding of investors / lenders. Ratings help investors access independent, unbiased opinions on several issuers. All the same, issuers get access to banks / debt capital market spanning a wide set of potential investors / lenders. Ratings facilitate issuers and investors discover and arrive at the fair pricing for the loan / debt. Since ratings are subject to ongoing reviews, they are expected to reflect a rating agency's current opinion on an issuer's continuing ability to repay debt obligations. Changes to credit profiles of issuers are disseminated and made publicly available through rating actions like upgrades, downgrades, changes to rating outlook et al. thus enabling anyone to access the current, independent opinion on the issuer published by the concerned rating agency.

ET: What is the role of a ratings agency and how has it been pivotal in the functioning of the Indian financial markets?

SC: Globally, ratings are used not only by banks, financial institutions and corporations but also by governments to raise debt. Ratings help arrive at a fair pricing for debt issuances. This is made possible due to the crucial role that ratings play in addressing the issue of information asymmetry. A rating once accepted by the issuer, is published, widely disseminated and becomes public information for use by anyone (though primarily by investors) to understand the issuer's credit profile and eventually make an investing decision. The use of ratings goes beyond borrowings as other counterparties (non-lenders) may get insights into the credit profile of a rated entity and can use the rating as an input in deciding whether or not to forge a business / trading relationship with the rated entity.

In India, highly rated mid-sized corporate entities that hitherto relied only on banks for their borrowing requirements, can possibly tap the capital markets. This has been made possible only because bank loan facilities are rated on the same, bond-rating scale used to rate debt-capital market instruments. Hence, a high category rating on bank loans can encourage some of these entities to move to capital markets to refinance their existing debt or avail finer pricing on their incremental borrowing plans.

Further, SEBI has introduced some measures to address the issue of rating shopping, viz: (i) It is mandatory for rating agencies to publish unaccepted ratings and (ii) In case an issuer fails to co-operate with the incumbent rating agency and approaches another rating agency, then the reason for non-cooperation with the incumbent rating agency has to be disclosed by the new rating agency in its rating rationale (on acceptance of rating). These measures provide investors with rating opinions from all the agencies that have carried out ratings of the issuer (where issuers approach multiple rating agencies) and are additional steps to eliminate information asymmetry.

ET: Ratings are especially important to MSMEs and SMEs in the country. What are the benefits of a rated company versus one which is not?

SC: MSME segment is known to be the backbone of the Indian economy. As per the U K Sinha Expert Committee Report on MSMEs (released in June, 2019), India has around 5.8 Cr MSME units (of which 22% are agricultural based & 78% non-agricultural based units) who together contribute to 29% of our GDP. When compared to this, Credit Rating Agencies put together have rated only 1.36 lakh MSMEs (as on July 2017 NSIC disclosure), that's about 0.23% of the universe, under the MSME Ministry's PCRS scheme run by NSIC. The primary reason for such poor rating coverage was the lack of recognition and benefits offered by Indian banks to MSMEs.

Despite the critical role that MSMEs play, they continue to face huge challenges in getting timely finance at fair terms. Most of them resort to debt from expensive sources, which makes them less competitive. In many cases, MSMEs don't even understand why their loan application is rejected. Our assessment is that risk averseness among the lending community and lack of availability of information are two major reasons why MSMEs are still facing this issue. Exactly, these are the benefits that a credit rating exercise can offer.

Today between 3-4 rating agencies, rating coverage on the 'MSME scale' is available on 1.36 lakh units, most of which are proprietorship & partnership firms. Had this coverage been anywhere near to 70 – 80%, India would have been riding on such a valuable database that every other country looks forward to. Wonders are possible by making use of technology on such databases.

The MSME Rating Report of SMERA is not only a comprehensive coverage on financial and operational performance of the unit, but also suggests various risk factors and areas of improvement for the business unit to consider. It thus acts as a self-improvement tool for an MSME, unlike a BLR or Bond rating that provides an opinion only on the creditworthiness of the company. The MSME units can use this report to establish their credibility and increase visibility amongst their existing stakeholders and prospective business partners. Higher ratings like MSE 1, 2 and 3 provide an edge to the MSME units amongst its peer community and offers negotiation power to avail business loans and other non-financial benefits at favourable terms.

ET: In recent years, ratings agencies have come under the scanner. What are the challenges facing them and how can these be tackled?

SC: Rating agencies rely on the business updates, audited financial statements and future financial projections furnished by issuers besides carrying out economy and industry research. Issuers are expected to share (in confidence) with the rating agency their future business / project expansion plans, M&A plans and proposed financing for funding their growth plans. The quality and depth of information shared by the issuers is critical for the rating agency in its evaluation of the issuer's credit profile and thus the rating.

Some additional suggestions to improve the quality of ratings:

1. A long-term relationship of an analyst (rating agency) and client representatives (issuer) has the potential to blur the much-needed objectivity in the rating exercise. A calibrated rotation by making mandatory switch to a new rating agency for new debt issuances after a fixed term (say 3 years) while the incumbent agency continuing to rate the older debt programs (that are not fully redeemed) for reasons of continuity can keep conflicts stemming from long-standing relationships at bay.
2. Making dual ratings mandatory for capital market instruments will ensure availability of an alternate rating that will act as a peer-review mechanism and keep rating agencies on their toes.
3. Bringing intermediaries like rating advisors under purview of regulation (for example: introduce registration of such intermediaries) will help address the challenge of lack of accountability of these intermediaries who play a key role in an industry that is otherwise highly regulated.

ET: Can you please tell us about your company, Acuité Ratings & Research?

SC: Acuité Ratings & Research Limited is a full-service Credit Rating Agency registered with the Securities and Exchange Board of India (SEBI). It is an institutionally promoted organisation with a unique combination of country's leading public & private sector banks along with a global data & analytics company as its shareholders. The company received RBI Accreditation as an External Credit Assessment Institution (ECAI), for Bank Loan Ratings under BASEL-II norms in the year 2012. Since then, it has assigned more than 8,000 credit ratings to various securities, debt instruments and bank facilities of entities spread across the country and across a wide cross section of industries. Achieving this feat within 7 years of establishing the bond and bank loan rating business reflects the trust of Indian lenders and investors on our actionable, independent and unbiased opinion.

Acuité introduced various Industry-first initiatives like QR enabled Rating Letters & Rationales (to verify and validate its authenticity) and Ratings Buzz - a user friendly mobile application (to provide easy access to all our ratings) which have been well appreciated by the lending fraternity. Acuité's 1 year, 2 year and 3 year Cumulative Default Rates (CDR) are the lowest in the investment grade categories which reflects the strength of its rating process and quality.

Further, Acuité conducts incisive research on various industries and the Indian economy. Our opinion on crucial economic events, impact analysis and views and outlook on performance of various sectors are used by corporate India in taking more informed business decisions. We cover industries ranging from aviation, to banking, cement, dairy, education, garment, hotel, IT & ITES, jewellery, leather, manufacturing, oil & gas, power, QSR, Steel, telecom and many more.

For rating MSMEs, we have a separate division known as SMERA. SMERA was incorporated as part of an initiative of Ministry of Finance (GOI) and Reserve Bank of India (RBI), to help Indian MSMEs grow and get access to credit through independent and unbiased credit opinion that banks and other lending institutions can rely on. This division has completed more than 50,000 ratings of MSMEs across the country.

In line with our name Acuité, meaning sharpness of thoughts and vision, we empower the capital market participants viz. investors, issuers or lenders, to make knowledge backed decisions.

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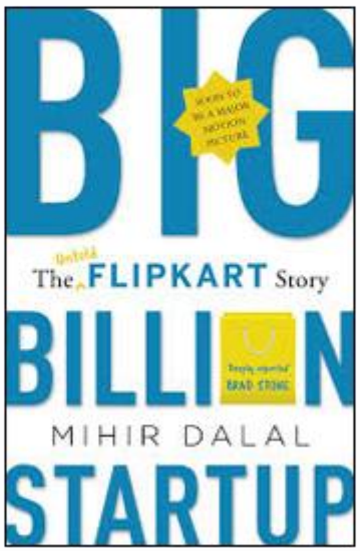
We Recommend

Big Billion Start up – The Untold Flipkart Story

Mihir Dalal



Business journalist, Mihir Dalal adds another book on e-commerce to his name. The Big Billion is the untold story of Flipkart, India's biggest internet start-up, which caught the writer's attention especially after Walmart decided to acquire over 70% stake of Flipkart in August 2018.

The book is an account of how IIT graduates, Sachin and Binny Bansal built and sold India's largest internet company. Flipkart's founding in 2007 had slowly redefined e-commerce and the way Indians shopped amid the lacklustre online retail scene at the time. What began as an online bookstore soon flourished as a one stop shop online outlet catering to the diverse needs of consumers from clothes to electronics!

The company stands as a perfect example of the toil that goes behind starting a firm and ensuring that the oil that runs it does not burn out. Flipkart was funded at crucial points (starting with Accel India with US$ 1 million and Tiger Global Management with US$ 10 million). Not only did its valuation shoot up, in 2012, Flipkart officially became a unicorn start-up. By 2013, Morgan Stanley, Sofina and Dragoneer had invested US$ 360 million in the company. The valuation of Flipkart continued to increase steadily in 2015 to US$ 15.5 billion when in a funding round another US$ 700 million was raised.

However, 2016 was when Flipkart was marked down for the first time; its valuation stood at US$ 11 billion. It was in 2017, when one of the biggest private funding ventures took place - SoftBank Vision invested US$ 2.5 billion.

Flipkart also raised another US$ 1.4 billion in funding from eBay, Tencent and Microsoft. This scaled up the total valuation to an estimated US$ 8 billion! Backed by the power that came with the Walmart acquisition, Kalyan Krishnamurthy, a former associate of Lee Fixel and a Tiger Global representative saw the opportunity to present himself as a powerful CEO of Flipkart. The author explains in detail every individual responsible for building the company's business.

The e-commerce name has indeed come a long way. From a humble two-storeyed building in Koramangala, to a Walmart acquisition and the exit of the founders! Sachin continues to be a visionary; he has incorporated a holding company - BAC Acquisitions Private Limited. He aims to make this a company that will have the characteristics of a Big Billion start-up, just like Flipkart did! Plans are underway to adapt Flipkart's story into a screenplay soon. Meanwhile, Binny Bansal is currently helping the next generation of start-up founders in India.

The book also traces the development of the wider start-up ecosystem in India. The read is inspiring, and the author has done a good job based on extensive research on Flipkart's co-founders. Mihir Dalal, a journalist with Mint, was previously associated with Reuters and CNBC TV18.

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THROUGH THE LENS

In-house naturalist, **Rupesh Balsara**, zooms in on a beautiful Grey Pansy - a species of butterflies found in South Asia. Largely feeding on fruits, it inhabits low elevations of regions with heavy rainfall at marshes and paddy fields.

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101, Lords Manor, 49, Sahaney Sujan Park, Lullanagar, Pune – 411040, Maharashtra, India

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