CARE RATING LTD.

Market Cap: Rs **3,311** Cr
Net Profit: Rs **162 Cr**

Financial Universe -

- Fee based
  - Asset Management Companies, Wealth Management
  - Investment banking, Credit rating, Stock Brokerage,
  - Stock Exchanges, Payment / Fintech
- Fund based
  - Banks, NBFCs (lending), Insurance Companies etc.

How it all started ?

- **Evolution**

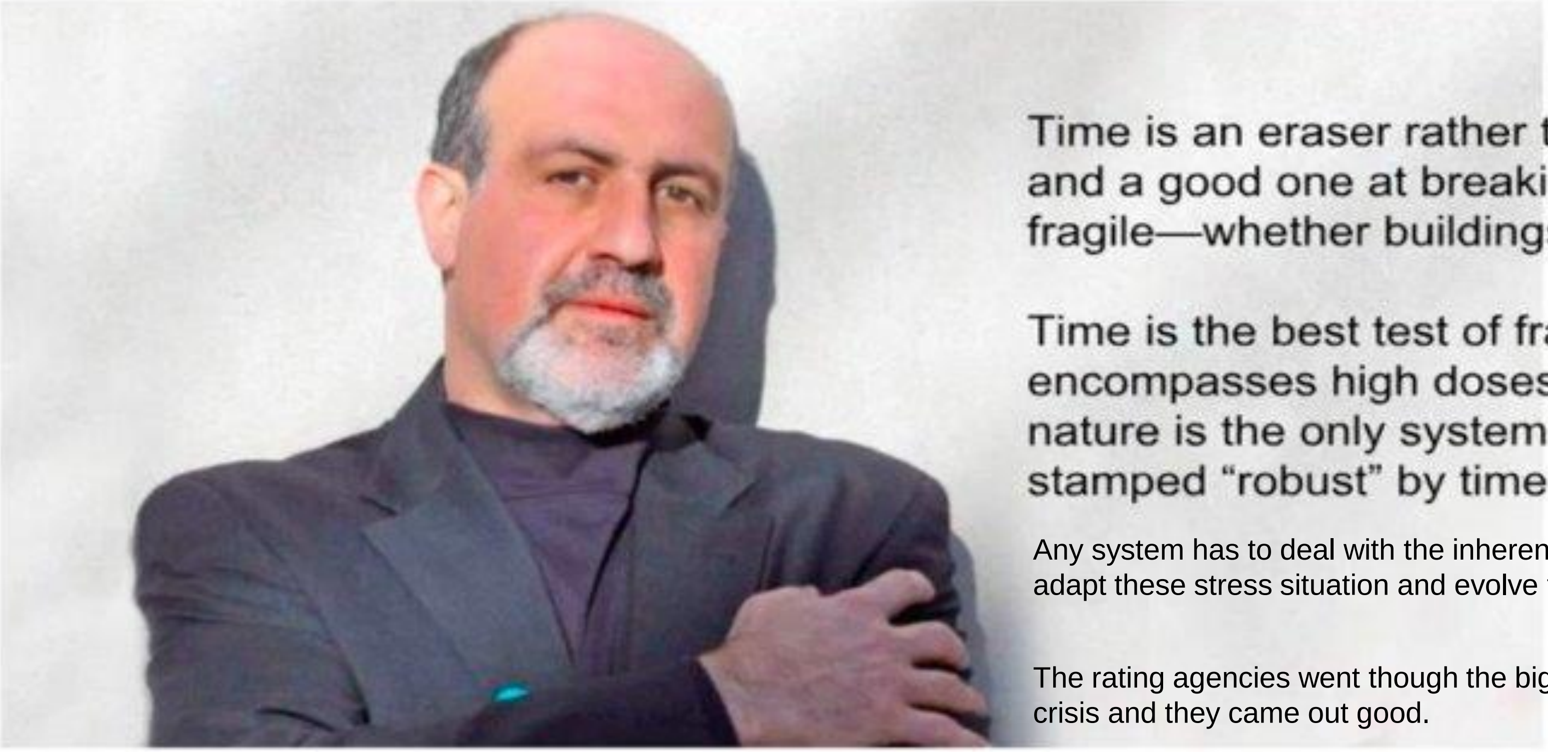
The credit rating business traces its origins to the mercantile credit agencies in the United States of America. Their function was to rate merchants' ability to honour their financial obligations. The first such agency was established in New York in 1841 by Louis Tappan. Robert Dun subsequently acquired the agency and published its first ratings guide in 1859. A similar mercantile rating agency was formed by John Bradstreet in 1849.

- In 1909 when John Moody started to rate US railroad bonds, and subsequently utility and industrial bonds.
- Poor's Publishing Company issued its first ratings in 1916.
- Standard Statistics Company issued its first ratings in 1922.
- The Fitch Publishing Company issued its first ratings in 1924.
- In 1941, Poor's Publishing and Standard Statistics merged to become Standard & Poor's Corp.

- What we learn from this ?

Cont...

Time is the best test of fragility



Any system has to deal with the inherent randomness of the world over time, If system able to adapt these stress situation and evolve that makes system more robust or anti fragile.

The rating agencies went though the biggest stress test of their history in 2008-09 financial crisis and they came out good.

cont...

- What we learnt from history ?
  1. Early move is huge advantage in this business. (Moody, S&P and Finch still donimates the markets – after 100's of years)
  2. These are robust businesses – Survived (Infact they thrived) the test of time.
  3. Anit Fragile - The rating agencies went though the biggest stress test of their history in 2008-09 financial crisis and they came out good.

Cont…

- In India, the first credit rating agency, Credit Rating and Information Services of India Limited ("CRISIL"), was set up in 1987.
- A second rating agency, ICRA Limited (then known as, Investment Information and Credit Rating Agency of India Limited) ("**ICRA**") was established in 1991.
- Third agency, CARE, was established in 1993.

History Repeats Itself Like u.s the **first-move advantage** played out in India as Well.

- Duff and Phelps Credit Rating India (P) Limited which started its operations in 1996 was renamed Fitch Ratings India Private Limited (Fitch) in 2001 and renamed again to India Ratings and Research Private Limited in 2012.
- Brickworks Ratings India Private Limited (Brickworks) began its rating business in 2008.
- SME Rating Agency of India Limited (SMERA) also began its rating business in 2008.

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Credit Rating Agencies

MISCELLANEOUS

Why only 3 rating agencies globally?

Trust = Brands --> it matters

- **Comfort with investors:** Rating assigned generally defines the pricing of financial instrument. Hence, investor comfort with sanctity of the rating holds key to long-run success of rating agency
- **Cost barriers to entry:** Ratings is a volume game. Pricing competition in this segment is quite high with rating yields as low as 4-5 bps. Hence, CRAs have to generate sufficient volume to sweat the assets (analysts effectively). Therefore, high employee and operating expenses are formidable entry barriers for this business
- **Complexity:** It requires expertise to understand, evaluate and grade various financial instruments – several tranched CDO's and CMO's, Principle protected notes, Credit Default notes etc. While rating agencies merely share their "opinion", in most practical cases that in effect determines the price of the instrument

Quote from Quartz India

"Considering that the three major agencies control more than 90% of the business, establishing a new one wouldn't be easy. It could take years, or even decades, to gel.

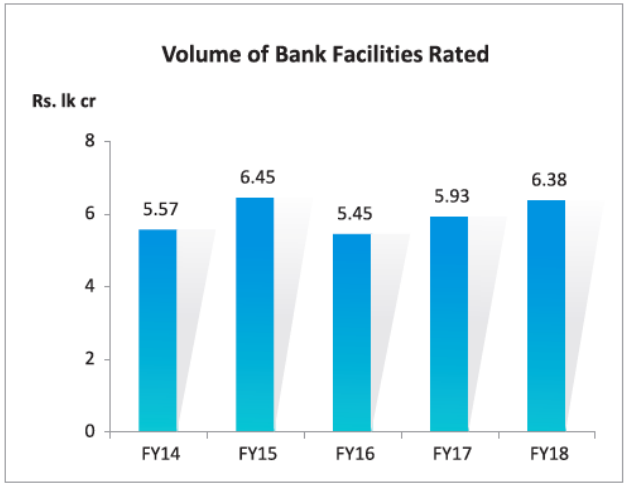
There have been previous attempts to launch new ratings agencies. All failed to take off. Examples include the Lisbon-based ARC Ratings which was launched in November 2013 as a consortium of five national ratings agencies from South Africa, Malaysia, India, Brazil, and Portugal. It is yet to release its first sovereign rating."

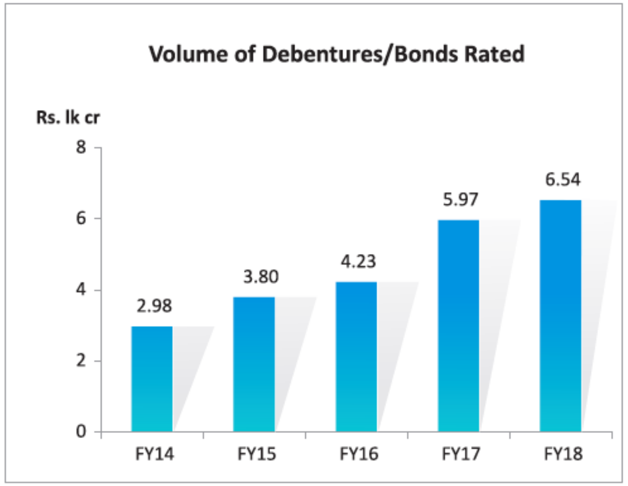
https://qz.com/905451/will-the-alternative-credit-rating-agency-planned-by-brics-work/

SUMMARY OF CARE BUSINESS -

The business comes from two main segments –

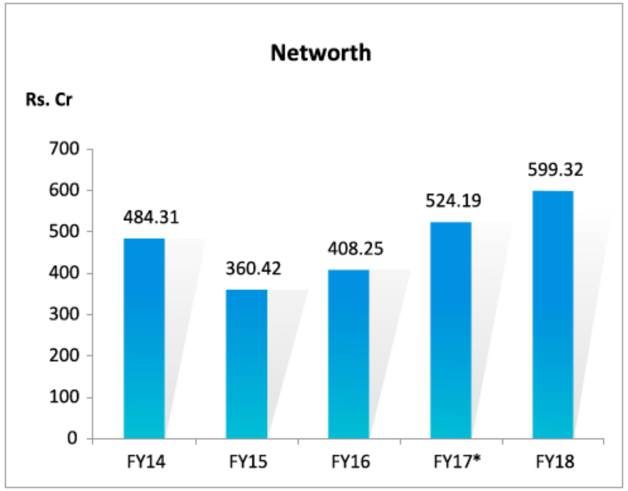
- **corporate debt raised.**
- **bank loans rated (BLR).**

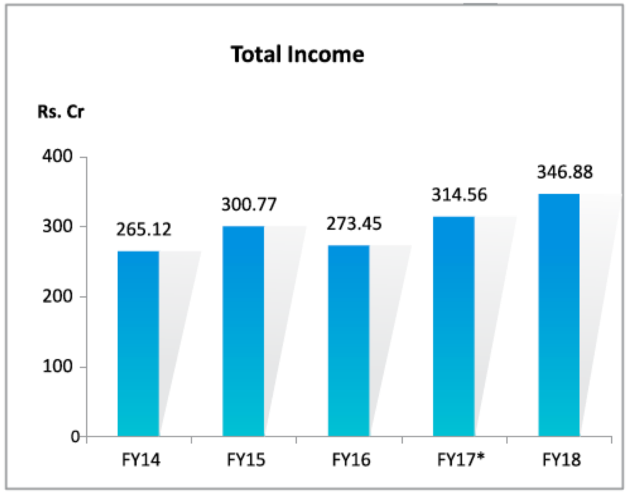




Total value of contracts traded - Rs 12 lac Crore - Total Income = Rs 346 Cr /-

Total income is 0.03% of total value rated. Hmm crazy.





Bank Loan Rating (BLR)

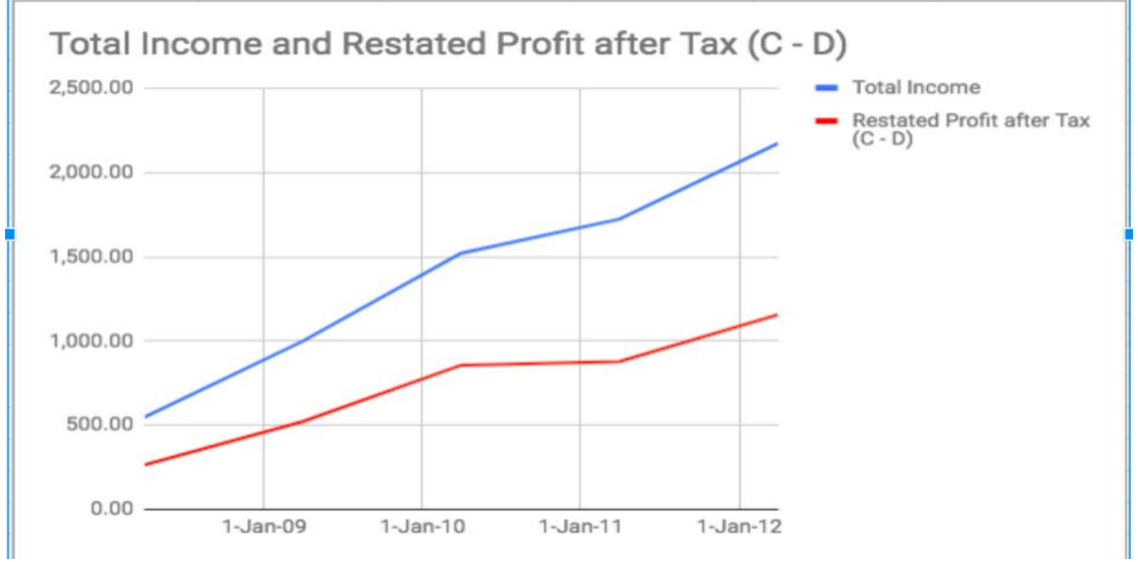
Although credit rating is not mandatory under Basel II, the utilization of capital by banks is likely to be more effective if their loans are rated. If a bank chooses to keep some of its loans unrated, it may have to provide, as per extant RBI instructions, a risk weight of 100 per cent for credit risk on such loans. As provided under Basel II, supervisors may increase the standard risk weight for unrated claims where a higher risk weight is warranted by the overall default experience in their jurisdiction. Further, as part of the supervisory review process, the supervisor may also consider whether the credit quality of corporate claims held by individual banks should warrant a standard risk weight higher than 100%.

Illustration of capital-saving potential by banks on a loan of Rs. 1,000 million:

Rating category	Basel I		Basel II		
	Risk Weight	Capital Required	Risk Weight	Capital Required	Capital Saved
AAA	100%	90	20%	18	72
AA	100%	90	30%	27	63
A	100%	90	50%	45	45
BBB	100%	90	100%	90	0
BB & Below	100%	90	150%	135	(45)
Unrated	100%	90	100%	90	-

A large number of Indian companies, hitherto unrated by rating agencies, have now come forward to get their bank facilities rated. Basel-II norms hold significant potential for further development of the domestic debt markets, by introducing into the public domain easily accessible credit information about a large pool of mid-sized companies.

	31-Mar-12	31-Mar-11	31-Mar-10	31-Mar-09	31-Mar-08
Total Income	2,171.93	1,722.55	1,520.26	999.31	549.11
Restated Profit	1,157.02	879.49	856.9	523.99	266.85



Coporate Debt Ratings-

- The corporates can raise funds either by taking

1. loans from banks (BLR).
2. issuing bonds/debentures or commercial paper.
3. Issuing external commercial borrowing/ foreign currency convertible bonds.

- The bond markets are bread and butter for the rating agencies.

Why people go to rating agencies – Solve turst issues or Are they forced to do so ?

- *In 1992, credit rating became **mandatory** for the issuance of debt instruments with maturity/convertibility of 18 months and above. (rating mandatory for debt issuance > 18 months)*

- *Subsequently, the RBI guidelines made rating **mandatory** for issuance of commercial paper.*

- *RBI also made rating of public deposit schemes **mandatory** for NBFCs.*

- *Further, in 2003, SEBI along with stock exchanges made ratings **mandatory** for debt instruments placed under private placement basis and having a maturity of one year or more, which are proposed to be listed.*

- *Another reason for increase in the demand for ratings is the **restriction** on certain classes of investors to invest not more than a stipulated part of their portfolio in unrated bonds.*

Cont…

- *The RBI in 2003 issued prudential guidelines on the management of the non-SLR investment portfolio of all scheduled commercial banks except regional rural banks and local area banks. These guidelines require such institutions to make fresh investment only in rated non-SLR securities. (stuff where banks invest their excess capital)*
- *Similarly, non-government provident funds, superannuation funds, gratuity funds can invest in bonds issued by public financial institutions, public sector companies/banks and private sector companies* ***only when they are dual rated*** *(i.e. rated by at least two different credit rating agencies).*
- *Further, such provident funds, superannuation funds, gratuity funds can invest in shares of only those companies whose debt is rated investment grade by at least two credit rating agencies on the date of such investments.*
- *Investment by mutual funds and insurance companies in unrated paper/non-investment grade paper is also* ***restricted****.*

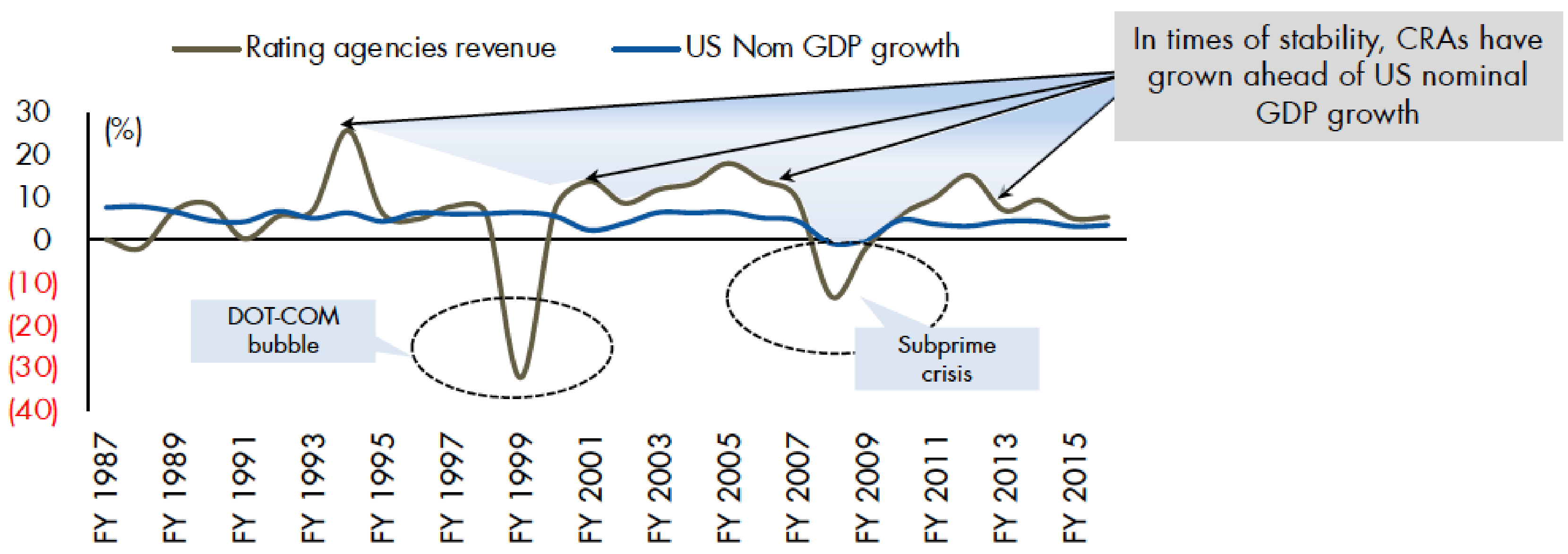
Rear View Mirror Analysis

- **CRAs in US: Track record of 30 years -**

Excluding the 2 blips, rating agencies have broadly maintained 1.7-1.8 x multiplier to nominal GDP growth

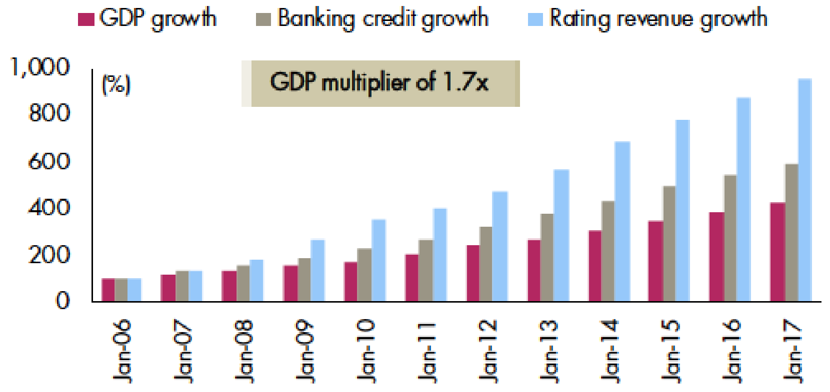
Thumb Rule - Growth profile: Similar to the global Big 3 CRAs (S&P, Moody's, Fitch), domestic CRAs have grown at ~1.7x nominal GDP over the last 10 years. We can expect 13-14% base case revenue growth over long term.

Except 2 periods of massive unrest, CRAs have performed in line with /better than US nominal GDP growth



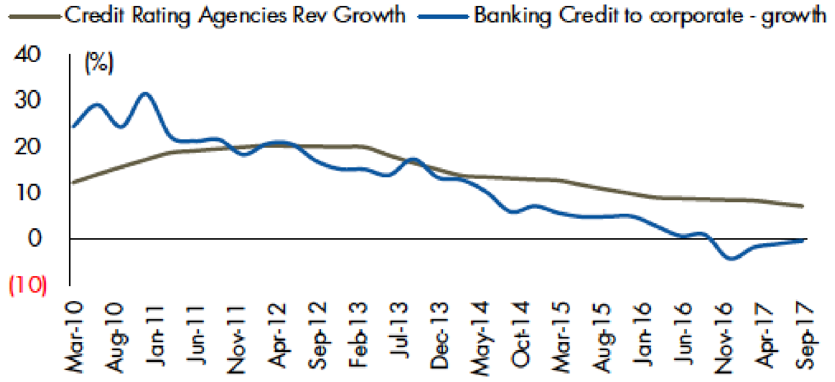
Indian CRAs: High correlation to India Inc. performance

Performance in line with or better than India GDP growth, banking credit



*Rebased to 100 from Jan'06

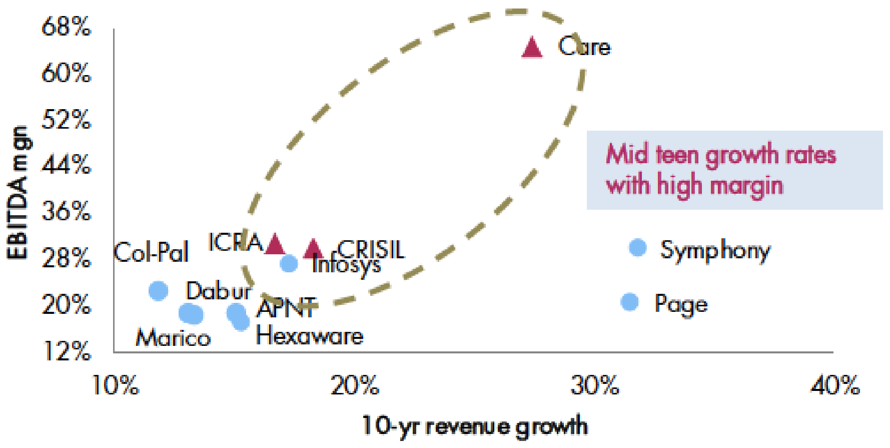
Revenue trajectory better than credit growth to India Inc.



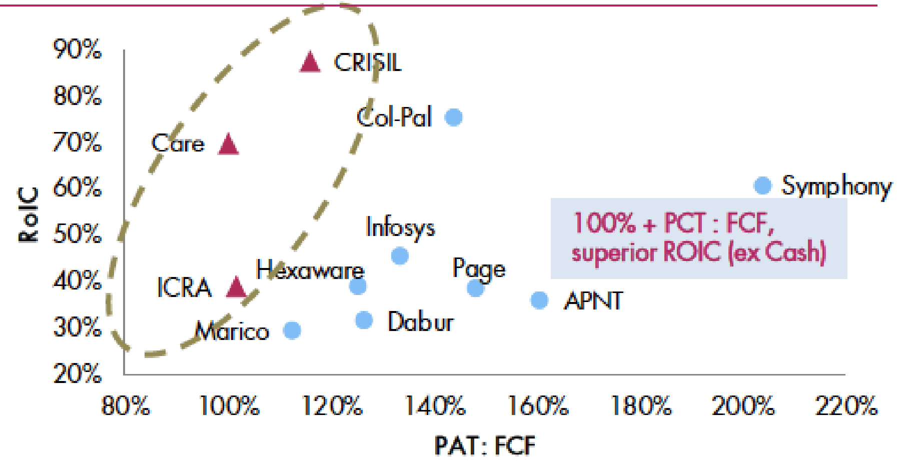
Outperformed the credit growth to corporates (7 years)

Rear view mirror analysis -

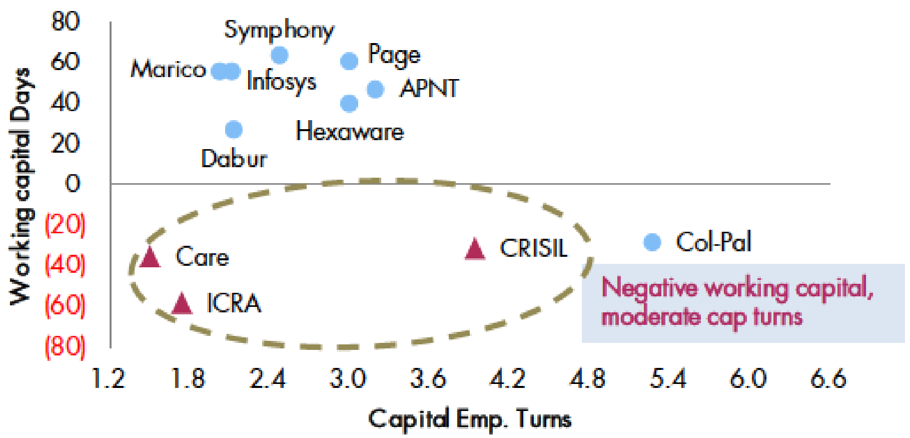
12%+ revenue growth (10-yr CAGR), 15%+ EBITDA margin



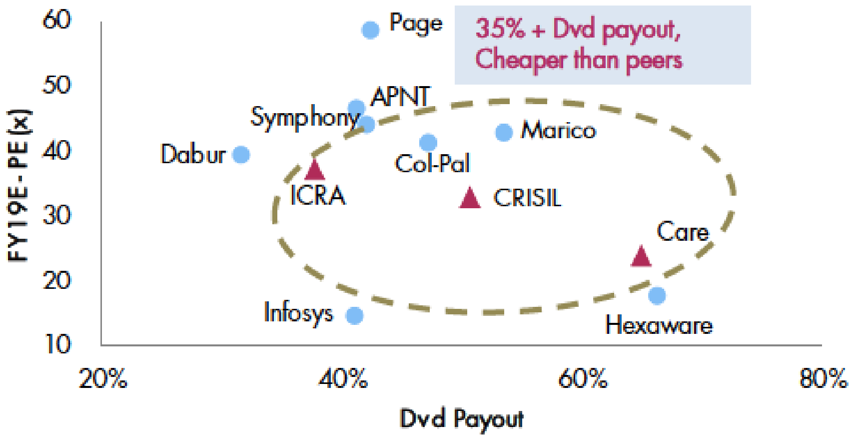
90%+ PAT: FCF, 15%+ RoIC (ex cash)



65 days working capital, 1x Cap Emp turn



30%+ dividend payout



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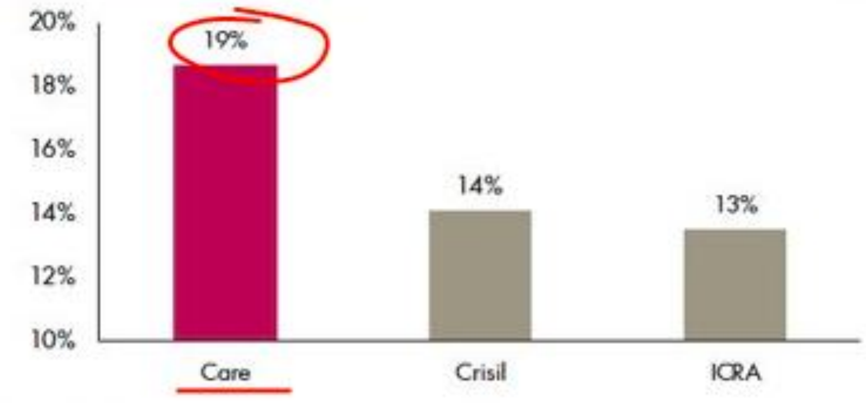
CARE Ratings

MISCELLANEOUS

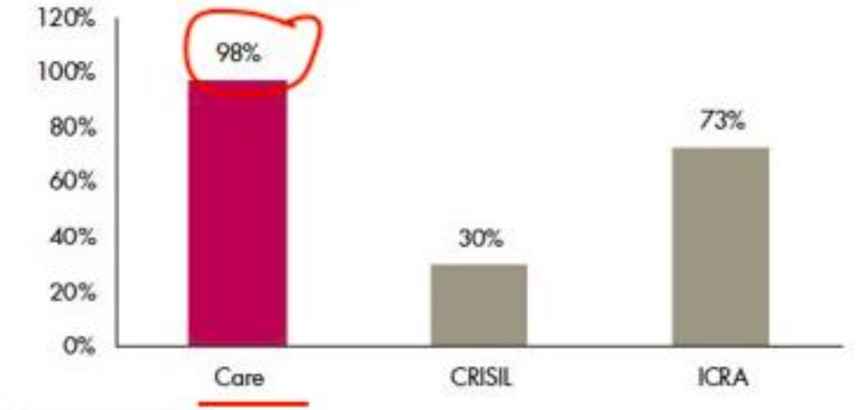
Pure play on rating business with superior returns profile

Last entrant in ratings business, but highest growth (last 5 years) profile amongst peers



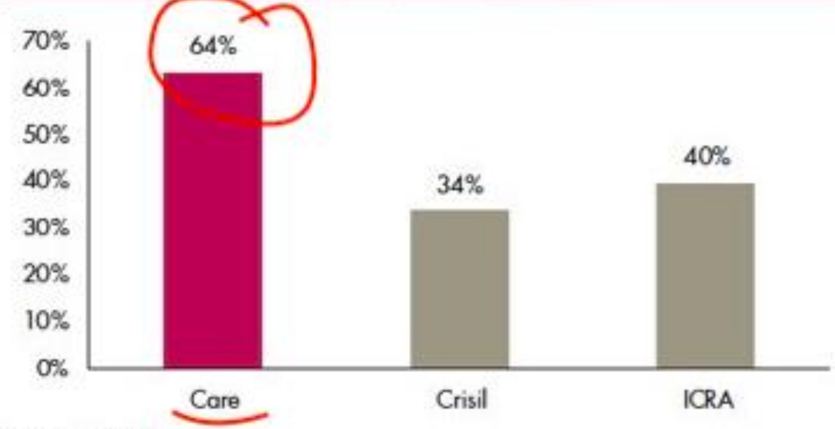
Source: Axis Capital

The only pure play on rating business



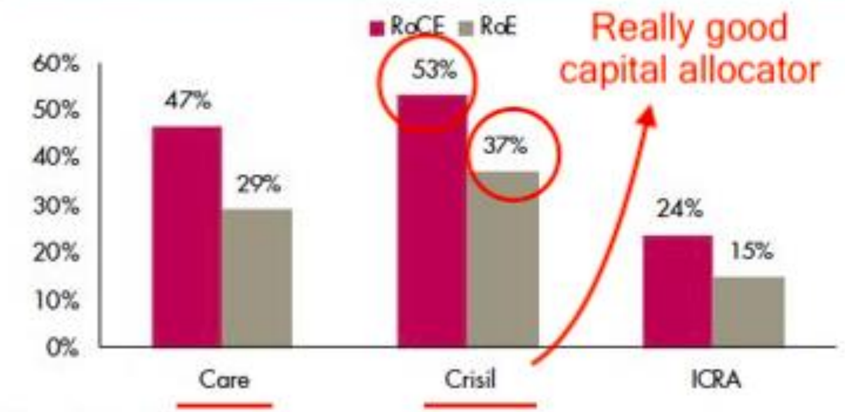
Source: Axis Capital

Best in class margin though operating efficiencies



Source: Axis Capital

Remarkable profitability compared to peers

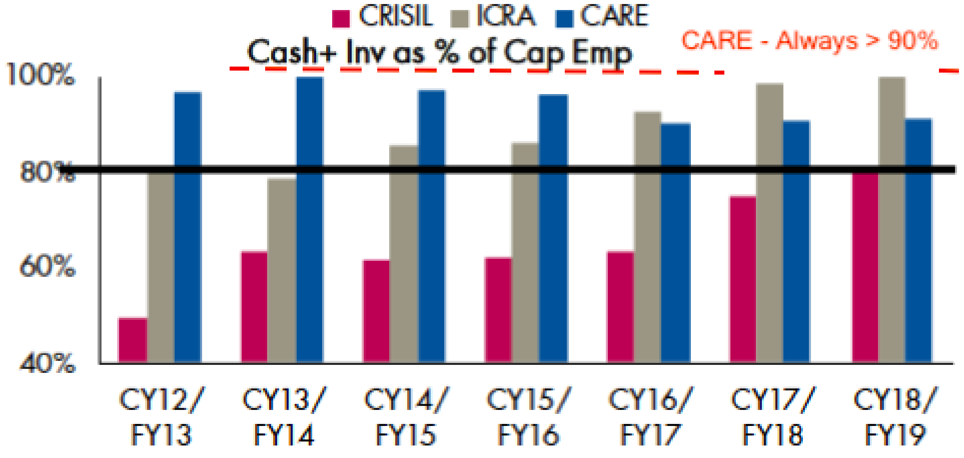


Source: Axis Capital

Capital allocation strategy – Crisil's acquisitions more successful

Best Capital Allocator

High cash levels maintained by all rating agencies



Source: Axis Capital

While we discussed the RoCE profile earlier, a point to note here is that most of the capital employed is either cash or liquid investments!

While ICRA did one round of buy-back in FY17(Rs 400 mn), we believe this would be a more regular feature for most CRAs

One of the way to reduce it is via buyback

Crisil's cherry-picked acquisition targets and their performance

(Rs mn)	Irevna	Pipal	Coalition
Year of Acquisition	CY04	CY10	CY12/13
Acquisition Cost	771	580	2500
Revenue at the time of Acquisition	331	363	1162
EV/ Sales	2.3	1.6	2.2
CY16 Revenues	8,374	307	2,840
Profit in year of acquisition	68	2.8	154
Profits in FY17	394	6.5	597

Source: Axis Capital

ICRA's capital allocation, hence acquisition strategy appears to be poorer

Particulars (Rs mn)	ICRA Mgmt Co	PT ICRA Indonesia	ICRA Online Ltd
Year	2005	2011	2005
Acquisition Cost	150	149.7	87.2
Rev in year of acquisition	121	0.7	29.5
EV/ Sales	1.2	NA	3.0
Rev in 2017	308	4	497
Profit in year of acquisition	11	(18.3)	2
Profits in FY17	(2)	(0.2)	84

Source: Axis Capital

Crisil's strategic stake in CARE – How do we read it

- Crisil has acquired ~9% stake in CARE Ratings
  - PURE PLAY, WELL MANAGED, ratings business
  - A segment Crisil understands

Why 9% ? because they can't buy >= 10%

Understanding Crisil's thought process

Initial Amount (Rs mn)		4,350
Particulars	Option 1 Buy back Crisil	Option 2 Buy Care
CMP	1955	1,660
O/S Shares	71	29
Mcap as on Date	139,461	48,887
% available to be purchased/ brought back	3.1%	8.9%
# number of shares	2	3
PAT CY18/FY19	3,665	1,636
CRISIL EPS pre acquisition	51	51
Revised PAT	3,665	3,811
CRISIL EPS POST ACQUISITION	53.0	53.4
Benefit		**0.7%**

Source: Axis Capital

Crisil has bought a 14% IRR business

	FY18	FY19	FY20	FY28	FY29
	Year 0	Year 1	Year 2	Year 10	Year 11
Intial Investment	(4,350)				
9% of CARE's Cash and investment	536				
Initial Outflow	(3,814)				
9% FCF ogf CARE	134	148	169	450	9,458
Total investment cashflow	(3,680)				
IRR	14%				

Source: Axis Capital

They made a general statement but reason should be more than that...

Crisil 's comments on acquisition

"Crisil continuously evaluates investment options as part of its corporate strategy. The stake purchase is an investment in the excellent long-term prospects of the credit rating sector in the country. The prospects for the sector are driven by the significant demand for capital investments and infrastructure financing in India over the long term, much of which should benefit the sector"

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22 JAN 2018 Company Report

CARE Ratings

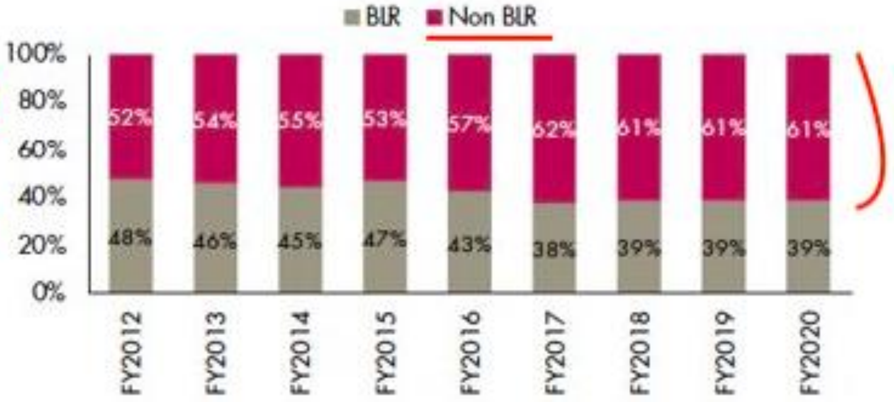
MISCELLANEOUS

CARE – Pure play on rating business

Consistent growth profile

Source: Axis Capital

Improving share of non-BLR revenue to help margin



Source: Axis Capital

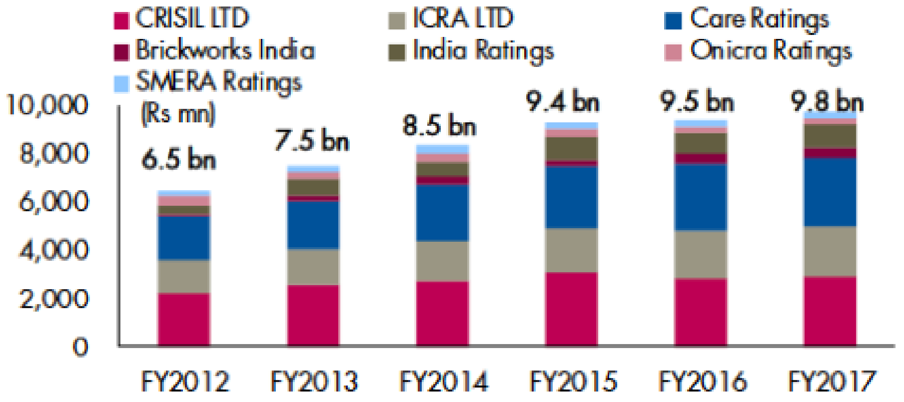
- In an endeavor to diversify its product portfolio beyond the traditional corporate bond and BLR business, CARE has been expanding its income-generating pool of products such as *SME rating, Edu-grade (education institutions grading), equi-grade (equity research of companies), real estate ratings and valuation of market-linked debentures in order to expand their pool of products.* CARE has also strengthened its position in IPO grading market and captured a significant market share.
- Continued expansion in product offerings will help CARE in maintaining market share in ratings industry

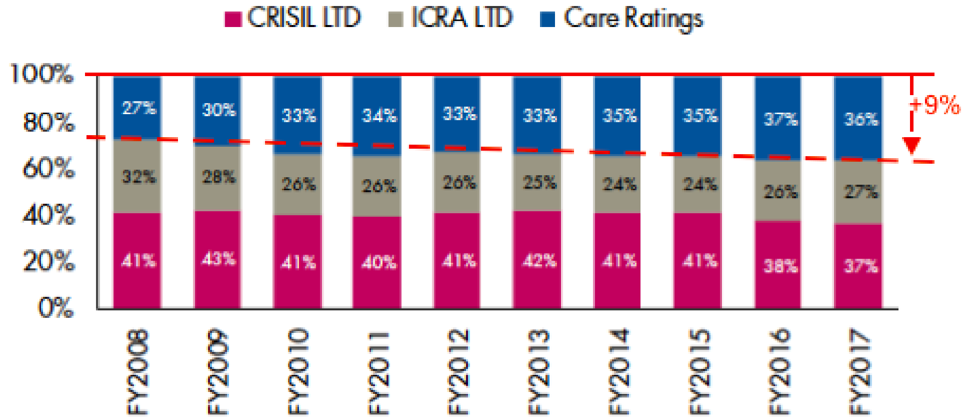
Gained market share in last 10 years

CARE was 3rd largest CRA in terms of revenue from ratings business till 2008. Basel II norms in 2008 augured well for entire rating industry especially for CARE, as it climbed to 2nd spot in terms of revenue and market share

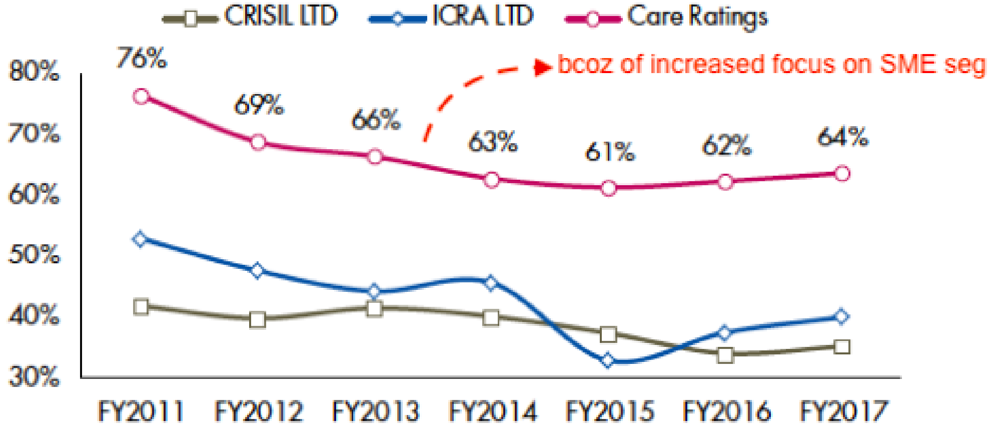
Over past 10 years, Crisil and ICRA have conceded share to CARE

Care Ratings and Brickworks (Smaller Base) have stood out in terms of revenue growth profile

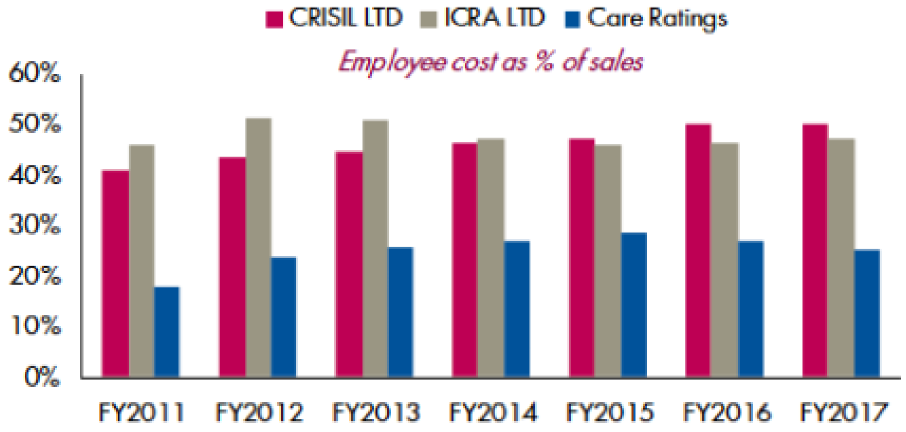




Margin profile of all players have deteriorated, reflecting high competitive intensity



Employee cost (CARE) is half of that of peers – major reason for EBITDA margin differential



Entry barriers – the biggest moat

If you are going to bond markets to raise money, you will want urself to be rated by top 3 not the bottom 2

All the 3 ratings agencies benefit from

- early mover advantage
- strong industry network playing a critical role
- credibility of the brand,
- quality of service, and
- wide exposure and expertise in various industries

Data base they build over time

Market share from 4th & 5th player could eventually shift to the top 3

Hence, we do not expect credible #4 or # 5 player in this space

The credit rating agencies enjoy some of the following advantages:

- **Customer stickiness and cost of new ratings:** Switching to other rating agency requires time as well as money. An existing rating agency would have a through understanding of the business along with a detailed database of the company. This would save precious time/ effort for incumbent rating agency
- Low input cost to the company - 300 bps
- **Network effect**: Established players enjoy brand recognition, provide quality service, and strong industry network which attracts new borrowers to old agencies.
- **Consistency and credibility**: Most corporate borrowers would desire consistency and comparability in credit opinions. Also investors preference for CRA's with long standing track record would ensure that newer players would take substantial time to gain investor confidence

As a result, over longer term, we expect the 3 key players to benefit disproportionately from structural and cyclical drivers of the ratings industry growth

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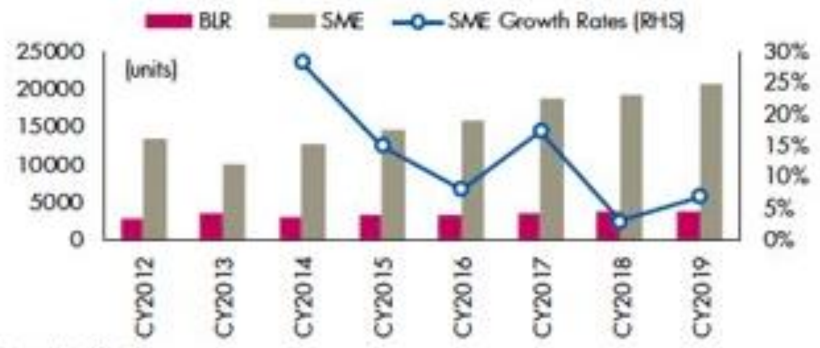
22 JAN 2018 Company Report

CRISIL

MISCELLANEOUS

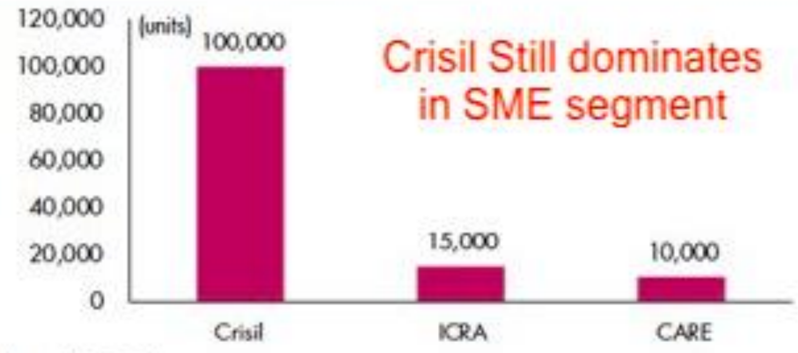
SME ratings – the growth machine

Strong growth rate in SME business



Source: Axis Capital

Crisil's SME book is 7-10x larger than peers



Source: Axis Capital

- SME ratings began in 2008, and soon witnessed an aggressive ramp-up. This led to Crisil being the market leader in SME rating, which rated ~16,000 SMEs in CY16 vs. ~2,500/4,000 for ICRA/CARE
- Crisil SME ratings designs affordable and tailor-made rating products and provides the widest range of ratings in India. It has rated and assessed 1,00,000 SMEs

Why SME rating is in demand ?

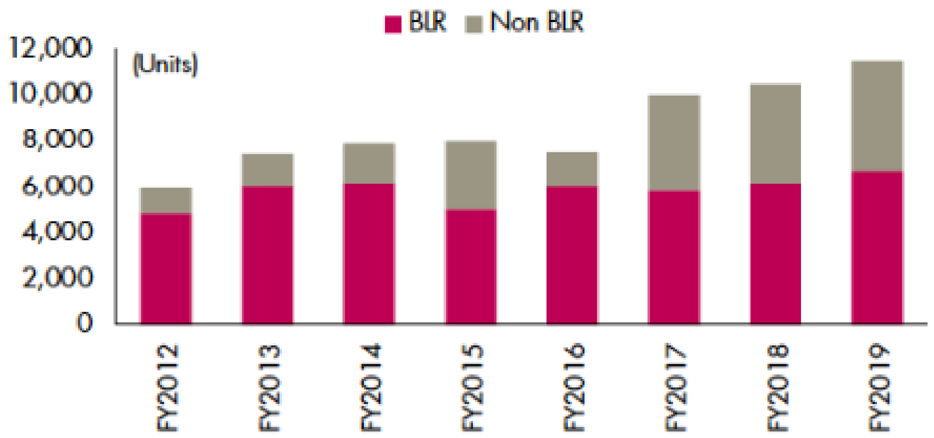
- A hallmark to the success of the SME business is that several of India's largest companies use Crisil's customized SME assessment services to evaluate their vendors, dealers, distributors, and franchisees

With such a diversified rated pool of SMEs- the banks acceptance of Crisil SME ratings have also increased Also Crisil's intensive outreach initiatives and expansion into new markets are expected to drive demand in CY18 and beyond

Growth aided by both BLR and non-BLR segments

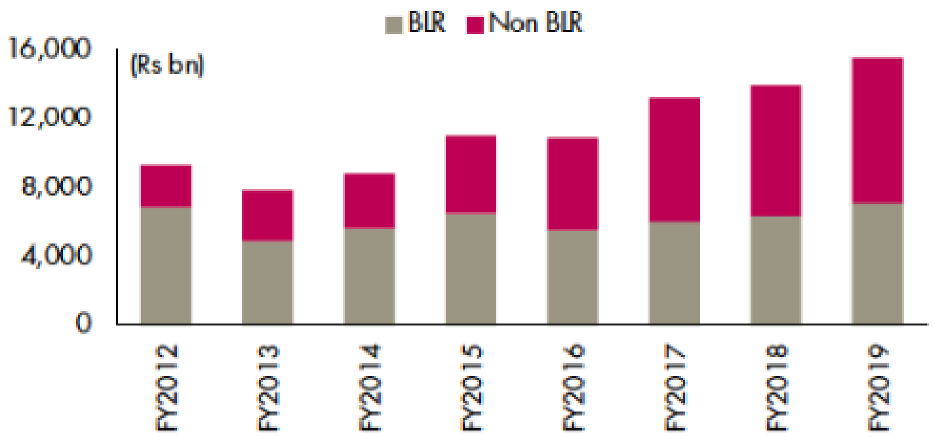
Declining volumes in BLR segment along with incremental focus on SME ratings led to higher share of non-BLR revenue

Count of instruments rated



Source: Axis Capital

Volume of instruments rated



Source: Axis Capital

There is a potential to gain huge market share in SME from Crisil, May be thats y Crisil invested in them ?

- Over the past 7 years (since 2010) the number of instruments rated has increased ~6x (largely in non-BLR category). However, the volume of business rated has increased only 2x, indicating lower ticket sizes
- We believe CARE could accept smaller ticket assignments largely due to overall cost competitiveness against Crisil and ICRA. This enabled CARE to demonstrate a higher revenue growth rate. However, this was not without consequence; operating margin compressed over 10% over the past 6-7 years

MACRO

India Story …. under-penetration

PSU to Private

Why not to bond markets ?

Blah Blah

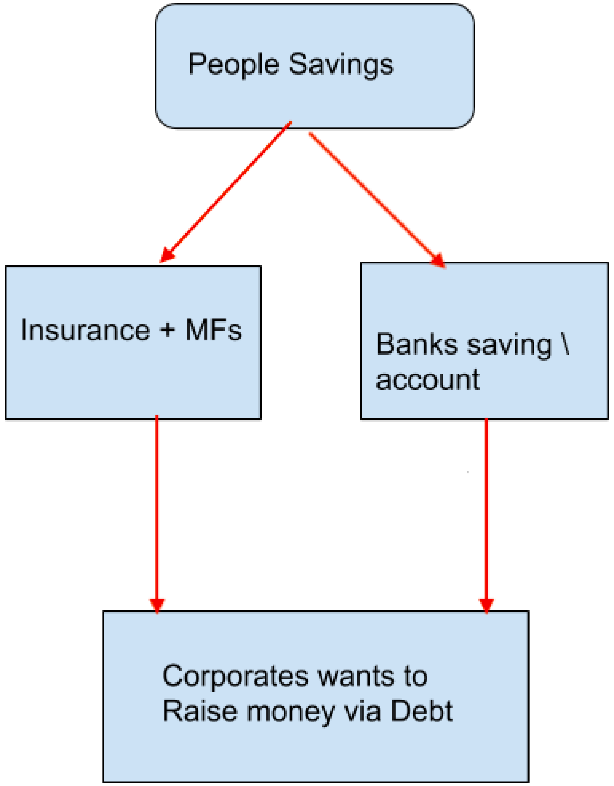
Why debt market in india never picked up ?

- We need on tap bond markets (SEBI is proposing ..) - If corporates wants to raise money generally it takes 6 months get this money in, whereas they can just walk to the bank and get this in 1-2 months. (Can we done for AAA.)

- We should allow insurance company to able to sell the protection - like Credit default swaps.

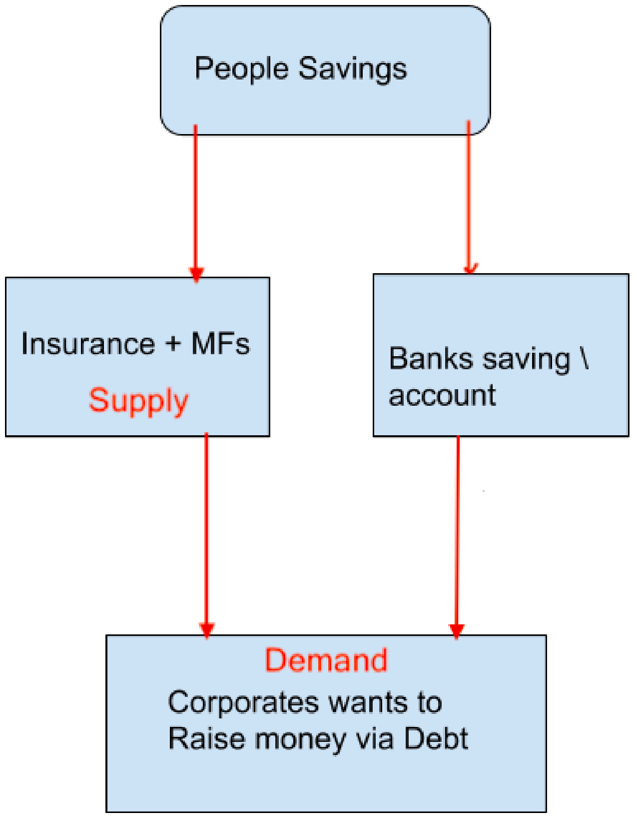
- Recovery in defaults - Insolvency bankruptcy code (biggest game changer).

  IBC going to play an important role in pricing the bonds in bond markets , before it was impossible to get money back in case of default. Now people will even prefer to investing in lower rated bonds which was earlier difficult as recovery wasn't just there.



What are the growth drivers ?

- Very high correlation with pick up in corporate debt markets.



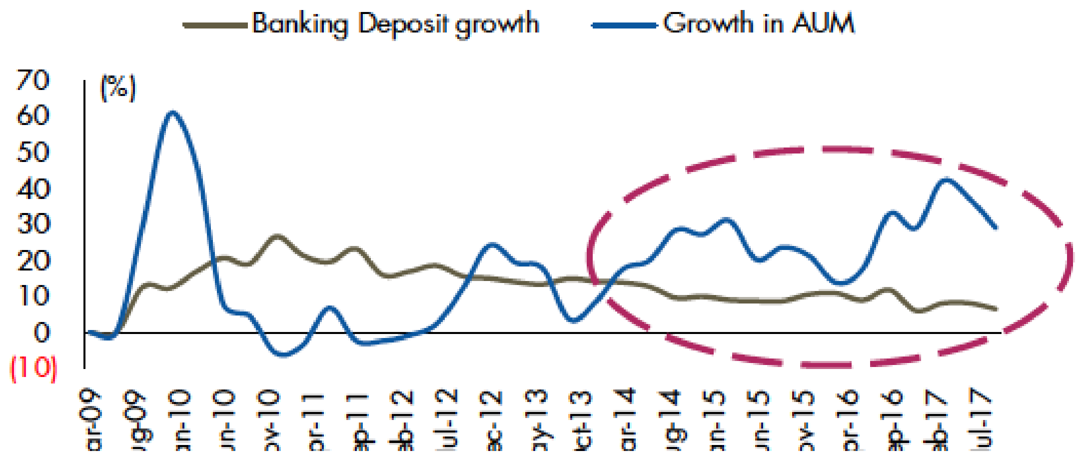
How the supply looks like ?

- Mutual funds may start playing important role -

Credit Rating Agencies
MISCELLANEOUS

Demand and supply side issues resolving for debt markets

Liquidity supply to financial institutions improving demand for corporate debt



Mutual funds' and Insurance companies' AUM has grown at >25% over past 3 years

How is the demand side looks like ?

- Investing is not about forecasting what going to happen but we should be hell sure about where we are in the cycle today.
- We don't know when co-capex going to pick up but we can say that there are signs it has bottomed out.

Early signs of recovery in capex

Credit Rating Agencies
MISCELLANEOUS

- As we see early signs of capex bottoming out, the increase in corporate capex and the changing funding mix bode well for CRAs
- Capex bottoming out: RBI data on corporate disbursements is showing signs of capex bottoming out. Our analysis of BSE 500 companies also suggests a similar trend in capex

There are signs of corporate capex picking up but will it pick up we dont' know

- Investment pipeline and bank sanctions turnaround: Most encouraging data point is over 50% rise in project pipeline and over 90% increase in corporate sanctions of banks. While we see these as green shoots of capex revival, we are not opening the champagne as yet. Despite rising 50%+ in FY17, the pipeline is still half of peak levels
- Close observation of break-up of banks' sanctions data suggests healthy trends:
  - Renewable power, Infrastructure construction, and metals have driven the incremental sanctions
  - Share of working capital in incremental credit declined to 31% in FY17 from 66% in FY15
  - Bulk of increase is from small (<Rs 5 bn) & mid-sized (Rs 5-50 bn) projects; large projects (>Rs 50 bn) bottomed out in FY16
- Other positive lead indicators that suggest corporate capex revival:

  Capacity utilisation is low from very long time

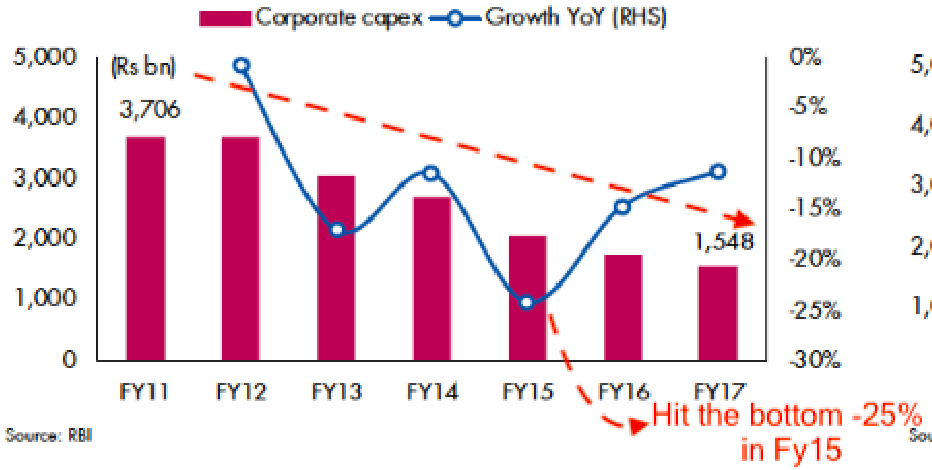
  - Improvement in India Inc's manufacturing capacity utilization (up from 71% in Sep'16 to 75% in Mar'17) and manufacturing PMIs rising above 50
  - Corporates with healthy balance sheets have now started talking about expansions: PSU refineries, steel (JSW Energy, Tata Steel), cement (Holcim, UltraTech) and fertilizer (Chambal Fertilizers)

  Lots of deleveraging has happened since financial crisis

Credit Rating Agencies
MISCELLANEOUS

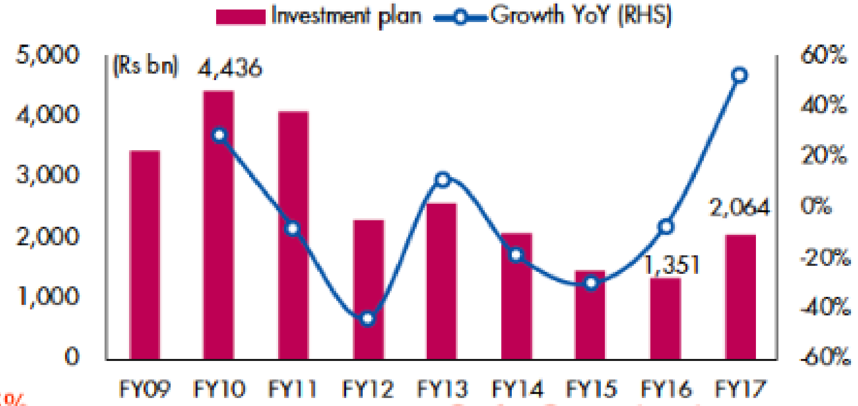
RBI data shows corporate capex bottomed out in FY17

Corporate capex bottomed out in FY17...



Source: RBI

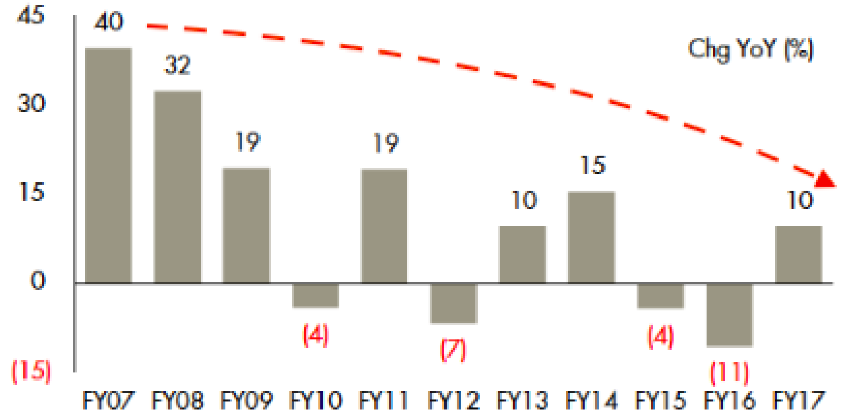
...turnaround from FY18 based on 53% rise in project pipeline



Source: RBI

So far Capex has been coming from Gov side

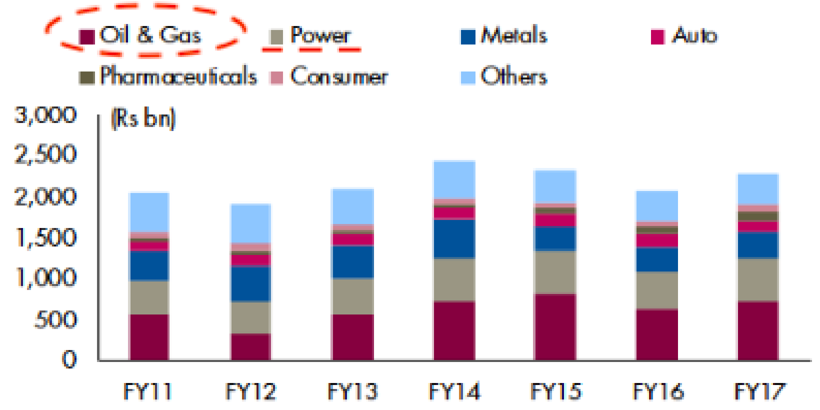
Capex bottoming out signs also visible for BSE 500*cos...



Source: C-Line, Axis Capital

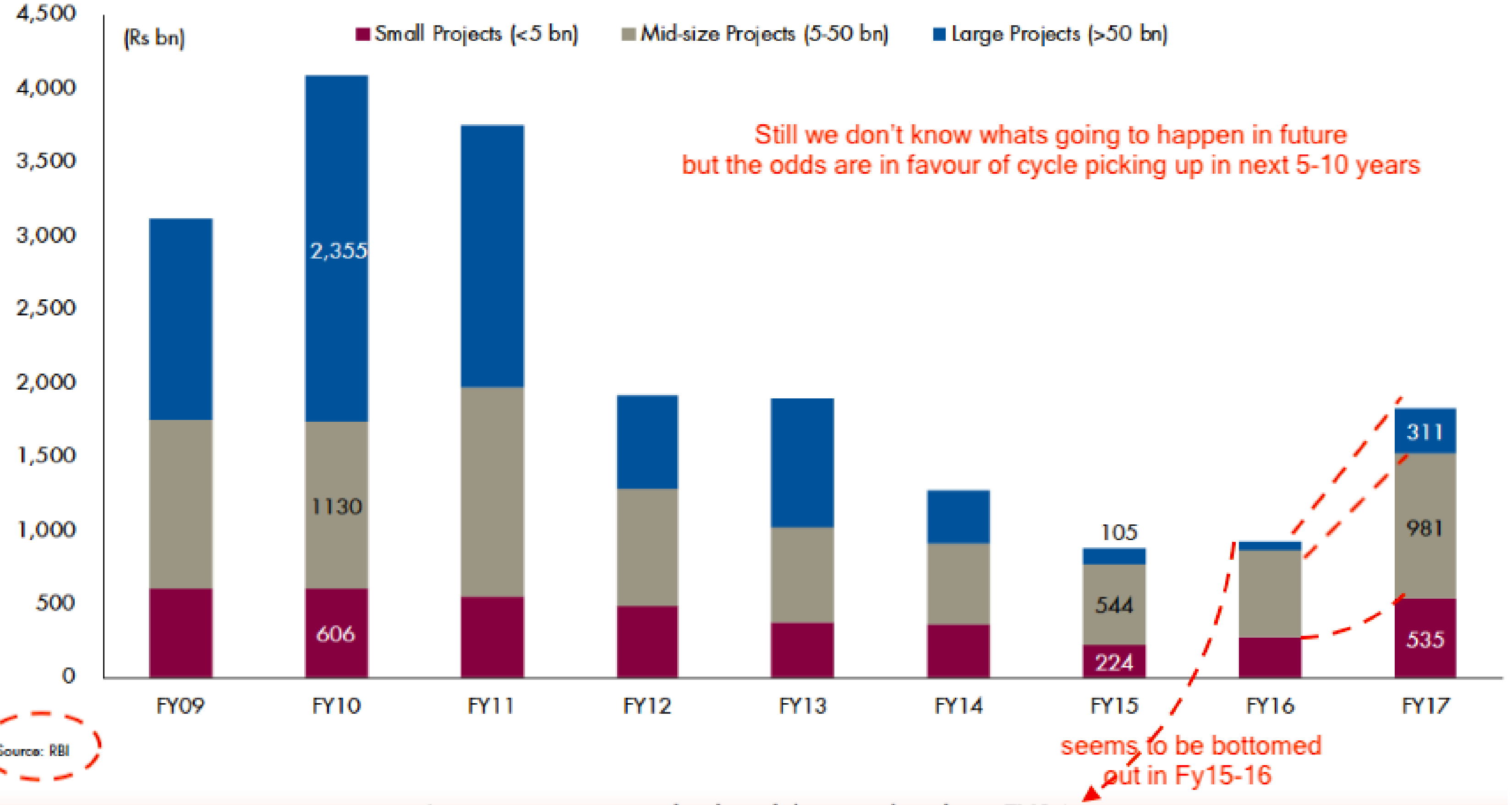
Note: *excluding telecom companies

...Oil and power PSUs, and RIL predominant drivers



Source: C-Line, Axis Capital

Recovery in capex plans is largely in small and mid-sized projects



Source: RBI

Large projects touched rock-bottom levels in FY16

Why corporate credit will pick up ?

- Betting big on corporate banks: Prashant Jain (SEP 28, 2018)
- Upturn in investment cycle likely to last for five years: RBI (October 16, 2018)

IBC – Biggest game changer.

- *"The Reserve Bank of India has asked banks to initiate bankruptcy proceedings against 12 large loan defaulters, accounting for a quarter of nearly INR 9trn (9 lac Cr) that the banking system has piled up in bad loans."* **Hindustan Times, 7 August 2017.**

The real investment rate in India generally trended upwards to peak at 36.7 per cent in 2007-08 before declining to 30.3 per cent by 2015-16 due to factors such as the global financial crisis, twin balance sheet problem -- high leverage by the corporate sector and high non-performing assets (NPAs) of the banking sector -- and subdued domestic capital market conditions, it said.

"The slowdown in the investment rate was one of the major factors, which pulled down India's growth rate from a high of 9.3 per cent in 2007-08 to a low of 6.7 per cent in 2017-18."

New bankruptcy code can strengthen creditor rights…

Countries with strong bankruptcy resolution mechanism have better recoveries

Country	Recovery rate (%)	Time (Years)	Distance to frontier *	Corporate bonds/ GDP ratio
Brazil	22.4	4	53	42%
Russia	41.7	2	58	20%
India	**25.7**	**4.3**	**33**	**17%**
China	36.2	1.7	55	46%
Japan	92.9	0.6	94	68%
UK	88.6	1	82	114%
US	80.4	1.5	90	115%

Source: World Bank's 'Doing business report'; BIS; SEBI; (*) Higher score on 'Distance to frontier' indicates stronger insolvency mechanisms

Lower than everybody

why can't this become 40% ?
How big a role default recovery plays in it ?

- Predictable recovery process enhances confidence of bond market investors
- Countries with better enforced creditor rights have larger domestic currency than foreign currency, bond markets: Burger & Warnock study, 2006, IMF

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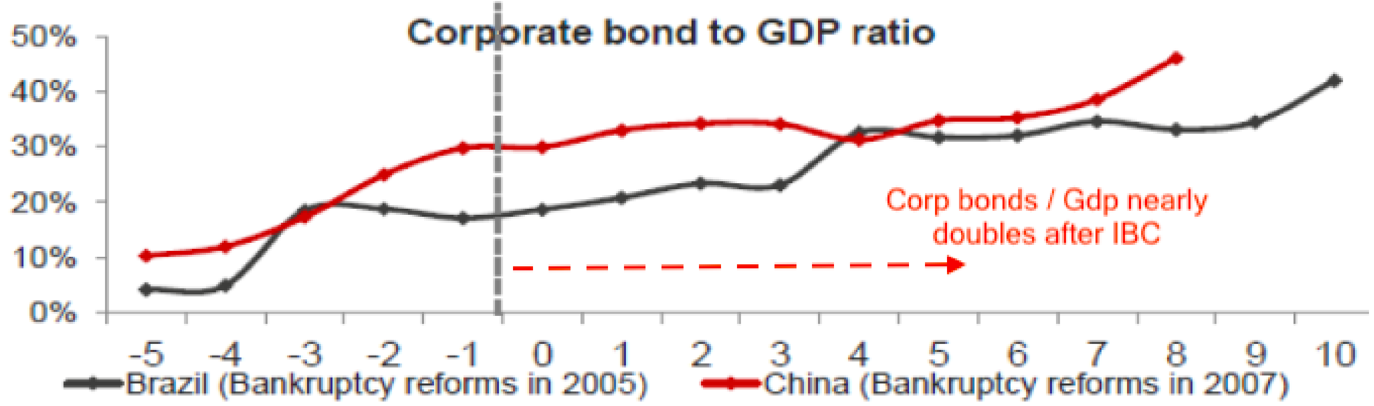
...and can lead to deepening of bond markets

Countries with strong bankruptcy resolution mechanism have better recoveries



Source: Crisil, Axis Capital

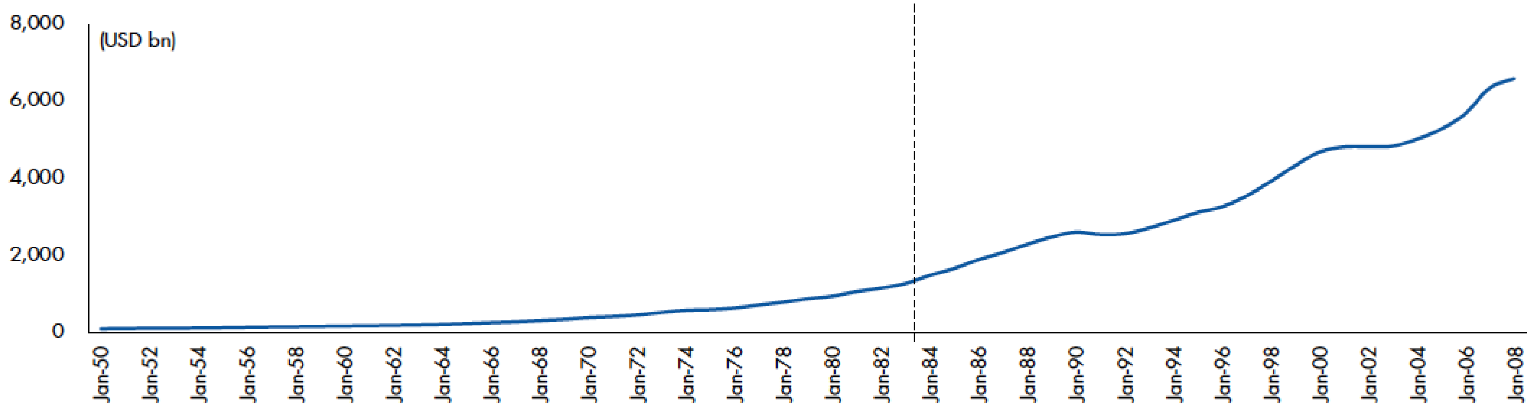
Corporate bond to GDP ratio nearly doubles 5 years after bankruptcy reforms

Country	Year of reforming the bankruptcy laws	5 year average (Pre-reforms)	5 year average (Post-reforms)
Brazil	2005	13%	26%
Russia	2009	8%	13%
India	**2016**	**18%**	**??**
China	2007	19%	33%
UK	2002	68%	107%

Source: Crisil, Axis Capital

Case study: US bond market

Rapid growth in US corporate debt issues in 1980s after decades of inactivity



Source: Bloomberg, Axis Capital

- As can be seen US corporate bond market did not grow for 25 years, after which it grew substantially
- Generally a reasonably well-developed government securities market precedes the development of the market for corporate debt securities
- So we believe, with the capital constraints faced by banks with Basel III implementation and government measures to deepen the bond penetration will lead to higher corporate bond market penetration over the longer term

- CRAs have the very attributes that shareholders seek for value creation

Value creation

Predictable

- CRAs have grown at a nominal GDP multiplier of 1.7x (similar to developed countries)
- Sticky customer base with annuity revenue stream
- Extensive data base providing multiple growth opportunities

Scalable

- Improvement in revenue growth trajectory as corporate capex cycle revives
- Borrowers seeking non-traditional forms of funding – bonds, CPs and new structures eg. InvITs
- Option value: scalability of non-rating subsidiaries

Profitable

- Stable revenue growth mirroring performance of India Inc, with operating margin @30%+
- OCF: EBITDA at 100%+
- Research & Consultancy – emerging business, however structurally lower margin profile

De-risked

- Moderately cyclical business with exposure across sectors
- Non-rating business (65% for Crisil and 30% for ICRA) reduce reliance on rating revenue
- Geographic diversification (predominantly South-east Asian countries)

Thank you ...