

The Philippine Water Revolving Fund Support Program

**MANUAL OF CREDIT RATING
FOR WATER DISTRICTS
IN THE PHILIPPINES**



This project is implemented by Development Alternatives, Inc. in association with:
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1 Basics of Credit Rating

1.1 *What is credit rating?*

Credit rating is a current opinion on credit quality of the debt in terms of a water district's (issuer) ability and inclination to meet its debt obligation in a timely manner, and an independent & unbiased evaluation of the creditworthiness of the water district and its relative position vis-à-vis its peers and other corporate borrowers.

As observed in the definition, it focuses on both the ability and the inclination (or willingness) of the water district to service its debt obligations. While the credit rating model and analysis focus mainly on the ability of water district, the inclination of the water district is gauged by the management's quality.

1.2 *What a credit rating is not?*

Credit rating is not a general purpose evaluation of issuer; it is neither an audit of water district nor a one time assessment of creditworthiness of the issuer valid over the future life of loan. Most importantly, it should not be perceived as a recommendation to extend or not extend loan to a water district. Instead, credit rating helps in making an informed credit decision backed by an understanding of underlying credit risks.

1.3 *What are the benefits of credit rating of water districts?*

Apart from the targeted objective of this assignment, namely evaluation and pricing of credit risks in the guarantees provided by LGUGC, the credit rating of water districts is a useful tool. The use of credit rating should be advocated as a cornerstone in the development of the debt market in the Philippines.

Various benefits of credit rating of water districts are given below:

- Helps in credit history formation;
- Will improve visibility & bankability with development institutions;
- Will facilitate flow of capital to water districts;
- Is indicative of improved governance and transparency in WD sector;

- Helps in benchmarking among WDs and with corporate entities;
- Facilitates independent monitoring of overall debt level & financial risks; and
- Will facilitate accessibility to funds from the bonds market in the long-term.

2 Credit Rating Process

2.1 Step 1: Information requirements furnished by the rating team

The credit rating process commences with the rating team identifying the information requirements and communicating the same to the water district. This will help the officials to be sensitized to the data and information required for their credit rating. The importance of information should also be explained to the management of the water district.

2.2 Step 2: Data provided by the rated entity

The water district should submit the data in the standard data sheet. While all efforts should be made to ensure completeness of the information, there may be instances wherein some of the information are not available. In such a situation, the rating team has to make suitable assumptions for the parameter.

2.3 Step 3: Analysis of the information using credit rating model

Once the information is received, the rating team will undertake analysis of the information, based on the credit rating model. The analysis can be supplemented by further evaluation of financial projections and projects proposed by the water district.

2.4 Step 4: Management interaction

The management interaction is aimed at gaining insights into various analytical aspects as well as management evaluation of water district.

2.5 Step 5: Preparation of the rating report

The rating report comprises of the background of water district, filled-in scoring sheet that assigns the credit rating, peer-benchmarking, rating report to put in public domain and annexes on data provided by the water districts.

2.6 Step 6: Presentation to the rating committee

The rating report outlining credit scores and overall rating should be presented to the rating committee.

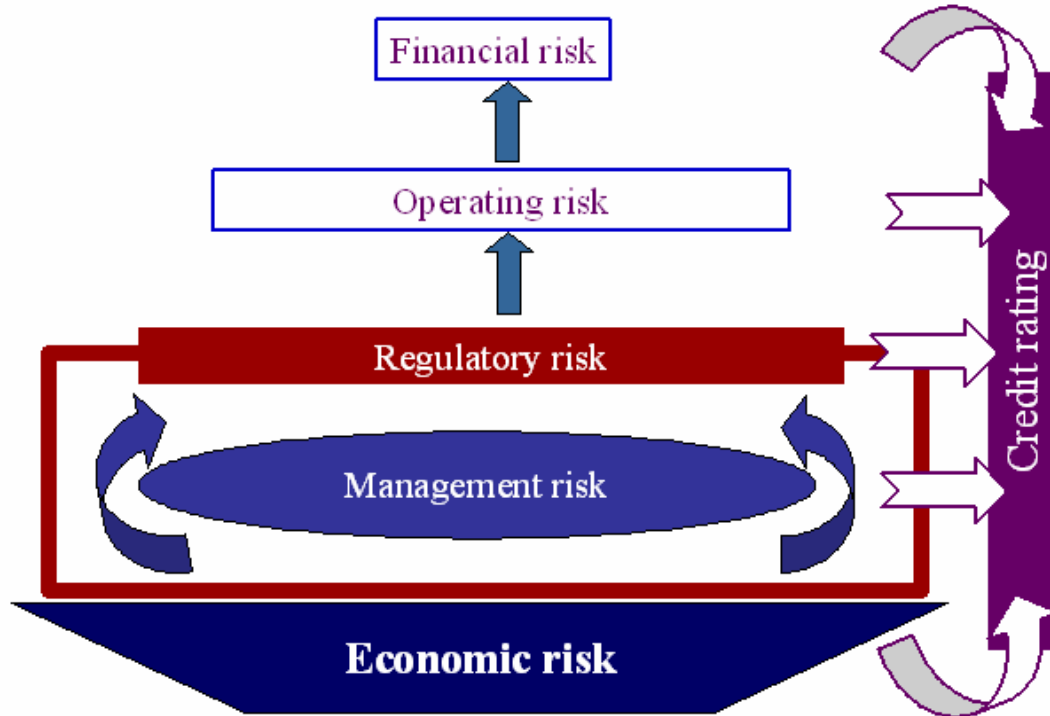
2.7 Step 7: Credit rating assigned by the rating committee

The rating committee assigns the final rating after discussing the credit score assigned by the rating team. Deviations, if any, to the rating assigned by the rating model can be undertaken only after due explanation for the same.

3 Credit Rating Criteria

3.1 Credit rating framework

The credit rating framework for water districts involves an evaluation of five broad credit risk factors as shown below.



3.2 Credit Risk factors

Regulatory risk

Analysis of the regulatory framework is based on the various laws and presidential directives governing the water districts.

Economic risk

The economic base of the water district's service area is analyzed to assess the revenue base, elasticity of revenues, and the possibility of enhancing the WD's revenue base and revenue-generating potential.

Financial risk

Financial risk analysis focuses on past financial performance to assess the future performance of the entity. The analysis is based on the audited financial results and is undertaken for individual parameters, including debt factors, accounts receivable, liquidity, and net revenues available for debt service.

Operating risk

The analysis of operating efficiency takes into account the concentration risk and existing infrastructure facilities.

Management risk

A key parameter for assessing a water district's credit profile is the quality of its economic management and project management. A water district's financial health is, to a large extent, linked to the initiatives its management has taken to enhance its resource base and improve the level of its services. The assessment revolves around the degree of effectiveness and efficiency exhibited by the management in harnessing the available resources and providing adequate infrastructure in its service area.

While assessing projects, it is important to analyze the revenue inflows arising out of improvements envisaged through the project, the project cost, the means of funding the project, and the effect of debt funding on the water district's debt service coverage ratio.

4 Rating Committee

The Rating Committee is comprised of experts who bring long standing experience in diverse companies and industrial sectors. Rating Committee Meetings (RCMs) form a crucial part of a rigorous exercise of assigning a credit rating. The RCM process ensures objectivity of the rating, since the decision results from the collective thinking of the think-tank that comprises experts. The RCM process also ensures high analytical quality and consistency since the reports and discussions are focused on critical rating factors that are relevant to a particular issuer. Accordingly, by drawing on the knowledge and expertise of the participants, the RCM decides on the individual ratings recommended by the rating team.

5 Credit Rating Scale

The rating scale is an 18-point scale to enable the wide distribution of rated entities. Credit rating scale varies from AAA to D category, where AAA rating belongs to highest degree of safety and D rating refers to default. Categories from AA to B have modifiers '+' and '-' suffixed.

| Investment Grade Ratings | |
|----------------------------------|---|
| AAA | (Triple A) Highest Safety Entities rated 'AAA' are judged to offer the highest degree of safety with regard to timely payment of financial obligations. |
| AA | (Double A) High Safety Entities rated 'AA' are judged to offer a high degree of safety with regard to timely payment of financial obligations. |
| A | Adequate Safety Entities rated 'A' are judged to offer an adequate degree of safety with regard to timely payment of financial obligations. However, changes in circumstances can adversely affect such entities more than those in the higher rating categories. |
| BBB | (Triple B) Moderate Safety Entities rated 'BBB' are judged to offer a moderate safety with regard to timely payment of financial obligations for the present; however, changing circumstances are more likely to lead to a weakened capacity to pay interest and repay principal than for entities in higher rating categories. |
| Speculative Grade Ratings | |
| BB | (Double B) Inadequate Safety Entities rated 'BB' are judged to carry inadequate safety with regard to timely payment of financial obligations; they are less likely to default in the immediate future than other speculative grade entities, but an adverse change in circumstances could lead to inadequate capacity to make payment on financial obligations. |
| B | High Risk Entities rated 'B' are judged to have greater likelihood of default; while currently financial obligations are met, adverse business or economic conditions would lead to lack of ability or willingness to pay interest or principal. |
| C | Substantial Risk Entities rated 'C' are judged to have factors present that make them vulnerable to default; timely payment of financial obligations is possible only if favorable circumstances continue. |
| D | Default Entities rated 'D' are in default or are expected to default on scheduled payment dates. Such entities are extremely speculative and returns from these entities may be realized only on reorganization or liquidation. |

'+' (plus) or '-' (minus) signs can be added for ratings from 'AA' to 'B' to reflect comparative standing within the category.

6 Surveillance

6.1 Frequency

The rating is kept under surveillance after the initial rating is assigned and during the entire time the loan guarantee is in force. The minimum frequency of surveillance should be one year when the latest financial results of the water district are available, though the rating should be reviewed as and when there is any event that can potentially impact the credit rating.

6.2 Process

The process for credit rating review is similar to the initial rating assigned, though the emphasis of the exercise would largely be to obtain an update on the existing information and analysis. The rating team should undertake a continuous, monitoring process to ensure that it is completely aware of the internal and external events that can affect the credit rating of the water district. The surveillance process should involve regular interaction with the key officials of the water district as well as with the external experts of the water sector.

The possible outcomes of rating review can be 'change in rating', 'outlook change' or 'credit watch'.

6.3 Credit rating outlook

The credit rating outlook can be assigned by the Rating Committee for ratings from 'AAA' to 'B', based on their assessment of future financial projections or expected improvement in operating parameters.

The outlook is assigned at the time of initial rating and is reviewed whenever the credit rating is reviewed. Ratings on credit rating watch will not carry outlooks. A rating outlook indicates the direction in which a rating may move over a medium-term horizon of one to two years. A rating outlook can be 'Positive', 'Stable' or 'Negative'. The default credit rating outlook will always be 'Stable'.

A 'positive' or 'negative' rating outlook is not necessarily a precursor of a rating change, however it provides investors an early indication of possible direction of rating change.

Positive outlook means that a rating may be raised.

Negative outlook means that a rating may be lowered.

Stable outlook means that a rating is not likely to change.

6.4 Credit rating watch

The credit rating can be put on watch by the Rating Committee in case there are events or circumstances (such as mergers and acquisitions, shareholding change, regulatory actions), the impact of which on outstanding rating needs to be evaluated with further information. The credit rating watch should be typically resolved within a 3 to 6 months timeframe.

6.5 Difference between credit rating watch and outlook

A credit rating watch is assigned only when there is an uncertainty on the assignment of exact credit rating. Accordingly, until the clarity on the credit rating emerges, the rating is put under watch. A credit rating is under watch only after some exceptional, uncertain events have taken place. Under normal circumstances, a credit rating watch will not be imposed.

An outlook is assigned for all ratings, under normal circumstances. When a rating watch is assigned, an outlook is not applicable.

7 Frequently Asked Questions (FAQs)

7.1 What are investment and speculative grade ratings?

Debt instruments rated 'BBB-' and above are classified as investment grade ratings. Instruments that are rated 'BB+' and below are classified as speculative grade category ratings. Instruments rated in the speculative grade carry materially higher risk compared to instruments rated in the investment grade.

7.2 Does a speculative grade rating mean that the issuer will default?

No, a speculative grade rating on a debt instrument does not mean that it is certainly going to default. All it indicates is that the instrument has risks associated with it that makes it significantly more vulnerable to default than instruments in the investment grade.

7.3 What is the validity period of a rating?

There is no fixed validity period of a rating, and it is valid until it is changed. Ratings are assigned based on certain expectations and assumptions about variables that impact the water district's performance. However, these variables can change significantly over a relatively short time-frame, causing the rated entity's performance to deviate materially from expectations. This changes its future debt repayment capability and is reflected in its changed ratings.

7.4 If a rating is downgraded, does it mean that a default is imminent?

Not necessarily. In most cases, unless the rating is deep into the speculative category, a downgrade does not mean that a default is anticipated. All it indicates is that the risk associated with the loan or instrument is relatively higher than what it was before the downgrade.