NORTHERN ARC

Underwriting Guidelines

Corporate Finance

Northern Arc Capital Ltd. (Formerly known as IFMR Capital Finance Ltd.)

Introduction

The IFMR Capital Underwriting Guidelines for Corporate Finance lay down the framework for evaluating companies that do not operate in the financial sector. The guidelines are organized into Eligibility criteria and Evaluation criteria.

The Eligibility criteria define the minimum standards that a company must meet to qualify to be eligible for on-boarding by IFMR Capital. The guidelines for Evaluation are a set of criteria against which the companies are benchmarked and evaluated. These are criteria which we would like originators to adopt and practice.

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Categorization of Borrowers

For the purpose of these Guidelines, potential borrowers are categorised as given below:

<table>
<tr><th colspan="2">Borrower profile</th></tr>
<tr><th>Early Stage / Transformational Company</th><th>Other Companies</th></tr>
<tr><td>These comprise of entities which
• Typically have a vintage of less than 5 years or are in the process of a material business transformation
• Are on a high growth trajectory
• Are typically institutionally funded (or by prominent / reputed individual investors)</td><td>• Any company which is not categorised as an Early Stage / Transformational Company
• Any company meeting minimum external credit rating criteria or financial ratios as defined in the Eligibility Criteria</td></tr>
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Underwriting Framework

The Eligibility and Evaluation Criteria for each category are different and the Credit Committee shall exercise discretion in determining the category under which each potential borrower shall be evaluated.

In the following sections, all eligibility and evaluation criteria are applicable for both categories of borrowers unless specified otherwise.

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Eligibility Criteria

Criteria	**Early Stage / Transformational Company**	**Other Companies**
Legal Structure	The legal structure of the company should be Private Limited or Public Limited	
Regulatory Compliance	• The company should have all relevant licenses (active) required to operate business or provide services. • The company should meet the guidelines issued by respective / applicable regulatory bodies • The company should have also filed all relevant documents including annual returns, balance sheets etc. with MCA (i.e., no default in filings) • No default in respect of deposit of any statutory dues • Not categorised as SMA1 or SMA2 or a non-performing asset in terms of overdue position to lenders • Neither company nor promoters or directors declared as wilful defaulters by Banks	
Promoter Experience in Fund raise	The promoters must have credible reputation and have a past track record proving their ability to raise financial resources in the form of equity and/ or debt	
Alternate Leadership (key man dependence)	The company should have an experienced second line of management	There has to be a clear alternate leadership to the main promoter(s)
Company vintage	The company should have been operational, in its current line of business, for at least 1 year	The company should have been operational, in its current line of business, for at least 3 years
Funding	Not Applicable	The company should have demonstrated capability in having raised prior debt from Banks/NBFCs
Board Of Directors	• The company should have a Board consisting of members with relevant experience in the industry • The company should have Board meetings regularly • The Board should be diverse by way of Investor Director or Independent Director Representation.	
Information	• The company must have a computerised MIS, to be able to provide operational level information • The company must be able to report data on a monthly / quarterly / semi-annual basis as required	
Reporting	• The financial statements should be audited by an Audit firm on an annual basis and should be available within six months of the end of the financial year • Quarterly financial details should be available within 45 days of the end of quarter	
Business Plan	The company should have a business plan indicating growth and expansion plans at least over 3 years (or the proposed tenor of the loan) with a clear	

	articulation of underlying business drivers and linking these to the achievability of projections	
Negative sectors	The company should not be operating in the following business: • As covered under ESG Guidelines • Infrastructure or Real Estate: Involved in Purchase / Construction / Marketing • Low sector scores of 2 or below by CRISIL/ICRA as updated on a quarterly basis	
Credit Bureau	The company, promoters and group entities must not have any overdue / arrears as reported in the CIBIL	
Political affiliation	The Promoter / any shareholder with >10% equity shareholding on a fully diluted basis / Company / Group company must not have any affiliation with any political person / party	
External Rating (or) Financial Ratios	Not Applicable	At least BBB- or equivalent (or) In case, External Rating criteria is not met, then financial ratios to be complied Total Debt <4.0x DSCR >1.1x Total Debt / EBITDA <5.5x

Guidelines for Evaluation

Criteria	Standard
Assessment and Structure	a. The shareholding structure should be simplistic to be able to identify majority shareholders. b. The company should not have multiple cross holdings through shell entities. c. The performance of the group / holding company must be assessed to understand its capabilities and support provided to or received from subsidiaries/parent companies/related entities in the form of guarantees/letters of comfort/put options etc. to be suitably disclosed and factored in assessment. d. Identify if any of the major shareholders of the company have encumbered the shares of the company to raise debt in personal capacity. Extent of encumbrance created on shares if any should be < 51%. e. Transfer pricing considerations if any would be carefully evaluated.
Assessment of the Management	a. The promoter / senior management should have at least 3 years of experience in the industry that the company is operating in. b. The promoter / management should be actively involved in the day-to-day operations of the business c. The promoter / management should be able to identify key business risks for his company and should have taken / should take considerable actions towards mitigating such risks d. Evaluation of the management also involves understanding the organisational and reporting structure, accountability and succession planning with respect to the size / strategy of the company e. The promoter / management should have displayed track record of financial management in terms of debt repayments, financial planning and internal controls
Assessment of the Industry	**Growth face of the industry** a. The company should be operating in a stable or growth industry (assessed growth rate above GDP estimates) • In the case of manufacturing companies, the key assessment parameters are – • Investment / Capital expenditure plan of key players in the sector • Understanding factors impacting the demand-supply dynamics • Analysis on historical input (raw materials) and output (sales) pricing • Changes in technology - the company should not have a long gestation period (>2 years) in terms of capital expenditure and return on investment • Analysis of cash conversion cycle

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b. The cyclical nature of an industry can be either dependent on the economy (infrastructure / power / automobiles) or commodity (metals / oil). Any volatility in cyclical industries can significantly impact the performance of the company coupled with such industries. It is important to ascertain the resilience of the company in managing cyclicality of the industry, since this will significantly impact its profitability and ability to service debt

Competition

It is extremely critical to understand the competitive nature of the industry. Companies operating in industry that has combination of low entry barriers, commoditised product offering, threat of substitution from other industries and low customer switching costs may find it difficult to grow its revenue, margins and profitability.

Regulatory framework

a. Involvement of the Government in terms of impact of changing regulations, e.g. changes in licensing, taxation, subsidies, and import-export restrictions or duties, policy intervention for the industry must be evaluated.
b. It is also important to assess the regulatory activism towards the industry:
i. Focus on consumer protection, for e.g. National Pharmaceutical Pricing Authority (NPAA) issuing notification on capping prices for stents
ii. Structural changes in the industry, for e.g. shifting towards payments digitisation
iii. Protection of environment, for e.g. ban of plastic usage
iv. Protection of domestic economy (may be through anti-dumping duties)
v. Sensitivity to changes in labour laws
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<td>Assessment of Business</td>
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The assessment of a strong business model encapsulates evaluation of the nature of business, market position, operational efficiency and diversification in terms of products, geography, client base, and supplier base

Nature of Business

a. In case of manufacturing business, the setup can be:
• Labour intensive: Various factors to be evaluated would be - management of human resources, relations with labour union / workforce, mix of fixed employee vs. temporary employee strength
• Capital Intensive: If the business is capital intensive by way of technology or equipment, then various factors to be evaluated
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	would be – obsolescence, cost of repairs and maintenance, cost and frequency of up gradation, eventually determining total cost of ownership. b. In case of service sector company, • Analyse the nature and complexity of services offered. Usually, complex services contribute higher margins for the company and also is difficult to replicate by other players • Nature of clients: − B2B: The nature, structure, pricing and tenure of contracts should be evaluated. Client retention, client concentration should also be assessed. − B2C: The evaluation of different models would be basis: 1. Offline: Distribution network, infrastructure cost, location 2. Online: sales Channels, various medium of marketing & effectiveness of social media campaigns, customer acquisition, transaction value, prepaid v/s post-paid, supply chain, website interface, client feedback • Sample checking of client contracts must be done to understand – size (amount), tenure, payment terms, deliverables, and termination clause. Analysing track record of contract renewals signifies revenue stickiness and client satisfaction c. The company should have clear plans for expansion in terms of geography, products, and new projects. The company should have a track record of achieving and sustaining previous year's expansion and growth plans • In case of a manufacturing company, assessing the success of past projects / capex implementation / expansion would be important • In case of a largely B2B service company, the tenure of the current management in the company should be assessed, since the business is largely driven by relationships with key executives. Also, the company should have defined parameters for measuring efficiency of service delivery. If the company's operations are focused in limited geographical area/limited product line, also analyse the scalability of business model. d. The company, if exposed to foreign currency risk, should have appropriate hedging mechanism in place to avoid losses due to currency fluctuations. **Competition** a. The company should be able to display its competitive position in the industry which could be by way of growing brand awareness, growing distribution network, client stickiness, and improvement in technology, accessibility to supply at competitive prices, superior product or any other. b. Having an USP which helps to provide the competitive edge to the company will enable it to generate revenues and profits.

	c. The sustainability of the competitive edge and business model is critical to evaluation of the company d. If the company is operating in offering commoditised goods / service, then the company should have achieved efficient cost structure and/or attained revenue lock-in from customers through long term contracts. e. The key players in the industry and the trend of market share over years should be analysed to understand opportunity to capture market share f. Examining the ability of the company to develop new product / service lines or improving knowledge domain by way of investment in R & D **Operating Efficiency** a. The linkage of input price, sales price and pricing contract should be established to ascertain the ability of the company to pass any increase in input cost to its clients. For e.g. a product that uses steel / petrochemical as its input is dependent on the global prices and could exhibit volatility. b. The efficiency of company's cash conversion cycle should be analysed and established. The company's Inventory procurement policy, turnaround time, handling of obsolete inventory and impact of inventory write-offs if any on financial health of the company. Its payment terms with customers, debtor ageing profile and history of debtor should be analysed to establish efficiency of debtor realization. Also, the company's relationship with suppliers and ability to stretch creditors should be analysed. • For a manufacturing company, analysis on various factors is important – Procuring raw materials through domestic markets can enable accessibility and certain cost benefits – Investments in technology also provides efficiency in terms of time / resource / quality – Capacity utilisation must be assessed to understand historical trend. This should also include assessment of time taken for the company to switch between production of different product / size • For a services company, the employee cost and IT spend constitute majority of operational expenses – Recruitment and training cost must be analysed, including attrition rates – Understanding mix of fixed employees v/s temporary employee strength – Cost of acquiring and servicing each client – IT upgradation cost **Diversification** a. Supplier / Vendor diversification:

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i. The Company should have multiple sources of procuring goods / raw materials / services. There should not be scenario where the borrower is significantly dependent on a single supplier
ii. The supply chain must be assessed to understand possibility of disruptions in raw materials reaching the company

b. Product / Revenue diversification:

i. Company having multiple revenue sources through channel diversification or product / service diversification, will be able to drive sales and scale up.
ii. The contribution of each business segment towards profitability (unit economics) must be separately assessed
iii. Single product offering might limit the ability of the company to manage business related risk.
iv. Geographic diversification of revenue to alleviate risks from region specific macro factors

c. Customer diversification:

i. The company should be able to display adequate degree of customer diversification. The degree of diversification should be assessed in the context of the company's business model
ii. While in a B2C business, the structure itself provides for diversification in terms of customers, however for B2B business it is prudent to diversify the client base.
iii. The company should have not considerable receivables coming from government clients, since this could lead to higher working capital cycle and/or risk of loss of revenue on account of cancellation of contracts without reasonable commercial remedy.

Risk Management

a. In case of manufacturing business: The company should have adequate insurance coverage for stock and fixed assets by way of comprehensive insurance covering loss / damage to the assets, in the event of fire, burglary, machine breakdown, etc.
b. In case of service sector company: In case of company providing customer sensitive professional services like healthcare / consultancy / law services etc., the people should be covered under indemnity insurance.
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<tr><td>Assessment of Financials</td><td>
Accounting Policy

Analysis of key areas in the company's audited financial statements should be done to assess the financial performance of the company –
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- Trend of revenues and profitability over past few years
- Auditors qualifications
- Income recognition and inventory valuation policy
- Contingent liabilities / similar items
- nature for investments on balance sheet (significant real estate/land bank investments/increasing investments in other group companies
- Corporate guarantee furnished for other companies
- Intangible Assets break-up

Financial Analysis

Financial analysis can be done basis :

- Income Statement Analysis: Evaluating the revenue growth, cost structure, operational profitability for the company as well as comparing with peers in the industry.
- Balance Sheet Analysis: Evaluating the capital structure, funding cost, diversification of funding sources and change in working capital requirements.

Cash Flow & Liquidity Analysis

a. Analyse expected Cash flow generation against maturing debt repayments in future.
b. Analyse cash accruals viz-a-viz repayment obligations over last 3 years and utilization of working capital funds over last 12 months to understand liquidity management in past.

- For manufacturing companies – Evaluating the ability of the company to raise funds for capital expenditure and procuring working capital limits.
- For service sector companies – Employee expenses being the largest component of opex, the company should have adequate cash as buffer to meet employee cost for at least 3 months. Also, since the working capital pertains primarily to receivables management, the company could get sanctioned credit limits to manage any cash flow mismatch.

Ratio Analysis

Margin Ratio	
Operating Profit Margin	Op. Profit / Op. Income
Net Profit Margin	Net Profit / Op. Income
Return on Capital Employed	Operating Profit / (Total Assets – Current Liabilities)

Leverage Ratio	
Gearing	Total debt / Tangible Net Worth
Interest Coverage Ratio	Op. Profit / Interest Exp
Debt Service Coverage Ratio	FCF / Current Debt due + Interest Exp
Debt to EBITDA	Debt / EBITDA

Liquidity Risk	
Quick ratio	Current Assets / Current Liabilities
Working Capital Cycle	Debtor days + Inventory days – Payable days

Cash flow analysis
Operating Cash Flow (-) Op. working capital changes
Free Cash Flow from Operations/Principal debt

Ratio Analysis for Early Stage / Transformational Company	
Net worth / Total assets – Forward 12 M	>30%
(Cash and Bank Balance) / (3M Opex + 3M Debt Servicing) – Forward 12 M	>1
DSCR – Forward 12 M	>1

Ratio Analysis for other Companies	
Total Debt / Equity	<4.0x
DSCR	>1.1x
Total Debt / EBITDA	<5.5x

For the purpose of the above table, Forward 12M numbers would be derived from the business plan after moderation and stress testing by IFMR Capital.