Acuite
RATINGS & RESEARCH

Criteria For Rating Of Manufacturing Entities

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PREAMBLE

Acuité's approach to rating of the credit facilities/ instruments of a manufacturing entity is broadly based on three pillars: Business Risk Assessment, Financial Risk Assessment and Management Risk Assessment. In certain cases where an entity is undertaking large projects, Project Risk Assessment is also a part of the rating exercise. The framework provides for the evaluation of an entity based on quantitative and qualitative parameters. The rating approach based on the said framework is essentially forward-looking and provides a robust basis for any lending/ investing decision.

The following sections discuss the framework in detail

I. BUSINESS RISK ASSESSMENT

A. Industry Risk:

The credit profile of any business entity has to be examined in the context of the industry in which it is operating. Hence, assessment of industry risk is a primary step during the overall credit rating exercise. Generally, industries tend to exhibit significant differences in their risk profiles in longer time frames due to various externalities like demand and supply dynamics, technological and regulatory shifts. Any business entity is a subset of its industry, and the industry is a subset of the economy.

The changes in the macro-economic landscape impinge on the performance of various industries. It is generally observed that units in a specific sector/ industry will exhibit a similar response to changes in the economic environment. Hence, evaluation of the macro-economic environment is the crucial prerequisite for the assessment of any industry.

The various macro-economic variables like GDP growth rates, level of interest rates in the economy, level of consumer spending, capex by the corporate sector, exchange rate stability etc., have a bearing on the performance of various industries in general. The extent of impact of these economic factors differs from industry to industry and from cycle to cycle. This adds to the complexities in arriving at an estimate of industry risk.

Assessment of Industry Risk:

a. **Demand Supply Balance**
The current and future imbalance between demand and supply determines product price trends. This impacts realisations and hence industry profitability.

i. Current Demand Supply Gap: Past price trends help to gauge whether an industry is in excess of supply or demand or is in an equilibrium situation. Price trends also need to be seen in the context of technical developments in

product innovation, process improvements, substitutes and emerging substitutes

ii. Demand Drivers: Demand drivers need to be assessed in order to identify the trends that are likely to affect the players within an industry. While demand estimation can be difficult, a combination of demand and supply dynamics, import export data, international price trends and end-user industry usage are often used as surrogate measures to estimate prospects. Some of the drivers analysed include:

- Product Usage: The volumes in the user sector influence the demand for the raw materials/ intermediates. Hence, it is critical to understand the applications, i.e., whether a product has single or multiple applications. In certain cases, the product is complementary to some other product. In such cases, the demand for the product will be linked to the demand for the other products. Similarly, products with substitutes can exhibit higher demand variability.
- Demand Cyclicality: Certain products exhibit a cyclicality in their demand i.e., volumes may increase or contract depending on the stage of the cycle. For instance, if the industry is at a peak and the volumes are likely to start tapering off, then the demand estimates should factor in these nuances. It is critical to understand and identify the inflexion points in the cycle so as to arrive at a realistic estimate of the demand over the medium to long term.

iii. Imports and Exports: Threats to the domestic industry from imports can influence the volumes of the domestic players. The pricing policies of the overseas suppliers, exchange rates and the government policies on protection to the domestic industry become critical in this regard. Similarly, an excessive focus on exports by domestic players to benefit from higher international prices may impact the domestic supply of the product. Accordingly, understanding dimensions of imports/exports such as quality, price and market segmentation is necessary.

iv. Capacity Addition/ New Projects: While assessing the projected supply demand gap, the magnitude of fresh capacity additions along with their timing is quite important.

b. **Extent of Competition**

Market Structure refers to the manner in which companies across an industry are organised and the competitive positioning of the different players. It has a significant bearing on the pricing power and profitability margins. The key points to be analysed are:

i. The number of players in the sector, both organised and unorganised- Competition, Monopoly, Duopoly, Oligopoly, etc.

ii. The competitive strategies of different players- Price, Innovation or catering to specific customer segments, branding, etc.

iii. Extent of competition from overseas players (imports) and its impact on price.

iv. Entry barriers- Capital expenditure, marketing and distribution network, production facilities, branding, captive raw material sources, licensing, etc.

v. Elasticity of demand- The response of consumers to price changes.

vi. Presence of product substitutes and complements.

vii. Manufacturing process- different product formats, technology used, availability of raw materials and price variation, pricing power of supplier, environmental and safety hazards.

c. **Regulatory Environment**

The government influences the economy and its sub-segments by way of various policy measures to channelise resources based on the needs of a society. The present-day policy measures include:

Varying duty structure (Goods and Services Tax, import, export, countervailing, anti-dumping, etc.)

Providing fiscal incentives to certain sectors (subsidies, tax holidays, setting up of special economic zones, increasing credit flow through policy prescriptions, permission to issue tax-free bonds, etc.)

i. Price controls

ii. Distribution controls

iii. Regulating imports, exports, issuing of licenses, and FDI norms

iv. Promoting bilateral and multilateral trade with other nations

In assessing the regulatory framework, one must take into account the stability of these policies. Frequent & Sharp policy changes may warrant revision in the business plans of the existing / prospective industry players. Such regulatory fluidity may impede the flow of investments into the sector over the long term. The overall impact of the regulatory environment can be gauged by its effect on competition, cost structure, growth prospects, profitability and ultimately on its sustenance in the near-to-medium term.

d. **Input Price Risk**

While evaluating an industry, it is also necessary to assess its input profile, i.e., availability of key inputs, volatility in prices of inputs, etc. In a competitive environment, any single player has only a limited influence on the final selling price; hence, input price assessment is necessary to understand the profitability levels. A critical assessment of the input price risk should cover the following:

i. What are the key inputs & the ease of availability?

ii. Is the supplier base diversified or concentrated?

iii. Does the unit have the flexibility to change suppliers without impacting its operations?

iv. Is the pricing of inputs market-determined or through regulatory intervention?

v. Is there a dependence on imports or are all the inputs domestically available?

vi. Are the prices of inputs volatile or relatively stable?

vii. Any frequent instances of shortages in key inputs?

B. Market Position

This assesses the market strength of the enterprise, its key markets, its market share, clientele profile, distribution strength, pricing power, etc. This section examines the company-specific analysis that covers revenue drivers and associated risks. The main emphasis is on analysing the competitive position of a company in the marketplace with respect to pricing and volumes. Key risk indicators include:

This assesses the market strength of the enterprise, its key markets, its market share, clientele profile, distribution strength, pricing power, etc. This section examines the company-specific analysis that covers risk drivers on the revenue side. The main emphasis is on analysing the competitive position of a company in the marketplace with respect to pricing and volumes. Key risk indicators include:

a. **Market Share**

A key factor affecting future volumes and pricing power is the current and projected market share of the company in its main product categories, along with the size and growth of those segments. It is necessary to determine if growth drivers that were prevalent in the past continue to hold good in the future. Also, the competitive advantage of the company in the market in terms of brand, product quality, innovation, cost, customer service, and committed offtake in the form of long-term contracts with existing customers, sales to group companies etc. and their sustainability needs to be gauged.

b. **Diversification of Sources of Revenue**
Revenue diversification can be gauged by analysing revenue break-up by product, by geography, by customer and by industry to ascertain concentration or reliance on a particular revenue stream. A diversified revenue stream is likely to withstand shocks in a particular market or geographic segment.

c. **New Product Introduction**
An additional factor to be considered while assessing a company's future revenue is the introduction of new products and services. New product introduction can be an extension of the existing product line, compliments or in a completely new domain. The assessment should critically evaluate the materiality of such new introductions to the revenue base of the entity. For instance, the revenue impact of a new product which is developed to augment the sales of an existing product vis-à-vis a new product which is introduced as a superior product to an existing product, is likely to be materially different.

d. **Pricing Power**
It is necessary to ascertain whether the company can maintain/ increase price realisation on its products and maintain/grow volumes. This is influenced by demand-supply factors and competitive pressures. Here, brand presence and size become important factors to guard against price erosion.

e. **Distribution Power**
One needs to analyse the presence and success of a company's market penetration efforts. Expanding the presence, new applications of existing products, ramping up delivery channels, entering into strategic alliances etc. are all important. Such factors help to evaluate the sustainability of the company's projected revenue plan.

Peer analysis with respect to the following factors can provide an insight into the relative position of the company and its market standing:

Market Share	**Distribution network**
Sales and Profit Growth	**Innovation**
Product Range	**Geographic Spread**
Brand Strength	

C. **Operating Efficiency**

Operating Efficiency considers the effectiveness and efficiency of different operational aspects of an enterprise in detail.

It is imperative that any business entity should continuously strive for staying cost competitive vis-à-vis its peers. The relevance of this can be understood in the context of a commodity like metals during periods of economic downturn. In such industries during a trough, the volumes and realisations decline and in this operating environment, only the low-cost players tend to survive, whereas the high-cost players have to scale down their operations to curtail their losses. Various factors to be examined for arriving at a rating on the Operating Efficiency parameter are given below:

a. **Current Cost Structure**

The study of the cost structure of any entity can be understood by a breakup of cost into fixed and variable components. Ceteris paribus, the lower the fixed costs, the lower will be the break-even volume & higher the resilience during an economic downturn.

In order to understand the cost competitiveness of any unit, it is critical to understand key costs in the overall cost structure. These key costs differ from industry to industry. For instance, in a cotton yarn spinning unit, raw material and power would be major drivers of the overall cost structure, whereas in a tea unit, labour costs would be a major item of cost. In a cement unit, besides the input costs, power & freight also has a bearing on the cost. Any business unit can gain in terms of cost competitiveness due to factors like location (proximity to ports, access to cheap power, availability of cheap labour etc) or backward linkages with raw material suppliers or forward linkages to an established distribution network. Such traits confer significant cost advantages to the players which has a bearing on their overall competitiveness and profitability etc.

a. **Future Cost Drivers**

While projecting future cost structure and cost competitiveness, it is necessary to factor in the impact of technological and market changes. To forecast the cost structure, it is necessary to gain an understanding of trends related to key cost elements. This is driven by supply-demand dynamics of the particular commodity, presence of captive sources, use of alternatives, long-term arrangements with suppliers, government policies etc.

For instance, if the business is generally carried in a physical format, through a network of stores, the real estate costs become relevant and large differentials between rentals/ establishments costs can impact the player's relative competitive positioning. However, once the business gradually moves to the online mode, the real estate costs assume a lower relevance in the overall cost structure. The likelihood and impact of unexpected shocks in the form of energy shortage, fuel

cost spikes, unfavourable litigation outcome, environmental issues also need be factored in along with the firm's ability to withstand the same.

Quality improvements, use of enhanced information technology applications such as ERP, CRM etc, deployment of analytical tools in determining product-mix, procurement strategy, inventory and logistics management etc., play a vital role in optimising the supply chain, minimising costs and sustaining operations in the long run.

II. FINANCIAL RISK ASSESSMENT

The ultimate barometer of the success of any business entity is its financial performance and position. From a credit rating standpoint, the assessment of the financial risk profile is critical both on a historical as well as a futuristic basis. The assessment covers various aspects such as revenue growth, margins, capital structure, coverage indicators, working capital management, resource raising ability and liquidity management. It also entails other aspects such as the Quality of accounting, Auditor's comments, disclosures, contingent commitments etc.

Ratio analysis is an essential part of financial assessment for any unit. While a number of financial ratios are considered, key ones are size of net worth, profitability ratios, coverage ratios, capital structure, efficiency ratios, inventory and debtors turnover ratios and liquidity ratios. The relative importance placed on different ratios would depend on the nature of the business. These ratios are compared with peers / industry benchmarks to arrive at the relative standing of the rated entity vis-à-vis other units.

As the rating involves assessment of an enterprise's ability to meet future debt obligations, significant stress is laid on the projected performance in terms of assumptions, sensitivity to changes in assumptions, projected capital expenditure, etc.

Acuité evaluates the financial flexibility of an enterprise in terms of its ability to generate additional funds from various sources if the need arises. Its track record in raising funds from the banking community, institutions, capital markets and money markets is analysed. The relationship with the lender community is important. Availability of liquid, marketable securities and assets would also impart financial flexibility to an enterprise. In addition, postponing capital expenditure, may be for a limited period, would also provide certain financial flexibility.

Financial risk parameters are used to evaluate credit risk. While analysing financial performance, it is essential to factor in the firm's accounting and financial policies as these play a major role in arriving at comparable figures. Apart from accounting adjustments, the analyst evaluates historical trends, future financial projections and the resource mobilisation ability of the company.

A. Historical Financial Analysis

Historical financials provide a snapshot of the financial performance of the company over the past 3-5 years & the current financial health of the company. Understanding of the historical financials is necessary to understand the business resilience demonstrated in the past and also to arrive at a realistic set of financial projections over the near to medium term. The analysis of the historical performance of a business unit is also done to understand how it performs in comparison with its peers.

The key variables covered as part of the historical financial assessment are:

- Size of Tangible Networth
- Adjusted Debt Equity Ratio and/or Adjusted Debt to EBITDA
- Adjusted Interest Coverage Ratio
- NCATD (Net Cash Accruals to Total Debt)
- DSCR (Debt Service Coverage Ratio)
- Movement in profitability margins (Operating margins/ Net profit margins)
- Working capital parameters (Gross working capital days)
- Current Ratio
- ROCE

Besides the above-mentioned ratios, which are examined over 3–5-year time frame, the analyst may examine other ratios specific to the industry.

B. Future Financial Outlook

Based on the historical financial assessment and the discussions with the management regarding the future plans, the analyst estimates the projected Profit & Loss Account, Projected Balance Sheet & Cash Flow Statements for the near to medium term. Generally, the projections factor in the medium-term capex plans, funding mix and the impact of these plans on the operating performance over the next 2-3 years.

Based on the projected figures, the analyst studies the various ratios (mentioned above) on a futuristic basis from the standpoint of a lender. Sensitivity analysis is a

part of the exercise to understand the impact on the key ratios in case of changes in underlying assumptions. The impact on debt repayment ability as measured by critical metrics such as debt service coverage ratio and interest coverage ratio is calculated as a part of this exercise.

C. Resource Mobilisation Ability

Resource mobilisation ability reflects the firm's ability to access funding conveniently and competitively. The financial flexibility/liquidity assessment is looked at under this parameter. Liquidity essentially refers to the ability to meet the various business obligations in a timely manner.

Cash Inflows include	**Cash Outflows include**
Cash accruals from business	Debt repayment
Access to multiple sources of funding - equity markets, bank finance, institutional support, trade credit, asset sale etc.	Planned capital expenditure and investments
	Working capital requirements

Management of liquidity is critical to the sustenance of any business entity. Acuité generally examines the following aspects to arrive at an opinion on liquidity profile/financial flexibility:

- Unutilised bank lines
- Unencumbered liquid assets
- Access to short term funding support from parent/ group companies
- Demonstrated ability to access capital markets for short term funding

D. Financial and Accounting Policies

While using a common yardstick to compare the financial performance of various firms, it becomes imperative to adjust for stark differences in accounting practices/ policies. With the introduction of the Ind AS accounting framework, which is generally applicable to most of the corporate entities in the country, the chance for any significant differentiation is reduced. Even otherwise, the auditor's opinion on

adherence to established accounting standards is examined. However, some aspects considered are:

- Auditors' comments and qualifications
- Changes in depreciation, write-off and reserving policy
- Off-balance sheet items such as contingent liabilities, guarantees etc.
- Leases
- Dividend policy
- Quality of financial disclosures

III. MANAGEMENT RISK ASSESSMENT

This is a very important aspect of the evaluation. The quality of management has a crucial bearing on the performance of an enterprise. The assessment focuses on management integrity, competence, governance and risk appetite. The risk framework for assessing the same has been laid down below:

A. Integrity

The integrity and credibility of the management is a key aspect influencing the decisions of any lender or investor. In the absence of credibility, the management will always face a certain level of trust deficit, which will have a bearing on its access to credit and pricing of loans. The manner in which a company conducts business has a bearing on perception of the market's perceptions about the company and its standing. Key aspects examined here are:

- Instances of delays/ defaults/ compromises with lenders/ investors.
- Legal proceedings against key promoters of key management personnel.
- Instances of frequent investigations by regulatory authorities
- History of litigation of a material nature
- Recurrent instances of non-adherence to local laws and environmental norms triggering regulatory action.
- Instances of significant default on statutory obligations
- Adverse news about the company / management regarding serious non-compliance with any laws.

B. Competence

Promoters influence management selection, decision-making and future course of the company. The promoter's demonstrated ability in navigating the business across various business cycles is examined under this parameter. The various points examined are as under:

- Ability to maintain growth along with profitability across a cycle
- Ability to attract and retain marquee clients and skilled employees at the senior level
- Ability to initiate course corrective measures in response to a changing business landscape
- Ability to lead the company into different segments and successfully execute diversification/expansion initiatives
- Ability to balance and manage the expectations of various stakeholders including customers, employees, lenders, creditors, channel partners investors, society and government.

C. Risk Appetite

The management's risk profiling is extremely critical from a lender's perspective. The key aspect to be examined and understood here is whether the management is a risk seeker, risk averse or risk neutral. This can be gauged from the management's approach to debt (gearing), hedging of currency/ commodity exposures etc. The management's approach to growth vs profitability is to be understood from the risk standpoint. An aggressive management will pursue growth at any cost irrespective of its impact on profitability whereas conservative management will be focussed on profits and cash flows. Again, some managements may prefer organic growth rather than inorganic initiatives which reflects their risk disposition.

D. Corporate Governance Practices

Along with a capable management team and an effective strategy, it is necessary for the management team to adopt best practices in corporate governance. This gets reflected in the composition and functioning of the board, attitude towards stakeholders and disclosures, among others. It is also important for the management team to undertake a systematic planning exercise that sets organisational priorities and ensures that those priorities percolate to the middle and lower management, helping the organisation's review mechanisms and track progress of plans and re-evaluate strategies and goals.

Key Factors to be considered are:

- Independence of the board, functioning of various committees
- Quality and adequacy of corporate disclosures
- Soundness & Stability of accounting practices

- Extent of intra-group transactions / related party transactions
- Perceptions regarding governance practices
- Stability of top management
- Alignment of organisational goals with employee targets and remuneration.
- Quality and adequacy of performance and market feedback to top management.

IV. PROJECT RISK ASSESSMENT

In case the rated entity is undertaking a large project, (vis-à-vis its current scale and size of operations) Acuité will consider the impact of this project on the credit profile of the entity over the near to medium term; in such cases the project risk assessment becomes important. Such projects may be crucial for the survival /growth of the entity and beneficial over the long run; however, they could impact the near-term liquidity and the credit profile of the unit. The nature of the project in terms of green field, brown field, diversification, and expansion is examined. Unrelated diversification and taking up projects of very large size in relation to its existing operations increases risk. A view is taken on the project based on the following broad parameters.

A. Funding Risk

The funding mix and the financial closure is one of the major milestones of any project. Any significant delays in tying up the equity/ debt portion will have implications for the project risk assessment and ability to meet the project deadlines.

B. Implementation Risk

Any significant delays in project execution vis-à-vis scheduled timeframes may result in cost overruns and higher funding requirements. Some factors influencing project delays are as under

- Management track record and ability to manage large projects, size and complexity of current project in comparison with earlier projects.
- **Delays in receipt of regulatory approvals**
- **Delays in tying up with contractors/ machinery vendors**
- Delays in utility setups
- Availability of land / labour
- Logistical issues/ Natural events, etc.

- Firm product offtake, committed supply of raw material and power.
- **Effectiveness of project supervision**- external or internal supervision, use of modern management and information technology tools.

C. Technology Risk

In case of an existing technology, the risk is relatively low. However, in case of new technology which is still to be adopted on a large scale, the technology risk is on an elevated level.

D. OFF take risk

The ultimate viability of any expansion project is dependent on how the said project can contribute to the overall profits/ cash flows. The cash generation from the project should be commensurate with the expectations of its lenders/investors. The project should be able to demonstrate optimal capacity utilisation so as to meet the expectations of the stakeholders. Any likely challenges in achieving the offtake levels will result in higher project risk assessment.

Group and Parent Support

The rating based on the analysis of above-mentioned parameters is a standalone rating. However, it is commonly observed that an enterprise belonging to an established business group or a company is on a different footing compared to a stand-alone entity. The former could benefit from the parent/ group in terms of credibility, brand equity, managerial, business and financial support. Notching the standalone ratings of individual companies up is based on the assumption that a company's creditworthiness, apart from its own business and financial strengths and weaknesses, is also dependent on the backing it enjoys with the group/ parent/ government.

The degree of linkage between the entity and its groupcompanies/ parent/ government needs to be ascertained to decide the extent of notching. Some of the factors influencing the degree of association are usage of common name, size of investment and holding in the entity by its parent/ group/ government, past instances of support, etc.

Please click here to access the criteria on "Group and Parent Support"

Assessment of Environmental, Social and Governance (ESG) Risks

In addition to the above-mentioned Rating Framework, Acuité also comments on the ESG parameters in case of certain listed entities in its Rating Rationale.

The primary goal of any commercial entity is to maximize the value for its owners/ shareholders through profit maximization. However, it has to be recognised that besides profit maximization any business entity has certain responsibilities towards the

society in which it is operating and towards the environment. Hence, an ESG assessment of a business entity assumes importance. ESG is a framework for measuring the performance of the company across three specific categories: Environmental, Social and Governance. ESG as a concept has been around for more than a decade. However, it has recently gained in prominence with large international investors tracking the ESG scores before taking the investment decisions. The regulators have also recognised the importance of the ESG framework. A SEBI circular on Business Responsibility and Sustainability Reporting dated May 10, 2021, requires the top 1,000 listed corporates to disclose significant non-financial information voluntarily in fiscal 2022 and compulsorily from fiscal 2023.

Acuité believes that the current trend among institutional investors of considering ESG scores along with the other conventional parameters like the credit rating will gain in importance over the near future.

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