



# Criteria For Rating Of Entities In Services Sector

## **PREAMBLE**

Different business models of services sector entities and their unique characteristics warrant a separate framework for assessment of credit risk. Service sector entities typically include educational institutions, advertising agencies, IT and IT-enabled services, as also other bodies in the hospitality and healthcare sectors. Apart from these conventional services, new-age services such as manpower supply and taxi fleet operators have contributed to the expansion of the service sector universe. From a credit rating standpoint, it is important to have a clear understanding of the business models of these entities, the risks involved therein and key risk mitigants.

The two key nuances of service sector entities, distinguishing them from manufacturing entities, are asset profile and cost structures. First, the most crucial asset of any service entity would be its human resource, which cannot be quantified on its balance sheet. Second, the cost structure of a service enterprise mostly comprises period costs that vary with time rather than with the level of activity for a certain period. Considering high fixed costs (employee costs and other committed overheads) in the overall cost structure of a service entity, the operating leverage tends to be higher vis-à-vis a manufacturing/ trading entity which have a relatively variable cost structure.

## **APPROACH**

From a broader perspective, Acuité has identified the following common factors for analysis of service sector entities:

- Industry Risk
- Market Position
- Operating Efficiency
- Financial Risk Assessment
- Management Risk Assessment

## **I. INDUSTRY RISK**

Acuité's assessment of the industry risk is based on four broad parameters- Demand Supply Balance, Extent of Competition, Regulatory Environment and Input Price Risk. Within these four parameters, Acuité examines the following aspects in a detailed manner.

Given below are the risk factors that Acuité considers with regard to the credit rating of service sector entities:

- Status of the industry - (Initial, consolidation, growth, maturity or decline), trends in each of the stages
- Outlook for the segment – (Positive/ Neutral/ Negative)

- Organised/ unorganised – Level of activity within the organised or unorganised sector (Largely organised with some portion in the unorganised segment/ Largely unorganised with limited players in the organised market)
- Entry barriers
- Capital or labour intensive
- Regulatory impact and price controls, if any
- Fiscal incentives, if any

Based on a critical analysis of the above factors, Acuité evaluates the industry risk of the entity and performance of the segment in which the entity operates. In case the entity's performance is divergent from industry trends, Acuité would recognise such divergence and factor in the same in the overall risk assessment.

## II. MARKET POSITION

Acuité considers the following while evaluating the market position:

### A. Revenue Visibility

The revenue visibility of entities such as schools and hospitals will be comparatively more stable than that of airlines, hotels and IT-enabled services. The divergence in revenue stability is essentially due to the insularity of entities like schools and healthcare from economic cyclicity. Acuité believes that relatively stable operating cash flows for such entities vis-à-vis other service entities (hotels and hospitality) support the former's ability to raise finances. From a debt servicing perspective, the lenders will prefer borrowers with a stable stream of revenues rather than a volatile revenue stream and hence, as a corollary, entities which are relatively insulated from cyclicity will be a better credit risk.

### B. Customer Profile

The profile of the customer base of a service entity is critical from a business resilience perspective. From a credit risk perspective, a diversified clientele profile is preferred to a concentrated one. Acuité, in addition to the diversity of the clientele base, also evaluates other finer aspects such as the nature of the relationship between the entity being rated and its customers. A higher level of integration between the service provider's business and that of the customer will be critical in this regard.

**Example 1:** A captive BPO of an investment bank will have customer concentration risk. However, if the credit quality of the investment bank is satisfactory and the dependency of the investment bank on the BPO is high, the captive BPO may be considered a low risk on the market assessment.

**Example 2:** For a school/ health care facility, the higher the economic strata of the clientele, the higher will be the pricing power and better will be the market position assessment.

**Example 3:** In the hospitality sector, it is important to ascertain whether a particular hotel is driven by business or tourism clientele. Tourism-dependent hotels are more prone to event risks, whereas a hotel dependent on business traffic will be influenced by economic cyclicalities.

**Example 4:** In an ITeS segment, there could be a focused concentration on the BFSI space. In such a scenario, downturns in the sector could impact the flow of business from the BFSI industry.

Acuité recognises these aspects related to the market position of an entity.

### C. Range of services/ Revenue Streams

The range of services offered by an entity plays an important role in determining stability of earnings. Key characteristics to be examined by Acuité will include the following:

- a) Presence across the value chain- A logistics company providing end-to-end solutions has an advantage over one that has presence in only one/ two segments of the logistics value chain.
- b) Regional presence vis-à-vis nationwide presence - An entity with regional presence vis-à-vis another with nationwide operations.
- c) Number of services under one roof- A hospital chain operating nationally with multi-speciality services and in-house diagnostic facilities would typically have a lower business risk compared to a hospital operating from a single location with limited services to offer.

Acuité believes that diversity of revenues across sectors/ geographies mitigates risk of revenue fluctuations to a large extent and imparts resilience to the credit profile of the entity being rated.

### D. Brand Image

The growth drivers of the services sector are brand image, track record and customer satisfaction. An entity with an established brand name definitely has an edge over others in terms of securing revenue from a potential customer. Strong brands can facilitate business growth in terms of volumes/market share enabling easy market penetration resulting in improved financial performance. Acuité evaluates these factors based on the extent of premium in margins/ higher growth in revenues vis-a-vis its peers. In certain industries, such as hotels the ability to attract franchisees is a strong indicator of the brand image.

Other things remaining the same, an entity with large portfolio of established brands will score higher on the market position assessment.

## III. OPERATING EFFICIENCY

### A. Cost Structure

Operating efficiency refers to an entity's ability to manage its cost structure efficiently so as to mitigate the impact of adverse revenue fluctuations on profitability margins. This can be done by containing fixed costs in the overall cost structure for a given level of output of services.

Different business models adopted by service entities to moderate the overall level of fixed costs would qualify for a higher rating on the Operating Efficiency parameter.

### **B. Human Resources**

Manpower resource is one of the key factors that contribute to the success or failure of a service entity. Continued availability of skilled manpower is crucial for success of a service enterprise. Tie-ups with institutions such as colleges, academies ensure continued stream of talent. Apart from external tie ups, in-house training/ skill development verticals in an organisation will have a positive impact from an operating efficiency perspective.

Acuite considers metrics such as manpower cost as a percentage of operating revenues, revenue per employee and profit per employee while comparing productivity across peers.

### **C. Operational Integration**

Acuite observes that higher the level of integration across the value chain, more operationally efficient the service level entity is likely to be.

Example 1: A training institute which has a tie-up with a leading bank will benefit by way of key inputs such as training faculty, course content and practical training infrastructure which can be provided by the bank. Hence, due to the operational benefits arising out of such integration, the training institute would qualify for a higher rating on the Operational Efficiency parameter.

Example 2: A health care facility with in-house diagnostic facilities will score more than a standalone hospital with limited ancillary facilities.

## **IV. FINANCIAL RISK ASSESSMENT**

While assessing financial risk, Acuite examines the capital intensity of the entity being rated. Certain entities such as airlines, educational institutions, healthcare, etc. with relatively higher capital intensity shall be evaluated on parameters applicable to manufacturing entities. The conventional metrics like size of networth, gearing, interest coverage, debt service coverage ratio, margins etc are evaluated a historical basis (past 3-5 years) as well as on a projected basis. The resource raising ability is also examined from the standpoint of financial flexibility. It may be noted that certain other entities may have steady cash flow visibility and its ability to raise additional debt will be linked to the quantum of these steady cash flows. In such cases, the relevance of conventional measures like Networth will get diluted in the overall assessment.

Acuite will accordingly factor in the differences in the financial risk assessment.

## V. 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. The 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 promoters' 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 senior level.
- Ability to initiate course corrective measures in response to 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 focus 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.

The Key Factors to be considered are:

- Independence of the board, the 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.

### 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 credit worthiness, 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 group companies/ 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".

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