

Rating Methodology for Manufacturing Companies

Credit analysis of an entity begins with a review of the Economy/Industry in which the entity operates along with an assessment of the business risk factors specific to the entity.

This is followed by an assessment of the financial risk factors and quality of management of the entity. The degree of financial risk exposure of the entity within the overall context of the business risk together with the evaluation of the entity management forms the basis for arriving at the rating level.

Economy and Industry risk analysis

CARE's analysis of industry risk focuses on the prospects of the industry and the competitive factors affecting the industry. The economic/industry environment is assessed to determine the degree of operating risk faced by the entity in a given business. Investment plans of the major players in the industry, demand-supply factors, price trends, changes in technology, international/domestic competitive factors in the industry, entry barriers, capital intensity, business cycles etc are key ingredients of industry risk. CARE also takes into account the economy-wide factors which have a bearing on the industry under consideration. The strategic nature of the industry in the prevailing policy environment, regulatory oversight governing industries etc, is also analysed.

Business risk analysis

Against the backdrop of economy and industry risk, CARE assesses the entity's position within the industry. Some of the key parameters used to assess business risk are discussed below:

- **Diversification:**

For entities that operate in several industries, each major business segment is analysed separately. The contribution of each business segment to the entity's overall profitability is assessed. While diversification results in better sustainability in cash flows, CARE also analyses the suitability and adequacy of management structure in such scenarios and forward and backward linkages present.

- **Seasonality and Cyclical**

Some industries are cyclical in nature with their performance varying through the economic cycle. Moreover, certain industries are seen to exhibit seasonality. CARE's ratings aim to be stable across seasons and economic cycles and are arrived at after deliberating on the long-term fundamentals.

- **Size**

Small size presents a significant hurdle in getting higher ratings commensurate with an entity's financials. Presence in selected market segments, limited access to funds leading to lack of financial flexibility etc, result in lower protection of margins when faced with adverse developments in business areas. Large firms, on the other hand, tend to have higher sustaining power, even during troubled times.

- **Cost structure**

The cost factors and efficiency parameters of the existing operations are assessed with respect to expenditure levels required to maintain its existing operating efficiencies as well as to improve its efficiency parameters in a competitive scenario. Nature of technology may also influence the cost structure.

- **Market share**

An entity's current market share and the trends in market share in the past are important indicators of the competitive strengths of the entity. A sustained leadership position leads to ability to generate cash over the long term. A market leader generally has financial resources to meet competitive pricing challenges.

Financial risk analysis

Financial risk analysis involves evaluation of past and expected future financial performance with emphasis on assessment of adequacy of cash flows towards debt servicing.

CARE's analysis is mainly based on audited accounts of the entity although unaudited accounts are noted. A review of accounting quality and adherence to prudential accounting norms (if any, set by local regulations) are examined for measuring the entity's performance. Accounting policies relating to depreciation, inventory valuation, income recognition, valuation of investments, provisioning/write off etc are given special attention. Prudent disclosures of material events affecting the entity are reviewed. Impact of the auditors' qualifications and comments are quantified to the extent possible and analytical adjustments are made to the accounts, if material. The rating team meets the auditors to understand their comfort level with the accounting policies, systems and controls within the entity and his assessment of the management of the entity.

Off-balance sheet items are factored into the financial analysis and adjustments made to the accounts, wherever necessary. Change of accounting policy in a particular year which results in improved reported performance is analysed more closely.

- **Financial ratios**

Financial ratios are used to make a holistic assessment of financial performance of the entity, as also to see the entity's performance w.r.t. its peers within the industry. They are not an 'end' in itself but a 'means' to understanding the fundamentals of an entity.

(i) Growth Ratios:

Trends in the growth rates of an entity vis-à-vis the industry reflect the entity's ability to sustain its market share, profitability and operating efficiency. In this regard, focus is drawn to growth in income, PBILDT, PAT and assets.

(ii) Profitability Ratios:

Capacity of an entity to earn profits determines the protection available to the entity and the position in the value chain. Profitability reflects the final result of business operations. Important measures of profitability are PBILDT, Operating and PAT margins, ROCE and RONW.

Profitability ratios are not regarded in isolation but are seen in comparison with peers and the industry segments in which the entity operates.

(iii) Leverage and Coverage Ratios:

Financial leverage refers to the use of debt finance. While leverage ratios help in assessing the risk arising from the use of debt capital, coverage ratios show the relationship between debt servicing commitments and the cash flow sources available for meeting these obligations. CARE uses ratios like Debt / Equity Ratio, Overall gearing ratio, Interest Coverage, Debt as a proportion of cash accruals and Debt Service Coverage Ratio to measure the degree of leverage used vis-à-vis level of coverage available with the entity for debt servicing.

(iv) Turnover Ratios:

Turnover ratios, also referred to as activity ratios or asset management ratios, measure how efficiently the assets are employed by the entity. These ratios are based on the relationship between the level of activity, represented by sales or cost of goods sold, and level of various assets, including inventories and fixed assets.

(v) Liquidity Ratios:

Liquidity ratios such as current ratio, quick ratio etc are broad indicators of liquidity level and are important ratios for rating short-term instruments. Cash flow statements are also important for liquidity analysis.

- **Cash flows**

Future debt obligations are required to be met by cash and hence only a thorough analysis of cash flow statements would reveal the level of debt servicing capability of an entity. Cash flow analysis forms an important part of credit rating decisions. Availability of internally generated cash for servicing debt is a more comforting factor in a credit perspective as compared to dependence on external sources of cash to cover temporary shortfalls. Cash flow adequacy is viewed by the capability of an entity to finance normal capital expenditure, as well as its ability to manage capital expenditure programmes as per envisaged plans apart from meeting debt servicing requirements.

- **Financial flexibility**

Financial flexibility refers to alternative sources of liquidity available to the entity as and when required. The entity's contingency plans under various stress scenarios are considered and examined. Ability to access capital markets and other sources of funds whenever required is reviewed. Existence of liquid investments, availability of support (implied or demonstrated) from strong group concerns to tide over stress situations, ability to sell idle assets quickly, deferment of capital expenditure etc are favourably considered.

- **Validation of projections and sensitivity analysis**

The projected performance of the entity over the life of the instrument is critically examined and assumptions underlying the projections are validated. The critical parameters affecting the industry and the anticipated performance of the industry are identified. Each critical parameter is then stress-tested to arrive at the performance of the entity in a stress situation. Debt service coverage for each of the scenarios would indicate the capability of the entity to service its debt, under each scenario.

Management Evaluation

Management evaluation is one of the most important factors supporting an entity's credit standing. An assessment of the management's plan in comparison to those of their industry peers can provide important insights into the entity's ability to sustain its business. Capability of the management to perform under stress provides an added level of comfort. Meetings with the top management of the entity are an essential part of CARE's rating process.

Some key dimensions of management evaluation are:

- **Track record:**

The track record of the management team is a good indicator for evaluating the performance of the management. Management's response to key issues/events in the past like liquidity problems, competitive pressures, new project implementation, expansions and diversifications, etc are assessed.

- **Corporate Strategy:**

The entity's business plans, mission, policies and future strategies in relation to the general industry scenario are assessed. An important factor in management evaluation is assessment of the management's ability to look into the future and its strategies and policies to tackle emerging challenges, in addition to succession planning.

- **Performance of group concerns:**

Interests and capabilities of the group concerns belonging to the same management give important insights into the management's capabilities and performance in general.

- **Organisational structure:**

Assessment of the organizational structure would indicate the adequacy of the same in relation to the size of the entity and also give an insight on the levels of authority and extent of its delegation to lower levels in the organization. The extent to which the current organisational structure is attuned to management strategy is assessed carefully.

- **Control systems:**

Adequacy of the internal control systems to the size of business is closely examined. Existence of proper accounting records and control systems adds credence to the accounting numbers. Management information systems commensurate with the size and nature of business enable the

management to stay tuned to the current business environment and take timely, judicious decisions.

- **Personnel policies:**

Personnel policies laid down by the entity would critically determine its ability to attract and retain human resources. Incidence of labour strikes/unrest, attrition rates etc, are seen in perspective of nature of business and relative importance of human capital.

- **Corporate governance**

Extent of transparency in the entity's dealings with various stakeholders, financial prudence and compliance with extant laws and regulations is seen closely.

The rating process is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. Rating determination is a matter of experienced and holistic judgment, based on the relevant quantitative and qualitative factors affecting the credit quality of the issuer.

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