Rating Methodology – Education Sector

[In supersession of "Rating Methodology – Education Sector" issued in July 2018]

Background

The Indian Education system can be broadly classified into three categories namely, Formal, Vocational and Informal Education. Formal education includes school education, also called K-12 (Kindergarten to 12th Standard), graduation and post-graduation courses, while informal education comprises pre-school & coaching classes. Vocational studies refer to parallel education system which involves imparting various skills to compete in business environment. The Formal education segment in India is regulated with regulations at both state and central level, while both vocational and informal segments are not regulated. Apart from its regulated nature, formal education segment is characterised by fragmentation with presence of a number of colleges and universities. The sector has also shown high growth potential.

The sector growth (in terms of enrolment) is expected to be fuelled by higher penetration in the Pre-school and K-12 segments of education apart from coaching class segment.

Rating Methodology

CARE Ratings has a well laid out methodology for rating of entities belonging to the manufacturing/service sector. CARE's rating process begins with the evaluation of the economy/ industry in which the entity operates, as well as the assessment of the business risk factors specific to the entity. This is followed by an evaluation of the financial and project-related risk factors as well as the quality of the management. This methodology is adopted while analysing all entities that come under the purview of the manufacturing/service sector. However, considering the size and diversity of each sector, CARE Ratings has developed methodologies specific to various sectors. These methodologies attempt to point out factors, over and above those mentioned in the broad methodology, which will be assessed while determining rating of entities belonging to the particular industry. The following is a list of such additional factors, along with their analytical implications, considered by CARE Ratings while arriving at the rating of the players that operate in education sector.

A. Management Risk

Experience and resourcefulness of promoters: While relevant experience of promoters in education sector and their competence are important for successful running of the institution, promoters' resourcefulness and their capability to financially support the operations is also a key consideration considering long gestation period involved in the case of educational institutions.

B. Business Risk

Track Record and reputation of institution: Operational track record and reputation of institution not only helps in attracting students but also ensures pricing flexibility subject to regulations. These factors also provide competitive edge to the institution over competition.

Trend in Enrolment/Enrolment Ratio: Enrolment ratio, the ratio of actual intake to sanctioned intake, indicates the ability of institute to attract students or demand for the courses offered by the institute. A higher enrolment ratio indicates higher utilisation of the available capacity. Besides reflecting the demand for courses offered, this is also likely to result in relatively high return on capital employed. Furthermore, consistently high enrolment ratio indicates higher stability in revenue streams.

Nature and diversity of courses offered: While specialisation in a particular course with high enrolments is positive, the same exposes the institution to the risk of higher dependence on single course. Having diverse course offerings mitigates the risk of dependence on performance of single course by providing cushion in terms of slowdown in demand of any of the courses. Hence, entities with diversified revenues stream and/or with highly stable revenue stream are better placed compared to others. However, adverse economic conditions, their impact on placements and economic outlook etc. to an extent affect enrolment levels and thereby income generation ability of the institution. While the impact of downtrend in economic conditions and extent of diversification is highly visible in manufacturing companies, the same is limited in education sector. As such, revenue and cash accruals of entities in education sector are generally less volatile. However, ability of institutes to adjust pricing and intake capacity of non-performing courses and introduce new courses on the basis of demand of the courses is also important as the same helps in better utilisation of infrastructure and resources of the institution thereby impacting its income and profitability.

Relative size of the entity: An entity with relatively larger size is better placed to absorb various fixed costs including administrative overheads, advertisements, etc. Also factors such as presence in multiple locations and geographical diversification of relatively larger entities are positive factors as they mitigate region-specific risks including regulatory risks to an extent.

Placement Track Record: While the factors like number of applications received against available seats and enrolment ratios indicate the standing of the institute among the student community and effective utilisation of available capacity respectively, placement record can be considered as an indicator of employability/industry readiness of the students who are graduating from the institute. In as much as there exists a preference among students for colleges with good placement track record (both in terms of number of students placed and quality of placements), this is likely to provide sustainability and revenue visibility.

C. Regulatory Risk

Education is in the Concurrent List of the Indian Constitution, wherein both state and central governments have powers to regulate the sector. Formal education sector is one of the highly regulated sectors with both state and central government regulating the industry directly and/or indirectly through various bodies including UGC (University Grants Commission) and AICTE (All India Council for Technical Education). UGC was established for the coordination, determination and maintenance of standards of university education in India. AICTE was established with a view to proper planning and co-ordinated development of the technical education system throughout the country. Further, other Government bodies like Central Board of Secondary Education, Medical Council of India (now superseded by Board of Governors), Bar Council of India, Indian Nursing Council, Dental Council of India, etc. are responsible for regulation of institutes offering respective courses. The scope of government regulations is wide, starting from establishment of course/institute, seat sharing, fee fixation and periodical review of the standards followed by the institute.

Status of institute (Affiliated/Autonomous/Private University/Deemed University): The status of an institute in terms of autonomy has significant bearing on the operational and financial flexibility. Colleges 'affiliated' to a particular university are required to follow the syllabus of the respective university and examinations are conducted by the university. There is limited scope for the college to differentiate its service from other colleges as it has control over the quality of faculty and teaching methodology only. At the same time, colleges which have operational autonomy are in a better position to review the types of courses offered, syllabus and examination standards periodically. This operational autonomy helps them to introduce most recent developments in the respective field of study and enable students to be updated with latest technology to meet highly demanding industry standards/requirements. This in turn is likely to help the institute to maintain higher academic standards and competitive market position leading to higher demand for its courses.

Risk related to non-renewal of courses and reduction in seats: The regulatory authorities have the power to give approval for renewal of courses as well as deciding number of seats. For example, in the recent past, AICTE reduced number of engineering course seats on account of lower enrolments in the engineering colleges. Similarly, there exists risk in the form of non-renewal of medical courses by the regulatory authorities which can impact cash flows of medical colleges in the short-term. However, the said risks get mitigated to some extent in the case of those entities which offer multiple courses and whose revenue is not dependent on single course.

Seat Sharing and Fee fixation: Each state has its own policy with respect to regulating seat sharing and fee fixation of non-aided private colleges. Generally, these colleges are required to surrender a portion of their sanctioned intake (called government quota) to the state government towards admission based on government entrance exams. Percentage of seat sharing varies based on criteria followed by respective state governments. Considering that students admitted under government quota are charged relatively lower fee, this has bearing on both profitability and revenue. In respect of fee charged for management quota of non-aided private colleges also, the fee is fixed by state level committees. Further, various state governments have introduced legislations to control school fees being charged by private schools in their states which has restricted the pricing flexibility of these schools thereby putting pressure on their cash flows. As such, colleges which have autonomous status and colleges which are under deemed universities are better placed as they are not required to share the seats and can fix their own fee.

Right to Education Act: As per the right to education act, all the private and minority schools are required to reserve 25% of seats to specified segment of students and fee for the same will be reimbursed by the government. The ability of the entity to mitigate the impact of the same on profit margin is also one of the key factors considered while assessing the credit risk.

Quality and availability of Faculty as well as infrastructure: All the colleges are required to maintain specified standards and norms with respect to teaching faculty across the hierarchy including student-teacher ratio. In respect of certain courses, the availability of good quality faculty is one of the challenges faced by the industry. Generally medical colleges and coaching institutes are required to offer higher salaries to recruit and retain good quality faculty. Further, the infrastructure of the institution in place and facilities being provided apart from institution ranking are also considered.

Corporate structure/Constitution: Most of the entities in the education sector are registered as Trusts/Societies under state or central government Act. While the entities follow the accounting norms which are standardised and uniformly applied across India, there is no standard accounting norms applicable for Trust or Societies. For example, an entity may follow cash basis for accounting income and accrual basis for expenses. The accounting norms followed by these entities are also factored in while assessing credit risk, which also requires suitable adjustments to be made in analysis. Further, impact of exposure to group entities/unrelated entities is also analysed.

In order to get tax exemption, entities (which are constituted as trusts/societies/Section 8 companies) are required to use 85% of their income towards the objective of the society/trust. While the permitted use includes regular operating expenditure, interest and principal repayments, given that most of the educational institutes generate relatively high surplus margin, there is need for continuous capex resulting in cash outflow which otherwise would have been available in the system to improve its liquidity position.

CARE Ratings believes that the government regulation on various aspects of the formal education sector has a major impact on the credit risk of the entities.

D. Financial Risk

Seasonality associated with cash flow of education institution: Unlike entities in manufacturing/service sector which have cash inflow spread over the year, cash inflows of most of the educational institutions are relatively skewed as the tuition fee is collected annually/semi-annually/quarterly/monthly. At the same time, cash outflow towards capital expenditure and operating expenditure is spread over the entire year. Given this, the management of cash flow assumes greater significance in educational institutions. Most of the institutes plan their repayments in such a way that they coincide with fee collection and any surplus funds are parked in liquid investments to meet operating expenditure during rest of the year. Further, unutilised bank limits (if available) also provide cushion for meeting expenses in case of any contingencies. While cash flow management is of greater importance, traditionally used liquidity ratios as such are not meaningful while analysing most of the educational institutes. Also, as the fee is collected in advance or within a period of 2-3 months of beginning of the academic year or semester, typically receivables of educational institutions is almost negligible or relatively low.

In respect of courses offered to students who are sponsored under various schemes of government, receipt of money (reimbursements from government) in timely manner is crucial due to procedural aspects involved. The extent of contribution of the same to total income of the institute and mitigation plans for managing cash flow mismatches arising on account of the same are also examined while rating entities in this sector. Further, timely receipt of grants and donation by institutes which receive regular financial aid from Govt. and other entities for funding expenses and capex programmes is crucial.

Need for continuous capital expenditure: Considering available infrastructure in terms of number of seats and courses offered, entities involved in offering education services need to carry out continuous capex for expanding seating capacity and improve existing infrastructure in order to ensure growth in revenue. While fulfilling the above obligation, effective planning of financing based on the existing and future cash flows is key to maintain/improve its financial position.

Trend/Stability of revenue: Well established institutes with good track record of enrolment and entities with relatively diversified courses are better placed as they offer stability in revenue. Further, alternate sources of revenue apart from tuition fees, like hostel fees, transportation fees, mess fees, etc. are also analysed.

Profitability: The trend in profitability margins vis-à-vis capital deployed is an important factor impacting the debt servicing ability of the institutes. With majority of the cost of an educational institution being of fixed nature, stability in margins is important.

Summary

Thus, the key rating factors for entities in education sector include enrolment ratios, type of courses offered, diversity of revenue stream and nature of regulatory environment in which they operate. Besides, factors such as need for continuous capex and effective management of cash flows are important from financial risk perspective.

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