Rating Methodology – Education Sector

[In supersession of "Rating Methodology – Education Sector" issued in June 2017]

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.

In terms of aggregate revenue earnings, the Indian Education System is expected to grow from Rs.6,18,500 crore during FY17 to Rs.8,87,500 crore during FY20 at a healthy CAGR of 12.8%. 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 analyzing 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. Business Risk

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: Courses like MBBS and M.D which are in high demand generally have 100% enrolment ratio providing highly stable revenue. In respect of engineering courses, while well-established courses/institutes are in a position to generate stable revenues, adverse economic conditions, their impact on placements and economic outlook etc to an extent affects enrolment levels and thereby income generation ability. Entities with diversified revenues stream and/or with highly stable revenue stream are better placed compared to others. 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.

Relative size of the entity: An entity with relatively larger size is better placed to absorb various fixed costs including administrative overheads, advertisements, etc. However, some of the entities which are running schools are better placed to manage their profitability level despite relatively smaller size primarily on account of higher demand. Also factors such as presence in multiple locations and geographical diversification of relatively larger entities are positive factors as they mitigate or 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.

B. 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. 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. However, 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.

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 fee charging capacity 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: All the colleges are required to maintain specified standards and norms with respect to teaching faculty across the hierarchy. This is to ensure that quality and number of faculties is up to required standards. In respect of courses like MBBS, the availability of good quality faculty is one of the challenges faced by the industry. Generally medical colleges are required to offer higher salaries to recruit and retain good quality faculty.

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.

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.

C. 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 either annually or semi-annually. 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. 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.

Need for continuous capital expenditure: In order to get tax exemption, entities (which are constituted as trusts/societies/Section 25 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. While fulfilling the above obligation, effective planning of financing based on the existing and future cash flow 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.

Profitability: The trend in profitability margins vis-à-vis capital deployed is an important factor impacting the debt servicing ability of the institutes.

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 it operates. Besides, factors such as need for continuous capex and effective management of cash flows are important from financial risk perspective.

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