Rating Methodology - Service Sector Companies

[In supersession of “Service Sector Companies” issued in June 2017]

Background

The services industry refers to providers of intangible goods to consumers. The services sector is not only the dominant sector in India’s Gross Domestic Product (GDP), but has also attracted significant foreign investment flows, contributed significantly to exports as well as provided large-scale employment.

The service industry is wide and covers a gamut of areas like asset based services (hospitality, education, hospitals, airports, retail, mobile service providers, etc.) and personnel based services (professional services like accounting firms, law firms, management consultancy and advisory, security services, support services, IT and facility maintenance services, logistic services, etc.).

The rating methodology here primarily covers the personnel based services while methodologies for various assets based services (like Airports, Education, Hotels, Mobile service providers, Retail and Shipping), considering the risk metrics specific to their business model, are individually available on CARE Ratings’ website.

Rating Methodology

A. Industry risk

CARE Ratings’ analysis of the industry risk focuses on the current industry scenario, demand-supply factors, the size of the industry, key players in the industry and competitive factors, cyclicality and seasonality, if any associated with the industry, any regulatory policies, etc. CARE Ratings also takes into account economy-wide factors which have a bearing on the service industry.

B. Management Evaluation

The business of a service provider is, to a large extent, influenced by the brand value which helps in winning consumer confidence and ensure consumer loyalty. The management evaluation is an important aspect of the rating process as it provides insights into the business strategy and the ability of the entity to sustain its business. The various parameters on which the management is evaluated are:

- **Business Strategy**

  The entity' mission, its vision, policies, business plan and future strategies provides valuable insight into the ability of the management to foresee the challenges and opportunities and prepare for them.

- **Promoter group strength**

  The promoter group's standing is assessed to understand the tangible and intangible support it could offer to the entity.

- **Profile of the management team and association with organization**

  The experience and track record of the management team helps in understanding its preparedness in handling stress scenarios. Further, for entities providing professional services like audit services, consultancy services, etc. the longevity of association of key executives with the organization is of importance. Such entities are people-oriented involving exchange of critical and confidential information between the entity and its client. As such, continuance of the senior executive provides a sense of security and stability to the client.

- **Organization structure**

  The organization structure, the delegation of powers, roles and responsibilities, accountability and succession planning, is assessed with respect to the size and strategy of the entity. The organizational structure also to a large extent defines the systems of controls and escalation within the organization which has a significant bearing on service quality delivery.

- **Personnel policies**

  Human resource is the most critical asset for a service company. Personnel policies laid down by the entity would critically determine its ability to attract and retain talent.

- **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.

- **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.

C. Business Risk

Given the economic and industry risk, the business risk of the entity is assessed by CARE to understand its position within the industry. The business risk is analyzed on the following key parameters:

- **Nature and complexity of the services offered**

  CARE analyses the nature and complexity of service provided by the service provider. A recurring form of service like business support services or Operations & Management (O&M) services provide more stability to income vis-à-vis one time services like product development service by an IT firm.

  Furthermore, highly complex services are generally high margin services and are difficult to replace by the clients of the service provider. As such, more complex and expertise-oriented services carry less risk of being replaced and provide more revenue visibility. This also creates entry barriers for newer players or possibility of substitution by other technology-driven products. For example, legal consultancy is a highly expert-oriented service and would command higher margins vis-à-vis a facility management service provider.

- **Nature of service contracts**

CARE analyzes the nature of service contracts signed with the clients by the entity. Contractual terms where the roles and responsibilities of either party are defined clearly, with defined payment terms and dispute resolution mechanisms are viewed favorably. Longer duration service contracts with difficult cancellation terms provides more visibility to revenues. A history of renewal of contracts signifies customer satisfaction and is an indicator of a long term relationship with a client. As such CARE, views a track record of contract renewals positively.

- **Service proposition**

Service sector is a highly competitive sector and typically, pricing in the service sector follows a declining trend and for a company to operate on a sustained basis and maintain or improve its margins, the company needs to have a unique selling proposition or add value to the client on an ongoing basis. CARE Ratings analyses the business of the entity from this perspective and its position in the value chain of services offered. Various 'per unit' metrics would be analyzed by CARE Ratings to assess the operating efficiency of the entity. In an IT company, billing rates per employee and cost per employee would be important metrics while in a logistics firm, the analysis may be focused on say 'yield' or realization per kg of materials handled.

- **Brand value**

Since a service entity deals in intangible products and is asset light, its brand is its biggest asset. The brand value is built over the years through sustained deliverance of quality services. The competitive position of an entity is a corollary of the brand value of the entity. High brand value provides a bargaining power to the service provider and lets it command a premium for its services. Also, high brand value enables an entity to leverage the brand to establish its position in new service lines with ease and higher probability of success.

- **Seasonality and cyclicality**

  The service industry is usually less cyclical in nature due to the non-discretionary nature of most services. Seasonality may be prevalent in service industry due to the nature of the end-users served by the entity. An IT firm may witness seasonality with lower revenue booking in December quarter due to holiday season in western countries who are generally its largest clients. CARE's ratings aim to be stable across seasons and economic cycles and are arrived at after deliberating on the long-term fundamentals.

- **Scale of operations**

  The scale of operations is critical in the analysis of a service entity. Large entities have better financial flexibility and are better placed to face adverse business environment.

- **Diversification**

  Diversification can be in form of services offered, client mix and geography. If an entity offers various services, each such business segment would be analyzed separately. Furthermore, any forward or backward linkages in the business segments are assessed. Inter-related service offerings provide better synergies to an entity than an entity in unrelated business segments which may necessitate different management structures and cost structures for its various business segments.

  Diversification in terms of geographical presence and number and type of clients is also critical. A high dependence on few clients would be detrimental for the entity if a client is lost. Similarly, a high proportion of government clients could lead to elongated receivable days for the entity. Geographical diversification also helps in case of any loss of business or temporary disruptions in individual markets where the entity operates.

- **Exposure to overseas markets**

  It is common for service entities to offer services overseas due to the huge outsourcing demand from western countries. In case of such entities providing onshore services in other countries, like IT or consultancy services companies, global economy-wide factors, visa regulations, and impact of foreign exchange fluctuation risk analysis is an important aspect in the rating process as against entities that are present in domestic markets alone.

- **Cost structure**

The major costs for a service company are the employee cost and IT infrastructure costs, which are analyzed to understand the trend in the profitability margins. The cost of the employees varies based on the education and background of employees, attrition rate, training costs, and incentive structures. The companies that have a larger proportion of variable cost employees would have a better control over costs in an event of decline in demand or loss of a service contract vis-à-vis a company that may have to bear high fixed costs. However, on the other hand, higher variable cost may also lead to higher attrition rates which may add to training costs for the company. A judicial mix of employees is critical to control costs for a service provider.

Also, the nature of technology used and IT infra influences the cost structure for the entity. Entities that offer services that involve access to confidential information from clients, need to invest well in the IT security systems and MIS systems. As such, analysis of the cost of up-gradation and recurring maintenance of the IT infrastructure is critical to the analysis of the cost structure of the company.

D. Financial Risk

Financial risk analysis involves evaluation of past and expected future financial performance with emphasis on assessment of profitability margins and working capital management.

CARE Ratings' 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 and amortization of intangible assets, income recognition, valuation of investments, forex transactions, 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 interacts with 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 analyzed 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. Some of the important financial ratios are:

a) **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.

b) **Profitability Ratios:** Capacity of an entity to earn profits determines the protection available to the entity and the control over the cost structure. 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.

c) **Leverage and Coverage Ratios**: in service industry, debt mainly comprises of working capital borrowings and/or non-fund based limits like performance bank guarantees. As the service entities are asset light businesses, long term debt is rarely present on the balance sheet of these entities. As such, Overall gearing ratio and Interest Coverage are the major ratios analysed in a service entity. Debt as a proportion of cash accruals and Debt Service Coverage Ratio would be important in case an entity has availed long term debt to measure the degree of leverage used vis-à-vis level of coverage available with the entity for debt servicing.

d) **Liquidity Ratios:** Liquidity ratio such as current ratio is broad indicators of liquidity level and is important ratios for rating short-term instruments. Cash flow statements are also important for liquidity analysis.

- **Working Capital Cycle Management and financial flexibility**

A service entity does not have any inventory and its working capital management mainly relates to receivables management. Service entities are usually cash rich with adequate amount of cash flow to finance normal maintenance capital expenditure, and to fund the working capital. However, the entity may rely on external working capital limits to meet any cash flow mismatches and as such its financial flexibility is also assessed. Financial flexibility refers to alternative sources of liquidity available to the entity as and when required. The entity's sanctioned bank limits and its average utilization, 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, etc. are favorably 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.

Conclusion

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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