# Rating Methodology - Service Sector Companies

[Issued in November 2020]

**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 www.careratings.com

**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, tax benefits, etc. Furthermore, as these service entities act as service providers for other core industries, the performance of such core industries is also a critical factor for the analysis of these entities.

**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. 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.

- **Promoter group strength**

  The promoter group's standing is assessed to understand the tangible and intangible support it could offer to the entity. The track record of the promoters/management team in terms of their response to key issues/events in the past like liquidity issues, competitive pressures, new service offering, expansions and diversifications, etc., are assessed. The methodology considers commitment of the promoters not only in the form of equity infusion but also their active involvement in the operations/management of the entity, reflecting the importance of the entity in the overall group's portfolio.

- **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. Furthermore, 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 executives 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.

- **Succession Planning**

  Succession planning is another critical part and is assessed in detail if the company's operations are dependent upon a single promoter or a key professional. A sound succession planning ensures the continuity in business operations without much disruption even after the most important employees retire or leave the company.

- **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. The depth and diversity of the skill sets available in the company along with the policies regarding training and enhancing the skills of employees are also evaluated. The company's asset utilization and attrition levels are compared with its peers and industry averages. High attrition rate is likely to not only adversely impact the execution of projects in terms of timelines and quality of deliverables but also create negative brand image amongst customers, which adversely affects the repeat business.

- **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. The market reputation of the group/entity is also factored in while assigning the ratings.

**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 analysed 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 be replaced 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 analyses 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 favourably. Longer duration service contracts with difficult cancellation terms provide more visibility to revenues. A history of renewal of contracts reflects 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 & Market Position**
  Service sector is a highly competitive sector, and 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 analyses the business of the entity from this perspective

and its position in the value chain of services offered. Various 'per unit' metrics are analysed by CARE 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 'yield' or realization per kg of materials handled. Furthermore, companies with niche service offerings have a stronger market value as it is difficult to replicate their services on account of complexities. Significant market position provides bargaining power to the service provider which also lets it command a premium for its services. Furthermore, the market position of the entity enables it 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. 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 ability to influence business trends and pricing within its service segments and show greater resilience to adverse changes in business environment. Large scale of operation also aids in better bargaining power with its customers and vendors along with sustenance in case of attrition or loss of key clients. Further, achieving a certain threshold of revenues supports companies in bidding for and winning large contracts through their demonstrated execution capabilities and resource mobilization strengths.

- **Diversification**

  Diversification can be in the form of range of services offered, client-mix, end-market and geography. Maintaining a high degree of diversification is crucial as it leads to lower revenue volatility, less susceptibility to regulatory or market changes, provides competitive advantages and ensures stable profitability.

  If an entity offers various services, each such business segment would be analysed separately. Diversified revenue streams also insulate the entities from any technological disruptions in any of their service offerings. 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. If majority of the revenue is from a particular industry then the performance of the industry is also taken into consideration.

  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 delays in realizations and subsequent liquidity stress making the analysis of its working capital management critical. In addition, CARE also evaluates the top clients of the entity for their overall credit quality as a marquee client base is a reflection of the quality of the company's offerings, assurance of timely receipt of dues and sustenance of its business operations.

Geographical diversification also helps in case of any loss of business or temporary disruptions in individual markets where the entity operates. Also, in case of IT services, the presence of various off-shore development centres and their geographical diversity as it provides uninterrupted services to the companies across time-zones and against unforeseen calamities.

- **Exposure to overseas markets**

  It is common for service entities to offer services overseas due to the huge outsourcing demand from the western countries. In case of such entities, which are engaged in providing offshore services in other countries, like IT or consultancy services companies, analysis of global economy-wide factors, government policies in those geographies, legal policies and exposure towards foreign exchange fluctuation risk are factored in the rating process as against entities that are present in domestic markets alone. Furthermore, the net foreign currency exposure of the entity and its hedging policy are also evaluated by CARE.

- **Cost structure**

  The major costs for a service company are the employee cost and IT infrastructure costs, which are analysed 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 infrastructure 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.

- **Financial Flexibility**

  An entity's financial flexibility is reflected in its ability to access the capital market at short notice, attract diverse and marquee investors and enjoy the confidence of banks, financial institutions and intermediaries. Financial flexibility could emanate from factors such as an entity's large scale of operations with strong financials, large unencumbered cash flows, unencumbered assets and the flexibility to borrow against such assets, strong parentage or

linkages with a strong group.

In contrast, high share of pledged promoter shareholding reduces the financial flexibility of an entity and is considered adversely.

**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 their assessment of the management of the entity. Off-balance sheet items are factored into the financial analysis and adjustments are 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. 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 and PAT.

b) **Profitability Ratios:** The 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. CARE also evaluates any capitalised expenses incurred by the company for developing any Patents or Intellectual Property (e.g., Software) and the future potential to generate profits out of such investments. 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 consists 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 indicator of liquidity level and is important ratio 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 significant inventory and its working capital management mainly relates to receivables management. The debtor ageing schedule along with the possible risk of bad debts is evaluated. CARE also evaluates the entities customer exposure to various Government organizations where the risk of elongated payment cycle is relatively higher.

  Furthermore, as employee salaries form a major portion of the operating costs and entities have limited flexibility to defer this expense, it is thus crucial to maintain necessary cash balance for specified number of months.

  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, the 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 considered favourably.

- **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 further stress-tested to arrive at the performance of the entity in a stress situation.

- **Contingent Liabilities**

  CARE takes note of contingent liabilities/off-balance sheet exposure reported by an entity and if the same is material, carries out an impact analysis and financial implication of the liabilities devolving upon the entity.

*For more details on Financial ratios please refer to the methodology on 'Financial Ratios-Non financial sector entities' on our website.*

CARE Ratings
Professional Risk Opinion

## 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.

[For previous version please refer 'Service Sector Companies' issued in October 2019]

**CARE Ratings Limited**
4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai 400 022.
Tel: +91-22-6754 3456, Fax: +91-22- 6754 3457, E-mail: care@careratings.com
Website : www.careratings.com

***Disclaimer***

CARE's ratings are opinions on the likelihood of timely payment of the obligations under the rated instrument and are not recommendations to sanction, renew, disburse or recall the concerned bank facilities or to buy, sell or hold any security. CARE's ratings do not convey suitability or price for the investor. CARE's ratings do not constitute an audit on the rated entity. CARE has based its ratings/outlooks on information obtained from sources believed by it to be accurate and reliable. CARE does not, however, guarantee the accuracy, adequacy or completeness of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. Most entities whose bank facilities/instruments are rated by CARE have paid a credit rating fee, based on the amount and type of bank facilities/instruments. CARE or its subsidiaries/associates may also have other commercial transactions with the entity. In case of partnership/proprietary concerns, the rating /outlook assigned by CARE is, inter-alia, based on the capital deployed by the partners/proprietor and the financial strength of the firm at present. The rating/outlook may undergo change in case of withdrawal of capital or the unsecured loans brought in by the partners/proprietor in addition to the financial performance and other relevant factors. CARE is not responsible for any errors and states that it has no financial liability whatsoever to the users of CARE's rating. Our ratings do not factor in any rating related trigger clauses as per the terms of the facility/instrument, which may involve acceleration of payments in case of rating downgrades. However, if any such clauses are introduced and if triggered, the ratings may see volatility and sharp downgrades.