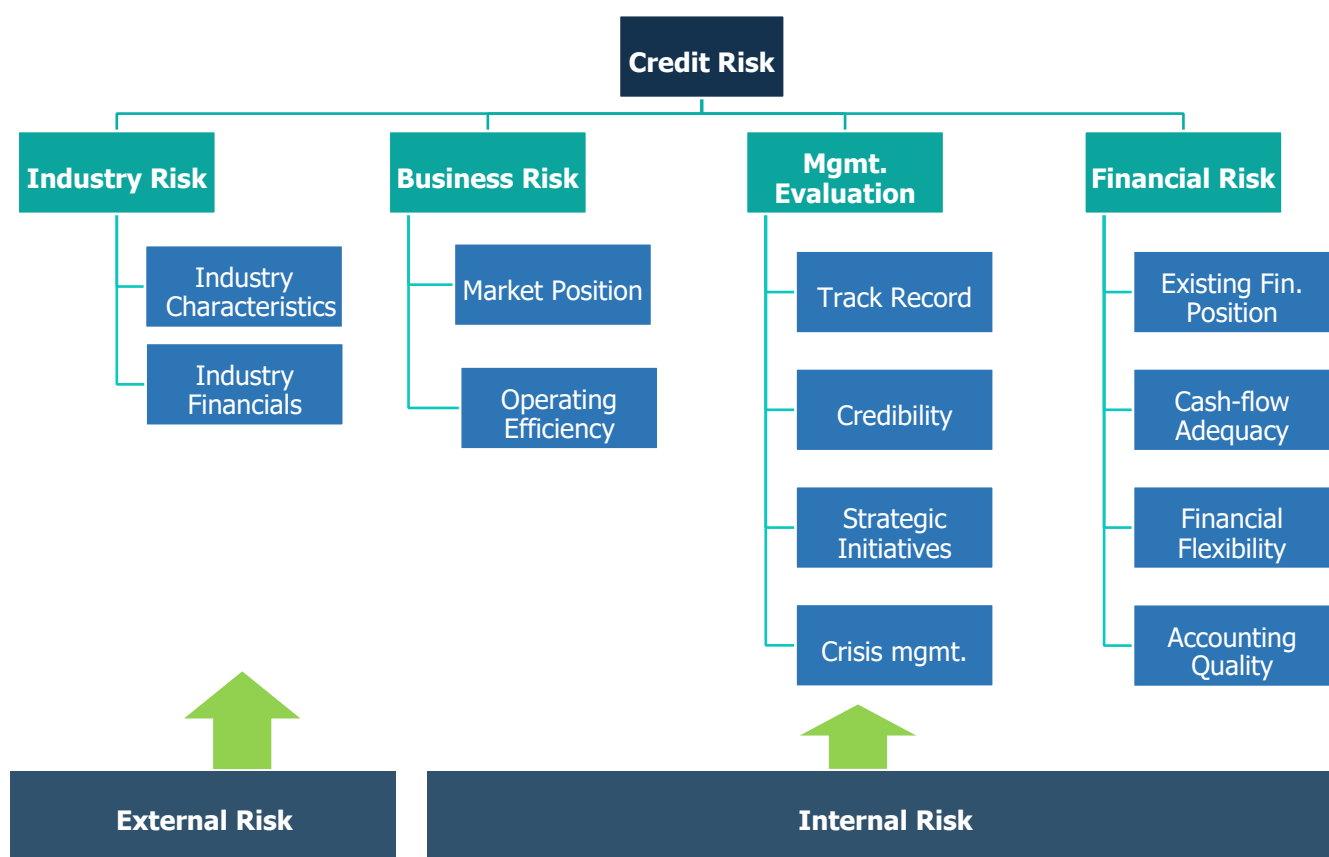


[Issued in March 2025]

Credit analysis of an entity begins with overall view of the economy/industry in which it operates, and an assessment of business risk factors specific to the entity.

This is followed by an assessment of the entity’s financial risk factors and quality of management. Support from the parent company, group, or government (as the case maybe) is also thoroughly analysed and incorporated into overall rating assessment in accordance with CARE Ratings Limited (CareEdge Ratings) Criteria on Notching, available on www.careratings.com. For entities undertaking projects, CareEdge Ratings also analyses project risk for arriving at the entity’s rating. A graphical representation of the risk assessment framework is shared below:



For companies with planned capital expenditure, project risk is also considered

This methodology covers factors considered while assessing credit risk of a general manufacturing entity. For sector-specific methodologies, please refer to CareEdge Ratings’ website (www.careratings.com).

A) Economy and Industry Risk Analysis

CareEdge Ratings’ analysis of industry risk focuses on the industry’s prospects and competitive factors affecting it. The economic/industry environment is assessed to determine degree of operating risk faced by the entity in a given business. Size of the industry, investment plans of major players in the industry, demand-supply factors, price trends, changes in technology, international/domestic competitive factors in the industry, entry barriers,

availability of substitutes, capital intensity, and business cycles, among others, are key ingredients of industry risk. CareEdge Ratings also considers economy-wide factors that have a bearing on the industry under consideration. Strategic nature of the industry in the prevailing policy environment, regulatory oversight governing industries including licensing, restricted access to raw material with protection, and anti-dumping duties, among others, are also analysed. Industry risk is external to an entity and while other risks are viewed in the backdrop of industry risks, if an entity consistently demonstrates its ability to tide through industry downturns and post better operational and financial performance compared to other players, it will be viewed positively.

CareEdge Ratings also considers whether an industry is in a position to command pricing or product prices in an industry are driven by market forces such as the landed cost of imports, among others, where even a large player may not be in a position to pass on the increase in input costs. CareEdge Ratings further considers gross margins enjoyed by the industry on an average to factor in the industry's tolerance to absorb increase in other operating and fixed costs.

B) Business Risk Analysis

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

- **Diversification**

Entities operating in diversified business segments generally exhibit a higher degree of sustainability in cash flows, and hence, are viewed more favourably. For diversified entities, each major business segment's income and profitability and its contribution to the overall business are analysed. In addition to segmental diversification, geographical diversification is also considered and an entity having a presence in diversified markets through its manufacturing facilities and distribution network is viewed positively. Customer and supplier diversification is also viewed favourably by CareEdge Ratings, as dealing with diversified counterparties mitigates risk of the business getting affected in case of liquidity issues with counterparties.

- **Seasonality and Cyclical**

Some industries are cyclical with their performance varying across economic cycles. However, companies in cyclical industries having a comfortable capital structure may not be considered risky. Certain industries are seen to exhibit seasonality. CareEdge Ratings assesses the working capital management capabilities of entities belonging to these industries with respect to their peak season requirement. CareEdge Ratings' ratings aim to be stable across seasons and economic cycles and are arrived at after deliberating on long-term fundamentals.

- **Size, Market Share and Competition**

Large size generally implies benefits such as economies of scale, higher bargaining power and the ability to access different markets against small-size entities, which are generally present in select market segments, exhibiting low resilience in margin protection, especially in adverse market conditions. Other factors being equal, large size is considered a credit positive.

Size is also viewed in relation to an entity's current market share and the trends in market share in the past, which are important indicators of the entity's competitive strengths. An entity with a small size but reasonably good market share against its peers may have a better bargaining power than a large-sized

entity operating in an industry driven by global market dynamics. A sustained leadership position leads to better revenue visibility and cash generation capability in the long term. The market leader typically has financial resources to meet competitive pricing challenges and generally exhibits flexibility to pass on rise in input prices. Against this, an entity operating in a fragmented market is a price taker and does not have control over selling prices, and hence, will have a lesser bargaining power, which could impact its profitability during a downturn.

- **Earnings Capacity**

Earnings capacity of a manufacturing entity is evaluated by considering its revenue visibility, trend of sales volumes and sales realisation over time. An entity demonstrating strong revenue visibility in the long-term is viewed positively.

- **Cost Structure and Operating Efficiency**

Operating efficiency is an entity's ability to produce at competitive costs, which are sustainable. In a manufacturing entity, operating efficiency can be gauged by capacity utilisation levels, flexibility in production process, input cost per unit, inventory levels, availability of resources, technology including research & development adopted and level of integration of operations. CareEdge Ratings evaluates gross margins of an entity, sales realisation net of raw material cost.

Trend of other operating costs of an entity such as power cost, sales cost, employee cost, and logistics cost, among others, is also analysed and all these costs for an entity are compared to industry benchmarks and a judgement with respect to the company's operating efficiency is made. Sufficiency of gross margins to absorb other operating costs and fixed costs is also assessed.

- **Force Majeure events**

The force majeure events such as natural disasters (floods, cyclones, earthquakes, fire etc); political or social upheavals (wars, civil disturbances, strikes etc) are unforeseen and cannot be anticipated. Occurrence of such unpredictable events can severely disrupt an entity's operations and consequently its cash flow generating capabilities. Typically, the issuers/borrowers try to mitigate the impact of force majeure events by availing insurance cover, in-built contractual remedies with counterparty etc. which become available only post-default. Therefore, due to unpredictability around occurrence of such events, the consequent impact of occurrence of such events cannot be factored in the credit risk assessment, as credit ratings principally follow probability of default approach.

C) 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.

CareEdge Ratings' analysis is mainly based on audited accounts of the entity although unaudited accounts are also factored in the analysis.

- **Accounting Quality**

A review of accounting quality and adherence to prudential accounting norms (prescribed by local regulations) are examined for measuring the entity's performance. Accounting policies relating to depreciation, inventory valuation, income recognition, valuation of investments, and provisioning/write-off, among others, are considered. Prudent disclosures of material events affecting the entity are reviewed. Impact of auditors' qualifications and comments are quantified to the extent possible and analytical adjustments are made to accounts, if material. The rating team also endeavours to interact with auditors

to understand their comfort level with the accounting policies, systems and controls within the entity and their assessment of the entity's management. Change of accounting policy in a particular year, which results in improved reported performance is analysed more closely. However, CareEdge Ratings does not conduct an audit of financial statements of an entity and relies on the judgement and financial prudence of auditors.

- **Financial Ratios**

Financial ratios are used to make a holistic assessment of the entity's financial performance and compare it with its peers within the industry. They are not an 'end' in itself but a 'means' to understanding the fundamentals of an entity. CareEdge Ratings follows a standard set of ratios for evaluating manufacturing companies. These can be divided into five categories:

- Growth Ratios
- Profitability Ratios
- Leverage and Coverage Ratios
- Turnover and Liquidity Ratios

For more details on financial ratios please refer to the methodology on 'Financial Ratios-Non Financial sector entities' on CareEdge Ratings' website (www.careratings.com).

- **Cash Flows**

Cash-flow analysis for past performance and future projections forms an important part of credit rating decisions. Cash flow analysis includes evaluating the operating cash flows of an entity. Working capital changes are then adjusted to arrive at cash flow from operations. A negative cash flow from operations may imply a high amount of funds being deployed in working capital requirements and exhibit working capital intensity of operations. Cash flow from investing activities is calculated to assess the entity's investing needs in terms of investment in fixed assets (normal and unplanned capital expenditure such as cost overruns) and financial support to be received/provided to the group entities. Assessment of cash flow from financing activities is undertaken to evaluate the entity's financing avenues (debt/equity), its repayment obligations, lease liabilities, among others.

Adequacy of cash flow from operations to meet an entity's investing and financing needs is evaluated. An entity continuously using cash flow from financing activities, especially debt funds, to meet cash flow from operating activities is not viewed favourably by CareEdge Ratings. Cash flow adequacy is viewed by an entity's capability to finance capital expenditure and support weak group entities, apart from meeting debt servicing requirements. Cash flows from short-term sources and long-term sources are also evaluated and mapped against their appropriate end-use.

- **Liquidity**

Liquidity risk assessment is an integral part of an entity's risk analysis. Liquidity in the form of unencumbered liquid investments consistently or unutilised lines of credit from banks, liquidity support from the group, among others, is viewed positively. Liquidity analysis also encompasses analysing liquidity available to meet working capital requirements. For more details on liquidity risk assessment please refer to the methodology on 'Liquidity Analysis of Non-Financial Sector Entities' on CareEdge Ratings' website (www.careratings.com).

- **Financial Flexibility**

Financial flexibility refers to the alternative sources of liquidity available to the entity as and when required. The entity's contingency plans under stress scenarios are considered and examined. The entity's ability to access capital markets and other sources of funds whenever required is reviewed. As such, steep decline in market capitalisation may impact an entity's financial flexibility and is factored in the analysis appropriately.

Existence of unencumbered liquid investments, availability of support (implied or demonstrated) from strong group concerns to tide over stress situations, timely monetisation of non-core assets, flexibility to defer capital expenditure, availability of consistently undrawn sanctioned banking lines, among others, are considered favourably. CareEdge Ratings does not assume equity fund raising and debt refinancing while analysing ability to repay debt unless funds have already been arranged.

- **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. The critical parameters are then stress-tested to arrive at the performance of the entity in a stress situation. Debt service coverage and interest coverage for each of the scenarios would indicate the capability of the entity to service its debt, under each scenario.

- **Working Capital Analysis**

The working capital analysis encompasses analysing working capital requirements of an entity and strategies adopted to meet these requirements. Components of working capital analysis conducted include:

Debtors

Analysis of debtors forms an important part of the credit risk analysis as an entity may face liquidity issues, if its customers stretch their payments and it is not in a position to finance funds stuck with debtors in a timely manner. Average collection period for an entity is also viewed in relation to industry benchmarks. CareEdge Ratings undertakes a detailed analysis of customers, especially for entities having long collection periods and considers debtor ageing, debtor concentration, reasons for delays in receipts from the customers, and status of disputes with customers, among others.

Inventory

Inventory held by an entity is further broken down for analysis into raw material inventory, work-in-progress inventory and finished goods inventory. Inventory period for each of these components and trend over the years is looked at against the industry benchmarks. Continuously increasing inventory levels, especially finished goods inventory, may hint at slow-moving sales and higher requirement of working capital funds, and thus, will be viewed critically.

Creditors

CareEdge Ratings assesses credit period availed by an entity from its suppliers, raw material sourcing arrangements, supplier concentration, bargaining power with suppliers and pricing flexibility. Creditor days are viewed with respect to industry benchmarks. High creditor days against industry standards are viewed critically, as they may hint at liquidity pressure and resultant stretching of payments to suppliers.

- **Contingent Liabilities**

CareEdge Ratings takes note of contingent liabilities reported by an entity and carries out an impact analysis of possible liabilities devolving on the entity.

- **Foreign Exchange Risk Analysis**

If an entity has dealings in a foreign currency by way of exports, imports, investments, loans, advances or otherwise, an impact analysis of change in foreign exchange rates is conducted to check the impact of adverse fluctuations in foreign exchange rates on profitability and debt servicing capability of an entity. CareEdge Ratings examines foreign exchange risk policy and hedging policy adopted by the entity to mitigate foreign exchange risk, if available.

D) 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 that of its industry peers can provide important insights into its ability to sustain business. Capability of the management to perform under stress provides an added level of comfort. Meetings/discussions with the entity's top management are an essential part of CareEdge Ratings' rating process. Key dimensions of management evaluation include:

- **Track Record**

Track record of promoters/management team and their market reputation are analysed. The management's response to key issues/events in the past such as liquidity issues, competitive pressures, new project implementation, expansions and diversifications, among others, are assessed.

- **Corporate Strategy**

The entity's business plans, mission, policies with respect to expansion, risk management, leverage profile and future strategies in relation to the general industry scenario are considered. An important factor in management evaluation is an 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.

- **Legal Constitution and Ownership Pattern**

An entity's legal constitution indicates level of oversight, and hence, has a bearing on governance and transparency requirements to which an entity is subjected to. Partnerships/proprietorships are subject to comparatively milder disclosures and regulatory requirements than private/public limited companies. Such entities also carry an inherent risk of withdrawal of capital, which is factored appropriately in ratings of partnerships/proprietorship concerns.

Extent of ownership of the promoters in a company signifies promoters' commitment, and hence, an entity having resourceful promoters holding controlling interests is viewed positively. Accordingly, if the company's shareholding is fragmented without a clear majority, it would entail further analysis of commitment of individual shareholder promoters to support it in times of stress. If a significant portion of the company's promoters' shareholding being rated is pledged, it is viewed negatively, as it has a direct bearing on the promoters' resource-raising ability.

- **Performance of Group Concerns**

Interests and capabilities of group concerns belonging to the same management give important insights into the management's capabilities and performance in general. The entity's related party transactions are assessed, while analysing a company. If an entity belongs to a resourceful group and other promoter group entities have exhibited a robust performance, the entity's financial flexibility will be strong. Against this, if other group entities are facing stress and require support, it will be viewed negatively and be accordingly factored into the rating.

- **Organisational Structure**

Assessment of organisational structure would indicate its adequacy in relation to the entity's size and give an insight into the levels of authority and extent of its delegation to lower levels in the organisation. The extent to which the current organisational structure is attuned to management strategy is assessed carefully.

- **Control Systems**

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

systems commensurate with the size and nature of the business enable the management to stay tuned to 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, and attrition rates, among others, are seen in perspective of the nature of business and relative importance of human capital.

- **Corporate Governance**

Extent of transparency in the entity's dealings with stakeholders, financial prudence and compliance with extant laws and regulations is seen closely. The company's effort to go beyond regulations is also viewed positively.

E) Project Risk Analysis

Implementing large projects may involve period of strain on a company's liquidity position. CareEdge Ratings analyses factors such as rationale for implementing the project, project size against current scale of operations and net worth of the company, and funding pattern of the project. CareEdge Ratings also assesses risks involved in implementation, which include aspects such as achievement of financial closure, status of regulatory approvals, agreements entered with equipment suppliers, track record of company/contractors in executing similar projects, project progress against scheduled implementation, cost or time over-runs, project cost against industry benchmarks, among others. This apart, post-implementation risks such as resolution of teething issues, tie-ups with raw material suppliers, arrangements for fuel, tie-ups for sales, marketing arrangements, among others, are also examined by CareEdge Ratings.

In this context, it may be noted that flexibility to defer capital expenditure or implement the project in phases eases the strain on the company's liquidity and is viewed favourably by CareEdge Ratings.

Analysis of Environmental, Social and Governance Risk Factors:

In the last few years, Environmental, Social and Governance (ESG) risks have started gaining importance across the globe and are increasingly influencing investment decisions. Companies may have to incur operational or capital costs towards mitigating these risks. CareEdge Ratings analyses impact of ESG risks on an entity's credit profile by assessing expected impact of these costs on future earnings/revenue/cash flows of entities.

Considerations with respect to ESG aspects are an integral part of assessing credit risk and get addressed under parameters wherever relevant.

Environmental risk:

Environmental considerations are crucial in credit risk assessment, particularly for industries with significant ecological impact. Factors such as emissions, energy consumption, water usage, land use, biodiversity impact, waste management, and by-product treatment are generally considered. Companies operating in highly polluting sectors invest in regulatory compliance, such as pollution control measures and waste treatment facilities, to mitigate potential financial and reputational risks. Businesses may face indirect environmental risks, such as climate-related disruptions affecting supply chains or regulatory changes promoting cleaner technologies.

Social risk:

Social risk would play out prominently in a labour/manpower intensive service industry such as banks and financial services or hospitality where social issues such as employee policies or customer relationships are important factors. Poor labour policies, reputational controversies, or inadequate customer service standards can impact business continuity and stakeholder trust.

Governance risk:

Governance parameters such as transparency, adherence to applicable regulations, public disclosures and costs towards these objectives form part of credit risk analysis. Importance of each risk may vary across sectors. Transparent financial reporting, strong shareholder relations, and adherence to statutory compliance enhance credibility and reduce governance-related risks. Entities with opaque governance structures, inadequate disclosures, or a history of mismanagement may be viewed as higher risk from a credit perspective.

Conclusion

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

[For the previous version, please refer to 'Rating Methodology – Manufacturing Companies' issued in [December 2022](#)]

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About:

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