

[Issued in March 2025]

Background

The services sector is not only the dominant sector in India's gross domestic product (GDP) but has also attracted significant foreign investments, contributed significantly to exports and has provided large-scale employment. This rating methodology primarily covers personnel-based services including professional services including accounting firms, law firms, management consultancy and advisory, security services, support services, IT and facility maintenance services, and logistic services, among others.

Credit analysis of a services sector entity begins with a comprehensive evaluation of the industry in which it operates, followed by an assessment of the entity's specific business risk factors. This is further supplemented by an analysis of its financial risk profile and management quality. Support from the parent company, group, or government (if applicable) is thoroughly examined and factored into the overall rating assessment, in accordance with CARE Ratings Limited (CareEdge Ratings) Criteria on Notching, available at www.careratings.com.

Rating Methodology

A. Industry Risk

CareEdge Ratings' analysis of the industry risk focuses on current industry scenario, demand-supply factors, industry size, key players and competitive factors, cyclicalities and seasonality, associated with the industry, regulatory policies, and tax benefits, among others. Given that these service entities act as service providers for other core industries, their growth prospects and risk exposure are closely linked to performance and stability of end-user industries they cater to. Downturns, structural shifts, or disruptions in these industries—such as evolving business models, regulatory changes, or economic slowdowns—can have a cascading effect on the demand for service-based offerings, impacting revenue streams and profitability. Rapid advancements in technology and automation are fundamentally reshaping industry dynamics, bringing opportunities and challenges. Hence, the extent to which an entity can adapt, and leverage automation will significantly impact its long-term competitiveness and financial stability.

B. Management Evaluation

The business of a service provider is largely influenced by the brand value, which helps in winning consumer confidence and ensuring consumer loyalty. The management evaluation is an important aspect of the rating process, as it provides insights into business strategy and the entity's ability to sustain its business. Parameters on which the management is evaluated include:

- **Track Record**

The 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 service offerings, and diversifications, among others are assessed.

- **Business Strategy**

The entity's mission, vision, policies, business plan and future strategies provide valuable insight into the management's ability to foresee 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.

- **Profile of Management Team and Association with Organisation**

The experience and track record of the management team helps in understanding its preparedness in handling stress scenarios. For entities providing professional services like audit services, consultancy services, etc., the longevity of association of key executives with the organisation 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 senior executives provides a sense of security and stability to the client.

- **Organization Structure**

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

- **Succession Planning**

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

- **Personnel Policies**

Human resource is the most critical asset for a service entity. Personnel policies laid down by the entity would critically determine its ability to attract and retain talent. Depth and diversity of the skill sets available and policies regarding training and enhancing the skills of employees are also evaluated. The entity's employee efficiency and attrition levels are compared to its peers and industry averages. A high attrition rate is likely to adversely impact the execution of projects in terms of timelines and quality of deliverables, and create a negative brand image among customers, which adversely affects repeat business.

- **Control Systems**

Adequacy of internal control systems commensurate to the entity's size is closely examined. Existence of proper accounting records and control systems adds credence to accounting numbers. Management information systems commensurate with 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 stakeholders, financial prudence and compliance with extant laws and regulations is seen closely. Market reputation of the group/entity is also factored in, while assigning ratings.

- **Legal Constitution**

Legal constitution of an entity indicates the level of oversight, and hence, has a bearing on the 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.

C. Business Risk

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

- **Nature and Complexity of Services Offered**

CareEdge Ratings 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 against one-time services such as product development service by an IT firm. Highly complex services are generally high-margin services and are difficult to be replaced by clients of the service provider. As such, more complex and skills or 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 against a facility management service provider.

- **Nature of Service Contracts**

CareEdge Ratings analyses the nature of service contracts signed with clients by the entity. Contractual terms, where 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, CareEdge Ratings views a track record of contract renewals positively.

- **Service Proposition and Market Position**

The services sector is highly competitive, and to operate on a sustained basis and maintain or improve its margins, the entity needs to have a unique selling proposition or add value to the client on an ongoing basis. CareEdge Ratings analyses the entity's business from this perspective and its position in value chain of services offered. Several 'per unit' metrics are analysed by CareEdge Ratings to assess the entity's operating efficiency. In an IT company, billing rates per employee and cost per employee would be important metrics, while in a logistics firm, analysis may be focused on 'yield' or realisation per kg of materials handled. Companies with niche service offerings have a stronger market value as it is difficult to replicate their services considering complexities. A significant market position provides bargaining power to the service provider, which also lets it command a premium for its services. The entity's market position enables it to leverage the brand and establish its position in new service lines with ease and a higher probability of success.

- **Seasonality and Cyclicalities**

The services industry is usually less cyclical in nature due to non-discretionary nature of most services. Seasonality may be prevalent in the services industry due to nature of end-users served by the entity. CARE Rating's ratings aim to be stable across seasons and economic cycles and are arrived at after factoring in 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 their 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 and sustenance in case of high attrition or loss of key clients. Achieving a certain threshold of revenues supports companies in bidding for and winning large contracts through their demonstrated execution track record and resource mobilisation capabilities.

- **Diversification**

Diversification can be in the form of a 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, and provides competitive advantages and ensures stable profitability. If

an entity offers different services, each such business segment would be analysed separately. Diversified revenue streams also insulate entities from technological disruptions in 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 business segments. If majority revenue is from a particular industry, then the industry's performance is also considered.

Diversification in terms of geographical presence and number and type of clients is also critical. 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 realisations and subsequent liquidity stress making the analysis of its working capital management critical. CareEdge Ratings also evaluates top clients of the entity for their overall credit quality. A marquee client base reflects the entity's service quality, ensures timely payments and supports business sustainability.

Geographical diversification also helps in case of loss of business or temporary disruptions in individual markets, where the entity operates. In case of IT services, presence of offshore development centres and their geographical diversity provides uninterrupted services to companies across time zones and against unforeseen calamities.

- **Exposure to Overseas Markets**

It is common for service entities to offer services overseas due to huge outsourcing demand from western countries. In case of such entities, which are engaged in providing offshore services in other countries, such as 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 against entities that are present in domestic markets alone. The entity's net foreign currency exposure and its hedging policy are also evaluated by CareEdge Ratings.

- **Cost Structure**

Major costs for a service entity are the employee cost and IT infrastructure costs, which are analysed to understand trend in profitability margins. Cost of employees vary based on their education and background, attrition rate, training costs, and incentive structures. Companies that have a larger proportion of variable cost employees would have better control over costs in an event of a decline in demand or loss of a service contract against an entity that may have to bear high fixed costs. However, higher variable costs may also lead to higher attrition rates, which may add to training costs. A judicious mix of employees is critical to control costs for a service provider. Nature of the technology used, and IT infrastructure influences the entity's cost structure. Entities that offer services involving access to confidential information from clients, need to invest well in IT security systems and MIS systems. As such, analysis of cost of upgrading and recurring maintenance of IT infrastructure is critical to analysis of the entity's cost structure. Lease or rental expenses for office space can be a significant overhead, particularly for entities operating in prime business locations, impacting their overall cost structure and profitability.

- **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.

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. A review of accounting quality and adherence to prudential accounting norms (set by local regulations) are examined for measuring the entity's performance. Accounting policies relating to depreciation and amortisation of intangible assets, income recognition, valuation of investments, and forex transactions, among others are also factored. 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 the accounts, if material. The rating team also endeavours to interact with auditors to understand their comfort level with accounting policies, systems and controls within the entity and their assessment of the entity's management. Off-balance sheet items are factored into financial analysis and adjustments are made to 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 the entity's financial performance, and to see its performance against its peers within the industry. They are not an 'end' in itself but a 'means' to understanding the fundamentals of an entity. Some important financial ratios include:

A) Growth Ratios:

Trends in growth rates of an entity against 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, profit before interest, lease rentals, depreciation, and taxation (PBILDT) and profit after taxes (PAT).

B) Profitability Ratios:

Capacity of an entity to earn profits determines the protection available to the entity and control over its cost structure. Profitability reflects the final result of business operations. Important measures of profitability are PBILDT, operating and PAT margins, return on capital employed (ROCE) and return on net worth (RONW). CareEdge Ratings also evaluates capitalised expenses incurred by the entity for developing Patents or Intellectual Property (for instance Software) and future potential to generate profits from such investments. Profitability ratios are not regarded in isolation but are seen in comparison with peers and industry segments in which the entity operates.

C) Leverage and Coverage Ratios:

In the services industry, debt mainly consists of working capital borrowings and/or non-fund-based limits such as performance bank guarantees. As service entities are asset-light businesses, long-term debt present on the balance sheet of these entities is generally insignificant. As such, overall gearing ratio and interest coverage are major ratios analysed in a service entity. Debt as a proportion of cash accruals and debt service coverage ratio (DSCR) would be important in case an entity has availed long-term debt to measure the degree of leverage used against 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.

For more details on financial ratios please refer to the methodology on 'Financial Ratios Non-Financial Sector Entities' on our website (www.careratings.com).

- **Working Capital Cycle Management and Financial Flexibility**

A service entity does not have significant inventory, and its working capital management mainly relates to receivables management. Debtor ageing schedule and possible risk of bad debts is evaluated. CareEdge Ratings also evaluates the entity's customer exposure to Government organisations, where the risk of an elongated payment cycle is relatively higher. As employee salaries form a major portion of the operating costs and entities have limited flexibility to defer these expenses, it is crucial to maintain necessary liquidity. 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 cash flow mismatches and as such its financial flexibility is also assessed. Financial flexibility refers to alternative sources of liquidity available to the entity, when required. The entity's sanctioned bank limits and its average utilisation, ability to access capital markets and other sources of funds, whenever required, are reviewed. Existence of liquid investments, availability of support (implied or demonstrated) from strong group concerns to tide over stress situations, among others, are considered favourably.

- **Validation of Projections and Sensitivity Analysis**

The entity's projected performance in the life of an instrument is critically examined and assumptions underlying projections are validated. Critical parameters affecting the industry and its anticipated performance are identified. Each critical parameter is further stress-tested to arrive at the entity's performance in a stress situation.

- **Contingent Liabilities**

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

- **Foreign Exchange Risk Analysis**

For service sector entities having global clientele or other global exposure, 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 considers the foreign exchange risk policy and hedging policy adopted by the entity to mitigate foreign exchange risk, if available.

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 its future earnings/revenue/cash flows.

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

Environmental risk:

Environmental risks for personnel-based service sector entities, though less direct than in industrial sectors, still play a role in assessing credit risk. Probable concerns may include energy consumption, which contributes to carbon emissions and operational costs. Frequent upgrades of technological infrastructure generate significant e-waste, necessitating proper disposal and recycling to comply with environmental regulations and avoid reputational risks.

Social risk:

Social risk would play out prominently in a labour/manpower intensive services industry, 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. Rating determination is a matter of experienced and holistic judgment, based on relevant quantitative and qualitative factors affecting credit quality of the issuer.

[For the previous version please refer to 'Service Sector Companies' issued in [December 2022](#)]

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