

Background

The Indian Education system can be broadly classified into three categories: 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 and coaching classes. Vocational studies refer to parallel education system, which involves imparting skills to compete in business environment. The formal education segment in India is regulated at state and central levels, while 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 schools, colleges and universities. The sector has also shown high growth potential. 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. There are some 'for profit' companies, which are engaged in managing operations of education sector entities, which own the education infrastructure, in return for agreed charges, and hence are also indirectly exposed to risks related to the education sector.

Rating Methodology

CARE Ratings has a well laid out methodology for rating of entities belonging to the service sector. CARE Rating's rating process begins with evaluation of the economy/ industry in which the entity operates, and assessment of specific business risk factors. This is followed by an evaluation of financial and project-related risk factors and quality of the management. This methodology is adopted while analysing all entities that come under the purview of the service sector. However, considering the size and diversity of each sector, CARE Ratings has developed methodologies specific to sectors. These methodologies attempt to point out factors, above those mentioned in the broad methodology, which will be assessed while determining rating of entities belonging to the particular industry. Following is a list of such additional factors, and their analytical implications, considered by CARE Ratings while arriving at the rating of players operating in the education sector.

A. Management Risk

Experience and resourcefulness of promoters: CARE Ratings considers relevant experience of promoters in the education sector and their competence as an important factor for successful running the institution, promoters' resourcefulness and their capability to financially support operations is also a key factor considering the long gestation period involved in educational institutions.

B. Business Risk

Track record and reputation of institution: CARE Ratings believes that operational track record and reputation of institution helps in attracting students and ensures pricing flexibility, subject to regulations. These factors also provide competitive edge to institutions over competition.

Trend in enrolment/enrolment ratio: Enrolment ratio, the ratio of actual intake to sanctioned intake, indicates the ability of an institute to attract students or demand for courses offered by the institute. A higher enrolment ratio indicates higher utilisation of available capacity. Apart from reflecting the demand for courses offered, this is also likely to result in relatively high return on capital employed. CARE Ratings believes that a

consistently high enrolment ratio indicates better stability in revenue streams. Apart from this, the trend of overall student strength is also analysed.

Nature and diversity of courses offered: While specialisation in a particular course with high enrolments is positive, it exposes the institution to the risk of higher dependence on single course. Having diverse course offerings through single or multiple institutes mitigates the risk of dependence on performance of single course by providing cushion in terms of slowdown in demand for courses. Hence, entities with diversified revenues stream and/or with highly stable revenue stream are better placed compared to others. As such, revenue and cash accruals of entities in education sector are generally less volatile. However, the ability of institutes to adjust pricing and intake capacity of low enrolment courses and introduce new courses basis the demand is important as it reflects operational flexibility and higher utilisation of infrastructure and resources of the institution, supporting its income and surplus.

Relative size of the entity: CARE Ratings considers an entity with relatively larger size to be better placed to absorb fixed costs including administrative overheads, and advertisements, among others. Factors such as presence in multiple locations and geographical diversification are seen positively as they mitigate region-specific risks and provide them access to student population in other geographies.

Placement track record: While CARE Ratings analyses factors such as number of applications received against available seats and enrolment ratios to indicate standing of the institute among the student community and effective utilisation of available capacity respectively, the track record of placements, wherever applicable, is also considered as an indicator of employability/industry readiness of students graduating from the institute. CARE Ratings also believes that a preference among students for colleges with good placement track record (in terms of number of students placed and quality of placements) provides sustainability and revenue visibility.

Quality and availability of faculty and infrastructure: All colleges are required to maintain specified standards and norms with respect to teaching faculty across the hierarchy including student-teacher ratio. In respect of certain courses, availability of good quality faculty is one of the challenges faced by the industry. Generally, medical colleges and coaching institutes are required to offer higher salaries to recruit and retain good quality faculty. The institution's physical infrastructure and facilities provided apart from its ranking are also considered. Its ability to deliver education services through other online/offline modes, such as online teaching, delivering off-campus lectures, among others, ensure smooth working in case of disruptions in operations of its physical infrastructure.

Trend/Stability of revenue: CARE Ratings considers well-established institutes with good track record of enrolment and entities with relatively diversified courses positively, as they offer stability in revenue. Alternate sources of revenue apart from tuition fees, such as hostel fees, transportation fees, mess fees, among others, are also analysed.

Surplus: The trend in surplus margins against capital deployed is an important factor impacting debt servicing ability of educational institutes. With majority cost of an educational institution being fixed, stability in margins is important. With increase in expenses, it is important for entities to maintain surplus margins through timely revision in fees and other charges subject to regulations without adversely impacting enrolments. Ability of the education institutes to reduce their overheads also play a crucial role in maintaining its surplus margins.

C. Regulatory Risk

Education is in the Concurrent List of the Indian Constitution, where state and central governments have powers to regulate the sector. Formal education sector is one of the highly regulated sectors with state and central government, regulating the industry directly and/or indirectly through bodies including University Grants Commission (UGC) and All India Council for Technical Education (AICTE). UGC was established for the coordination, determination and maintenance of standards of university education in India. AICTE was established for proper planning and co-ordinated development of technical education system in the country. Other Government bodies such as Central Board of Secondary Education, National Medical Commission, Bar Council of India, Indian Nursing Council, Dental Council of India, among others, are responsible for regulation of institutes offering courses in their respective domains. The scope of government regulations is wide, starting from establishment of course/institute, intake, seat sharing, fee fixation and periodical review of the standards followed by the institute. CARE Ratings considers regulatory risk to be an important factor governing the entire Education sector. CARE Ratings also takes into cognisance the impact on operational performance of institutions owing to external factors arising from regulatory challenges such as delays in conducting entrance exams, counselling sessions among others.

Status of institute (Affiliated/Autonomous/Private University/Deemed to be University): CARE Ratings considers the status of an institute to have significant bearing on its operational and financial flexibility. Degree of autonomy is higher in the case of Deemed to be Universities, Private Universities and Autonomous Institutes. However, colleges 'affiliated' to a particular university are required to follow 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 quality of faculty and teaching methodology only. Colleges which have operational autonomy are in a better position to review types of courses offered, syllabus and examination standards periodically. This operational autonomy helps them 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 helps the institute to maintain higher academic standards and competitive market position, leading to higher demand for its courses.

Seat sharing and fee fixation: Each state has its own policy to regulate 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 surplus and revenue. In respect of the fee charged for management quota of non-aided private colleges also, the fee is fixed by state level committees. State governments have introduced legislations to control fees being charged by private schools in their states, which has restricted pricing flexibility of these schools, putting pressure on their cash flows. As such, CARE Ratings considers colleges having autonomous status and colleges under deemed universities to be better placed, as they are not required to share seats and can fix their own fee.

Risk related to non-renewal of courses and reduction in seats: Regulatory authorities have the power to give approval for renewal of courses and decide number of seats. For example, in the past, AICTE had reduced number of engineering course seats considering lower enrolments in engineering colleges. Accordingly, CARE Ratings factors risk of non-renewal of courses by regulatory authorities, which can impact cash flows of educational institutions in the short-term. However, this risk gets mitigated to some extent in case of those entities offering multiple courses and whose revenue does not depend on a single course.

Right to Education Act: As per the Right to Education Act, all private and minority schools are required to reserve 25% of seats to specified segment of students and their fee will be reimbursed by the central and state government. CARE Ratings analyses the entity's ability to mitigate its impact on surplus/profit margin and risks of delayed reimbursement of fee from the government, as one of the key factors considered while assessing the credit risk.

Corporate structure/Constitution: Most entities in the education sector are registered as Trusts/Societies under state or central government Act. While corporate entities follow standardised accounting norms which are 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. Accounting norms followed by these entities are also factored in while assessing credit risk, which also requires suitable adjustments to be made in the analysis. Impact of exposure to group entities/unrelated entities is also analysed by CARE Ratings.

To get tax exemption, entities (which are constituted as trusts/societies/Section 8 companies) are required to use 85% of gross receipts towards the objective of the society/trust. While permitted use includes regular operating expenditure, interest and principal repayments, given that most educational institutes generate relatively high surplus margin, there is need for continuous capex resulting in cash outflow that otherwise would have been available in the system to reduce leverage and improve its liquidity position.

CARE Ratings believes that the government regulation on aspects of the formal education sector have a major impact on the credit risk profile of entities.

D. Financial Risk

Seasonality associated with cash flow of education institution: Cash inflows of most educational institutions are relatively skewed, as tuition fee is collected annually/semi-annually/quarterly/monthly. 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 institutes plan their repayments in such a way that they coincide with fee collection and surplus funds are parked in liquid investments to meet operating expenditure in rest of the year. Unutilised bank limits (if available) also provide cushion for meeting expenses in case of contingencies. While cash flow management is of greater importance, traditional liquidity ratios are not meaningful while analysing most educational institutes. As the fee is collected in advance or within 2-3 months of beginning of the academic year or semester, typically receivables of educational institutions are almost negligible or relatively low. However, CARE Ratings believes that the ability to timely realise dues from existing batches and generate revenues from the new batches in case of adverse circumstances is crucial.

In respect of courses offered to students sponsored under schemes of government, receipt of money (reimbursements from government) in timely manner is crucial due to procedural aspects involved. The extent of contribution to total income of the institute and mitigation plans for managing cash flow mismatches arising are also examined while rating entities in the education sector. CARE Ratings also considers timely receipt of grants and donation by institutes, which receive regular financial aid from Government and other entities for funding expenses and capex programmes, as crucial.

Need for continuous capital expenditure: Considering available infrastructure in terms of number of seats and courses offered, entities involved in offering education services need to carry out continuous capex for expanding seating capacity and improve existing infrastructure to ensure growth in revenue. While fulfilling this obligation, effective planning of financing based on existing and future cash flow and future debt servicing is key to maintain/improve the financial position.

E. Analysis of Environmental, Social and Governance (ESG) Risk Factors:

In its overall credit rating framework, CARE Ratings analyses critical ESG risks and their impact on the entity's credit profile. CARE Ratings analyses materiality of ESG risk factors and mitigating factors being implemented by the entity.

Environmental risk

The education sector has low exposure towards environmental risks. However, educational institutions are now focusing on minimising their environmental footprint by adopting energy-efficient technologies, waste reduction practices, and sustainable transportation methods.

Social Risk

Education holds a high position on the social scale. However, practices that could impact quality or reputation of education, given its sensitivity as a social sector, must be carefully monitored. Adverse events such as strikes, student unrest, and unfair practices can negatively affect social responsibility standing of educational institutions.

Governance risk

As compared to Environmental and Social risk factors, which primarily arise from external influences or industry trends, Governance risk is more closely associated with internal factors. Most educational institutions in India are constituted as trusts or societies, as required by the law. This structure can sometimes lead to governance issues, if there is a lack of transparency or accountability in the management of the trust's activities and finances. Academic councils or Board of Studies are responsible for maintaining academic standards and curriculum development. Governance risks arise if these councils and boards are not functioning effectively, leading to outdated or irrelevant curricula, and poor academic quality. Maintaining academic integrity is also a crucial aspect. Examinational malpractices, including paper leaks, can undermine the institution's credibility.

By embracing ESG principles, educational institutions can enhance their reputation, attract and retain students and staff, and contribute positively to the society and the environment.

Conclusion

Thus, 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 they operate. Factors such as need for continuous capex and effective management of cash flows are important from a financial risk perspective. CARE Ratings considers all these to analyse the education sector.

[For previous version please refer 'Rating Methodology – Education Sector' issued in [September 2022](#)]

CARE Ratings Limited

Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022
Phone : +91 - 22 - 6754 3456 | CIN: L67190MH1993PLC071691

Connect :



Locations: Ahmedabad | Andheri-Mumbai | Bengaluru | Chennai | Coimbatore | Hyderabad | Kolkata | Noida | Pune

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