



## Rating Criteria for Services Sector

### **Executive Summary:**

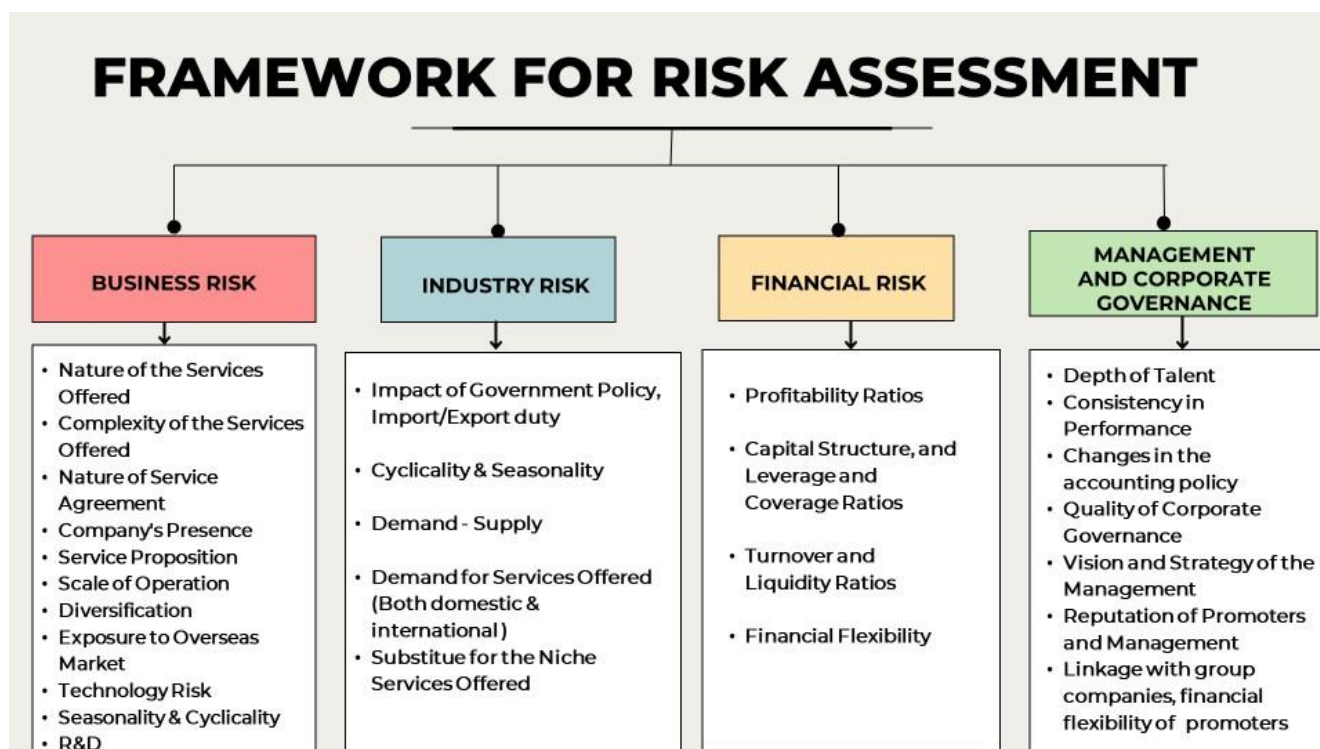
The services sector is the key driver of economic growth in India. The Indian government has recognised the importance of service sector entities, these functions as a process improvement facilitator/ service provider/ requirement facilitator. India's services sector covers a wide variety of activities such as retail, hospitality, logistics, communication, audit firms, information technology, BPO, KPO, business services, community, social and personal services and travel & tourism amongst others.

Services sector growth is governed by both domestic and global factors. The Brickwork Ratings (BWR) criteria for the Services Sector provides a framework for assessing creditworthiness and financial health of companies operating within the services industry. The rating methodology considers both sector-specific factors and broader economic and financial elements to determine an entity's ability to meet its financial obligations.

### **Scope of the Criteria**

The document provides a brief analysis of the various attributes considered by Brickwork Ratings (BWR) in the rating of the entities falling under the purview of the services sector. The risks are primarily defined in broad risk parameters of Business, Industry, Financial, and Management risk. This methodology aims to provide investors and stakeholders with a clear understanding of the risks and opportunities associated with the entity. The primary risks and the way in which they are incorporated in the rating framework are detailed in the below mentioned section (Risk assessment and methodology).

## Risk Assessment and Rating Methodology:



BWR framework for services entities covers the assessment of business risk, industry risk, financial risk and management risk (Refer to the General Criteria available on BWR website for more details) in General Criteria. In addition, depending on the type of services industry, sector-specific factors are also taken into consideration. The criteria for parent/group/ government support are also addressed wherever applicable (separate criteria available on the BWR website).

### A. Business Risk Analysis:

Business risk focuses on an entity's ability to sustain its business and have consistent cash flow over the long run. It includes risks related to the environment that the entity operates in, which affects its turnover, margins, position within the industry and operational efficiencies, along with the relationship between the client and suppliers or buyers. BWR evaluates the long-term stability and sustainability of the business. Detail parameters mentioned below:

- **Nature of the Services Offered:** The nature of the services offered plays a crucial role in assessing the business risk within the services sector. Different service industries come with unique risk profiles /that affects their competitive positioning, revenue stability, and ability to withstand external shocks, such as economic downturns, technological disruption, or regulatory changes.

Service Tie-Ups are often central to the nature of services offered in sectors like hospitality, healthcare, and travel. Through these partnerships, service providers can offer specialized offerings or packaged services, increasing customer satisfaction and increasing their clientele. Nevertheless, any change in conditions or a failure to maintain solid connections with these service partners might present operational risks, have a detrimental effect on service delivery, and possibly jeopardize the stability of the company.

In order to guarantee dependable service delivery, it is important to consider the strength of the service

channel, infrastructure, relationship age, and logistics. Robust service channels, efficient logistics, and strong infrastructure allow for seamless operations and reduce interruptions. Stability and risk reduction are further improved by long-term, high-quality partnerships with important partners. Operational inefficiency, elevated business risk, and consumer discontent might result from disruptions in these areas.

- **Complexity of Services Offered:**

Highly complex services are generally high-margin and are difficult to replace by the service provider's clients. 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 a possibility of substitution by other technology-driven products. Recurring services such as business support services, Operations and Management (O&M), provide more stability in terms of revenues to the service provider entity than one-time services.

- **Nature of Service Agreement:**

Generally, entities enter into long-term contracts with the entities that enjoy various benefits. Depending on market conditions, such agreements may be favourable to entities or otherwise, which BWR assesses carefully. BWR analyses the service provider's concentration risk arising out of a limited number of customers or when the entity must rely on spot services to cater to its customer commitments, exposing it to the price volatility risk. Customer concentration is viewed as limiting bargaining power for the entity.

- **Market Position/Entity's Presence:**

A stronger market position gives an entity bargaining power among its suppliers and customers. BWR assesses in detail, factors such as market share, reputation, brand recognition, and demand and supply scenario, operational parameters such as billing and cost per employee, number of hours billed, contributing to a market position that would help an entity profitably. The higher the entity in the value chain, the higher its brand value and bargaining power. Invariably, the size of the entity plays an important role while assessing its market share.

Brand linkages are essential for defining a company's market position. A powerful, reputable brand affects a company's total market presence and helps set it apart from rivals. Good brand connections can boost competitive positioning, increase consumer loyalty, and support company expansion. Conversely, a company's reputation, market appeal, and business risk can all be negatively impacted by weak or irregular brand links. Therefore, in order to properly manage business risk, brand connections and market position are closely related.

- **Scale of Operation:**

Large entities operate on a greater scale, giving them an advantage in negotiating contract terms with customers, including pricing, duration, and the selection of materials. Generally, large entities do not get affected in cases of loss of scale due to their superior margins and ability to attract a wider customer base as compared to their competitors.

Furthermore, large businesses may swiftly modify operations to satisfy fluctuating demand because to capacity flexibility, which guarantees reliable service delivery and lowers operational risks. They have an edge over smaller rivals because of their effective scaling up or down, which enables them to adjust to changes in the market.

- **Service Proposition:**

The service provider must have a unique selling proposition and certain value-added services to existing or prospective customers. BWR analyses the entity from the perspective of its service and its position in the value chain of services offered.

- **Geographic Diversification:**

Entities that have diversification in terms of products and geographical locations are looked at favourably as they help minimise the demand–supply gap, concentration risk and loss of sales due to region-specific economic issues. A well-diversified portfolio further ensures the stability of cash flows and limits dependence on a few customers for sales. Additionally, diversification of clientele aids in managing

working capital, particularly when the entity engages with government or government agencies.

- **Exposure to Overseas Market and Foreign Currency Risk:**

For the service providers that cater to their overseas clients, their operations or margins tend to get affected because of unavoidable factors such as government policies in those geographies, legal policies and exposure towards foreign exchange fluctuation risk and foreign currency exposure. Such risks are factored in the rating process as against entities that are present in domestic markets alone. In the case of a services entity dealing in foreign currency on account of exports-driven revenues in foreign currencies, an impact analysis of the change in foreign exchange rates is conducted to check the impact of adverse fluctuations in foreign exchange rates on an entity's profitability. Businesses that have a stated hedging policy with an appropriate mechanism in place towards short- and long-term exposures are less exposed to foreign currency risks. The strategy of the services entities for risk mitigation through consistent forex hedging policies such as the hedging of such exposure through derivatives contracts or through natural hedging are studied as necessary.

- **Diversity of client Profile:**

As for any entity, having established relationships with large clients ensures generation of repeat business, and it also provides cash flow stability. High prospects of repeat business and long-term relationships with clients helps assess the entity's execution track record. Additionally, the addition of new clients, customer base, quality of clients, past trends as compared to its peers, and capabilities and service offerings highlight the entity's business risk profile.

- **Technology Risk:**

As service industries increasingly depend on digital platforms, automation, and data-driven solutions, technology-related risks have grown, impacting operational efficiency, data security, and competitiveness. BWR assesses these risks by evaluating technology complexity and its alignment with industry standards.

- **Seasonality and Cyclicity:**

Service sector entities are less dependent on seasonality and cyclical nature, as most services are non-discretionary in nature. Seasonality can be prevalent where the entity is serving the end customers. This may cause uneven cash flows during different points in time of the year and those entities are likely to be more vulnerable to cyclical downturn. That said, the sustenance of cash flows over the longer term remains the basic premise of the rating.

- **Human Resource Policy:**

Managing human resources is the most important asset for any services entity. The knowledge base and diversified skill sets of the employees provide an edge over its competitors and the entity's ability to offer more services. The entity's human resource policies play a critical role towards retaining its pool of talent, training, skills enhancement and attracting new resources. Further, delegation of power, control mechanism, and escalation matrix emanate confidence in the entity's service quality. BWR assesses the entity's attrition level vis-à-vis its competitors and level of asset utilization for its project execution.

## **B. Industry Risk:**

Industry risk is identified from factors such as the current industry scenario in terms of demand and supply, competitive landscape, demographic presence, dependence on the global market, capital intensive nature of industry and barriers to entry. BWR uses the understanding of the key factors affecting the industry through extensive research and a broader view of evaluating multiple entities in a particular industry. The methodology looks at determining the degree of competitiveness of the industry with a higher degree of competitiveness leading to greater risk towards the business of the rated entity. Additionally, factors such as dependence on government and regulatory intervention can have a significant impact on the way a particular industry is viewed.

Apart from regulatory factors, BWR assesses the impact of technological changes, resource availability, cyclicity & seasonality, demand-supply scenario, price trends, peer comparison, investment plans of the major players in the industry and availability of substitutes to measure the industry risk.

BWR largely assesses the industry based on the below mentioned factors however may include other industry specific metrics wherever applicable.

**Impact of Government Policy:** Government policies can influence the cost structure, profitability, and competitive dynamics of businesses, directly affecting their ability to operate efficiently, expand, and remain profitable. While favorable policies can drive growth and reduce risks, unfavorable trade barriers or regulatory changes can introduce substantial challenges, such as increased costs, limited market access, or disruptions to service delivery. BWR assesses the impact of government policies and strategic planning for potential changes, which is essential for minimizing industry risks and ensuring long-term sustainability.

**Cyclicity & Seasonality:** Entities in service industries must carefully monitor economic cycles, seasonal trends, and industry-specific fluctuations to manage risks effectively. Strategies such as diversification, flexible pricing, seasonal staffing, and financial buffering can help mitigate these risks and ensure sustainable growth, even in the face of cyclical or seasonal demand changes.

**Demand – Supply:** Managing the balance between demand and supply is crucial to mitigating risks in the service sector. Entities must carefully assess factors such as market competition, economic conditions, customer preferences, and operational capacity to anticipate fluctuations and avoid service delivery bottlenecks or demand shortfalls. BWR analyses regional and nationwide demand supply while giving ratings to an entity.

**Demand for Services Offered (Both domestic & international):** Understanding and adapting to domestic economic conditions, shifting consumer preferences, regulatory changes, and global market trends are crucial to managing risks. Service providers must also consider external factors such as geopolitical events, exchange rates, and technological advancements to ensure they are well-positioned to meet both local and international demand.

**Substitute for the Niche Services offered:** The availability of substitutes for niche services is a key factor in industry risk. Alternatives threaten market share when they provide comparable demands more affordably, conveniently, or with improved technology. In order to guard against the decline in demand and profitability brought on by replacements, service providers need to innovate and set themselves apart.

## C. Financial Risk:

BWR assesses an entity's financial risk through the evaluation of the previous and projected financials, particularly the availability of cash flow and debt servicing capability.

BWR also carries out sensitivity analysis on some key variables as identified on a case-to-case basis and the general industry the entity is operating in to assess the impact on the financials. For a more detailed description of ratios, please refer to BWR's Approach to Financial Ratios. Services entities are usually cash rich with adequate amounts of cash flow to fund their working capital cycle and maintenance and capital expenditure. An entity's higher cash flow through operations denotes stronger debt servicing ability and is an indicator of an entity's ability to efficiently manage its suppliers and debtors. The resultant leverage and coverage ratios ascertain the ability to pay off debt obligations. The following are some key ratios that BWR assesses to rate services providing entities:

- **Profitability Ratio:**

BWR assesses the operating and profitability margins, and returns on capital employed to assess the entity's ability to generate internal accruals and attract external capital and withstand adverse business situations. Better margins are reflective of the entity's competitive position, cost competitiveness and indicate the demand for services offered in the market.

<b>Profitability Ratio</b>	Revenue Growth
	Operating Margin
	PBT Margin
	PAT Margin
	ROCE

- **Capital Structure, and Leverage and Coverage Ratios:**

The entity's debt levels, and the leverage ratios help in assessing their ability to pay off debt obligations. The leverage ratios determine the level of debt incurred by the business relative to either the equity or assets of the entity. The interest coverage indicator reflects the entity's ability to fund its borrowing cost after meeting operating expenses.

<b>Leverage &amp; Coverage Ratio</b>	Debt/Equity Ratio
	Interest Coverage Ratio
	Total outside liabilities / tangible net worth
	Debt Service Coverage Ratio

- **Turnover and Liquidity Ratios:**

These ratios help identify risks related to the entity's working capital management, cash availability and liquidity position. Generally, a services entity is asset light, has short-term debt and its working capital management revolves around its ability to maintain its receivables position i.e. realisation rates, limiting bad debts etc. Further, BWR assesses the liquidity position by analysing the current ratio, unencumbered liquid investment, free cash flow available with the entity and the utilisation of bank limits.

<b>Turnover and Liquidity Ratio</b>	Receivable Days
	Payable Days
	Current Ratio
	Quick Ratio
	Cash to Current liabilities

- **Financial Flexibility:**

It defines the entity's ability to raise funds or alternate sources of funding availability in case need arises. In the case of a stress scenario, the entity's ability to raise funds determines its strong financial position. Some factors seen positively while assessing the entity's track record include access to banks/capital markets, the availability of parent support, availability of bank undrawn limits and the timely monetisation of non-core assets.

A longer Receivables cycle can cause liquidity issues and increase borrowing costs, while faster velocity improves liquidity, reduces disruptions, and strengthens financial stability. Efficient receivables management minimizes risk and ensures smooth operations.

## D. Management Risk:

A strong, dedicated and highly experienced board of directors/key management helps the entity achieve its profitability and operating efficiency targets and helps improve the entity's financial and liquidity position. The presence of Skilled Human Resources and Subject Knowledge Experts within the management team enhances decision-making and service delivery, ensuring the company stays competitive and responsive to market changes. BWR assesses the consistency of performance demonstrated by the management and the quality of corporate governance adopted by the entity. Additionally, BWR also assesses entity's accounting quality and declaration of financial statement while

assessing the key risks and performance.

A strong, dedicated and highly experienced board of directors helps the organisation achieve its profitability and operating efficiency targets, and helps improve the entity's financial and liquidity position. Red flags, if any, highlighted by internal or external stakeholders, would negatively reflect in the rating.

The financial flexibility of the management, tested by the empirical evidence of successfully supporting the group entities, past track record of successfully running services businesses, and quality of corporate governance practices followed by the entity, are factored in while assessing the entity's overall credit profile.

In addition to this, the management's track record of timely repayments, meeting all statutory requirements and level of corporate disclosure also determine the view on the transparency.

In addition to the mentioned risks above, BWR also believes Environmental, Social and Corporate governance (ESG) risks and opportunities can increasingly have an impact on the operations and sustainability of business of an issuer. Hence, BWR while assessing the credit profile also assesses the ESG profile of the issuer based on data availability. It may be noted that the impact of the ESG profile of the issuer, both in terms of its strengths and weaknesses, are incorporated in the various management risk related parameters while assessing the credit risk associated with the issuer entity.

## **Conclusion:**

BWR analyses each of the above parameters after measuring the impact of each of the above-mentioned risks and attributes, along with financial projections over the next couple of years or the life of the facility to arrive at the overall assessment of the credit quality of a service provider entity. The methodology comprises the comprehensive analyses of various risks associated with the regulatory aspects, financial risk, industry, operational and business risk while arriving at the overall rating.

*The previous version of this document can be found in  
<https://www.brickworkratings.com/download/Criteria-ServicesSectorUpdated.pdf>*

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