Rating Criteria for Services Sector

Executive Summary:

The services sector is the key driver of economic growth in India. Not only is it the dominant sector contributing to India's GDP, but has also attracted significant foreign investment flows, contributes significantly to exports and provides large-scale employment.

The sector 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, insurance, information technology, BPO, KPO, business services, community, social and personal services, construction services, healthcare and travel & tourism amongst others. Services sector growth is governed by both domestic and global factors.

The Indian government has recognised the importance of service sector entities and has offered various incentives towards sectors such as healthcare, tourism, education, engineering, communications, transportation, information technology, banking, finance, and management to promote growth in these sectors, as well as to help them boost the Indian economy.

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 risks on which the entity's ability to generate cash and service its debt obligations are ascertained.

Risk Assessment and Methodology:

BWR framework for services entities covers the assessment of business risk, industry risk, financial risk and management risk, applying the standard criteria defined in our Rating Criteria documents on Manufacturing Companies and Trading Companies and General Criteria. In addition, depending on the type of the services industry, sector-specific factors are also taken into consideration.

Business Risk:

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 assesses the stability and sustainability of the business.

1. **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), provides more stability in terms of revenues to the service provider entity than one-time services.

2. **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 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.

3. **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, no. of hours billed, contributing to a market position that would help an entity profitably. 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.

4. **Scale of Operation and Service Proposition:**
   Large entities have a large scale of operation. Such entities also have an upper hand in bargaining with customers in terms of contract agreement terms such as pricing, duration and materials to be used. Generally, large entities do not get affected in cases of loss of sales due to their superior margins and ability to attract a wider customer base as compared to their competitors. 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.

5. **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. Further, diversification in clientele helps in working capital management, especially if the entity deals with government/ government agencies.

6. **Exposure to Overseas Market and Foreign Currency Risk:**
   Most service providers cater to their overseas clients. The operations or margins of such entities 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 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.

7. **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.

8. **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.

9. **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 provides 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.

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. Furthermore, the risk increases when the entity has a high dependence on government initiatives and the regulatory environment for its growth and cost competitiveness. Apart from regulatory factors, BWR assesses the impact of technological challenges, resource availability, price trends, peer comparison, gross margins and the availability of substitutes, to arrive at the rating of the service provider entity.

Financial Risk:

BWR assesses an entity's financial risk through the evaluation of the previous and projected future 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 its 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. Following are some key ratios that BWR assesses to rate services providing entities:

1. **Profitability Ratio:**
   Notwithstanding the sales volumes of the rated entity, BWR assesses the operating and profitability margins and return 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 also indicate the demand for services offered in the market.

2. **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. On the other hand, strong capital structure determines its ability to raise funds from alternate sources in case need arises. The interest coverage indicator reflects the entity's ability to fund its borrowing cost after meeting operating expenses.

3. **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.

4. **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.

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. BWR assesses the consistency of performance demonstrated by the management and the quality of corporate governance adopted by the entity as also the performance of other group concerns. 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.

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
www.brickworkratings.com/download/Criteria-ServicesSector.pdf

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