Rating Criteria – Rating of Manufacturing Companies

Executive Summary

The Indian manufacturing industry mainly consists of sectors such as automobile, food and agro-based products, drugs and pharmaceuticals, textiles, chemicals and chemical products, consumer goods, construction materials, engineering products, metals and metal products, machine tools industry, transport equipment, electronics, miscellaneous manufacturing and diversified manufacturing. Of these, the highest FDI equity inflow, between April 2020 and September 2020, was seen in the automobile industry, followed by cement, drugs and pharmaceuticals.

However, the sector suffered a huge setback since the onset of the coronavirus pandemic, which halted its growth and thus, its contribution to the GDP. At present its gross value added (GVA) estimated at $348.53 mn (at current prices) as of FY21 and accounts for 19% of India's real gross value added. Demand-side (reduced investment due to an increase in future uncertainty, a reduction in consumption due to the loss of wages/incomes, reduced demand for non-essentials) and supply-side (the reverse migration of migrant laborers and inability to work from home, among other factors) shocks badly affected the performance of the sector, which was already dealing with challenges, including the lack of skilled workforce, limited access to low-cost finance and regulatory burden; the pandemic further added to this set of challenges. Even amid these hurdles, the sector somehow remained resilient, with rural demand driving overall economic activity. Although the core manufacturing industries (coal, natural gas, cement, fertilisers, crude oil, steel, electricity and petroleum products) were estimated to contract to 8.4% during FY21; however, the sector has continued to remain in the expansionary mode.

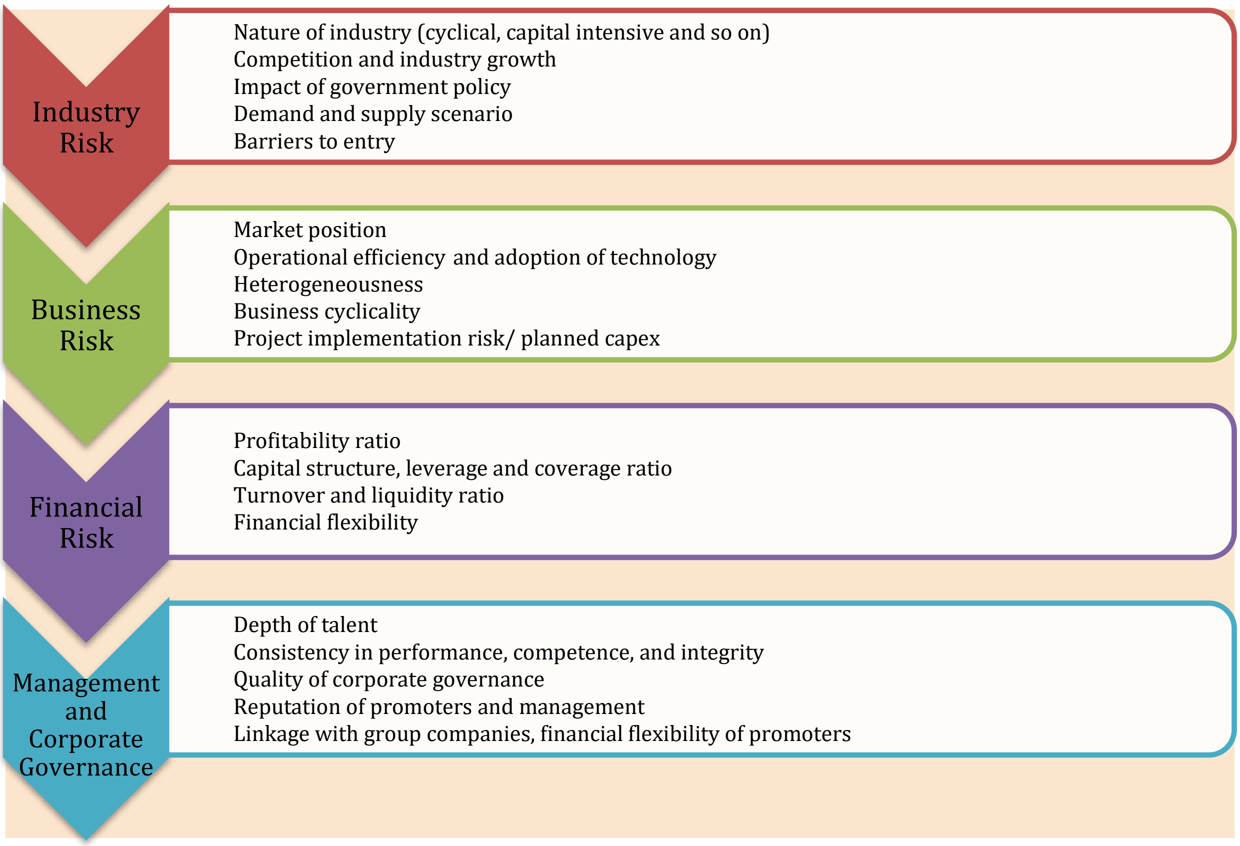
The crisis also presented an opportunity for the sector in the form of various initiatives taken to boost the production process. As part of its economic stimulus packages, the government provided Production-Linked Incentive (PLI) schemes worth Rs. 1.45 lakh crore for 10 sectors. Union Budget 2021 also committed the infusion of Rs. 1.97 lakh crore for the sector, along with the announcement of setting-up a mega-investment textile park scheme, to be established over a period of 3 years. Additionally, the sharp increase in capital expenditure with an expected outlay of Rs. 5.54 lakh crore in physical infrastructure would help generate demand for manufacturing and its allied activities as well.

Scope of the Criteria

The document provides a brief analysis of the various attributes considered by Brickwork Ratings (BWR) in the rating of the manufacturing sector. The scope of this document is to capture the key risks assessed by BWR while arriving at the rating of manufacturing companies. These attributes are mainly business- and industry-related factors in which the entity operates, such as nature of industry, regulatory environment, market position, demand and supply scenario, operational efficiencies and business cyclicality, etc. which help ascertain the debt servicing capability, as against the cash flow generation.

Risk Assessment and Rating Criteria

BWR factors in various quantitative and qualitative risks that manufacturing companies are exposed to, while assessing these manufacturing companies. As highlighted above, the key risks that manufacturing companies may face are industry, business, financial and management risks. These primary risks and the way in which they are incorporated in the rating framework are discussed in detail below.



A. Industry Risk:

BWR assesses manufacturing entities based on the industry in which the entity operates. Industry risk is identified from factors such as demographic presence, dependence on the global market, competitive landscape, capital intensiveness, nature of industry and barriers to entry. Furthermore, the risk will increase when the entity has a high dependence on government initiatives and the regulatory environment, such as the anti-dumping duty and access to raw material, for their growth and cost competitiveness. Apart from regulatory factors, BWR assesses the vulnerability to technological changes, resource availability, demand-supply scenario, price trends, product substitution availability, investment plans of the major players in the industry, industry-wide financial position, gross margins and availability of substitutes to arrive at the rating of the manufacturing entity.

B. Business Risk

These include risks related to the environment in which the entity operates, which affect its turnover, margins, the entity's position within the industry and operational efficiencies. BWR assesses the stability and sustainability of the business.

1. Market position: A stronger market position gives an entity bargaining power among its suppliers and customers. BWR assesses factors such as market reputation, brand recognition, and demand and supply scenario, which contribute to a market position that would help an entity improve its profitability. Invariably, the size of the entity plays an important role while assessing its market share.
2. Operational efficiency and adoption of technology: It includes an analysis of all the factors that help ascertain the cost competitiveness of an entity, which is an indicator of its sustainability in the market, while maintaining market share. The ability to deal with exigencies with minimal impact would augur well for the overall credit profile of the rated entity. Also, BWR assesses whether the current technology-in-use is in accordance with the latest industry developments. This assumes greater significance since businesses which are more technology oriented would, in essence, have high entry barriers and thus lower competition intensity.
3. Heterogeneousness: BWR assesses the multiple business segments in which an entity function. An entity present in multiple segments, may be likely be rated higher than an entity focusing on one product line, on account of its expected higher ability to sustain economic shocks. That said, the management's capex plans and adequacy of resources for tying-up the same are crucial factors considered during evaluation. Additionally, risks associated with different processes for diversified products are factored in the assessment.
4. Business cyclicality: For entities characterised by cyclicality, these are assessed through the business cycle since cash flows are expectedly uneven at different times of the year. That said, the sustenance of cash flows over the longer term remains the basic premise of the rating.
5. Project implementation risk: BWR assesses the expected capex planned by the entity, rationale for undertaking such a capex, funds required, management's ability to arrange requisite funds and expected cash flows from the project. BWR also evaluates the client's experience in implementing a similar scale of projects, past timeliness of implementation and whether these have been implemented within budgeted costs. Arrangements related to raw material supply and equipment supply are also factored in the assessment.

C. Financial Risk

BWR assesses a company's financial risk through the evaluation of the previous and projected financials, particularly the availability of cash flow and debt servicing capability. Financial accounting policies, especially those related to inventory, and liquidity analysis are additional characteristics considered for manufacturing companies. Unutilised banking limits or the level of utilisation of the banking limits are viewed favourably from a credit perspective and provide additional liquidity buffer with the company, in case need arises. While funds from operations denote stronger debt servicing ability, the cash flow from operations indicates 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 manufacturing companies:

1. Profitability ratio: Notwithstanding the sales volumes of the rated entity, the profit that a manufacturing entity generates to offer value to its shareholders determines its financial well-being and performance. BWR assesses the operating and profitability margins to assess the manufacturing company's performance. Better margins identify the company's competitive position and cost competitiveness, and product demand in the market.

2. Capital structure, leverage and coverage ratios: Keeping in mind the stability of revenue generation, coverage ratios help ascertain an entity's ability to pay-off its interest and principal debt obligations. On the other hand, leverage ratios determine the level of debt incurred by the business relative to either the equity or assets of the company.
3. Turnover and liquidity ratios: These help in identifying risks related to the payment from/to debtors/creditors, contingent liabilities, cash availability and liquidity position of an entity to service working capital requirements. Liquidity analysis is an integral part of the company's assessment, which identifies its liquidity availability in the form of unencumbered liquid investment, cash available with the company and the utilisation of bank limits as against meeting its short-term debt servicing obligations.
4. Financial flexibility: It defines the company's ability to raise funds or alternate sources of funding availability in case need arises. In the case of a stress scenario, the company's ability to raise funds determines its strong financial position. Some factors seen positively while assessing the company's track record include access to banks/capital markets, the availability of parent support, continuous bank undrawn limits and the timely monetisation of non-core assets.

D. Management and Corporate Governance

A strong, dedicated and highly experienced board of directors helps the organisation achieve its profitability and operating efficiency targets, and helps improve the company'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 companies/manufacturing units, past track record of successfully running manufacturing units and quality of corporate governance practices followed by the company are factored in while assessing the company's overall credit profile.

Conclusion

BWR analyses an entity by assessing 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 manufacturing company. While the methodology comprises the comprehensive analyses of various risks associated with the regulatory aspects; financial, industry, operational and business risk; and the market position, the final rating is assigned based on the entity's overall credit assessment.

The previous version of this document can be found in
https://www.brickworkratings.com/download/Criteria_ManufacturingCompanies.pdf

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