CRISIL Ratings criteria for rating educational institutions

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CRISIL Ratings

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Executive summary

Education institutions in India are mostly not-for-profit organisations. They operate under trusts or charitable societies. Such institutions need to be always in capital expenditure (capex) mode to avail of income tax exemption. That explains why their liquidity and operating cash flows are generally under pressure, even if they generate substantial operating profit. In fact, institutions offering tertiary education may undertake capex as if by routine and seek to ramp up scale and diversity by regularly adding new courses. Similarly, schools offering K12 (kindergarten to Standard 12) education either keep adding capacities or setting up new campuses, sometimes even in multiple geographies.

Given the strong demand, the gap between demand and supply continues to be favourable, and stability of cash flows better for schools and medical institutions (offering MBBS and allied courses such as pharmacy) more than for institutions offering engineering or business management courses.

The CRISIL Ratings' framework for assessing the credit quality of education institutions considers their liquidity and the stability and predictability of cash flows. The ability to manage cash flows, particularly timing mismatches between fee collection and debt servicing, is a key rating driver.

Scope of criteria

This criteria[1] document highlights the CRISIL Ratings' approach for assessing the credit quality of educational institutions, and focuses on analysing their business and financial risk profiles. The document also covers CRISIL Ratings' approach to financial ratios used for analysing these entities, including adjustments, if any, carried out to the reported metrics in the financial statements.

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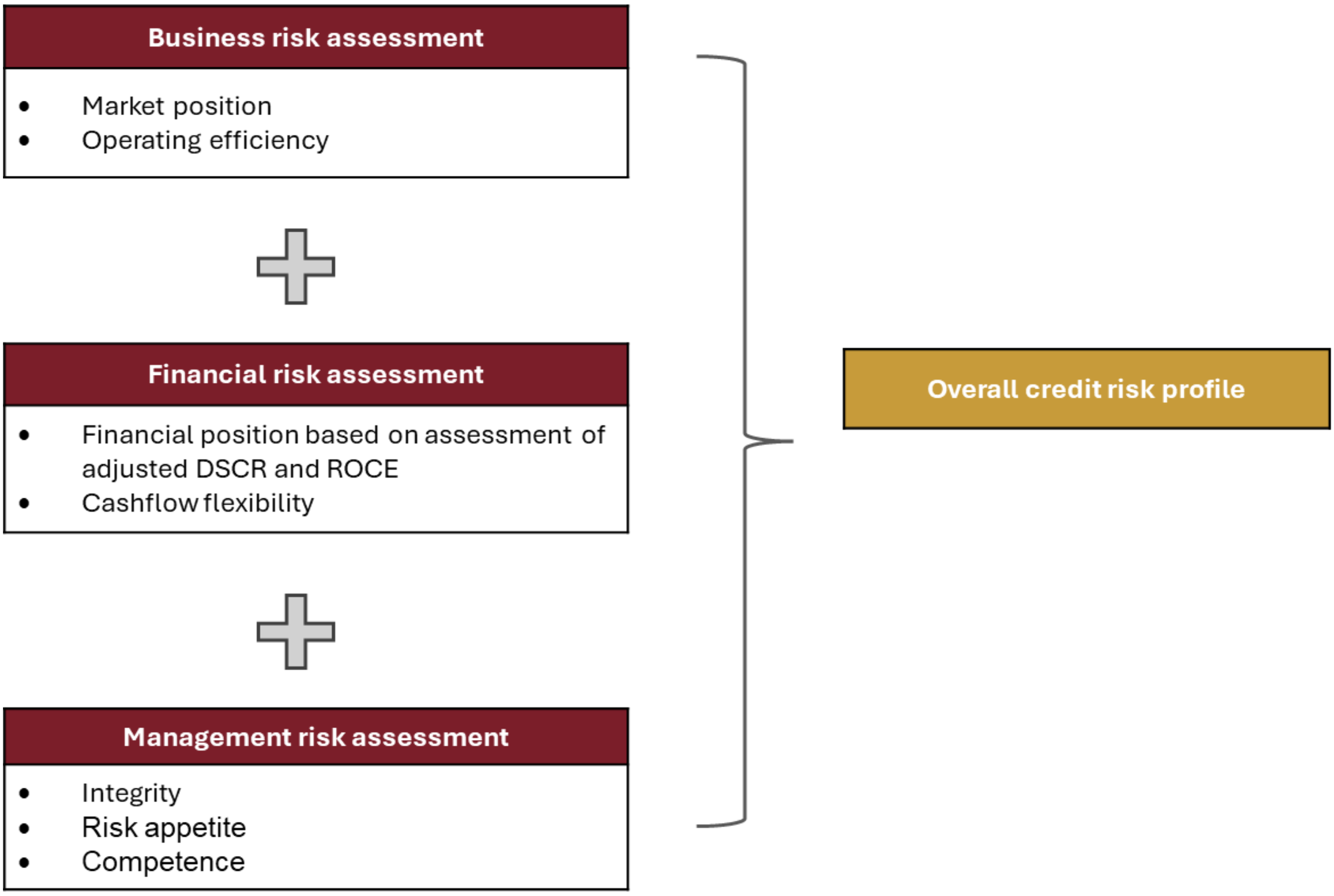
[1] *For accessing the previously published document on "CRISIL Ratings criteria for rating educational institutions", follow the link: https://www.crisilratings.com/content/dam/crisil/criteria_methodology/education-institutions/archive/CRISILs-criteria-for-rating-Education-institutions-june2023.pdf*

Methodology

The chart below indicates the framework for assessing educational institutions:



Assessment of business risk

Market position

Track record of operations and revenue (fees) growth is critical when assessing the market position of an educational institution. Institutions build track record only after operating for reasonably long periods. The reputation and defined catchment they come to acquire will not only determine classroom occupancy, but also help in diversification in terms of courses and geography. The ranking acquired at the state and national levels, performance in placements, and whether the institutions are part of a reputed group or trust, are among the other factors considered.

Given that primary and secondary education are a basic need, K12 schools with an established track record tend to see strong demand, and therefore maintain steady student occupancy. However, demand and occupancy at institutions offering tertiary education are determined by factors such as demographic mix, overall economic conditions, perceived employment opportunities, brand, reputation, regulatory framework and social mindset of the students and their families.

How education institutions stack up

Parameter	Medical	K-12	Engineering	MBA
Demand-supply gap	Favourable	Favourable	Unfavourable	Unfavourable
Occupancy level	High	High	Low-Moderate	Low-Moderate
Correlation with economy	Low	Low	High	High
Reliance on brand, location, placements	Low	Low	High	High
Regulatory framework complexity	High	Moderate	Moderate-High	Moderate-High
Availability of professional management and competent staff	Moderate	Moderate	Low-Moderate	Low-Moderate
Outlook for medium to long term	Positive	Positive	Negative-Neutral	Negative-Neutral

As the table indicates, schools and medical institutions fare better on market position compared with those offering engineering or business management courses.

Operating efficiency

Occupancy is a critical parameter for evaluating operating efficiency, especially because educational institutions are constantly in capex mode. CRISIL Ratings closely monitors the ability to ramp up seat utilisation after each round of capex because the quantum of cash flow will determine the ability to service capex-related debt. With the Income Tax Act restricting retention of profits by trusts, cash accrual is generally used for capex or debt servicing. This limits the ability to service incremental debt.

Operating profitability and return on capital employed (RoCE) are other factors that are analysed as part of operating efficiency. Cost structure, of which employee cost (salary) is a major component, is largely fixed and predictable, given that employee cost increases at a steady rate each year. Institutions should, therefore, maintain stable operating margin if there is no significant expansion in occupancy.

Operating margin is vulnerable to sharp increases in capacity as occupancy may stabilise with a lag. Thus, institutions with a higher operating margin are better placed to absorb changes in occupancy and maintain a stable credit risk profile over the medium term.

RoCE indicates the return generated by the institute on the total capital employed in the business. The ratio comprehensively indicates how well the institute is run and is a critical indicator of seat occupancy. A consistently low RoCE implies poor viability over the long term.

RoCE = Profit before interest and tax (PBIT) / [total debt + adjusted networth + deferred tax liability]

In evaluating operating efficiency, the cost structure and operating margin of each institution is also compared with those of its peers.

Assessment of management risk

Integrity, risk appetite and competence

As in the case of manufacturing companies, CRISIL Ratings evaluates the management profiles of education institutions also under three heads: integrity, risk appetite and competence.

For details, please refer to the CRISIL Ratings article, 'Rating criteria for manufacturing companies' available at www.crisilratings.com.

Assessment of financial risk

Cash flow stability and predictability

The predictability and stability of cash flow are ascertained by analysing the following:

Risks	Severity of risk
Cash flow certainty	Highly predictable and certain as instances of student dropouts are rare
Receipt of cash flow	In advance (before delivery of service)
Exposure to economic cycles	Low-to-moderate
Seasonality of cash flow	Moderate-to-high
Customer concentration	Low
Counterparty risk	Low
Timely inflow of income	Yes
Operating expense as % of income	Moderate at 50-60%
Working capital	Negligible
Capex	Moderate-to-high

Education institutions have a steady and reasonably predictable single-stream cash flow: fees from students. The predictability of outflow is high in the absence of major variable overheads. The following factors support cash flow stability:

- **Strong demand for education, especially in urban and semi-urban areas:** Education is becoming a priority in rural areas also, due to several government schemes. Payment of tuition fees, therefore, takes precedence over other household expenses, thus mitigating credit risk for institutions.
- **Steady occupancy:** Instances of students dropping out midway through a course are rare, and occupancy for the duration of a course is, therefore, stable.
- **Low risk of unfavourable regulations:** Business continuity is assured, as institutions are reasonably insulated from adverse regulations or controversies; this, in turn, lends stability to cash flow.
- **Ability to accurately forecast cash outflow:** The major operating expense comprises staff salaries, which increase at a predictable rate each year. This facilitates forecasting of cash outflow.
- **Low working capital requirement:** Absence of major variable overheads helps minimise working capital requirement, which again lends stability to cash flow.
- **Predictability of capex:** Capex requirement, though high, remains largely predictable. Trusts generally plan capex over a medium-term horizon, complete with timelines for completion and funding sources.

Therefore, cash flows of education institutions are stable, unlike in the manufacturing or trading sectors. Hence, the CRISIL Ratings criteria for education institutions places significant emphasis on the analysis of the adequacy of cash flow and overall liquidity.

Cash flow adequacy

Debt is repaid using fees collected from students. Hence, CRISIL Ratings considers an institution's debt service coverage ratio (DSCR) or its ability to service debt (both principal and interest) from the fees collected.

Trusts and societies cannot freely raise equity and tend to rely on accrual to fund capex. Under the Income Tax Act, to avail of exemptions, trusts need to utilise 85% or more of their gross receipts each year towards operating expenses and capex.

As the capex may be reasonably committed in nature, the DSCR needs to be adjusted accordingly. To factor in the use of net cash accrual (NCA) in funding capex, the DSCR is adjusted as follows:

Adjusted DSCR = ((NCA - part of NCA to be used for capex) + Interest) / (Interest + Repayment)

Liquidity

Most of the defaults in the CRISIL Ratings' portfolio of education institutions over the past decade have been because of mismatches, rather than inadequacy, of cash flow.

CRISIL Ratings believes the risk of mismatches can be mitigated by maintaining sufficient liquidity to cover monthly outflow. The liquidity that needs to be maintained will be a function of the frequency of fee collection relative to the quantum and frequency of debt obligation. Liquidity is also adjusted for monthly operational expenses, a significant portion of which consists of staff salaries that must be paid on time.

Liquidity is to be maintained as cash, fixed deposits and unutilised working capital limits, to cover cash outflow till the next cycle for fee collection starts.

Conclusion

The CRISIL Ratings' analysis of education institutions places significant emphasis on their track record, as well as on cash flow and liquidity. These factors, combined with management risk, are evaluated to arrive at the credit rating of the institution.

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