Ratings

Rating criteria for manufacturing and services sector companies

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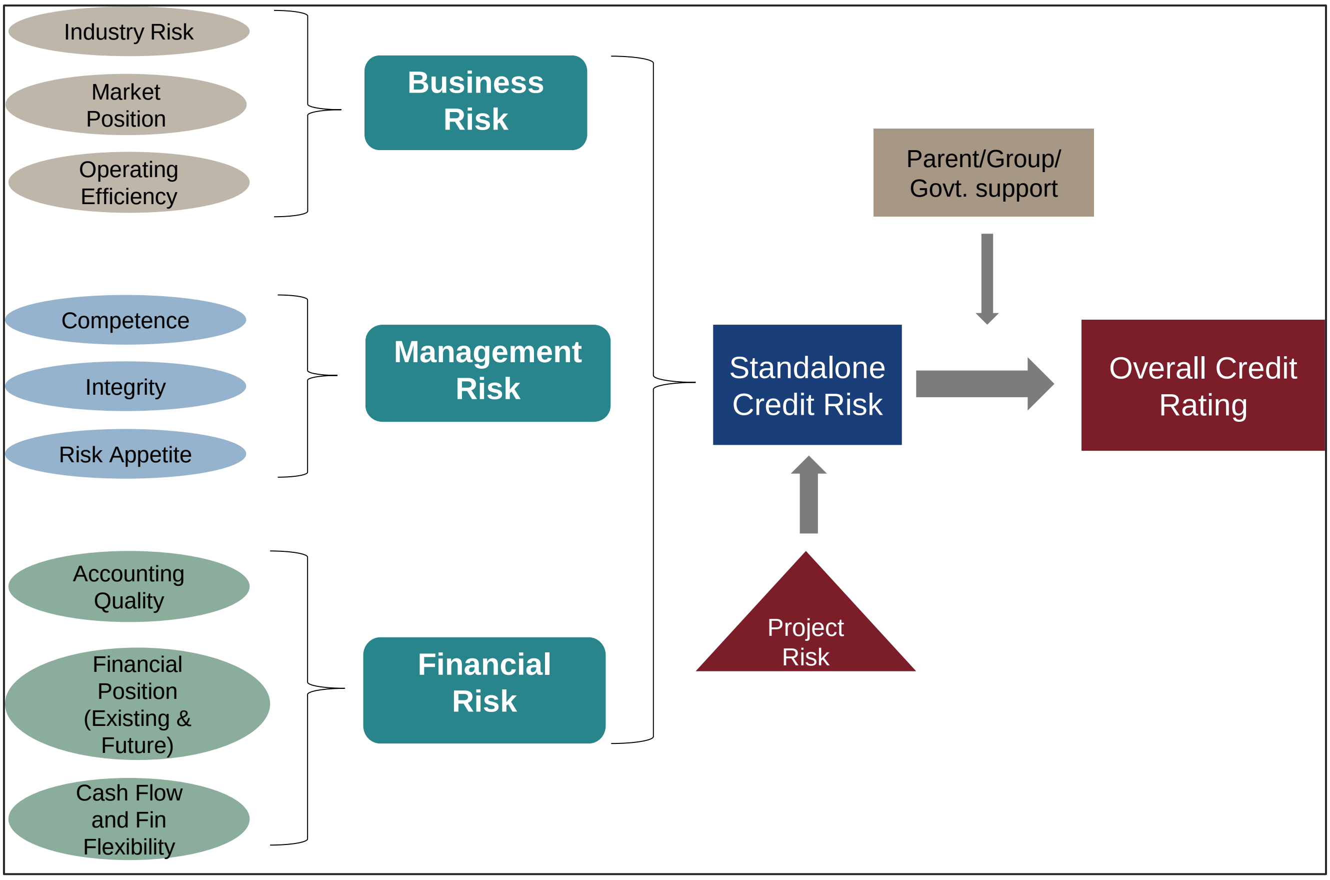
Executive summary

The CRISIL Ratings framework for assessing the credit quality of manufacturing and service sector companies entails the four broad areas of business, financial, management, and project risks.

- Business risk analysis is an assessment of the sustainability and stability of a company's cash flows. It includes the business fundamentals of the rated company, the characteristics of the industry in which it operates, its competitive market position in the industry, and its operational efficiency.
- Financial risk analysis assesses the sustainability and adequacy of the company's cash flows with particular emphasis on debt servicing ability. It analyses how the business strengths of the rated company translate into its current and future financial performance and its financial flexibility, with particular emphasis on liquidity.
- The company's management philosophies, strategies/policies, and risk appetite are evaluated while assessing management risk.
- If the company is implementing any large project, the risks associated with the project implementation, funding, and marketing are evaluated.
- Support from the parent/group/government is also analysed and factored into the overall rating.

CRISIL Ratings believes environmental, social and corporate governance (ESG) risks and opportunities can have a bearing on the credit profile of an issuer. Based on materiality and adequacy of data on ESG factors, CRISIL Ratings will assess and suitably factor in the ESG profile of the issuer in its credit risk analysis.

Chart 1: The CRISIL Ratings framework for rating manufacturing and service sector companies



Scope of the criteria

This article[1] details the broader rating criteria for entities in the manufacturing and services sectors. These entities have relatively higher degree of value addition compared with traders, which add minimal value to the products they deal in. The criteria for assessing the risks within industries (cement, steel, auto ancillaries, real estate, education, solar power producers, and so on) is discussed in separate industry-specific criteria available on the CRISIL website. Criteria for parent/group/government support is also covered under separate articles available on the CRISIL website.

Business risk analysis

The analysis begins with a fundamental assessment of the environment in which the company operates, and essentially covers the overall aspects of the industry, the risks the industry faces, and the government policies

[1] The previous version of this article, which was updated in January 2019, can be accessed here:- https://www.crisil.com/content/dam/crisil/criteria_methodology/industrials/archive/Rating-criteria-for-manufaturing-and-service-sector-companies-Jan2019.pdf

affecting that particular industry. The evaluation extends to an assessment of the company's market position and its operational efficiency.

Industry risk

Assessing the industry risk is fundamental to evaluating a company's business risk profile. The industry risk rating largely indicates the median rating for companies in that industry. It should be noted that the presence or otherwise of strong credit quality factors in terms of market position, operating efficiency, and financial position will eventually determine the final rating assigned to the debt instruments of individual companies.

For industry risk analysis, CRISIL Ratings evaluates the size of the industry, its growth prospects, the competitive scenario and demand-supply dynamics, vulnerability to technological change, the importance of the industry to the economy, government policies, entry barriers, profitability and cyclicality. Industries that have steady demand growth, ability to maintain margins without impairing future prospects, flexibility to time capital expenditure, and moderate capital intensity are regarded favourably. Favourable industry risk factors may not, however, directly translate into higher ratings for all companies within that industry, but such factors do support the credit quality of these companies.

Market position

An analysis of the rated company's market position, in essence, is an assessment of its ability to profitably sell goods and services in a stable and sustainable manner. The ability to sell what is produced and to control selling prices critically determine the market position of a company. Thus, a large market share is not always synonymous with competitive advantages or industry dominance if the company does not have the flexibility to determine the selling price of its products. For instance, in a highly competitive industry, with limited product or service differentiation or a business where landed cost of imports govern prices, even large companies may lack pricing leadership potential.

To evaluate the market position of an entity, CRISIL Ratings undertakes a detailed analysis of both the degree of competition in each market segment and the competitive dynamics among different players. Entry barriers to the industry and capacity expansion by existing players are examined to understand the dynamics of demand and supply on a forward-looking basis.

CRISIL Ratings also considers regional demand-supply balances, especially for those industries where the logistical cost of transporting products across regions is prohibitive.

A company's ability to pass on increased input or service cost to its customers is a crucial factor for stable profitability. A diversified presence, both geographically and through a wide product mix, leads to a stable market position, vis-à-vis a region-specific distribution network and limited product portfolio. Similarly, large exposure to a single client (or a few clients) will increase the concentration risk and curtail pricing flexibility.

For industries such as cement, branded consumer goods and fast-moving consumer goods, the key factors for assessing market position are distribution network and brand equity. For service industries, strong customer relationships, and ability to brand and differentiate the service offerings are critical factors. An analysis of positioning categories on the basis of their size, features, price range, and consumer segments gives CRISIL Ratings an insight into the company's market strategy. The market position of companies in industries such as software, drugs and pharmaceuticals, and consumer durables is analysed in terms of their track record, and ability to innovate and launch products and achieve commercial success.

Operating efficiency

Operating efficiency is an analysis of a company's ability to produce goods and provide services at competitive costs in a sustainable manner. The factors considered while evaluating operational efficiency vary from industry to industry. Some of the key factors common across industries are technology, access to resources, human resources, capacity utilisation, flexibility in the manufacturing process, extent of integration, and research and development (R&D). These factors could contribute to the stability of a company's cost structure or create sustainable cost advantage, or conversely, lead to volatile cost structures and only short-term cost advantage.

Technology

Technology remains a significant factor for maintaining a competitive position in the business. Companies with strong technology-oriented businesses have fewer competitors as technology provides a significant entry barrier to the unorganised sector.

Access to resources

Companies with easy access to raw materials and bargaining power with suppliers maintain healthy operating margins in the long term. Domestic availability of raw materials and captive sources impart flexibility in protecting operating margins. For power-intensive industries such as aluminum, steel and cement, access to captive power generation facilities provides operational flexibility and even significant cost advantages in some industries.

Price volatility of key raw materials/inputs

The extent of volatility in raw material prices is another key element of analysis. CRISIL Ratings analyses the linkage (or absence thereof) between input prices and the pricing of goods sold. Strong linkages will normally imply low volatility of operating margins. However, commodity-based businesses such as steel and petrochemicals, wherein raw material prices are linked to global prices and not related to final product prices, report more volatile operating margins; such businesses are viewed less favourably by CRISIL Ratings.

Human resources

While evaluating entities in knowledge-based industries, CRISIL Ratings analyses the company's ability to attract and retain qualified and experienced manpower as well as the depth and diversity of skill sets available in the company, and policies regarding training and upgrading skills of employees. The company's attrition level is compared with the industry level, and the impact of attrition evaluated. This becomes especially important for companies in the services sector, as their largest cost component is employee cost and it is through the quality of human capital that they differentiate themselves in the industry.

CRISIL Ratings also evaluates the company's relationships with labour unions and the workforce in general, and any history of disruptions in operations driven by labour unrest.

Capacity utilisation and flexibility

Economies of scale achieved through optimum capacity utilisation are very important to reduce production cost per unit. CRISIL Ratings assesses the flexibility of the company to shift between products or redeploy human resources. Operating parameters are developed for each industry and the individual industry rating criteria highlights these parameters, which are critical for the profitability levels in that sector.

Level of integration

A high level of vertical integration usually results in a better cost structure. CRISIL Ratings analyses the flexibility available to a company to alter various stages in its process to adapt to adverse movements in its cost structure.

R&D

CRISIL Ratings examines the rated company's ability to develop new products to serve changing needs of the market or to acquire new domain knowledge. CRISIL Ratings also studies the quality, annual spend and the adequacy of the company's R&D facilities.

Operating efficiency parameters specific to individual industries are discussed in greater detail in the industry-specific rating criteria.

Financial risk analysis

The financial risk analysis essentially focuses on determining the sustainability and adequacy of the issuer's cash flows in relation to its debt obligations. The key parameters for assessing financial risk are accounting quality, adequacy of cash flows, and financial flexibility. CRISIL Ratings considers various financial ratios while analysing the financial risk profile of a firm. For further details, please refer to the article 'CRISIL's approach to financial ratios' available on the CRISIL website.

Accounting quality

The financial ratios and statements used by CRISIL Ratings to analyse a company's financial performance are derived from the audited financial statements. Consequently, CRISIL Ratings commences its financial risk analysis by assessing the company's accounting quality. Some key areas that are analysed are:

- Any overstatement/understatement of profits
- Qualifications made by auditors
- Method of income recognition and depreciation
- Inventory valuation policies
- Off-balance-sheet items/contingent liabilities and similar factors

Wherever required, analytical adjustments are made and the company's financial statements are recast to reflect an accurate picture of its true financial position. This is essential for an accurate assessment of the company's financial performance vis-à-vis its peers.

Adequacy of cash flows

As a credit rating is an assessment of a company's ability to meet its future debt obligations, the financial risk analysis primarily involves an assessment of the company's future earning capacity in relation to its debt obligations. It is pertinent to note that the analysis is cash-flow based: CRISIL Ratings uses a proprietary financial model to estimate the cash flow that will be generated by the company during a particular year. Several adjustments are made to the reported financial statements, including those for working capital changes and provision for expenses, to ensure comparability and to provide analytically sound metrics for the assessment of financial performance.

The CRISIL Ratings cash flow analysis includes two steps:

(A) Assess the company's financial performance (that is, its income statement). The company's past and future profit potential is evaluated to understand the available credit protection and the sustainability of the same. This encompasses an analysis of absolute levels of various ratios, trends across years, and comparison across industry peers. CRISIL Ratings evaluates the profitability of the company's operations and its sensitivity to price fluctuations and downturns in the industry. The operational cost structure is also analysed and compared with other players in the industry. The financial performance is correlated with the business risk evaluation and an assessment made as to whether the financial performance truly reflects the business position of the company. Based on this understanding, CRISIL Ratings arrives at an estimate of the company's future financial performance and cash flows, and assesses its adequacy with respect to its debt obligations.

(B) Assess the company's financial position, that is, balance sheet analysis. The assessment includes the company's capital structure, cost of funding and working capital management. This is studied in relation to the company's business risk profile. Companies with volatile earnings (such as steel, cement and petrochemical companies) may increase their financial risk if they leverage excessively, while companies with stable operations (power, for example) can operate at a high leverage without adversely affecting their financial risk profiles. CRISIL Ratings analyses any proposed capital expenditure, organic and inorganic growth plans, funding strategies and the maturity profile of debt.

Liquidity and financial flexibility

CRISIL Ratings evaluates a company's ability to generate funds through alternative sources during any financial distress. The company's contingency plans and its ability to deal with adverse scenarios are analysed. Its ability to raise funds through internal sources (internal accrual, saleable assets) and external sources (relationships with bankers, access to capital markets) to cover temporary shortfalls is examined. The company's record in raising funds, especially from the capital markets, relationships with lending institutions, and the quantum of marketable securities it holds are some of the indicators of its financial flexibility. Capitalisation ratios are analysed to evaluate if the company is overly reliant on debt funding as this will limit its ability to raise resources from the debt market.

To assess liquidity, CRISIL Ratings evaluates bank limit utilisation with respect to drawing power on a monthly basis. The bank limit utilisation indicates the flexibility available to the company to manage its working capital through external sources. Working capital management is a key parameter that has a direct impact on profitability, and therefore, cash accruals. Working capital management becomes especially important for companies in working capital-intensive industries or those that supply to cyclical industries. Efficient working capital management will reduce pressure on liquidity, and hence enable timely servicing of debt.

For service sector entities, especially those in the information technology (IT) sector, employee salaries form a major chunk of operating costs and there is limited flexibility in deferring this expense. Therefore these companies, as a policy, maintain necessary cash to pay specified months of employee cost (for example, a company may maintain cash to pay three months of employee costs as a policy). While analysing financial flexibility, CRISIL Ratings factors in the cash in excess of what is required to be maintained as per policy.

A company's flexibility to defer its capital expenditure plans if its financial position weakens is also studied. If the rated company is a subsidiary or part of a group, the external support that it can receive from the parent company or group companies is analysed at great length and factored into the overall rating. Conversely, any support by the rated company to group companies is also considered.

Growing importance of ESG risks and opportunities

ESG risks and opportunities can have a bearing on the long-term sustainability of businesses, which can, in turn, affect their creditworthiness. For instance, investments that help reduce emissions, deploy efficient methods of waste disposal and introduce sustainable sourcing of raw material mean lesser regulatory issues, better community engagement and long-term sustainability of business operations. Strong governance structure is the cornerstone of any successful business and long-term viability is impossible without it. How a company implements its strategies to mitigate ESG risks and leverage opportunities indicates its ability to handle changes in the business environment. Therefore, all parameters—including ESG parameters—that have the potential to impact business or the financials of the business are assessed to arrive at a credit opinion.

The last few years have seen the emergence of ESG-led investments globally. ESG investments account for about a third of global assets under management and are expected to grow more than 2.5 times to ~$100 trillion by 2030. Investments in emerging markets, pegged at ~15% in these global funds, are likely to reflect a similar trend, thereby significantly improving access to funds for ESG-focused entities. Over time, ESG readiness may well become an important distinguishing feature for corporates to access funds.

World over, non-financial disclosures are still evolving. India is no exception. Some of the large corporates have been early adopters, voluntarily tracking and disclosing their ESG-related parameters and policies. ESG-led investing is at a nascent stage in India, but is steadily gathering pace. As information availability is largely restricted to large listed companies, Indian banks—a major source of funding for corporates—are expected to gradually integrate ESG in their lending decisions.

However, disclosure levels in India are expected to improve. A SEBI circular on Business Responsibility and Sustainability Reporting dated May 10, 2021, requires the top 1,000 listed corporates to disclose significant non-financial information voluntarily in fiscal 2022 and compulsorily from fiscal 2023. Improving data availability and ability to benchmark non-financial parameters will help in suitably factoring in ESG risks in credit assessment and other investment decisions in the future.

Factoring the impact of ESG in credit ratings:

As investors begin to screen their investments through the ESG lens, CRISIL Ratings believes the ability of an entity to manage ESG related risks will have a bearing on access to funds. Consequently, and based on materiality, CRISIL Ratings will assess and disclose the impact of these on the credit risk profiles of companies, underscoring their ability to raise funds and, in turn, their financial flexibility. This will especially hold true for companies that are accessing global capital pools to meet their funding needs and for businesses that have large global operations. CRISIL Ratings will assess the impact of ESG risk on corporates subject to availability of information. Parameters such as sectoral characteristics, proportion of foreign investment holding and existence of external market borrowings will be considered in assessing the materiality of ESG for an entity.

CRISIL Ratings will assess parameters such as emissions and energy consumption, water usage, land use and bio diversity, treatment and discharge of waste and by-products and end product for assessment of environment; information pertaining to human capital, product and customer management, vendor management and community engagement for assessment of social aspects; board performance, ownership concentration, shareholder relations and disclosures and financial statements for assessment of governance. CRISIL Ratings may look at a specific combination of these parameters based on the materiality and availability of information.

CRISIL Ratings believes improvement in non-financial disclosures will be critical to increase the scope of integrating ESG into credit risk assessment.

Management risk analysis

The CRISIL Ratings evaluation of a company’s management entails understanding the goals, philosophies, and strategies that drive the company's business and financial performance. If the company is a part of a larger business group or if it is a multinational, the parent company's management philosophies or those of the business group are used as pointers to assess managerial responses in the enterprise being evaluated.

An evaluation of the management involves several aspects such as understanding the organisational and reporting structure, the management’s experience and track record, the level of commitment and track record in debt servicing, and the adequacy of planning and control systems.

The management’s past success in introducing new products and ability to manage change in the external environment, such as regulatory or technological changes, are also analysed. In addition, the company’s overall risk appetite is assessed. A high risk appetite, manifested in high leverage, or a propensity to undertake projects that are larger than existing operations, is not viewed favourably by CRISIL Ratings.

Succession is another key area of concern if the company’s operations are dependent on a single promoter or manager. Corporate governance principles followed by the management in its daily operations and transparency in management actions are also evaluated.

Project risk analysis

If a company is implementing a new project, CRISIL Ratings evaluates the risks associated with that project and factors in these risks while assigning the overall rating. The size of the project compared with the existing operations indicates the significance of the project risk in the overall rating.

Implementation risks such as time and cost overruns and technology obsolescence risk, along with the impact of these risks on the project’s viability, and funding risks in terms of the project's capital structure and funding arrangements, are also evaluated.

The project’s market risks in relation to the company’s existing product line and track record in implementing such projects are given adequate importance in assigning the rating.

Conclusion

The rating methodology of CRISIL Ratings for manufacturing and services companies involves intensive analysis of the business, financial, and management risk profiles of the company. The analysis primarily seeks to determine the quantum, stability, and adequacy of the company’s future cash flows in relation to its debt servicing requirements. The above note provides the basic parameters for the analysis which are applicable to all industries. Separate industry-specific criteria will dive deep into the particular issues considered while evaluating various sectors.

About CRISIL Limited

CRISIL is a global analytical company providing ratings, research, and risk and policy advisory services. We are India's leading ratings agency. We are also the foremost provider of high-end research to the world's largest banks and leading corporations.

CRISIL is majority owned by S&P Global Inc., a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

About CRISIL Ratings

CRISIL Ratings is part of CRISIL Limited ("CRISIL"). We pioneered the concept of credit rating in India in 1987. CRISIL is registered in India as a credit rating agency with the Securities and Exchange Board of India ("SEBI"). With a tradition of independence, analytical rigour and innovation, CRISIL sets the standards in the credit rating business. We rate the entire range of debt instruments, such as, bank loans, certificates of deposit, commercial paper, non-convertible / convertible / partially convertible bonds and debentures, perpetual bonds, bank hybrid capital instruments, asset-backed and mortgage-backed securities, partial guarantees and other structured debt instruments. We have rated over 24,500 large and mid-scale corporates and financial institutions. CRISIL has also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and microfinance institutions. We also pioneered a globally unique rating service for Micro, Small and Medium Enterprises (MSMEs) and significantly extended the accessibility to rating services to a wider market. Over 95,000 MSMEs have been rated by us.

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