Ratings

CRISIL

An S&P Global Company

Rating criteria for manufacturing and services sector companies

December 2016

Criteria contacts

Pawan Agrawal
Chief Analytical Officer – CRISIL Ratings
Email: pawan.agrawal@crisil.com

Somasekhar Vemuri
Senior Director – Rating Criteria and Product Development
Email: somasekhar.vemuri@crisil.com

Ramesh Karunakaran
Director – Rating Criteria and Product Development
Email: ramesh.karunakaran@crisil.com

Ankit Dhawan
Senior Rating Analyst – Rating Criteria and Product Development
Email: ankit.dhawan@crisil.com

In case of any feedback or queries, you may write to us at Criteria.feedback@crisil.com

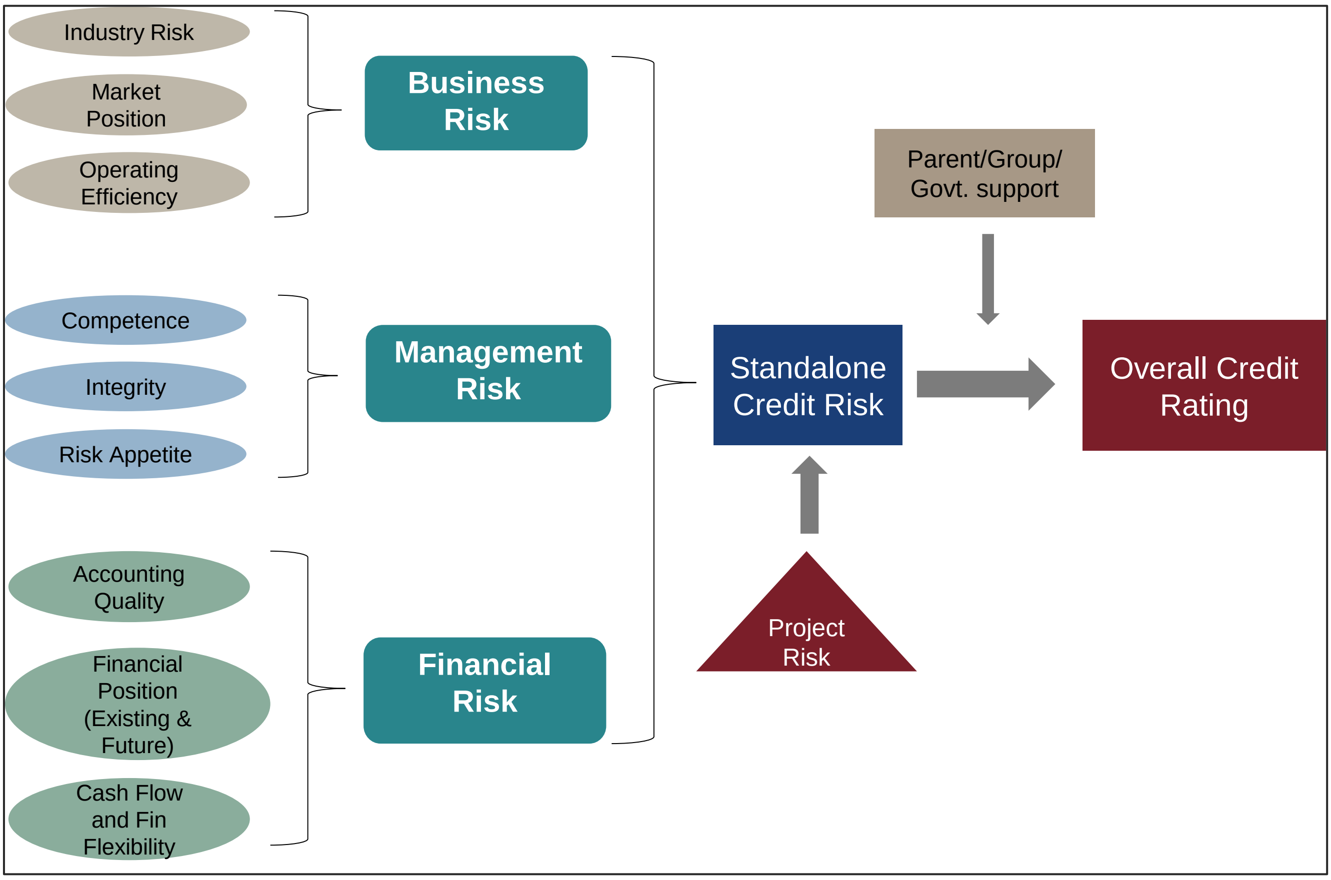
Executive summary

CRISIL's 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 efficiencies.
- Financial risk analysis assesses the sustainability and adequacy of the company's cash flows with particular emphasis on debt servicing ability. It includes an assessment of how the business strengths of the rated company are translated into its current and future financial performance and its financial flexibility, with particular emphasis on its liquidity.
- An evaluation of the company's management philosophies, strategies/policies, and risk appetite is undertaken while assessing management risk.
- If the company is implementing any large project, the risks associated with the project's implementation, funding, and marketing are also evaluated.

Support from the parent/group/government is also analysed and factored into the overall rating.

Chart 1: CRISIL's rating framework for manufacturing and service sector companies



Scope of the criteria

This article details the broader criteria for all firms in the manufacturing and services sectors. These firms are marked by 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 associated within individual industries (cement, steel, auto ancillaries, real estate, education, solar power producers, etc) are discussed in separate industry-specific criteria available on CRISIL's website. Criteria for parent/group/government support are also covered under separate articles available on CRISIL's 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 to which that industry is exposed, and the government policies affecting that particular industry. The evaluation extends to an assessment of the company's market position and its operational efficiencies.

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. However, 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 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 favorably. Favorable 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.

CRISIL undertakes a detailed analysis of both the factors—the degree of competition in each market segment and the competitive dynamics among different players—to evaluate a firm's market position. Entry barriers to the industry and capacity expansions of existing players are analysed to understand the dynamics of demand and supply on a forward-looking basis.

CRISIL also analyses 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 the 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 presence that is restricted by a region-specific distribution network and a limited product portfolio. Similarly, large exposure to a single client (or a few clients) will increase the concentration risk and curtail a company’s 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 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 their 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 in 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 a 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 CRISIL's analysis. CRISIL analyses the linkage (or absence thereof) of 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.

Human resources

CRISIL analyses a company’s ability to attract and retain qualified and experienced manpower while evaluating knowledge-based industries. CRISIL also evaluates the depth and diversity of skill sets available in the company, and policies regarding training and upgrading skills of employees. The company's attrition levels are compared with those in the industry levels, and CRISIL analyses the impact of attrition on the company. This becomes especially important for services sector firms, 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 also evaluates the company’s relations 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 costs per unit. CRISIL assesses the flexibility of the company to shift between products or redeploy human resources. Operating parameters are developed for each industry and individual industry rating criteria highlight these parameters, which are critical for the relative profitability levels of in that sector.

Level of integration

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

R&D

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

CRISIL's financial risk analysis essentially focuses on determining the sustainability and adequacy of the issuer's cash flows in relation to its debt servicing obligations. The key parameters for assessing financial risk are accounting quality, adequacy of cash flows, and financial flexibility. CRISIL 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 Ratio’s’ available on CRISIL’s website.

Accounting quality

The financial ratios and statements used by CRISIL to analyse a company's financial performance are derived from the audited financial statements. Consequently, CRISIL 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 debt obligations in future, CRISIL's financial risk analysis primarily revolves around an assessment of the company's future earning capacity in relation to its debt servicing obligations. It is pertinent to note that CRISIL's analysis is cash-flow based: CRISIL 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 assessment of financial performance.

CRISIL's cash flow analysis includes two steps:

(A) Assess the company's financial performance (that is, its income statement). An evaluation of the company's past and future profit potential is carried out 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 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 a comparison is made 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 arrives at an estimate of the company's future financial performance and cash flows, and assesses its adequacy with respect to its debt servicing needs.

(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, among others. 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 with a high leverage without adversely affecting their financial risk profiles. CRISIL also analyses capital expenditure plans, organic and inorganic growth plans, the funding plans, and maturity profile of debt.

Financial flexibility

CRISIL evaluates a company’s ability to generate funds through alternative sources in the event of any financial distress. The company's contingency plans and its ability to deal with various adverse scenarios are analysed. Its ability to raise funds through internal sources (internal accruals, saleable assets) and external sources (relationships with bankers, access to capital markets) to cover temporary shortfalls is evaluated. The company’s record in raising funds, especially from the capital markets, its relations with lending institutions, and the quantum of marketable securities that it holds are some of the indicators of its financial flexibility. An analysis of capitalisation ratios is also undertaken 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 the company’s liquidity, CRISIL also 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 from external sources. Working capital management is a key parameter that has a direct impact on a company’s profitability, and therefore, its cash accruals. Working capital management becomes especially important for companies which operate in working-capital-intensive industries, or those that supply to cyclical industries. Efficient management of working capital will reduce pressure on a company’s liquidity, and hence enable timely servicing of debt.

For service sector entities, especially those in IT sector, employee salaries form major portion of operating costs and firms have limited flexibility in deferring this expense. Therefore these firms, as a policy, maintain necessary cash to pay specified months of employee costs (e.g. a firm maintaining cash to pay three months of employee costs as a policy). CRISIL’s analysis of financial flexibility of such firms takes into account the cash in excess of what they are required to maintain as per policy.

Additionally, a company's flexibility to defer its capital expenditure plans in case of weakening in its financial position is also analysed. 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.

Management risk analysis

CRISIL’s evaluation of a company’s management entails understanding the goals, philosophies, and strategies that drive the company's business and financial performance. Furthermore, 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 payments, and the adequacy of its planning and control systems.

The management’s past success in introducing new products and its 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.

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 evaluates the risks associated with that project and factors in these risks while assigning the overall rating. The relative size of the new 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

CRISIL's rating methodology for manufacturing and service 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 sectors. Separate industry-specific criteria will dive deep into the specific 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.