Rating Criteria for Service Sector Companies

I. Introduction

ACER Credit Rating Private Limited (ACER), a SEBI-registered credit rating agency, is committed to providing independent and transparent opinions on issuer and credit ratings. ACER's credit insights aim to empower investors, lenders, and businesses with opinions on ratings. It enables external stakeholders with informed decisions and fosters confidence in India's financial markets. With a clear vision to support India's economic growth story, ACER upholds the highest ethical and analytical standards, combining deep domain expertise, advanced analytics, and rigorous processes to ensure every rating is objective and insightful.

The Company reserves the right to amend this policy from time to time in accordance with the applicable regulations, circulars, and directives issued by the Securities and Exchange Board of India. This rating criteria will be reviewed annually.

The services sector is the dominant driver of economic growth in India, significantly contributing to the Gross Domestic Product (GDP), attracting substantial foreign investment, and providing large-scale employment. The services industry is primarily personnel-based and expertise-oriented.

India's services sector encompasses a diverse range of activities, including but not limited to:

- **Professional Services:** Accounting and audit firms, law firms, and management consultancy.
- **Information Technology:** IT services, BPO, KPO, and digital platforms.
- **Logistics and Communication:** Transport, supply chain management, and telecommunications.
- **Hospitality and Tourism:** Travel services, hotels, and community-based services.
- **Support and Maintenance:** Facility management, security services, and Operations & Management (O&M).
- **Healthcare and Pathology centers:** Hospitals, pathology laps and medical centers.
- **Educational Institutions:** Schools, Colleges and other educational institutions.

The growth of this sector is governed by both domestic economic conditions and global market trends. Key characteristics include a high reliance on brand value to win consumer loyalty and the critical importance of human capital as the primary productive asset. As service providers often cater to other core industries, their performance is frequently linked to the stability and demand of their end-user industries.

II. Introduction to the Four Rating Methodology Pillars

ACER's credit rating framework for the services sector is built upon five fundamental pillars:

1. **Financial Risk:** A quantitative assessment of financial health, focusing on profitability, debt servicing ability, and liquidity.

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Regional Off.: Unit 1513-1514, C Wing, One BKC, Bandra Kurla Complex, Mumbai 400051
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2. **Business Risk:** An evaluation of the entity's market position, the complexity of its services, and its resilience to industry-specific risks like cyclicality or technological disruption.
3. **Management Risk:** An assessment of the leadership team's experience, strategic vision, integrity, and their ability to manage human resources.
4. **Legal and ESG Risk:** A review of the entity's regulatory compliance, corporate governance transparency, and environmental and social impact.
5. **Industry Risk:** It is characterized by external factors such as demand-supply dynamics, the competitive landscape, and regulatory frameworks that impact all entities within a specific service line. ACER assesses these risks to determine the degree of competitiveness in the industry, as higher competition generally leads to greater risk for the rated entity.

Pillar I: Financial Risk

Financial risk mainly focuses on revenue visibility, operating leverage, working capital intensity, and debt-servicing capability.

1. Profitability Ratios which include many others

Profitability reflects the final result of business operations and the entity's ability to withstand adverse cycles.

I. **Operating and Profit Margins:** ACER evaluates EBITDA/Operating margins, PBT margins, and PAT margins to assess an entity's capacity to earn profits and control its cost structure
II. **Return on Capital (ROCE & RONW):** These ratios measure how effectively management generates returns from invested capital and net worth
III. **Revenue Growth Trends:** Growth rates are compared against industry peers to determine the entity's ability to sustain or expand its market share and operating efficiency.

2. Leverage and Coverage Ratios

Since service entities often have insignificant long-term debt, the focus shifts to working capital and interest coverage.

I. **Interest Coverage Ratio:** Assesses the ability to fund borrowing costs after meeting operating expenses.
II. **Debt Service Coverage Ratio (DSCR):** Crucial if the entity has taken long-term debt, measuring the cushion available for debt servicing from cash accruals.
III. **Overall Gearing (Debt/Equity):** Determines the reliance on debt relative to the equity.

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IV. **Total Outside Liabilities/Tangible Net Worth (TOL/TNW)** to provide a comprehensive view of external obligations, including non-fund-based limits, contingencies etc.

V. **Debt to Cash Accruals:** This assesses the proportion of debt relative to internal cash generation and whether cash accruals are sufficient to service debt obligations.

3. Turnover and Liquidity Ratios which include many others

Liquidity management in services revolves around the efficiency of the working capital cycle.

I. **Receivable Days:** The primary financial risk for a service provider is the realization rate of its debtors and the potential for bad debts. A longer cycle can cause liquidity stress and increase borrowing costs, while faster velocity improves financial stability.

II. **Liquidity Indicators**: These include the Current Ratio, Quick Ratio, Cash to Current Liabilities, and the availability of unencumbered liquid investments.

III. **Working Capital Intensity**: Working capital intensity reflects the amount of net working capital required to support a given level of revenue and is primarily influenced by receivables management.

IV. **Operating Cash Flow (OCF):** High cash flow from operations is a strong indicator of an entity's ability to manage its debtors and fund maintenance capital expenditure without external debt.

4. Financial Flexibility

ACER evaluates an entity’s ability to raise alternate funding during stress. This includes access to capital markets, sanctioned but undrawn bank limits, and potential support from a strong parent or group. ACER meticulously tracks all reported contingent liabilities and off-balance-sheet exposures. If these are deemed material, ACER carries out an impact analysis to quantify the financial implications should these liabilities devolve on the entity.

5. Stress-Testing Critical Parameters

ACER identifies key variables on a case-to-case basis and according to the specific service industry the entity operates in to assess their direct impact on financials. Each critical parameter is then stress-tested to determine the entity's resilience and debt-servicing capability in a stress situation

Pillar II: Business Risk

This pillar evaluates the entity’s ability to sustain consistent cash flows and its position within the industry. It encompasses the environment in which the entity operates, impacting its turnover, margins, market position, and operational efficiencies. ACER evaluates both the intrinsic strengths and external vulnerabilities of the business, integrating the following parameters into a comprehensive assessment:

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1. Nature and Complexity of Services Offered

ACER analyses the fundamental nature of the services provided, as different service lines carry unique risk profiles regarding revenue stability and resilience to external shocks.

I. **Revenue Stability:** Recurring services, such as Operations and Management (O&M) or business support, are viewed more favorably than one-time project-based services (e.g., product development by an IT firm) because they provide greater income visibility. For example, the hotel industry exhibits moderate to high revenue volatility due to its strong linkage with economic cycles, tourism flows, corporate travel, and discretionary spending. The hospital industry in contrast demonstrates relatively stable and resilient revenues, driven by non-discretionary demand for healthcare services. Patient inflows are less sensitive to economic cycles, as medical treatment is often essential rather than optional.

II. **Complexity and Barriers to Entry:** Highly complex, expertise-oriented services such as legal consultancy, high end IT services or specialized medical services are generally high-margin and difficult for clients to replace. This complexity creates natural entry barriers for new players and provides stronger revenue visibility compared to lower-skilled services like facility management.

III. **Service Tie-Ups:** In sectors like healthcare and hospitality, partnerships and service tie-ups are central. ACER evaluates the strength, age, and quality of these relationships, as a failure to maintain solid connections can jeopardize service delivery and company stability.

2. Nature of Service Contracts and Agreements

The contractual framework defines the predictability of the entity's revenue and its exposure to price volatility.

1. **Contractual Terms:** ACER views long-term contracts with clearly defined roles, responsibilities, and payment terms favorably. Contracts that include robust dispute resolution mechanisms and difficult cancellation clauses provide significant revenue visibility.
2. **Global Contract:** Global or multi-geography service contracts are viewed to assess the cross-border regulatory risk, execution and complexity, risk management system, data security and regulatory standard and more.
3. **Renewal Track Record:** A history of consistent contract renewals is a primary indicator of customer satisfaction and long-term relationship stability.
4. **Concentration vs. Spot Risk:** ACER assesses the risk of relying on a limited number of customers, which limits an entity's bargaining power. Furthermore, entities relying on spot services are more exposed to price volatility and market fluctuations than those with established long-term agreements.

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3. Service Proposition and Market Position

An entity's standing within its industry determines its ability to influence pricing and sustain margins in a competitive environment.

1. **Unique Selling Proposition (USP):** To maintain margins, an entity must offer value-added services or a USP that is difficult for competitors to replicate.
2. **Value Chain Positioning:** Entities positioned higher in the value chain typically enjoy higher brand value and greater bargaining power over both customers and suppliers.
3. **Operating Metrics:** ACER evaluates efficiency through industry-specific 'per unit' metrics, such as billing rates and costs per employee for IT firms, or yield and realisation per kilogram for logistics providers.
4. **Brand Linkages:** Strong, reputable brands facilitate expansion into new service lines and increase customer loyalty. Conversely, weak or irregular brand links can negatively impact market appeal and increase business risk.

4. Scale of Operations

The size and scale of an entity are critical to its resilience and competitive positioning.

1. **Operational Resilience:** Large entities typically show greater resilience to adverse changes in the business environment and are less affected by the loss of individual clients or high employee attrition due to their superior margins.
2. **Bargaining Power:** Massive scale allows an entity to influence industry trends and provides significant bargaining power in negotiating contract terms, pricing, and duration with both customers and vendors.
3. **Capacity Flexibility:** Larger businesses can swiftly modify operations to meet fluctuating demand, ensuring reliable service delivery even during market shifts.

5. Diversification Strategies

Diversification acts as a primary risk mitigation tool against regional economic issues or sector-specific downturns.

1. **Service and Client Mix:** A well-diversified portfolio across different service lines and a broad client base reduces concentration risk and revenue volatility. ACER also assesses the credit quality of the top clients; a marquee client base ensures timely payments and supports sustainability.
2. **Geographic Diversification:** Operating across multiple regions helps minimize the demand-supply gap and limits the impact of temporary disruptions in any single market. In IT services, diverse offshore development centers ensure uninterrupted service across time zones and against local calamities.

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3. **Government Exposure:** While government clients provide scale, a high proportion of such clients can lead to elongated payment cycles, making working capital management critical.

6. Operational Efficiency and Cost Structure

In the services sector, managing human capital and infrastructure costs is paramount to maintain profitability.

1. **Labour and Fixed Costs:** ACER examines the proportion of fixed versus variable employee costs. A higher proportion of variable cost employees allows for better control during demand declines, though it may increase attrition risks.
2. **Logistics and Infrastructure:** Efficient logistics, robust service channels, and strong physical or digital infrastructure are essential for seamless operations and reducing interruptions.
3. **Overheads:** Lease or rental expenses for office space in prime locations are analysed as significant overheads that can impact overall cost structures and profitability.

7. Technology, Innovation, and Substitute Risk

As services become increasingly digital, technology is both a driver of efficiency and a source of significant risk.

I. **Digital Leadership:** ACER evaluates the entity's investment in automation, digital platforms, and data-driven solutions, as these are crucial for maintaining long-term competitiveness.

II. **Data Security:** Robust cyber security and data protection protocols are critical, especially for entities handling confidential client information.

III. **Technological Obsolescence:** The methodology assesses the risk of niche services being replaced by technology-driven substitutes or more affordable automated alternatives.

IV. **R&D and Innovation:** For sectors like IT or specialized consultancy, continuous innovation and the ability to introduce new products are vital for sustained revenue visibility.

V. **Intellectual Property Capitalization:** For sectors like IT or software development, ACER evaluates capitalized expenses for patents or intellectual property and the future potential to generate profits from these investments.

8. External Market Dynamics

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The performance of service providers is inextricably linked to the broader economic environment and the stability of end-user industries.

I. **End-User Linkages:** Since many service entities cater to core industries, downturns or structural shifts in those end-user sectors can have a cascading effect on service demand.
II. **Seasonality and Cyclicality:** While the services sector is generally less cyclical due to the non-discretionary nature of many services, ACER factors in seasonal demand fluctuations (e.g., in travel or retail-linked services) that may cause uneven cash flows during the year.
III. **Overseas Market Exposure:** For entities with global operations, ACER evaluates the impact of foreign exchange fluctuation risk, geopolitical events, and changes in the legal or regulatory policies of foreign geographies

Pillar III: Management Risk

In a people-oriented sector, the quality of leadership and personnel policies is paramount.

1.Quality and Profile of the Management Team

In expertise-oriented services, the "human asset" and its leadership define the entity's competitive edge.

1. **Experience and Expertise:** The track record and relevant experience of promoters in related businesses are scrutinized to gauge their industry knowledge and depth of capability. The presence of Subject Knowledge Experts and skilled human resources within the team enhances decision-making and service delivery.
2. **Period of Association:** For professional services like audit, law, or consultancy, the longer period of the association of key executives with the organization is paramount. Because these businesses involve the exchange of critical and confidential information, the continuance of senior leadership provides a sense of security and stability to the clients.
3. **Resourcefulness:** The ability of promoters to raise funds at competitive costs and their history of supporting group entities provide evidence of financial flexibility and commitment
4. **Planning Robustness:** ACER evaluates the effectiveness of the planning process in managing the inherent operational complexities of the services sector. ACER specifically evaluates the management's historical response to stress scenarios, such as liquidity issues, competitive pressures, or the need for rapid diversification.

2. Organization Structure

The organizational framework is assessed to determine how effectively a company can execute its strategy and maintain service quality.

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1. **Delegation and Accountability:** ACER evaluates the delegation of powers, roles, and responsibilities within the entity to ensure they are commensurate with its size and operational complexity. A clear escalation matrix and established control mechanisms are vital for maintaining confidence in service delivery.
2. **Systems of Control:** The structure must support robust internal control systems and Management Information Systems (MIS). These systems enable leadership to remain tuned to the business environment and make timely, judicious decisions based on accurate accounting records.

3. Succession Planning

This is a critical risk factor, particularly for entities that depend heavily on a single promoter or a few key professionals. ACER assesses whether a sound succession plan exists to ensure continuity in business operations without disruption, even after the retirement or departure of high-impact employees.

4. Personnel and Human Resource Policies

1. **Talent Retention:** Since human resources are the most critical asset for the service sector, ACER examines policies for attracting, training, and retaining talent.
2. **Attrition Levels:** High attrition is viewed negatively as it disrupts project execution, increases training costs, and damages the brand image.

Pillar IV: Legal and ESG Risk

ACER increasingly factors Environmental, Social, and Governance (ESG) risks into credit profiles, as they impact long-term sustainability.

1. Legal and Regulatory Framework

1. **Constitution:** The legal form (e.g., Partnership vs Public Limited) affects transparency requirements. Partnerships carry an inherent risk of capital withdrawal.
2. **Compliance:** Adherence to statutory requirements and the history of litigation or governance violations are tracked.

2. Environmental and Social Risk

1. **Environmental:** While indirect, service entities are evaluated on energy consumption and the management of e-waste from technological infrastructure upgrades.
2. **Social:** This is a prominent risk in manpower-intensive sectors. ACER reviews labour relations, employee policies, and customer service standards to ensure they don't lead to reputational controversies.

3. Corporate Governance

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Corporate governance reflects the ethical framework and transparency through which the entity interacts with its stakeholders.

1. **Transparency and Disclosure:** ACER examines the extent of transparency in dealings with stakeholders and the level of public disclosure. Transparent financial reporting and strong shareholder relations enhance credibility and significantly reduce credit risk.
2. **Board Composition and Independence:** We evaluate board size, independence levels, and the overall effectiveness of governance. This includes monitoring the attendance and tenure of non-executive directors to ensure they are actively engaged in oversight.
3. **Regulatory Compliance:** Adherence to statutory requirements, anti-corruption frameworks, and whistleblower policies is closely tracked. Any red flags highlighted by internal or external stakeholders, or a history of mismanagement, are viewed as significant negative factors.

Pillar V: Industry Risk

The following factors are critical to understanding industry risk in service sector:

1. **Interdependence with End-User Industries:** A unique aspect of industry risk for service providers is their linkage to core industries. Because service entities often function as facilitators or requirement facilitators for other sectors, their growth and stability are closely tied to the performance of the end-user industries they serve. Downturns, economic slowdowns, or structural shifts in these core industries can have a cascading effect, leading to a direct drop in demand for services and impacting overall profitability.

2. **Impact of Government and Regulatory Policy:** Regulatory intervention and government policies significantly influence cost structures and competitive dynamics. While favourable policies can drive growth, unfavourable trade barriers, changes in tax benefits, or sudden regulatory shifts can introduce substantial challenges, such as limited market access or increased operational costs.

3.**Technological Disruption and Substitutes:** Rapid advancements in technology and automation are fundamentally reshaping the industry. Industry risk increases when substitutes for niche services become available, particularly if these alternatives are more affordable, convenient, or leverage improved technology to replace traditional service models.

4. **Demand-Supply and Market Trends:** Managing the balance between demand and supply is essential to avoid service delivery bottlenecks or demand shortfalls. Industry risk analysis must also factor in shifting consumer preferences, geopolitical events, and global economic conditions that may alter local and international demand.

5. **Cyclicality and Seasonality:** Although many services are non-discretionary and less cyclical than manufacturing, entities must still monitor economic cycles and seasonal trends. Specific service lines may be vulnerable to cyclical downturns or uneven cash flows at different points in the year based on the nature of their end-customers.

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