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This methodology note stands superseded. Refer to ICRA's website www.icra.in to view the updated methodology note on the sector.

ICRA Rating Feature

Rating Methodology for Entities in the Information Technology (Services) Industry

RATING METHODOLOGY

May 2017

This rating methodology updates and supersedes ICRA's earlier methodology note on the sector, published in December 2014. While this revised version incorporates a few modifications, ICRA's overall approach to rating entities in the sector remains materially similar.

Overview

The Indian IT-BPM (Information Technology & Business Process Management) Industry with revenues of over US$154 billion (in FY2017e) grew by approximately 8.0% and contributing approximately 7.7% to GDP. The IT services segment has a 52% share, followed by BPM and ER&D (19% each) and hardware (9%). Exports of IT Services/BPM contributed US$117 billion with growth of 7.6% and constituted majority of the revenue generated by the industry.

The industry's growth over the last decade has been led by the global sourcing from India by developed economies of USA and Europe, given India's value proposition of offering highly skilled talent at relatively lower wages. With the ample availability of talented and a skilled manpower pool and Government policies encouraging export of IT services, the industry has been able to capture over 50% market share in the global IT sourcing industry (Source: Nasscom). The IT services industry value chain includes traditional product offerings including application development and maintenance, software testing, infrastructure management, BPO services, consulting, system integration and research and development services in the area of hardware and software design. Increasingly, entities are developing new lines of business such as cloud-based computing, social media and mobility solutions that also provide non-linear growth opportunities though this requires extensive employee training.

This rating methodology document explains ICRA's approach to analysing business and financial risk in IT services companies. It aims to help issuers, investors and other interested market participants understand ICRA's approach towards analysing the quantitative and qualitative risk characteristics that are likely to affect rating outcomes in the sector. This methodology does not include an exhaustive discussion of all factors that are reflected in the ratings but would enable the readers to understand the rating considerations that are most important. These factors have been clubbed under three broad heads of Business Risk, Financial Risk and Management Quality as outlined below:

Business Risk Assessment

» Scale and Market Position
» Diversification
» Client Profile
» Operating Parameters
» Systems, Processes and Compliance

Financial Risk Assessment

» Revenue Growth and Profitability
» Foreign Currency related Risk
» Working Capital Intensity

- Leverage, Coverage Indicators
- Cash Flows, Liquidity
- Tenure Mismatches and Risk Relating to Interest Rates and Refinancing
- Contingent liability/off-balance sheet exposures
- Accounting Quality
- Event Risk

Promoter/ Management Quality

BUSINESS RISK ASSESSMENT

Scale and Market Position

The scale for the IT services player is a function of its revenues while the market position is reflected through its competitive position in key markets such as the USA, the UK and the EU. The ability of a global IT outsourcing player to sustain a strong competitive position hinges on its ability to attract mid and bulge bracket clients and maintain high renewal rates, by offering a comprehensive range of services – including end-to-end solutions, products and services that are relevant to the marketplace. The size of a player's operation in the IT services industry directly impacts economies of scale benefits and its ability to sustain headwinds in terms of pricing pressure, attrition and loss of key clients. Further, achieving certain threshold of revenues supports companies to bid for and win large size contracts by virtue of their demonstrated execution capabilities and resource mobilisation strengths. In addition, entities with scale benefits can afford to have a larger bench strength (idle manpower) to be deployed quickly for a new contract leading to faster execution capability coupled with the flexibility to deploy critical resources across multiple projects simultaneously, leading to higher utilisation rates. Nevertheless, companies with niche offerings with intellectual property also stand on a strong footing as it is difficult to replicate the product owing to the complexities involved in the same. Such companies can withstand market pressures and continuously innovate to stay relevant in the market place (such as ERP systems designed for the banking sector, engineering design services for specific sectors).

Diversification

Revenue diversification imparts greater long-term stability to revenues and cash flows of an entity. For an IT services Industry player, ICRA evaluates diversification in the form of service offerings, end-user industries, customer as well as geographies.

Service/ Product Offerings Diversification: The IT services industries offer various services such as application development and maintenance, system integration, infrastructure management services, ERP implementation, consulting etc as well as certain software products. Companies that are present in multiple business lines are better placed to offer bundled services to clients as well as bid for larger deals. ICRA also evaluates the presence of entities in various emerging technologies such social networking, mobility solution, automation, cloud computing that offer scope for non-linear growth opportunities as well as critical for future success.

End-User Industries Diversification: The IT services companies are primarily application-driven software firms where the company's position is often achieved by catering to specific industry verticals, ahead of the competition and then nurturing the end-market relationship through continued product development and strong customer support. The fortunes of the IT services industry are linked to business prospects offered by such industries and the same is evaluated by ICRA. Some of the predominant end-user industries include Banking & Financial Services, Media, Telecommunication, Manufacturing, Retail etc. Diversified presence buttresses the industry against prolong recessionary conditions in certain verticals leading to drastic cut in their IT spending.

Customer Diversification: An adequate degree of customer diversification reduces an entity's vulnerability to variability in demand associated with a select few customers as well as disruption in the business of single customer. While certain small/mid size companies in the growth phase may have high concentration on single client, ICRA takes into account the strategic nature of such relationships as well as the projected client concentration risk. ICRA evaluates the proportion of revenues coming from top client, top 5/10 clients in order to assess customer concentration risk.

Geographical Diversification: Considering the fact that Indian IT services are mainly export driven, with the US contributing more than 50% of the revenues, it is inevitable that a majority of the firms will have a similar proportion of revenues coming from the USA. In ICRA's opinion presence across various key regions such as the USA, Europe, Asia Pacific, Latin America, despite high proportion of revenues coming from a few territories that represent adequate geographic diversity. ICRA believes that geographical diversity is of utmost importance considering events such as slowdown in economic activity in one of the key markets or visa restriction for Indian IT professionals in a specific geography. Further, ICRA also evaluates the presence of various off-shore development centres and their geographical diversity as it provides companies uninterrupted services across time-zones and against unforeseen calamities.

Client Profile

Entrenched relationships with large companies or Fortune 500 companies ensure repeat revenues and provide stability in revenues. In ICRA's experience a high level of repeat revenues (exceeding 90%) indicating high level of dependence on such IT service providers and is viewed a credit positive. ICRA also evaluates the addition of new clients over the last few years to assess the company's execution track-record and limited new client additions compared to peers, which can depict a sign of weakening delivery capabilities. Trends in customers across different revenue buckets, active clients, repeat revenues, new client added as well as quality of clients are evaluated to arrive at an entity's business strength.

Operating Parameters

Employee cost (including sub-contracting cost) forms the largest part of operating expense for any IT services entity. Hence an ICRA analysis of operating efficiency primarily involves around levers available for better utilisation of manpower - both offshore and onshore. Rising manpower cost and pressure on billing rates for commoditised services have led to pressure on profitability of Indian IT service players. Since operating margins of the IT service players are under pressure, control over the cost structure i.e. employee cost, SG&A (Selling, General and Administrative) and optimisation of the same remains critical.

Contract Mix (Time/Material or Fixed Price Contracts; Onsite/Offshore) and Billing Rates: There are primarily two types of contracts entered into by companies – Time/Material Contracts where the billing is based on the number of people deployed on projects multiplied by average billing rate skill-wise. In case of fixed price contracts, the contract value is at a lumpsum value with the focus on deliverables and success-based outcomes rather than the number of people working on the project. Fixed price contracts have an advantage of higher margins by virtue of ability of a company to manage resources better though it requires better project management skills and execution capabilities to prevent cost and time over-runs. For example, critical and high cost resources can be utilised for multiple projects leading to scale benefits. In case of time and material contracts, though the risk is relatively less from cost-overrun point of view the potential margin is also low.

ICRA also evaluates the employee mix for the onshore/offshore component. Companies having a large proportion of the workforce on-shore report higher revenue growth as billing rates are higher for onshore employees though the same is true for costs as well leading to lower operating margins. While workforce deployment is determined by the nature of the business contract, a healthy mix between onshore and offshore leads to relatively higher operating margins as costs are lower for off-shore employees. A larger proportion of local hires (onshore) increase expenses significantly and this may often lend greater stability during visa restrictions.

IT companies have been offering relatively low value-add services such as application development, system integration where the billing rates are lower, though they have gradually moved to relatively higher value-add services such as Infrastructure Management Services, Consulting, ERP designing and implementation. Further, aggressive investments in emerging technologies such as Automation, Social Networking, Mobility, Analytics, and Cloud Computing Solutions, which are in demand, provide opportunities to generate better rates as well as provide non-linear growth opportunities for IT service companies. These high end services provide higher billing rates and may offset pricing pressure on commoditised offerings.

Manpower Utilisation, Attrition and Training: The IT industry being service oriented has high dependence on employees (vis a vis manufacturing concerns) and ICRA evaluates the utilisation and attrition rate of the rated company across its peers and industry averages. High attrition rate has a direct and indirect bearing on the present and future success of the company as it not only hampers the execution of projects in pipeline but also creates a negative brand image amongst customers, which may adversely impact repeat business. Employee utilisation levels have a direct bearing on profitability levels. While high utilisation levels (vis a vis industry averages) benefit the operating margins in the short term, they also impair the entity's ability to deploy people on new contracts at short notice. Similarly, a wide gap in employee utilisation levels (on the lower side) compared to peers may indicate delays in deployment of such bench strength owing to lack of new contracts or mismatch in skill sets leads to additional cost levels, thereby impacting margins.

Being in a people and skill-focused industry, IT services companies are expected to have adequate training and development programmes for employees to keep them updated technologically. This has gained more prominence in view of the technological shifts such as focus on SMAC and re-training of existing employees.

Systems, Processes and Compliance

A large organisation need to organise itself along various functions, geographies and technologies in order to manage itself as a part of evolution from a few employees to a multi-billion dollar enterprise. ICRA evaluates the level of standardisation of various systems and processes, implementation and monitoring of the same through interaction with the management and public documents such as Annual Reports. Similarly, ICRA also evaluates compliance of Indian IT companies with various local laws especially pertaining to visas, based on management feedback and past track record as any deviations can lead to a high level of claims and damages in case of lawsuits.

FINANCIAL RISK ASSESSMENT

This section provides a brief summary of the key financial metrics evaluated by ICRA to assess an IT service player's exposure to financial risk. For a more detailed description, readers may refer to the note titled, "Approach for Financial Ratio Analysis" available on ICRA's website.

Revenue Growth and Profitability

Sustained revenue growth matching or above industry average is a positive and typically reflects a high level of repeat business, end market relationships and deep market knowledge. Companies that are able to sustain growth on a healthy base, are able to continuously develop new products, enter into new lines of business/industries and provide strong customer support. This acts as an entry barrier as it is difficult to replace existing vendors through competitive displacement. On the other hand, stagnating or declining revenues are indicative of a lack of portfolio depth or inability of the company to provide industry level products and services indicating weakening of competitiveness.

A company with higher profitability margins and returns on capital has a greater ability to generate internal accruals, attract external capital, and withstand business adversity. As employee benefits form the largest cost component for the IT services industry, the ability to leverage variable component to protect margins in case of headwinds is viewed as a credit positive. ICRA also evaluates capitalised expenses on developing own Intellectual Property (e.g. Software) in relation to current profit levels as well as future potential to generate profits out of such investments. The complexity of service offered in the value chain, presence of escalation clauses, offshore-onshore mix, non-linear business model, variable salary component and employee utilisation rate are some of the main factors that determine the profitability of IT services companies. The two important profitability ratios ICRA evaluates are Operating margin (OPBDITA/ OI) and Return on Capital Employed (RoCE).

Foreign Currency Related Risk

The Indian IT services sector is primarily export-driven with revenues denominated in foreign currencies such as the US dollar, the sterling pound, the euro while the costs are In Indian rupees exposing them to any adverse movement in INR vis a vis such currencies. ICRA evaluates the net foreign exchange exposure of the Indian IT company and its hedging policy. Companies that have a stated hedging policy with appropriate mechanism in place to hedge both long-term and short-term exposures are viewed positively. However, hedging long-term contracts beyond the existing agreements runs the risk of lower profitability if contract prices are renegotiated at lower rates or cost moves upwards drastically while realisations remain fixed despite favourable rupee movement. Companies hedging their foreign currency debt and related interest outgo as well as companies having foreign currency debt with the ability to repay the same out of profits from international operations leading to natural hedge are viewed positively.

Working Capital Intensity

The Indian IT service players generally have low to moderate working capital intensity with majority of the working capital requirement arising from receivables. ICRA evaluates the ageing schedule of receivables to arrive at the company's ability to realise its assets as well as assess the possible risk of bad debts in the future. ICRA compares the working capital ratios of the IT services players with its peers and any significant deviation in the ratios like debtors days and inventory days gives a possible indication of the dispute with the client regarding certification/approval of work, recognition of work, and/or release of payments. Also evaluated is the exposure to various Government bodies where the risk of elongated payment cycle is observed to be relatively higher. ICRA also monitors the trend in "Unbilled Revenues"[1] as a percentage of revenues over the past few years, and its conversion to cash. Companies with a stipulated payment policy, project monitoring systems and adherence to quality and time stipulations are generally able to secure a faster release of payments.

Leverage, Coverage Indicators

ICRA's assessment of the financial risk profile of the company is based upon the company's ability to generate healthy cash flows to reinvest in the business as well as meet the debt-servicing obligations.

1 Unbilled Revenues refer to portion of work completed by the company at year-end though will be billed after completion of agreed milestone.

Leverage ratios are an indicator of the degree of financial flexibility a company enjoys in terms of its ability to raise funds from alternate sources in times of financial distress. Such flexibility is reflected in a company's gearing (Total Debt-to-Tangible Net-worth) and Total Debt-to-EBDITA multiple. A low gearing ratio indicates a cushion while continuing to invest in new technologies, capex and entry into new markets. It also implies adequate financial flexibility available in terms of raising funds, primarily from external sources (debt borrowings) for meeting funding requirements. However, the extent to which a company can leverage its balance sheet is determined primarily by the management's philosophy.

The interest coverage indicator reflects the company's ability to fund the cost of external borrowings after meeting all operating expenditure requirements. It is an important rating consideration as a weak EBDITA-to-interest or debt service coverage multiple indicates that the company is not generating adequate profits to meet its interest and debt maturities and may signal a default risk.

Cash Flows and Liquidity

Strong free cash flows indicate the ability of a company to fund capital expenditures, seek organic and inorganic growth opportunities and service the debt obligations. Analysed here are the trends in an entity's Funds Flows from Operations after adjusting for working capital changes, the Retained Cash Flows, and the Free Cash Flows after meeting debt repayment obligations and capital expenditure needs. Since the prime objective of the rating exercise is to assess the debt-servicing capability of a company, ICRA draws up projections on the likely financial position of the company, based on the expected movements in operating performance factoring in capex and investment requirements as well as upcoming debt obligations to study the impact on revenue growth and profitability, cash flows, leverage as well as debt protection indicators. We also look at the funding requirements of a company and the funding options available to it.

In addition to long-term financial flexibility the liquidity profile of the company is equally important to understand the company's ability to meet short-term financing requirements. A key indicator of the same is the monthly working capital utilisation of the company and the available drawing power or sufficient cash/liquid investments to meet operating expenses, margin required to undertake capex, fund incremental working capital requirement, investment commitments and debt-service obligations.

Tenure Mismatches, and Risks Relating to Interest Rates and Refinancing

Large dependence on short-term borrowings to fund long-term investments can expose a company to significant re-financing risks, especially during periods of tight liquidity. The ratings factor in the existence of adequate buffers of liquid assets/bank lines to meet short-term obligations and the extent to which the company could be impacted by interest rate movements on such borrowed funds.

Contingent Liabilities/Off-Balance Sheet Exposures

For this, the likelihood of devolvement of contingent liabilities/off-balance sheet exposures and the financial implications of the same are evaluated

Accounting Quality

Here, the Accounting Policies, Notes to Accounts, and Auditors' Comments that are part of the Annual Report of the issuer are reviewed. Any deviation from the Generally Accepted Accounting Practises is noted and the financial statements of the issuer adjusted to reflect the impact of such deviations. The management approach towards accounting policies such as classification of revenue and capital expenditure, depreciation policy (useful life of assets), amortisation of goodwill etc is also evaluated vis a vis Industry standards.

Event Risk

The IT services industry has historically experienced its share of corporate action often having a material impact on the credit profile of a company. Such an event could include a substantial debt-funded acquisition; mergers, business restructuring, asset sales and spin-offs, capital restructuring, litigations etc and is factored in subject to management inputs or on the occurrence of the event.

Financial flexibility

The entity's financial flexibility—as reflected by it unutilised bank/credit limits, liquid investments, and the nature of its relationship with banks, financial institutions and other intermediaries—is assessed. The comfort derived from a strong parentage also helps in improving its financial flexibility.

Promoters/ Management Quality

All debt ratings necessarily incorporate an assessment of the quality of the issuer's management, as well as the strengths/weaknesses arising from the issuer being a part of a "group". Also of importance are the issuer's likely cash outflows arising from the possible need to support other group entities, in case the issuer is among the stronger entities within the Group. Usually, a detailed discussion is held with the management of the issuer to understand its business objectives, plans and strategies, and its views on past performance.

Some of the other key points assessed are:

- Experience of the promoter/management in the line of business concerned
- Commitment of the promoter/management to the line of business concerned
- Attitude of the promoter/management to risk, including pursuing business opportunities that are prone to bad debts, though may provide higher growth in the near term
- The issuer's policies on leveraging, interest risks, and currency risks
- The issuer's plans on new projects, acquisitions, expansion, etc.
- Strength of the other companies belonging to the same group as the issuer
- The ability and willingness of the group to support the issuer through measures such as capital infusion, if required

Summing Up

ICRA's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the instrument being rated. This opinion is arrived at following a detailed evaluation of the rated entity's industry, business and financial risks, its likely cash flows and the adequacy of such cash flows vis-à-vis the debt servicing obligations and other funding requirements.

As this note highlights, the credit quality of an IT services player depends upon the presence of large and reputed clients with a high level of repeat business, well diversified services offerings, deep market knowledge as well as geographically diversified revenue and service delivery base. Further, operating efficiency in the form of employee utilisation, which forms a major chunk of the cost, remains critical. ICRA's financial risk analysis for IT service players focuses on a track record of sustained profitability, leverage levels, ability to generate free cash flows and financial flexibility. ICRA's rating approach also involves making an assessment of the entity's management quality and governance practises.

ICRA Limited

CORPORATE OFFICE
Building No. 8, 2nd Floor, Tower A; DLF Cyber City, Phase II; Gurgaon 122 002
Tel: +91 124 4545300; Fax: +91 124 4050424
Email: info@icraindia.com, Website: www.icra.in

REGISTERED OFFICE
1105, Kailash Building, 11th Floor; 26 Kasturba Gandhi Marg; New Delhi 110001
Tel: +91 11 23357940-50; Fax: +91 11 23357014

Branches: **Mumbai**: Tel.: + (91 22) 24331046/53/62/74/86/87, Fax: + (91 22) 2433 1390 **Chennai**: Tel + (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294, Fax + (91 44) 2434 3663 **Kolkata**: Tel + (91 33) 2287 8839 /2287 6617/ 2283 1411/ 2280 0008, Fax + (91 33) 2287 0728 **Bangalore**: Tel + (91 80) 2559 7401/4049 Fax + (91 80) 559 4065 **Ahmedabad**: Tel + (91 79) 2658 4924/5049/2008, Fax + (91 79) 2658 4924 **Hyderabad**: Tel +(91 40) 2373 5061/7251, Fax + (91 40) 2373 5152 **Pune**: Tel + (91 20) 2556 1194/0195/0196, Fax + (91 20) 2556 1231