Interpreting the Sector Credit Factor Reports for Corporates

Special Report

This report updates and replaces *Interpreting the Sector Credit Factor Reports for Corporates*, dated 16 November 2012.

Sector-Level Guidance: India Ratings' Sector Credit Factors (SCFs) are designed to enable issuers and investors to understand the building blocks used when rating companies in a particular sector. They highlight the key rating factors most frequently applied in major corporate sub-sectors, while still recognising the potential for the unique characteristics of a company and sector to affect ratings.

Rating Category Indications: Each SCF report's page 2 Building Blocks chart identifies industry- and company-specific risk profiles per rating category most commonly observed for that sector. The mid-point financial ratios quoted are indicative of the range relevant to that rating category.

Factors Unweighted: The weighting between qualitative and quantitative factors varies substantially over time, despite the linear appearance of the building blocks diagram. That said, as a general guideline, where one factor is significantly weaker than the others, the downside risks of this weakest element tend to attract a greater weight in the analysis.

Publications: To date, India Ratings has published 5 SCFs.

Figure 1

SCF Reports Published

Rating Indian Construction Companies
Rating Indian Cement Producers
Rating Indian Telecoms Companies
Rating Indian Mining Companies
Rating Indian Steel Producers

Source: Ind-Ra

Complementing India Ratings Criteria: The sector credit factors should be read in conjunction with India Ratings' master criteria *Corporate Rating Methodology* which details the overarching approach to rating corporates and which includes a list of the main financial ratios used. The principal rating factors are listed in Figure 2 below. Reports on sector-specific credit factors complement the master criteria report, but employ a greater focus on how criteria are applied at the sub-sector level.

Figure 2

Master Criteria Rating Factors vs. Sector Credit Factors

Corporate rating methodology – rating factors	SCF building blocks diagram – credit factors
Industry profile and operating environment	Sector risk profile
Company profile	Company-specific traits
Financial profile	Financial profile
Management strategy and corporate governance ownership, support and group factors	Other

Source: Ind-Ra

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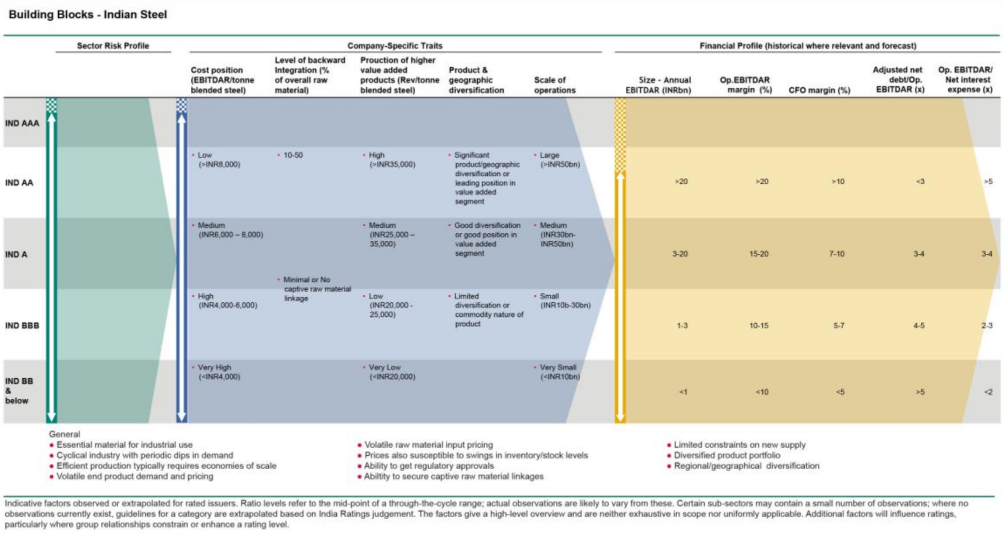
Understanding the Building Blocks Template

The solid vertical arrowed segments denote the range of rating categories typically consistent with, in turn, the sector risk profile, company-specific traits, and the company financial profile. A chequered box denotes the potential to be rated at a higher rating level, albeit in relatively rare cases.

Figure 3



Sector Risk Profile (Green)

India Ratings generally approaches the analysis sequentially by starting with sector risk. This will typically set a range of rating categories where most observations for this sector are found. Sectors that have the capacity to offer the lowest levels of business risk, such as integrated steel producers, will identify multiple rating categories. Sectors with typically high risks will start the process with a lower number of likely rating categories.

Company-Specific Traits (Blue)

Company level traits may very rarely offer the potential to enhance the final rating of that company beyond that indicated in the first column's sector risk profile. For example, being a single, dominant player in a higher risk sector may confer modest additional benefit beyond the rating profile observed for the rest of the sector.

Financial Profile (Mustard)

The financial profile column may equally indicate a higher range of ratings and thus some potential further rating uplift, albeit in very rare circumstances. Much more frequently, weak financials can drag a company well below the rating suggested by the first two columns.

Other Factors

Finally, this column may have an overriding enhancement or detrimental feature, which can also affect the end-result credit rating, or other criteria usually used for that sector.

Applicable Criteria

Corporate Rating Methodology

Sector Risk Profile

- India Ratings believes most industries carry a fundamental range of rating possibilities linked to their business risk.
- The sector risk profile is thus the first credit factor to be assessed.

The sector risk profile provides a starting point for rating a company in a given sector. In highlighting general sector characteristics, India Ratings has identified key attributes consistent with particular rating categories. A company's overall risk profile cannot become completely detached from these typical ranges for ratings in the sector risk profile column.

The rating parameters in this column do not simply replicate the spectrum of existing company ratings within the sector; they place the inherent risks of the sector into broad rating categories. The characteristics of a cyclical sector that sells highly discretionary goods to consumers, and is part of a competitive market with no particular niche and no barriers to entry, is unlikely to sit comfortably in the higher investment grade categories such as 'IND AA' and above.

Definitions

- **A rating category** includes all three ratings (eg, 'IND BBB−', 'IND BBB' and 'IND BBB+').
- **A rating level** is the notch-specific level within the rating category (eg, 'IND A+' within the 'A' rating category).

Where relevant, India Ratings also lists sub-sector attributes and where such risk profiles sit within the rating spectrum. Where sector attributes are not allocated to a specific rating category, these are listed under the *General* heading at the bottom of the building blocks graphic.

Industry Risk

"India Ratings determines an issuer's rating within the context of each issuer's industry fundamentals. Industries that are in decline, highly competitive, capital intensive, cyclical or volatile are inherently riskier than stable industries with few competitors, high barriers to entry, national dominance, and predictable demand levels.

Major industry developments are considered in relation to their likely effect on future performance. The inherent riskiness and/or cyclicality of an industry may result in a ceiling for ratings within that industry. Therefore, an issuer in such an industry is unlikely to receive the highest rating possible ('IND AAA') despite having a very conservative financial profile.

Equally, reflecting differences in financial and management profile, not all issuers in low-risk industries can expect high ratings. Instead, many credit issues are weighed in conjunction with the risk characteristics of the industry, to arrive at a balanced evaluation of credit quality."

Source: India Ratings' Corporate Rating Methodology

Business risk is not looked at in a vacuum. To provide maximum clarity and avoid overly theoretical bands, representative financial profiles are assumed in defining the sector risk profile in some industries.

Company-Specific Traits

- This second set of credit factors addresses the position of an individual company within a sector.
- These individual factors help position the issuer within the ranges provided for sector risk.
- The cumulative effect of company-specific factors may occasionally take the issuer outside the range of categories identified for general sector risk.

Company-specific traits and financial measures further refine the rating to specific rating levels whether within or outside the "natural" rating territory defined under the sector risk profile.

Turning to this company traits column, specifics of the company (sometimes overlapping with the previous column) may help to place further limits as to the appropriate rating. Single-product companies are unlikely to reach the upper end of the rating range.

Diversification in terms of product or geography may help to pitch a rating at or above the sector risk profile, if the bulk of sector players represented in the column do not typically have a mix of product or geographical diversification to lower their individual risk profiles.

Equally, size may be a company-specific characteristic that secures market dominance or price control, or economies of scale unrepresented in the previous column. The size of the company also often denotes diversification in terms of product or geography, or local dominance.

Figure 4
Illustrative Table: Company-Specific Traits

	Diversification and scale of operation	Complexity of product offerings	Technical capability	Customer concentration	Market position
IND AA	Large companies with well-balanced revenues from end-user segments	Portfolio of technology-oriented offerings across product categories/ functionalities	Product development focus through in-house R&D or JVs providing access to technology	Sole supplier status or group links with large manufacturers Low; top 5 customers contributing <50% revenues	Market leadership in most offerings
IND A	Large companies with presence across end- market segments	High value, technology-oriented products	Product development focus through in-house R&D or JVs providing access to technology	Sole supplier status or group links with large manufacturers Low; top 5 customers contributing <50% revenues	Strong position in key products
IND BBB	Medium-sized companies with limited diversification	Simpler components/parts	Product differentiation with average technical capability	Medium; top 5 customers contributing 50%-70% revenues	Leadership position in small segments; moderate position in key segments
IND BB and below	Small companies supplying to niche segments	Simple process-oriented offerings	Low levels of technology	High; top 5 customers contributing >70% revenues	Low barriers to entry

Source: Ind-Ra's report Rating Indian Automotive Suppliers

In turn, individual factors are defined in greater detail in the report's commentary with some linked to financial metrics.

Company Profile

"Several factors indicate an issuer's ability to withstand competitive pressures, which can include, for example, its position in key markets, its level of product dominance, and its ability to influence price. Maintaining a high level of operating performance often depends on product diversity, geographical spread of sales, diversification of major customers and suppliers, and the comparative cost position.

Size may be a factor if it confers major advantages in terms of operating efficiency, economies of scale, financial flexibility, and competitive position. Size may not, however, always support higher ratings. For example, in commodity industries, size is not as important as cost position, since the ability of one participant to influence price in a global commodity is usually not significant."

Source: India Ratings' Corporate Rating Methodology

Financial Profile

The financial profile column lists indicative financial metrics, based on those contained in the *Corporate Rating Methodology* used in assessing the financial strength of a representative company in the sector.

As the third column in the diagram, this rating factor should not be used as a "read-across" that a company can be afforded a high rating purely because it has upper-level financial metrics yet a lower-tier sector risk profile and lower-bracket company-specific traits. However, it can be assumed that healthy financial metrics may indicate some uplift compared with the read-across from the previous two columns' lower reference points.

- Financial credit factors complete the assessment, and often have a significant impact on refining the final rating judgement.
- "Weakest link" analyses are often most critically affected by the financial factors, eg liquidity weaknesses.

Equally, weak financial metrics may be offset in part for companies cited within the upper end of the previous two columns, and may be assigned a higher rating because stability and predictability of operational performance is assured, and therefore slightly higher leverage is acceptable compared with other sector participants without the same lower business risk profile.

Mid-point median ratios relate to the category rather than notch-specific levels. The danger in providing guideline financial metrics is that users view this column as ultimately defining the rating. Clearly, this is not the case. Financial metrics can alleviate only some of the pressures from the sector risk profile and company traits, and do not enable the company to completely detach itself — even where, for example, financial leverage levels are very low (or even potentially in a net cash position).

Similarly, India Ratings does not offer financial metrics for points on the rating scale where business risk would reduce to negligible the chances of a final rating actually being assigned at a particular level. For example, many well-run technology companies typically have significant cash resources to carry them through a sudden drop in volumes. Consequently, this sector's upper risk profile would be representative of net cash technology companies. Conversely, net cash (lease-adjusted leveraged basis) asset-intensive shipping companies are not the norm when considering the sector risk profile.

India Ratings also does not rate to a snapshot year-end metric. Instead, the sustainability of these credit-protection measures is evaluated over a period of time — using both historical data and India Ratings' near-term forecasts. Consequently, the indicative medians quoted are multi-year medians rather than single-year metrics. This approach is consistent with India Ratings' "rating through the cycle" approach (see below), which in a recession focuses on the "exit point" — the profile after the company exits the cycle.

Other Factors

This final column acknowledges that other rating factors may override the cumulative effect of the previous types of credit factors. Management or governance failures may reduce the rating level. External support from a parent company or state may lift the rating.

Inter-Relationship of Factors

Precisely because there are so many combinations of different factors, and some may weigh more heavily in some sectors than others — and all will weigh more or less heavily at different points over time — India Ratings does not set out to weight these columns' different attributes. There is no standard formula to link these inputs into an exact rating. For example, a poor liquidity financial metric will often completely override the benefits of all the previous columns, and result in a low credit rating. Similarly, a high FCF margin and low leverage may be "the last hurrah" of an expiring industry, disposing of stock in a fire sale.