Non-Profit Institutions Rating Criteria

Sector-Specific Criteria

This criteria report updates and replaces the previous version, dated 11 September 2015.

This report describes the operating and financial factors India Ratings and Research (Ind-Ra) considers in rating certain non-profit institutions (institutions, or societies, associations, organisations, trusts or institutions registered under the Societies Registration Act, 1860; the Indian Trusts Act, 1882; the Charitable & Religious Trusts Act, 1920 or as a charitable company under Section 8 (old Section 25 of the companies Act, 1956) of the Companies Act, 2013 are considered as Voluntary organisations/Non-governmental organisations. In addition, there are informal groups working at grassroots level without being registered under any legislation but may also be considered as part of voluntary sectors). Most of these institutions are not created for profit maximisation and are generally exempted from paying income tax under Income Tax act. Not all rating factors outlined in this report may apply to an individual rating or rating action. Each specific rating action commentary or rating report will discuss those factors most relevant to the individual rating action.

This report represents a sector-specific extension to Ind-Ra criteria report "Revenue Supported Rating Criteria," dated 6 December 2018.

Broad Spectrum of Credits: Charitable/voluntary organisations, private foundations, human service providers, co-operative societies and cultural institutions, are typical examples of non-profit institutions covered by these criteria. Non-profit colleges and universities, independent schools, and various healthcare entities are covered by separate, sector-specific criteria.

Role of Essentiality: Institutions providing income generation and critical services, including physical, mental, and social care, would be deemed strongest in terms of essentiality. Many social service providers are fairly small; serve a client base consisting of at-risk individuals with significant, fairly expensive, acute care needs; and depend on a single contract from just a handful of referral agencies for the bulk of their revenues.

Conversely, many of these institutions do not serve as critical a societal need as a human service provider yet offer robust income, educational or cultural support to a large section of society. As a result, these institutions may demonstrate a strong track record of demand-driven funding support that compensates for the less critical, less immediate need served. Co-operative societies, including milk co-operatives are playing a major role in improving income generation activities in rural areas. These co-operatives receive funding support not only from their state governments but also from the central government.

Other Considerations: An institution's mission, market position vis-à-vis competitors, programs and services quality, and leadership play an integral role in the analysis of a nonprofit institution. In addition, depending on business model, fundraising and investment may also be important factors.

Variations from Criteria

Ind-Ra's criteria are designed to be used in conjunction with experienced analytical judgment exercised through a committee process. The combination of transparent criteria, analytical judgment applied on an instrument-by- instrument or issuer-by-issuer basis and full disclosure through a rating action commentary (RAC), strengthens Ind-Ra's rating process while assisting market participants in understanding the analysis used in the ratings.

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A rating committee may adjust the application of these criteria to reflect the risks of a specific instrument or entity. Such adjustments are called variations. All variations will be disclosed in the respective RACs, including their impact on the rating where appropriate.

A variation can be approved by a ratings committee where the risk, feature, or other factor relevant to the assignment of a rating and the methodology applied to it are both included within the scope of the criteria, but where the analysis described in the criteria requires modification to address factors specific to the particular instrument or entity.

Methodology

In assessing the credit quality of an institution, Ind-Ra will focus on several core factors as follows:

Operational Effectiveness

Demand-driven revenues are the primary source of operating funds for most non-profit organisations. Consequently, an institution's ability to support its mission and effectively position itself vis-à-vis competitors is critical to maintaining or improving its financial position.

Demand Flexibility

Non-profit organisations with an established operating track record are better positioned to cultivate and nurture a patron for their program or service. Such organisations tend to be less susceptible to changes in demand and related revenues.

Fundraising

Demonstrated fundraising prowess may enable an institution to diversify revenues and offset the costs associated with certain non-self-supporting programs or services.

Revenue Diversity and Operating Margin

A lower level of revenue concentration suggests an unexpected interruption in funding from one source will not affect these institutions ability to manage expenditures in line with revenues.

Balance Sheet Resources and Liquidity

Institutions with a sizable financial cushion are better protected from an unexpected material decline in core revenues and/or unexpected significant increases in costs.

Debt Burden

The ability of an institution to service annual carrying charges from current operations may offset the significance of projected maximum annual debt service (MADS) as a percentage of current unrestricted operating revenues.

Governance and Management

An organisation's financial position and operating performance are highly influenced by the strategic direction and management oversight exercised by the organisation's board of directors/trustees. Moreover, the effectiveness of the executive management team is critical to the success and long-term viability of any organisation. Yet, the evaluation of governance and management quality is the most subjective part of Ind-Ra rating analysis.

For this reason, a meeting with key board members and/or senior management is valuable, particularly for new credit ratings. For larger organisations, key senior management is considered to be the CEO, CFO, the chief operating officer, and the head of human resources. The purpose of the meeting is to develop an understanding of the organisation's mission, philosophy, and strategic goals. Ultimately, a borrower's ability to meet its financial commitments is driven by the business strategy adopted and pursued in the markets it serves. Ind-Ra will attempt to assess the soundness of the business strategy through an analysis of historical performance relative to projections, the competitive landscape and payer dynamic, and the regulatory environment.

Applicable Criteria

Revenue Supported Rating Criteria, December 2018

If a new capital project is being undertaken, Ind-Ra will inquire as to the genesis of the project, the depth of the planning process, expected funding sources for capital investments and how the board and management have interacted to identify all risks in the project to minimise the probability for unsuccessful execution.

Throughout its credit analysis, Ind-Ra will focus on management best practices and assess the effectiveness of operational tools (e.g. management information systems) in measuring and evaluating performance and efficiency. Management practices are one of the leading qualitative factors that Ind-Ra evaluates.

Operating Profile

Demand Drives Financials: Fundraising and Investment Income Important for Some

For the vast majority of non-profit institutions, the ability to meet financial obligations hinges on demand for their core product or service. Consumers of this product or service could be the general public (e.g. charitable foundations or cultural organisations or milk co-operative societies), state or local governments (e.g. human service providers), or higher education (e.g. research organisations). Given that there are often many institutions competing for the same stream of revenues, including activity-based revenues, donations, and sponsorships, the essentiality of these institutions is critical to understanding how reliable demand for a product or service will be over time.

Although demand-based revenues are key credit drivers for many institutions, fundraising and investment income also play an important role. For some institutions, notably charitable organisations, fundraising for a specific purpose, such as cancer research, may be the institution's primary focus. The purpose of fundraising for other institutions may be to support operations, defray annual debt carrying charges, fund capital projects, or build financial resources, including endowment.

In most years, a sizable endowment and/or pool of long-term investments yields increasing levels of investment income as an endowment or investment spending policy is applied annually to a growing resource base. The receipt of investment income generally facilitates diversification of revenue, although investment income is occasionally the primary source of operating revenues for these institutions. These institutions would tend to be significantly deficit-generating in the absence of investment income allocated under the annual endowment or investment spending policy pay out.

Figure 1

Attributes: Operating Profile

Stronger attributes	• Provider of an essential service or high quality product or service to a firmly established client or patron base; institution tends to be a leader in its respective market, supported by an experienced, forward-looking management team
Midrange attributes	• Provider of a product or service that is competitive with other institutions, though not market leading; client or patron base is less established could face demand variability overtime; management is less seasoned and more reactionary
Weaker attributes	• Provider of a product or service in low demand and/or of lower perceived quality than that its of primary competitors; client or patron base tends to be small and less loyal; management experience could be lacking, particularly in articulating a more focused message necessary to build a more stable demand

Source: Ind-Ra

Operational Effectiveness

Trends in Activity Data Highlight Program and/or Service Demand

Given the reliance of most of these institutions on demand-driven revenues, unbudgeted variance in activity could be a credit concern, particularly if the increase or decrease in activity is unexpected, has a material adverse financial impact, and, from a budgetary perspective, cannot be managed. Generally, stable to upward trending activity data are viewed favourably; a one-year decrease or increase is not considered a trend but should be explained by the institution's management.

To gauge overall trends in demand for such institution's programs and/or services, Ind-Ra reviews five years of activity data. Depending on the type of institution, the data could highlight an institution's utilisation trends (e.g. admissions or memberships) or overall support for its mission (e.g. grant funding or contributions).

As discussed, certain well-endowed institutions derive the vast majority of their operating revenue from the annual receipt of investment income. For many of these institutions, demand-based operating revenues have little, if any, meaningful bearing on financial performance. While in these situations Ind-Ra may weigh more heavily its analysis of the balance sheet (*see Financial Profile, page* 5) as part of the overall rating process, activity-based data are still reviewed. Positive or negative trends in the data may signal a fundamental change in the actual or perceived quality of an institution's programs and/or services or in its overall competitive position. Such changes or shifts could potentially complicate an endowment-dependent institution's future ability to maintain or build balance sheet resources in the absence of financial market gains.

Demand Flexibility

Market Position and Track Record Correlated with Financial Strength

With the exception of state-regulated human service providers and large research institutes sponsored by external parties (e.g. central government), actual barriers to entry are fairly low. However, in reality, this concern can be mitigated by an institution's operating history, supported by an effectively communicated mission, and its longstanding identification with a certain cause of purpose. Across many activities, there is a strong correlation between length of operating history and financial strength, largely a function of the time needed to grow core revenue streams and cultivate a donor base necessary for effective fundraising.

In light of this industry characteristic and as part of its evaluation of activity-based data, Ind-Ra discusses with an institution its history, overarching mission, and the tactical implementation of its various components. Ind-Ra's analysis also incorporates a review of the competitive environment and an assessment of an institution's track record in responding to developing opportunities and threats.

Proposed major shifts in organisational strategy or focus are carefully scrutinised, particularly if they come with a potentially significant financial burden. Admissions or membership-driven cultural institutions tend to be the most susceptible institutions to the threat of competitors, often attempting to address sagging visitation trends or a stale exhibition with expensive new or expanded facilities. While these plans are not necessarily viewed negatively, the feasibility of a project, both from a construction and operations standpoint, is thoroughly vetted in Ind-Ra's analysis.

Fundraising

Contributed Funds Provide Operating and Capital Support

Institutional development, commonly referred to as fundraising, provides an important resource for many of these institutions. While charitable organisations are in the business of collecting donor contributions earmarked for a specific cause, contributions to other institutions provide an important source of budgetary flexibility and, over time, help build financial resources and finance necessary capital improvements.

Contributions to an institution come from a variety of sources, including board members, patrons, and other non-affiliated foundations and corporations. State and central government grants are also periodically allocated to certain institutions to support operations, facility development, or both. Ind-Ra typically requests information on the professional background of the board and other key supporters to assess giving potential. As the presence of an affluent board alone does not translate into actual giving, the board's track record of giving above the minimum required level is reviewed.

Figure 2

Attributes: Fundraising

Stronger attributes	• Long-standing fundraising culture, perpetuated by an identifiable mission and supported by mature, well-developed infrastructure to effectively solicit donor contributions; annual fund and capital campaign giving tends to be robust
Midrange attributes	• Established fundraising culture, supported by basic infrastructure needed to solicit donor contributions; giving tends to be adequate, though largely associated with specific projects or purposes
Weaker attributes	• Lacklustre fundraising culture, possibly as a result of the organisation's service line, highlighted by a spotty track record of development activities; generally no infrastructure in place to support effective fundraising, with most donations solicited on an ad hoc basis

Source: Ind-Ra

Gifts and contributions are typically made to an institution on an unrestricted basis in the form of a one-time or annually recurring donation or are restricted to a specific purpose. Unsecured loans from family and friends are a common form of revenue for such institutions. Outside of annual giving, which for some institutions could represent a sizable percentage of operating revenues, unrestricted gifts to most of these institutions are fairly limited, as donors generally prefer to lend their support to specific, identifiable projects or initiatives. Still, restricted giving enhances financial flexibility, as it enables an institution to free up funds it would have otherwise dedicated to a cause now being supported and funded by a donor.

Donor Cultivation Not a Short-Term Process

A robust fundraising culture takes time to develop. Many institutions initially focus on increasing annual fund participation among patrons and other supporters, later building off this base to launch comprehensive capital campaigns. Such campaigns target a host of institutional priorities, including academic and recreational facilities, deferred maintenance, scholarships, endowment, and athletics. In assessing an institution's fundraising prowess, Ind-Ra reviews the track record of development activities in the context of institutional mission, operating environment, and established fundraising culture.

Generally, there is a strong correlation between ratings and an institution's ability to fundraise, particularly when proceeds of a capital campaign are earmarked for the endowment or will help provide budgetary support for programmatic and/or service offerings. Institutions with a compelling mission (e.g. children's cancer research) and preeminent reputation often attract significant annual and capital support from a well-cultivated, highly galvanised donor base. To some degree, institutions located in metropolitan areas derive a fundraising advantage due to their proximity to larger pockets of wealth.

Financial Profile

Quantitative Assessment of Factors Informs Rating Process

Financial metrics contribute significantly to rating determinations. With inputs derived from audited financial statements and other supporting financial documents, Ind-Ra calculates and evaluates quantitative assessments of revenue diversity, operating performance, balance sheet resources, and debt burden, as well as the historical trends of such measures. Expectations for future financial performance and, ultimately, the credit rating are informed by assessments of those factors. As long as a borrower's underlying strategic position remains sound, a certain amount of variability in financial performance should not affect the rating on the bonds.

Ind-Ra analyses both the revenue and expense sections of the statement of activities to determine concentration of revenues and flexibility of expenses. Significant changes in revenues or expenses from one year to another should be explained by management. For most institutions, the ability to at least annually cover operating expenditures and debt-carrying charges from operating revenues has positive implications for its long-term financial position.

Expenditure Flexibility Key to Operating Stability

Given the potential impact that unexpected changes in funding could have on an institution's ability to achieve budgetary balance, Ind-Ra reviews an institution's expenditure flexibility, notably its ability to hold constant or even decrease its total operating budget during times of revenue weakness. Integral to this analysis is an assessment of significant expenditures. In general, most institutions are adept at managing variable expenses, including those directly tied to their provision of programs and/or services, and demonstrate a willingness to pare down their offerings in response to less favourable economic conditions or reimbursement levels.

Importantly, Ind-Ra recognises that certain institutions perform mission-critical activities, such as critical hospital care, regardless of the negative financial impact. As part of its expenditure analysis, Ind-Ra discusses with management its long-term strategy for cost containment related to such mission-critical offerings and attempts to ascertain what control, if any, management may have in maximising future revenues or reimbursement. Ind-Ra also seeks to understand whether the failure of a mission-critical program or service to achieve certain financial benchmarks over time will result in its cancellation or restructure. In general, an institution's ability to identify specific triggers that may cause it to exit an unprofitable business line and articulate an overall strategy for managing loss-generating, mission-critical activities is viewed favourably in the rating process.

Although most institutions maintain a fairly lean and flexible operating budget, costs associated with staff salaries and related benefits are generally fixed and, depending on the organisation, often significant. While Ind-Ra notes that institutions with an ability to temporarily reduce headcount and/or freeze salaries during a period of financial weakness are often better able to achieve larger expenditure reductions, these actions have implications, particularly as related to a client or patron's view of quality. Less favourable views of quality could result in weakening demand for an institution's programs and/or services and its ability to fundraise.

Revenue Diversity

Stability of Demand-Based Revenues May Offset Concentration Concerns

Depending on the institution's mission and mix of offerings, an institution's revenue base can range from extremely diverse to extremely limited. As part of its analysis, Ind-Ra discusses with management the composition and historical stability of key revenue streams and projections for future funding levels. For some institutions, a seemingly concentrated revenue base may, in fact, be more diverse when the primary sources of those funds are revealed. For example, the income statement of a research organisation may indicate grants and contracts represent 95% of total operating revenues. However, when the pool of grants and contracts is analysed, no one granting agency comprises more than 15% of the total. Similarly, a museum's income statement may highlight a significant reliance on fundraising, although the pool of donors is actually not concentrated and includes other activities (e.g. space rental and event income).

Diversity of Revenues Affords Flexibility; Sources of Diversification Analysed Operating Profile

Generally, keeping other things same, the more diverse an institution's funding mix, the higher its credit rating. This stems principally from the increased financial flexibility afforded by the presence of multiple revenue sources that are often uncorrelated.

Ind-Ra recognises that sources of diversification often have their own associated risks, and these risks are considered in the rating process. In addition, while revenue concentration may increase an institution's vulnerability, management's ability to closely manage the drivers of that key revenue stream, such as a research institute carefully complying with the requirements of a central funding grant, may help mitigate the dependency risk. Regardless of the concentration of revenue, the ability of an institution to articulate a well-reasoned strategy for managing pending changes in its funding environment is viewed favourably in the rating process.

Figure 3
Select Operating Performance Metrics

Diversity of revenues	Concentration in any one revenue source could be a concern but may be mitigated by a history of stability
Volatility of revenue	A revenue source that contributes at least 10% of revenues is reviewed for changes that have affected its consistency
Operating margin	Operating surplus divided by total unrestricted operating revenues this is specifically being addressed in the next point, do we still need it here

Note: Both revenues and expenses are reviewed over several years, usually five, to determine the consistency of the institution's financial performance
Source: Ind-Ra

Operating Margin

Fiscal Balance Achieved Through Revenue and Expenditure Match

The operating margin measures an institution's ability to generate revenue from its core operations sufficient to meet annual expenditures, fund routine maintenance, and service financial obligations. While Ind-Ra recognises margins may vary from year to year, over a five-year period the expectation is for at least a break-even level of performance. By generating a consistent margin at or above a break-even level, an institution is less reliant on its unrestricted reserves for operating support and can generally service debt from net available income.

Figure 4
Attributes Box: Operating Margin

Stronger attributes	• Consistent track record of strong positive operating performance supported by a diverse revenue base and solid resource levels; exposure to non-marketable, illiquid securities tempered by operating strengths and availability of other, more liquid funds
Midrange attributes	• Consistent track record of moderate operating performance, although years of slight deficits are not uncommon; and adequate to healthy resource levels; modest exposure to nonmarketable securities, with a more limited ability to manage the illiquidity issues accompanying these investments
Weaker attributes	• Generally negative, fairly volatile operating performance and adequate to fairly weak resource levels; extremely limited financial capacity to manage the risks associated with any exposure to nonmarketable asset classes

Source: Ind-Ra

Adjustments to Operating Margin Enhance Analysis

Ind-Ra omits the non-core items like profit or losses on sale of capital assets - land and other assets including operating assets - and income or expenditure unrelated to the core business activities while computing the operating margin for an institution.

The exclusion of all gains and losses, including that portion of an annual endowment pay out derived from accumulated gains, will typically result in a negative operating margin. Consequently, Ind-Ra generally calculates two operating margins to better gauge operating performance. The first calculation includes an institution's interest and dividend income, with no recognition of any gains or losses. Under the second calculation, Ind-Ra includes dividend and interest income and the portion of accumulated gains recognised under the endowment spending policy to the extent this amount can be obtained from the financial statements.

For institutions that budget for a portion of expenses to be supported by investment returns, Ind-Ra views the operating margin inclusive of the full spending policy pay out as a better indicator of financial health. As long as the return on long-term investments exceeds distributions made under the spending policy, reliance on the pay out alone is not, in and of itself, a negative credit factor. However, the greater an institution's reliance on the pay out, the less flexibility it maintains to ratchet back spending under the policy during times of prolonged financial market turbulence.

Balance Sheet Resources and Liquidity

Financial Cushion Provides Buffer

In analysing an institution's resource base, Ind-Ra examines the magnitude of financial assets and the liquidity of these holdings. In general, the size of an institution's resource base correlates strongly with its fundraising track record and its ability to annually operate at or above the break-even level.

For institutions with significant resources, the largest component of their investment portfolio tends to be financial assets held for the long term. These assets include endowment funds and other funds that function similarly to endowment assets although with fewer restrictions as to use. In addition to long-term investments, well-endowed institutions may also maintain sizable short- and intermediate-term cash and investment pools to support short-term working capital needs and variable-rate demand programs. Generally, these investments tend to be highly liquid and available on demand, with minimal notice.

To gauge the magnitude of an institution's resource base, Ind-Ra calculates available funds, or total cash and investments not permanently restricted. This balance is then compared to operating expenditures and financial leverage as measures of financial flexibility. As part of its analysis of balance sheet resources, Ind-Ra reviews investment performance from the close of the most recent audited fiscal year and considers the potential impact that financial market movement may have had on available fund metrics derived from those audited financial statements.

Balance Sheet Resources Not Necessarily a Proxy for Liquidity

Ind-Ra acknowledges that many institutions invest sizable shares of their long-term investment portfolios in alternative asset classes. Held with a long-term investment horizon, alternative investments provide the opportunity for enhanced returns although generally illiquid, not immediately accessible, and sometimes require subsequent commitments of capital. Given these characteristics of alternative assets, which maybe significant (in excess of 50% or more of an institution's total investment holdings), available funds no longer provide a sufficient proxy for liquid resources. Consequently, Ind-Ra will also calculate an adjusted available funds metric that attempts to distil the core available funds calculation discussed above into its most liquid, most accessible components. In the adjusted calculation, Ind-Ra typically includes traditional equity and fixed-income investments as well as central and state government-backed securities, mutual funds, and cash. Private equity and real estate are the most common alternative investments stripped out of the adjusted metric.

Figure 5

Select Measures of Liquidity and Leverage

Measure	Description
Available funds	• Includes cash and investments that are not permanently restricted. Available funds provide a measure of balance sheet resources
Adjusted available funds	• Includes cash and investments that are not permanently restricted; excludes financial assets deemed as alternative investments per the audited financial statements
Debt service coverage	• Measures an institution's ability to service debt from net available income.
Debt burden	• Measures pro forma MADS as a percentage of total unrestricted operating revenues. Ind-Ra considers a debt burden equal to or greater than 10% as high.

MADS – Maximum annual debt service
Source: Ind-Ra

While adjusted available funds may suggest a much weaker level of financial flexibility for some institutions, Ind-Ra recognises that this calculation is conservative, as it gives no credit to holdings, which, while not immediately available, will likely have a value at the end of their investment horizon. Moreover, these investments are rarely intended as a source of near-term liquidity or working capital. For these reasons, Ind-Ra will continue to calculate available funds and adjusted available funds as measures to assess total resources and liquid resources, respectively.

While analysing liquidity position of an institution, Ind-Ra examines receivable and payable days, cash conversion cycle and working capital utilisation.

Asset Allocation Evaluated in Context

Ind-Ra does not associate a target asset allocation with a particular rating level. However, an institution's investment policy will be evaluated in the context of its overall financial position and financial management practices. For institutions with significant revenue concentration and erratic, generally negative operating performance, an asset allocation weighted toward traditional fixed-income and equity investments would be more appropriate given the reliance on unrestricted, liquid reserves to subsidise operations. Overexposure to less liquid alternatives or fluctuation in available fund balances for such an institution could have negative credit implications.

In contrast, an institution that is consistently able to cover annual expenditures and debt carrying charges from operating surpluses is not as dependent on balance sheet resources. Consequently, this institution is better equipped to handle the illiquidity risks associated with a heavy exposure to nonmarketable securities and has a greater capacity to withstand temporary, periodic fluctuations in available fund balances.

Debt Profile

Planning Documents Facilitate Assessment of Debt Portfolio and Future Needs

When assessing financial leverage, Ind-Ra reviews an institution's existing level of debt and future plans for debt issuance. For this reason, Ind-Ra prefers to see that an institution has a capital improvement plan with a documented process for assessing capital projects, a time horizon for completion, and anticipated sources of funding. Typically, capital plans cover a period of at least five years and are subject to periodic review. As part of its analysis of pro forma leverage and future debt capacity, Ind-Ra may incorporate a planned borrowing into certain debt ratios to the extent sufficient detail relating to the financing is available.

As current and proposed debt structure is an important consideration, Ind-Ra evaluates an institution's debt policy outlining parameters for incurring leverage and any related documents. Variable-rate exposure for an institution rated below 'IND A' will be evaluated for the potential impacts on cash flow and liquidity of a failed variable-rate bond remarketing, bank bond term out, and loss of an external liquidity provider.

Debt Burden

Budgetary Impact of Debt-Carrying Charges Measured on an Historical Projected Basis

To assess an institution's ability to annually manage its financial obligations, Ind-Ra calculates a debt burden and will review historical and projected debt service coverage levels. The debt burden, calculated by Ind-Ra as the ratio of projected MADS to unrestricted operating revenues, indicates the portion of current-year unrestricted operating revenues required to meet maximum principal and interest on outstanding and proposed new borrowing. In addition to carrying charges on long-term debt instruments, pro forma MADS also includes debt service, capital leases, and non-cancellable operating leases.

To the extent debt service is not level and large bullet maturities are utilised, Ind-Ra assesses the institution's ability to the pay bullets when due or effectuate a timely refinancing in advance of maturity dates. For upward sloping and back-loaded debt structures, Ind-Ra evaluates the reasonableness of assumptions underpinning an institution's plan for ramping up operations to support higher debt-carrying charges in future years. Similar to the aforementioned variable-rate debt and swaps, non-level amortising debt structures are more likely to yield credit pressure at lower rating levels.

Other factors, notably consistently strong coverage of debt service (discussed below), may help mitigate at least some of these concerns. Ind-Ra views favourably the ability of management to articulate a well-reasoned and achievable strategy for stabilising or reducing a high debt burden over time.

Debt Service Coverage Calculated on a Legal and Economic Basis

Consistently healthy coverage of debt service may help mitigate at least a portion of the risks associated with a significant debt burden. For institutions, Ind-Ra calculates legal debt service coverage per the terms of transaction documents, using pledged revenues, and computes economic coverage based on an institution's net income available for debt service (net income). Pledged revenues and net income are then compared to historical carrying charges and projected MADS. The calculation of economic coverage enables a comparison of debt manageability metrics across the non-profit institutions sector that is not possible with legal coverage, as transaction documents tend to differ from one bond issue to the next.

In calculating annual net income available for debt service (net available income), Ind-Ra begins with the change in unrestricted net assets from operations (excluding realised and unrealised gains and losses) and adds back noncash items, such as depreciation, and interest expensed during the year. The stronger the coverage of debt service provided by net available income, the greater the likelihood that the institution will make timely debt service payments and not rely on unencumbered liquid reserves to meet minimum coverage thresholds.

Peer Comparisons

Comparative Analysis Highlights Similarities and Contrasts Among Like Credits

Lack of standardisation of demand and financial data is a major bottleneck for a robust comparison among institutions having a similar mission and mix of programmatic and service offerings, comparisons across unrelated non-profit business lines will be less meaningful. As an example, the credit drivers of a voluntary institute engaged in social development differ from the drivers of a research institute, meaning that certain demand and financial metrics will not translate to both entities. Consequently, Ind-Ra generally conducts its peer analysis for institutions among credits at a given rating level having similar attributes.

In cases where Ind-Ra does not maintain ratings on a critical mass of similar credits or in situations where the metrics do not consistently align with or support a rating recommendation, Ind-Ra may expand the universe of comparable institutions. The expanded universe could include median values for dissimilar institutions at the proposed rating level or, in the case of situations on the margin, institutions rated above or below the proposed rating level. In most cases, this analysis helps bolster the rating recommendation and highlights important contrasts.

Importantly, Ind-Ra notes that the ranges over which demand and financial metrics vary can be broad, and overlap among rating categories for certain metrics is inevitable. Moreover, ratings are forward looking and imply expectations for the future rather than being solely based on what previously occurred. Nevertheless, improvement or deterioration in an institution's demand and/or financial metrics is an important rating driver, with such improvement or deterioration relative to medians and peers a potential source of positive or negative rating pressure. Other intangible, qualitative variables, such as the strength of management, also play an integral role in the analysis.

Financial Metrics

Ratios Remain a Valuable Analytical Tool

Financial results correlate reasonably well with credit ratings. The table below details the core factors discussed as part of this sector-specific criteria report and provides examples of typical characteristics exhibited across the ratings spectrum.

Median financial ratios will vary over time because ratings allow for a certain amount of performance variability and cyclicality, and no absolute floors or ceilings are prescribed for individual metrics to qualify for a particular rating level. Strong performance in one metric may or may not compensate for poor performance in another, depending on the metrics involved and other circumstances of the borrower. Also, qualitative factors and expectations for future performance often result in ratings for borrowers that may have one or several metrics that diverge from published medians.

Figure 6

Key Financial Ratios

Ratio	Calculation	Significance
Capital structure and cash flow		
Debt service coverage by EBITDA	EBITDA/MADS	Indicates the net revenue available to meet MADS requirements
Debt service coverage by operating EBITDA	Operating income + interest, taxes, depreciation, and amortisation expense/MADS	Indicates the net revenue available from core operations (excludes non-operating income) available to meet MADS requirements
MADS as % of total revenue	MADS/total revenues	Indicates the relative burden of debt service relative to total revenues. Higher percentages indicate less room for operating profitability variance
Debt to capitalisation	(Total debt)/(total debt +unrestricted net assets)	Indicates the size of debt compared to the adjusted net worth of the entity
Capital expenditures as % of depreciation expense	Net purchase of property, plant, and equipment/annual depreciation expense	Indicates the level of capital reinvestment into the facility
Variable-rate debt/total debt.	Variable-rate debt/total debt	Provides context for an issuer's exposure to variable rate debt
Liquidity		
Days cash on hand	Unrestricted cash and investments/(cash operating expenses/365)	Indicates financial flexibility and cushion against decline in operating profitability
Cash to debt	Unrestricted cash and investments/total debt	Indicates financial flexibility and cushion against decline in operating profitability
Cushion ratio	Unrestricted cash and investments/MADS	Indicates financial flexibility and cushion against decline in operating profitability
Profitability		
Operating margin	Total operating revenue-total operating expenses/total operating revenue	Provides an indication of a borrower's profitability from core operations
Operating EBITDA margin	Income from operations before interest, taxes, depreciation, and amortisation/total operating revenue.	Provides an indication of the cash flow from core operations which is available for the payment debt service
EBITDA margin	EBITDA/total operating revenue + non-operating revenue	Provides an indication of cash flow from operating and non-operating (primarily investment income) which is available for the payment of debt service
Personnel costs as % of total operating revenues	Salaries, wages, benefits, and professional fees/total operating revenue	Provides an indication of how efficient labour is being used

Source: Ind-Ra

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