Principles of Assessing Industry Factors in the Rating Analysis of Non-financial Corporations

Services

This document is part of the Methodology for Assigning Credit Ratings to Non-financial Corporations under the International Scale (hereinafter, the Methodology) and describes the specifics in conducting rating analyses of the operational and financial profiles of service companies.

The document provides lists of indicators used, factor weights, assessment score boundaries for quantitative factors, and the principles of assessing qualitative factors for the services industry.

1 Industry Companies

The assessment approaches described in this document are applicable to companies whose main business is to provide a wide range of services. However, this document does not describe approaches to evaluating companies that provide services in industries such as passenger transportation, telecommunications, or retail, as they are set out in separate industry appendices. The global services market is represented by companies that provide services in the following areas: information technology, medicine, business process management, fitness, paid education, real estate management, consulting services, etc.

2 Rating Factor Structure

Creditworthiness analyses of rated entities in the services industry are based on assessing eight indicator blocks, which are combined in two profiles and have their own weights totaling 100%. The weights presented in Table 1 are base weights, i.e., they may change depending on the assessment scores derived for factor blocks (see subsection 4.1.3 of the Methodology for a description of the floating weights concept).

Table 1. Scorecard for services companies

Profile	Factors	Factor weighting	Sub-factors
Operational Profile	Business profile	25%	Stability of demand
			Market position
	Financial policy and corporate governance	10%	Financial policy
			Corporate governance
Financial profile	Size	15%	Revenue (USD bln)
	Profitability	10%	Profitability on funds from operations (FFO) before fixed payments and taxes
			Qualitative profitability assessment
	Leverage	15%	Adjusted total debt to FFO before fixed payments
			Qualitative leverage assessment
	Coverage	15%	FFO before fixed payments to fixed payments
	Liquidity	5%	Liquidity ratio
			Qualitative liquidity assessment
	Cash flow	5%	Free cash flow (FCF) margin
			Qualitative assessment of FCF stability

Source: ACRA

3 Operational Profile

The following describes the basic factors in the rating analysis of the operational profile, the degree of their influence when determining the credit rating of a non-financial corporation, and assessment specifics.

To assess operational profile qualitative indicators for rated entities in the services industry, ACRA uses a set of characteristics specific to the industry that translate into a qualitative assessment category. Operational profile indicator weights are shown in Table 5.

3.1. Business Profile

The business profile assessment is based on a qualitative analysis of a company's market structure and its position in key markets. An important evaluation factor is the characteristics of the demand for services provided, such as sustainability, as well as the range of services provided (full/limited). In addition, the volatility of the company's results, the diversification of services provided, the uniqueness of services provided, and the company's position in the market are taken into account. The analysis of companies in the industry also assesses the risks of jurisdiction and the specifics of regulation in it. The business profile is assessed based on the sub-factors listed below.

3.1.1. Stability of demand

Stability of demand and low volatility of operational and financial indicators in various phases of the economic cycle have a positive impact on the financial reliability of the rated entity, as well as the presence of a long-term development strategy that takes into account the characteristics of demand and contributes to the diversification of a company's range of services. In addition, when assessing the stability of demand for services provided, the range of services provided is taken into account (i.e., its uniqueness, demand from consumers, the possibility of replacement or obsolescence of services provided), which allows companies to maintain the necessary level of profitability and stable cash flow.

The qualitative assessment category for stability of demand is determined according to Table 2.

Table 2. Qualitative assessment of stability of demand

Assessment category	Main features
I	Range of services offered is diversified (main service accounts for no more than 35% of revenue); demand for key services is stable and is not affected by economic cycle for a long period; low concentration in customer base; range of services offered is necessary for consumers
II	Range of services offered is moderately diversified (main service accounts for no more than 55% of revenue); demand for key services not greatly affected by economic cycle (quick recoveries in demand after downturn); low concentration in customer base; range of services offered is very important for consumers
III	Range of services offered is moderately diversified (main service accounts for more than 55% of revenue, has plans to enter new segments/launch new services); demand for services moderately cyclical, but contract back log consistently supports revenues for the next 1.5–2 years; medium concentration in customer base; range of services offered is important for consumers

IV	Range of services offered is poorly diversified (main service accounts for more than 55% of revenue); demand for services is moderately cyclical; high concentration in the customer base; importance of the range of services is limited for the consumer
V	Demand for services is extremely volatile and cyclical, or there is no information about demand dynamics because of novelty of services; range of services offered has no value for the consumer and can be replaced by other types of services

Source: ACRA

3.1.2. Market position

A company's market position is determined by its share in the market or in its individual segments, the number of segments of presence, the possibility of further increase in market share, as well as the potential risks of new competitors. Diversification across multiple service segments provides greater stability in operating and financial results, while limited competition or a quasi-monopoly market position helps maintain high business margins. Geographical diversification, including leading positions in national or international markets, has a positive impact on the financial stability of the rated entity, while presence in the local market only and weak competitive positions negatively affect creditworthiness.

The qualitative assessment category for market position is determined according to Table 2.

Table 3. Qualitative assessment of market position

Assessment category	Main features
I	A leader in the national or international markets; wide range of services balanced between different segments; no concentration of consumers; significant experience and expertise in providing specific types of services; probability of new players in the market is minimal due to significant investment costs and the uniqueness of services provided
II	A key player in the national market with limited presence outside of it; wide range of services that is moderately cyclical; operates in several segments, however there is a key segment; low concentration of consumers; experience and expertise in providing services in which it specializes; probability of new players in the market is low due to significant investment costs
III	Significant player in the local market (or competitive position in local markets); operates in several segments, but range of services is limited; concentration of consumers in one key segment is above average, probability of new players in the market is average due to moderate investment costs
IV	Local market player; operates in several segments, but is highly dependent on one segment; high concentration of consumers; probability of new players in the market is high
V	Small player in the local market; operates in one segment; very high concentration of consumers; significant number of similar players in the market; probability of new players in the market is very high

Source: ACRA

3.2. Financial Policy and Corporate Governance

To assess the financial policy and corporate governance of rated entities in the services industry, ACRA uses a common set of characteristics that translate into a qualitative assessment category for all industries (for a general description of the concept of the corporate governance qualitative assessment, see Section 5 of the Methodology). The assessment of financial policy and corporate governance is carried out according to Table 5.

4 Financial Profile

The following describes the basic factors in the rating analysis of the financial profile, the degree of their influence when determining the credit rating of a non-financial corporation, and assessment specifics.

To assess the qualitative indicators in the financial profile of rated entities, ACRA uses a common set of characteristics that translate into a qualitative assessment category for all industries (for a general description of the qualitative assessment of financial profile indicators, see Section 6 of the Methodology), as well as an individual set of quality characteristics according to Table 4.

Quantitative indicators in the financial profile are assessed in points based on being part of a particular range, with qualitative indicators based on qualitative assessment categories according to Table 6.

4.1. Size

To assess the business scale of companies in the industry, ACRA uses the size of their revenue, which is important in assessing creditworthiness. In addition, revenue dynamics are analyzed: companies that demonstrate high growth rates in this indicator are rated higher than those with stagnant revenue or low growth rates.

4.2. Profitability

To assess profitability, the profitability on FFO before fixed payments and taxes is used. This allows for an accurate comparative analysis between companies that use their own infrastructure and those that rent it.

Additionally, the profitability of the rated entity is evaluated in comparison with that of its main competitors. ACRA assesses how changes in the company's profitability over the past three to five years correlate with industry development trends. A company that demonstrates significantly higher levels of profitability compared to its competitors is rated higher than a company whose profitability is at the industry average or is difficult to predict due to the volatility of its indicators.

Table 4. Qualitative profitability assessment

Assessment category	Main features
I	Very high profitability compared to competitors
II	Consistently high profitability (no significant fluctuations over the past three years)
III	Profitability at the industry average (no significant fluctuations over the past three years)
IV	Profitability at the lower end of the industry average (low volatility)
V	Consistently low profitability or difficult to predict dynamics (high volatility)

Source: ACRA

The profitability of operating activities for companies in the services industry is traditionally high, so their quantitative assessment indicators are higher than those of companies from most other industries.

4.3. Leverage

To assess leverage, ACRA uses the ratio of adjusted total debt[1] to FFO before fixed payments. Qualitative characteristics are also used.

4.4. Coverage

To assess coverage, ACRA uses an indicator calculated as the ratio of FFO before fixed payments to fixed payments. This allows for a more accurate comparative analysis between companies that use their own infrastructure and those that rent it.

4.5. Liquidity

This allows for a more accurate comparative analysis between companies that use their own infrastructure and those that rent it.

4.6. Cash Flow

To assess the cash flow of rated entities in the industry, ACRA uses the FCF margin indicator, as well as the qualitative assessment of FCF stability.

If a company in the industry has its own infrastructure, it needs to maintain a high level of capital expenditures and finance them with cash flow (to avoid infrastructure deterioration, technological lag behind competitors, and deterioration of financial performance). The analysis of dividend payouts made by the company is carried out separately. Amid high capital expenditures, high dividend expenses can put significant pressure on FCF.

[1] Taking into account the current practice of estimating the cost of infrastructure leases for service sector companies, ACRA uses a 4x operating lease capitalization multiplier when adjusting the amount of debt.

Table 5. Operational profile factors

Factors	Sub-factors	Sub-factor weighting	Sub-factor score				
			5	4	3	2	1
Business profile	Stability of demand	50%	V	IV	III	II	I
	Market position	50%	V	IV	III	II	I
Financial policy and corporate governance	Financial policy	50%	V	IV	III	II	I
	Corporate governance	50%	V	IV	III	II	I

Source: ACRA

Table 6. Financial profile factors

Factors	Sub-factors	Sub-factor weighting	Sub-factor score				
			5	4	3	2	1
Size	Revenue (USD bln)	100%	[0; 0,5)	[0,5; 2)	[2; 7)	[7; 30)	[30; ∞)
Profitability	Profitability on FFO before fixed payments and taxes	50%	(-∞; 7%)	[7%; 15%)	[15%; 25%)	[25%; 35%)	[35%; ∞)
	Qualitative profitability assessment	50%	V	IV	III	II	I
Leverage	Adjusted total debt to FFO before fixed payments	70%	(8; ∞)	(5; 8]	(3; 5]	(1; 3]	[0; 1]
	Qualitative leverage assessment	30%	V	IV	III	II	I
Coverage	FFO before fixed payments to fixed payments	100%	(-∞; 1)	[1; 3)	[3; 6)	[6; 10)	[10; ∞)
Liquidity	Liquidity ratio	50%	(-∞; 0,8)	[0,8; 1)	[1; 1,25)	[1,25; 1,5)	[1,5; ∞)
	Qualitative liquidity assessment	50%	V	IV	III	II	I
Cash flow	FCF margin	50%	(-∞; -10%)	[-10%; 0%)	[0%; 5%)	[5%; 10%)	[10%; ∞)
	Qualitative assessment of FCF stability	50%	V	IV	III	II	I

Source: ACRA

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