



ICRA Rating Feature

This methodology note stands superseded.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

Rating Methodology for Issuers in the Information Technology (Hardware) Industry

Overview

The Indian Information Technology (IT) hardware industry is approximately US\$ 14 billion in size (FY2016), growing at a CAGR of 2.8% (FY2012-16) and deriving a majority of its revenues from the domestic market. The hardware industry includes desktops, laptops, printers, fax machines, network equipment, storage devices, equipment, servers, and computer peripherals, among others. Leading MNCs (OEMs) who manufacture or assemble products for the Indian market include Acer, Dell, HP, IBM and Lenovo. In the Indian IT hardware industry, a pan-India distribution reach and effective after sales service and maintenance have proven to be critical for sustainability. A large part of the hardware demand stems from the government – both the Centre and the States – and government-sponsored schemes like digitisation of education. With intense competition, the industry has been facing challenging times over the past four years, characterised by low profitability and elongated working capital cycles, especially for the government and PSU clients. This has led to scaling down or exit from the hardware business by several companies, especially small and mid-size players. Since a majority of the hardware products are either imported or assembled in India, the scope of this methodology note includes entities which are involved in importing, assembling and system integration of IT Hardware for corporates.

ICRA's Risk Analysis Framework

This rating methodology explains ICRA's approach to analysing the credit risk of entities engaged in the IT hardware industry, particularly entities involved in importing, assembling and system integration of IT hardware for corporates. The note aims to help issuers, investors and other interested market participants understand ICRA's approach to analysing the quantitative and qualitative risk characteristics that are likely to affect rating outcomes for this sector. This methodology does not include an exhaustive treatment of all factors that are reflected in ratings but enables the readers to understand the rating considerations that are the most important.

The key rating drivers for the sector are clubbed in this note under three broad heads of Business Risk, Financial Risk and Management Quality:

1. Business Risk Assessment

- Scale and Market Position
- Service Offerings and Distribution Network
- Revenue and Client Mix

2. Financial Risk Assessment

- Revenue Growth and Profitability
- Foreign Currency Related Risk
- Working Capital Intensity
- Leverage, Cash Flows and Coverage Indicators
- Tenure Mismatches and Risk Relating to Interest Rates and Refinancing
- Debt Servicing Track Record
- Adequacy of Future Cash Flows

- Accounting Quality
- Contingent Liabilities

3. Promoter/Management Quality

Business Risk Assessment

Scale and Market Position

The Indian IT hardware industry is highly fragmented with multiple small and mid-sized players operating. The entry barriers are low as most players trade in hardware, bundling the equipment with installation, after-sales service support, providing licences or other services such as networking, system integration or infrastructure management services. The ability to sustain a healthy market share depends on the domestic hardware players' ability to attract orders from mid and large sized clients, offer an array of value-added services, including end-to-end solutions, and have a pan-India footprint. Further, the past track record of execution and client satisfaction remain critical to generate repeat business and referrals. The scale of a player's operations in the IT hardware industry directly impacts its sourcing terms and also its ability to sustain headwinds in terms of pricing pressure, loss of key clients and economic down cycles. The industry is susceptible to domestic economic cycles as higher investments by corporates and government lead to higher spends on IT hardware and related services. Overall, in the backdrop of the fragmented industry structure with low entry barriers, it becomes imperative for a player to achieve the scale and size so as to absorb overheads and generate adequate profits.

Service Offerings and Distribution Network

The IT hardware industry encompasses a range of products, including computers, laptops, printers, networking systems, video conferencing equipment, CCTVs, servers and scanners, catering to a wide range of requirements from office automation, security and surveillance, telecommunications etc. The hardware offerings, which are mostly traded, generally have to be complemented with on-ground service support for the purpose of Operations and Maintenance. Further, most orders are also accompanied by service contracts which may extend beyond the free warranty period of OEMs. These service contracts are generally annuity deals which cover maintenance and upkeep of the hardware and software during their tenure in addition to the replacement of faulty parts. This requires experts in respective areas such as installation, networking or video-conferencing and the company's ability to service the equipment in a timely manner remains critical. Entities which offer bundled offerings such as installation, after-sales service and facility management services have better leverage with clients, compared to pure hardware suppliers.

Larger contracts are also generally multi-location-oriented, necessitating a pan-India presence of the issuer through offices and service centres in key locations across various states. This also acts as an entry barrier for other players. Overall, a wide array of products, services including installation, after sales and facility management along with a pan-India presence are considered credit positives.

Revenue and Client Mix

The Indian IT hardware industry primarily supplies to various corporates, public sector entities, Central and State governments, and government-sponsored schemes such as NREGA – National Rural Employment Guarantee Act, and RSBY – Rashtriya Swasthya Bima Yojna. High concentration towards entities that operate in the government/PSU sector comes with the challenge of a longer working capital cycle, even as payment receipts generally remain secured. ICRA also evaluates the revenues from high margin annuity contracts such as facility management services and their proportion to overall revenues and profits. Generally, hardware trading involves thin margins with a majority of the profits generated from the service-oriented facility management contracts. Hardware vendors may have an arrangement with the clients to directly procure the required hardware in order to save on working capital blockage while offering the remaining services. This reduces working capital requirements and also potential payment disputes, regarding hardware specifications and timelines.

ICRA also evaluates the client profile of an issuer as a marquee client base is a reflection of the quality of the company's offerings and its competitive position. While the hardware business is generally project-based, repeat business from past clients is viewed positively. Further, the project-like nature of business may lead to high client concentration in particular years; sustained high concentration over a few years raises concern over

future revenue visibility and volatility. Overall, the presence of bundled contracts with annuity service contracts, established client base and high repeat business associated with it is viewed favourably by ICRA.

Financial Risk Assessment

Revenue Growth and Profitability

Sustained revenue growth matching or above industry average typically reflects a high level of repeat business, customer satisfaction and market knowledge. Companies that are able to sustain growth on a healthy base are able to continuously develop new offerings, enter into new lines of applications and industries and achieve greater geographic diversity. These aspects create entry barriers and aid competitiveness. On the other hand, stagnating or declining revenues are indicative of the lack of portfolio depth or reflect the inability of an issuer to serve customer requirements, implying weakening of competitiveness.

An issuer with higher operating margins and returns on capital has a greater ability to generate internal accruals, attract external capital, and withstand business adversity. The Indian IT hardware industry operates on low margins because of the trading nature of hardware sales. The upside, however, comes from bundled service offerings. Also, effectively managing overheads and employee costs remain critical to generate adequate profits. The trends in operating margin and return on capital employed are analyzed by ICRA to establish the stability of the cash flow generation and the sufficiency of the same vis-à-vis the company's future debt service obligations and investment plans.

Foreign Currency Related Risk

The Indian IT hardware sector is primarily import driven with revenues denominated in local currency while the hardware import costs are in foreign currencies, exposing them to any adverse movement in INR vis a vis such currencies. ICRA evaluates the net foreign exchange exposure of the entity to be rated and its hedging policy. Companies that have a stated hedging policy with appropriate mechanisms in place to enter into back to back contracts once orders are awarded are viewed positively. Companies hedging their foreign currency debt and related interest outgo as well as companies having foreign currency debt with an ability to repay the same out of profits from international operations leading to natural hedge are viewed positively.

Working Capital Intensity

The Indian IT hardware players generally have moderate to high working capital intensity with majority of the working capital requirements arising from receivables and inventory. ICRA evaluates the ageing schedule of inventory and receivables to assess an entity's ability to realize its assets as well as evaluate the possibility of bad debts in the future. Since Indian players are predominantly not involved in manufacturing, the hardware inventory requirements primary stems from contracts to be executed or general hardware for maintenance contracts. ICRA compares the working capital ratios of the IT hardware players with their peers and any significant deviation in the ratios like debtors days and inventory days gives a possible indication of disputes 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 high. ICRA also monitors the trend in "unbilled revenues"¹ as percentage of revenues over the past few years and its conversion to cash. Entities having a well stipulated payment policy, project monitoring system and adherence to quality and time stipulations are generally able to secure faster release of payments.

Leverage, Cash Flows and Coverage Indicators

ICRA's assessment of the financial risk profile of an entity is based upon its ability to generate healthy cash flows to reinvest in the business as well as meet the debt-servicing obligations. The financial policies—past as well as future—are key rating factors which help assess the risk appetite of the management and the impact of the same on the financial performance of the company.

Leverage ratios are an indicator of the degree of financial flexibility a company enjoys in terms of its ability to raise funds from alternative 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-EBIDTA multiple. A low gearing ratio indicates cushion in servicing debt obligations while continuing to invest in new lines of business, incur capital

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

expenditure (capex) and enter 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 and is a credit positive.

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

Strong free cash flows indicate the ability of an issuer to fund investments, pursue organic and inorganic growth opportunities and meet debt repayments. In addition to long-term financial flexibility, the liquidity profile of an entity is equally important to understand its ability to meet short-term financing requirements. A key indicator of the same is an entity's free cash flow position, availability of undrawn lines of credit and presence of sufficient cash or liquid investments.

Tenure Mismatches, and Risks Relating to Interest Rates and Refinancing

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

Debt Servicing Track Record

Any history of past delays or defaults in meeting interest and principal repayment obligations reduces the comfort level with respect to the entity's future debt-servicing capability. ICRA also factors in the ability of an entity to honour its debt obligations during periods of cyclical stress.

Contingent Liabilities/Off-Balance Sheet Exposures

ICRA looks at the quality of accounting practices, followed by an entity based on interactions with the Statutory Auditors as well as studying the Auditors' Report and other Notes to Accounts disclosed in the Annual Report. Some of the key factors looked at include auditor qualifications, with respect to internal control systems, debt servicing and asset liability mismatch, contingent liabilities and other off-balance sheet items and the method of revenue recognition and depreciation policy of an entity in comparison with industry peers.

Consolidated Financial Analysis

The IT industry in India comprises several large players with presence across diverse business segments (hardware, services, BPO) and geographies through various subsidiaries and associate companies. While evaluating the financial risk profiles of such companies, ICRA evaluates both standalone and consolidated financial indicators in terms of profitability, capital structure, debt coverage indicators, cash flows and funding requirements.

Adequacy of Future Cash Flows

ICRA draws up projections of the likely financial position of the company based on 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. ICRA also evaluates the funding requirements of a company and the funding options available to it.

Accounting Quality

The company's 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 Practices (GAAP) is noted and the financial statements of the issuer adjusted to reflect the impact of such deviations. Management approach towards accounting policies such as classification of revenue and capital expenditure, depreciation policy (useful life of assets), and amortization of goodwill is also evaluated vis-a-vis industry standards.

Event Risk

The IT hardware industry has experienced its share of corporate action in the past, often with a material impact on the credit profile of a company. Such events could include substantial debt-funded acquisitions mergers, business restructuring and write-offs, asset sales and spin-offs, capital restructuring or litigations.

The impact of such events is adequately factored into the ratings based on management inputs or on the occurrence of such events.

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

This rating methodology broadly highlights ICRA's approach in assessing the business and financial risk profiles of issuers in the IT and hardware sector. It should not be treated as an exhaustive discussion of all the factors considered while assigning a credit rating but a broad framework to help stakeholders understand the approach to the same.



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) 2552 0194/95/96, Fax + (91 20) 553 9231

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