This methodology note stands superseded.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 Healthcare - Diagnostic

March 2016

This rating methodology is meant to help investors, issuers and other market participants understand the key factors considered by ICRA in assessing the creditworthiness of issuers belonging to the Indian Diagnostic Services Industry.

Industry Profile

The healthcare industry comprises of hospitals, diagnostic service providers, health insurers, wellness centres, medical equipment providers and medical researchers, among others. The Indian healthcare industry has grown at a robust pace over the past decade owing to improving penetration of healthcare services, higher purchasing power (on back of rising disposable incomes), improving awareness levels, greater thrust by both public and private sector in improving healthcare infrastructure and increasing penetration of medical/health insurance. According to industry estimates, the overall Indian health care market stood at US$ 65 billion in 2015, of which the hospital supplies and health care equipment segment is believed to be only around US$ 4.5-5 million. Healthcare delivery, which includes hospitals, nursing homes and diagnostics centres, and pharmaceuticals, constitutes ~65% of the overall industry[1].

Within the healthcare industry, the diagnostics services segment plays an important role, being the source of critical information related to the diagnosis of diseases/ailments, forming the basis of eventual treatment provided to patients by medical practitioners. The diagnostics services industry can broadly be classified into a) pathology services and b) imaging services. The pathology testing services[2] involve the collection of samples (in form of blood, urine and stool among others), analysis in laboratories and diagnosis to arrive at useful clinical information. The diagnostic results are then examined by medical practitioners to evaluate the disease burden in a patient and accordingly decide the course of treatment. Likewise, the imaging (or radiology) testing services[3] help mark anatomical and physiological developments in a patient's body and arrive at useful clinical information.

In India, diagnostics services are primarily provided by a) hospitals, b) standalone diagnostic centres and c) large organized diagnostic chains, which either operate on an independent-basis or are associated with hospital chains. While the share of such organized players is gradually rising, the industry remains fairly fragmented and is characterised by the presence of numerous un-organized and standalone diagnostic centres. Over the past decade, several organized players have emerged to create a pan-India network and even spread their presence in some of the international markets. These organized chains have developed capabilities to offer a range of comprehensive pathology and imaging services by virtue of their ability to invest in capital intensive equipment, deploy skilled manpower (to conduct complex tests) and adopt internationally accepted practices. With established capabilities, these chains have gained strong

[1] *India Brand Equity Foundation - Trust established by the Department of Commerce, Ministry of Commerce and Industry, Government of India*

[2] *Refers to Biochemistry, Immunology, Hematology, Clinical Pathology, Histopathology and Immunohistochemistry, Microbiology, Molecular Biology, Cytogenetics and Flow Cytometry*

[3] *Refers to X-ray, Ultrasound, Color Dopplers, Mammography, Bone Densitometry, Orthopantomography (OPG), CT scan and MRI*

brand equity among the medical community as well as patients, a factor that plays an important role in reputation building leading to repeat customers and thus revenue visibility. As a result of these factors, the market share of organised diagnostic chains is gradually increasing and is currently estimated to be ~10[4]% of the overall diagnostics services industry in India.

Apart from greenfield expansion, organised diagnostic chains have also gained scale through the acquisition of small, often regional diagnostic chains. Further, with the opening up of opportunities to offer diagnostic services at public hospital/healthcare centres (through PPP route), the market for organized players has further widened. Given India's relatively cost competitive healthcare services, some of the organized sector players have also started offering diagnostic services in international markets with operations supported by their infrastructure in India. Given the high fixed overheads' nature of the diagnostics industry and their aggressive expansion plans, organized players have also been fairly active in raising equity funding either through private equity route or IPOs. The growth prospects for diagnostics service providers remain buoyant over the long-term, with relatively low-base, increasing instances of lifestyle-related diseases, steadily rising standard of living as a result of higher disposable income, improving access to healthcare services, rising awareness levels and growth of medical tourism. The health insurance sector is expected to provide an additional impetus to the diagnostics sector, leading to better accessibility to a wide range of testing facilities for preventive, acute and chronic care.

This rating methodology broadly highlights the quantitative and qualitative risk factors that are likely to influence the rating outcomes in the diagnostics services industry, including, but not restricted to:

- Business Model
- Scale
- Diversification
    - Business Mix
    - Location
- Competitive intensity and market positioning
- Operational efficiency
- Regulatory Risk
- Event Risk
- Financial Profile
- Management and Accounting Quality

Business Model

In assessing the credit quality of a diagnostic services issuer, ICRA studies its business model across various parameters including the ability to generate repeat customers, growth prospects and investment intensity. These parameters determine the issuer's ability to generate sustained and consistent cash flows to service its debt obligations in a timely manner.

In India, the diagnostic industry consists of numerous players, ranging from large organized chains (including foreign players) to small un-organised standalone service providers.

The large diagnostic chains operate through the 'hub-and-spoke' model, which consists of setting up large labs (called reference labs) in key locations along with a network of smaller labs and collection centres, which act as spokes to the reference lab. This model allows them to a) expand their footprint in a relatively short time period, b) limit investments in setting up fully equipped labs at multiple locations and c) achieve optimum utilisation levels for reference labs (or hubs). The main source of revenue is through patients (walk-ins, referrals or corporate tie-ups) at the owned labs and revenue-share (varies from case to case) with franchisee labs. The organized players face stiff competition from both un-organized as well as in-house diagnostic departments of hospitals. In India, the unorganised format is more prevalent, where privately owned standalone labs span metros, as well as small cities and towns. Their growth has flourished due to the fact that acquiring accreditation is either not mandatory in most states or not

[4] *Indian Diagnostic Services Market Outlook 2015 - Report published by RNCOS Industry Research Solutions, June 2012.*

enforced effectively[5]. Although these labs have resources to only carry out neighbourhood publicity, their referral tie-ups with physicians and frequent walk-ins along with an offering of cheaper services compared to high end labs, has helped them to cater to a majority of population in a given locality.

The third format of diagnostic operation encompasses labs operating at public or private hospitals. These can either be overseen by the hospital itself or have a tie-up with one of the big diagnostic chains thereby sharing the revenues in a predefined manner. The volume of business and revenue visibility at hospital labs is relatively higher than other labs due to its linkages with the hospital operations that undertake both OPD (Out-patient-department) and in-patient business.

Most of the larger laboratories have a professional and experienced managerial setup, fully automated equipment, follow standardised quality controls for material and lab processes and strive for regular up gradation of staff skill sets, thus commanding a good reputation, which would provide scope for attaining a larger scale through repeat customers. An organised chain would be able to establish a trusted perception in the market, which would support its funding requirements to expand both organically or inorganically. With a substantial scale of operations, these organised players benefit from operational efficiencies, and are better positioned to make incremental investments in new labs and latest technology, thereby reinforcing their brand reputation and increasing market share. On the other hand, small labs are run in an unorganised manner by mostly family run businesses that lack the expertise and funding to procure the latest technology/equipment to provide specialised pathology or radiology services (although some of the equipment can also be taken on lease from third-parties which limits the amount of upfront investments), skill set to develop new tests and vision to grow in a pre-defined manner. Due to the lack of standardised systems in place and a limited test portfolio, these labs can lose customers to organised players and thus face scalability constraints.

Scale

Scale is defined in terms of the revenue/asset size of the issuer or the number of labs operated by the issuer etc. The scale of operations is an important determinant of the operating leverage and financial flexibility, on the back of which it can expand its network further and sustain itself in times of financial distress or unexpected regulatory changes; though this needs to be assessed on a case-to-case basis.

Generally, a large scale of operations leads to economies of scale in terms of the ability to spread overhead costs (related to reference labs, administrative, marketing etc.) over a higher revenue base and attain cost efficiencies in procurement and administrative functions, thereby supporting margins. Companies with a large scale are better placed to invest in new diagnostics centres and equipment while introducing complex tests/services in their portfolio. The inclusion of complex tests in turn, command higher realizations and allow diagnostics service providers to attain higher profitability and product differentiation. Further, a large diagnostic chain would have greater financial flexibility to grow fast, establish their labs at prominent locations, have a team of technically adept professionals, possess the ability to market themselves, and thus command a market stronghold. A large-scale standalone lab or chain would comprise of the latest radiology equipment and pathology test facilities to provide a full-service experience to its customers ensuring deeper penetration within its existing customer base. ICRA notes, that all of the above mentioned advantages of having a large scale lead to robust revenue growth and higher profitability, thereby enabling the issuer to consistently ensure timely debt servicing. However, large-scale labs or diagnostic chains are also exposed to high costs during the initial investment phase of a new lab and continuous price competition from smaller labs, which can affect margins if scale is not achieved.

[5] *The Clinical Establishments Act (2010) is applicable in nine states and all union territories except Delhi. It is now compulsory for diagnostic labs in those states to register and prescribe to the pre-defined minimum standards of facilities and services.*

In contrast, small unorganised companies are unable to offer a diverse range of tests or specialized tests requiring advanced technology, have limited skilled technicians and would have limited bargaining power with suppliers owing to low levels of scale. Although small labs posses a cost advantage owing to their lean cost structure, which enables them to acquire customers on the basis of competitive prices for routine or less specialised tests, the scale achieved will be limited and not comparable to a large issuer.

Diversification

Diversity enables an issuer to mitigate the cash flow volatility associated with product/service and market specific changes. A well-diversified profile, either in terms of business mix or lab location is a positive factor as it provides access to a larger clientele and reduces the exposure to a particular region.
Diversification and scale of operations are closely linked, with an issuer having a large scale, also generally being well-diversified on the back of larger financial resources and risk taking appetite. ICRA evaluates a diagnostic lab/chain on the basis of its revenue diversity in terms of business-mix (mainly pathology and radiology), therapeutic mix and lab location.

Maintaining a strong level of diversification is crucial as it leads to higher revenue visibility, less susceptibility to regulatory changes[6] or market changes, provides competitive intensity and ensures higher profitability on the back of product/services differentiation.

Business Mix

In ICRA's view, a diagnostic player having a business mix of a wide range of tests and services across categories would be well placed to cater to a customer's requirements more effectively. Growth prospects and revenue potential of a diagnostic lab/chain are closely linked to the range of tests and services being offered and the pricing, which in turn drives footfalls/enquiries/referrals. Business diversity is reflected in the variety and number of tests and services offered mainly in two key segments - pathology and radiology and also presence in alternative platforms like preventive healthcare and wellness. Moreover, a presence in both pathology and radiology increases the bargaining power and eventually the profitability of the issuer, as it can bundle offerings to cater to all customer requirements and is thus factored in the ratings positively. Further, ICRA notes the ability of a player to maintain sufficient depth in each therapeutic test category that enables better customer service, thereby ensuring repeat customers. Diversifying across or within a test segment is easier for large diagnostic players as they have the access to funding, new technology and also maintain an in-house R&D department.

Recently some large diagnostic chains have also ventured into academia, which provides an additional source of revenue, by extending courses and fellowships in advanced diagnostics. These chains can capitalise on this by recruiting quality students from these courses, thereby aiding talent management.

Location

Along with having a well-diversified business profile, good geographic coverage (regional, national and international) is a positive factor as it provides access to a larger clientele and reduces the vulnerability of revenues to disease cycles and variations in standards of living. A fairly densely populated area is likely to experience higher footfalls as against the one located on the outskirts of a city. While in some cases, the brand strength of a diagnostic centre and the varied basket of tests and services it offers, generate strong footfalls despite the location of the outlet, in ICRA's experience, it is observed that the outlets situated in a demographically favourable location (nearer to hospitals, prominent markets and main roads) enjoy the distinct advantage of high visibility and better recall with prospective clients - in turn driving business volumes.

In the case of a diagnostic chain that has the resources to expand and maintain a larger clientele spread across various cities, the geographic concentration reduces with the ability to reach out to different classes of society. With a large population base, Tier II and III cities present an attractive opportunity for large corporate players.

A large organised diagnostic chain has the resources to attain the international location advantage on the back of large financial resources to fund the expansion and related marketing costs. The issuer

[6] *Regulatory changes are a state subject and not all states may alter regulations at the same time*

diversifying internationally also benefits from better pricing and higher capacity utilisation of domestic labs to which it receives send-backs (in case of specialised tests requiring specific equipment or technicians). Although apart from diversification within India, a diagnostic chain de-risking its exposure by entering multiple markets overseas is seen favourably, however, the additional investments and challenges of managing business in relatively unknown markets could impact profitability and deteriorate the issuer's capital structure.

In India, the growing demand for retail space coupled with lack of proper infrastructure has pushed up commercial rentals in many locations to uneconomical levels for diagnostic players. It should be noted that geographical diversification can entail higher costs in terms of infrastructure investments and stretched roll-outs due to delays by developers in case of greenfield expansions. This is a significant risk and can lead to cost overruns. Therefore diagnostic chains that open new labs in established hospitals and doctors' clinics or adopt the franchisee route save on the initial fixed asset cost. The ability of the issuer to absorb such incremental costs of expansion and maintain healthy operating margins are key rating factors.

Competitive intensity and Market positioning

The extent of competitive intensity in a region and a diagnostic lab/chain's market position plays an important role in determining its growth prospects, bargaining power and in turn its future profitability and cash flow potential. An important aspect influencing the sales volume of a diagnostic lab/chain is its price competitiveness vis-a-vis other players in the market. Although small, unorganised labs lack infrastructure, technology, skilled professionals or resources to expand, they are able to garner customers on the basis of the cost advantage derived from their lean cost structure. This is especially on account of standardised tests, where a meaningful price difference between players can result in the switching of loyalties by customers. However, certain categories of diagnostic labs and specialised tests are relatively less vulnerable to pricing pressures compared to others. ICRA notes that, despite the relatively higher price competition in routine test segments, metropolitan cities' based diagnostic labs with a strong brand name known for timely, accurate and standardised practices and hygienic and efficient test processing are more likely to get repeat customers. Labs that offer niche and complex tests and services command premium pricing and also possess pricing flexibility, thus reflecting product differentiation, which is factored positively while rating.

Market position reflects reputation, customer loyalty and bargaining power, which is achieved by having a large scale of operations, successful track record of operations, ability to respond to competitive pressures while maintaining cost efficiency and profitability during varied disease/season cycles.

While ICRA notes that in the case of an unorganised diagnostic centre, sales generally pick up over a period of time after some credibility has been established, for new labs of an organised diagnostic chain garnering of market share can be faster owing to brand reputation on the back of standards' implementation and regulatory accreditation. Therefore, apart from having a diverse set of tests and services, a diagnostic lab/chain that carries out effective marketing along with initiating loyalty programs (offers discounts on consecutive visits) to achieve a stronger brand recall, is seen positively by ICRA. This is because having a strong brand recall strengthens an issuer's market position and leads to faster acquisition and subsequent retention of clients, supporting profitability.
Business viability depends on the loyalty of clients which is dependent on the quality, timeliness and pricing of services. The loyalty of a client can be measured by sales per client leading to consistent revenues and eventually stronger brand equity through word-of-mouth publicity. The same can be used as a measure of the lab's position in the market. Any slippage in execution can have an adverse impact on customer loyalty, and could lead to loss of business due to declining credibility of services offered.

ICRA takes into account the market position through brand strength and reputation of the diagnostic lab/chain, which in turn drives demand and footfalls. Referral tie-ups with or on-site labs at renowned doctor clinics and hospitals are factored in positively, as it assures revenue visibility owing to the credibility of the doctor or hospital. In the fragmented and highly competitive diagnostic sector, a higher number of walk-ins, referrals and test volumes enable an issuer to achieve higher bargaining power to negotiate favourable rental rates, avail discounts through bulk raw material purchasing and acquire the most qualified and technically sound personnel to drive operational efficiency to sustain its leadership position. Therefore, the impact of a healthy market position results in the stability in operating margins of the issuer.

A sustained healthy market position also acts as an entry barrier for new players, thereby requiring them to make significant investments in marketing, infrastructure and technology. The ability to sustain its market position and competitive intensity on a consistent basis is key to defending margins and ensuring sustained cash flows.

Operational efficiency

Operational efficiency can be defined by the accuracy and timeliness of test results, the latter encompassing the delivery time i.e. from taking the test to releasing results. Although these factors play a crucial role in retaining clients, managing costs pertaining to the same is essential in maintaining profitability. For instance, most large and established labs have an online test result retrieval system that ensures quick turnaround. In such a context, it is observed that a large diagnostic player is generally better positioned to leverage the use of technology on account of its large financial resources and scale of operations. That said, irrespective of the scale, an issuer that focuses on operational efficiency is better

placed at managing test execution which is supported by a well tracked logistic process, competent and skilled personnel/technicians, fast test processing time that is dependent on latest technology and proximity of reference labs etc. Such an issuer shall record superior lab-wise profitability and a shorter break-even level for new labs, thus being better placed to face competition and generate better margins.

Regulatory Risk

Most of the compliance requirements for diagnostic services come under state purview and consequently there is no uniformity or detailed regulation of medical devices (diagnostic services comes under the same). Regulations currently include automation, quality controls, accreditation, etc. In the past, there was ambiguity in interpreting the regulations and thus different laboratories used it in a way that is convenient to cultivate a brand image for superseding competition. Therefore, the government has taken several steps to develop a well defined regulatory framework for the healthcare industry through CDSCO (Central Drug Standard Control Organization) that works under the aegis of MoHFW (Ministry of Health and Family Welfare) to lay down rules, standards and approves import as well as manufacturing of drugs, diagnostics, devices, and cosmetics. Under the same government institution, the National Accreditation Board for Testing and Calibration Laboratories (NABL)[7] was established to accredit diagnostic laboratories. NABL provides laboratory accreditation services to labs that are performing tests in accordance with ISO/IEC 17025:2005 and ISO 15189:2007 (for diagnostic laboratories). These services are offered in a non-discriminatory manner and cover all testing and calibration laboratories in India and abroad, regardless of their ownership, legal status, size and degree of independence. This leads to a standardized pattern across different scales of labs, ensuring uniform practices in a crucial segment like healthcare. However, this accreditation is still not compulsory in most Indian states, leaving ambiguity in the implementation of quality standards. On the other hand, although the Clinical Establishments Act (2010) is compulsorily applicable in nine states and all union territories except Delhi, the registering and prescribing of diagnostic labs to the pre-defined minimum standards of facilities and services has not been enforced effectively. It is estimated that only a few labs, mainly forming part of the organized market have proper accreditation. Laboratory Accreditation provides formal recognition of competent laboratories, thus providing a means for customers to find reliable testing and calibration services in order to meet their demands. Till date, the Ministry of Health has mandated NABL accreditation compulsory for only medical laboratories empanelled by CGHS and the laboratories under the Centre and State Government hospitals.

In the long term, if accreditation is made compulsory, it may deter sectoral growth to an extent but offer a significant opportunity to large diagnostic players[8] that have the resources and infrastructure to attain such accreditation and gain a lead on the smaller players.

Along with the accreditation, the healthcare segment being a necessity is susceptible to Government intervention in terms of pricing. An unexpected ceiling of prices on essential or epidemic related tests can impact profitability adversely.

Event Risk

ICRA also recognizes the possibility of events, such as, a substantial debt-funded capital expenditure; unrelated diversification, mergers and acquisitions; business restructuring, asset sales and spin-offs; capital restructuring; and litigations, which could have a material impact on the credit profile of an issuer and the same is factored in as a key rating sensitivity.

[7] *National Accreditation Board for Testing and Calibration Laboratories (NABL) is an autonomous body under the aegis of Department of Science & Technology, Government of India, and is registered under the Societies Act 1860. NABL has been established with the objective to provide Government, Industry Associations and Industry in general with a scheme for third-party assessment of the quality and technical competence of testing and calibration laboratories. Government of India has authorised NABL as the accreditation body for Testing and Calibration Laboratories.*

[8] *Some large diagnostics are also acquiring International accreditations like College of American Pathology (CAP), NABL, National Glycohemoglobin Standardization Program, Clinical Pathology Accreditation (UK), Clinical Laboratory Standards (USA), Health Insurance Portability and Accountability Act of 1996 (HIPAA) compliance, International Organization for Standardization (ISO)- 27001:2005.*

In addition to the factors mentioned above, ICRA also looks at other indicators, which are common to all industries including, ownership, management, governance and liquidity.

Financial Profile

Revenue Growth

The scale of operations, revenue growth prospects and sustainability of market share are important parameters while assigning a credit rating as they reflect the operating leverage an issuer enjoys with respect to its industry peers. These indicators reflect the market position of the issuer and its ability to capitalize on the position to generate healthy test volume and realisation growth and to withstand low entry barrier pressures relating to the industry.

The revenue growth of diagnostic players although not generally vulnerable to cyclicality due to diagnostics being a necessary and integral part of healthcare, is impacted by the intense competition in a fragmented sector. Although a competitive unorganised lab might achieve robust revenue growth, the scale would be limited with low geography and product diversification and in most cases lack of funding to expand its network.

Profitability

Although both large and small labs can work on a relatively less capital-intensive model by renting space and equipment, both are required to incur fixed overheads in the form of manpower costs and corporate overheads. Thus, achieving an optimum level of utilization (which has a gestation period) is essential for diagnostic labs to turn profitable. While evaluating profitability of diagnostic chains, ICRA attempts to examine the profitability of labs based on their vintage. This allows segregation of the performance of established labs from the ones which may have been set-up recently and generating lower margins or even incurring losses. Alternatives to managing a network of labs are through the franchisee model and tie-ups with doctors. With substantial scale of operations, an issuer is better positioned to make incremental investments in latest technology and skilled personnel required in the diagnostic space.

A large revenue base leads to economies of scale in terms of cost efficiencies in purchasing, conducting operations, logistics and administrative functions, thereby supporting operating margins. Apart from the economies of scale, operating profit margins are also a function of the product mix (pathology/radiology/wellness/preventive services), vendor negotiations, contribution of niche tests (which command high margins) to overall sales, and the promotions being offered, which in turn are dependent on the competitive intensity and demand scenario. As many of the players in the organized segment have been in expansion mode over the past few years, their profitability indicators have also been under pressure owing to the gestation period associated with achieving optimum level of utilization of lab network.

Apart from the cost of procuring specialised equipment and hiring technically adept manpower, rental cost is also one of the key factors influencing the breakeven level for a lab. For instance, despite higher sales per client or test, labs in prominent locations with high rental levels can take a relatively longer time to achieve break-even levels, as the pricing may not be in line with the affluence of the locality. Thus, it entails tight control on lease rentals and other overheads to achieve profitability. In the fragmented and highly competitive diagnostic sector, healthy walk-ins, referrals and test volumes enable an issuer to negotiate favourable lease rental/raw material rates and acquire the most qualified and technically sound personnel to sustain its leadership position.

Leverage, Cash Flows and Coverage Indicators

ICRA's assessment of the financial risk profile of the issuer hinges on 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 a key rating factor to ascertain the risk appetite of the management and the impact of the same on the financial performance of the issuer.

Leverage ratios are an indicator of the degree of financial flexibility an issuer enjoys in terms of its ability to raise funds from alternative sources in times of financial distress. Such flexibility is reflected in an issuer's gearing (Total Debt-to-Tangible Net worth) and Total Debt-to-EBDITA multiple. A low gearing ratio indicates a cushion in servicing debt obligations while continuing to invest in new technologies,

capex and entry in new markets. It also implies adequate financial flexibility available in terms of raising funds primarily from external sources (debt borrowings) for meeting funding requirements.

The interest coverage indicator reflects the ability of the issuer 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 multiple indicates that the issuer is not generating adequate operating profits to meet its interest and debt maturities and may signal a default risk.

Strong free cash flows indicate the ability of an issuer to fund investments, organic and inorganic and make timely debt repayments. A low Total Debt-to-EBIDTA multiple is a credit positive as it reflects the ability of the issuer to service its debt obligations; fund growth opportunities and improve its competitive position without being overly reliant on external debt capital.

In addition to long-term financial flexibility, the liquidity profile of the issuer is equally important to understand the ability of the issuer to make good short-term obligations. Although the working capital intensity of a diagnostic services provider is relatively low, with less inventory and majority upfront cash receipts, the monthly working capital utilization of the issuer and the available drawing power remains a key indicator of its financial health.

Foreign Currency Risks

The foreign currency risks for the diagnostics' space primarily arise on account of import of equipment and technology (imports may be undertaken against letter of credit) and foreign currency denominated debt. While assessing the exposure of an issuer to foreign currency risks, ICRA focuses on the impact of adverse movement in foreign exchange rates on the cost structures, profits and net cash outflows, besides evaluating the hedging mechanisms put in place.

Tenure Mismatches, and Risks Relating to Interest Rates and Refinancing

Large dependence on short-term borrowings to fund long-term investments can expose an issuer 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 issuer could be impacted by interest rate movements on such borrowed funds.

Debt Servicing Track Record

The debt servicing track record of the issuer forms an important rating consideration. Any history of past delays or defaults in meeting interest and principal repayment obligations reduces the comfort level with respect to the issuer's future debt servicing capability. ICRA also factors in the ability and willingness of the issuer to honour its debt obligations during periods of cyclical stress.

Contingent Liabilities/Off-Balance Sheet Exposures

ICRA also looks at the quality of accounting practices followed by an issuer based on interactions with the Statutory Auditors as well as studying the Auditors' Report and the Notes to Accounts disclosed by an issuer in its 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 issuer in comparison with industry peers.

Consolidated Financial Analysis

The diagnostic industry in India comprises of large players with a presence across both domestic and international geographies through various subsidiaries and associate labs. While evaluating the financial risk profiles of issuers, ICRA assesses the consolidated/group level financial indicators in terms of capital structure, debt coverage indicators and future funding requirements.

Adequacy of Future Cash Flows

Since the prime objective of the rating exercise is to assess the debt servicing capability, ICRA draws up projections on the likely financial position of the issuer 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. ICRA also looks at the funding requirements of an issuer and the funding options available to it.

Management and Accounting Quality

In addition to the business and financial risk analysis, ICRA also factors in the management profile of the issuer while assigning the ratings. In ICRA's experience, several of the unorganised diagnostics labs are controlled by a family or operate as partnerships with limited technical expertise. Their policies may also witness changes as ownership moves through generations. The managements in some cases may be more conservative and exercises significant control on the financial policies of the issuer. However, in big diagnostic chains, the management is usually more professional with independent board representation and a qualified top management having experience in the healthcare industry. Thus, the comfort level of the management with leverage as evident from discussions and past actions becomes a key rating consideration in such cases.

An interaction with the management not only provides a better insight into the current operations of an issuer but also helps understand the management's business strategies, growth plans as well as risk appetite which may have an impact on the future performance of the issuer. Periodic interactions with the management also help ICRA estimate the probability of the management's tendency to deviate from its business philosophy in times of stress.

Conclusion

The rating methodology broadly highlights ICRA's approach in assessing the business and financial risk profiles of issuers in the healthcare (diagnostic) 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.

Trend in Rating Movements of Diagnostic Companies rated by ICRA

	2010		2011		2012		2013		2014		2015	
	Month-Yr	**Rating**	**Month-Yr**	**Rating**	**Month-Yr**	**Rating**	**Month-Yr**	**Rating**	**Month-Yr**	**Rating**	**Month-Yr**	**Rating**
SRL Limited	Mar-10	LA/Stable/A1	May-11	LA/Positive/A1	Jan-12	[ICRA]A/Stable/A1	Dec-13	[ICRA]A/Stable/A1	Sep-14	[ICRA]A+/Stable/A1+	Oct-15	[ICRA]A+/Positive/A1+
Reasons for change	-		Equity infusion by private equity funds and improvement in operating results as a result of strong volume growth.		Ratings of parent company Fortis Healthcare (India) Limited has been revised to 'Stable' from 'Negative' following the infusion of funds by the promoters to support the acquisition of Fortis Healthcare International.		-		Synergistic benefits with integration of SRLD (a 100% subsidiary of SRL) enhancing the bargaining power as well as imparting benefits of operating leverage and savings on rentals, scaling up of majority of owned labs.		Improved profitability arising from increased efficiency in cost structure benefiting from economies of scale at major labs, scale back or complete shutdown of loss making labs further supported by favorable price negotiations with key partners as well as steadily decreasing debt levels resulting in further strengthening of coverage indicators.	
	Jul-10	LA/Rating watch with developing implications/A1	Nov-11	LA/Negative/A1	-		-		-		-	
Reasons for change	Announcement by Piramal Healthcare Limited (PHL) of a definitive agreement being signed between PHL and SRL, wherein SRL would acquire Piramal Diagnostic Services Private Limited (PDSL), a subsidiary of PHL.		Ratings of parent company Fortis Healthcare (India) Limited have been revised downwards from [ICRA]AA- (Rating watch developing implications) to [ICRA]A+ (Negative) and [ICRA]A1+ to [ICRA]A1, following proposed acquisition of Fortis Healthcare International, which is expected to be predominantly debt funded.		-		-		-		-	
SRL Diagnostics Private Limited	-		-		-		Aug-13	[ICRA]BBB/Stable/A2	Sep-14	[ICRA]A-/Stable/A2+	Oct-15	[ICRA]A-/Stable/A2+

Reasons for change	-		-	-		-		Change in parent company SRL Limited's rating from [ICRA] A/Stable/[ICRA] A1 to [ICRA] A+/Stable/[ICRA] A1+ given the strong operational and financial linkages between the two entities besides the continued improvement in the coverage indicators.		-	
Medhall Healthcare Private Limited	Dec-10	LBB+/Stable	-	May-12	[ICRA]BB/Stable	Mar-13	[ICRA]BB+/Stable	Aug-14	[ICRA]BBB-/Stable	Aug-15	[ICRA]BBB/Stable
Reasons for change	-		-	Stretched financial profile of the company due to continuing losses, sharp increase in debt levels owing to the capital expenditure for expansion and low coverage metrics.		Healthy increase in the operational profile of the company with the centre count increasing from 40 to 51 between February 2012 and January 2013 in addition to the setting up of 48 captive Points of Presence resulting in modest improvement in operational profitability.		Healthy increase in the company's operating base with 20 new centres set up in the past 18 months and through the establishment of captive points of presence at various hospitals. This has resulted in a significant increase in revenues and in operating profitability accruing from economies of scale.		Increase in operating base with the set up of over 40 new centres including presence at various hospitals. Comfort from PPPs (Public-Private Partnership) Andhra Pradesh) and Jharkhand. Improvement in financial profile with additional equity funding from investors in FY2014–15.	

ICRA Limited

CORPORATE OFFICE
Building No. 8, 2nd Floor, Tower A, DLF Cyber City, Phase II, Gurgaon – 122002
Tel.: +(91 124) 4545 300; Fax: +(91 124) 4545 350

REGISTERED OFFICE
Kailash Building, 11th Floor 26, Kasturba Gandhi Marg, New Delhi 110001
Tel.: +(91 11) 2335 7940-50; Fax: +(91 11) 2335 7014, 2335 5293
Email: info@icraindia.com Website: www.icraratings.com, www.icra.in

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 0450, 2240 6617/8839, 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) 2553 9231