ICRA Rating Feature

Rating Methodology for Diagnostic Service Providers

Overview

This rating methodology provides a reference tool for investors and issuers to understand ICRA's approach to assessing the business and financial risk profiles of companies in the Indian Diagnostic Services industry. It aims to help issuers, investors and other interested market participants understand ICRA's approach in analysing the quantitative and qualitative risk characteristics that are likely to affect rating outcomes. This methodology does not include an exhaustive treatment of all factors that are reflected in ratings but enables the reader to understand the rating considerations that are usually the most important. For analytical convenience, the key factors are grouped under the following broad heads – Industry Risk Assessment, Business Risk Assessment, Financial Risk Assessment, and Management, Governance and Financial Reporting Assessment.

- ***Industry Risk Assessment***
  - Competitive Intensity
  - Regulatory Risk

- ***Business Risk Assessment***
  - Scale
  - Diversification
  - Geographic Coverage
  - Competitive Intensity and Market Positioning
  - Operational Efficiency

- ***Financial Risk Assessment***
  - Profitability Indicators
  - Leverage and Coverage Indicators
  - Foreign Currency Risks
  - Tenure Mismatches and Risks Relating to Interest Rates and Refinancing
  - Debt Servicing Track Record
  - Contingent Liabilities/Off-Balance Sheet Exposures
  - Consolidated Financial Analysis
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- ***Management, Governance and Financial Reporting Assessment***

- ***Event Risk***

Industry Risk Assessment

For assessing the diagnostic services industry, ICRA studies the various business models in the industry, the competitive intensity, and regulatory risks. The risks associated with an industry impact the credit rating of an issuer in the sector.

Competitive Intensity

In India, the diagnostic industry consists of numerous players, ranging from large organised chains to small unorganised standalone service providers. The fragmented nature of the industry has resulted in high competitive intensity especially with the advent of the aggregator business model.

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 organised players face stiff competition from unorganised 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 because acquiring accreditation is either not mandatory in most states or not enforced effectively[1]. The share of the unorganised sector is higher in the imaging segment as many of the organised diagnostic providers do not offer integrated imaging and radiology services at their diagnostic centres. This is primarily due to the high capital costs associated with setting up an imaging centre.

Although the smaller labs have limited resources with only the local neighbourhood being aware of their existence, their referral tie-ups with physicians and frequent walk-ins as well as the provision of cheaper services compared to high-end labs, have helped them to cater to a reasonable proportion of the population in a given locality.

The third format of diagnostic operations encompasses labs operating in public or private hospitals. These are either overseen by the hospital itself or there is a tie-up, in the form of a revenue sharing agreement, with a third-party diagnostic chain. The volume of business and revenue visibility in hospital labs is relatively higher than other labs due to their linkage to the hospital's operations that include the out-patient department (OPD) as well as the in-patient business. However, the number of organised diagnostic service providers in hospitals is limited at present.

Recently, there has been a growth in players offering diagnostic services but instead of setting up a reference lab, they outsource the services to existing organised diagnostic companies. The companies benefit by offering complete healthcare services to customers and by getting new business without having to invest in collection centres.

The diagnostics industry has also witnessed an increase in diagnostic service aggregators who utilise the facilities of unorganised single lab diagnostic companies. These players offer significant discounts to gain market share, thereby leading to pricing pressure in the industry. They also benefit from the fact that they offer a diverse range of tests in the imaging as well as diagnostic segment.

Most of the larger laboratories have a professional and experienced managerial set up, and automated equipment. They follow standardised quality control measures for material and lab processes and strive for regular upgradation of staff skill sets, thus commanding a good reputation. This provides 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

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

positioned to make incremental investments in new labs and the latest technology, thereby reinforcing their brand reputation and increasing their 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 needed to procure the latest technology/equipment for specialised pathology or radiology services (although some of the equipment can be taken on lease from third parties, which limits the amount of upfront investment), skill set to develop new tests and vision to grow in a pre-defined manner. Due to the lack of standardised systems and a limited test portfolio, these labs can lose customers to organised players and thus face scalability constraints.

Regulatory Risk

With most of the compliance requirements for diagnostic services falling under state purview, there is no uniformity in regulations pertaining to the same. Regulations relate to automation, quality controls, accreditation, etc. The Central Government has taken several steps to develop a well-defined regulatory framework for the healthcare industry through the Central Drug Standard Control Organization (CDSCO). The CDSCO works under the aegis of the Ministry of Health and Family Welfare (MoHFW) to lay down rules and standards, and approve the import as well as manufacture of drugs, diagnostics, devices, and cosmetics. Under CDSCO, the National Accreditation Board for Testing and Calibration Laboratories (NABL)[2] provides laboratory accreditation services to labs that perform tests in accordance with standards. This is expected to lead to a standardised 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 of diagnostic labs and their adherence to the pre-defined minimum standards of facilities and services has not been enforced effectively.

If accreditation is made compulsory, it may offer significant opportunity to large diagnostic players[3], which have the resources and infrastructure to attain such accreditation, to gain a lead on the smaller players.

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

[2] *NABL is an autonomous body under the aegis of the Department of Science & Technology, Government of India (GoI), and is registered under the Societies Act, 1860. It was established with the objective of providing the government, industry associations and the industry, in general, with a scheme for third-party assessment of the quality and technical competence of testing and calibration laboratories. The GoI has authorised NABL as the accreditation body for testing and calibration laboratories.*

[3] *Some large diagnostic labs/chains 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, and International Organization for Standardization (ISO)- 27001:2005.*

Business Risk Assessment

Scale

Scale is defined in terms of the revenue/network of labs 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. However, 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 diagnostic centres and equipment while introducing specialised tests/services in their portfolio. Complex tests, in turn, command higher realisations and allow diagnostic service providers to attain higher profitability and product differentiation. Further, a large diagnostic chain would have greater financial flexibility to grow fast, establish labs at prominent locations, have a team of technically adept professionals, possess the ability to market itself, and thus command a market stronghold. A large-scale standalone lab or chain would have the latest radiology equipment and pathology test facilities to provide a full-service experience to its customers, thereby ensuring deeper penetration within its existing customer base. 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 the desired scale is not achieved.

In the fragmented and highly competitive diagnostics 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 purchases, and acquire the most qualified and technically sound personnel to drive operational efficiency to sustain its leadership position. Therefore, a healthy market position leads to stability in the issuer's operating margins.

In contrast, small unorganised companies are unable to offer a diverse range of tests or specialised tests requiring advanced technology, have limited skilled technicians and limited bargaining power with suppliers owing to low levels of scale. Although small labs possess a cost advantage owing to their lean cost structure, which enables them to acquire customers based on 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 a 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 exposure to a region.

Diversification and scale of operations are closely linked with an issuer having a large scale, and also generally being well diversified on the back of larger financial resources and risk-taking appetite. ICRA evaluates a diagnostic lab/chain based on its revenue diversity in terms of the business mix (mainly pathology and radiology), therapeutic mix and lab location.

Maintaining a high degree of diversification is crucial as it leads to lower revenue volatility, less susceptibility to regulatory[4] or market changes, provides competitive advantages and ensures higher profitability on the back of product/services differentiation.

Business Mix

A diagnostic service player with a business mix of a wide range of tests and services across categories would be well placed to cater to customer 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

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

tests and services offered mainly in two key segments, pathology and radiology, and also a 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. This is considered favourably in the ratings. 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 access to funding, new technology, and also maintain an in-house R&D department.

Recently, some large diagnostic chains have 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.

Geographic Coverage

Along with having a well-diversified business profile, good geographic coverage (regional, national and international) is a positive credit factor as it provides access to a larger clientele and reduces the vulnerability of revenues to disease cycles and variations in the standards of living in a single geography. A diagnostic service centre located in a densely populated area is likely to experience higher footfalls compared to one that is 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 its location, in ICRA's experience, it is observed that outlets situated in a demographically favourable location (near hospitals, prominent markets and main roads) enjoy the distinct advantage of high visibility and better recall with prospective clients. This drives business volumes.

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

Major organised diagnostic chains have 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 diversifying internationally also benefits from better pricing and higher capacity utilisation of domestic labs via test send-backs (in case of specialised tests requiring specific equipment or technicians). Apart from diversification within India, a diagnostic chain that de-risks its exposure by entering multiple markets overseas is seen favourably. However, the additional investment and challenges of managing a business in relatively unknown markets could impact profitability.

Competitive Intensity and Market Positioning

The extent of competitive intensity in a region and a diagnostic lab/chain's market position play 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-à-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 applicable/true for standardised tests, where a meaningful price difference between players can result in the switching of customer loyalty. However, certain categories of diagnostic labs and specialised tests are relatively less vulnerable to pricing pressure compared to others. ICRA notes that despite the relatively higher price competition in routine test segments, certain diagnostic labs in Tier I cities, 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.

The market position is reflected in reputation, customer loyalty and bargaining power, which are achieved by having a large network of labs, successful track record of operations, ability to respond to competitive pressure while maintaining cost efficiency and profitability during varied disease cycles/ seasons.

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, new labs of an organised diagnostic chain can garner market share quickly owing to brand reputation on the back of implementation of standards 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 loyalty programs (offers discounts on consecutive visits) to achieve a stronger brand recall, is seen positively by ICRA. A strong brand recall strengthens an issuer's market position and leads to faster acquisition and subsequent retention of clients, thereby supporting profitability.

Business viability depends on client loyalty, which is dependent on the quality, timeliness and pricing of services. A client's loyalty 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 to measure 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 considers the market position through the brand strength and reputation of the diagnostic lab/chain, as this drives demand and footfalls. Referral tie-ups with or on-site labs at renowned doctor clinics and hospitals are factored in positively, as they assure revenue visibility owing to the credibility of the doctor or hospital.

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.

Financial Risk Assessment

The various financial metrics assessed by ICRA could be divided into four categories, viz. profitability, leverage, coverage and liquidity. This section provides a brief summary of why ICRA considers these ratios to be important. For a more detailed description, readers may refer to the note titled, "Approach for Financial Ratio Analysis" published on ICRA's website. Some of the key metrics analysed are discussed below.

Since the prime objective of the rating exercise is to assess the debt servicing capability, ICRA draws up projections on the issuer's likely financial position based on the expected movement in operating performance, factoring in capex and investment requirements as well as upcoming debt obligations to study their 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.

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 utilisation (which has a gestation period) is essential for diagnostic labs to turn profitable. While evaluating the profitability of diagnostic chains, ICRA attempts to examine the profitability of labs based on their vintage. This allows the segregation of the performance of established labs from those that may have been set up recently and are generating lower margins or even incurring losses. Alternatives to managing a network of labs are through the franchisee model and tie-ups with doctors.

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 economies of scale, operating profit margins are also a function of the product mix (pathology/radiology/wellness/preventive services), customer mix (walk-ins/referrals/collection centre customers/wellness), vendor negotiations, contribution of niche tests (which command high margins) to overall sales, and the promotions being offered, which depend on the competitive intensity and demand scenario.

Apart from the cost of procuring specialised equipment and hiring technically adept manpower, rental cost is 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 rentals 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.

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 issuer's financial performance.

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 Total Debt-to-EBDITA multiple. A low gearing ratio indicates better ability to withstand volatility in cash flow generation during situations of economic downturn, competitive challenges, unexpected costs or regulatory changes. As a result, it can help the company to continue to invest in new technologies, capex and entry in new markets during adverse conditions.

Coverage indicators such as interest coverage ratio and debt service coverage ratio (DSCR) reflect the issuer's ability 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 issuer's ability to fund investments, organic and inorganic, and make timely debt repayments. Trends in an entity's fund flow from operations after adjusting for working capital changes, the retained cash flows, and the free cash flows after meeting debt repayment obligations and capital expenditure can help in understanding the entity's external funding requirements to meet its maturing obligations.

Foreign Currency Risks

The foreign currency risks for the diagnostics space primarily arise from the import of equipment and technology, and foreign currency denominated debt. While assessing an issuer's exposure to foreign currency risks, ICRA focusses on the impact of adverse movements in foreign exchange rates on the cost structure, profits and net cash outflows, besides evaluating the existing hedging mechanisms.

Tenure Mismatches and Risks Relating to Interest Rates and Refinancing

High dependence on short-term borrowings to fund long-term investments can expose an issuer to significant refinancing 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.

The liquidity profile of the issuer is important for understanding its ability 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 utilisation of the issuer and the available drawing power are key indicators of its financial health.

Debt Servicing Track Record

The debt servicing track record of the issuer is 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 by studying the Auditors' Report and Notes to Accounts disclosed by an issuer in its Annual Report. Some of the key factors that are considered include auditor's qualifications with respect to internal control systems, debt servicing and asset liability mismatch, contingent liabilities and other off-balance sheet items and the issuer's method of revenue recognition and depreciation policy compared to industry peers.

Other Considerations

Management and Accounting Quality

In addition to the business and financial risk analysis, ICRA factors in the management profile of the issuer while assigning the ratings. In ICRA's experience, several of the unorganised diagnostic labs are controlled by a family or operate as partnerships with limited technical expertise. However, in big diagnostic chains, the management is usually more professional with independent board representation and a qualified top management with experience in the healthcare industry. Thus, the comfort level of a strong management, as evident from discussions and past actions, becomes a key rating consideration in such cases.

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

Event Risk

ICRA also recognises the possibility of events such as 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 issuer's credit profile.

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

Summing Up

ICRA's credit ratings are a representation of its opinion on the relative credit risk associated with the instrument being rated. This opinion is arrived at following a detailed evaluation of the issuer's business and financial risks, its competitive strengths, likely cash flows over the life of the instrument being rated, and the adequacy of such cash flows vis-à-vis its debt servicing obligations. As the note has highlighted, in case of diagnostic service providers, special attention is also paid to the business model, market position, scale of operations, cost competitiveness, and diversification besides the management's strategies in context of the changing regulatory environment and increasing competitive intensity in the industry.

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