

RATING METHODOLOGY – HIGHER EDUCATION

February 2022



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This rating methodology describes ICRA's approach to assess the credit quality of entities in the higher education sector and supersedes ICRA's earlier methodology document on this subject, published in February 2020. While this revised version incorporates a few modifications, ICRA's overall approach towards rating entities in the sector remains materially similar.

This rating methodology aims to help entities, investors and other interested market participants understand ICRA's approach to analysing the quantitative and the qualitative considerations 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.

Overview

The Indian education system can be broadly classified into two key segments—formal or core education and informal or non-core education. The formal education sector, comprising schools, colleges and universities, is highly regulated by the Government, whereas the informal sector, which primarily comprises pre-schools, training institutes and coaching centres, is unregulated. Moreover, while the private sector has been present in the schooling and informal education sector for many decades, its involvement at the college and University levels has picked up pace only over the past two decades.

The funding of Government schools, colleges and universities is carried out through budgetary allocations from the Central Government and state governments with no borrowings by Government-owned institutions on their own balance sheets. As a result, ICRA's rated universe in the higher education space comprises only private institutions. Further, these private institutions tend to be owned by not-for-profit societies, trusts or Section 8 companies¹ (with a few exceptions), as regulations require formal education in India to be carried out as a not-for-profit activity².

The higher education sector in India has witnessed a manifold increase in the number of universities and colleges. Over the past two decades, the number of Universities³ in the country has increased nearly five-fold to 1,043 in 2020 from 254 in 2001; while the number of colleges⁴ has increased nearly four-fold to 42,343 from 10,152 during the same period⁵. Increasing demand for higher education, but limited Government spending has resulted in increased private sector participation, as

¹ Section 8 companies under the Companies Act 2013 are the same as the Section 25 companies under the Companies Act 1956. These include companies that are established for the promotion of commerce, art, science, sports, education, research, social welfare, religion, charity, protection of the environment or any such other object, provided they intend to apply their profits, if any, or other income in promoting their objects and intend to prohibit the payment of any dividend to its members.

² There are some business models in the sector, wherein a for-profit company owns assets and/or manages operations of educational institutions under not-for-profit entities, in return for contractual charges. Further, while the formal education segment is predominantly considered a not-for-profit activity in India, there are a few exceptions such as the case of Haryana where state regulations permit for-profit entities to set up schools.

³ As per University Grants Commission, All India Survey on Higher Education (Ministry of Human Resource Development) 2019-20 (AISHE 2019-20); includes Central Universities, State Universities, State Private Universities and Deemed to be Universities

⁴ Including Private Unaided Colleges, Private Aided Colleges and Government Colleges

⁵ As per AISHE 2019-20

reflected in an increase in the proportion of private universities among total universities to ~39% in 2020 from less than 2% in 2001.

The following rating methodology explains ICRA's approach in analysing credit profiles of entities involved in offering higher education through colleges and Universities under their aegis.

Analytical Framework for Assessing Higher Education Entities

The broad list of rating factors that ICRA assesses while analysing entities in the higher education sector is covered in this methodology note. While these do not necessarily represent an exhaustive set of factors, they do provide an overall perspective to the lenders, investors and other market participants on the rating considerations that are usually considered the most important. For analytical convenience, the key factors are grouped under the following heads — industry risk drivers, business risk drivers, financial risk drivers, management quality and other considerations.

Industry Risk Assessment

- Regulatory landscape
- Growth prospects
- Competitive intensity

Business Risk Assessment

- Scale of Operations
- Average ageing of institutes
- Autonomy
- Enrolment Ratio
- Ranking and Placements
- Faculty Quality
- Cash Flow Alignment
- Diversification

Financial Risk-Assessment

- Cost structure and expenditure flexibility
- Leverage and debt coverage
- Tenure mismatches and risks relating to interest rates and refinancing
- Accounting quality
- Liquidity
- Financial flexibility

Other Elements of Credit Risk Assessment

- Parentage
- Philanthropic support
- Not-for-profit nature of business

Management Quality

Assessment of Environmental, Social and Corporate Governance Risks

Industry Risk Assessment

Regulatory Landscape

The Indian education sector is highly regulated by the Government because of its social importance and associated positive externalities. Further, education is part of the concurrent list of the Indian Constitution, whereby both the state as well as the Central Government have powers to regulate the sector, resulting in multiplicity of regulators. The sector is regulated through various regulatory bodies, such as:

- University Grants Commission (UGC)⁶
- All India Council for Technical Education (AICTE)⁷
- National Medical Commission (NMC)⁸
- Dental Council of India (DCI)
- Bar Council of India (BCI)
- Indian Nursing Council (INC)
- National Council for Teacher Education (NCTE)

These entities specify various operational norms and infrastructure requirements to maintain the quality standards. Therefore, the regulations on various aspects of formal education sector, coupled with the multiplicity of regulatory bodies, result in operational and financial implications for the sector, and are thus an important factor influencing the risk profile of entities offering higher education.

Accordingly, ICRA attaches importance to the degree of operational autonomy and regulatory risk that a college or university is exposed to, given its structure and affiliations, if any, as these factors can have a significant influence on the operations.

While the scope of regulations affecting the Indian higher education sector is wide, from an operational autonomy perspective, regulations could limit the flexibility in determining the course offerings, curriculum, seat allocation, student selection criteria, appointments for key managerial positions, and fee structure. In addition, regulations could influence the criteria related to qualifications and number of faculty, requirements for establishing a college or University and procedure for commencement and closure of a course.

Accordingly, institutes enjoying autonomous status such as deemed universities, private universities or colleges that have operational autonomy are in a relatively better position to review the courses offerings, curriculum and examination pattern periodically.

In India, each state has different policies for regulating the seat allocation and fee structure of private colleges, whereby the colleges may be required to allocate a certain percentage of sanctioned intake towards the Government quota for admissions based on specified entrance examinations. The fee charged for enrolments under different quotas is also regulated, with a wide difference in the fee levels, thereby having a bearing on the financial performance.

⁶ UGC was established for the co-ordination, determination and maintenance of standards of University education in India

⁷ AICTE was established for the proper planning and co-ordinated development of the technical education system

⁸ NMC came into force on September 25, 2020 by gazette notification dated September 24, 2020 and replaced the erstwhile Medical Council of India (MCI)

Growth Prospects

While increased private sector participation has supported the creation of infrastructure and the Government's effort towards increasing the gross enrolment ratio (GER⁹) in the country from ~8% in 2002 to the current levels of ~27.1% in 2019-20, it continues to be low, presenting significant growth opportunities. Nevertheless, despite the infrastructure created, low enrolment levels in many institutes reflect the lack of quality education as well as socio-economic factors such as the need to take up early employment, besides the high level of unemployment, even among the educated population.

Competitive Intensity

The higher education sector in India is highly competitive with numerous Government and private institutions competing to attract meritorious students and quality faculty members. The ranking of the institutes in various reputed domestic and international surveys help them in standing out among competitors. Some factors that affect their rankings include vintage of the institute, infrastructural facilities, industry connections, global collaborations, among others.

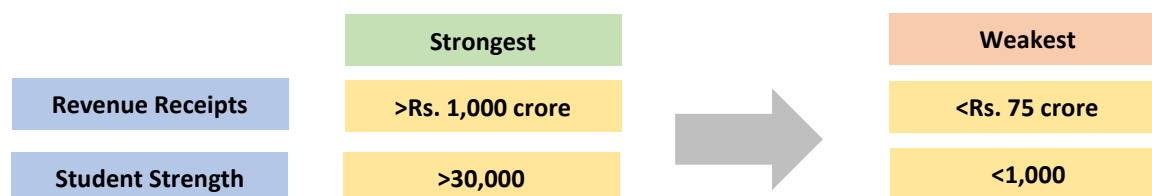
Business Risk Assessment

Scale of Operations

A large scale would indicate significance of an entity's institutes within its region of operations/ country, besides reflecting on its brand recognition and the overall importance in the system. Further, a larger scale may support better absorption of administrative overheads and facilitate larger advertising campaigns and better infrastructure facilities, besides a greater impact in the region that can be leveraged to secure philanthropic support. ICRA assesses an entity's scale based on its revenue receipts and student strength.

Assessment of Scale of Operations

[Indicative Metrics¹⁰]



Average Ageing of Institutes

The higher education sector is highly capital intensive with large upfront investment required in fixed assets. The operating leverage is also high as a sizeable proportion of the operating cost is fixed in nature (for instance, faculty costs) and has to be borne from the date of commencement, given the stringent operating norms applicable by way of multiple regulations (such as prescribed faculty to student ratios) governing an institution. Moreover, the gestation period is long as the ramp up in student strength progresses at the pace of enrolment of new student batches. Thus, apart from the large upfront investment, regular financial support is required during the initial years to cover the fixed operating costs. Subsequently, upon the achievement of a reasonable scale of operations, the operational surpluses improve the capability to fund future growth.

⁹ GER in a specific level of education is enrolment expressed as a percentage of the eligible population. GER in higher education in India is calculated for the 18-23 years' age group

¹⁰ The indicative financial metrics mentioned here and elsewhere in the document are intended to provide a broad overview to the readers regarding what ICRA generally considers as 'relatively strong' or 'relatively weak' metrics. It is, however, possible that an entity has relatively weaker metrics on one or more financial parameters, but its credit risk is assessed to be low because of other mitigating factors, including (but not limited to) stronger metrics on other financial parameters, a healthy business risk profile, strong financial flexibility or a strong promoter group that is willing to extend distress support to it.

Sufficient operating vintage coupled with a track record of healthy enrolment ratio result in higher occupancy and thus better utilisation of the available capacity. This higher utilisation, besides reflecting the healthy perception and demand for courses offered, also generally results in higher and stable surpluses and asset turnover ratios, and thus better credit profile.

Apart from financial implications, an institution with an established track record usually has greater visibility among its applicants, a larger alumni network, more tie-ups and better ability to attract and retain experienced faculty.

Assessment of Operating History

[Indicative Metrics]



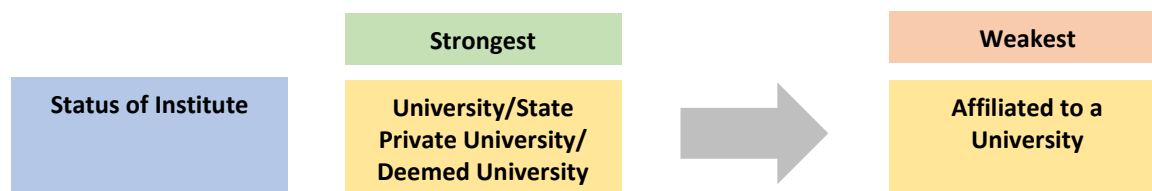
Autonomy

Growth in revenue receipts of an institute is a function of the increase in the number of student enrolments as well as the fee hikes implemented to cover for increase in operating costs. As employee, power, transportation and some other costs tend to witness a year-on-year inflationary increase (in a steady state of operations), it is critical for an institute to have sufficient pricing power to implement an adequate fee hike without impacting the enrolments.

Besides the constraint arising from possible adverse impact on enrolments, ICRA notes that institutes, especially colleges affiliated to various state universities, may have limited flexibility to revise the fee structure because of regulatory constraints. Moreover, as the fee hikes are generally applicable for new batches, the increase in overall revenue receipts tends to be phased out and typically may not be commensurate with the increase in employee expenses in the initial years, which can thereby impact the surpluses and hence debt servicing. Given the importance of regular and adequate fee revisions for supporting credit profile, ICRA examines the impact of regulations on pricing flexibility and frequency of fee revision, besides making a comparison with the peers on the fee charged. Moreover, higher levels of operational autonomy enable the institutes to introduce/ discontinue courses and revise curriculum to suit the changing requirements and preferences of students and maintain healthy enrolment levels.

Assessment of Autonomy

[Indicative Metrics]



Enrolment levels

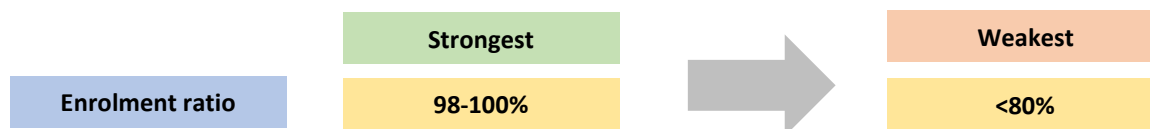
Parameters such as Enrolment ratio¹¹ reflects the perception of the institute among the student community. The ability of an institute to consistently operate at healthy enrolment levels reflects favourably on its operational profile, besides providing

¹¹ Enrolment ratio = (Number of students admitted) / (Sanctioned seat strength)

revenue visibility. ICRA may also look at additional parameters including acceptance ratio¹², wherever available, to evaluate the demand for the institute's courses.

Assessment of Enrolment levels

[Indicative Metrics]



Ranking and Placements

Reputation of the institute, characterised by its ranking among various recognised domestic and international surveys, is a key factor in attracting meritorious students, retaining quality faculty members and drawing leading recruiters for placements to the campus. A high-ranking institute is more likely to be able to record high enrolment levels for its flagship courses and charge higher fees as compared to its low ranked peers leading to higher revenue visibility.

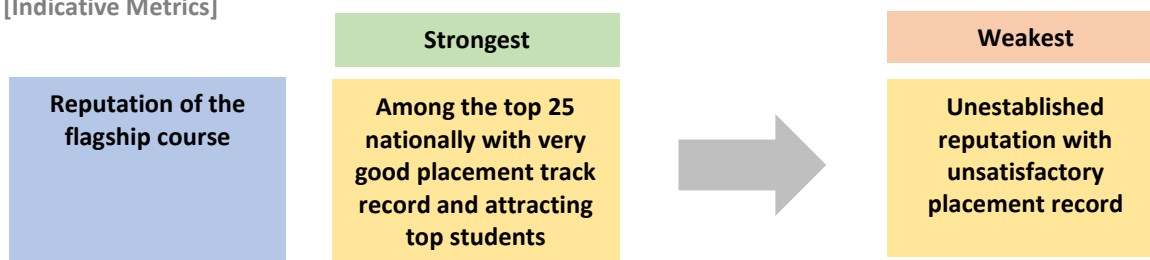
The quality of placements is another crucial parameter while assessing the credit profile of an institute as it is not only a measure of student quality and performance but also serves as a key indicator of the institution's acceptability in the corporate world. In addition, as placement statistics form a key driver of student preference for an institute, a healthy and stable placement track record lends enrolment stability and revenue visibility. While assessing the industry interface of a college or a University, ICRA may observe the type and quality of relationships the institute has with the corporate world, research institutes and industry bodies, besides the initiatives taken to connect with the industry. The job placement statistics are a key indicator/proxy of quality and effectiveness of industry interface achieved by an institute.

Key placement statistic considered by ICRA includes the placement ratio¹³. However, the criticality of placements may vary depending upon the type of courses offered. For instance, while the placements are a very important consideration while assessing the effectiveness of an institute offering technical courses, the significance of the same may be low in other courses, such as medical education. ICRA may also evaluate the number of offers made per student and the compensation packages offered, while also making a qualitative assessment of the corporate entities that visit the campus, based on data availability.

The quality and adequacy of physical and learning infrastructure, critical platform for delivering education, also impacts the brand perception among various stakeholders, including sector participants, philanthropists, and prospective students and faculty. Thus, it has a bearing on future enrolments and on the operational as well as the financial risk profile. Moreover, the student preference for one institute over others is another important indicator of market reputation or perceived value of education imparted by a college or University. The extent of student interest in the courses offered by an institute also determines the flexibility available in deciding the student selection process and the fee structure. This is reflected in a diversified student mix, high number of applications per seat and interest from meritorious students.

Assessment of Reputation

[Indicative Metrics]



¹² Number of applications accepted / total number of applications received

¹³ Number of students placed as a percentage of number of students eligible for placement

Faculty Quality

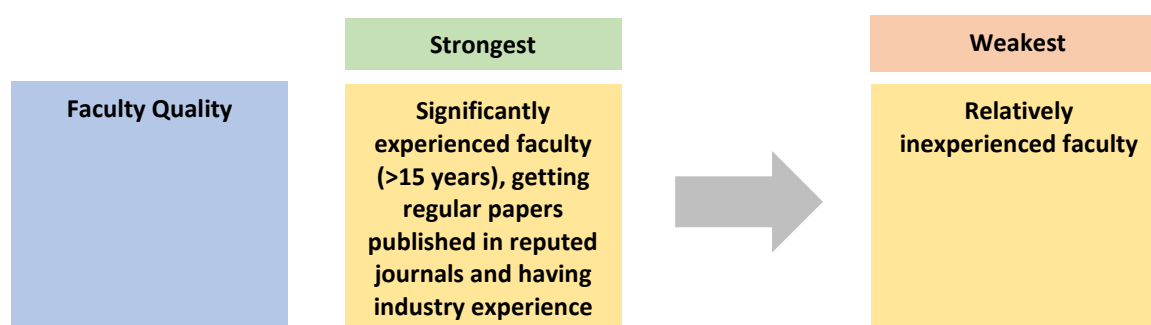
Qualified and experienced faculty can be a key differentiator and a source of competitive strength for an educational institute, besides the infrastructure facilities and the latest teaching methodologies supporting the delivery of knowledge and experience to students. ICRA believes an institution with an adequate number of good quality faculty is in a better position to deliver good education. This is subsequently reflected in the performance of the students in academics and placements, in turn elevating demand for the college among better candidates. Some of the parameters which ICRA reviews, to assess faculty profile and adequacy, include:

- Student–teacher ratio
- Educational background, teaching experience, industry exposure, published research papers and positions of eminence held by teaching staff

Besides the availability of quality faculty, ICRA believes it is also important for an institute to ensure stability among teaching staff. Given the shortage of competent faculty, it is imperative to be able to attract, develop and retain talent, for which effective human resource policies are required.

Assessment of faculty quality

[Indicative Metrics]

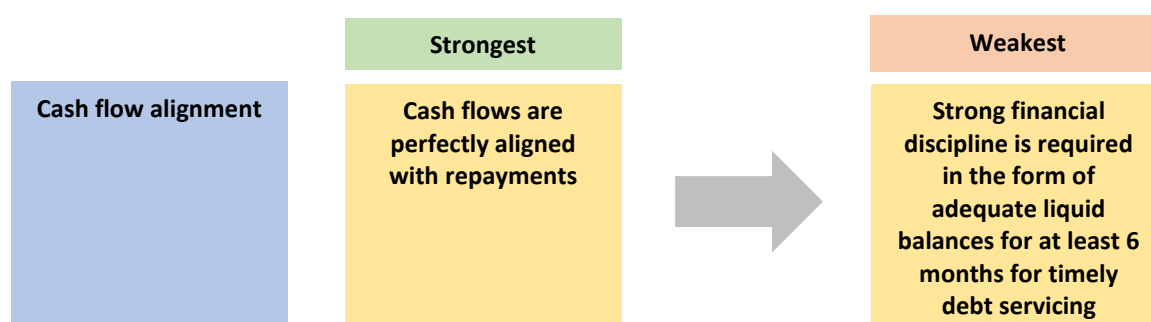


Cash Flow Alignment

Cash inflows are usually bundled towards the beginning of the academic year for most entities in the higher education sector due to them collecting the tuition fees in advance. However, the cash flow in terms of repayment of debt is likely to be staggered throughout the year. This is likely to create a cash flow alignment scenario wherein the entity may be required to follow a disciplined approach to maintain adequate liquid buffers for servicing of debt. ICRA analyses the entity's cash flow alignment by studying the timing of cash inflows and outflows along with the track record of the management towards financial discipline and liquidity position of the entity.

Assessment of cash flow alignment

[Indicative Metrics]



Diversification

Significant dependence on a single course/ stream exposes an entity to unfavourable changes in market demand. An established and well-perceived presence in multiple courses adds greater stability and shields operations from shifts in student preferences in situations of economic or demographic changes. However, merely a large portfolio of course offerings without specialisation / differentiation in a course is not considered a positive. In case of an institute offering a large number of courses without a leadership position in any course, the management's flexibility to react to changing student preferences in a timely manner, by expanding or reducing the number of course offerings, is important as the non-performing courses can have an adverse impact on the perception of the institute. Moreover, non-performing courses could become a drain on financial resources.

Further, diversity of revenues across multiple institutes reduces an entity's exposure to several risks such as operational interruptions, reputational risks arising out of errors/ omissions/ misconduct by employees as well as the risk of litigations and regulatory changes, among others. Apart from asset diversification through ownership of multiple institutes under the ambit of an entity, ICRA also considers an entity's geographic diversification in terms of presence across regions. Being located in a single location/state exposes an entity to risks emanating from adverse developments in any particular region, besides heightened regulatory risks. On the other hand, having multiple campuses provides locational diversity and enables an entity to cater to a larger student base, thereby establishing greater market visibility.

Assessment of Diversification

[Indicative Metrics]

	Strongest		Weakest
Share of largest stream in revenue	<25%		>90%
No. of states in which the institute operates	>3 states		1 state
Share of largest institute in revenue	<=35%		>90%

Financial Risk Assessment

While ICRA believes that a strong business profile drives strong financial profile in the long-term, the financial profile of an entity is also governed by the risk appetite and growth plans of the management. Accordingly, while assessing the financial risk profile, apart from the past and the current financial position, ICRA also takes note of the growth plans of the entity and its likely impact on the financial position in future. Suitable adjustments in reported financials are also made to make them comparable for meaningful peer comparison.

While analysing revenue and the expected growth, the various revenue streams including tuition fee, hostel fee, transport fee, mess fee and their expected growth are factored in. In assessing the revenue visibility, the proposed fee hikes for various courses and expected occupancy, given operating seats, current enrolments and past trends, are taken into account.

Since the prime objective of the rating exercise is to assess the debt-servicing capability of an entity, ICRA draws up projections on the likely financial position of the entity based on the expected movements in operating performance. While doing so, capital expenditure and investment requirements as well as upcoming debt obligations are also factored in to assess the impact on revenue growth and surplus generation, cash flows, leverage as well as debt protection indicators. ICRA also assesses the anticipated funding requirements of an entity and the funding options available to it. Further, the sensitivity of the financial performance of institutes to changes in key metrics including enrolment ratio, fee structures, etc. are also considered.

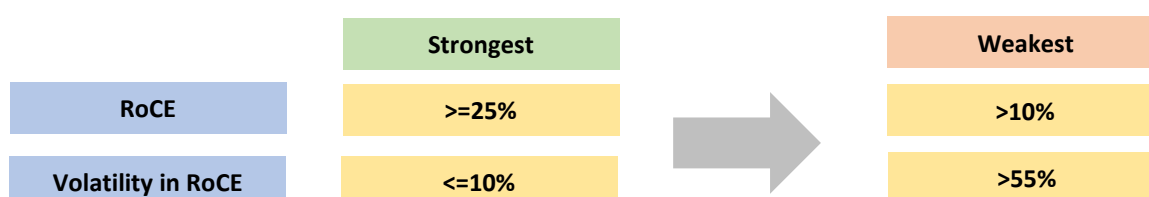
The following section provides a brief summary of the financial metrics which ICRA considers to be important and reasons for the same. For a more detailed description, readers may refer to the note titled, *Approach for Financial Ratio Analysis* published on ICRA's website.

Cost Structure and Expenditure Flexibility

Given the sizeable capital investments required in creating physical infrastructure in the higher education sector, the asset turnover of entities is typically low at ~50%. Accordingly, the institutes are required to operate at high operating surplus margins to cover the fixed capital costs. Besides, expenses related to faculty, power, transportation, subscription of journals, etc., are typically fixed in nature. Thus, given the high operating leverage because of fixed capital as well as operating costs, the entity's ability to adjust its operations during times of weak enrolments or limited fee hikes is critical for the stability of credit profile.

Validation of Business Risk through Profitability Metrics

[Indicative Metrics]



Leverage and Debt Coverage

The credit profile of entities that pursue an aggressive financial policy, including heavy reliance on debt financing, is likely to be more vulnerable to decline in enrolments/ operating surpluses than entities that employ a lesser degree of financial leverage. Leverage ratios are an indicator of the degree of financial flexibility an entity enjoys in terms of its ability to raise funds from alternate sources in times of pressure on surpluses. Such flexibility is reflected in an entity's total debt-to-operating surplus ratio and free cash flows-to-debt ratio. A low leverage ratio indicates adequate cushion available in terms of raising funds primarily from external sources (debt borrowings) for meeting funding requirements and is a credit positive. A strong

free cash flows-to-debt ratio also points towards an entity's ability to fund investments in infrastructure and make debt repayments.

Low leverage not only improves the financial flexibility of the entity, but also keeps the fixed financing expenses low. The higher education sector, being fixed capital intensive, has high funding requirements for investment in fixed assets. ICRA takes into consideration the funding mix of the entity towards such investments.

Depending on the operating history, an issuer's debt coverage indicators may vary significantly vis-à-vis peers for a given operational profile. In addition, the tenure of the term debt is a key driver for the debt coverage as entities with longer tenure debt and similar levels of leverage will be more comfortably placed compared to entities with shorter tenure debt.

Assessment of Leverage

[Indicative Metrics]

	Strongest		Weakest
Indebtedness Ratio	$\leq 0.9x$		$> 3.0x$
Debt to Profit Ratio	$\leq 0.5x$		$> 5.0x$

Assessment of Coverage

[Indicative Metrics]

	Strongest		Weakest
Interest Cover	$\geq 18.0x$		$< 2.0x$
DSCR	$\geq 4.0x$		$< 1.1x$

Tenure Mismatches and Risks Relating to Interest Rates and Refinancing

Large dependence on short-term borrowings to fund long-term investments can expose an entity to significant liquidity and re-financing risks. The ratings factor in the existence of adequate long-term funding in line with its requirements and buffers of liquid assets/bank lines to meet short-term obligations/cash flow mismatches and the extent to which the entity could be impacted by interest rate movements on borrowed funds.

Accounting Quality

As formal education has been classified as a not-for-profit activity, most entities in the education sector are registered as trusts or societies under the state or Central Government Act or as Section 8 companies. While these entities typically follow the accounting standards applied across corporate sector entities, there is no standard accounting norm applicable for trusts or societies. Therefore, the accounting policies followed by these entities are taken into account and necessary adjustments are made while assessing the credit profile. In addition, the quality of internal controls and management information systems are aspects that are examined closely as the presentation of accounts by educational institutions is not governed by the Companies Act, 2013.

Liquidity

Liquidity is the measure of an entity's ability to meet its short-term cash obligations from various internal or external resources. Internal resources include fund flow from operations, unencumbered cash and cash equivalents on balance sheet and cash inflows expected from the monetisation of physical and financial assets. External resources include undrawn lines of credit or equity capital/corpus funds. Short-term obligations include committed as well as contingent claims on an entity's cash,

including the debt-servicing obligations, working capital requirements, capital expenditure and other investment outlays, besides the sudden demand arising from crystallisation of discrete events such as litigation penalty. The higher the cushion between available resources (especially internal resources) and obligations, better the liquidity profile of an entity.

Educational institutes face seasonality in cash flows as the tuition fee is generally not received on a monthly basis. Accordingly, the cash inflows of an educational institute are not uniformly spread across the year, though the operating expenses and outflows towards debt servicing and capital expenditure are spread out over the entire year. Thus, alignment of debt repayments, with expected cash inflows and prudent management of cash flows and liquidity, become vital from a credit perspective. It is a credit positive if an entity maintains sufficient liquidity by way of undrawn overdraft bank limits or liquid investments to not only meet operating expenses on an ongoing basis, but also for debt servicing, given the lumpy nature of fee collections. On the positive side, given that the fee is collected in advance from the students for the academic year/semester, the institutes are able to generate cash flows and working capital requirement tends to be negative.

While tuition fee is typically collected in advance, an institute can have sizeable receivables because of the delay in the receipt of reimbursements from the Government pertaining to courses offered to students who are sponsored under various Government schemes. As the procedural aspects generally result in these delays, it is important to assess the contribution of such income to the overall revenue receipts and steps taken to manage the cash flow mismatches arising because of this.

Financial Flexibility

An entity's financial flexibility (or the lack thereof) is reflected in its ability to raise funds at short notice, attract diverse and marquee investors and enjoy the confidence of banks, financial institutions and intermediaries. A strong financial flexibility allows an entity to raise fresh borrowings or refinance existing ones in quick time and whenever required. Financial flexibility could arise from factors such as an entity's large scale of operations with strong financials, large unencumbered cash flows, unencumbered assets and the flexibility to borrow against such assets, or strong parentage or linkages with a strong group.

Other Elements of Credit Risk Assessment

Parentage

All debt ratings necessarily incorporate an assessment of the quality of the entity's promoters/ founders as well as the strengths/ weaknesses arising from the entity's being a part of a "group". Also of importance are the entity's likely cash outflows arising from the possible need to support other group entities, in case it is among the stronger entities within the group. Some key factors considered include:

- Strength of the other entities belonging to the same group as the entity
- Ability and willingness of the group to support the entity through measures such as donations, corpus funds etc., if required

Philanthropic support

Funding support (by way of donations) received from industry, alumni and research bodies can be a key source of financial flexibility for an educational institute. Besides, it reduces the dependence upon income generated from enrolments for funding the growth requirements. While assessing the philanthropic support available to an education institute, key parameters assessed are:

- Diversity, quality and stability of support received
- Quantum of support in relation to requirements

Given that such financial support is voluntary, the timing and the quantum of such support cannot be predicted reasonably in advance. Thus, increased reliance on such support for meeting funding requirements for operational/ growth purposes can

stretch the liquidity of the entity and hence its debt servicing ability. Diversified, reputed, identifiable and stable stream of donations, on the other hand, are positive attributes.

Given the lack of recurring/operational nature of these funds, ICRA treats these as a part of the corpus funding and not as revenue receipts. However, receipts such as development fund or building fund, which are charged as a part of student fees, are treated as revenue receipts, though it may be for capital expenditure purposes. Reported financials adjusted for these items are taken into account by ICRA for the assessment of financial risk profile.

‘Not for profit’ nature of operations

Entities operating in the formal education sector have to operate on a not-for-profit basis and are permitted a ‘reasonable surplus’ to meet cost of expansion and improvement of facilities. In addition, the surplus money has to be ploughed back into the institution/ applied for charitable purposes to maintain a tax-free status and no dividend can be distributed to the members of the entity who operate the institute.

Though ‘reasonable surplus’ has not been defined, the guidelines under the Income-Tax Act allow tax exemption to institutions as long as the quantum of spending of income (towards revenue expenditure and capital expenditure) identify at least 85% of its revenue and capital receipts in any given year. In case of the above spending being less than 85% in any given year, the difference is allowed to accumulate for a period of five years without becoming taxable¹⁴.

Earlier (prior to the Finance Act, 2001), the clause of spending a minimum percentage of income was not applicable. Subsequently, the Finance Act 2001 imposed the condition of spending at least 75% of the income, where Finance Act 2002 further increased the amount of spending of income to be at least 85%. Any further change in the amount of spending as required under the Finance Act could affect the level of surpluses, which an entity can operate at, and hence remains a regulatory risk.

The use of revenue receipts or income includes operating expenses, financing cost and principal repayments; however, as mature entities in higher education sector generate healthy operating surpluses, there is a tendency to undertake continuous capital expenditure, thereby resulting in cash outflows instead of retention to augment the liquidity position. ICRA thus assesses whether the issuer is undertaking prudent financial planning on the basis of expected cash flows while pursuing the objective of maintaining a tax-exempt status.

Management Quality

The assessment of an education-sector entity’s credit profile factors in the commitment of the management to the institution’s day-to-day operations, and the steps taken by them to promote and improve the institution. The quality and stability of the key decision-makers like Deans and Heads of Departments are considered crucial from the point of view of continuity and execution of strategic plans. Usually, a detailed discussion is held with the management to understand its plans, strategies and views on past performance, besides the outlook on the sector and direct competition. Some of the other points assessed are:

- Experience of the management in the education sector
- Commitment of the management to the institutes
- Risk appetite of the management and risk mitigation plans
- Policies on leveraging and interest rate risks
- Plans on infrastructure improvement, new projects, expansion, etc.

¹⁴ Any university or educational institute as prescribed under section 10 (23C) of the Income Tax Act, 1961, is mandated to apply its income or accumulate wholly and exclusively only for the objects for which it is established. In case more than 15% of income is accumulated after April 2002, the period of accumulation of the amount exceeding 15% of its income, in no case can exceed five years.

These apart, ICRA assesses the management's viewpoint on fee structure and revision, and expenditure flexibility. Given the high operating leverage in an education sector entity, because of high fixed capital as well as operating costs, the management's ability and willingness to quickly adjust its operations during times of weak enrolments or limited fee hikes is critical for the stability of credit profile. An effective management should be able to build in expenditure flexibility through strategic initiatives such as outsourcing of certain non-critical support services and infrastructure facilities, use of a prudent mix of full time faculty and guest faculty, and flexibility to defer capital expenditure towards infrastructure improvement or addition of new courses. College affiliated to state/Central universities generally have limited flexibility to revise their fee structure. Even in case of other colleges where flexibility is available, the fee hikes have to be gradual and rational factoring in the prevailing scenario, to maintain competitiveness. Further, as the fee hikes are generally made effective for new batches, the increase in revenue receipts in initial year of fee-hike implementation may not be commensurate with the increase in employee expenses, thereby resulting in a pressure on operating surpluses. ICRA, therefore, assesses the management's ability and preparedness to monitor and identify such adverse trends and have contingency plans in place to manage operating costs without impacting market reputation. Periodic interaction with the management provides insights into the operations of the entity and ongoing developments and further helps understand the management's commitment and strategies. The interaction with the management also helps ICRA assess the management's tendency to deviate from its philosophy in times of stress.

Assessment of Environmental, Social and Corporate Governance (ESG) Risks

The assessment of ESG risks by ICRA involves a broad range of considerations that pertain to the sustainability of an entity with focus on aspects that can have a material impact on its credit quality. While the E&S risks tend to be both sector-related as well as entity-specific and could be driven by external factors such as regulations and demographic changes, the G risks are largely entity driven. The impact of the E&S risks on an entity's credit profile tends to be asymmetric. If the ESG risks are material but unmitigated, these generally pull down the ratings, but generally the ratings are not pushed up even when the ESG context is favourable.

Environmental (E) and Social (S) Risks

As this methodology highlights, while undertaking credit assessment of entities, ICRA seeks to incorporate all relevant credit considerations into its rating decisions while taking a forward-looking view on the risks and the mitigants. The relevant credit considerations include (sometimes overtly, sometimes covertly) the E&S factors that could affect the rated entity/ transaction. While ICRA's analytical approach does not explicitly disaggregate these risks to assess their impact on the rating, these risks are often assessed broadly. Further, it is not always feasible to fully or precisely disaggregate the sub-components of E&S risks in credit analysis since these considerations often tend to overlap.

That said, the materiality of the E&S risks and the time horizon over which they are expected to crystallize differs widely across sectors and entities. In some cases, while the E&S risks could be material, their effect on the credit profile may be muted because of other fundamental strengths of the entity. In other cases, the adverse impact of the E&S risks is expected to play out in the distant future, and hence these considerations do not necessarily weigh on the rating today—with the expectation that when these risks manifest in the distant future, the rated entity by then would possibly adapt itself by realigning its business model. While evaluating E&S risks, ICRA's objective is only to assess the direct and indirect risks that an entity faces and how it already is or is intending to mitigate the impact of such risks on its credit profile. As an example, ICRA only assesses whether an entity is exposed to physical climate risks, or carbon transition risks such as those arising from changes in regulations or other environmental and social risks; and seeks to understand the various mitigation and adaptation approaches that the entity is implementing to mollify these risks.

Exposure to environmental risks remain low for the higher education sector. The higher education sector is exposed to moderate social risks emanating from changes in demographic and societal trends which may result in lower student intake and reduced tuition fees. The entities also need to adapt to the changing requirements of industry from time to time. Further, specialised talent requirements for some academic and research positions may result in increased employee costs. Moreover, any large increase in

fees could be counter-productive for the larger social objective that such institutes intend to achieve and may result in regulatory, reputational or social implications for the institutions.

Governance Practices

A sound corporate governance structure attempts to make clear the distinction of power and responsibilities between the Board of Directors and the management. The constitution of an entity's Board and the Board of Directors' participation in strategy formulation, besides the entity's adherence to legal and statutory compliance requirements are factored in during credit assessments. ICRA seeks to gain a qualitative understanding of an entity's commitment to following transparent and credible practices by the way its financial statements are reported, their level of disclosures, consistency in communication and the openness about sharing information during the credit rating exercise. Besides, the corporate group structure (whether simple or complex), the rated entity's related party transactions and instances of supporting group entities at the expense of debt holders are assessed.

Summing Up

ICRA's credit ratings are a symbolic 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 operational and financial risks, its competitive strengths, its 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 and other funding requirements. The credit profile of entities operating in the higher education sector involves an assessment of the operational strengths and weaknesses as reflected by their market positioning against a backdrop of a regulatory landscape. While operational strengths and weaknesses are typically reflected in the financial performance of an institute, the financial risk profile of an educational entity is also governed by the measures deployed to manage liquidity amid seasonality in tuition fee receipts and planned incremental investment in fixed assets, given the incentive to undertake regular expenditure for the creation of fixed assets to retain a tax-exempt status.

ANNEXURE

Summary of rating factors and an example to illustrate the key building blocks of a credit rating

		Strong			Comfortable			Adequate			Moderate			Weak		
Industry Risk	Industry Position															
	Scale – Revenue															
Business Risk	Scale – Student Base															
	Average Ageing of Institutes															
	Autonomy															
	Enrolment Ratio															
	Ranking and Placements															
	Faculty Quality															
	Cash Flow Alignment															
	Diversification across States															
	Diversification across Institutes															
	Diversification across Courses															
Financial Risk	Leverage															
	Coverage															
		Enhance					Support/ Neutral					Hinder				
Do these factors enhance or hinder the credit profile?	Refinancing Dependence, Liquidity and Financial Flexibility															
	Financial Policy															
	Foreign Exchange Risk															
	Management, Governance & Reporting															
		Very High					High			Moderate				Low		
Parent Support	Likelihood of Parent Support															
	Rating of Parent	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B/ C category	
	Final Rating	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B/ C category	

The above graphic is only for illustration purpose and does not represent a rating output from a formulaic model. The ratings assigned by ICRA are determined by Rating Committees based on both quantitative and qualitative considerations.

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