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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in July 2020. While this revised version incorporates a few modifications, ICRA's overall approach to rating healthcare diagnostic service providers remains materially similar.

### Overview

This methodology document describes the key factors considered by ICRA in assessing the credit risk profile of healthcare diagnostic service providers. 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.

The Indian healthcare diagnostic industry is highly fragmented, consisting of numerous players, ranging from large national and regional organised chains to small unorganised standalone service providers. The large diagnostic chains operate through the 'hub-and-spoke' model, which consists of setting up large labs (also known as 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.

Another 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 between the hospital and the diagnostic service providers. 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 and the in-patient department's. However, the number of organised diagnostic service providers in hospitals is limited at present and most of these labs are operated as captive units by the hospitals.

Certain diagnostic service providers outsource the services to existing organised diagnostic service providers instead of setting up a reference lab themselves. Such companies benefit by offering complete healthcare services to customers and by getting new business without having to invest in reference labs.

The National Accreditation Board for Testing and Calibration Laboratories (NABL)<sup>1</sup> provides laboratory accreditation services to labs that perform tests in accordance with the prescribed standards. This is intended to support standardisation of tests

<sup>1</sup> NABL is a constituent board of Quality Council of India, which is an autonomous body set up under the Department of Promotion of Industry and Internal Trade, Ministry of Commerce and Industry and 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 of laboratories

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across different scales of labs, ensuring uniform practices. However, NABL accreditation is voluntary. The Clinical Establishments Act (2010) provides for registration and regulation of clinical establishments in the country and prescribes the minimum standards of facilities and services to be provided by them. However, the Act is mandatory in only 11 states and all Union Territories except Delhi.

ICRA's analysis focuses on the following key rating factors that are common for assigning ratings in the sector:

**Industry risk assessment****Business risk assessment**

- Market position
- Scale
- Diversification

**Financial risk assessment**

- Profitability indicators
- Leverage and coverage indicators
- Working capital intensity
- Liquidity and adequacy of future cash flows
- Foreign currency risks
- Tenure mismatches and risks relating to interest rates and refinancing
- Contingent liabilities / off-balance sheet exposures
- Consolidated financial analysis
- Accounting quality

**Other considerations**

- Parentage
- Financial flexibility
- Debt servicing track record
- Event risk

**Management quality assessment****Assessment of environmental, social and governance (ESG) risks**

- Environmental (E) and social (S) risks
- Governance practices

## Industry Risk Assessment

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### Competitive Intensity

The Indian diagnostic industry is highly fragmented with a few large organised players and many small unorganised standalone service providers. The organised players face stiff competition from unorganised players 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 either acquiring accreditation is not mandatory in most states or it is not enforced effectively. 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 because the organised players have initially focused more on the pathology segment to scale up their business, while the imaging segment is more integrated within the hospital infrastructure.

The competition has intensified for organised players with the advent of online diagnostic service aggregators who utilise the facilities of unorganised single lab diagnostic companies. These aggregators enable the customers to explore various diagnostic labs in their vicinity and the services offered by them. They offer significant discounts to gain market share, thereby leading to pricing pressure in the industry and benefit from the fact that they offer a diverse range of tests in the imaging as well as the pathology segment.

With increasing focus on healthcare and shift in patient expectations towards convenience and reliability supporting healthy growth for organised diagnostic chains, entities in other healthcare businesses such as pharmaceutical companies and hospitals are also entering the market, in turn increasing the competitive intensity.

### Growth prospects

Although the smaller labs have limited resources with mostly only the local neighbourhood being aware about them, their referral tie-ups with physicians and competitive pricing offered by them compared to high-end labs, have helped them cater to a reasonable proportion of the population in a given locality. That said, the consolidation of such smaller players with national diagnostic service providers has been supporting the expansion of the national diagnostic chains into newer geographies and thus helping them gain market share.

The increasing awareness on preventive health and wellness, rise in chronic and lifestyle diseases, higher insurance penetration, evidence-based treatments and rising income levels are expected to support the growth prospects of the healthcare diagnostic service providers.

### Regulatory risks

Healthcare services, being a necessity, are susceptible to Government intervention in terms of pricing. A ceiling on prices of essential or epidemic-related tests in the interest of the public at large can impact revenue growth and profitability of diagnostic companies adversely. However, such interventions have been largely limited and restricted to a few tests during the onset of various seasonal infections.

## Business risk assessment

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### Market position

ICRA assesses the market position of a diagnostic service provider/ chain through an evaluation of its brand strength and reputation, as this drives demand and footfalls. The brand strength of a diagnostic chain is supported by continuous investments in technology and supply chain management (through a network of collection centres and reference labs) which facilitates accuracy of tests, a faster turnaround time, and wider reach.

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 market position on a consistent basis supports margins and cash flows.

While ICRA notes that in the case of a diagnostic centre in the unorganised segment, 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 regulatory accreditation and maintenance of quality standards. Therefore, apart from having a diverse set of tests and services, a diagnostic lab/chain with a stronger brand recall, is seen favourably by ICRA. A strong brand recall strengthens an entity's market position and leads to faster acquisition and subsequent retention of clients, thereby supporting profitability.

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-à-vis other players in the market. Although small, unorganised labs lack the infrastructure, technology, skilled professionals or resources to expand, they are able to garner customers on the basis of the pricing 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 command higher pricing while getting 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 favourably while rating.

### Scale

Scale is measured in terms of the revenues and the network of labs operated by the entity. The scale of operations is an important determinant of the operating leverage and financial flexibility, based on which a diagnostic service provider can expand its network further and sustain itself in times of unexpected regulatory changes.

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 costs, marketing costs, etc) over a higher revenue base and attain cost efficiencies in procurement and administrative functions, thereby supporting margins. Companies with a larger scale are better placed to invest in new diagnostic centres, technology 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 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 associated with setting-up a new lab, and continuous price competition from smaller labs, which can affect margins if the desired scale is not achieved. In a fragmented and highly competitive diagnostics sector, a higher scale would enable an entity achieve greater bargaining power to negotiate favourable rental rates, avail discounts through bulk raw material purchases (primarily reagents), and attract the most qualified and technically-sound personnel to drive operational efficiency to sustain its leadership position. Therefore, a high scale also contributes to stability in the entity's operating profit margins.

On the other hand, small labs, run mostly by family businesses, may 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). 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. 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 tends to be limited which could constrain their competitive position.

### Diversification

Business diversification enables an entity 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, customer mix or lab location, is a positive credit 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 entity 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 based on its revenue diversity in terms of the business mix (mainly pathology and radiology), customer mix (i.e. retail vs. institutional business), therapeutic mix and lab location.

Maintaining a high degree of diversification is crucial as it leads to lower revenue volatility, less susceptibility to regulatory<sup>2</sup> or market changes, provides competitive advantages and ensures higher profitability on the back of product/ services differentiation.

### Product diversification

A diagnostic service provider with 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. Product diversity is reflected in the variety and number of 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 entity, 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 diversification

Along with having a well-diversified product 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 in a particular region. In addition, the location of the labs and collection centres is also an important factor for attaining a wider customer reach. 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, generates 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.

Major organised diagnostic chains have the resources to enter into international markets on the back of large financial resources to fund the expansion and related marketing costs. The entity 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

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<sup>2</sup> Regulatory changes are a state subject and not all states may alter regulations at the same time.

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 also poses downside risks and could adversely impact profitability.

**Customer diversification**

The customer profile of a diagnostic service provider broadly falls under three categories- a) customer walk-ins (B2C), b) hospitals and laboratories (B2B) and c) corporate customers (B2B). The walk-in customers directly visit a diagnostic centre, opt for the services/ tests required and pay the price upfront. Some diagnostic chains have referral tie-up with hospitals and laboratories for offering health packages at special prices. Diagnostics chains also tie up with corporate customers for providing diagnostic services at specialised prices for their employees.

The diagnostic chains that derive a higher share of revenues from the B2C segment have a low customer concentration risk and generally high profit margins. Tie-ups with B2B players such as hospitals, laboratories and corporate clients provide a wider reach and higher revenue visibility/ stability to diagnostic chains. While this improves the absolute levels of profits, however, the long-term nature of the contracts and bulk offerings result in relatively lower prices and lower profit margins.

Summary of the salient business risk factors

	Strongest		Weakest
<b>Market Share</b>	Entity is the market leader or is among the top few players that has a market share close to that of the market leader - in the addressable sub-segments within the industry in which it operates	➔	Entity is a marginal or a fringe player in the addressable sub-segments within the industry in which it operates.
<b>Pricing Position</b>	Entity's products or services are priced among the highest in the addressable sub-segments of the industry because of superior brand equity, technological leadership, value-added offerings or quality of service. Entity is expected to sustain this advantage going forward	➔	Entity often has to sell its products or services at a price which is significantly lower than the average market price in the addressable sub-segments of the industry.
<b>Scale</b>	Entity is the largest player or is among the top few players in the industry having scale of operations close to that of the largest player.	➔	The entity is a marginal player in the industry in terms of scale of operations.
<b>Diversification</b>			
Product diversification	The entity's range of products or services is among the most comprehensive in its industry. It derives its revenues and profits from a broader set of products or services than the industry average.	➔	The entity's product or service line-up is limited compared to peers; it derives profits from only limited number of products or services
Customer Diversification	Entity is a B2C player, implying that customer diversification is by the business model's very nature, high. Further, the entity also has a diversified set of B2B customers such that the loss of even top few customers is unlikely to pose a material risk to business stability	➔	The entity relies on a small set of customers, and the characteristics of the customer base do not mitigate this risk.
Geographic Diversification	The entity enjoys an extremely diversified geographical presence as compared to its peers and demand slowdown in a few top regions is unlikely to pose any significant risk to business stability.	➔	The entity depends disproportionately on a single region or local economy for selling its goods or services

## 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.

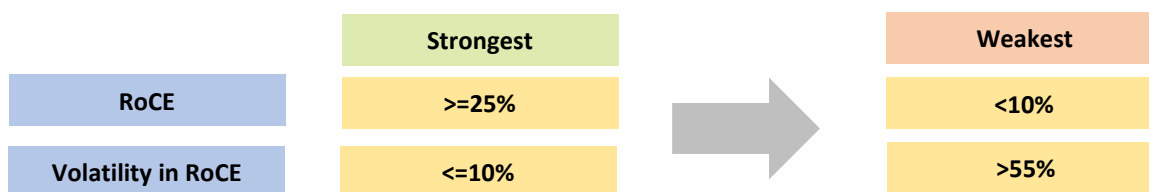
Since the prime objective of the rating exercise is to assess the debt-servicing capability, ICRA draws up projections on the entity’s likely financial position based on the expected movement in operating performance, factoring in capex and investment requirements as well as upcoming debt obligations to study their impact on revenue growth and profitability, cash flows, leverage as well as debt protection indicators. Depending on the uncertainty around how the various credit drivers could evolve in the future, ICRA also carries out a sensitivity analysis to assess the impact of the key variables on the various financial metrics. ICRA also looks at the funding requirements of an entity and the funding options available to it. In case of groups consisting of entities with strong financial and operational linkages, various parameters such as capital structure, debt coverage indicators and future funding requirements are assessed at the consolidated/group level.

### Profitability metrics

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. 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 profit 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), 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, labs in prominent locations with high rentals can take a relatively longer time to achieve break-even levels.

### Validation of business risk through profitability metrics [Indicative metrics<sup>3</sup>]



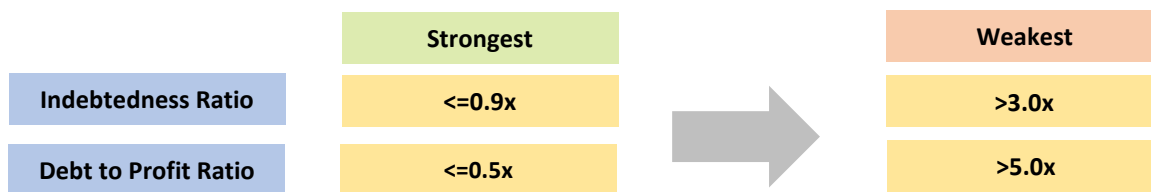
<sup>3</sup> The indicative financial metrics mentioned here and elsewhere in the document are intended to provide a broad overview to the readers regarding what ICRA generally considers as ‘relatively strong’ or ‘relatively weak’ metrics. It is, however, possible that an entity has relatively weaker 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.

**Leverage and coverage indicators**

ICRA’s assessment of the financial risk profile of the entity 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 entity’s financial performance.

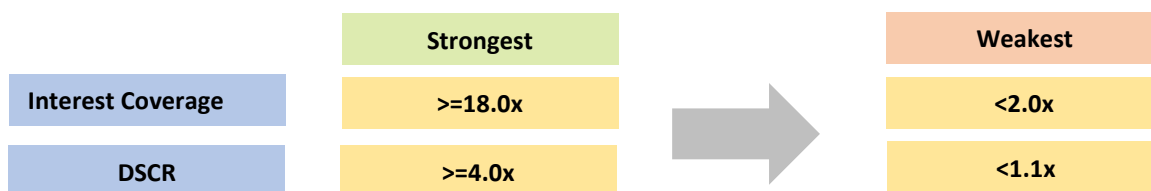
Leverage ratios are an indicator of the degree of financial flexibility an entity enjoys in terms of its ability to raise funds from alternative sources in times of financial distress. Such flexibility is reflected in an entity’s Total Debt-to-EBIDTA multiple. A low leverage ratio indicates better ability 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 entity to continue to invest in new technologies, capex and entry in new markets during adverse conditions.

**Assessment of leverage**  
[Indicative metrics]



Coverage is a measure of an entity’s debt-servicing ability and is calculated as the ratio of profits to the debt servicing obligations in a given time period. The higher the ratio, the higher the cushion available with an entity to withstand variability in profits for making good its financial obligations. Coverage is a function of an entity’s profits, leverage and debt characteristics (in terms of cost of debt and repayment schedule). The interest coverage indicator reflects the company’s ability to fund the cost of external borrowings after meeting all the operating expenditure requirements. It is an important rating consideration as a weak EBIDTA-to-Interest multiple indicates that the entity is not generating adequate operating profits to meet its interest and debt maturities and may signal a default risk. The debt service coverage ratio (DSCR) is a measure of an entity’s debt-servicing ability and is calculated as the ratio of profits to the debt servicing obligations in a given time period. Entities with higher profitability and lower leverage will generally have better coverage ratios and thereby healthier financial risk profiles. ICRA is particularly concerned with an entity’s capability to honour its contractual obligations under stress conditions. The more robust an entity is likely to perform under stress scenarios, the better it is from a credit evaluation perspective.

**Assessment of coverage**  
[Indicative metrics]



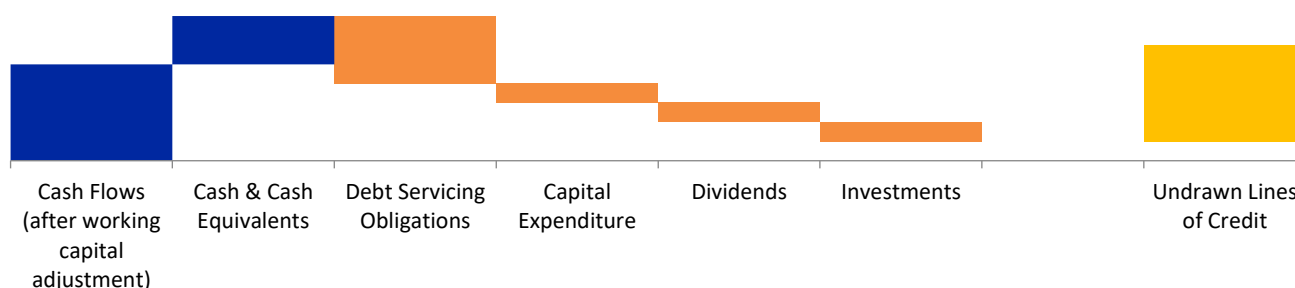
**Working capital intensity**

Generally, the operations of diagnostic service providers tend to be less working capital intensive, with revenues generated from B2C (direct walk-ins, which provide immediate payments) and contracted payments from corporate customers (credit period tends to be lower) and relatively lower investment in inventory. In case of revenue-sharing models with public and private hospitals, the working capital requirements tend to be relatively higher. ICRA compares the working capital cycle of rated entities with their peers to gauge the rated entity’s working capital management system as a proxy of their business efficiency.

**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 cash flows 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. The short-term obligations include both committed as well as the contingent claims on an entity’s cash, including the debt servicing obligations, working capital requirements, capital expenditure and other investment outlays, dividend and share buyback-related outflows, besides the sudden demand arising from the crystallisation of discrete events such as unfavourable outcome of an ongoing litigation. The higher the cushion available between the resources available (especially internal resources) and the obligations, better the liquidity profile of an entity. Liquidity is generally assessed in conjunction with the vulnerability of an entity to timely refinancing/renewal of short-term sources of funding. Depending upon the circumstances, an entity that has a relatively modest liquidity profile but a strong refinancing ability may not be viewed too unfavourably. ICRA also notes that the liquidity available with an entity may be for a temporary period and hence an entity’s overall policy towards maintaining adequate liquidity (given the trade-off between returns and liquidity) is accorded due importance in the analytical approach<sup>4</sup>.

**Liquidity snapshot over any defined period**



**Adequacy of future cash flows**

Cash is required to service obligations. Cash flows reflect the sources from which cash is generated and deployed. ICRA analyses the trends in the entity’s funds flow from operations (FFO) after adjusting for working capital changes, the retained cash flows, and the free cash flows after meeting the debt repayment obligations and capital expenditure needs. Strong free cash flows indicate the entity’s ability to fund investments, organic and inorganic, and make timely debt repayments. The cash flow analysis also helps in understanding the external funding requirement that an entity has to meet its maturing debt obligations. ICRA also draws up projections on the likely financial position of the company based on the expected movements in operating performance, factoring in the capex and investment requirements as well as the 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 a company and the funding options available to it.

<sup>4</sup> For more details on how ICRA assesses liquidity, readers may refer to the document titled, “Liquidity Analysis of Entities in the Non-Financial Sector” published on ICRA’s website

**Foreign currency risks**

The foreign currency risks for the diagnostics service providers primarily arise from the import of equipment and technology, and foreign currency denominated debt. While assessing an entity'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**

Large dependence on short-term borrowings to fund long-term investments or other long-term funding requirements can expose an entity to significant re-financing risks, especially during periods of tight systemic liquidity. ICRA evaluates the extent of such mismatches and the mitigating factors therein. One source of mitigation could be the existence of adequate buffers of liquid assets/committed bank lines to meet short-term obligations. Another source of mitigation could be the entity's strong financial flexibility to be able to garner fresh funds at a short notice or a potent ability to refinance. Further, ICRA evaluates the extent to which an entity might be impacted by movement in interest rates.

**Contingent liabilities/off-balance sheet exposures**

The likelihood of devolvement of contingent liabilities/off-balance sheet exposures and the financial implications of the same are evaluated.

**Consolidated financial analysis**

While evaluating the financial risk profiles of companies that have subsidiaries and associate companies, ICRA analyses consolidated/group level financial indicators in terms of capital structure, debt coverage indicators and future funding requirements.

**Accounting quality**

ICRA reviews the accounting policies, notes to accounts, auditors' comments and other disclosures that are parts of the Annual Report of a rated entity. Deviations, if any, from the accounting standards/practices are assessed and the financial statements of the entity are adjusted to reflect the impact of such deviations.

## Other considerations

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### Parentage

While the credit rating of an entity is a function of its standalone credit profile, in certain cases, the entity's credit quality can also be driven by the relationship with its parent or the promoter group (henceforth referred to as the parent). If the parent's credit profile is relatively strong than the rated entity, ICRA assesses the ability and the likelihood of the parent extending extraordinary support to the entity. Support here means financial support from the parent expected to be available to the entity in the form of loans, equity, extended credit period, advances etc in times of credit or liquidity stress on the entity. Support here does not mean operational support in the form of new business opportunities, technology sharing, distribution network sharing and so on as these aspects are factored in the standalone credit profile assessment itself. It may be noted that promoters in their individual capacity, or private equity firms/ other financial investors are generally not treated as parents for assessing the likelihood of extraordinary financial support coming in. If the parent's credit profile is weaker than the rated entity, the entity's rating may be lower than what its standalone credit profile assessment would have merited, given the possibility that the entity may at some point of time be bound to extend financial support to its weaker parent, possibly to the detriment of its own credit profile<sup>5</sup>.

### Financial flexibility

A healthcare diagnostic service provider's financial flexibility (or the lack thereof) is reflected in its ability to access the capital or the money markets at short notice, attract diverse 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. In contrast, among the various measures of an entity's depleting financial flexibility, one relates to a high share of pledged promoter shareholding. A sign such as this may imply that the entity might be persuaded to distribute high dividends or support the promoter group through other means to the detriment of its own credit profile. If the promoters fail to repay their loans (availed by pledging of shares) or top up collateral when required, the lenders could sell the pledged shares. In some cases, this could trigger a change-of-control clause in the rated entity's bond indentures or loan documents and require it to redeem its debt ahead of schedule, creating a liquidity squeeze, besides affecting fresh capital raising ability.

### Debt servicing track record

The debt servicing track record of the company 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 company's future debt servicing capability and willingness. Nevertheless, the reason behind past defaults are also analysed, which could also be due to adverse demand situations in the underlying segments. The company's ability to honour its debt obligations during a period of cyclical stress is also factored in.

### Event risk

ICRA recognises the possibility of events such as unrelated diversification, mergers and acquisitions, business restructuring, asset sales and spin-offs, litigations, equity infusion and refinancing, which could have a material impact on the credit profile of an entity. Incorporating the impact of such discrete events in the credit rating, from the beginning, is often difficult. Depending on whether and when such events occur, the rating opinion could be substantially different. To take rating decisions in such cases, ICRA applies its analytical judgment based on the rated entity's track record, the credibility of the management and the experience of having seen similar situations play out in other entities. However, given the nature of such events, it is possible that the rating may undergo a material change later, upon the occurrence of the event.

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<sup>5</sup> For more details on this, readers may refer to the document titled, "Impact of Parent or Group Support on an Entity's Credit Rating", published on ICRA's website.

## Management quality assessment

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In addition to the industry, business and financial risk analysis, all credit ratings incorporate an assessment of the quality of the rated entity's management and its financial policies. The management risk analysis also factors in the historical track record of the entity or the group in timely servicing its obligations.

### Quality of management and financial policies

As a part of its process, ICRA undertakes discussions with the rated entity's management to understand its views on past performance as well as its future plans and strategies, besides the outlook on the industry. Some of the points assessed are:

- » Experience of the promoter/management in the industry
- » Commitment of the promoter/management to the rated entity
- » Risk appetite of the promoter/management and risk mitigation plans
- » Policies on leveraging, managing interest rate and currency risks
- » Management's past success in introducing new projects and managing changes in the external environment
- » Management's plans on new projects, acquisitions and expansions
- » Track record of balancing the interests of shareholders, creditors and other stakeholders

Periodic interactions with the management help ascertain the shifts, if any, in their financial policies.

## Assessment of environmental, social and governance (ESG) risks

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### 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 crystallise differs widely across sectors and entities. In some cases, while the E&S risks could be material but 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.

Diagnostic service providers do not face any major physical climate risk. However, they are exposed to environmental laws and regulations pertaining to handling, transportation and disposal of medical specimens, infectious and hazardous waste along with radioactive exposure during imaging procedures. This requires investments in infrastructure to handle the generated waste. Accordingly, entities in the industry have a moderate exposure to environmental risks.

Exposure to social risks is moderate for the healthcare diagnostic service provider sector. Social risks for industry players include litigation exposure, and compliance standard requirements given the importance of the service being provided. Further, regulatory interventions such as price control measures, if any, specifically levied could impact the earnings of industry players.

While the increasing shift of consumer preferences towards preventive health and wellness checks supports this industry, any pertinent issues in the quality and accuracy of diagnostic reports could impact specific entities in this sector.

### 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 Director's 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 towards 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

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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 entity's business 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-a-vis its debt servicing obligations. As highlighted in the note, ICRA evaluates the market share, pricing position, scale, product diversification, customer diversification and geographic concentration of the entity in the healthcare diagnostic service provider industry and the capability of the entity to generate cash over the lifetime of the instrument being rated, to arrive at an opinion on the credit risk associated.

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																
	Market Share																
Business Risk	Pricing Position																
	Scale																
	Product Diversification																
	Customer Diversification																
	Geographic Diversification																
Financial Risk	Profitability and Earnings Stability																
	Leverage																
	Coverage																
		Enhance					Support/ Neutral					Hinder					
Do these factors enhance or hinder the credit profile?	Diversification																
	Refinancing Dependence, Liquidity and Financial Flexibility																
	Currency Risk																
	Financial Policy																
	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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### About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

For more information, visit [www.icra.in](http://www.icra.in) and [www.icraresearch.in](http://www.icraresearch.in)

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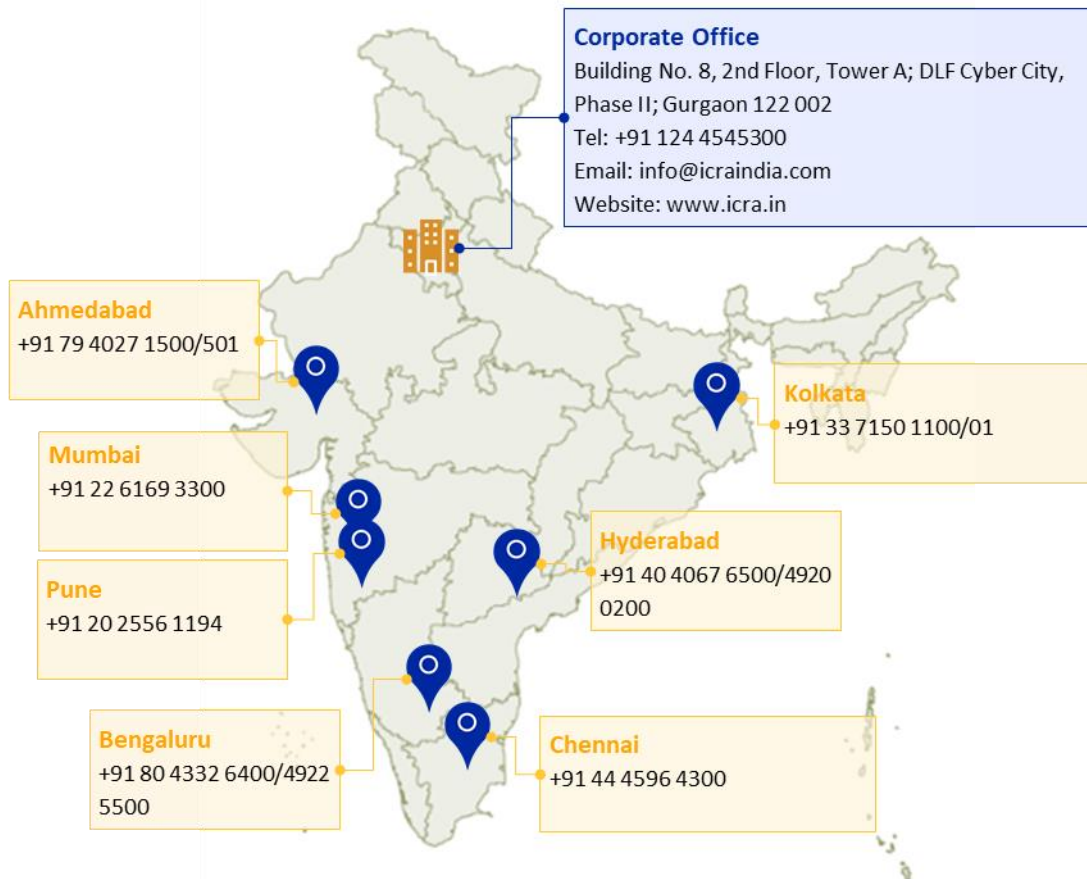


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