This methodology document stands superseded. Please refer to ICRA's website www.icra.in to view the updated methodology document on this subject.

ICRA

RATING METHODOLOGY – HOSPITALS

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

Overview

This methodology document describes the key factors considered by ICRA in assessing the credit risk profile of hospitals. 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 industry comprises hospitals, diagnostic service providers, pharmaceutical companies, medical insurance, telemedicine, and medical equipment providers, among others. Hospitals comprise the largest component (~60-65%) in the domestic healthcare industry. They provide curative services, i.e., medical, nursing and related services. Some large hospitals also offer diagnostic services. This industry is fragmented, consisting of numerous players, ranging from large national and regional organised hospital players to unorganised standalone hospitals. Some hospitals are standalone while some are associated with medical colleges. Some hospital players also enter into operation and management (O&M) contract and franchisee agreements for expanding their presence in the domestic market.

Based on the range of services offered, hospitals can be identified as single speciality or multi-speciality hospitals. Moreover, based on the nature of services provided, the hospitals are classified as:

- Primary care – offer basic point-of-contact medical and preventive services, very few specialties
- Secondary care – includes general as well as speciality secondary care; five to 10 main clinical specialties including internal medicine, general surgery, gynaecology, paediatrics and orthopaedics; bed capacity typically ranges from 50 to 300 beds
- Tertiary care – highly specialised staff and technical equipment for handling complex treatments like cardiology, neurology, oncology, intensive care unit, high-risk trauma cases and specialised imaging units; clinical services highly differentiated by function; could be undertaking education and research as well; bed capacity range is typically upwards of 300 beds.

High real estate, equipment, and operating costs, and shortage of medical professionals (leading to higher resource costs) result in elongated payback periods for hospitals. Some hospitals tend to have a star doctor model, which leads to revenue dependence on a specific set of doctors. In such cases, loss of key doctors can lead to decline in patient footfalls, which may adversely impact the overall revenue and profitability of a hospital. However, over a period of time, brand-based models (backed by the established brand equity generated by the entity) have witnessed healthy growth in the domestic market.

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

Industry risk assessment

- Growth prospects
- Competitive intensity
- Regulatory risks

Business risk assessment

- Scale and market position
- Operational profile
- Diversification
- Project risk

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- Environmental (E) and social (S) risks
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Industry Risk Assessment

Growth prospects

The Indian hospital industry is underinvested with structural supply deficiencies compared to its counterparts in developed economies in terms of infrastructure and availability of clinical talent. India spends about 3.5% of its GDP on healthcare, which is significantly lower than the US (16.9%), Brazil (9.5%), the UK (10.0%), Vietnam (5.9%) and global average of 8%. Despite growth in both public and private sector investment in the healthcare sector in general and for setting up hospitals in particular, India continues to suffer from low availability of beds in relation to its population. The country currently has 10-15 beds per 10,000 people compared to 29 beds per 10,000 in the US, 71 in Russia, 43 in China, 21 in Brazil, and the global average of 27. At nine physicians and 17 nursing personnel per 10,000 people, India trails the global median of 17 physicians and 39 nurses. The structural gap in demand and supply tends to be one of the key growth drivers for this industry. Nevertheless, the industry performance has been impacted by travel restrictions and the Covid-19 pandemic in recent times.

The Indian hospital industry has also witnessed increasing demand over the past few decades driven by increasing penetration of medical services and health insurance. Growing population, increasing life expectancy, rising income, increasing incidence of non-communicable diseases related to lifestyles, greater awareness of personal health and hygiene, growing per capita spend and health insurance cover and increasing medical tourism are long-term positives for the sector. With increasing purchasing power, consumers are demanding and willing to pay for quality healthcare services. Over the years, share of revenues from medical tourism have also improved for large industry players given the relatively low cost of treatments than other countries. While the flow of international patient footfalls was significantly impacted by the pandemic, the same is expected to revert to earlier levels gradually. Further, technological advancements and digital interventions on treatments (robotic surgeries) also support business prospects of industry participants.

Competitive intensity

The players range from a single doctor-run facility catering to limited specialties and low complexity procedures to a large player catering to multiple specialties and highly complex procedures. This industry is fragmented, consisting of numerous players, ranging from large national and regional organised hospital players to standalone hospitals. Smaller players can enter and cater primarily to low complexity cases which also requires relatively low capital investment while larger players enjoy dominant position in complex and high value treatments. Though standalone hospitals have limited resources with mostly only the local neighbourhood being aware about them, their relatively lower pricing helped them cater to a reasonable proportion of population in each region. Also, in addition to large hospital brand equity, the brand value of star doctors in a large hospital also tends to drive the patient footfalls.

The capital investment required for setting up a multi-speciality hospital providing tertiary care is high due to requirement for procuring land and setting up a building in an easily accessible location and need for expensive medical equipment and infrastructure. Use of imported equipment can further increase outlay towards equipment costs. In general, India remains under-penetrated in terms of hospital beds and the demand supply situation favours the industry participants. However, given the high capex requirements, long gestation period for breakeven, and multitude of approvals required to set up a hospital, the barriers to entry in this segment are considerable, thereby, the competitive intensity is moderate.

Regulatory risks

The hospital industry operates in a regulated market which includes number of approvals and licenses from governmental and regulatory authorities. The hospital industry is governed by several state and central government laws. Few regulations include accreditations from the National Accreditation Board for Hospitals and Healthcare Providers (NABH) and National Accreditation Board for Testing and Calibration Laboratories (in case diagnostic services are provided). There are price caps on stents, knee implants, oncology drugs, Covid-19 treatments, etc, and the hospital services have been recently brought under the GST regime (for hospital bed charges). Some actions from regulators/governments in the past have also been in the form of penalties, and even the cancellation of licences for facilities or a particular division of the facility. While the impact of the regulatory intervention on the industry players had not been significant so far, more stringent or adverse regulations, if any, can impact the pricing power and thereby the margins of industry players. A price ceiling on specific essential or epidemic-related treatments in the interest of the public at large can also impact the revenue growth and profitability of industry players. Given the importance of healthcare to the citizens and the economy, the industry is continuously subject to interventions by state and central governments and other relevant regulatory authorities.

In addition to government interventions, litigations, if any, could also pose risk to the brand value of the hospital, impacting its footfalls and revenues. Litigations could pertain to patient(s) seeking a legal course of action against the hospital for providing medical treatment that falls short of the accepted medical standard of care. ICRA assesses the impact of these risks on an issuer's credit profile on best effort basis.

Business Risk Assessment

Scale and market position

ICRA views scale as an important parameter while assessing hospitals as it is a key driver of operating earnings (efficiencies in purchasing and better absorption of fixed overheads). Scale is measured in terms of the revenues and the hospital network operated by any entity. A hospital with a diversified speciality profile is more likely to have a large revenue base which also lends stability to operations. Further, large hospitals which are mature assets tend to exhibit stronger earning profile, providing necessary resources to expand and invest. ICRA looks at the sustainability of revenue growth as one of the critical parameters given the high capital intensity and high degree of operating leverage inherent to the business. Ability to consistently record revenue growth remains paramount for covering increasing inflationary pressure on operating costs and capital investments (equipment and real estate). Consistent revenue growth also indicates the hospital's ability to leverage its market standing and generate surplus earnings for capital investments, which are critical success factors. ICRA considers the low cyclicality associated with the hospital business favourably as demand for such services is largely insulated from macroeconomic cycles. A larger revenue base is viewed as a positive factor, as smaller hospitals tend to exhibit higher revenue volatility due to their dependence on few specialties or consultants, indicating high concentration risk.

The market position is reflective of the entity's scale, brand strength and track record, and aids in capturing a higher patient share. A strong market position also determines a hospital's growth prospects and its ability to attract and retain patients and consultants, which lends stability to earnings. The market position of the entity in the geographies in which it operates enhances the rating comfort as the same influences the revenue stability to a large extent. The brand value of the clinical talents (doctors) in the hospital also tends to have an impact on the market position of medium-sized hospitals. ICRA undertakes a detailed assessment on this parameter on a best effort basis. A hospital with a large market share or with multi-discipline services or single speciality hospital with a strong market position enjoys better pricing power. The average revenue per occupied bed day (ARPOB) is the metric used by ICRA for understanding the pricing power and complexity of the specialty mix. Some of the above parameters are qualitatively incorporated into the assessment by ICRA, considering data constraints. Certain facilities have been accredited by NABH, under the purview of the Ministry of Commerce, Government of India, which provides guidelines and accreditation for running hospitals. This accreditation aids a hospital in empanelment with government institutions, corporates and other nations and helps attract more patients, both domestic as well as international. It also helps gain a better market position.

Operational profile

ICRA looks at various operational parameters which reflect a hospital's ability to optimise asset utilisation and generate stable earnings over a period of time. These parameters also lend an insight into the management's business strategy and efficiency of operations. Managing brand equity and maintaining quality infrastructure to attract both medical consultants and patients and rendering effective patient services are critical success factors for efficient hospital operations. Further, ICRA also assesses the payor constitution for hospital entities, based on information availability. For measuring asset utilisation, ICRA assesses parameters such as occupancy levels, ARPOB, average length of stay (ALOS), growth in inpatient admissions and outpatient volumes.

Occupancy level: This refers to the proportion of beds used for in-patient treatments during a time period. This rate is calculated as total occupied bed days divided by the total operating bed days. Bed capacity indicates the number of beds which is set-up by the hospital while the operating beds are the number of beds that a hospital can put into use at a specific point of time. Stable occupancies in a matured hospital and improving occupancies in a new hospital tend to be one of the key operational parameters to assess the entity's business profile. However, in some specialities, day-care procedures are prevalent with technological advancements, thereby in such cases, occupancy levels tend to be lower. That said, occupancy levels are assessed along with the patient footfalls, ALOS and ARPOB of the hospital at any point of time. As occupancy levels improve to optimal levels, speciality mix improvements with high-end procedures will ensure revenue stability and growth.

ARPOB: This refers to the average revenue generated by a hospital from every occupied bed day. ARPOB is generally a function of case mix, the criticality of the procedures/specialities in the hospital, pricing position driven by brand equity or doctor reputation, geographic location of the hospital (tier-1 cities typically realise better prices than tier-2 and 3) and payor mix of the hospital. Annual price increases (to offset the inflationary pressures in cost of medical services) taken by the hospital players supports growth in ARPOB to some extent. The pricing power is decided based on the location of any hospital and the competition in the said region. Presence of various standalone hospitals or centres of regional hospitals could pose competition risk and could impact the ARPOB levels. Large hospital players tend to have Centres of Excellences (COE) to focus on key specialities like cardiac sciences, oncology, neurosciences, orthopaedics, and critical care, which generally contributes to highest ARPOB as compared to other hospitals. Higher the revenues from international patients and domestic cash / insurance patients (compared to government scheme patients), better the ARPOB levels. ICRA assesses ARPOB trends of issuers and does a comparative analysis with peers to understand an issuer's market positioning.

ALOS: This refers to the average time spent by a patient in a hospital. Lower ALOS helps in faster turnaround of beds, leading to higher patients being treated from existing bed capacities. The advancement in medical technology leading to increase in minimally invasive procedures and faster diagnosis and treatments, along with day-care procedures for critical specialities could result in lower ALOS.

Diversification

Revenue diversification reflects the quality of revenues in terms of sustainability and the associated profitability. Diversity is measured in terms of geographic/ asset diversity, depth and breadth of services rendered and the diversity of the patient pool. A large and well-diversified hospital generally carries a strong brand perception and is able to offer high-end value-added medical services, which augments profitability. However, in certain exigencies, in case the outpatient department (OPD) visits or elective procedures are curtailed, it may lead to volatility in revenues, even with a diversified revenue profile.

Geographic/ Asset diversification: Geographic/asset concentration risk is measured through the assessment of the number of facilities operated across markets and the degree of cash flow concentration in the various facilities. Geographic diversification reduces the impact of regional regulations on the entity. However, high diversification with limited scale of operations could result in sub-optimal utilisation of resources and diffused management attention. For certain entities which have presence in only one or two locations but derive patient footfalls from various regions either by virtue of providing services at competitive rates or providing highly complex/critical services for a particular specialty, this risk is mitigated to a certain extent. ICRA undertakes assessment on this parameter on a best effort basis.

Specialty diversification: ICRA looks at the diversity of services offered in terms of the range of specialties and the complexity of procedures provided to the patients. ICRA notes the contribution of revenues and profits from the major specialties to evaluate revenue concentration, if any, towards any particular specialty. A larger bouquet of specialties leads to improved scale and provides a larger scope for branding the hospital, which is factored positively for the rating assessment. That said, high focus on a single speciality (more on chronic diseases), however, spread across geographical locations with a reputed doctor base and brand position, would not have a negative impact on the ratings. Any change in disease patterns would require the hospitals to realign its speciality mix over a period of time to ensure sustainability in revenues. Further, complex medical service offerings improve a hospital's pricing power and leads to better margins. Hospitals generate income from the out-patient department (OPD), the in-patient department (IPD), pharmacy and the laboratory (diagnostic) services. The hospital's revenue mix from the above segments is also assessed for understanding the sustainability of growth and profitability levels.

Diversity of payor/ Payor mix: ICRA looks at the diversity of the patient pool, such as international patients, domestic out-of-pocket paying patients, insurance, Government schemes (central government health scheme/employees health scheme), etc. Cash / insurance patients and international patients provide hospitals with better pricing power and low collection cycle, thereby reducing its working capital requirements. On the other hand, institutional patients that are government scheme-linked or institution-linked tend to result in lower realisations and longer payment cycles. However, it may also generate healthy volumes, which could provide a cushion in absorbing the high fixed costs of running a facility. A diverse patient pool would provide multiple levers to support revenues, enables maintaining a base occupancy level and helps mitigate concentration towards any particular segment.

Project risk

Given the growing demand for healthcare services, hospitals have tended to be on an expansion drive in a bid to diversify and garner a larger share of under-penetrated markets. This is in addition to the brownfield expansion via bed capacity additions undertaken at existing facilities. While analysing a hospital under construction, apart from the parentage and support from group entities (required to fund losses during the initial gestation period), ICRA analyses project-specific factors such as location, region-specific demand-supply dynamics, costs and sources of funding, and execution risks. The location and market determine the project's ability to attract patients (i.e., occupancy and ARPOB), which dictates the potential to generate cash flows. The initial gestation period of any standalone hospital also depends upon its location, considering the flow of patient footfalls and presence of other hospital players in the same vicinity. ICRA assesses the investment required per bed against other comparable projects as well as existing hospitals and compares the same to expected earnings from the unit to assess the debt-servicing ability. On account of long gestation periods, the mode of financing of the project influences the credit risk associated with the project (including tenure and interest rate related risks). The experience and ability of the management to ensure the timely execution of projects within the budgeted cost levels play a key role in determining the viability and returns from the project. Expansion may also be done through the operations & maintenance (O&M) and leasing models for hospitals, which are considered to be an asset-light route for growth. However, ICRA evaluates the same on a case-to-case basis and the potential revenues from the managed/leased facilities are to be weighed along with the additional costs involved under this model, mainly in the form of payments to the asset owner.

Summary of the Salient Business Risk Factors

	Strongest		Weakest
Scale	>Rs. 2,000 crore	⇨	Less than Rs. 100 crore
Geographic/Asset Diversification	Derives revenues from 7 or more hospitals/centres	⇨	Derives revenues from a single hospital
Average Revenue Per Occupied Bed (ARPOB)	ARPOB/day above Rs 25,000	⇨	ARPOB/day less than Rs 8,000

	Strongest		Weakest
Speciality Diversification	Top 2 specialties account for less than 30% of revenues	→	Top 2 specialties account for more than 75% of revenues
Occupancy	Occupancy more than 75%	→	Occupancy less than 35%
Payor Mix	Top payer category account for less than 30% of revenues	→	Top payer category for more than 60% of revenues

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 indicators

Hospitals have high operating leverage due to significant fixed costs in the operating structure. Medical consumable costs and employee costs (including payouts to doctors/medical consultants) comprise sizeable portion of the hospital's operating costs. While hospitals employ doctors on payroll with fixed remuneration structure, some key medical consultants typically tend to have revenue share as remuneration along with a minimum monthly guaranteed payment. A variable remuneration structure makes the interest of the key consultants better aligned with that of the entity and it also reduces cost pressure in case of decline in revenues/volumes. A large revenue base leads to economies of scale in terms of cost efficiencies in purchasing medical consumables which in turn supports operating profit margins. In addition to this, operating margins are also a function of optimum utilization of operating beds and pricing power of the hospital (which also depend upon competitive intensity and demand scenario of the region). Further, some hospital players incur rental costs (pay-per-use model or fixed rentals) on large medical equipment in lieu of purchasing the same, to reduce the capital investment in the hospital, which may impact the operating margins in the nascent stage of operations; however, this reduces the fixed capital costs while providing flexibility in managing the cost structure. Newly built facilities take time to ramp up and face pressure on profitability during the initial years of operations, due to high unabsorbed fixed costs. On the other hand, a mature facility with a track record of operations will have a stable and moderately growing revenue profile. A hospital's performance is viewed in tandem with its vintage. ICRA uses EBITDA an important metric to measure profits for the hospital industry, as it is reflective of the extent of value addition. Hospitals, in general, tend to operate on relatively higher EBITDA margins (operating profit margins) in the healthcare value chain, reflecting the high fixed capital intensity and value addition. Also, ICRA evaluates stability in operating margins over a period of time, as it measures the entity's ability to withstand competitive pressure apart from event-specific risks. ICRA also measures the return on capital employed (RoCE) as diversified and mature hospitals exhibit relatively stable levels of return.

Validation of business risk through profitability metrics
[Indicative metrics[1]]

	Strongest		Weakest
RoCE	>=25%	→	<10%
Volatility in RoCE	<=10%	→	>55%

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.

Hospitals have significant re-investment requirements for expansion and upgradation of facilities. ICRA places considerable emphasis on measuring the adequacy of cash flows (after meeting operating and investment needs) to meet debt repayment obligations and the adequacy of the surplus to meet the investment requirements. The debt profile of hospitals is typically skewed towards long-term debt on account of capital intensity, with the cash and carry nature of the business limiting working capital requirements. ICRA analyses the indebtedness, including features such as interest rate, tenure, and structure of the debt fund.

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]

	Strongest		Weakest
Indebtedness Ratio	<=0.9x	→	>3.0x
Debt to Profit Ratio	<=0.5x	→	>5.0x

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

[1] 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 metrices 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 metrices 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.

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]

	Strongest	Weakest
Interest Coverage	>=18.0x	<2.0x
DSCR	>=4.0x	<1.1x

Working capital intensity

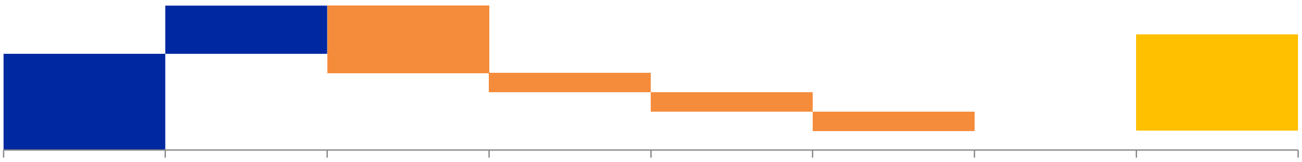
Generally, the working capital intensity of the entity depends on the payor mix of the hospital. While cash/walk-in patients provide immediate cash realisations, insurance patients tend to have a payment cycle of ~30-45 days (mainly for completion of documentation formalities from the Third-party administrator (TPA)). Central Government, State Governments, armed forces and PSUs operate various government schemes for their employees (along with their dependents) and empanelment with these public sector schemes enables a hospital in attaining reasonable volumes. Sans the empanelment, a hospital misses out on business from large number of beneficiaries enrolled under these schemes. However, the payment cycle of these public-sector schemes is long and in some instances in the past has become significantly stretched, which leads to cash flow mismatch, high working capital intensity of operations and in some cases, stretched liquidity position. Thus, ICRA evaluates working capital intensity of operations specific to each hospital, while assessing the credit risk profile of an entity. 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 model and efficiency.

Liquidity and adequacy of future cash flows

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[2].

[2] 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.

Liquidity snapshot over any defined period



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.

Foreign currency risks

Foreign currency risks for the industry primarily arise on account of the import of equipment and technology, operations outside India and foreign currency denominated debt. While assessing the exposure of an issuer to foreign currency risks, ICRA focusses on the impact of adverse movement in foreign exchange rates on the cost structures, profits and net cash outflows, besides evaluating the hedging mechanisms in place. This apart, currency movements impact demand through medical tourism, which is gaining prominence.

Tenure mismatches and risks relating to interest rates and refinancing

The hospital industry remains highly dependent on the banking system to meet its funding requirements, with limited access to capital markets except for a few large corporate entities. 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

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[3].

Financial flexibility

Hospital'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 and 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.

[3] 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.

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 is 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.

Management Quality Assessment

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

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.

The hospital sector does not face any major physical climate risk. However, they need to comply with environmental laws and regulations pertaining to handling and disposal of bio-medical specimens, wastewater, infectious and hazardous waste. Further, energy consumption on the large medical equipments with emissions could pose environment risks. This requires investments in infrastructure to handle the generated waste, treating the wastewater effluents and conserve energy. Accordingly, entities in the industry have a moderate exposure to environmental risks.
Exposure to social risks is moderate for the hospital 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, imposition of restrictions, if any, specifically levied could impact the earnings of industry players.

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

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 position, scale, operational performance, diversification level, project risk in the hospital 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															
Business Risk	Scale															
	Geographic Diversification															
	Average Revenue Per Occupied Bed															
	Speciality Diversification															
	Occupancy															
	Payer Mix															
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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