

RATING METHODOLOGY – INFORMATION TECHNOLOGY (SERVICES)

July 2023



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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in July 2021. While this revised version incorporates a few modifications, ICRA's overall approach to rating entities in the Information Technology (IT) Services sector remains materially similar.

Overview

The domestic IT services industry comprises IT-Services, Business Process Management (BPM), and Engineering Research and Development (ER&D). Exports account for majority of the industry revenue, with 80-90% of revenues generated from the two key markets of US and Europe.

The industry's growth over the past decade has been led by global sourcing from India by the developed economies of North America and Europe, given India's value proposition of offering highly skilled talent and relatively lower wages. The Indian IT services industry's growth will be dependent on the economic growth in such regions. With ample availability of talent and a skilled manpower pool, along with Government policies encouraging exports of IT services, the Indian IT services industry has been able to capture healthy market share in the global IT sourcing industry. The IT services industry value chain includes traditional product offerings, including application development and maintenance, software testing, infrastructure management, consulting, system integration, and research and development services in the hardware and software design segments. Increasingly, entities are developing new lines of business such as cloud-based computing, social media, artificial intelligence, analytics and mobility solutions that also provide non-linear growth opportunities, while requiring extensive employee training.

This rating methodology explains ICRA's approach to assessing the business and financial risk profiles of entities in the IT services sector. It aims to help issuers, investors and other interested market participants understand ICRA's approach to analysing the quantitative and qualitative risks that are likely to affect rating outcomes in this sector. The list of rating drivers covered in this methodology is not exhaustive but provides an overall perspective on the rating considerations that are usually considered the most important. For analytical convenience, the key factors are grouped under the following broad heads — Industry Risk Assessment, Business Risk Analysis, Financial Risk Analysis, Other Considerations, Management Quality Assessment, and Environmental, Social and Governance Risk Assessment.

Industry Risk Assessment

- Regulatory risk
- Competitive intensity

Business Risk Analysis

- Scale and market position

- Diversification
- Client profile
- Key operating parameters

Financial Risk Analysis

- Profitability
- Leverage and coverage indicators
- Cash flows and liquidity profile
- Working capital intensity

Other Elements of Credit Risk Assessment

- Tenure mismatches and risks relating to refinancing and interest rates
- Financial flexibility
- Debt servicing track record
- Foreign currency-related risks
- Accounting quality
- Contingent liabilities and off-balance sheet exposures
- Event risk
- Parentage/Group support

Management Quality Assessment

Assessment of Environmental, Social and Governance (ESG) Risks

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

Industry Risk Assessment

Regulatory risk

The Indian IT services industry derives most of its revenues from exports markets such as the US, the UK and Europe. To provide IT services, the Indian IT companies tap into the pool of skilled manpower available in the country and deploy them for projects - both offsite as well as at client locations through long-term and short-term visas. Over the years, the issuance of visas has gradually tightened, reflected in the restrictions on the number of visas issued by select countries, higher scrutiny, and increased compliance requirements. This has led to higher onshore hiring and sub-contracting, generally associated with higher cost and thereby lower operating margins. Further, regulatory risks manifest in the form of bans on IT services outsourcing by local government bodies and institutions in select countries as part of their protectionist measures. Accordingly, ICRA evaluates the regulatory risk associated with the key operating markets, its possible impact on margins and business sustainability, along with risk mitigation strategies deployed by the rated entity. In ICRA's opinion, the regulatory risk for the IT-Services sector remains low, given the value proposition offered by the IT software entities and availability of low-cost skilled manpower, which has even resulted in several larger global entities establishing their captive IT service centres in India.

Competitive intensity

The Indian IT services industry comprises several well-established domestic and international players as well as captive centres or global in-house centres (GICs) set up by international players. Companies have set up GICs not only to optimise costs but also for data integrity and privacy controls. While global players predominantly have similar business models as the Indian IT services players, the latter also face competition from other countries that provide or have the potential to provide English-speaking and skilled, low-cost manpower. However, Indian companies have a global business model with presence in other low-cost countries and are expected to maintain their market share in the global outsourcing market. Over the years, the IT industry has evolved from providing standard services to becoming an integral part of the customers' IT strategies by providing end-to-end solutions. Accordingly, IT services companies need to continuously adapt to new technologies such as digital - social, mobility, analytics, cloud (SMAC) and artificial intelligence (AI) to remain competitive and enjoy higher billing rates. Generative Artificial Intelligence (GAI), a subset of AI, has exhibited notable development in recent periods with the launch of several tools. As the field evolves further, its overall impact on the IT services industry might be mixed. GAI is likely to create business opportunities for IT services companies, promoting higher adoption of technology across sectors. Given that increased GAI deployment can help boost employee productivity, most leading Indian IT services companies have already started making investments/collaborations in this space. However, a part of the savings may have to be passed on to the customers. At the same time, increased penetration of GAI globally could have some adverse impact on the relatively smaller Indian BPO/BPM companies which are involved in providing entry-level services. These companies primarily provide services such as data entry, back-office services, customer support (voice and chat), parts of which could be replaced by generative AI. ICRA attempts to evaluate a rated entity's ability to provide differentiated services and solutions that mitigate competitive pressures within the overarching context of an evolving technological landscape.

Business Risk Assessment

Scale

The scale of IT services players, measured by their revenues, drives the ability to attract mid and bulge-bracket clients by offering a comprehensive range of services, including end-to-end solutions, products, and services. The size of a player's operations in the industry directly impacts its economies of scale, benefits, and its ability to sustain headwinds in terms of pricing pressure, employee attrition and loss of key clients. Further, achieving a certain threshold of revenues supports companies in bidding for and securing large contracts through their demonstrated execution capabilities and resource mobilisation strengths. In addition, entities with scale benefits can afford to have a larger bench strength (surplus manpower), ready to be deployed for any new contract, leading to faster execution capabilities. This, coupled with their flexibility to deploy critical resources across multiple projects simultaneously, results in higher utilisation rates.

Diversification

Revenue diversification imparts greater long-term stability to revenues and cash flows of an entity. For an IT services player, ICRA evaluates diversification in the form of service offerings, end-user industries, customer concentration as well as geographies.

Service/product offerings diversification: The IT services industry offers various services such as application development and maintenance, system integration, infrastructure management services, ERP (Enterprise Software Planning) software implementation, and consulting, etc. The sector also develops software products and applications. IT companies that are present in multiple business lines are better placed to offer bundled services to clients as well as bid for larger projects. ICRA also attempts to evaluate the proportion of revenues from new technologies such as cloud, mobile, digital transformation, and analytics that offer scope for non-linear growth opportunities that are unhinged to employee count. These services are more value additive providing higher billing rates, unlike the standard offerings such as routine application development and maintenance as well as system integration, that are relatively more vulnerable to pricing pressures.

End-user industries diversification: IT services companies are primarily application-driven service providers for specific or diversified industry verticals who nurture their end-market relationships through continued product development and strong customer support. The growth drivers of the IT services industry are linked to business prospects offered by the end-user industries and accordingly revenue diversification by end-user industries is evaluated by ICRA. Some of the predominant end-user industries include banking and financial services, media, telecommunication, manufacturing, retail, healthcare, etc. A diversified presence mitigates downside risk from any slowdown in specific sectors and cuts in the collective IT spends.

Customer diversification: An adequate degree of customer diversification reduces an entity's vulnerability to any variability in demand associated with a select few customers as well as disruptions in the business of a single customer. While certain small/mid-size companies in the growth phase may have high concentration on a single client, ICRA considers the strategic nature and tenure of such relationships. ICRA evaluates the proportion of revenues coming from the top client as well as the top-five to 10 clients, to assess customer concentration risk. In case of captive IT Services outfits, ICRA assesses the possibility of volatility in revenues owing to high dependence on parent as well as the parent's dependence on the captive.

Geographic diversification: The Indian IT services industry is mainly export driven, with the US contributing approximately 60% to the total export revenues. While assessing the geographical diversity of a rated entity in terms of its presence across various key regions such as North America, Europe, Asia Pacific, Latin America, etc, ICRA evaluates whether the same is in line with the general industry norms. Geographical diversity is an important credit factor, considering the risk of events such as slowdown in economic activity in a given market or visa restriction for Indian IT professionals in a specific geography. Further, ICRA also evaluates the presence of various offshore development centres and their geographical diversity, as it supports the delivery of uninterrupted services across time zones and against unforeseen calamities.

Client profile

Entrenched relationships with large companies ensure repeat business and provide stability in revenues. In ICRA's view, high level of repeat revenues indicates a strong service delivery capability and client stickiness, which is viewed as a credit positive. ICRA also evaluates the addition of new clients on a steady basis to assess the company's execution track record. Limited new client additions compared to peers, can depict a sign of weakening delivery capabilities or service offerings. Trends in the customer base across different revenue buckets, active clients, repeat revenues, new client additions as well as the quality of clients are evaluated to assess an entity's business strength.

Operating parameters

Employee cost (including sub-contracting cost) forms the largest part of the operating expense for any IT services entity. Hence, an analysis of operating efficiency primarily involves assessing the levers available for better utilisation of manpower — both offshore and onshore. Rising manpower cost and pressure on billing rates for commoditised services could lead to pressure on the profitability of Indian IT service players. As the operating profit margins are sensitive to above factors, control over the cost structure, i.e., employee cost, selling, general and administrative (SG&A) costs and optimisation of the same remains critical. ICRA evaluates parameters such as employee cost as proportion to revenues, contract mix, manpower utilisation and employee attrition against peers to evaluate operating efficiency.

Contract mix (time/material or fixed-price contracts; onsite/offshore): Broadly, there are two types of contracts that companies enter into — a) time/material contracts and b) fixed-price contracts. In case of time and material contracts, the billing is based on the number of people deployed on projects, multiplied by the average billing rate on a skill-wise basis. In case of fixed-price contracts, the contract value is fixed at a lump sum value with higher focus on deliverables and success-based outcomes, rather than the number of people working on the project. Fixed-price contracts generally provide an advantage of higher margins related to the company's ability to manage resources better, although it requires better project management skills and execution capabilities to prevent cost and time overruns. For example, critical and high-cost resources can be utilised for multiple projects, leading to scale benefits. In case of time and material contracts, although the likely risk from cost overruns is relatively lower, so are the potential profit margins.

ICRA also evaluates the employee mix in terms of their onshore/offshore allocation. Companies with a large proportion of an onshore workforce report higher revenue growth as billing rates are higher for onshore employees, though the same is true for costs as well, resulting in potentially lower operating profit margins. While workforce deployment is determined by the nature of the business contract, a healthy mix of onshore and offshore components provides a greater flexibility to manage the costs. A larger proportion of onshore hires increase expenses significantly, though this lends greater stability during periods of visa restrictions.

Employee attrition and training: Being services-oriented, the IT services industry is heavily dependent on its employees and ICRA evaluates the utilisation and attrition rate of the rated company across its peers. A high attrition rate has a direct and indirect bearing on the delivery capabilities of the company as it may not only hamper the execution of projects in the pipeline, but could cause service disruptions for existing customers, which may adversely impact repeat business. Employee utilisation levels have a direct bearing on profitability levels. While high utilisation levels (compared to industry averages) benefit the operating profit margins in the short term, they also impair the entity's ability to deploy people on new contracts at short notice. Similarly, a wide gap in employee utilisation levels (on the lower side) compared to peers may indicate delays in deployment of bench strength, owing to lack of new contracts or mismatch in skill sets leading to additional costs, thereby impacting margins.

Being a people and skill-focused industry, IT services companies are expected to have adequate training and development programmes for employees to keep them technologically updated. This has gained more prominence with new technological shifts such as focus on SMAC and re-training of existing employees.

Summary of Salient Business Risk Factors

	Strongest		Weakest
Scale	The entity has revenue of more than Rs 6,000.0 crore.	➔	The entity has revenue less than Rs 300.0 crore.
Service offerings Diversification	The entity operates in multiple service offerings with significant presence in such offerings.	➔	The entity has presence in single service offering.
Geographic Diversification	The entity's revenues are well diversified with no single geography (US, Europe, India) accounting for more than 60% of the revenues	➔	The entity's revenues are concentrated with single geography contributing more than 90% of revenues.
Client Diversification	The entity's revenues are well diversified with no single client contributing more than 10% and Top 5 clients contributing less than 25% of the revenues.	➔	The entity generates more than 60% of the revenue from top 5 clients.
Client Profile	The client profile includes leading Fortune 500 companies with a high level of repeat revenues.	➔	Client base includes companies with no long-standing relationship and limited/nil reputed clients
User Industry Diversification	Well diversified with no single end user industry contributing more than 30% and presence in more than five such end user industry.	➔	More than 80% of the revenues derived from single end user industry.
Employee Attrition	Employee Attrition less than 15% on annualized basis	➔	Employee Attrition of more than 25% on annualized basis

Financial Risk Assessment

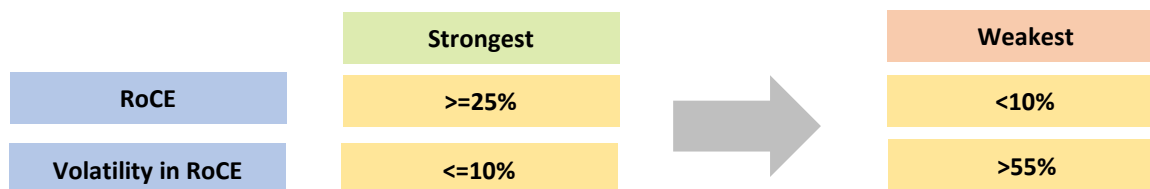
The various financial metrics assessed by ICRA could be divided into four categories viz., Profitability, Leverage, Coverage and Liquidity. This document provides a brief summary of why ICRA considers these ratios to be important. For a more detailed description, readers may refer to the note titled, Approach for Financial Ratio Analysis published on ICRA’s website.

ICRA also draws up projections on the likely financial position of the company based on the expected movements in operating performance, factoring in capex and investment requirements as well as upcoming debt obligations to study the impact on revenue growth and profitability, cash flows, leverage as well as debt protection indicators. Depending on the uncertainty around how the various credit drivers could evolve in the future, ICRA also carries out sensitivity analysis to assess the impact of the key variables on the various financial metrics.

Profitability metrics

A company with higher profit margins and return on capital has a greater ability to generate internal accruals, attract external capital, and withstand any business adversity. As employee benefits form the largest cost component for the IT services industry, the ability to use the variable component lever to protect margins in case of any headwinds is analysed. ICRA also evaluates capitalised expenses on developing own intellectual property (e.g., software) in relation to current profit levels as well as future potential to generate profits out of such investments. The complexity of services offered in the value chain, the presence of escalation clauses, offshore-onshore mix, non-linear business model, variable salary component, employee utilisation rate and transfer pricing norms in case of captives are some of the main factors that determine the profitability of IT services companies. The two primary measures of profitability that ICRA evaluates are: (i) operating profit before depreciation, interest, and tax margin (OPBDIT margin), and (ii) return on capital employed (RoCE).

Validation of Business Risk through Profitability Metrics [Indicative metrics¹]



Leverage and coverage indicators

Financial leverage is a measure of an entity’s dependence on borrowed funds. Lower the dependence on borrowings, the lower (better) the leverage. When an entity borrows, it is obliged to pay both interest as well as principal to the lenders, as per a defined schedule. This increases the fixed-cost burden on the borrowing entity and in the limiting case, increases the default risk. While high leverage may mean high risk from a credit perspective, it is an often-adopted course by shareholder-oriented managements, given that high leverage, in good times, leads to high returns on equity capital. An entity’s financial leverage could thus be a function of its management’s financial policy and risk tolerance, besides being a point-in-time reflection of an entity’s business and financial choices. An entity with lower leverage is better equipped to withstand any volatility in cash flow generation in situations of economic downturn, competitive challenges, unexpected costs, changing consumer preferences,

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 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.

or regulatory changes. Companies that generally pursue an aggressive financial policy, which involves significant reliance on debt financing, are likely to be more vulnerable to cyclical downturns than the companies who pursue a conservative financial policy.

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 during a given period. Higher the ratio, higher the cushion available with an entity to withstand any 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 operating expenditure requirements. 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 during a given period. Entities with higher profitability and lower leverage will generally have better coverage ratios and, thereby, healthier financial risk profiles.

Assessment of coverage

[Indicative metrics]

	Strongest		Weakest
Interest Coverage	≥18.0x	➔	<2.0x
DSCR	≥4.0x		<1.1x

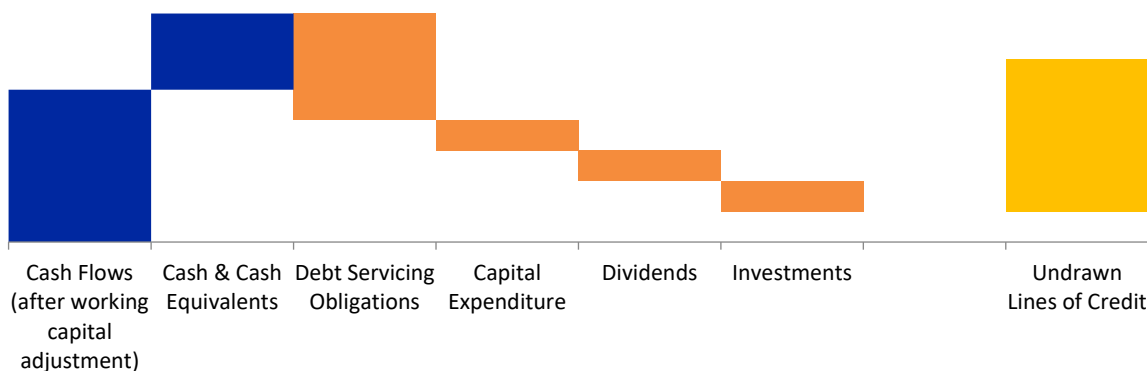
Cash flows and liquidity profile

The rating exercise is primarily focused on assessing the future debt servicing capability of a company. As it is cash that is required to service the debt obligations, it is imperative that a cash flow analysis is undertaken to evaluate the external funding requirements and likely financial position of the company, going forward. A cash flow statement represents the sources from which cash is generated, as well as its deployment. Analysed here are the trends in an entity’s funds flow from operations, cash consumed to fund the working capital, the retained cash flows after paying out dividends or carrying out share buybacks, and the free cash flows after meeting debt repayment obligations and capital expenditure (capex) needs.

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 the committed as well as the contingent claims on an entity’s cash, including the debt servicing obligations, working capital requirements, capex and other investment outlays, dividend and share buyback-related outflows, besides the sudden demand arising from 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.

Liquidity snapshot over any defined period



Working capital intensity

Indian IT service players generally have low-to-moderate working capital intensity (15-25% of operating income) with most of their working capital requirement arising to fund receivables. ICRA attempts to evaluate the ageing schedule of receivables to arrive at a company’s ability to realise its cash flows as well as assess the possible risk of bad debts in the future. ICRA compares the working capital ratios of industry players with its peers and any significant deviation in the ratios, such as debtor and inventory days, gives a possible indication of any dispute with clients regarding certification/ approval of work, recognition of work, and/ or release of payments. Also evaluated is the exposure to various domestic Government bodies, where the risk of an elongated payment cycle has been observed to be relatively higher. ICRA also monitors the trend in unbilled revenues² as a percentage of revenues over the past few years and reasons for volatility, if any.

Other Elements of Credit Risk Assessment

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 refinancing 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.

Financial flexibility

An entity’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 and marquee investors and enjoy the confidence of banks, financial institutions and intermediaries. A strong financial flexibility allows an entity to raise fresh borrowings or refinance existing ones quickly and whenever required. Financial flexibility could emanate from factors such as an entity’s large scale of operations with strong financials, large,

² Unbilled revenues refer to the portion of work completed by the company at the year-end and are to be billed after reaching an agreed milestone.

unencumbered cash flows and 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

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 any adverse demand situations in the underlying industry. The company's ability to honour its debt obligations during the period of cyclical stress is also factored in.

Foreign currency-related risk

The Indian IT services sector is primarily export driven with revenues denominated in foreign currencies such as the US Dollar, the Sterling Pound and the Euro, while the costs are mostly in the Indian Rupee (barring those related to onshore employees and other administrative expenses), exposing players to any adverse currency movements of the latter. ICRA evaluates the net foreign exchange exposure of an industry entity and its hedging policy. Companies that have a stated hedging policy with appropriate mechanisms in place to hedge short-term as well as long-term exposures can withstand any fluctuations in currency rates better.

Accounting quality

The company's accounting policies, notes to accounts, and auditors' comments that are part of the annual report of the issuer are all reviewed. Any deviation from the Generally Accepted Accounting Practices (GAAP) is noted and the financial statements of the issuer adjusted to reflect the impact of such deviations. ICRA also evaluates contingent consideration, accounting, and amortisation of intangible assets with respect to any acquisitions, while assessing the credit profiles of entities in the IT services industry.

Contingent liabilities and off-balance sheet exposures

ICRA reviews the contingent liabilities and off-balance sheet exposures as disclosed by the entity in its annual report and evaluates the likelihood of their devolvement and the financial implications of the same. Disclosures by captive centers with respect to contingent liabilities for income tax related to transfer pricing matters are also evaluated.

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 judgement 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.

Parentage/Group Support

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 stronger than the rated entity, ICRA assesses the ability and the likelihood of the parent extending extraordinary support to the entity. Support here refers to financial support from the parent, expected to be available to the entity in the form of loans, equity, extended credit period and advances 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. If the parent's credit profile is relatively 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.

Management Quality Assessment

In addition to the industry, business and financial risk analyses, all credit ratings incorporate an assessment of the quality of the rated entity's management and its financial policies. An entity with an experienced management is considered a positive factor. 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
- The management's success in introducing new projects and managing changes in the external environment
- The management's plans on new projects, acquisitions and expansions

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 as 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, differ widely across sectors and entities. In some cases, while the E&S risks could be material, their effect on the credit profile may be muted because of other fundamental strengths of the entity. In other cases, the adverse impact of 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 future, the rated entity would possibly have adapted 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. Despite the above, as an example, it is possible that even if entity A has a higher carbon footprint than entity B, it does not materially affect ICRA's credit opinion on entity A. This is because ICRA's credit opinion on an entity considers a wide gamut of credit-relevant factors, and the E&S factors are only one among those.

Being a service-oriented industry, the direct environment risks are limited for the IT services sector. A diversified geographical presence of delivery centres and remote working set-ups could enable IT companies to maintain business continuity. From a social standpoint, the Indian IT services sector faces two key risks. Firstly, there is the risk of data breaches and cyber-attack affecting the large volumes of customer data that such entities manage. ICRA evaluates the disclosures made by such companies outlining the key policies, processes, and investments that the company has made to mitigate the occurrence of such instances. Notwithstanding the above, any material lapses on this front can result in substantive liabilities, fines or penalties and reputational impact. Secondly, companies remain exposed to the risk of changes in immigration/outsourcing laws in the key developed markets where it provides its services. While such changes in laws would be motivated by such countries' own social considerations, they could have the effect of heightening the competition among IT players for skilled workforce and may have an adverse impact on IT services entities' profitability.

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's participation in strategy formulation, besides the entity's adherence to legal and statutory compliances are factored in during credit assessments. ICRA seeks to gain a qualitative understanding of an entity's commitment to following transparent and credible practices by the way its financial statements are reported, its level of disclosures, consistency in communication and openness in 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 near-to-medium-term and the adequacy of such cash flows against its debt servicing obligations and other funding requirements. As this note highlights, the credit quality of an IT services player depends on the presence of large and reputed clients with a high level of repeat business, well-diversified service offerings, market knowledge as well as geographically diversified revenue and service delivery base. Further, operating efficiency in the form of employee utilisation, which forms a major chunk of the cost, remains critical. ICRA's financial risk analysis for IT service players focuses on a track record of sustained profitability, leverage levels, ability to generate free cash flows and financial flexibility.

ANNEXURE

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

		Strong	Comfortable	Adequate	Moderate	Weak									
Industry Risk	Industry Position														
	Scale and Market Position														
Business Risk	Service offerings Diversification														
	Geographic Diversification														
	Client Diversification														
	Client Profile														
	User Industry Diversification														
	Attrition														
	Profitability and Earnings Stability														
	Financial Risk	Leverage													
	Coverage														
		Enhance			Support/ Neutral										
	Diversification														
Do these factors enhance or hinder the credit profile?	Refinancing Dependence, Liquidity and Financial Flexibility														
	Currency Risk														
	Financial Policy														
	Management, Governance & Reporting														
		Very High		High		Moderate									
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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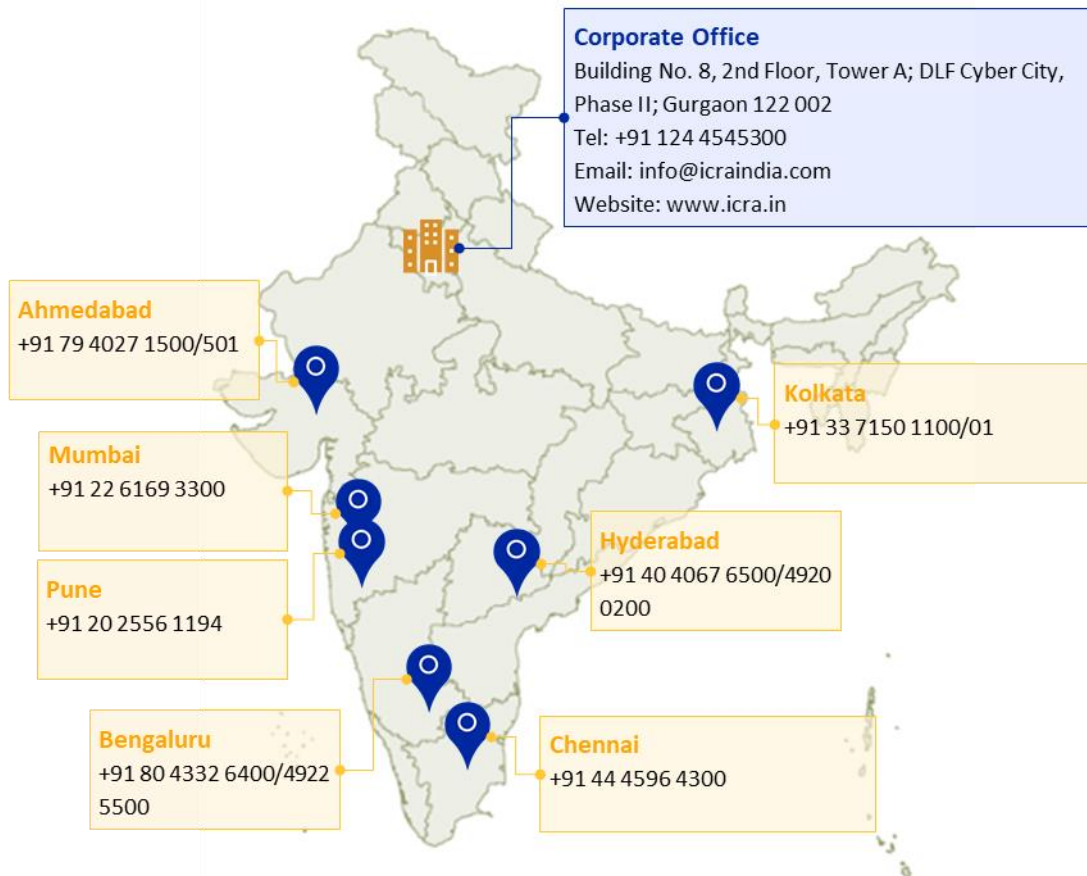


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