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Global Rating Methodology for Business and Customer Service Companies

Summary

This rating methodology adopted by China Chengxin (Asia Pacific) Credit Ratings Company Limited ("CCXAP") applies to companies that provide services to other businesses or customers.

This document replaces the "Rating Methodology for Business and Customer Service Companies" published in June 2017. The new version amends the key rating factors that are used to assess the overall credit qualities of service companies. Service companies refer to companies that derive most of their revenues or operating cash flows from the service lines. This rating methodology covers wide range of service sectors such as information technology outsourcing, healthcare outsourcing, design and consulting services, education and training services, real estate services, advertising services, human resources services, leisure and entertainment services and other business activities. This methodology excludes specialized service sectors such as retail, telecommunication, and passenger airlines, to which CCXAP will apply other rating methodologies.

We are publishing these criteria to help market participants better understand our approach in reviewing the key rating factors of this industry. The information of the rating changes is available on our website or by clicking on the following link: [link].

Introduction of Rating Methodology

This rating methodology incorporates the key, but not exhaustively discuss all, of rating factors considered in our rating. As a result, the rating indicated by the grid may not match the final rating of each company.

We consider 4 rating factors comprising of 10 quantitative and qualitative sub-factors, as follows:

Rating Factors	Sub-factors
Business Profile	Competitive Strength
	Demand Characteristics
	Diversification
Scale	Total Revenue
Profitability	EBITDA Margin (%)
	Return on Equity (%)
Financial Strength	Total Capitalization Ratio (%)
	Total Debt / EBITDA (x)

EBITDA / Interest (x)
FFO / Total Debt (%)

Key Rating Determinants

This section discusses the rating factors and sub-factors in detail, including their rationale, measurement and how they will affect the industry rating.

1. Business Profile

Assessing the underlying demand characteristic and competitiveness of service companies is crucial for evaluating its business capacity. The pricing power of service companies is determined by their market position, while companies with strong brand value and long track record of stable demand tend to maintain stronger competitive position over time.

(1) Competitive Strength

CCXAP starts the analysis from evaluating the competitive strength of the company. Both market characteristics and the market share of the service company are taken into consideration.

Oligopoly markets or those having significant barriers to entry help secure the competitive position of the leading service companies in the industry. There is less competitive pressure, and companies have stronger pricing power. Companies with larger market share typically have enlarged customer base and strong competitive profile, and can weather economic cycles earlier and adjust to violate demand. CCXAP measures a Company's competitive profile by the industry concentration and compares the company's revenue or sales to the industry's total revenue or sales.

(2) Demand Characteristics

CCXAP considers the demand stability and the brand value of a service company. If a company has long track record in the industry and the market has strong and stable demand for its services provided, the company is exposed to lower risk of operating failure. When companies provide homogeneous services to customers, those with stronger brand value and unique products would be more recognized, and tend to attract stronger demand.

CCXAP also considers the cyclicality of the services provided by a company. Demand that fluctuates with economic cycles reflects high degree of cyclicality, and the companies typically exhibit less stability and generate volatile earnings.

(3) Diversification

CCXAP considers the business diversification of the company. In assessing this factor, CCXAP uses the number of different types of services the company operates and the percentage of revenues from each operating segment or customer. CCXAP considers a company to be business-wide diversified if the company has lower reliance on a single segment or a single client.

CCXAP also considers the geographic diversification of the company. Companies with wide service regions have lower operational risks and less demand shocks, which generate greater stability of revenue by balancing the regulatory / environmental / seasonal issues. CCXAP considers a company to be geographically diversified if its services are provided in various regions and the percentage of revenue generated from each region is balanced.

2. Scale

Large service companies typically have strong reputation and customer base in the industry. Within service industry, large companies show competitive advantage in adjusting supply to fit market demand in a faster pace, and they typically have easier access to diversified financing channels. In the evaluation of the scale of the company, CCXAP reviews total revenue of the company.

(1) Total Revenue

CCXAP considers revenue in measuring the scale of the company. Service companies that generate larger revenue have stronger market share, and typically have access to operate in various regions. Sustainable revenue growth also reflects strong market demands for the company and the unique services it provides. Conversely, companies generating smaller revenue exhibit lower market share and weaker operating capacity.

3. Profitability

Service companies incur increasing cost if labor cost rises, and may encounter difficulties in passing the cost to customers. As a result, the ability of cost control and operating efficiency are important considerations of credit rating for service companies. In the evaluation of profitability, CCXAP uses the EBITDA margin and the return on net assets.

(1) EBITDA Margin

CCXAP focuses on the EBITDA margin of service companies, which is calculated by EBITDA to total revenue. Companies with higher EBITDA margins tend to conduct better cost control and generate stronger operating cash flows. A decline in EBITDA margins indicates increasing operating costs, lower pricing power or even loss-making projects.

(2) Return on Equity

In assessing profitability of a service company, CCXAP also uses return on net assets, which is calculated by dividing net income by two-year average equity. This indicator confirms the company’s competitive position, and reflects its future growth capacity from the shareholders’ equity perspective.

4. Financial Strength

In the evaluation of financial strength, CCXAP reviews various financial indicators of the company. The leverage indicators reflect the company’s financial flexibility and long-term viability. The coverage indicators measure the company’s debt repayment capability. The cash flow indicators indicate the company’s cash generating ability. These indicators together reveal the financial policy and strength of the company.

(1) Total Capitalization Ratio

In assessing the financial leverage of service companies, CCXAP uses the total capitalization ratio, which is calculated by dividing total debt by total capital. Total debt refers to interest-bearing debt, including bonds, notes, short-term and long-term borrowings. Higher leverage exerts pressure on the company's debt servicing capability, and adversely affects the company's credit metrics.

(2) Total Debt / EBITDA

CCXAP also focuses on the company's debt burden relative to its expected cash flows to measure the company's ability to repay debt from its operating earnings. This indicator is calculated by dividing total debt by EBITDA. Even for companies with the same financial leverage, their profitability and cash-generating capability reveal different level of financial risk.

(3) EBITDA / Interest

This indicator is used to measure the company's ability to repay the interest of interest-bearing debt and other fixed charges by its operating earnings. The indicator is calculated by dividing EBITDA by the sum of interest expense and capitalized interest.

(4) FFO / Total Debt

This is an indicator measuring the company's ability to repay its debt using cash flow from operating activities. This indicator compares earnings from net operating income plus depreciation, amortization, deferred income taxes and other non-cash items to total debt.

Other Rating Considerations

In assessing the overall creditworthiness of the company, other than the factors and sub-factors discussed above, CCXAP considers financial policy and corporate governance.

Financial Policy

The financial policy of the company reveals management's risk appetite, and it directly affects the capital structure and credit quality of the company. CCXAP focuses on the formulation and execution of financial policy to check whether the board and senior management follow their commitments on the financial targets of the company.

Corporate Governance and Management

Corporate governance and management represent the system of rules, practices and processes by which a company is controlled and directed, and it is an important rating consideration. A company with strong corporate governance has fair and transparent sets of rules and controls in which all stakeholders have aligned incentives.

External Support

External support is an adjustment factor while it can influence companies' future performance and strengthen its credit profile. Evaluation of external support can be split into two aspects, which are parental support and other institutional support.

Parental support is usually come from the shareholders and the parent company. We consider the willingness and degree of support in order to assess the parental support. In the evaluation of willingness of support, CCXAP considers the company's importance, market position and ownership structure. For example, if a company is important to the conglomerate, such as generating a large proportion of income, then the conglomerate is more willing to support the company. Shareholders' financial profile is examined in order to analyze the degree of support because capital injection is the most common way of support. CCXAP recognizes that government can be the shareholder of a company and can offer a more consolidated support to the company. However, we also recognize that a company's operation can be intervened by government, which can be unfavorable to the company.

Other institutional support is defined as the support from government or banks, which are not the shareholders of companies. Those institutions usually have a strong financial profile and are willing to support those companies which are strategically important to the country. Therefore, we consider these companies to have a strong external support and good creditworthiness.

Companies' credit profile will not be damaged if they do not have external support but strong external support can lower companies default probability and companies' credit rating deserves uplift.

Important Information

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