

Background

The services industry refers to providers of intangible goods to consumers. The services sector is the dominant sector in Mauritius's Gross Domestic Product (GDP) as well as provided large-scale employment.

The service industry is wide and covers a gamut of areas like asset-based services (hospitality, education, hospitals, airports, retail, mobile service providers, etc.) and personnel-based services (professional services like accounting firms, law firms, management consultancy and advisory, security services, support services, IT and facility maintenance services, logistic services, etc.).

The rating methodology here primarily covers the personnel-based services while methodologies for various assets-based services (like Education, Hospitality, Mobile service providers, Retail and Banking and Insurance), considering the risk metrics specific to their business model, are individually available on CRAF's website www.careratingsafrica.com

Rating Methodology

A. Industry risk

CareEdge Africa (CRAF) analysis of the industry risk focuses on the current industry scenario, demand-supply factors, the size of the industry, key players in the industry and competitive factors, cyclicity and seasonality, if any associated with the industry, any regulatory policies, tax benefits, etc. Furthermore, as these service entities act as service providers for other core industries, the performance of such core industries is also a critical factor for the analysis of these entities.

B. Management Evaluation

The business of a service provider is, to a large extent, influenced by the brand value which helps in winning consumer confidence and ensure consumer loyalty. The management evaluation is an important aspect of the rating process as it provides insights into the business strategy and the ability of the entity to sustain its business. The various parameters on which the management is evaluated are:

- **Business Strategy**

The entity's mission, its vision, policies, business plan and future strategies provides valuable insight into the ability of the management to foresee the challenges and opportunities and prepare for them. An important factor in management evaluation is assessment of the management's ability to look into the future and its strategies and policies to tackle emerging challenges, in addition to succession planning.

- **Promoter group strength**

The promoter group's standing is assessed to understand the tangible and intangible support it could offer to the entity. The track record of the promoters/management team in terms of their response to key issues/events in the past like liquidity issues, competitive pressures, new service offering, expansions and diversifications, etc., are assessed.

The methodology considers commitment of the promoters not only in the form of equity infusion but also their active involvement in the operations/management of the entity, reflecting the importance of the entity in the overall group's portfolio.

- **Profile of the management team and association with organization**

The experience and track record of the management team helps in understanding its preparedness in handling stress scenarios. Furthermore, for entities providing professional services like audit services, consultancy services, etc., the longevity of association of key executives with the organization is of importance. Such entities are people-oriented involving exchange of critical and confidential information between the entity and its client. As such, continuance of the senior executives provides a sense of security and stability to the client.

- **Organization structure**

The organization structure, the delegation of powers, roles and responsibilities, accountability and succession planning, is assessed with respect to the size and strategy of the entity. The organizational structure also to a large extent defines the systems of controls and escalation within the organization which has a significant bearing on service quality delivery.

- **Succession Planning**

Succession planning is another critical part and is assessed in detail if the company's operations are dependent upon a single promoter or a key professional. A sound succession planning ensures the continuity in business operations without much disruption even after the most important employees retire or leave the company.

- **Personnel policies**

Human resource is the most critical asset for a service company. Personnel policies laid down by the entity would critically determine its ability to attract and retain talent. The depth and diversity of the skill sets available in the company along with the policies regarding training and enhancing the skills of employees are also evaluated. The company's asset utilization and attrition levels are compared with its peers and industry averages. High attrition rate is likely to not only adversely impact the execution of projects in terms of timelines and quality of deliverables but also create negative brand image amongst customers, which adversely affects the repeat business.

- **Control systems**

Adequacy of the internal control systems to the size of business is closely examined. Existence of proper accounting records and control systems adds credence to the accounting numbers. Management information systems commensurate with the size and nature of business enable the management to stay tuned to the current business environment and take timely, judicious decisions.

- **Corporate governance**

Extent of transparency in the entity's dealings with various stakeholders, financial prudence and compliance with extant laws and regulations is seen closely. The market reputation of the group/entity is also factored in while assigning the ratings.

C. **Business Risk**

Given the economic and industry risk, the business risk of the entity is assessed by CRAF to understand its position within the industry. The business risk is analysed on the following key parameters:

- **Nature and complexity of the services offered**

CRAF analyses the nature and complexity of service provided by the service provider. A recurring form of service like business support services or Operations & Management (O&M) services provide more stability to income vis-à-vis one-time services like product development service by an IT firm.

Furthermore, highly complex services are generally high-margin services and are difficult to be replaced by the clients of the service provider. As such, more complex and expertise-oriented services carry less risk of being replaced and provide more revenue visibility. This also creates entry barriers for newer players or possibility of substitution by other technology-driven products. For example, legal consultancy is a highly expert-oriented service and would command higher margins vis-à-vis a facility management service provider.

- **Nature of service contracts**

CRAF analyses the nature of service contracts signed with the clients by the entity. Contractual terms where the roles and responsibilities of either party are defined clearly, with defined payment terms and dispute resolution mechanisms are viewed favourably. Longer duration service contracts with difficult cancellation terms provide more visibility to revenues. A history of renewal of contracts reflects customer satisfaction and is an indicator of a long-term relationship with a client. As such, CRAF views a track record of contract renewals positively.

- **Service proposition & Market Position**

Service sector is a highly competitive sector, and to operate on a sustained basis and maintain or improve its margins, the company needs to have a unique selling proposition or add value to the client on an ongoing basis. CRAF analyses the business of the entity from this perspective and its position in the value chain of services offered. Various 'per unit' metrics are analysed by CRAF to assess the operating efficiency of the entity.

In an IT company, billing rates per employee and cost per employee would be important metrics, while in a logistics firm, the analysis may be focused on 'yield' or realization per kg of materials handled. Furthermore, companies with niche service offerings have a stronger market value as it is difficult to replicate their services on account of complexities. Significant market position provides bargaining power to the service provider which also lets it command a premium for its services. Furthermore, the market position of the entity enables it to leverage the brand to establish its position in new service lines with ease and higher probability of success.

- **Seasonality and cyclicity**

The service industry is usually less cyclical in nature due to the non-discretionary nature of most services. Seasonality may be prevalent in-service industry due to the nature of the end-users served by the entity. CRAF ratings aim to be stable across seasons and economic cycles and are arrived at after deliberating on the long-term fundamentals.

- **Scale of operations**

The scale of operations is critical in the analysis of a service entity. Large entities have better ability to influence business trends and pricing within its service segments and show greater resilience to adverse changes in business environment. Large scale of operation also aids in better bargaining power with its customers and vendors along with sustenance in case of attrition or loss of key clients. Further, achieving a certain threshold of revenues supports companies in bidding for and winning large contracts through their demonstrated execution capabilities and resource mobilization strengths.

- **Diversification**

Diversification can be in the form of range of services offered, client-mix, end-market and geography. Maintaining a high degree of diversification is crucial as it leads to lower revenue volatility, less susceptibility to regulatory or market changes, provides competitive advantages and ensures stable profitability.

If an entity offers various services, each such business segment would be analysed separately. Diversified revenue streams also insulate the entities from any technological disruptions in any of their service offerings. Inter-related service offerings provide better synergies to an entity than an entity in unrelated business segments which may necessitate different management structures and cost structures for its various business segments. If majority of the revenue is from a particular industry, then the performance of the industry is also taken into consideration.

Diversification in terms of geographical presence and number and type of clients is also critical. A high dependence on few clients would be detrimental for the entity if a client is lost. In addition, CRAF also evaluates the top clients of the entity for their overall credit quality as a marquee client base is a reflection of the quality of the company's offerings, assurance of timely receipt of dues and sustenance of its business operations.

Geographical diversification also helps in case of any loss of business or temporary disruptions in individual markets where the entity operates. Also, in case of IT services, the presence of various off-shore development centres and their geographical diversity as it provides uninterrupted services to the companies across time-zones and against unforeseen calamities.

- **Exposure to overseas markets**

It is common for service entities to offer services overseas due to the huge outsourcing demand from the western countries. In case of such entities, which are engaged in providing offshore services in other countries, like IT or consultancy services companies, analysis of global economy-wide factors, government policies in those geographies, legal policies and exposure towards foreign exchange fluctuation risk are factored in the rating process as against entities that are present in domestic markets alone. Furthermore, the net foreign currency exposure of the entity and its hedging policy are also evaluated by CRAF.

- **Cost structure**

The major costs for a service company are the employee cost and IT infrastructure costs, which are analysed to understand the trend in the profitability margins. The cost of the employees varies based on the education and background of employees, attrition rate, training costs, and incentive structures. The companies that have a larger proportion of variable cost employees would have a better control over costs in an event of decline in demand or loss of a service contract vis-à-vis a company that may have to bear high fixed costs. However, on

the other hand, higher variable cost may also lead to higher attrition rates which may add to training costs for the company. A judicious mix of employees is critical to control costs for a service provider.

Also, the nature of technology used and IT infrastructure influences the cost structure for the entity. Entities that offer services that involve access to confidential information from clients, need to invest well in the IT security systems and MIS systems. As such, analysis of the cost of up-gradation and recurring maintenance of the IT infrastructure is critical to the analysis of the cost structure of the company.

- **Financial Flexibility**

An entity's financial flexibility is reflected in its ability to attract diverse and marquee investors and enjoy the confidence of banks, financial institutions and intermediaries. Financial flexibility could emanate from factors such as an entity's large scale of operations with strong financials, large unencumbered cash flows, unencumbered assets and the flexibility to borrow against such assets, strong parentage or linkages with a strong group.

In contrast, high share of pledged promoter shareholding reduces the financial flexibility of an entity and is considered adversely.

D. Financial Risk

Financial risk analysis involves evaluation of past and expected future financial performance with emphasis on assessment of profitability margins and working capital management.

CRAF' analysis is mainly based on audited accounts of the entity although unaudited accounts are noted. A review of accounting quality and adherence to prudential accounting norms (if any, set by local regulations) are examined for measuring the entity's performance. Accounting policies relating to depreciation and amortization of intangible assets, income recognition, valuation of investments, forex transactions, etc. are given special attention. Prudent disclosures of material events affecting the entity are reviewed. Impact of the auditors' qualifications and comments are quantified to the extent possible and analytical adjustments are made to the accounts, if material. The rating team interacts with the auditors to understand their comfort level with the accounting policies, systems and controls within the entity and their assessment of the management of the entity. Off-balance sheet items are factored into the financial analysis and adjustments are made to the accounts, wherever necessary. Change of accounting policy in a particular year which results in improved reported performance is analysed more closely.

E. Financial ratios

Financial ratios are used to make a holistic assessment of financial performance of the entity, as also to see the entity's performance w.r.t. its peers within the industry. They are not an 'end' in itself but a 'means' to understanding the fundamentals of an entity. Some of the important financial ratios are:

- **Growth Ratios:** Trends in the growth rates of an entity vis-à-vis the industry reflect the entity's ability to sustain its market share, profitability and operating efficiency. In this regard, focus is drawn to growth in income, EBIDTA and PAT.
- **Profitability Ratios:** The capacity of an entity to earn profits determines the protection available to the entity and the control over the cost structure. Profitability reflects the final result of business operations. Important measures of profitability are EBIDTA, operating and PAT margins, ROCE and RONW. CRAF also evaluates any capitalised expenses incurred by the company for developing any Patents or Intellectual Property (e.g., Software) and the future potential to generate profits out of such investments. Profitability

ratios are not regarded in isolation but are seen in comparison with peers and the industry segments in which the entity operates.

- **Leverage and Coverage Ratios:** In service industry, debt mainly consists of working capital borrowings and/or non-fund-based limits like performance bank guarantees. As the service entities are asset-light businesses, long-term debt is rarely present on the balance sheet of these entities. As such, overall gearing ratio and interest coverage are the major ratios analysed in a service entity. Debt as a proportion of cash

accruals and Debt Service Coverage Ratio would be important in case an entity has availed long-term debt to measure the degree of leverage used vis-à-vis level of coverage available with the entity for debt servicing.

- **Liquidity Ratios:** Liquidity ratio such as current ratio is broad indicator of liquidity level and is important ratio for rating short-term instruments. Cash flow statements are also important for liquidity analysis.

F. Working Capital Cycle Management and financial flexibility

A service entity does not have any significant inventory and its working capital management mainly relates to receivables management. The debtor ageing schedule along with the possible risk of bad debts is evaluated. CRAF also evaluates the entities customer exposure to various Government organizations where the risk of elongated payment cycle is relatively higher.

Furthermore, as employee salaries form a major portion of the operating costs and entities have limited flexibility to defer this expense, it is thus crucial to maintain necessary cash balance for specified number of months.

Service entities are usually cash rich with adequate amount of cash flow to finance normal maintenance capital expenditure, and to fund the working capital. However, the entity may rely on external working capital limits to meet any cash flow mismatches and as such its financial flexibility is also assessed. Financial flexibility refers to alternative sources of liquidity available to the entity as and when required. The entity's sanctioned bank limits and its average utilization, the ability to access capital markets and other sources of funds whenever required is reviewed. Existence of liquid investments, availability of support (implied or demonstrated) from strong group concerns to tide over stress situations, etc., are considered favourably.

G. Validation of projections and sensitivity analysis

The projected performance of the entity over the life of the instrument is critically examined and assumptions underlying the projections are validated. The critical parameters affecting the industry and the anticipated performance of the industry are identified. Each critical parameter is further stress-tested to arrive at the performance of the entity in a stress situation.

H. Contingent Liabilities

CRAF takes note of contingent liabilities/off-balance sheet exposure reported by an entity and if the same is material, carries out an impact analysis and financial implication of the liabilities devolving upon the entity.

For more details on Financial ratios please refer to the methodology on 'Financial Ratios-Non financial sector entities' on our website.

Conclusion

The rating process is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. Rating determination is a matter of experienced and holistic judgment, based on the relevant quantitative and qualitative factors affecting the credit quality of the issuer.

[Reviewed in October 2025. Next Review due in October 2027]

CRAF (AFRICA) PRIVATE LIMITED

Corporate Office: 5th FLOOR, MTML SQUARE, 63, CYBER CITY, EBENE MAURITIUS

CIN: 127054 | BRN: C14127054 | FSC License No.: CR14000001

Connect:



Locations: Ebene

Saurav Chatterjee

Director & Chief Executive Officer

+ 230 5862 6551
+ 230 5955 3060

Vidhyasagar Lingesan, CFA, FRM

Chief Rating Officer

+ 230 5273 1406
+ 230 5955 3060

Naveen Kumar Dhondy

Rating Head

+ 230 5511 0811
+ 230 5955 3060

About:

CareEdge is a knowledge-based analytical group that aims to provide superior insights based on technology, data analytics and CRAF (Africa) Private Limited (CRAF) is the first credit rating agency to be licensed by the Financial Services Commission of Mauritius in May 2015. It is also recognized by Bank of Mauritius as External Credit Assessment Institution (ECAI) from May 2016. CRAF is also licensed by Capital Markets Authority of Kenya to operate as a Credit Rating Agency in Kenya. CRAF intends to expand across other geographies in Africa with Mauritius as its hub of operations. With an equitable position in the Mauritius capital market, CRAF (Africa) Private Limited provides a wide array of credit rating services that help corporates to raise capital and enable investors to make informed decisions backed by knowledge and assessment provided by the company.

CRAF's shareholders are CRAF Limited, African Development Bank, MCB Equity Fund and SBM (NFC) Holdings Limited.

CRAF gets its technical support in the areas such as rating systems and procedures, methodologies, etc. from CRAF Limited on an ongoing basis. CRAF Limited, with an established track record of rating companies over almost three decades, follows a robust and transparent rating process that leverages its domain and analytical expertise backed by the methodologies congruent with the international best practices.

CRAF's Rating Committee consist of full-time members comprising of Senior Rating officials from CRAF Limited and a panel of experienced professionals from Mauritius and African Development Bank.

CRAF has had a pivotal role to play in developing bank debt and capital market instruments including MMIs, corporate bonds and structured credit.

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