中誠信(亞太)
CCX

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Rating Methodology for

Business and Customer Service Companies

Summary

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

CCXAP defines service companies as ones with 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 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.

This rating methodology introduces the key determinants for rating business and customer service companies. CCXAP assigns credit ratings to them using its rating scale.

Introduction of Rating Methodology

The key rating determinants for the assessment of service companies are divided into qualitative determinants and quantitative determinants. The rating methodology provides a summarized guidance for the important factors used in assigning ratings, but it does not include every aspect of rating consideration. As a result, the mapped rating may not match the final rating of each company.

In this rating methodology, there are four rating factors comprising 11 sub-factors as follow:

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

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

Key Rating Determinants

Rating factors and sub-factors are discussed in details in this section, including their rationale, measurement and how they will affect the 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 Net Assets

In assessing profitability of a service company, CCXAP also uses return on net assets, which is calculated by dividing net income by 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 Debt / Total Capital

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) RCF / Net Debt

The metric is calculated by removing dividend payments from funds from operations and then divided by net debt of the Company, which is the Company's total debt minus cash and cash equivalents. It measures the Company's debt servicing capability from its cash flow generation before working capital movements.

(5) 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

Other than the factors and sub-factors discussed before, the availability of external support to a company when needed can help strengthen its credit capacity. CCXAP gives consideration to financial policy, corporate governance and support from shareholders when assessing a company's overall credit strength.

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

External Support

Support from companies' shareholders affects the company's future development and credit profile. CCXAP believes that support from shareholders is related to the subsidiary's importance to the holding company. We measure the willingness of support by development strategy, market position, ownership structure, and the subsidiary's importance within the group. CCXAP also views that a company with strong shareholders may receive parental support of capital injection.

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