Rating Methodology for Incorporated Educational Institutions

Education system of Bangladesh can be classified under two key segments – formal education and informal education. These are alternatively termed as core and non-core education segments, respectively. The formal education sector, consisting of schools, colleges and universities, is highly regulated by the government, whereas the informal education, which primarily consists of pre-schools, training institutes and coaching centers is unregulated. Further, formal education being an important social objective, it has been classified as a not-for-profit activity by the government and hence private sector participation is largely through institutions managed by not-for-profit societies, trusts etc. NCR takes into consideration corporate forms, which establish different schools in determination of rating for educational institutions. Such forms include private (incorporated educational institution). This rating methodology explains NCR's approach to analyzing the credit risk profile of entities operating in the education sector with a focus on higher education within the formal education segment. For analytical convenience, the key factors are grouped under four broad heads – **Operational Risk Analysis, Business Risk Analysis, Financial Risk analysis and Management Quality & Governance.**

Operational Risk Analysis:

(A) Assessment of Business Base: As reflected by the large number of higher education institutes in Bangladesh, the higher education sector is highly segmented. Accordingly, the market position of an institute's programs determines the demand for courses offered. A strong market position improves the university's ability to attract high quality students and faculty, which in-turn leads to better learning environment and better perception amongst recruiters resulting in better job placements, thereby enhancing the market positioning. The market positioning is assessed by NCR by analyzing the following parameters:

1) Student preference
2) Teaching quality and effectiveness
3) Course specialization/diversification
4) Operating history
5) Quality of infrastructure

(B) Regulatory Risk: Most of the entities in the education sector are registered as Trusts/Societies. The Bangladeshi education industry is highly regulated by the government because of its social importance and associated positive externalities. Apart from formal education being classified as a not-for-profit activity, the sector is also regulated through various regulatory bodies, such as-

1) University Grants Commission (UGC)
2) Ministry of Education (MoED)

(C) Trend in enrolment: Enrolment ratio, the ratio of actual intake to sanctioned intake, indicates the ability of an institute to attract students or demand for the courses offered by the institute. A higher enrolment ratio indicates higher utilization of the available capacity. Besides reflecting the demand for courses offered, this is also likely to result in relatively high return on capital employed. Furthermore, consistently high enrolment ratio indicates higher stability in revenue streams.

Management Quality & Governance:

In addition to the operational, business and financial risk analysis, all ratings necessarily incorporate an assessment of the quality of the entity's management. Understanding of the management's management ability, performance and business attitude are important in terms of rating. The assessment of the credit worthiness of an entity operating in educator sector factors in the commitment of the management to the institution's day-to-day operations, and the steps taken by them to promote and improve the institution. The quality and stability of the key decision makers like Deans and Heads of Departments are considered crucial from the point of view of continuity and completion of strategic plans. Usually, a detailed discussion is held with the management to understand its plans, strategies and views on past performance, besides the outlook on the sector and direct competition. Some of the other points assessed are:
Experience of the management in the education industry

1) Commitment of the management to the institutes
2) Viewpoint of the management on fee structure and revision, and expenditure flexibility
3) Plans on infrastructure improvement, new projects, expansion, etc.

Business Risk Analysis:

(A) Trend/stability of revenue: Well-established institutes with a good track record of enrolment and entities with relatively diversified courses are better placed as they offer stability in revenue. The trend in profitability margins vis-à-vis capital deployed is an important factor impacting the debt servicing ability of the institutes.

(B) Seasonality associated with cash flow of education institution: Unlike entities in the manufacturing/service sector which have cash inflow spread over the year, cash inflows of most of the educational institutions are relatively skewed as the tuition fee is collected either quarterly or semiannually. At the same time, cash outflow towards capital expenditure and operating expenditure is spread over the entire year. Given this, the management of cash flow assumes greater significance in educational institutions. Most of the institutes plan their repayments in such a way that they coincide with the fee collection and any surplus funds are parked in liquid investments to meet operating expenditure during rest of the year. While cash flow management is of greater importance, traditionally used liquidity ratios as such are not meaningful while analyzing most of the educational institutes. Also, as the fee is collected in advance or within a period of 2-3 months of the beginning of the academic year or semester, typically receivables of educational institutions are almost negligible or relatively low.

(C) Cost Structure and Expenditure Flexibility: Given the capital intensity of the higher education sector, which requires significant investments in physical infrastructure, hence requires the institutions to operate at high operating surplus margins to cover the fixed capital costs. Besides, expenses related to faculty, power, transportation, subscription of journals etc are typically fixed in nature. Thus, given the high operating leverage because of fixed capital costs and operating costs, the management's ability and willingness to quickly adjust its operations during times of weak enrolments or limited fee hikes is critical for the stability of credit profile. An effective management should be able to build in expenditure flexibility by way of strategic initiatives such as outsourcing of certain non critical support services and infrastructure facilities, use of a prudent mix of full time faculty and guest faculty, and flexibility to defer capital expenditure towards infrastructure improvement or addition of new courses.

Financial Risk analysis:

(A) Leverage and Debt Coverage: The credit profile of entities that pursue an aggressive financial policy, including heavy reliance on debt financing, is likely to be more vulnerable to decline in enrolments/ operating surpluses than entities that employ a lesser degree of financial leverage. Low leverage not only improves the financial flexibility of the entity, but also keeps the fixed financing expenses low. Higher education industry being fixed capital intensive results in high funding requirements for investment in fixed assets. NCR takes into consideration the funding mix of the entity towards such investments and its ability to maintain a healthy liquidity profile against the back drop of seasonality in tuition fee collection. Leverage ratios are an indicator of the degree of financial flexibility an entity enjoys in terms of its ability to raise funds from alternate sources in times of pressure on surpluses.

(B) Cash Flows and Liquidity: Entities operating in the formal education industry have to operate on a not-for-profit basis and are permitted a 'reasonable surplus' to meet cost of expansion and improvement of facilities. Also, the surplus money has to be ploughed back into the institution and no dividend can be distributed to the members of the entity who operate the institute. Also, as

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the tuition fee is not received on a monthly basis, the cash inflows of an educational institute are not uniformly spread across the year, though the operating expenses and outflows towards capital expenditure are spread over the entire year. Thus, prudent management of cash flows and liquidity becomes vital from a credit perspective. It is a credit positive if an entity maintains sufficient liquidity by way of undrawn overdraft bank limits or liquid investments to not only meet operating expenses on an ongoing basis but also for debt servicing, given the lumpy nature of fee collections. On the positive side, given that the fees is collected in advance from the students for the academic year/semester, the institutes are able to generate cash flows and working capital requirement tends to be negative, which is in contrast to manufacturing companies.

Thus, the key rating factors for entities in the education sector include enrolment ratios, type of courses offered, diversity of revenue stream and nature of regulatory environment in which it operates. Besides, factors such as need for continuous capex and effective management of cash flows are important from the financial risk perspective.