



The Credit Rating Services of India Limited

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CRISIL is one of India's two leading credit rating companies. The company's shares are available at an attractive price, and are recommended for long-term investors who prefer to invest in "better businesses."

Business Model

The Credit Rating business is one of the world's great business models. In contrast to most businesses which earn their money through increased expenditures on the part of their customers, credit rating agencies actually lower their clients' overall costs. By issuing a credit rating, the agency lowers the client's cost of borrowing funds, because the rating makes the issuer's securities available to a much broader spectrum of investors. The rating agency can therefore charge for their services almost any price up to the amount saved.

The credit rating brand, as well as the need to be licensed in order to issue a credit rating, create very significant barriers to entry. Furthermore, a prominent rating agency has very little need to advertise its services: the rating itself, as well as a regular flow of news releases relating to the rating, tend to create the agency's own free publicity, which in itself improves the rating agency's moat.

The business is not at all asset-intensive, which leads to a very high return on owner equity, as well as requiring very little reinvestment in the business in order to grow.

Lastly, the business benefits from a very favorable macro environment—both in India, as well as the rest of the world. As financial disintermediation takes place, and financial assets become securitized and traded, there is an increasing need for the issuances to be rated. This is true of both India, as well as more developed economies. The developing nature of India's economy adds the extra tailwind of higher economic growth.

Background

CRISIL was the first company to commence credit rating operations in India and has been in existence for almost 16 years now. CRISIL was promoted by a few financial institutions and banks, such as ICICI and UTI, to provide credit rating service for debt issues in the capital market. CRISIL is India's first and the only listed credit rating agency involved in the business of rating corporate debt obligations such as debentures, preference shares, fixed deposits, commercial paper, structured obligations, etc.

Credit rating is CRISIL's core business, constituting approximately 70% of the total revenues. The agency has, arguably, the best reputation among companies offering similar service. A feature of the company's business is that it is often the first to provide rating to innovations in debt-financing. The trend has positive implications because in the coming days, innovative instruments will be used in raising finance for infrastructure development.

About 30% of the revenue is derived through advisory services, information vending, and treasury operations. Over the next five years, the company intends to increase non-rating revenue to about 45%. Over the last couple of years, CRISIL has invested resources in businesses that would lead to such diversification of its income stream. Simply put, the new businesses hope to benefit from CRISIL's bank of knowledge and information about the business and economics in the country. In the foreseeable future, these businesses are unlikely to replace credit rating in importance. But diversification in income means the risk associated with its income stream is lower.

CRISIL has played a stellar role in the development of the debt markets in India, setting risk assessment benchmarks and rating more than 4,000 debt instruments till date, worth over US\$75 billion, for more than 1,800 companies. CRISIL's other businesses—Advisory and Research & Information—leverage the organization's core competencies in the areas of risk identification, quantification and assessment.

Revenue distribution for the year ended

on 31st March 2003:

Revenue stream	% age
Rating Services	68.0
Advisory Services	23.0
Research & Information	9.0

Systems

Total revenues:

INR 670 million (*approx. \$14 million*)

Current Issues

Core business has been slowing....

The current slowdown in fresh investment has led to a slowdown in the core business of rating debt instruments of the corporate sector. The company has embarked on an exercise to explore new business opportunities that can be tapped with its traditional strengths. Thus, there are ventures in information vending and advisory services. The contribution of the new ventures to revenue and profit is almost insignificant in relation

to rating. However, the potential of these new businesses is rich and can be exploited without CRISIL straying from its core strengths.

Fresh growth initiatives....

The management of the company is looking for fresh ways to drive growth such as introducing ratings for hospitals, educational institutions, builders, state governments and even film projects. Key developments such as an increase in securitization of receivables by financial and non-financial companies (since all securitized paper has to be rated for investor satisfaction) have the potential to kick start growth.

Advisory business....

This business has impressive growth prospects due to the developing nature of the Indian economy and the dismal infrastructure available to the country. At the same time the company's margins in this business are only marginally lower than the ratings business though debtors here are higher. CRISIL has also broadened the scope of its advisory services to include risk management for the banking sector as well as consultancy for capital market related activities.

Information business will take time to contribute....

If the impact of subsidiaries is taken into account, the valuations appear on the high side. The large losses of CRISIL.com are pulling down the consolidated net profit. It is unclear if CRISIL will continue to support the loss-making subsidiary (CRISIL.com Limited) and when the operations will start contributing to profitability.

Very long period of competitive advantage....

CRISIL's competitive advantage period, i.e. the period where it can earn returns on capital exceeding cost of capital, is very large. This is due to several facts. Firstly, the bargaining power of customers of the rating business is low, as a credit rating is essential in certain areas for the business of the customer and has no close substitute. Secondly, the CRISIL brand has over the years developed into a highly trusted brand in the financial industry and hence a rating by the company is generally accepted as a confidence-inspiring statement. This can be seen from the mutual fund industry using CRISIL's ratings even in their advertisements. This will act as a natural entry barrier for others. Finally, credit rating and advisory is a stable business with little likelihood of a catastrophic event changing the fortunes of the industry.

Impact of policy announcements....

Recent policy announcements by the Securities and Exchange Board of India ('SEBI') include the stipulation barring credit rating agencies ('CRAs') from rating securities issued by any borrower, subsidiary, or associate of the promoter of the CRA if there are:

- Common chairman, directors between CRA and these entities,
- Common employees, and
- Common chairmen, directors, or employees on the rating committees.

This regulation outlined by SEBI is likely to force CRAs floated by financial institutions to consider altering the composition of their Board of Directors and the rating committees

to suit the requirement of the regulations or alternatively risk losing a substantial chunk of their future business.

Financial Analysis, Earnings Power, Valuation

A great advantage of investing in India is that the language of business is English. Furthermore, India has adopted the Anglo-American “true and fair” approach to accounting for a business. However the specifics of Indian accounting conventions make it a little more difficult to get an accurate picture of what is taking place in the business.

The attached financial summary has been taken from the company’s extensive and detailed accounts, although close examination of the numbers reveals various apparent inconsistencies that are not easily reconciled. Nevertheless, the figures can be used as an indication of the 20%-plus annualized growth in earnings power that the company has achieved over the last 10 years. Such rates of growth are not inconsistent with the experience of companies such as Duff and Phelps in the United States.

The company has no debt.

The company currently trades at a multiple of 10 times reported earnings, and the ten year Indian government bond is currently yielding 6%.

Comparison with Duff and Phelps

From its spin-off from Phoenix Duff and Phelps to acquisition by Fimalac, Duff and Phelps compounded value at around 50% annualized. At spin-off, the company traded at valuations as low as 6-7 times earnings. So the high rate of return was partly the result of a low entry price, partly the result of a high rate of growth of intrinsic business value—growth which did not require much cash—and lastly, it was also a result of regular repurchases of shares at a discounted price. Duff and Phelps had management that allocated capital intelligently.

It is not clear that the management of CRISIL is equally astute: the company has not repurchased shares, even when they were at single digit earnings multiples. Furthermore, the company regularly recognizes gains and losses on the sale of smaller businesses which suggest that the company regularly allocates capital to projects which are at best not central to its mission, and are at worst value-destroying. Under the right management, the earnings power of the business might well be capable of growing at an even higher rate than the 20% annualized that we have witnessed.

The annualized return in CRISIL from now to a probable purchase of the company by Standard and Poors is unlikely to be much below 20% annualized, and might well be above this rate.

Risks

As the world’s largest fully-functioning democracy, India probably presents a much lower country risk than most other developing countries. Furthermore, CRISIL benefits from being central to the Indian financial sector, and being in a business which is capable

of attracting some of the most talented employees who have little to gain from cutting corners.

Standard and Poor's and the State Bank of India are both 10% shareholders, as are a number of India's leading financial institutions. This suggests that this company is much less likely than most in India to engage in practices that are obviously inimical to the shareholders.

That being said, the jurisdiction is India, not the United States.

Exhibit 1**Credit Rating Information Services Of India Ltd.****Summary Income Statement**

(Millions of Indian Rupees)	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>CAGR</u>
Revenues	69	100	153	217	267	360	402	403	515	693	26%
Pretax Profit	52	64	106	147	171	196	250	222	188	356	21%
Net Income After Tax									115	156	
Reported Net Worth	68	183	226	286	345	414	502	594	654	710	26%
Apparent ROE									18%	22%	
Revenues (US\$M)											15
After tax income (US\$M)											3