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Rating Methodology by Sector

Information Services

1. Business base

Despite sluggish growth in the domestic information services market, the number of companies remains large and competition is intensifying. In assessing credit ratings, JCR focuses on the stability of a company's business base and project management capabilities.

(1) Characteristics of the industry

(i) Market overview

Japan's information services industry, which emerged in the 1960s, has continued a trend of high growth through active IT investment aimed at building an information system infrastructure for users. The Japanese information services market is one of the largest in the world and comparable to its U.S. and European counterparts. In recent years, however, growth of the domestic market has been slowing due to increased penetration of the information system infrastructure and a shift of demand for information services toward other countries as a result of the globalization of domestic companies. While actual market growth is expected to continue, the pace of that growth is likely to decline.

Meanwhile, overseas markets are expected to continue their upward trend in the medium- and long-term, boosted by the continued growth of the giant U.S. and European markets as well as the development of emerging markets.

(ii) Competitive situation

As entering the information services industry is relatively easy, requiring only a small initial investment, the market is crowded with small and medium-sized companies. The market structure has taken the form of a pyramid, with the larger companies at the top followed by a gradually increasing number of medium-sized and small companies at the bottom. With sizeable projects, in many cases, the larger companies act as prime contractors who then outsource the development process to multiple layers of subcontractors. These layers may not only include small and midsize companies, but also hardware vendors and independent enterprises.

The past business relationships between service providers and their customers have generally been stable. The growth slowdown of the domestic market and an increase in offshoring (outsourcing to overseas service providers) by users, however, suggest that competition will intensify.

(iii) Cost structure

The pressure to reduce prices placed on service providers by customers aiming to cut costs is considerable, placing a heavy burden on a provider's earnings. Information services is a labor-intensive industry, with personnel and outsourcing expenses comprising the largest proportion of total expenditures. Service providers, therefore, need to be able to flexibly reduce their expenses by, for instance, controlling their outsourcing expenses in response to changes in demand.

Appropriate project management and cost controls are essential to eliminating unprofitable projects due to the large additional costs involved in contracted system development.

In recent years, cloud computing, in which service providers invest in the system and charge the users service fees, has been increasing. This suggests the possibility that providers will have to bear the burden of making prior investments in data centers and system development as well as the business risks associated with such investment. The effect on the cost structure, thus, must be monitored.

(2) Important factors in market position and competitiveness

(i) Market position

When determining a credit rating of information service providers, it is important to assess whether a company is capable of serving as the prime contractor in contracted system development or not. A prime contractor in charge of a large system development project, who uses subcontractors for the development, assumes the ultimate responsibility, including the project's cost and period of development. This involves a significant amount of risk while offering the potential for a relatively high level of earnings if the project is successfully completed. Such a prime contractor needs a number of skills, including the ability to draw good workers along with technical know-how. The development of mission critical systems that require high reliability is often led by industry-leading companies acting as prime contractors.

(ii) Business structure

The operations of information service providers can be broadly divided into contracted system development, system operation and maintenance, and business process outsourcing ("BPO"), such as contracted data entry. Because contracted system development is considerably affected by the IT investment trends of customers, demand is relatively volatile, and there is a risk that projects will be unprofitable. The contracts for system operation and maintenance and BPO are relatively long-term in many cases and thus, demand is more stable than in the case of system development. The risk that projects will become unprofitable is generally low, which is likely to contribute to cash flow stabilization and support the business to a degree, even when the number of system development project decreases. Rating assessment considers such characteristics of each operation and focuses on the business structure of each company. JCR investigates whether the strategy taken considers the balance among contracted system development, system operation and maintenance, and BPO.

(iii) Customer base

At present, information systems in Japan vary in the requirements and specifications for each company. Consequently, when a user planning to develop a system selects a prime contractor, one of the key factors is whether that contractor is familiar with the user's existing system and business model. Because this is likely to result in a relatively stable business relationship between the user and information system provider, an assessment of the customer base is important in establishing a credit rating. Factors to be examined include the business conditions with major customers, level of customer and industry diversification, and securing of overseas customers.

(iv) Ability to control outsourcing

When the number of system development projects decreases, a certain income level must be maintained by adjusting the amount of outsourced development processes to increase the ratio of in-house production and by reducing the unit price of outsourced operations to ensure the spread from the unit price of orders received. Outsourcing management with a clear direction that also attempts to acquire quantitative and qualitative resources when the conditions for orders received are favorable is considered essential.

Because improving the skills of internal human resources is crucial for appropriate outsourcing management, JCR also focuses on internal education and the qualifications obtained.

(v) Project management skills

Contracted system development, in some cases, becomes unprofitable when outsourced workers must be added or other measures must be taken for such reasons as unclear definitions of contract requirements with the customer, an inadequate follow-up during the process, and system problems arising during the development process.

Information services business is a labor-intensive business model, and completely avoiding unprofitable projects would be difficult. Information service providers nonetheless need to reduce the number of unprofitable projects by carrying out surveys prior to receiving orders or strengthening the review system during the process of projects.

In establishing a rating, JCR considers that improvement in the order acceptance policy and project management system must be carefully examined in addition to changes in the number of orders received, and subsequently, the profitability must be evaluated.

2. Financial base

(1) Earnings Strength

In the past, large information service providers have generally maintained a certain level of earnings, even during an economic downturn, by flexibly controlling their expenses, such as those for outsourcing The overall earnings environment of each company, however, has become increasingly severe, given the slowdown in market growth and intensifying competition among companies. The rating assessment focuses on how earnings strength is improved and maintained in such a harsh business environment. To assess the comprehensive earning strength, including the level of technical capabilities, project management skills, and cost cutting capacity in response to changes in demand, JCR focuses on the operating income and the ratio of operating income to sales.

Key financial indicators:

- Operating income
- Operating margin

(2) Cash flow

The ability to generate cash flow to provide funds for the repayment of interest-bearing debt is one of the financial indicators on which JCR focuses in assessing the credit rating of an information service provider. Such providers generally lack the assets that can be offered as collateral, and loan guarantees are limited to their ability to generate cash flow, which, therefore, is considered important in establishing a rating. JCR also examines the balance between interest-bearing debt and cash flow.

Key financial indicators:

- Cash flow from operating activities
- Free cash flow
- EBITDA
- Ratio of interest-bearing debt to cash flow from operating activities

(3) Safety

Information service providers basically do not require a large amount of capital expenditure, except when building a data center or other facilities. Many of them, therefore, carry a low level of interest-bearing debt. In addition, the ratio of fixed assets to total assets is generally low, even with low asset capacity and reserves. Such providers boast stable financial bases with well-balanced debt and capital.

In recent years, however, the need for investment, such as in the construction of data centers, in response to an increase in cloud computing as well as mergers and acquisitions aiming to gain a business base and expertise has been increasing. Because maintaining a sound financial structure continues to be important, JCR considers such indicators as the equity ratio in the rating assessment of information services providers.

Key financial indicators:

- Shareholders' equity
- Equity ratio
- Debt equity ratio

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