Rating Methodology

AIRLINE INDUSTRY

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RATING METHODOLOGY

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MEANING OF CREDIT RATING

CRISL defines credit rating is a measure of assessing relative risk of default and the severity of default associated with particular securities issue, issuer and/or other financial assets. It is a symbolic indication of current opinion of the relative capability of timely servicing of the debts and obligations as per the terms of contract. It is an independent, impartial best judged professional OPINION on the ABILITY and WILLINGNESS of a borrower to discharge its debt when due, in case of a debt instrument and assessment of net worth, external liability and earning prospects in case of a corporate Entity.

Rating agencies are perceived as impartial, professional and best judged opinion giving agencies in the investment process to safeguard the interest of the general investors. Rating reflects neutral and influence free professional opinion on the assessment of credit risk associated with an instrument or a corporate. The rating services provide a guideline to the investors as to the degree of certainty of payment of principal and interest in case of debt instrument and the degree of acceptability of the net worth and earning prospects of an entity seeking public finance.

SCOPE AND LIMITATIONS OF CRISL RATINGS

CRISL ratings are in local currency and therefore, it does not take into consideration the sovereign risks and foreign currency risk of Bangladesh. CRISL being a domestic rating agency of Bangladesh considers the government of Bangladesh as the highest pay master and all government guaranteed securities are considered as AAA.

CRISL issues two types of rating namely Entity Rating and Debt Instruments Rating. Entity rating reflects ability and willingness of an entity to discharge its debt obligation when due. It also reflects earning prospects and increase in shareholders value in the long run. The debt instrument rating reflects the inherent features and structures and extent of credit enhancement compared to unsecured creditors. It also reflects all associated risks that may affect the instrument over a period of it life.

TIME HORIZON

CRISL ratings are forward looking and sustainable throughout normal business cycle. CRISL issues normally two types of ratings – short term and long term. Short term rating carries the validity of six months while the long term rating is valid for one year. The changes in economic scenario, complexities and change in government policy may have an impact on the ratings assigned over a period of time. CRISL updates the rating periodically with the cooperation of the client. Incase the client is not willing to cooperate, CRISL withdraws the rating after due notice to the client. Therefore, CRISL ratings are to be read with the time

RATING DEFINITION

CRISL follows standard definition of ratings in line with the global rating agencies. It follows an eight notch scale with AAA being the highest while lowest rating D reflects default in discharging its liabilities in time. With the addition of plus (+) and minus (-) signs before the scale the 10 notch scale reflects 26 notches. These plus and minus signs indicates the position of each rating in the scale. The rating scales along with the definition are enclosed at the end of this report.

DEFINITION OF DEFAULT

CRISL adopted the international definition of default as being adopted by global rating agencies. Under the above definition, Default is:

A) A missed installment (Principal and or Interest) which has not been discharged / paid as per schedule or within the grace period allowed by the regulators/ creditors.
B) Failure to honour the corporate guarantee obligations as per contract or within the allowed grace period;
C) The legal insolvency or bankruptcy of the issuer/ entity
D) A distress exchange in which the bondholders/ creditors are offered a substitute instrument with inferior terms and conditions
E) Restructuring of a financial obligation substantially disadvantageous to the creditors;

RATING METHODOLOGY

CRISL rating objective for an Airline Industry is to assess likelihood of the company not being able to make timely payment of its obligations. Ratings being prospective in nature, CRISL integrates analysis of an entity's qualitative and quantitative factors with an assessment of the firm's strategic plan. CRISL rating analysis of airlines begins with the quality of a firm's balance sheet, the appropriateness of its liquidity and capital funding policies, and the effectiveness of its risk management strategies with regard to asset/liability management, exposure limits on clients, etc.

CRISL reviews the quality of the firm's financial fundamentals, evaluating its ability to attract adequate funding and generate profitable returns through market cycles. This review is central to the rating process and is supported by consistent monitoring of industry dynamics and competitive forces.

1. THE QUALITATIVE FACTORS

1.1 Industry Dynamics and Regulatory Framework

The airlines industries are highly regulated both by locally and internationally. In Bangladesh, Civil Aviation Authority Bangladesh (CAAB) functions as the regulatory body for all aviation related activities. At present, aviation activities are being carried out from 3 international and 5 domestic airports, about 17 air lines are now operating in and out of the country; about 43 States signed bilateral agreements with Bangladesh. Moreover, International Civil Aviation Organization (ICAO) sets standards and regulations necessary for aviation safety, security, efficiency and regularity, as well as for aviation environmental protection.

Airlines industries main strengths are global economic and demographic trends favorable for long-term demand growth, good government support and low technological risk, as such changes are evolutionary. The airlines service is vital to almost all national economies. In contrast, Airlines Industries are involved in a highly competitive industry in which business activity can be greatly impacted by fuel price volatility, sensitivity to the economic cycles, price competition, high barriers to exit and seasonal demand for travel. The labors are usually organized and powerful so unrest can impact severely in the industry. The industry can also be significantly affected by event risk, particularly resulting from regulatory or political developments. Such factors can lead to greater volatility in earnings and profitability relative to other industry sectors.

1.2 Competitive Position

Management

Success of any organization is in the continuity of its business strategies and depth & stability in its management team. CRISL reviews managerial involvement in risk control, its ability to innovate, focus of management on core competencies and the management's flexibility in responding to competition. Importance is given to planning & implementation processes, and the decision-making hierarchy also provide insight into the level of controls in place in the company and the confidence in the management team itself. Per employee revenues and costs would help determine management efficiency and economical utilization of resources. In the end, management expertise is reflected in the financial performance of the company.

Market Position

Market position is an important rating factor because it determines, to a large extent, the potential for revenue generation. These aspects are Route network, extent of competition, and barriers to entry; position within markets served; and passenger preference/customer service reputation and loyalty programs.

Diversification

Large airlines tend to benefit from geographic diversity. The sources of revenue can be diversified through customer base service, non-passenger airline business, and non-airline businesses such as engineering and other supporting services to other airlines.

Operating efficiency

Revenue generation is usually measured by operating revenue per available seat mile (one seat flown one mile). This measure combines the effects of capacity utilization and pricing. Similarly, costs are usually measured using operating cost per available seat mile. Evaluation of operating efficiency can be divided into Revenue generation, Cost structure, and Fleet evaluation.

2. THE QUANTITATIVE FACTORS

2.1 Financial Statements Analysis

Financial statements and related footnotes are the primary source of information about a company's financial condition and performance. The analysis begins with a review of accounting characteristics to determine whether ratios and statistics derived from the statements adequately measure a company's performance and position relative to those of both its direct peer group and the universe of industrial companies. This assessment is important in providing a common frame of reference and in helping the analyst determine the quality of disclosure and the reliability of the reported numbers.

2.2 Cash Flow Stability and Adequacy

Cash flow of a company plays a very important part in CRISL assessment procedure. CRISL in many cases reads the Financial Statements with due emphasis to cash flow. Stable cash flow provides comfort of judging the capability of the company to discharge its liabilities while free cash flow predicts company's ability to go for expansion or loan repayment capacity or business growth. Analysis of cash flow patterns can reveal debt-servicing capability that is stronger or weaker than might be apparent from earnings. For airlines, cash flow analysis assesses a carrier's ability to generate cash from internal sources relative to the claims against that cash.

2.3 Financial Flexibility and Liquidity

Liquidity is the key to judge the short term financial flexibility of a company. In addition the franchise value of the company to borrow quick fund from the market, relationship with the financial institutions, level of financial limits allowed by the banks and its utilization level, perception of the financial institutions for funding projects under the company, cash operating cycle etc provide wider coverage to the CRISL analysis. In case of Group companies, CRISL analysis goes beyond the individual company, rather Group cash flow, support of Group companies in case of funding need, extent of inter- company cash movement gets highest weight in judging the liquidity position of a company.

2.4 Capital Structure, Leverage, and Asset Protection

Funding structure of an organization may have an impact on its cash flow and mismatch in cash generation. CRISL places due importance to the financing pattern of long term and short term assets vis a vis the short term and long term debts. In addition, dependence of the company on financial intermediaries such as leasing companies for short term fund may also face liquidity problem in the economic volatile situation. CRISL also ties up the asset life with its financing pattern. Any machinery purchased through lease must not have any repayments after the machinery life is exhausted. Airlines tend to have higher leverage than other comparably rated industrial companies. This reflects heavy debt and lease usage to finance their fleets, as well as historically weak profitability (and thus retained earnings).

2.5 Risk Administration and Controls

Airlines have ready access to equipment financing, which sometimes tempts management to operate at higher-than-prudent debt leverage or even highly leveraged positions. Broad parameters of risk include price and interest rate risk, Market Risk, Fuel Price Volatility risk, Aircraft Utilization, Foreign Currency Risk and operational risk. A company's vulnerability to these risk factors may be measured by the volatility in revenues and pre-tax income. Earnings of an airline are exposed to the volatility of fuel price which is the most operating expense items of airlines industry. Airlines Industries' main source of revenue includes passenger services, air shipment or cargo services, Cargo Handling to Other airlines, Engineering Services to other airlines etc.

CRISL reviews the risk management guidelines, which have been developed by the company and the extent of any deviation from these guidelines. Risk management should be a continuous process in the company. CRISL evaluates the level of risk and the risk measurement & management tools being used and the extent of transparency. These tools should be robust enough to adapt to the changing needs of the company and the market. The management information system (MIS) should enable the company to carry out scenario and stress tests, identify concentration areas and signal non-compliance. Technology is one of the forces that have driven change in the aviation industries.

CRISL RATING SCALES AND DEFINITIONS LONG-TERM RATINGS OF AIRLINES INDUSTRIES	
RATING	**DEFINATION**
AAA Triple A (Highest Safety)	**Investment Grade** Airlines rated in this category are adjudged to be of best quality, offer highest safety and have highest credit quality. Risk factors are negligible and risk free, nearest to risk free Government bonds and securities. Changing economic circumstances are unlikely to have any serious impact on this category of companies.
AA+, AA, AA- (Double A) (High Safety)	Airlines rated in this category are adjudged to be of high quality, offer higher safety and have high credit quality. This level of rating indicates an airlines entity with a sound credit profile and without significant problems. Risks are modest and may vary slightly from time to time because of economic conditions.
A+, A, A- Single A (Adequate Safety)	Airlines rated in this category are adjudged to offer adequate safety for timely repayment of financial obligations. This level of rating indicates an airlines entity with an adequate credit profile. Risk factors are more variable and greater in periods of economic stress than those rated in the higher categories.
BBB+, BBB, BBB- Triple B (Moderate Safety)	Airlines rated in this category are adjudged to offer moderate degree of safety for timely repayment of financial obligations. This level of rating indicates that a company is under-performing in some areas. Risk factors are more variable in periods of economic stress than those rated in the higher categories. These airlines are however considered to have the capability to overcome the above-mentioned limitations.
BB+, BB, BB- Double B (Inadequate Safety)	**Speculative Grade** Airlines rated in this category are adjudged to lack key protection factors, which results in an inadequate safety. This level of rating indicates a company as below investment grade but deemed likely to meet obligations when due. Overall quality may move up or down frequently within this category.
B+, B, B- Single B (Risky)	Airlines rated in this category are adjudged to be with high risk. Timely repayment of financial obligations is impaired by serious problems which the entity is faced with. Whilst an entity rated in this category might be currently meeting obligations in time through creating external liabilities.
CCC+,CCC, CCC- Triple C (Vulnerable)	Airlines rated in this category are adjudged to be vulnerable and might fail to meet its repayments frequently or it may currently meeting obligations in time through creating external liabilities. Continuance of this would depend upon favorable economic conditions or on some degree of external support.
CC+,CC, CC- **Double C** **(High Vulnerable)**	Airlines rated in this category are adjudged to be very highly vulnerable. Airlines might not have required financial flexibility to continue meeting obligations; however, continuance of timely repayment is subject to external support.
C+,C,C- (Extremely Speculative)	Airlines rated in this category are adjudged to be with extremely speculative in timely repayment of financial obligations. This level of rating indicates Airlines with very serious problems and unless external support is provided, they would be unable to meet financial obligations.
D (Default)	**Default Grade** Airlines rated in this category are adjudged to be either already in default or expected to be in default.

Note: For long-term ratings, CRISL assigns + (Positive) sign to indicate that the issue is ranked at the upper-end of its generic rating category and - (Minus) sign to indicate that the issue is ranked at the bottom end of its generic rating category. Long-term ratings without any sign denote mid-levels of each group

SHORT-TERM AIRLINES RATING

ST-1	**Highest Grade** Highest certainty of timely payment. Short-term liquidity including internal fund generation is very strong and access to alternative sources of funds is outstanding. Safety is almost like risk free Government short-term obligations.
ST-2	**High Grade** High certainty of timely payment. Liquidity factors are strong and supported by good fundamental protection factors. Risk factors are very small.
ST-3	**Good Grade** Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Although ongoing funding needs may enlarge total financing requirements, access to capital markets is good. Risk factors are small.
ST-4	**Moderate Grade** Moderate liquidity and other protection factors qualify an entity to be in investment grade. Risk factors are larger and subject to more variation.
ST-5	**Speculative Grade** Speculative investment characteristics. Liquidity is not sufficient to ensure discharging debt obligations. Operating factors and market access may be subject to a high degree of variation.
ST-6	**Default** Entity is in default or is likely to default in discharging its short-term obligations. Market access for liquidity and external support is uncertain.