Rating Methodology – Trading Concerns

INTRODUCTION

CRISL defines credit rating is a measure of assessing relative risk of default and the severity of default associated 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.

MEANING OF CRISL RATING

Understanding the increasingly important role of ratings, especially in the light of Basel II guidelines, consistent and uniform default definition is critical and it has significant impact on the reliability and comparability of ratings across rating agencies. A rigorous and transparent definition of default makes the ratings assigned by a rating agency meaningful. Ratings can either indicate probability of default (PD) or Expected Loss (EL). The underlying principles guiding each of these approaches are not similar, and ratings that indicate probability of default are not directly comparable with ratings that indicate Expected Loss, especially at lower rating levels. Investors and market participants, thus, will compare only those ratings that are based on similar approaches, or make appropriate adjustments before comparison.

Considering the stage of development of rating environment in Bangladesh CRISL adopted rating definition of "Probability of Default". Therefore, all CRISL ratings indicate the probability of default and not the EL that may arise after the default.

DEFINITION OF DEFAULT

CRISL defines a default event as:

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;

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 Government. 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.

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 change 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 rating are to be read with the time.

RATING DEFINITION

CRISL follows standard definition of ratings in line with the global rating agencies. It follows a ten 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 notches scale reflects 26 positions. 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.

RATING METHODOLOGY

In order to rive at a meaningful rating CRISL considers a large number of qualitative and quantitative factors and applies the same in its analytical rigor. In order to avoid biasness in analysis, CRISL tries to convert the qualitative factors to quantitative which ultimately assist CRISL for back-testing of its methodologies. Quantitative factors include appraisal of the historic and projected financials, level of profitability, capacity utilization, capital expenditure need, cash flow adequacy, debt servicing capacity, free cash flow, and time series analysis. In order to arrive at meaningful assessment the financial statements are recast in order to make the ratios and analytical factors meaningful in line with the time horizon. All the factors considered by CRISL in its Analytical rigor may be clustered into four broad analytical risk blocks- Industry Risk, Business Risk, Financial Risk and Governance Risk.

1. INDUSTRIAL RISK

A. Regulatory framework

Regulatory framework has direct impact on the industry and to the firms operating under the industry. The regulatory framework of the industry in most cases are dictated by the government industrial policy, annual budgetary frame work and measures including tax holidays, cash incentives, labour laws, environmental compliance issues and even by the import policy of the government. In countries like Bangladesh, these policies are very unstable. There are instances that many good industrial units fell sick due to change of government policy allowing the import of the products at a cheaper price without due protection to the industries. The regulatory environment of the country sometimes also been influenced by external factors such as buyers requirements from abroad, WTO Commitment of the government etc.

B. Industrial Risks

Risks are inherent in all business. The operating environment dictates the factors to be taken into account while evaluating its long term performance and its possible impact on the cash flow, profitability and ultimately repayment capacity. As a general rule, the business profile, consumption pattern of the products being traded dictates the limitations and constrains of operating activities. For example, a firm in an industry can hardly achieve any effective growth if the industry as a whole has been suffering from recession.

The operating performance of trading firms is affected by trend of various economic variables including GDP, interest and exchange rates and nature of the industry. In addition, pattern of demand growth, elasticity of demand, plays an important rule in evaluation. The above unstable framework is again fuelled by inherent risk in manufacturing, unstable power supply, small and unstable market, entry of advance technologies in the economy. In view of above, with few exceptions, there is hardly any top category ratings in the manufacturing sector.

C. Growth Potentials

Growth potential of a firm vis a vis its industry growth plays an important role in CRISL analytical rating framework. The industry life cycle such as introductory stage, growth stage, maturity stage and sunset stage, all deserves a weightage in analysis. However, the above potential is always reviewed in the context of future risks potentials. Again the matured industries are not over risk weighted in view of maturity rather the factors such as business stability gets due priority vis a vis its other peripheral factors.

D. Vulnerability

The vulnerability of the industry through controllable and uncontrollable factors is considered in the analytical framework of CRISL. The degree of sensitivity of demand to economic cycle, change in government policies such as import policy, industrial policy, tariff policy etc are the key elements to be considered in rating an industrial unit. The volatility of prices of raw material may also create a vulnerable situation for the industries.

E. Industrial Cyclicality

Cyclicality of the products being traded plays important role in business. Companies dealing with sugar, cotton spinning, automobiles paper and pulp etc whose sales in volume moves with the macro economic fundamentals and the operation of which needs different volume of resources as it moves with cycle. CRISL analytical framework considers the high and low picks of the cycle and gives due weights to the factors at each stage of cycle and tries rates through the cycle. Under the above circumstances CRISL ratings are forward looking. Normally the companies in cyclical industries accumulate cash and creates buffer during the boom period in order to keeping the company in smooth operation during the down turn.

F. Entry Barrier

Strong restriction on the new entrant in the industry protects the interest of the existing companies and viewed as plus point while keeping the industry open for any body may at any point of time take away the share of the existing companies and ultimately poses a threat for survival or profitable operation. However, CRISL considers that the strong prohibition factors such as huge capital outlay, creation of franchise value and brand image of the products needing time, Government restriction, distribution net work etc may create entry barrier for the new entrants.

G. Size of the Business

Size of the business on the economy and the size of the companies operating under the industry play an important role in analyzing long term and long term viability. Large companies have greater tenacity and staying power due to their extensive resource base and stronger shields. Those companies also enjoy broader market access, larger market share, strong marketing network, franchise value which ultimately assist the company's long term viability.

H. Threats of Product Substitution

Availability of substitute at cheaper price or availability of substitute products at the door step may intensify the competition. CRISL analysis inter alia considers existing and potential substitutes that may stand as threat to the existing products of the company. In addition alternative use of the products is also explored to have an understanding under distress situation.

2. BUSINESS RISK ANALYSIS

Under the business risk analysis CRISL evaluates the issuers business model, business strategies and competitive strength in the industry. There is large number of sub sectors in the trading business depending on the product. Each need to be looked differently after due care to the business, manufacturing and competitive edges and advantages. However the broad spectrum of the analysis centers on the following broad guidelines.

3. MARKET RISK

A. Competition

The product lines and its market share determine the nature of competition an organization may face. In order to survive in the competition, the cost efficiency in production and quality of product at competitive price is essential. Presently competitive advantages are being created through strong IT infrastructure build up and supply chain which are given due weight in the analytical process.

B. Market Position and Size

Market share and size of the organization plays an important role in deciding on the competitiveness of a company. Size of an organization assist in achieving economy of scale, determining economic order size, cost efficiency and thereby lowering the unit cost of production. The size of an organization also justifies the research expenditure, effective distribution channel and branch network. However, size of an organization does not always speak for the advantages mentioned above. In a highly fragmented industry, price leadership goes with the quality of product and not by the size of the organization.

C. Product Demand

Product demand in the market is a very important factor in the process of ascertaining the market stability and future growth. In this connection CRISL reviews the organizations' business handling capacity compared to the market demand, seasonality of the product demand etc are critically reviewed.

D. Product and Service Diversity

In a highly competitive environment more particularly in the industries having frequent change in technology, product diversity and scope of switchover to other alternative products with small or no cost is considered to be a favorable point in the overall rating process. In the rating process, the diversity is considered to be mitigating factor against concentration risk. Companies having more product lines are always preferred to the companies dependent on single product or product line.

E. Customer Analysis

The number of customers occupying large portion of receivables, customer concentration, company reliability on few customers, capacity of the company to absorb the shock of switching over to new customer, impact of customer shifting to other competitors are reviewed by CRISL in its analytical exercise. Dependence on the customers in various market segments such as Domestic vs export market, whole sale vs retail market, distribution channels, long term sales contract, impact on market due to change in price all are given due weightage while carrying out customer analysis.

F. Customer Satisfaction

CRISL reviews customer satisfaction of an organization in order to ascertain the market continuation and market growth. Customer satisfaction can be reviewed by average continuation of a customer with the company, repeat orders, product rejection rate etc.

4. OPERATIONAL RISK

A. Credit Controls

Credit control policies and its effectiveness play an important role in the liquidity management of the trading companies. The companies require cash constantly from the business cycle. In case of export/import oriented trading companies, the Status of payment terms of the export LC vis a vis back to back LCs needs review to assess the funding mismatch.

B. Inventory Management

Inventory management plays a vital role in the working capital management of a trading organization. Excess inventory increases the holding cost and thus increase the working capital need while inadequate inventory leads to market loss production stop or excess production cost. CRISL reviews inventory planning, supply chain management, lead time, economic order quantity etc in addition to the risk of getting the finished products out of fashion , risk of expiry date etc.

C. Distribution Network Management

Distribution network management covering maximum clients to receive the goods in time is an essential element of running business successfully. Customer relationship management systems, tracking sales by network, exclusive vs non-exclusive distributorship rights etc gets due priority in CRISL evaluation.

5. FINANCIAL RISK

Every business decision ultimately leads to a financial decision. While the financial risks are the outcome of the business risk and activities, CRISL reviews the same from the perspective of short-term and long term financial planning and projections vis a vis financial flexibility to meet emergency financial need. CRISL generally reviews the audit reports in order to ascertain as to its reliability from various perspectives. However, in many cases CRISL reviews the financial statements from the view point of cash flow trend, management reports, peer analysis based on quantitative production/activity reports. Accounting systems/ practices, measurement system, inventory valuation, depreciation methods, quality of audit and auditors comfort level, audit qualification, management report of the auditors, application of international accounting standards in accounting plays an important role in CRISL financial analysis.

A. Profitability and Coverage

Although the absolute profitability figures such as Earning (profit) before Tax and interest,(EBIT), Return on equity, return in investment etc, CRISL puts due weight to profitability indicators, profitability trend vis a vis industry norms, position of a particular company in the peer.

B. Funding Structure

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.

C. Capital Structure / Leverage

Capital structure of an organization varies from industry to industry. CRISL identifies industrial norms in respect of debt equity ratio, coverage ratios, overall gearing ratio, interest coverage ratio, debt servicing coverage ratio in order to measure the degree of leverage. CRISL also reviews the off balance sheet assets and liability items such as guarantees, LCS together with BB LCS in order to ascertain its leverage.

D. 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. To CRISL, Cash flow balance sheets rather provide more reliability of financial statements than normal statements. 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.

E. 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 provides wider coverage to the CRISL analysis. CRISL also reviews the company's failure in updating CIB/any compliance report of the central Bank in case of any default. 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 weightage in judging the liquidity position of a company.

F. Financial Management

CRISL rating analysis places due weight to the quality of financial management. Managing Finance through budgetary control system, working capital management through budgetary control system, management of cost efficiency through installation of appropriate cost accounting system, product costing , use of accounting information by the management, IT base financial management system, quality of the manpower and their qualification etc all are taken into consideration while ascertaining the extent of financial management.

6. GOVERNANCE RISK

A. Corporate Goals and Strategy

Although the Memorandum of Association of the company contains a large number of objectives, the company normally pursues one or two main objectives on the basis of which the MISSION and VISION Statements are prepared in order to determine the corporate goals. Companies operating on the basis of certain corporate goals as reflected in operating activities.

B. Corporate Governance

Corporate governance is a blend of law, regulations, enforcement and appropriate voluntary practice by the organizations that permit a corporate to attract capital, perform efficiently and generate long term economic value for its shareholders while respecting the interest of its stakeholders and society as a whole. The specific areas covered are composition of Board, formation of Committees, transparency in disclosure of relevant, reliable financial and operational information, information on ownership and control and information on internal processing of management. CRISL places due importance to the governance factors in the rating process of an organization

C. Succession Planning/ Family Owned Outfit

The succession plan is the key indicator of corporate philosophy that an organization is a going concern and it has unlimited life and its viability will not be affected on the departure of any individual professional. In order to reduce the dependency on single / few individuals a succession plan in a corporate reflects the management idea of business management continuity and its succession. CRISL while reviewing the management philosophy takes into consideration of the above factor. In addition, through the succession plan, the visibility of family management vs professional management becomes more prominent.

D. Credibility and Integrity

Credibility to a great extent may be reflected in its franchise value and public perception in the market. However, in order to identify the willingness of the company to discharge a liability in time, CRISL philosophy is to see the corporate environment prevailing in the organization vis a vis the strategy being followed to achieve the corporate goals through managing its diversified business. In addition, corporate policy to management of conflict of interest, handling inter company transfer pricing and inter company transactions also reflects the credibility of the organization and its system.

E. IT Infrastructure

The extent of Information technology and communication infrastructure installation and the extent of its use in the production and product management, cost management, inventory management play an important role in managing an organization. CRISL review process places due importance to the above factors in order to ascertain the competitiveness in both local and international market.

CRISL RATING SCALES AND DEFINITIONS

LONG TERM RATINGS OF CORPORATE

RATING	DEFINITION
AAA Triple A (Highest Safety)	**Investment Grade** Entities 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)	Entities rated in this category are adjudged to be of high quality, offer higher safety and have high credit quality. This level of rating indicates a corporate 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)	Entities rated in this category are adjudged to offer adequate safety for timely repayment of financial obligations. This level of rating indicates a corporate 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)	Entities 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 entities are however considered to have the capability to overcome the above-mentioned limitations.
BB+, BB, BB- Double B (Inadequate Safety)	**Speculative Grade** Entities 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)	Entities 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)	Entities 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)	Entities rated in this category are adjudged to be very highly vulnerable. Entities 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)	Entities rated in this category are adjudged to be with extremely speculative in timely repayment of financial obligations. This level of rating indicates entities with very serious problems and unless external support is provided, they would be unable to meet financial obligations.
D (Default)	**Default Grade** Entities 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 RATINGS OF CORPORATE

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	**Non-Investment / 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.