Small and Medium Enterprise

Rating Methodology

SME

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PREAMBLE

Small andMedium Enterprises, popularly known as SME, are playing an unique role in a developing economy like Bangladesh and contributing significantly towards GDP. In the declining trend of agricultural land and limited absorptive capacity of large industries, SMEs in Bangladesh have an important role to play in generating employment opportunities for nearly a million new entrants to the labor force every year. In order to cater to the need of the growing export sector, the linkage support services are creating a congenial atmosphere for the growth of SMEs side by side with the Export oriented industries. Present encouragement of the government and its policy reforms supported by growth of domestic demand for SME products and services are creating a level playing ground for the sector to exist, side by side with large industries in the country. There is increasing realization at the policy level that efforts towards development of SME need to be integrated with the mainstream poverty reduction strategy. Keeping the view in mind Government and lending institutes are keen to support the sector. Realizing the importance, some of the banks have already opened separate SME branch. At present SME lending constitutes more than 20% of the total lending portfolio of banks.

Like many other countries, SME sector in Bangladesh is, by and large, unstructured and informal; and in most cases required documentation is absent either for lack of expertise or knowledge. In many cases the entrepreneurs are unaware of the business or the market risk emanating from change in Govt. policy which results to a big credit portfolio to fall under default risk. From the lenders point of view, these organizations, in most of the cases, do not have accurate financial statements, required information for appropriate documentation and sectoral studies. On the contrary, the security arrangements against the loan exposures of the small enterprises are at minimum level; even in case of medium enterprises, it may not cover the loan amount. In view of the above, proper assessment of risk through research, and sectoral study side by side with Government policy is very crucial. Having the above in reality, SME is a potential large sector for financing which also needs substantial fund and encouragement for the overall development of the economy. In view of the growing importance as well as inherent distinguished feature of SMEs, CRISL developed separate rating methodology for Small and Medium Enterprises with the Title 'SME Rating Methodology'. CRISL SME Ratings is an overall assessment of the creditworthiness of the borrower as well as a guide in assessing the risk of the business which will ultimately identify the inherent advantages and limitations of the individual enterprises and thus assist it to increase the business efficiency and its graduation towards next higher scale. CRISL SME rating methodology differs significantly from traditional corporate rating methodology in view of their business nature. The SME ratings basically cover those entities which are ideally not any limited company rather business entities operating under sole proprietorship or partnership. However, private limited companies operating in a small scale within the range of definition by the regulator may be included in the SME rating periphery of CRISL.

CRISL RATING PERSPECTIVE

Understanding the increasingly important role of ratings, 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 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;

DEFINITION OF SME

CRISL recognizes the SMEs in accordance with the definition of Industrial Policy 2010 and the definition approved by the Bangladesh Bank's SME and Special Programs Department or any changes thereof made from time to time. As per definition, SMEs are categorized into three broad areas: manufacturing, service and trading. The recognition criteria of Bangladesh Bank for small and medium enterprises are fixed assets (excluding land and building) and number of workforce. The latest criteria for SMEs as given by Bangladesh Bank are given below:

A. Medium Industry/Enterprises:		
Recognition Criteria	Manufacturing	Service / Trading
Fixed Assets in Mill. TK Workforce	100-300 or 100-250	10 to 150 or 50-100

B. Small Industry/Enterprises:		
Recognition Criteria	Manufacturing	Service / Trading
Fixed Assets* Workforce	5 to 100 or 25-99	0.50 to 10 or 10-25

** Excluding Land and Building*

While recognizing the SMEs, CRISL primarily focuses on the number of workforce which can be determined from the payroll sheet of the last month. However other criterion will also be used if available and reliably measured.

CRISL RATING SCALE

From entity point of view most of the Small andMedium enterprises are not incorporated as companies under the Companies Act and operating as a sole proprietorship enterprise, partnership enterprise, associations or joint ventures. However, with the above status these Enterprises are enjoying various funded and non-funded financial facilities from the bank and non-banking financial institutions as an enterprise with valid Trade license, specific permission from local authorities, certification of trade bodies or other recognized authorities. The central bank has been encouraging the banks to extend financial support to the small and medium enterprises, in view of its contribution to the national economy.

CRISL Small and Medium Enterprise rating scales have been made different from corporate rating scale to depict clear distinction of its operation from traditional corporate entities. Considering the nature of finance CRISL offers only long term rating. For long term SME rating, CRISL uses rating scale with a prefix "*CRISL-Mefor medium enterprises and CRISL-Se*" for small enterprise rating.

The loan facilities/ exposures being enjoyed by those enterprise with the prefix *blr* like the bank facilities being enjoyed by the corporate or any other organizations.

CRISLRating Scales for Medium Enterprises

Long Term

CRISL Me 1 (Highest Safety)	**HighestInvestment Grade** MediumEnterprises 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 entities.
CRISLMe 2 (Higher Safety)	**High Investment grade** MediumEnterprises 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 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.
CRISL Me 3 (Adequate Safety)	**Investment Grade** MediumEnterprises rated in this category are adjudged to offer adequate safety for timely repayment of financial obligations. This level of rating indicates an enterprise with an adequate credit profile. Risk factors are more variable and greater in periods of economic stress than those rated in the higher categories.
CRISL Me4 (Moderate Safety)	MediumEnterprises rated in this category are adjudged to offer moderate degree of safety for timely repayment of financial obligations. This level of rating indicates that an Enterprises may also have some under-performing areas due to economic, financial or operational environment. Risk factors are more variable in periods of economic stress than those rated in the higher categories. These Enterprises are however considered to have the capability to overcome the above-mentioned limitations.
CRISL Me5 (Inadequate Safety)	**Speculative Grade** MediumEnterprises rated in this category are adjudged to lack key protection factors, which results in an inadequate safety. This level of rating indicates an enterprises as below investment grade but deemed likely to meet obligations when due. Overall quality may move up or down frequently within this category.
CRISL Me 6 (Risky)	Medium Enterprises rated in this category are adjudged to be with high risk. Timely repayment of financial obligations is impaired by serious problems, which the enterprise is faced with. Whilst an enterprises rated in this category might be currently meeting

	obligations in time, continuance of this would depend upon favorable economic conditions or on some degree of external support.
CRISL Me 7 (Vulnerable)	**Non investment grade** Medium Enterprises 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.
CRISL Me 8 (Highly Vulnerable)	Medium Enterprises 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.
CRISL Me 9 (Extremely vulnerable)	Medium Enterprises rated in this category are adjudged to be extremely speculative in timely repayment of financial obligations. This level of rating indicates Enterprises with very serious problems and unless external support is provided, they would be unable to meet financial obligations.
CRISL Me 10 (Default)	**Default Grade** Medium Enterprises rated in this category are adjudged to be either already in default or expected to be in default.

CRISLRating Scales for Small Enterprises

CRISLSe 1 (Highest Safety)	**Highest Investment Grade** Small Enterprises 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 entities.
CRISLSe 2 (Higher Safety)	**High Investment grade** Enterprises 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 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.
CRISLSe 3 (Adequate Safety)	**Investment Grade** Small Enterprises rated in this category are adjudged to offer adequate safety for timely repayment of financial obligations. This level of rating indicates an enterprise with an adequate credit profile. Risk factors are more variable and greater in periods of economic stress than those rated in the higher categories.
CRISLSe 4 (Moderate Safety)	SmallEnterprises rated in this category are adjudged to offer moderate degree of safety for timely repayment of financial obligations. This level of rating indicates that an Enterprises may also have some under-performing areas due to economic, financial or operational environment. Risk factors are more variable in periods of economic stress than those rated in the higher categories. These Enterprises are however considered to have the capability to overcome the above-mentioned limitations.
CRISLSe 5 (Inadequate Safety)	**Speculative Grade** Small Enterprises rated in this category are adjudged to lack key protection factors, which results in an inadequate safety. This level of rating indicates an Enterprises as below investment grade but deemed likely to meet obligations when due. Overall quality may move up or down frequently within this category.
CRISLSe 6 (Risky)	Small Enterprises rated in this category are adjudged to be with high risk. Timely repayment of financial obligations is impaired by serious problems, which the SME is faced with. Whilst an Enterprises rated in this category might be currently meeting obligations in time, continuance of this would depend upon favorable economic conditions or on some degree of external support.
CRISLSe 7 (Vulnerable)	**Non-Investment grade** Small Enterprises 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.
CRISLSe 8 (Highly Vulnerable)	Small Enterprises 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.

CRISLSe 9 (Extremely Vulnerable)	Small Enterprises rated in this category are adjudged to be extremely speculative in timely repayment of financial obligations. This level of rating indicates Enterprises with very serious problems and unless external support is provided, they would be unable to meet financial obligations.
CRISLSe10 (Default)	**Default Grade** Entities rated in this category are adjudged to be either already in default or expected to be in default.

BENEFITS OF SME RATING

For lenders, a CRISL SME Rating would:

• Provide an objective, independent and reliable opinion on credit quality

• Serve as an additional input in the credit decision making process

• Assist in risk pricing and capital allocation

• Facilitate portfolio management and monitoring

For the rated SME, a CRISL Rating may help to:

• Improve the comfort level with prospective/existing lenders

• Negotiate better terms on the basis of the credit quality reflected by the Rating

• Reduce the time involved in obtaining loan approvals

• Project a better image to prospective/existing trade partners

• Carry out self-evaluation and take timely and corrective measures for improvement

RATING METHODOLOGY

CRISL considers both quantitative and qualitative factors in reviewing the SME operation. The methodology is comprehensive where review area concentrates six broad categories– Financial Risk, Industry Risk,Business Risk, ManagementRisk Banking Relationship Risk, Security Risk. Although, the above concentration areas are in line with corporate rating methodology, the relative weightage for different parameters may differ in between the two sectors. Due to such unstructured form of information as well as poor recording system of SMEs, CRISL has developed its own structured format covering the aforementioned areas of concentration for information collection. The financial position (i.e. Balance Sheet and Income Statement) and Cash flow Statement may either be collected as per the structure provided or the analyst team justifies the information provided as per their reporting format that may either be audited or management reporting signed by the sponsors/promoters. The analytical rigor may differ among the SMEs due to operation nature; however, major categorization will be in line with the definition of Bangladesh Bank which are: Trading, Manufacturing and Service oriented business. CRISL tries to convert the qualitative factors to quantitative which ultimately assist CRISL for back testing of its methodologies. In order to arrive at meaningful assessment the financial statements are reshaped frequently in order to make the ratios and analytical factors meaningful in line with the time horizon.

INDUSTRY RISK

SME as such does not represent a particular industry. However, it has its presence in majority of the economic sectors of the economy since it operates as linkage and supportive to the industry either by productor by services. Therefore, the industry related risks might have impact on the operation of related SMEs. In consideration of the above CRISL factors the scope of diversification, industry size, supply gap, government policy towards the industry, nature of the product, social desirability, entry and exit barriers etcwhile rating SEMs broadly.

BUSINESS RISK:

Business risk arises due to change in market situation and from its own operation infrastructure. Under the business risk, CRISL assesses the sustainability of the business in the changing market situation. Due to their limited scale of operation, their business nature differs in different mode like manufacturing & marketing in a specific geographical region or functioning as support service to large scale manufacturers or trading of goods through import or local procurement, or even at agro-based level. CRISL reviews the relevant infrastructures of each of the client and compares its standing among the peers. Most SMEs are basically the backward operation of the formal sector; hence, rarely have control over pricing or fully market dependent. Even market competition is very high due to large number of SMEs in the same business. Thus, customer group, performance track record, relationship with the suppliers, business network and the necessary infrastructures are important in market positioning of an enterprise. In order to assess the entity's manufacturing facilities, and other parameters mentioned above, CRISL team visits the premises of the enterprise and also sometimes meet with the suppliers and consumers to assess the relationship between them. CRISL also meet with the promoters to understand the business plan and growth strategies.

In case of new project in SME sector, CRISL follows the same key consideration factors in the project finance in limited scale. The key parameters include: project viability in respect of market situation, estimated project cost, cost overrun, implementation plan, competence of the sponsor in implementing new project, estimated cash generation from the project and also the project location and availability of necessary manpower. Evaluation of the above factors is vital in new projects rating framework along with the expansion of the existing business.

MANAGEMENT RISK:

SMEs are typically managed by one or two promoters mostly related as family members or members from the known community. Unlike corporate, SMEs are rarely managed by qualified professionals; hence, performance of the enterprise is highly dependent on the experience and expertise of the entrepreneur in managing the business. A good number of promoters do not have formal education, however, involved in the business as inheritance. In assessing the competence of the promoters, track record and risk taking capacity is an important consideration in CRISL SME rating framework. CRISL, however, considers the capacity of the support employees in many cases to handle the business efficiently. Working condition and relationship between the employer and employees is an important consideration factor. CRISL reviews all those factors that may cause business failure due to perceived inefficiencies in management. Generally lenders have good control over the borrowers in SME sector, however, willingness to repay loan is an important characteristics even having good ability to pay its obligations which is being reflected by his/her track record. CRISL, in addition to those, reviews the performance of the promoters in other business, experience in the same or different line of business, succession of the promoters etc.

FINANCIAL RISK:

As mentioned earlier, SMEs are typically set up as, sole proprietorship, partnershipor private limited companies (very few in number in the country context). SMEs that are constituted as a company are required to prepare audited financial statement in each year. However, most cases audited statements do not reflect the true business picture due to possible tax burden. Additionally, disclosures in the statements are very poor to derive reasonable conclusion. In most cases CRISL faces constraint to give comments based on it. The situation is more acute in case of sole proprietorship and partnership businesses. CRISL, in consideration of the above, provides structured format to each client being rated to supply information about its financial position, working capital utilization and cash flow movement. Besides bank transaction statement may be a good support to justify and assess its business volume.

CRISL assessment of financial risk includes identification of net worth, asset size, liability, turnover, cost pattern, profitability, cash flow adequacy to debt repayment, and other important performance indicators. The ratio calculation is same as in the corporate ratings but adjustment is made as per the nature of the business. CRISL analysts are basically entrusted with the responsibility to frame opinion about the entity's ability in debt repayment based on its cash flow assessment. The future cash flow estimation against the debt obligation is also important in CRISL SME rating framework.

CRISL also assesses the flexibility of the entity in fund arrangement; especially the relationship with the bank is considered. CRISL also assesses the expected financial support from the sponsors in any distressed position of the SME. In view, the sponsor(s)' personal assets are being assessed specially for sole proprietorship and partnership business.

BANK RELATIONSHIP RISK:

Review of banking relationship is very important in SME rating process. The analyst team must visit the respective branch to meet with the bank professionals to collect information about the loan payment history, reason against the delay in payment, utilization performance of the loan limit, security against the loan, control over the security, and related issues. Any loan classification may create problem to the respective entity in further borrowing from the bank.

SECURITY RISK

Although security against a loan is a post-default event and has bearing only in recovery rating, security offered against an SME loan plays an important role in the repayment sbehavior of the borrower even in the process of loan repayment. In view of the above CRISL places special emphasis on the collateral offered against SME loan. Loan coverage through FDR, hypothecation, guarantee, collateral, third party guarantee etc. are factored in the rating evaluation process.

OTHER FACTORS:

Other than the above broad areas, other parameters like impact of subsidies/taxation by the government, sudden business loss, impact of non-insurance or inadequate insurance of assets, extraordinary or windfall gains and losses, legal or environmental embargo, disaster management policy, impact of the new monetary or fiscal policies or significant development in the industry are thoroughly assessed on case to case basis.

RATING VALIDITY

CRISL's rating of the SMEsis valid for one year from the date of rating assigned. However, CRISL keeps the rating under surveillance with half yearly assessment during the validity periodand rating needs renewal every year to keep the rating updated.

CRISIL