CRISL

Credit Rating Information and Services Limited

# Credit Rating Methodology – Debt Instrument

## Meaning of Credit Rating

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.

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 Limitation of Credit Rating

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 al government guaranteed securities are considered as AAA.

CRISL issues to types of rating for the manufacturing corporate namely Entity Rating and debt instruments. Entity rating reflects ability and willingness of an entity to discharge its debt obligation when due. It also reflects earning prospects and increase in share holder's 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 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. In case the client is not willing to cooperate, CRISL withdraws the rating after due notice to the client. Therefore, CRISL rating is 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 notch 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.

## 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 honor 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

In order to arrive 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.

## Rating Debt Instruments

CRISL undertakes debt instrument ratings for all kinds of short-term and long-term instruments. A debt instrument rating is an assessment of a specific debt issue of an entity and it provides an opinion on the entity’s ability to meet the financial obligations with respect to the debt instrument, when it becomes due. CRISL considers both the payment of interest and repayment of principal in the rating framework of debt instrument. In its analytical rigor CRISL takes into cognizance of both the issuer and issue specific fundaments as well as legal recourse of Trustee.

## A. ISSUER STRENGTH CONSIDERATION

While forming an opinion on an issuer, CRISL evaluates the underlying entity as per the specific methodology applicable to its operation. For instance, for an industrial corporate issuer, Corporate Rating Methodology would apply, while, for a Bank/NBFI, Bank and NBFI Methodology would be applied to arrive at rating of the issuer. Broadly, the rating criteria applied to issuer is as follows:

**Qualitative Factors for Issuer**

Qualitative risk profile is assessed by soliciting information from client and direct interaction with senior and mid level management, review of operation of all functional departments conducting a visit to plant site and head offices as well as conduct meeting with Board for potential change in key policy/ strategic objectives that may guide the entity’s future operation.

In qualitative evaluation CRISL analyzes the legal structure and shareholding mix of an entity to determine the man at the last mile. Determining the skillset of the sponsor and sponsor’s willingness and ability to support the entity financially, if needed. It covers the studying of historical evolution of an entity and the nature, scale and diversity of its operations. Quality, effectiveness and soundness of management personnel as well as systems of an entity Effectiveness and transparency of governance practices of an entity is evaluated in qualitative assessment. Others key factors for qualitative assessment of entity are

1. Market Demand
2. Market share (both local & export market)
3. Product diversification
4. Market diversification
5. Experience in the relevant sector
6. Infrastructural facility and technical collaboration
7. Quality control Mechanism

**Quantitative Factors for Issuer**

Quantitative risk profile is assessed by looking at economic conditions, industry dynamics, and standalone performance of the issuer relative to peers – through financial statements, projections, financial strategy and cash flow analysis. This is very much numbers driven.

**Business Risk:** Study of the macroeconomic environment within which an entity operates, its current standing and level of competitiveness. Looking at the scale, stability and diversification of revenues, as well as key costs. Analyzing the impact of the aforementioned factors on financial performance and profitability of the entity and how it is likely to behave, going forward.

**Financial Risk:** Analyzing an entity's financial profile with respect to working capital management, coverages and capitalization with the key objective of understanding the nature, volume and quality of the entity's financial assets and liabilities and how well it is managing them.

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.

## B. B.0 INSTRUMENT RATING CONSIDERATION:

Apart from issuer profile the factors that CRISL emphasizes while rating of debt instrument, are: i) relative seniority of the instrument compared to the issuer's other obligations, and ii) presence of credit enhancement features. An instrument that carries a claim equal or superior to the issuer's other obligations, is viewed positively from a rating perspective, compared to subordinated instruments.

**B.1 Credit Enhancements:** Presence of certain features may place a particular debt instrument in comfortable or higher position relative to its issuer or its issuer's other debt instruments. Some common examples of credit enhancement features include collateralization, cash collection mechanism and third party guarantees.

**B.1.1 Collateralization:** The collateral underlying a debt instrument may influence the rating debt instrument provided that the terms of the issue allow for the liquidation of the collateral to making the missed payment/installment before an event of default is recognized. In such cases, CRISL looks at the following features of the collateral:

- Extent of coverage – the higher the coverage offered by the collateral compared to the debt obligation, the more favorable rating impact to the issue. This is viewed in conjunction with the volatility in collateral value

- Liquidity/marketability – the higher the likelihood of the collateral being monetized in a timely manner with minimal premium, the more favorable rating impact to the issue .

- Nature of charge – exclusively held, earmarked collateral (preferably in favor of an independent third party usually the trustee) is likely to lead to favorable impact to the issue rating.

Collateralization over and above the outstanding instrument value, with assets that can be monetized before the due date for debt servicing by the issuer or trustee/investment agent in case the issuer misses a payment/installment, is considered superior and likely to result in higher rating. Provision of any upfront liquid asset/cash collateral may also warrant higher impact in case of issue rating.

**B.1.2 Cash Collection Mechanism:** Debt instruments may be secured by a cash collection mechanism, whereby cash flows generated by the issuer are used to fund a debt service reserve, typically monitored by the trustee/investment agent. These cash flows may or may not emanate from earmarked assets (also referred to as "escrow mechanism"). In determining the impact of the cash collection mechanism on the credit rating of the instrument (if any), key factors to assess include:

- Cash source – greater comfort would be derived if the source of the cash is identified/earmarked.

- Extent of coverage – a cash collection mechanism covering both principal and markup, and the longer the period of debt servicing covered by the cash collection mechanism, the higher the rating impact

- Replenishment mechanism – timely restoration of the reserve once it is utilized to make a payment and source of replenishment, is important. CRISL looks at the cushion in No. of days between the date of replenishment and payment date

**B.1.3 Third Party Guarantees:** The debt instruments that carry third party guarantee may provide additional support to its rating. In determining the impact of a guarantee on the credit rating of the instrument (if any), key factors to assess include:

- **Invocation of the guarantee** – a pre-default guarantee invocation mechanism must be in place; CRISL does not consider post-default guarantees to be a credit enhancement from rating perspective
- **Legal clauses** – strong legal clauses pertaining to enforceability, irrevocability and unconditionality are expected

- Financial profile of the guarantor (or its credit rating, where available) having incorporated the burden of the guarantee into its debt profile – if the guarantors' financial profile/credit rating is weaker than that of the issuer, it is unlikely to result in higher rating benefit
- **Extent of coverage** – a guarantee which does not cover all obligations of the instrument (partial guarantee), for its entire duration, is likely to result in limited rating benefit

Overall, the strongest form of guarantee is considered where the guarantee covers all obligations of an instrument for its entire tenure, with strong legal clauses and a well-defined invocation mechanism.

In such cases, given that the financial profile/credit rating of the guarantor is stronger than that of the issuer, it may carry positive impact on instrument rating and may also result in equalization of instrument rating with the credit rating of the guarantor.

Between the various types of credit enhancements, third party guarantees are generally likely to result in the highest rating impact. This is because other forms of credit enhancement, including collateralization and cash collection mechanism cannot fully be isolated from the issuer and remain vulnerable to changes in issuer's operational viability and credit profile. Explicit third-party guarantees provide supplementary support completely delinked from the issuer.

## CRISL RATING SCALES AND DEFINITIONS

### LONG TERM RATINGS OF DEBT INSTRUMENT

| RATING | DEFINITION |
|---|---|
| **AAA**<br>Triple A<br>(Highest Safety) | **Investment Grade**<br>Securities rated in this category are adjudged to be of highest credit quality. This level of rating indicates highest level of safety for timely payment of interest and principal. Risk factors are negligible and nearest to risk free government securities. |
| **AA+, AA, AA-**<br>(Double A)<br>(High Safety) | Securities rated in this category are adjudged to be of high credit quality and offer higher safety. This level of rating indicates a security with sound credit profile and without significant problems. Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions. |
| **A+, A, A-**<br>Single A<br>(Adequate Safety) | Securities rated in this category are adjudged to be of good credit quality and offer adequate safety for timely repayment of financial obligations. Protection factors are considered variable and more susceptible to changes in circumstances than securities in higher-rated categories. |
| **BBB+, BBB, BBB-**<br>Triple B<br>(Moderate Safety) | Securities rated in this category are adjudged to offer moderate safety for timely repayment of financial obligations. This level of rating indicates deficiencies in certain protective elements but still considered sufficient for prudent investment. Risk factors are more variable in periods of economic stress than those rated in the higher categories. |
| **BB+, BB, BB-**<br>Double B<br>(Inadequate Safety) | **Speculative Grade**<br>Securities rated in this category are considered to be of speculative grade but deemed likely to meet obligations when due. Present or prospective financial protection factors fluctuate according to industry conditions or company fortunes. Overall quality may move up or down frequently within this category. |
| **B+, B, B-**<br>Single B<br>(High Risk) | Securities rated in this category are considered to be of highly speculative grade. This level of rating indicates high risk associated with timely repayment of interest and principal. Financial protection factors will fluctuate widely according to economic cycles, industry conditions and/or company fortunes. Potential exists for frequent changes in the rating within this category or into a higher or lower rating grade. |
| **CCC+,CCC,CCC-**<br>(Vulnerable) | Securities rated in this category is currently vulnerable to non-repayment, and is dependent upon favourable business conditions for the obligor to meet its financial commitments on the obligation. |
| **CC+,CC,CC-**<br>(High Vulnerable) | Securities rated in this category is currently high vulnerable to non-repayment. |
| **C+,C,C-**<br>(Near to Default) | Securities rated in this category are considered to be near to default. Protection factors are scarce. Timely repayment of interest and principal is possible only if favorable circumstances continue. |
| **D**<br>(Default) | **Default Grade**<br>Defaulted debt obligations. Issuer failed to meet scheduled principal and/or interest payments. |

For long-term ratings, CRISL assigns + (plus) 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 OF DEBT INSTRUMENTS

| | |
|---|---|
| **ST-1** | **Highest Grade**<br>Highest certainty with regard to the obligor's capacity to meet its financial commitments. Safety is almost like risk free government short-term securities. |
| **ST-2** | **High Grade**<br>High certainty with regard to the obligor's capacity to meet its financial commitments. Risk factors are very small. |
| **ST-3** | **Good Grade**<br>Good certainty with regard to the obligor's capacity to meet its financial commitments. Risk factors are small. |
| **ST-4** | **Satisfactory Grade**<br>Satisfactory protection factors qualify a security to be in investment grade. Risk factors are larger and subject to more variation those rated in higher categories. |
| **ST-5** | **Speculative Grade**<br>Speculative investment characteristics with high risk of default. Obligor's capacity to meet its financial commitments depends upon favorable business, financial and economic conditions. |
| **ST-6** | **Default Grade**<br>Defaulted debt obligations. Issuer failed to meet scheduled principal and/or interest payments. |