



Credit Rating Information and Services Limited

Credit Rating Methodology – Small and Medium Enterprise

Concept of Credit Rating

CRISL defines credit rating as a measure of assessing the relative risk of default and the severity of default associated with a particular securities issue, issuer and/or other financial assets. It is a symbolic indication of the current opinion of the relative capability of timely servicing of the debts and obligations as per the terms of the 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. The rating reflects neutral and influences 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 the case of the debt instrument and the degree of acceptability of the net worth and earning prospects of an entity seeking public finance.

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 ratings that indicate the probability of default. Therefore all CRISL ratings indicate the probability of default and not the EL that may arise after the default.

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 risks of Bangladesh. CRISL being a domestic rating agency of Bangladesh considers the government of Bangladesh as the highest paymaster and all government-guaranteed securities are considered as AAA.

The SME ratings cover those entities which are ideally not any limited companies but rather business entities operating under sole proprietorship or partnership. However, private limited companies operating on a small scale within the range of definition by the regulator may be included in the SME rating periphery of CRISL.

The SME Credit rating report are prepared based on an audited report/ management report along with information provided by the sponsors and responsible persons of the concerned bank(s)/NBFIs regarding related documentation, procurement process, revenue, operational and financial expenses along with related margin, risk and its hedging policy, prospect and business strategy of the entity. Since the SME-

supplied financial statements carry minimum information in general, CRISL collects and collates information through physical verification and interviews key management officials of the enterprise. In the absence of any structured financial information, CRISL applies its techniques, analysts' judgment and assumption to cross-check the data supplied to draw meaningful conclusions. In the absence of a physical site visit, in some cases, CRISL conducts off-site interviews of core management personnel and concerned officials of the lending bank(s) to assess the loan repayment status and history as well as the current operational status and prospects of the enterprise. With the above, CRISL duly factors industry information along with peer group comparison of the same business.

Time Horizon

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

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;

CRISL Rating Scale

From an entity point of view, most of the Small and Medium enterprises are not incorporated as companies under the Companies Act and operate as sole proprietorship enterprises, partnership enterprises, 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 licenses, 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 small and medium enterprises, given its contribution to the national economy. CRISL Small and Medium Enterprise rating scales have been made different from

corporate rating scales to depict a clear distinction between its operations from traditional corporate entities. Considering the nature of finance CRISL offers only long-term ratings. For long-term SME Rating, CRISL uses a rating scale with the prefix “CRISL –Me” for medium enterprises and “CRISL-Se” for small enterprises. The loan facilities/ exposures are enjoyed by those enterprises with the prefix ‘blr’ like the bank facilities being enjoyed by the corporate or any other organizations.

Industry Structure

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), number of workforce, loan limit and turnover. The latest criteria for SMEs as given by Bangladesh Bank are given below:

Enterprise	Fixed Assets excluding Land and Building	Employees	Loan Limit	Turnover
Micro	Tk. 10 lakh to Tk. 75 lakh (Manufacturing)	16-30	Tk. 1 crore	N/A
	Less than Tk. 10 lakh (Service)	15 max	Tk. 25 lakh	
Cottage	Less than Tk. 10 lakh	15 max	Tk. 10 lakh	
Small	Tk. 75 lakh to Tk. 15 crore (Manufacturing)	31-120	Tk. 20 crore	
	Tk. 10 lakh to Tk. 2 crore (Service)	16-50	Tk. 5 crore	
Medium	Tk. 15 crore to Tk. 50 crore (Manufacturing)	121-300 (Garments/labor intensive organization 1,000 max)	Tk. 75 crore	
	Tk. 2 crore to Tk. 30 crore (Service)	51-120	Tk. 50 crore	
Trading Sector	Less than Tk. 10 lakh (Micro Enterprise)	15 max	Tk. 25 lakh	Tk. 1 crore maximum (Annual)
	Tk. 10 lakh to Tk. 2 crore (Small Industry)	16-50	Tk. 5 crore	Over Tk. 1 crore to Tk. 12 crore maximum (Annual)

Rating Methodology

The SME Rating framework is built upon two fundamental aspects of credit analysis. The first is the analysis of qualitative factors and the second is the analysis of quantitative factors. Since the SME-supplied financial statements carry minimum information in general, CRISL designs its methodology with significant weight in qualitative factors accordingly. All the factors considered by CRISL in rating may be clustered into five broad analytical risk blocks- Financial Risk, Industry Risk/Business Risk, Management Risk, Banking Relationship Risk, and Security Risk. Due to such an unstructured form of information as well as the weak recording system of SMEs, CRISL has developed its structured format for information collection covering the aforementioned areas of concentration. The financial position (i.e. Balance Sheet and Income Statement and Cash flow Statement) may either be collected as per an audited report or the assessment team justifies the information provided as per their reporting format that may be in the form of management reporting signed by the sponsors/promoters. The analytical rigor may differ among the SMEs due to their operational nature; however, major categorization will be in line with the definition of Bangladesh Bank. CRISL tries to convert the qualitative factors to quantitative which ultimately assist CRISL in back testing of its methodologies. To arrive at a meaningful assessment the financial statements are reshaped frequently 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 the majority of the sectors of the economy since it operates as a linkage and is supportive to any industry either by product or by services. Therefore, the industry-related risks might have an 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 etc while rating SMEs broadly.

BUSINESS RISK:

Business risk arises due to changes in the market situation and from its operating 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 modes 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 the agro-based level. CRISL reviews the relevant infrastructures of each of client and compares its standing among its peers. Most SMEs are the backward operation of the formal sector; hence, rarely have control over pricing or are fully market dependent. Even market competition is very high due to the large number of SMEs in the same business. Thus, the size of the business, age of the business, business growth compared to the industry, market competition, customer group, performance track record, relationship with the suppliers, business network and the necessary infrastructures are important in the market positioning of an enterprise. Additionally, CRISL also considers factors like- franchise/ dealership, Trademark, patent and copyright, business outlook, level of technology or services, etc. To assess the entity's manufacturing facilities, and other parameters mentioned above, the CRISL team visits the premises of the enterprise and also sometimes meets 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 the case of a new project in the SME sector, CRISL follows the same key consideration factors in project finance on a limited scale. The key parameters include project viability in respect of market situation, estimated project cost, cost overrun, implementation plan, the competence of the sponsor in implementing the 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 the new projects rating framework along with the expansion of the existing business.

MANAGEMENT RISK:

Management plays a crucial role in the success or failure of a company. To evaluate the management team's capabilities, CRISL focuses on the team's track record, past successes and failures, vision, credibility, and managerial style in terms of transparency, teamwork, a delegation of authority, and succession plan. Even though the analysis is largely subjective, certain objective measurements are also taken into consideration. In reality, 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, the 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, gets involved in the business as an inheritance.

CRISL, however, considers the capacity of the support employees in many cases to handle the business efficiently. Working conditions and the relationship between the employer and employees is an important consideration factors. 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 the SME sector, however, willingness to repay the loan is an important characteristic even having a good ability to pay its obligations which is reflected by his/her track record. Besides this, CRISL also reviews the performance of the promoters in other businesses, experience in the same or different line of business, succession of the promoters and Income tax and VAT payment history, etc. The assessment of management quality is partly justified through interviews with the management team and support employees.

FINANCIAL SECURITY RISK:

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

BANK RELATIONSHIP RISK:

A review of banking relationships is very important in the 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 for the delay in payment, utilization performance of the loan limit, personal deposit, etc. Any loan classification may create problems for the respective entity in further borrowing from the bank.

FINANCIAL RISK:

As mentioned earlier, SMEs are typically set up as, sole proprietorships, partnerships or private limited companies (very few in the country context). SMEs that are constituted as a company are required to prepare audited financial statements each year. However, in most cases, audited statements do not reflect the true business picture due to possible tax burden. Disclosures in the statements are very limited to derive at reasonable conclusions. CRISL, in consideration of the above, provides a structured format to each client being rated to supply information about its financial position, working capital utilization and cash flow movement. Besides bank transaction statements may be a good support to justify and assess its business volume. Based on the above consideration, CRISL gives moderate weight to financial risk for SME Rating methodology. CRISL assess the financial risk in three broad categories which include Solvency and Coverage, Business Performance and Profitability, and finally Liquidity and Fund Flow Analysis. Under Solvency and Coverage categories CRISL looks into Leverage/Debt to the owner (s) found in business, interest coverage ratio, debt service coverage ratio, business as well as personal net worth and equity development trend.

Under Business Performance and Profitability, CRISL looks into Return on Average Assets (ROAA), Return on Average Equity (ROAE), Gross Profit Margin (GPM), Net Profit Margin (NPM), etc. Under Liquidity and Fund Flow Analysis, CRISL focus mainly on the sufficiency of the sources of funds to cover the uses of funds, especially over the next 12-24 months. Moreover, the liquidity profile is considered in conjunction with the Current Ratio, Quick Ratio, Working Capital Loan to Current Assets, Cash Conversion Cycle, Utilization of Loan Limit during the year and trend of Operating Cash Flows, etc.

CRISL assessment teams are entrusted with the responsibility to frame opinions 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 the 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)' assets are assessed especially for sole proprietorship and partnership business.

OTHER FACTORS:

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

RATING VALIDITY

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

CRISL SME RATING SCALE AND DEFINITION
LONG TERM RATING FOR MEDIUM ENTERPRISE

<i>CRISL Me-1</i> (Highest Safety)	Highest Investment Grade Medium Enterprise rated in this category is 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.
<i>CRISL Me-2</i> (Higher Safety)	High Investment grade Medium Enterprise rated in this category is 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.
<i>CRISL Me-3</i> (Adequate Safety)	Investment Grade Medium Enterprise rated in this category is 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.
<i>CRISL Me-4</i> (Moderate Safety)	Medium Enterprise rated in this category is adjudged to offer moderate degree of safety for timely repayment of financial obligations. This level of rating indicates that an enterprise 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.
<i>CRISL Me-5</i> (Inadequate Safety)	Speculative Grade Medium Enterprise rated in this category is adjudged to lack key protection factors, which results in an inadequate safety. This level of rating indicates an Enterprise as below investment grade but deemed likely to meet obligations when due. Overall quality may move up or down frequently within this category.
<i>CRISL Me-6</i> (Risky)	Medium Enterprise rated in this category is adjudged to be with high risk. Timely repayment of financial obligations is impaired by serious problems, which the SME is faced with. Whilst an Enterprise 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.
<i>CRISL Me-7</i> (Vulnerable)	Non-Investment grade Medium Enterprise rated in this category is 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.
<i>CRISL Me-8</i> (Highly Vulnerable)	Medium Enterprise rated in this category is 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.
<i>CRISL Me-9</i> (Extremely Vulnerable)	Medium Enterprise rated in this category is adjudged to be extremely speculative in timely repayment of financial obligations. This level of rating indicates Enterprise with very serious problems and unless external support is provided, they would be unable to meet financial obligations.
<i>CRISL Me-10</i> (Default)	Default Grade Medium Enterprise rated in this category is adjudged to be either already in default or expected to be in default.

**CRISL SME RATING SCALE AND DEFINITION
LONG TERM RATING FOR SMALL ENTERPRISE**

<i>CRISL Se-1</i> (Highest Safety)	Highest Investment Grade Small Enterprise rated in this category is 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.
<i>CRISL Se-2</i> (Higher Safety)	High Investment grade Small Enterprise rated in this category is 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.
<i>CRISL Se-3</i> (Adequate Safety)	Investment Grade Small Enterprise rated in this category is 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.
<i>CRISL Se-4</i> (Moderate Safety)	Small Enterprise rated in this category is adjudged to offer moderate degree of safety for timely repayment of financial obligations. This level of rating indicates that an enterprise 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.
<i>CRISL Se-5</i> (Inadequate Safety)	Speculative Grade Small Enterprise rated in this category is adjudged to lack key protection factors, which results in an inadequate safety. This level of rating indicates an Enterprise as below investment grade but deemed likely to meet obligations when due. Overall quality may move up or down frequently within this category.
<i>CRISL Se-6</i> (Risky)	Small Enterprise rated in this category is adjudged to be with high risk. Timely repayment of financial obligations is impaired by serious problems, which the SME is faced with. Whilst an Enterprise 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.
<i>CRISL Se-7</i> (Vulnerable)	Non-Investment grade Small Enterprise rated in this category is 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.
<i>CRISL Se-8</i> (Highly Vulnerable)	Small Enterprise rated in this category is 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.
<i>CRISL Se-9</i> (Extremely Vulnerable)	Small Enterprise rated in this category is adjudged to be extremely speculative in timely repayment of financial obligations. This level of rating indicates Enterprise with very serious problems and unless external support is provided, they would be unable to meet financial obligations.
<i>CRISL Se-10</i> (Default)	Default Grade Small Enterprise rated in this category is adjudged to be either already in default or expected to be in default.

CRISL RATING SCALES AND DEFINITIONS
BANK LOAN/ FACILITY RATING SCALES AND DEFINITIONS- LONG-TERM

RATING	DEFINITION
<i>bl</i> CRISL Se/Me-1 (Highest Safety)	Investment Grade Bank Loan/ Facilities enjoyed by banking clients rated in this category are adjudged to have highest credit quality, offer highest safety and carry almost no risk. Risk factors are negligible and almost nearest to risk free Government bonds and securities. Changing economic circumstances are unlikely to have any serious impact on this category of loans/ facilities.
<i>bl</i> CRISL Se/Me-2 (High Safety)	Bank Loan/ Facilities enjoyed by banking clients rated in this category are adjudged to have high credit quality, offer higher safety and have high credit quality. This level of rating indicates that the loan / facilities enjoyed by an entity has sound credit profile and without any significant problem. Risks are modest and may vary slightly from time to time because of economic conditions.
<i>bl</i> CRISL Se/Me-3 (Adequate Safety)	Bank Loan/ Facilities rated in this category are adjudged to carry adequate safety for timely repayment/ settlement. This level of rating indicates that the loan / facilities enjoyed by an entity have adequate and reliable credit profile. Risk factors are more variable and greater in periods of economic stress than those rated in the higher categories.
<i>bl</i> CRISL Se/Me-4 (Moderate Safety)	Bank Loan/ Facilities rated in this category are adjudged to offer moderate degree of safety for timely repayment /fulfilling commitments. This level of rating indicates that the client enjoying loans/ facilities under-performing in some areas. However, these clients are considered to have the capability to overcome the above-mentioned limitations. Cash flows are irregular but the same is sufficient to service the loan/ fulfill commitments. Risk factors are more variable in periods of economic stress than those rated in the higher categories.
<i>bl</i> CRISL Se/Me-5 (Inadequate Safety)	Speculative/ Non investment Grade Bank Loan/ Facilities rated in this category are adjudged to lack key protection factors, which results in an inadequate safety. This level of rating indicates loans/ facilities enjoyed by a client are below investment grade. However, clients may discharge the obligation irregularly within reasonable time although they are in financial/ cash problem. These loans / facilities need strong monitoring from bankers side. There is possibility of overcoming the business situation with the support from group concerns/ owners. Overall quality may move up or down frequently within this category.
<i>bl</i> CRISL Se/Me-6 (Somewhat Risk)	Bank Loan/ Facilities rated in this category are adjudged to have weak protection factors. Timely repayment of financial obligations may be impaired by problems. Whilst a Bank loan 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. Special monitoring is needed from the financial institutions to recover the installments.
<i>bl</i> CRISL Se/Me-7 (Risky)	Risky Grade Bank Loan/ Facilities rated in this category are adjudged to be in vulnerable status and the clients enjoying these loans/ facilities might fail to meet its repayments frequently or it may currently meeting obligations through creating external support/liabilities. Continuance of this would depend upon favorable economic conditions or on some degree of external support. These loans / facilities need strong monitoring from bankers side for recovery.
<i>bl</i> CRISL Se/Me-8 (High Risky)	Bank Loan/ Facilities rated in this category are adjudged to carry high risk. Client enjoying the loan/ facility might not have required financial flexibility to continue meeting obligations; however, continuance of timely repayment is subject to external support. These loans / facilities need strong monitoring from bankers side for recovery.
<i>bl</i> CRISL Se/Me-9 (Extremely Speculative)	Bank Loan/ Facilities rated in this category are adjudged to be extremely risky in timely repayment/ fulfilling commitments. This level of rating indicates that the clients enjoying these loan/ facilities are with very serious problems and unless external support is provided, they would be unable to meet financial obligations.
<i>bl</i> CRISL Se/Me-10 (Default)	Default Grade Bank Loan/ Facilities rated in this category are adjudged to be either already in default or expected to be in default.