AlphaRating

RATING METHODOLOGY

Small and Medium Enterprises

Alpha Credit Rating Limited

BUSINESS RISK/INDUSTRY RISK

Business Risk Analysis is segmented into two or three sub sectors - industry characteristics and outlook, competitive positioned, and, as appropriate, operations analysis.

- **Industry Characteristics and Outlook**

Industry Characteristics and Outlook evaluates the level of risk involved in participating in a particular SME business. Factors to consider include but are not limited to demand growth, pricing flexibility, capital intensity, barriers to entry and particularly for utilities and corporations involved in sponsoring infrastructure projects, regulatory framework. The degree to which the business is driven and/or affected by local, regional or international business, economic and political conditions must be considered. If appropriate, benefits of diversification will also be evaluated. In general, companies participating in industries with less favorable industry outlooks (i.e. having high industry risk) will require maintenance of more conservative financial profiles/policies to achieve the same rating level as firms operating in industries with more favorable industry outlooks. Relatively favorable industry outlooks should allow stronger industry participants the possibility of producing operating results which have the following features: adequate operating margins, solid returns on assets and on equity, and growing, or at worst, stable cash-flows. As SMEs have presence in majority of the economic sectors of the economy, these types of enterprise operate as linkage and supportive to the industry either by products or by services.

- **Competitive Position**

Competitive Position looks at an organization's competitive strengths and weaknesses relative to its peers. As implied above, unless regulation is a factor that makes such comparisons meaningless, peers may well include firms outside the home market. Specifically, the question analysts must answer is whether the firm's market position and associated business strategies allow it to favorably differentiate itself from its competitors or, alternatively, limit it to a mediocre performance at best. Competing manufacturers can often be differentiated on the basis of manufacturing efficiency, which may or may not have anything to do with size. The age of plant and equipment in use, together with the quality of systems and processes, will often be the more telling explanation for differences in performance. Similarly, for SMEs operating in service industries, performance differentials are most typically associated with the quality and execution of business strategies. Size is a less important consideration.

Net operating (or profit) margin is the universal measure of performance on which firms in the same industry can be compared. It relates earnings before non-operating income/expense, interest expense and taxes to sales revenue. Some caution needs to be exercised in utilizing this measure to compare firms in different industries, due to differing structural characteristics. What is considered a reasonable net operating margin depends very much on the industry. An additional or alternative measure, especially for SMEs in industries with larger fixed assets and/or regular amortization of goodwill and patents, relates earnings before interest expense, taxes, depreciation and amortization (i.e. "EBIT") to sales revenue. Again, what is considered reasonable depends very much on the industry. Industries that allow high Net Operating and EBITDA margins will generally score well on the Industry Characteristics and Outlook risk factor.

For SMEs operating in several different industries, segment information should be obtained to enable net operating margins to be calculated for each part of the business, thus enabling more meaningful peer comparisons to be made.

The relationship of sates/assets is a measure of capital intensity. Industries with lower capital intensity are not inherently less risky than those with higher capital intensity, but comparing sales/assets ratios within a peer group may indicate differences in relative operating efficiency. Likewise, comparing relative growth rates, measured in terms of both physical volumes and sales levels if obtainable, can help in understanding actual competitive strengths or weaknesses that may be obscured if only headline sales figures are considered. Other industry-specific measures of competitive position, such as sales/square foot for retailers, energy finding costs for oil and gas producers, or load factor for airline companies, should be used whenever possible.

- **Operations Analysis**

Operations Analysis is a useful additional element of Business Risk analysis in those cases where technical competence is an absolutely critical ingredient of success. Such situations would most prominently include those where human safety is at issue and, therefore, a sudden loss of customer confidence could potentially translate rather quickly into financial disaster.

FINANCIAL RISK:

SMEs are typically set up as, Proprietorship, partnership or private limited companies. Each category of SMEs will prepare their own yearly financial statement (B/S, Profit and Loss A/C, Cash Flow Statement, statement of WC utilization etc.) in a structured format applicable for them and the same will be provided to the Rating Agencies. Bank transaction statement will also be provided which may be a good support to justify and assess its business volume.

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 (profit margin, ROE, ROA, leverage, liquidity etc). The ratio calculation is same as in the corporate ratings but adjustment may be made as per the nature of the business.

In addition to above, assessment of the flexibility of the entity in fund arrangement; especially the relationship with the bank and Assessment of the expected financial support from the sponsors in any distressed position may be considered.

MANAGEMENT RISK:

SMEs are typically managed by one or two entrepreneurs 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 entrepreneurs 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 SME rating framework. However, the capacity of the support employees in many cases to handle the business efficiently may also be considered. Working condition and relationship between the employer and employees is an important consideration factor. 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. In addition to those, assess the performance of the entrepreneurs in other business, experience in the same or different line of business, succession of the entrepreneurs etc. should be assessed rigorously.

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.

FINANCIAL 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 behavior of the borrower even in the process of loan repayment. Loan coverage through FDR, hypothecation, guarantee, collateral, third party guarantee etc. will be considered in the rating evaluation process.

OTHER FACTORS:

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

SMEs Rating Scale

ARSME 1	Issuers rated ARSME 1 represents the strongest credit quality relative to other Bangladeshi obligors in SME sector.
ARSME 2	Issuers rated ARSME 2 represents very strong credit quality relative to other Bangladeshi obligors in SME sector.
ARSME 3	Issuers rated ARSME 3 represents above average credit quality relative to other Bangladeshi obligors in SME sector.
ARSME 4	Issuers rated ARSME 4 represents average credit quality relative to other Bangladeshi obligors in SME sector.
ARSME 5	Issuers rated ARSME 5 represents slightly below average credit quality relative to other Bangladeshi obligors in SME sector.
ARSME 6	Issuers rated ARSME 6 represents weak credit quality relative to other Bangladeshi obligors in SME sector.
ARSME 7	Issuers rated ARSME 7 represents extremely weak credit quality relative to other Bangladeshi obligors in SME sector. Rating of ARSME-7 will normally be assigned when an obligor is in technical default on certain commitments or obligations, but not yet in financial default.
ARSME 8	Issuers rated ARSME 8 have failed to meet their financial commitment on time or when due.

Rating Outlook

Rating Outlook assesses the potential direction of the Debt Rating over the intermediate term (typically over a one to two-year period). The Rating Outlook may either be :	
POSITIVE	Which indicates that a rating may be raised;
NEGATIVE	Which indicates that a rating may be lowered;
STABLE	Which indicates that a rating is likely to remain unchanged;
DEVELOPING	Which indicates that a rating may be raised, lowered or remain unchanged.