ARGUS CREDIT RATING SERVICES LIMITED

RATING METHODOLOGY:

CORPORATE

RATING PROCESS FLOW

1. Primary Document Collection
2. Agreement Signing
3. Preliminary Assessment
4. Field visit, Meeting
5. Assessment by IRC
6. Final Rating by RC
7. Publish Report

ACRSL'S RATING METHODOLOGY - CORPORATE

Credit analysis of a corporate entity begins with the review of the industry in which the entity operates along with an assessment of business risk factors specific to the entity.

This is followed by an assessment of the financial risk factors and quality of management of the entity. For project stage entities / entities undertaking large projects, ACRSL also analyses project risk for arriving at the entity's rating. The degree of financial risk exposure of the entity within the overall context of the business risk together with the evaluation of the entity's management forms the basis for arriving at the rating level.

Both quantitative and qualitative factors will be considered in assessing the Corporate operation. The financial position (i.e. Balance Sheet and Income Statement) and Cash Flow Statement may be collected as per accounting standard provided by concerned regulators that may either be audited or signed by the appropriate authority.

The methodology is comprehensive where assessment area concentrates five broad categories:

1. Financial Risk
2. Business/Industry Risk
3. Management Risk
4. Security Risk
5. Relationship Risk

1. FINANCIAL RISK

Financial risk analysis involves evaluation of past and expected future financial performance with emphasis on assessment of adequacy of cash flows towards debt servicing.

ACRSL's analysis is mainly based on audited accounts of the entity although unaudited accounts are noted. A review of accounting quality and adherence to prudential accounting norms (if any, set by local regulations) are examined for measuring the entity's performance. Accounting policies relating to depreciation, inventory valuation, income recognition, valuation of investments, provisioning/write off etc. are given special attention. Prudent disclosures of material events affecting the entity are reviewed. Impact of the auditors' qualifications and comments are quantified to the extent possible and analytical adjustments are made to the accounts, if material. The rating team meets the auditors to understand their comfort level with the accounting policies, systems and controls within the entity and his assessment of the management of the entity.

Off-balance sheet items are factored into the financial analysis and adjustments made to the accounts, wherever necessary. Change of accounting policy in a particular year which results in improved reported performance is analyzed more closely.

Financial Ratios: Financial ratios are used to make a holistic assessment of financial performance of the entity, as also to see the entity's performance w.r.t. its peers within the industry. They are not an 'end' in itself but a 'means' to understanding the fundamentals of an entity. ACRSL follows a standard set of ratios for evaluating manufacturing companies. These can be divided into five categories:

- Growth Ratios
- Profitability Ratios
- Leverage & Coverage Ratios
- Turnover Ratios
- Liquidity Ratios

Cash Flows: Future debt obligations are required to be met by cash and hence only a thorough analysis of cash flow statements would reveal the level of debt servicing capability of an entity. Cash flow analysis forms an important part of credit rating decisions. Availability of internally generated cash for servicing debt is a more comforting factor in a credit perspective as compared to dependence on external sources of cash to cover temporary shortfalls. Cash flow adequacy is viewed by the capability of an entity to finance normal capital expenditure, as well as its ability to manage capital expenditure programs as per envisaged plans apart from meeting debt servicing requirements.

Financial Flexibility: Financial flexibility refers to alternative sources of liquidity available to the entity as and when required. The entity's contingency plans under various stress scenarios are considered and examined. Ability to access capital markets and other sources of funds whenever required is reviewed. Existence of liquid investments, availability of support (implied or demonstrated) from strong group concerns to tide over stress situations, ability to sell idle assets quickly, deferment of capital expenditure etc. are favorably considered.

Validation of projections and sensitivity analysis: The projected performance of the entity over the life of the instrument is critically examined and assumptions underlying the projections are validated. The critical parameters affecting the industry and the anticipated performance of the industry are identified. Each critical parameter is then stress-tested to arrive at the performance of the entity in a stress situation. Debt service coverage for each of the scenarios would indicate the capability of the entity to service its debt, under each scenario.

2. BUSINESS RISK/INDUSTRY RISK

Business risk/Industry Risk can be termed as "a risk of direct or indirect loss arising due to deficient or unsuccessful internal systems, process, people or external factors." Business risk arises due to change in market situation and from its own operation infrastructure. Under the business risk, the sustainability of the business in the changing market situation will be assessed. Due to the limited scale of operation, 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. A significant number of corporates are doing their business as 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 corporates in the same business. ACRSL takes into account the economy-wide factors which have a bearing on the industry under consideration. The strategic nature of the industry in the prevailing policy environment, regulatory oversight governing industries etc., is also analyzed.

Diversification: For entities that operate in several industries, each major business segment is analyzed separately. The contribution of each business segment to the entity's overall profitability is assessed. While diversification results in better sustainability in cash flows, ACRSL also analyses the suitability and adequacy of management structure in such scenarios and forward and backward linkages present.

Seasonality and Cyclicality: Some industries are cyclical in nature with their performance varying through the economic cycle. Moreover, certain industries are seen to exhibit seasonality. ACRSL's ratings aim to be stable across seasons and economic cycles and are arrived at after deliberating on the long-term fundamentals.

Size: Small size presents a significant hurdle in getting higher ratings commensurate with an entity's financials. Presence in selected market segments, limited access to funds leading to lack of financial flexibility etc., result in lower protection of margins when faced with adverse developments in business areas. Large firms, on the other hand, tend to have higher sustaining power, even during troubled times.

Market Share: An entity's current market share and the trends in market share in the past are important indicators of the competitive strengths of the entity. A sustained leadership position leads to ability to generate cash over the long term. A market leader generally has financial resources to meet competitive pricing challenges.

3. MANAGEMENT RISK

Management evaluation is one of the most important factors supporting an entity's credit standing. An assessment of the management's plan in comparison to those of their industry peers can provide important insights into the entity's ability to sustain its business. Capability of the management to perform under stress provides an added level of comfort. Meetings with the top management of the entity are an essential part of ACRSL's rating process. Some key dimensions of management evaluation are:

Track Record: The track record of the management team is a good indicator for evaluating the performance of the management. Management's response to key issues/events in the past like liquidity problems, competitive pressures, new project implementation, expansions and diversifications, etc. are assessed.

Corporate Strategy: The entity's business plans, mission, policies and future strategies in relation to the general industry scenario are assessed. An important factor in management evaluation is assessment of the management's ability to look into the future and its strategies and policies to tackle emerging challenges, in addition to succession planning.

Performance of Group Concerns: Interests and capabilities of the group concerns belonging to the same management give important insights into the management's capabilities and performance in general.

Organizational Structure: Assessment of the organizational structure would indicate the adequacy of the same in relation to the size of the entity and also give an insight on the levels of authority and extent of its delegation to lower levels in the organization. The extent to which the current organizational structure is attuned to management strategy is assessed carefully.

Control Systems: Adequacy of the internal control systems to the size of business is closely examined. Existence of proper accounting records and control systems adds credence to the accounting numbers. Management information systems commensurate with the size and nature of business enable the management to stay tuned to the current business environment and take timely, judicious decisions.

Personnel Policies: Personnel policies laid down by the entity would critically determine its ability to attract and retain human resources. Incidence of labor strikes/unrest, attrition rates etc., are seen in perspective of nature of business and relative importance of human capital.

Corporate Governance: Extent of transparency in the entity's dealings with various stakeholders, financial prudence and compliance with extant laws and regulations is seen closely.

4. SECURITY RISK

Although security against a loan is a post-default event and has bearing only in recovery rating, security offered against a Corporate 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.

5. RELATIONSHIP RISK

Review of banking relationship is very important in Corporate rating process. The analyst team must communicate with the respective branch of the bank 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.

MEASUREMENT OF KEY RATING FACTORS

ACRSL ratings are dynamic and, thus, incorporate future financial and operating performance. The rating process makes use of both historical and projected financial results. Historical results of operations help us understand the pattern of a company's performance and how it compared to its peer group. By analyzing historical data, we analyze earnings volatility in line with its business cycle; and on the other hand, evaluate expected or projected results are realistic or not. The rating process makes use of both historical and projected financial results. Table given below shows risk parameters and detailed weight distribution under each broad and sub-rating factors.

Risk Parameters	Max Score
i) Financial Risk	**50**
1. Leverage ratio	15
2. Liquidity ratio	15
3. Profitability ratio	15
4. Coverage ratio	5
ii) Business/Industry Risk	**18**
5. Size of business	5
6. Age of business	3
7. Business outlook	3
8. Industry growth	3
9. Market competition	2
10. Entry/Exit barriers to business	2

Risk Parameters	Max Score
iii) Management Risk	**12**
11. Track Records of the sponsors	2
12. Educational Qualification, Experience & Technical know-how of sponsors/stuffs	4
13. Succession	4
14. Working Environment/Team Work	2
v) Security Risk	**10**
15. Security Coverage	4
16. Collateral coverage	4
17. Support/Guarantee	2
iv) Relationship Risk	**10**
18. Account conduct	4
19. Utilization of limit	3
20. Compliance of covenants/conditions-If any	2
21. Personal Deposit	1
Grand Total	**100**

The rating process is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. Rating determination is a matter of experienced and holistic judgment, based on the relevant quantitative and qualitative factors affecting the credit quality of the issuer.

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