ARGUS CREDIT RATING SERVICES LIMITED

RATING METHODOLOGY:

SMALL & MEDIUM ENTERPRISE

RATING PROCESS FLOW

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

SIGNIFICANCE OF SME RATING

Re-enforcing Credit Risk Management in the Banking Sector:

- Comply with standardized approach of Basel II requirements
- Creation of Risk Rating System
- Help to automate credit origination, credit approval process, risk administration and monitoring functions and management of non-performing assets
- Help to provide data feeds for management reporting

Concessional funding: A good rating will help millions of entrepreneurs in Bangladesh to gain faster and cheaper credit for their SMEs.

Better Business opportunities: The independent risk evaluation of SMEs by an unbiased third party lends credibility to them and opens doors for them while dealing with MNCs and corporates.

Tools for self-improvement: Another advantage of rating is that the highlighting of strengths and weaknesses acts as a trigger for self-correction. A regular renewal of ratings not only helps improve a firm's performance but also builds confidence within the lender fraternity and trading channel.

CLASSIFICATION OF SME

The National Industrial Policy 2022 and accordingly Bangladesh Bank's SME & SPD website CMSME definition, small and medium enterprises, in terms of the value of fixed assets with replacement cost excluding land and building or in terms the number persons employed as given below:

Category	Industry	Value of Fixed Assets (in BDT)	Number of Person Employed
Medium	Manufacturing	15 Crore to 50 Crore	121 to 300
	Service/Trading	2 Crore to 30 Crore	51 to 120
Small	Manufacturing	Less than 15 Crore	31 to 120
	Service/Trading	Less than 2 Crore	16 to 50
	Micro/ Cottage Industry	Less than 15 Lacs	Less than 16

ACRSL'S RATING METHODOLOGY - SME

Both quantitative and qualitative factors will be considered in assessing the SME 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. Bank Relationship Risk
5. Financial Security Risk and others

1. 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 (Balance Sheet, Income Statement, 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 and loan statements 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.). 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 SME rating framework.

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. In view, the sponsor(s)' personal assets may be assessed specially for sole proprietorship and partnership business.

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 SMEs 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 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 case of new project in SME sector, the same key consideration factors in the project finance will be followed but in limited scale. SME project rating Framework would include parameters like: 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.

The industry related risks might have impact on the operation of related SMEs. So, the factors like the scope of diversification, industry size, supply gap, government policy towards the industry, nature of the product, social desirability, entry and exit barriers etc. should be considered while rating SMEs broadly. 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.

3. 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 characteristic 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.

4. Bank Relationship Risk

Review of banking relationship is very important in SME 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.

5. 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.

6. 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.

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	**30**
1. Leverage ratio	6
2. Liquidity ratio	6
3. Profitability ratio	5
4. Coverage ratio	3
5. Additional risk parameters to be assessed (ROA, ROE, Equity Development Trend (Last 3 years), Trend of Operating Cash Flow (OCF), Business as well as personal net worth)	10
ii) Business/Industry Risk	**23**
6. Size of business	4
7. Age of business	2
8. Business outlook	2
9. Industry growth	3
10. Market competition	3
11. Entry/Exit barriers to business	1
12. Additional risk parameters to be assessed (Level of Technology/ Service, Infrastructure Facility, Government Policy Toward Industry, Nature of the Product & potentialities/Social Desirability, Dependency on suppliers/clients, Trade mark/Patent/copy right, Franchise/ dealership, Marketing strategy)	8
iii) Management Risk	**18**
13. Track Records of the sponsors	3
14. Educational Qualification, Experience & Technical know-how of sponsors/stuffs	4
15. Risk Taking Capacity of Sponsor(s)	2
16. Personnel Policy & Internal Control System	3
17. Succession	2
18. Working Environment/Team Work	2
19. Income Tax/VAT payment history	2

Risk Parameters	Max Score
iv) Bank Relationship Risk	**12**
20. Relationship with bank	4
21. Current Status of Loans	3
22. Compliance of covenants/conditions-If any	3
23. Personal Deposit	2
v) Financial Security Risk	**10**
24. Security Coverage (Primary)	5
25. Collateral coverage (Property Location)	2
26. Support/Guarantee	2
27. Legal Intervention regarding security Coverage	1
vi) Other Factors	**7**
28. Legal /Environmental Issue	2
29. Disaster Management capacity	2
30. Insurance	1
31. Govt. Subsidies/Tax Waiver	1
32. Any other Material risk factor	1
Grand Total	**100**

[Last updated on February 2024. Next review due in January-June 2025]