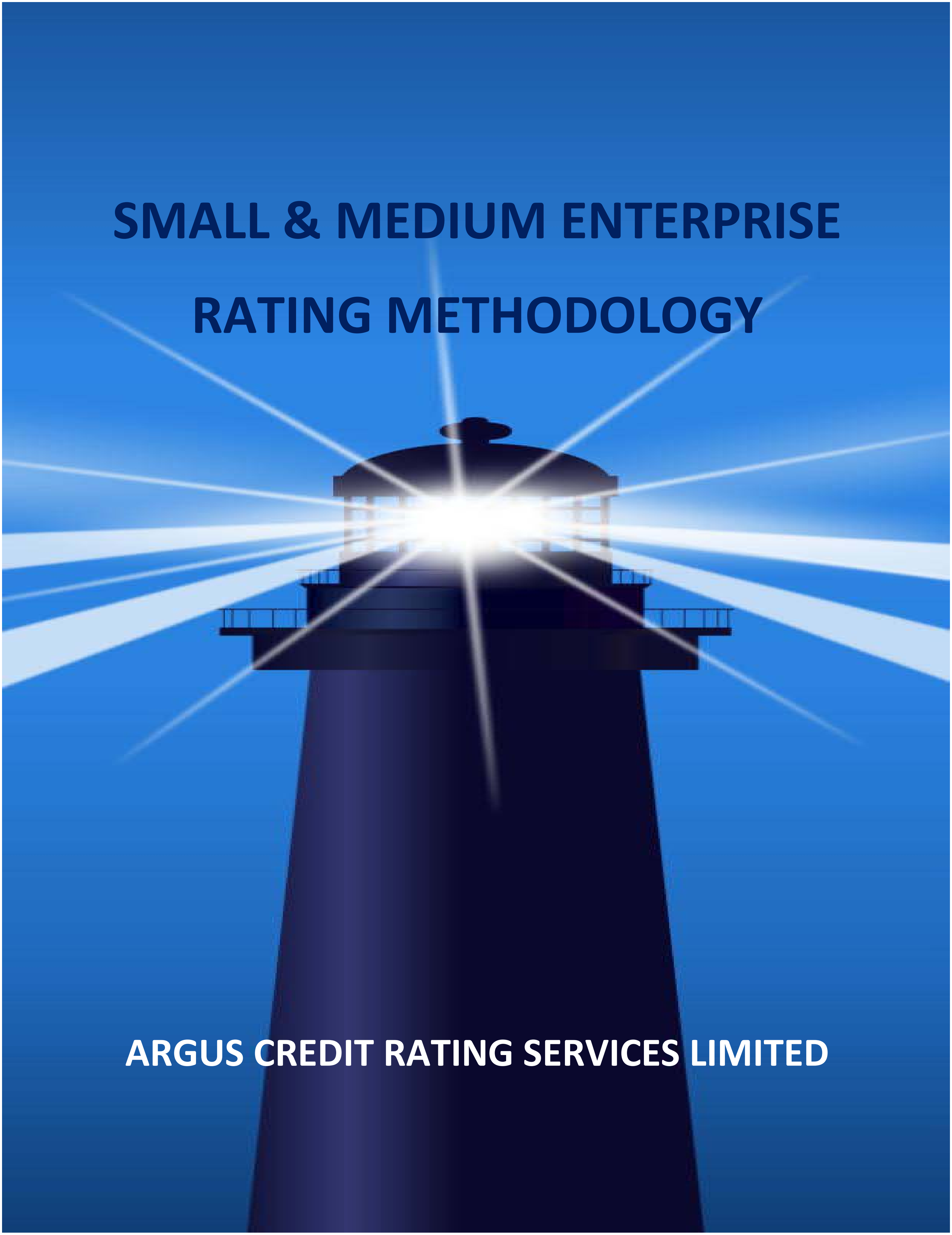
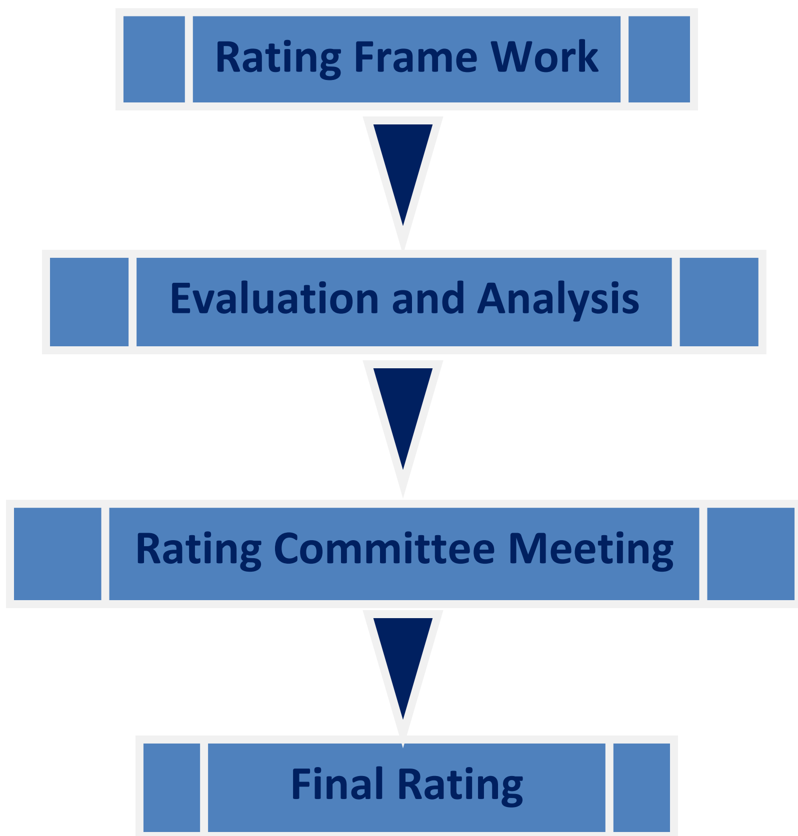
SMALL & MEDIUM ENTERPRISE RATING METHODOLOGY



ARGUS CREDIT RATING SERVICES LIMITED

RATING PROCESS FLOW



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'S

The Industrial policy 2010 and accordingly Bangladesh Bank's SME & SPD circular no.1 dated 19th June, 2011 defines 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 under-

Category	Industry Type	Value of Fixed Assets (Tk.)	Number of Persons Employed
Medium	Manufacturing	>1000 lacs -3000 Lacs	100-250
	Service/ Trading	100-1500 Lacs	10-25
Small	Manufacturing	50 -1000 Lacs	25-99
	Service/ Trading	5-100 Lacs	10-25

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 (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). 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 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.

4. 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.

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.

[Last updated on February 2021, Next review due in January-June 2022]