CORPORATE CREDIT RATING METHODOLOGY

FRAMEWORK

Credit rating is an opinion on associated credit risk related to instrument being rated. The rating determination process involves estimation of capacity of the issuer to generate cash flows from operations and the adequacy of the cash flows to meet the issuer's debt servicing obligation over the life of the instrument. This methodology describes the approach used by Infomerics Nepal to assess the credit risk prevailing in the entity in the corporate sector for all kinds of debt products like bonds, debentures, bank loans lines etc.

The main objective of this writeup is to help issuers, investors and other stakeholders understand Infomerics Nepal's approach to analysing the risks that are likely to affect the rating outcomes of corporate sector entities.

RATING METHODOLOGIES

Credit analysis of an entity attempts to examine the key determinants of the business and begins with the evaluation of the economy/industry in which the entity operates. This is then followed by assessment of the business risk factors specific to the entity, financial risk factors and quality of management of the entity. With regards to entities undertaking large projects, Infomerics Nepal additionally analyses risk associated with project execution and implementation for arriving at the entity's rating. Assessing liquidity and financial flexibility of the issuer gains more prominence while arriving at ratings of short-term instruments/facilities apart from the analysis of the basic fundamentals of an issuer. For the purpose of arriving at the long term or short term rating, the entity's audited financials for past five years are studied and analysis of its projections for the next three financial years is carried out under various sensitivity scenarios.

The key determinants covered in the corporate credit rating analysis are enumerated below:

Market/ Industry Risk Assessment

The industry overview brings out the characteristics of the industry in general and various key factors, its performance, linkage with the global front, its strategic position in the economy and its near-term and long-term outlook. It captures, in a nutshell, all the prospects and concerns. Entities having similar risk profiles may have different credit ratings differentiated by dissimilar risk characteristics of industries they operate in. The following factors are examined under market/ industry risk assessment:

Cyclicality

Cyclicality of industry and economy have adverse effect on the prospects of corporate entities. Debt servicing capability of entities in cyclical industries is largely impacted by shifts in economic and commodity price cycles. Cyclical industries tend to have lower tolerance for financial and operating leverage as adverse swings in revenues and profits heighten the probability of default. In addition, industries having longer gestation period for setting up new capacity may adversely impact the prospects due to difficulty in predicting well the timing, severity and duration of a cyclical downturn. Infomerics Nepal considers cyclical nature of the industry and factors the effect of the same in the rating assigned.

Competitive Markets

Competition risk is associated with the fact that there are often competing companies in the market, each of which seeks to attain market dominance in order to maximize benefits, in terms of profit, customer volume, revenues, qualities etc. High competitive intensity is mainly driven by high industry fragmentation, similarity in market share of prominent players, low entry barriers, high exit barriers, nature of product, excess production capacity and possibly low product differentiation.

Growth Prospects

Entities operating in an industry with higher growth prospects have a larger likelihood of higher operation level leading to expansion in revenue and returns compared to entities operating in low growth phase or even declining phase. However, a high growth industry does not always lead to low credit risk profile as it is subject to other aspects like sustainability of the long term growth and the sources of volatility.

Regulatory Scenario

Various regulatory interventions including direct or indirect taxation, duties and subsidies, pricing, supply chain, import export barriers etc. have direct effect on many industries. Infomerics Nepal evaluates whether the intervention is of a direct and controlling nature or of indirect nature and takes into account the impact of the same in its rating.

Business/ Operational Risk Assessment

The business risks broadly cover scale of operations, market share, geographical and product diversity, demand-supply scenario, locational economics, market structure, extent of competition, capacity utilization, cost efficiencies, level of technology, sourcing of major inputs, power & fuel sensitiveness, export potential, logistics, brand development, fiscal incidence, Government policies & intervention, pending litigations, industrial relation, environmental issues, ongoing and/or proposed projects, if any, etc. The business risks, in general, attempts to capture all the major risks associated with the industry and how the entity being rated is positioned in the market. Infomerics Nepal evaluates each of these sub-factors as described below:

Economies of scale

Larger scale of operation generally reflects competitive market position, operating and financial flexibility and higher endurance; and is also a driver of operational efficiency. An entity's scale in relation to its competitors can determine its ability to influence business trends and pricing within the industry. There could be various measures of an entity's scale including revenues, asset base, net worth or capital employed. While entities could be compared with each other on the basis of revenues, such a comparison may not be meaningful if it is done among entities belonging to different industries. Hence, while assessing an entity on the scale parameter, Infomerics Nepal evaluates the same in relation to the peers of the entity in its related market segment.

Competitive Position

Infomerics Nepal analyses the source of competitive positioning of the entity in terms of brand, distribution network, customer loyalty, strategic location, technology, long history or any other distinguishing factors. A good competitive position leads to better profitability, revenues and cash flows on a sustained basis.

Operating Efficiency

Operational efficiency is primarily a metric that measures the efficiency of profit earned as a function of operating cost. The greater the operational efficiency, the more profitable a firm or investment is. This is because the entity is able to generate greater income or returns for the same or lower cost than an alternative. The variable cost of production of an entity could be influenced by the source of raw materials, pricing arrangements with suppliers, throughput ratios, rejection rates and energy consumption etc. Likewise, the fixed cost base of an entity could be influenced by the type of technology used, level of backward or forward integration and the interest servicing burden etc. Infomerics Nepal assesses an entity's operating efficiency by undertaking an analysis of the above elements.

Diversification

Diversification is simply expansion of the network be in terms of customer, geography, product or supplier. Diversification supports survival and often act as a strategic lever to enhance business growth. Adequate diversification imparts greater long term stability to earnings and cash flow of the entity.

Project Risk

Apart from the above risk factors, a project entity or an entity undertaking a large-sized project capital expenditure (capex) is also exposed to other risks, including cost and time over-runs.

Implementing large projects usually involves periods of strain on a company's liquidity position. To ascertain project risks, Infomerics Nepal endeavors to understand the entity's rationale for undertaking new investments, size of the project vis-à-vis the current scale of operations and net worth of the company, and the funding pattern of the project. Risk in implementation including aspects like achievement of financial closure, status of regulatory approvals, agreements entered with equipment suppliers, track record of company/contractors in executing similar projects, project progress vis-à-vis scheduled implementation etc. are also taken into account. The risk profile could be different depending on whether the new project is a case of related diversification or an unrelated diversification. The other factors that are assessed include:

- Management's track record w.r.t. implementation of similar projects.
- Project Implementation team's quality
- Experience of contractor and technology/equipment supplier;
- Capital cost competitiveness
- Financing arrangements
- Raw materials arrangements
- Demand outlook
- Competitive environment; and
- Marketing arrangement and plans.

Significantly, the impact of project risk on the rating depends on the scale of project in relation to the size of assets and cash flows of the entity's existing operations.

Financial **Risk Assessment**

The financial risks broadly cover revenue & profits growth, profitability, working capital management, leverage & capital structure, adequacy of future cash flow vis-a-vis maturity of debt obligation, risks relating to interest rates & refinancing, past debt servicing track record, foreign currency related risks, if any, contingent liabilities & off-balance sheet exposures, consolidated financial position, if applicable, financial prudence & accounting policies, quality of auditors & their observations, etc. Deviations from the Generally Accepted Accounting Practices are noted and the financial statements of the entity are adjusted to reflect the impact of such deviations. The financial risks attempt to capture the various risks associated with the financial position of the entity and also the capability of the entity to meet its debt/loan obligations as per the debt servicing schedule. It is also seen as to how the entity being rated is placed vis-a-vis its peers in terms of financial parameters. The various financial metrics assessed by Infomerics Nepal could be divided into four categories viz., Profitability, liquidity, Leverage and Coverage.

Profitability Indicators

These indicators are mostly concerned with the profits and earning of an entity. Some of the ratio indicators of profitability are:

- Operating profit Margin
- Net Profit Margin
- Return on Assets
- Return on Capital Employed etc.

Liquidity Indicators

These indicators show the position of net liquid assets in the entity. It also measures a company's ability to pay short debt obligation from various internal and external sources. Higher the cushion available between the resources available and the obligations, better the liquidity profile of an entity. In addition to the adequacy of internal and external resources, the liquidity profile is also driven by the vulnerability of an entity to timely refinancing / renewal of short-term sources of funding. Infomerics Nepal also notes that the liquidity available with an entity may be for a temporary period and hence an entity's overall policy towards maintaining adequate liquidity (given the trade-off between returns and liquidity) is accorded due importance in the analytical approach. Some common indicators are:

- Current Ratio

- Working Capital Cycle
- Working Capital Intensity

Leverage Indicators

Leverage is the proportion of borrowing funds in the capital structure. Ratios seen are

- Gearing Ratio
- Total Indebtedness Ratio
- Accruals to Debt Ratio

Coverage Indicators

Coverage indicators measure the company's ability to service its debt and meet its financial obligations. Entities with higher profitability and lower leverage will generally have better coverage ratios and thereby healthier financial profile. The various ratios used are as follows:

- Interest Coverage Ratio
- Debt Service Coverage Ratio

Corporate Governance and Management Structure

Management structure and corporate governance plays a vital role in overall rating process. As a part of credit rating, Infomerics Nepal undertakes management meetings and discussion to get an overview of the entity, strategic planning and major decisions etc. Following aspects are covered under this assessment:

- Experience of the promoter/management team
- Status of group companies
- Commitment and financial support to the entity
- Prevailing corporate governance practices and continuity in top management
- Risk appetite and risk management plans
- Past history and track record in implementing new projects
- Management's attitude and outlook towards the industry

- Future plans and strategy

Other Elements for Assessment

Besides above risk assessment there may be other risk factors which needs to be seen before arriving any conclusion. Some of them are:

Forex risk

This risk arises when the entity engages in financial transactions that are denominated in a currency other than local currency of the company's domicile. Entities involved in import or export or those that borrow foreign currency face a forex risk. Infomerics Nepal's analytical focus here is on assessing the hedging policy of the entity concerned in the context of the tenure and the nature of its contracts with its customers.

Accounting and finance quality

It refers to the accounting policy and accounting treatment adopted by the rated entity. The entity's reporting framework and any deviation in Generally Accepted Accounting Principles is noted and relevant adjustments are made while assessing the financial risk profile of the rated entity.

Financial Flexibility

Financial flexibility is reflected in the entity's un-utilized line of credit/ credit limits, liquid investments and the nature of relationship with the banks and other intermediaries. This could also be evaluated from other factors like large unencumbered cash flows, entity's strong parentage or linkage with the strong group, flexibility to borrow from existing assets etc.

Contingent and off balance sheet risk

Under this aspect, Infomerics Nepal evaluates the potential impact of contingent liabilities on the entity's performance and ability to fulfill its debt obligations.

CORPORATE CREDIT RATING SCALE WITH DEFINITIONS

Infomerics Nepal's Long Term Debt Instruments Rating Scale

Long term rating scale-All debt instruments with original maturity exceeding one year.

Rating Symbols	Rating Definitions
IRN AAA	Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such Instruments carry lowest credit risk.
IRN AA	Instruments with this rating are considered to have the high degree of safety regarding timely servicing of financial obligations. Such Instruments carry very low credit risk.
IRN A	Instruments with this rating are considered to have the adequate degree of safety regarding timely servicing of financial obligations. Such Instruments carry low credit risk.
IRN BBB	Instruments with this rating are considered to have the moderate degree of safety regarding timely servicing of financial obligations. Such Instruments carry moderate credit risk.
IRN BB	Instruments with this rating are considered to have the moderate risk of default regarding timely servicing of financial obligations.
IRN B	Instruments with this rating are considered to have the high risk of default regarding timely servicing of financial obligations.
IRN C	Instruments with this rating are considered to have the very high risk of default regarding timely servicing of financial obligations.
IRN D	Instruments with this rating are in default or are expected to be in default soon in servicing of debt obligations.

Modifiers {"+" (plus) / "-"(minus)} can be used with the rating symbols for the categories IRN AA to IRN C. The modifiers reflect the comparative standing within the category.

Infomerics Nepal's Short Term Debt Instruments Rating Scale

Short term rating scale: All Instruments with original maturity of up to one year.

Rating Symbols	Rating Definitions
IRN A1	Instruments with this rating are considered to have very strong degree of safety regarding timely payment of financial obligations. Such instruments carry lowest credit risk
IRN A2	Instruments with this rating are considered to have strong degree of safety regarding timely payment of financial obligations. Such instruments carry low credit risk.

IRN A3	Instruments with this rating are considered to have moderate degree of safety regarding timely payment of financial obligations. Such instruments carry higher credit risk as compared to instruments rated in the two higher categories.
IRN A4	Instruments with this rating are considered to have minimal degree of safety regarding timely payment of financial obligations. Such instruments carry very high credit risk and are susceptible to default.
IRN D	Instruments with this rating are in default or expected to be in default on maturity.

Modifiers {"+" (plus)} can be used with the rating symbols for the categories IRN A1 to IRN A4.

The modifiers reflect the comparative standing within the category.