CORPORATE CREDIT RATINGS
A Note on Methodology

The basic objective of credit rating is to provide an opinion on the relative credit risk associated with the instrument being rated. The process, in a nutshell, involves estimating the issuer's capacity to generate cash from operations and assessing the adequacy of this estimate vis-à-vis the issuer's debt servicing obligations over the tenure of the instrument. Additionally, the rating process also involves assessing the cash flow support that may be available to supplement the operational cash flows. Such support, also termed financial flexibility, provides an indication of an issuer's ability to refinance maturing obligations and raise finances through means such as liquidating marketable securities and drawing group support.

All factors that have a bearing on the issuer's ability to generate cash flows are considered while assigning ratings. Conceptually, these factors may be classified as business risk, financial risk drivers, and management related factors. ICRA Lanka's rating process places considerable emphasis on evaluating business risks, as it does on evaluating the financial ratios. For credit risk evaluation, stable businesses (low industry risk) even with lower level of cash generation are viewed more favourably as compared with businesses with higher cash generation potential but relatively high degree of volatility associated with such cash flows (higher industry risk). This risk analysis is complemented by a cash flow analysis that seeks to capture the adequacy of the issuer's projected cash flows vis-à-vis its debt servicing obligations.

The risk analysis framework for a typical manufacturing company may be depicted as follows:

BUSINESS RISK	FINANCIAL RISK
• Industry Risk • Competitive Position • Management Quality • New Project Risk	• Financial Position • Profitability • Capital Structure • Financial Flexibility • Future Cash Flow Adequacy

Some of the key risk factors that ICRA Lanka analyses while arriving at a credit rating are discussed in the following sections.

Business Risk

The business risk that an issuer is exposed to is a combination of the industry risk in its major product segments and its competitive position within the industry.

Industry Risk

The objective here is to understand the attractiveness of the industry in which the issuer operates. The aspects examined include:

- Existing and expected demand-supply situation
- Intensity of competition
- Vulnerability to imports
- Regulatory risks
- Outlook for user industries
- Working capital intensity
- Overall prospects and outlook for the industry

The rating analysis begins with an evaluation of the business that the company is in. The dynamics of the business influence a company's operating risk to a large extent. The analysis thus focuses on the overall industry prospects as well as the key success factors in the industry. The factors assessed include the demand-supply position, competitive intensity, the bases of competition, and the various sources of vulnerability. Favourable industry characteristics would include good demand growth, stable operating margins, and moderate capital intensity.

Issuer's Competitive Position

An assessment of the issuer's competitive position within an industry is made on the basis of its operating efficiency as well as its market position. Some of the factors assessed are:

- Scale of operations
- Vintage of technology used
- Capital cost position
- Location advantage in terms of proximity to raw material sources as well as markets
- Operating efficiencies (yields, rejection rates, energy consumption, etc.)
- Market position as reflected in trends in market share, ability to command premium pricing, span of distribution network, and relationship with key customers

Usually, a peer comparison is carried out to evaluate each of the above factors. The weight attached to these factors depends on their relative importance in the industry that the issuer operates in. For instance, if the issuer is engaged in a commodity business, low cost of production would be the single most important factor since product differentiation is virtually non-existent in commodities. The cost of production, in turn, would be influenced by the factors mentioned earlier, for instance, the economies of scale, advantage arising from use of superior technology and so on

A peer comparison is done to determine the relative efficiency of the manufacturing operations. Some of the indicators of production efficiency are: resource productivity (both assets and manpower), material usage (or input-output ratios), and energy consumption. Collection efficiency and inventory levels are important indicators of both market position and operating efficiency.

Unlike in the case of commodities, there are industries in which product differentiation is the primary basis of competition. An example in this regard would be a fast moving consumer goods (FMCG) company. For such a company, the factors that would be of prime importance would include positioning of products, perceived quality of products or brand equity, proximity to markets, reach of distribution network, and relationship with customers. The company's positioning on these parameters would be reflected in its ability to maintain/improve market share and command price premium.

New Project Risks

The scale and nature of new projects can significantly influence the risk profile of an issuer. Unrelated diversification into new products is invariably assessed in greater detail.

Besides the rationale for new projects, the other factors that are assessed include: (i) track record of the management in project implementation; (ii) experience and quality of the project implementation team; (iii) experience and track record of the technology supplier; (iv) extent to which the capital cost is competitive; (v) financing arrangements in place; (vi) raw material linkages; (vii) demand outlook; (viii) competitive environment; and (ix) marketing arrangement and plans.

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

Financial Risk

The objective here is to determine the issuer's current financial position and its financial risk profile. Some of the aspects analysed in detail in this context are:

Operating profitability: The analysis here focuses on determining the trend in the issuer's operating profitability and how the same appears by peer comparison.

Gearing: The objective here is to ascertain the level of debt in relation to the issuer's own funds and is viewed in conjunction with the business risks that the issuer is exposed to.

Debt service coverage ratios: The objective here is to ascertain the adequacy of profit generation in relation to the debt servicing requirements.

Working capital intensity: The analysis here involves evaluating the trends in the issuer's key working capital Indicators like Receivables, Inventory, and Creditors, again with respect to peers.

Cash flow analysis: Cash is required to service obligations. Cash flows reflect the sources from which cash is generated and its deployment. Analysed here are the trends in the issuer's Funds Flow from Operations (FFO) after adjusting for working capital changes, the Retained Cash Flows, and the Free Cash Flows after meeting debt repayment obligations and capital expenditure needs. The cash flow analysis also helps in understanding the external funding requirement that an issuer has, to meet its maturing obligations.

Foreign currency related risks: Such risks arise if an issuer's major costs and revenues are denominated in different currencies. Examples in this regard would include companies selling in the domestic market but making large imports, and export oriented units operating largely on the domestic cost structure. The foreign currency risk can also arise from unhedged liabilities, especially for companies earning most of their revenues in local currency. The focus here is on assessing the hedging policy of the issuer concerned in the context of the tenure and nature of its contracts with clients (short term/long term, fixed price/variable price).

Tenure mismatches, and risks relating to interest rates and refinancing: Large dependence on short-term borrowings to fund-long term investments can expose an issuer to significant re-financing risks, especially during periods of tight liquidity. The existence of adequate buffers of liquid assets/bank lines to meet short-term obligations is viewed positively. Similarly, the extent to which an issuer would be impacted by movements in interest rates is also evaluated.

Accounting quality: Here, the Accounting Policies, Notes to Accounts, and Auditors' Comments that are part of the Annual Report are reviewed. Any deviation from the Generally Accepted Accounting Practices is noted and the financial statements of the issuer are adjusted to reflect the impact of such deviations.

Contingent liabilities/Off-balance sheet exposures: In this case, the likelihood of devolvement of contingent liabilities/off-balance sheet exposures and the financial implications of the same are evaluated.

Financial flexibility: The issuer's financial flexibility—as reflected by its unutilised bank/credit limits, liquid investments, and the nature of its relationship with banks, financial institutions and other intermediaries—is assessed.

Financial Risks: Key Ratios Evaluated

Profitability
Operating Margins: OPBDITA/Operating Income
Net Margins : PAT/Operating Income
ROCE : PBIT/(Total Debt+ Tangible Net Worth + Deferred Tax Liability – CWIP)

Capitalisation & Coverage
Gearing : Total Debt/Tangible Net Worth
Interest Coverage : OPBDITA/Interest & Finance charges
PBDITA/Interest & Finance charges
Total Debt/OPBDITA
Net Cash Accruals/Total Debt

Liquidity Ratios Net Working Capital/Operating Income

Cash Flow Ratios
Fund Flow from Operations/Interest
Fund Flow from Operations/Total Debt
Retained Cash Flows/Total Debt

NB : OPBDITA denotes Operating Profit before Depreciation, Interest, Taxes and Amortisation, PAT denotes Profit after Tax, PBIT denotes Profit Before Interest and Taxes , PBDITA denotes Profit before Depreciation, Interest, Taxes and Amortisation, CWIP denotes Capital Work in Progress.

Strength of Promoters/Management Quality

All debt ratings necessarily incorporate an assessment of the quality of the issuer's management, as well as the strengths/weaknesses arising from the issuer's being a part of its "group". Usually, a detailed discussion is held with the management of the issuer to understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the issuer's industry. Some of the other points assessed are:

- Experience of the promoter/management in the line of business concerned
- Commitment of the promoter/management to the line of business concerned
- Attitude of the promoter/management to risk taking and containment
- The issuer's policies on leveraging, interest risks and currency risks
- The issuer's plans on new projects, acquisitions, expansion, etc.

- Strength of the other companies belonging to the same group as the issuer
- The ability and willingness of the group to support the issuer through measures such as capital infusion, if required
- The possible need to support other group entities, in case the issuer is among the stronger entities within the group

Adequacy of Future Cash Flows

Since the prime objective of the rating exercise is to assess the adequacy of the issuer's debt servicing capability, ICRA Lanka draws up projections on the likely financial position of the issuer under various scenarios. These projections are based on the expected operating and financial performance of the issuer, the outlook for the industry concerned (in ICRA Lanka's view), and the issuer's medium/long-term business plans. Sensitivity tests are also performed on certain key drivers, such as selling prices, input costs, and working capital requirements. Also of particular importance are the projected capital expenditure and debt repayment obligations of the issuer over the projection horizon.

Summing up

ICRA Lanka's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the instrument being rated. This opinion is arrived at following a detailed evaluation of the issuer's business and financial risks, its competitive strengths, its likely cash flows over the life of the instrument being rated, and the adequacy of such cash flows vis-à-vis its debt servicing obligations.

ICRA Lanka's Ratings Scale and Definitions

ICRA Lanka's Long-Term Rating Scale

Long-Term rating Scale: All Bonds, NCDs, and other debt instruments (excluding Public Deposits) with original maturity exceeding one year.

LAAA	The highest-credit-quality rating assigned by ICRA Lanka. The rated instrument carries the lowest credit risk
LAA	The high-credit-quality rating assigned by ICRA Lanka. The rated instrument carries low credit risk.
LA	The adequate-credit-quality rating assigned by ICRA Lanka. The rated instrument carries average credit risk.
LBBB	The moderate-credit-quality rating assigned by ICRA Lanka. The rated instrument carries higher than average credit risk.
LBB	The inadequate-credit-quality rating assigned by ICRA Lanka. The rated instrument carries high credit risk.
LB	The risk-prone-credit-quality rating assigned by ICRA Lanka. The rated instrument carries very high credit risk.
LC	The poor-credit-quality rating assigned by ICRA Lanka. The rated instrument has limited prospects of recovery.
LD	The lowest-credit-quality rating assigned by ICRA Lanka. The rated instrument has very low prospects of recovery.

ICRA Lanka's Medium-Term Rating Scale (only for Public Deposits)
Medium-Term Rating Scale: All Public Deposit Programmes.

MAAA	The highest-credit-quality rating assigned by ICRA Lanka. The rated deposits programme carries the lowest credit risk
MAA	The high-credit-quality rating assigned by ICRA Lanka. The rated deposits programme carries low credit risk.
MA	The adequate-credit-quality rating assigned by ICRA Lanka. The rated deposits programme carries average credit risk.
MB	The inadequate-credit-quality rating assigned by ICRA Lanka. The rated deposits programme carries high credit risk.
MC	The risk-prone-credit-quality rating assigned by ICRA Lanka. The rated deposits programme carries very high credit risk.
MD	The lowest-credit-quality rating assigned by ICRA Lanka. The rated instrument has very low prospects of recovery.

ICRA Lanka's Short-Term Rating Scale
Short-Term Rating Scale: All instruments with original maturity within one year.

A1	The highest-credit-quality rating assigned by ICRA Lanka to short-term debt instruments. Instruments rated in this category carry the lowest credit risk in the short term.
A2	The above-average-credit-quality rating assigned by ICRA Lanka to short-term debt instruments. However, instruments rated in this category carry higher credit risk than instruments rated A1.
A3	The moderate-credit-quality rating assigned by ICRA Lanka to short-term debt instruments. However, instruments rated in this category carry higher credit risk than instruments rated A1 and A2.
A4	The risk-prone-credit-quality rating assigned by ICRA Lanka to short-term debt instruments. Instruments rated in this category carry high credit risk.
A5	The lowest-credit-quality rating assigned by ICRA Lanka to short-term debt instruments. Instruments rated in this category have very low prospect of recovery.

Notes:
For the short-term ratings of A1 through to A4, the sign of + (plus) may be appended to the rating symbols to indicate their relatively stronger position within the rating categories concerned. Thus, the rating of A2+ is one notch higher than A2.

For the rating categories LAA through to LC and MAA through to MC, the sign of + (plus) or – (minus) may be appended to the rating symbols to indicate their relative position within the rating categories concerned. Thus, the rating of LAA+ and MAA+ are one notch higher than LAA and MAA respectively, while LAA- and MAA- are one notch lower than LAA and MAA respectively.