

**SME RATING METHODOLOGY**

Small and Medium Enterprises largely known as SMEs are playing a significant role in the economy of a country. Developing countries like Bangladesh has put more emphasis on flourishing of SME to cope up with challenges of employment generation, eradication of extreme poverty, narrowing the gap of income inequality, maintaining the pace of economic growth, SDGs achievement and so on. In this essence, SMEs are indispensable for overall economic development of the country due to its labor intensive nature with short gestation period. The central bank of the country, Bangladesh Bank, has introduced dedicated desk presently known as SME & Special Program Department. Similarly, the Government of Bangladesh has developed policy to encourage this sector as reflected through the Industrial Policy. According to the BB instruction, banks must raise its investment in SME sector to 25% of total investment by 2021.

**DEFINITION OF SME**

National Credit Ratings Limited (NCRL) has defined Small and Medium Enterprises (SMEs) in accordance with the Industrial Policy 2016 and the approvals of Bangladesh Bank over time to time. Under this definition, the updated attributes to categorize SMEs are as follows:

<b>Recognition Criteria</b>				
<b>Category</b>		<b>Fixed assets</b>	<b>Employees</b>	<b>Loan Limit</b>
Micro	Manufacturing	TK. 1.00-7.50	16-30	TK. 10.00
	Service	> TK. 1.00	15 max.	TK. 2.50
Cottage		> TK. 1.00	15 max.	TK. 1.00
Small	Manufacturing	TK. 7.5-150	31-120	TK. 200.00
	Service	TK. 1.00-20.00	16-50	TK. 50.00
Medium	Manufacturing	TK. 150.00-300	121-300 [1000 min. for Garments]	TK. 750.00
	Service	TK. 20.00-30.00	51-120	TK. 500.00

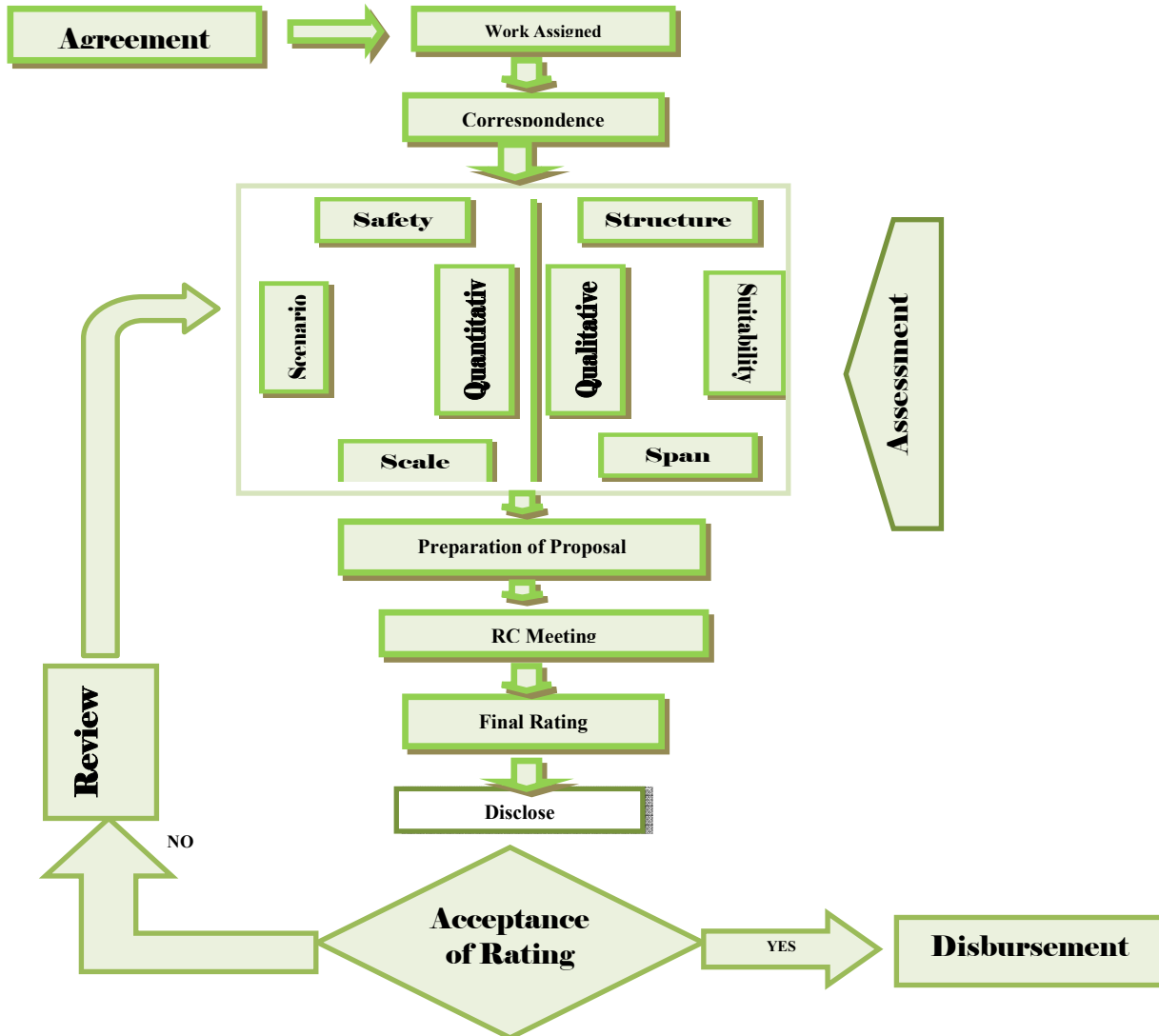
NCR recognizes the SMEs taking into account the loan limit approved by the banks & financial institutions and the division under which the facility/facilities is/are sanctioned as well.

**PURPOSE OF SME RATING:**

- Addressing the risks of the lending institutions to finance SMEs
- Implementing the guidelines of BASEL Accords by the Financial Institutions.
- To measure the creditworthiness involving the ability and willingness considering certain factors to mitigate the risk of recovery

## PROCESS OF SME RATING:

The process of SME Rating is graphically represented below:



## BENEFICIARIES:

The beneficiaries of SME rating has been largely viewed from two ends.

### Lenders:

- Third party opinion about the credit quality.
- Independent & objective review of the entity.
- Assist in credit decision process.
- Help to set pricing and calculation of risk weighted asset.

### Borrowers:

- Negotiate for better and convenient credit terms.
- Self-evaluation and develop strategies to cope up with the shortcomings.
- Reduce time constraint.

## RATING SCALE:

NCRL has assigned eight (08) rating grades after completing the rating process that is approved by the Bangladesh Bank. These eight (08) rating grades along with the explanation is shown in following table:

Rating Scales and Definition (SME Rating Grade)	
Rating Scale	Definition
NSME – 1	<b>Highest Credit Quality:</b> Entity under this category offering <b>highest safety</b> for timely servicing of financial obligations. Such institutions carry <b>lowest credit risk</b> .
NSME – 2	<b>High Credit Quality:</b> Entity under this category offering <b>high safety</b> for timely servicing of financial obligations. Such institutions carry <b>very low credit risk</b> .
NSME – 3	<b>Adequate Credit Quality:</b> Entity under this category offering <b>adequate</b> capacity for timely servicing of financial obligations. Such institutions carry <b>low credit risk</b> .
NSME – 4	<b>Moderate Credit Quality:</b> Entity under this category offering <b>moderate safety</b> for timely servicing of financial obligations. Such institutions carry <b>moderate credit risk</b> .
NSME – 5	<b>Inadequate Credit Quality:</b> Entity under this category offering <b>Inadequate safety</b> for timely servicing of financial obligations. Such institutions carry <b>high credit risk</b> .
NSME – 6	<b>Risk-Prone Credit Quality:</b> Entity under this category offering <b>Low safety</b> for timely servicing of financial obligations. Such institutions carry <b>very high credit risk</b> .
NSME – 7	<b>Poor Credit Quality:</b> Entity under this category offering <b>lowest safety</b> for timely servicing of financial obligations. Such institutions carry <b>highest credit risk</b> .
NSME – 8	<b>Lowest Credit Quality:</b> Entity under this category are either in <b>default</b> or likely to be in default soon.

## OUTLOOK:

NCRL has designed four outlook status assigned with the SME rating. Outlook status with explanation is depicted in below:

<b>Positive</b>	Indicates that rating may be upgraded in near future.
<b>Negative</b>	Indicates that rating may be degraded in near future.
<b>Stable</b>	Indicates that rating may remain unchanged as existing fundamentals may remain unchanged in near future.
<b>Developing</b>	Indicates that rating may be raised, lowered or remain unchanged depending on changes in the performance indicators.

The outlook addresses what direction we believe the rating may take in near future. It is not necessarily a precursor of any rating changes and often used to maintain the stability of the rating. The outlook provides indication to investors on the potential evolution of a rating. Hence, it increases the precision of the rating.

**METHODOLOGY:**

While rating of SMEs is taken into account, NCRL categorizes the enterprise rating factors into two broad areas i.e. qualitative and quantitative. In the rating process, NCRL follows Bangladesh Bank guidelines that are incorporated in the rating model with some modifications to quantify the qualitative information of SMEs. According to the guideline, NCRL assigns 60% weight on qualitative and 40% weight on quantitative analysis while rating of SMEs. In addition, the rating process of NCRL considers industry risk analysis, business risk analysis, financial risk analysis, operational risk analysis, managerial risk analysis, bank relationship risk analysis, security risk analysis and other factors.

**Industry Risk Analysis:**

As every enterprise resides within an industry, the enterprise cannot segregate itself from the impact of industry dynamics. Under Industry risk analysis NCRL examines the SMEs through several crucial aspects as follows:

- Influence of industry scenario over the SMEs.
- Strengths and challenges of SMEs.
- Trends of technological changes.
- Government patronization.
- Political environment.
- Entry and exit barrier.
- Bargaining power and the existence of substitute products.

**Business Risk Analysis:**

To measure the credit worthiness of SMEs, NCRL under the business risk analysis tries to project and define all the business uncertainties and risks inherent with the SMEs. To do so NCRL focuses on assessing under following factors.

- Ownership structure.
- Span and scale of operation.
- Product line.
- Overall manufacturing condition.
- Relationship with the stakeholders.
- Legal approvals.
- Profitability like gross profit margin, operating profit margin, net profit margin, return on equity and return on asset etc.
- Compare the performance of SMEs with the industry average benchmark developed by NCRL based on the information/data obtained from its client..

**Financial Risk Analysis:**

The financial risk analysis of SMEs largely depends on certain ratios that actually reveal the performance of financial position of the enterprises. While evaluating the ratios of financial performance, the analysis is limited to the disclosures of the enterprises that they made in their Audited/ financial statement prepared by the management of the units. The ratios fall into three broad categories such as -

- Liquidity position:** To evaluate liquidity position of SMEs, NCRL generates current and quick ratio. Additionally, NCRL also takes into account the net working capital and free cash flow of the units.

- Asset management:** To assess asset management quality of SMEs, NCRL looks into the total asset turnover ratio and the cash cycle.
- Debt management:** To find out the efficiency and effectiveness of debt management, NCRL rationalizes through the leverage ratio, coverage ratios both interest coverage ratio and debt service coverage ratio and equity multiplier.

**Management Risk Analysis:**

In most cases of SMEs there are very little differences between promoters and management team as most of the SMEs are formed under sole proprietorship and partnership structure. But, NCRL believes that the capacity and efficiency of the promoters have large impact over the management risk relieving. In case of eligibility under Management Risk Analysis NCRL looks into-

- Personal net worth statement
- Promoters' experience, educational qualification etc.
- Promoters' involvement with any other businesses.
- Successor involvement in the business.
- Number of personnel employed and
- Ability to adapt with the changing environment.

**Operational risk management:**

For smooth functioning of day to day operation of SMEs operation risk management is very crucial for enterprises. To measure the operational risks of SMEs, NCRL examines the following factors:

- Infrastructure of the SMEs.
- Compliance issues regarding the work nature of SMEs.
- IT structure and the record keeping process.

**Bank Relationship Risk:**

To assess the willingness and ability of the SMEs to meet its obligations, it is quiet important to scrutinize the banking relationship that enterprises maintains. Banking relationship of SMEs can be portrayed through analyzing statements and account transaction behavior. The factors that NCRL focus on evaluating bank relationship risk are depicted below:

- Tenor of relationship with the entity/concern.
- Utilization of capacity.
- Any history of reschedule, restructure and default payments.
- Status of the facility.
- Relationship with the suppliers and customers
- Willingness to follow the compliance and be guided by law etc.

**Security Risk Analysis:**

NCRL focuses on the cash generating capacity of the SMEs but NCRL resting its eyes on the recovery prospect putting relative importance on the security and collaterals. NCRL take into account the following areas:

- Adequacy of the collaterals.
- Quality of the collaterals.

**Other Risk Factors:**

Besides the mentioned factors, NCRL also evaluates the factors like production process, environmental issues, delivery channel and like, depending on type/nature of the entities to be evaluated.

**Disclaimer:**

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