



## Corporate Credit Rating 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.

This rating methodology describes ICRA Nepal's approach to assessing credit risk of entities in the corporate sector for all kind of debt products excluding public deposit viz. all bonds, debentures, bank loans lines etc. It aims to help issuers, investors and other interested market participants understand ICRA Nepal's approach to analysing risks that are likely to affect rating outcomes of corporate sector entities. This document does not include an exhaustive discussion of all the rating factors that our analysis considers, but provides an overall perspective of the considerations that are usually the most important. While this document provides a general overview of the salient rating considerations, for more details readers may refer to the various sector-specific and other cross-sector methodologies available on ICRA/ICRA Nepal's website.

This rating methodology updates and supersedes ICRA Nepal's earlier methodology document on this subject, published in May 2013. While the revised version incorporates a few modifications, ICRA Nepal's overall approach to rating corporate sector entities remains materially similar.

### Overview

#### Fundamental premise of ICRA Nepal's ratings

ICRA Nepal's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with timely debt servicing by an entity. The rating approach involves evaluating the rated entity's ability to generate cash from operations, the predictability of such cash flows and assessing their adequacy to meet the debt servicing obligations over the tenure of the rated instrument. 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 industry risk, business risk, financial risk and management related risk. ICRA Nepal'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. Additionally, the rating approach involves assessing other forms of cash flow support available to an entity that supplement its operational cash flows. Such support may be in the form of cash balances, liquid marketable securities, external sources of financing, or some manner of third-party support, implicit or explicit.

#### Credit risk differentiation: What forms the basis, what doesn't?

In effect, ICRA Nepal's ratings, being ordinal measures of credit risk, aim to rank order debt instruments in terms of their relative probability of default. The rating assessment does not explicitly take into

account the loss borne by an investor or a lender in the event of actual crystallisation of default or subsequent bankruptcy/liquidation. Because of this approach, ICRA Nepal's ratings do not differentiate among debt instruments in terms of their secured or unsecured nature. This, however, does not preclude differentiating for credit risk among rated instruments based on their seniority and other contractual features.

### Sources of credit risk

The credit rating of an entity is governed by the degree of its exposure to industry risk, business risk, financial risk and management risk. The relative impact of each of these broad risk categories on an entity's credit risk may vary from case-to-case and is assessed by ICRA Nepal based on empirical and qualitative judgement. An entity may have a strong competitive position within its business, but it may be operating in an industry that is highly cyclical or is exposed to a high degree of uncertainty. The final rating of such an entity, which would have otherwise been buttressed by virtue of a strong competitive position, would likely get significantly constrained because of the vulnerability to high industry risk. In such a case, industry risk would tend to have an overbearing impact on the final rating outcome than it would have been otherwise.

## ICRA Nepal's Credit Risk Assessment Framework

For analytical convenience, this document describes ICRA Nepal's methodology for rating corporate sector entities under four sections viz., Industry Risk Assessment, Business Risk Assessment, Financial Risk Assessment and Management Quality & Corporate Governance Assessment. In addition to these considerations, an entity's credit rating may also be influenced by its ownership, the nature of linkages with its parent or group entities, the corporate legal structure, degree of financial flexibility, track record of operations and debt servicing and vulnerability (if any) to discrete event risks.

### Credit Risk Categorization

Industry Risk	Business Risk	Financial Risk	Management Risk
» Growth Prospects	» Relative Scale	» Profitability	» Quality of Management
» Cyclicity	» Competitive Position	» Leverage	» Financial Policies
» Competitive Intensity	» Diversification	» Coverage	» Governance Structure
» Regulatory Risk	» Operating Efficiency	» Cash Flows & Liquidity	and Practices
	» Project Risks		

### Industry Risk Assessment

The industry in which an entity operates provides an overarching context to its riskiness. Two entities may have different credit ratings if they operate in industries that have dissimilar risk characteristics, despite having similar risk profiles in all other respects. As an example, an education institute is less prone to the vicissitudes of demand volatility, vicious competition and intrusive regulations compared with a sugar mill, implying that the former would generally be on a better foothold than the latter, ceteris paribus, to timely service an equivalent volume of debt. The riskiness of an industry is largely governed by the following subfactors:

#### Growth Prospects

Entities that operate in industries experiencing high growth, benefit from an expansion in their earnings and returns at a rate faster than entities operating in industries that may be in a low growth phase or on a declining curve. A high growth industry, however, is not an unqualified promise of low credit risk. While an emerging industry like e-commerce offers the lure of high growth, it is replete with the threats

of fickle consumer acceptability, intense price-based competition and the uncertainty around efficient management of human and economic capital. In a separate vein, road annuity projects or gas transmission utilities are typically low growth industries, yet have other low credit risk attributes. Overall, while ICRA Nepal favourably considers the presence of an entity in a high growth industry, the virtues of growth are not assessed in isolation. Rather, these are assessed against the backdrop of other aspects including the sustainability of long-term growth and the sources of volatility.

### Cyclicalities

Cyclical industries could be grouped into two categories—one, whose fortunes depend on how well the economy is doing (like real estate, shipping or automobiles); and two, whose performance is linked to the level of and the volatility in commodity prices (like ferrous metals, oil or agro-commodities). For entities in cyclical industries, the shifts in economic and commodity price cycles could significantly jeopardize the debt servicing ability. Compared with stable industries, cyclical industries have lower tolerance for financial and operating leverage as adverse swings in revenues and profits heighten the probability of default. The deleterious impact of demand cyclicalities is even more pronounced for industries that have a long gestation period for setting up new capacity. This is because of the difficulty in predicting well the timing, severity and duration of a cyclical downturn. It may happen that by the time new capacity is set to become operational (*the capital expenditure having been initiated at the peak of the cycle*), after a long execution period, the up-cycle may well be at the fringe of a reversal. Overall, ICRA Nepal favourably considers entities operating in industries that have stable demand and realisation patterns, as opposed to entities operating in industries that are cyclical, all other things being equal.

### Competitive Intensity

The more intense the competition is in a given industry, the less likely would be the industry participants' ability to grow revenues and profits. Even if such an industry per se may have strong growth prospects, the industry players may not be able to retain the bounty of profits with themselves, but rather be constrained to fully pass on or share the benefits with their consumers. Competitive intensity in a given industry would generally be high if a combination of the following factors is at work: high industry fragmentation, similarity in market share of prominent players, low entry barriers, high exit barriers, commodity nature of product or service, low customer switching costs, or excess production capacity. Competitive intensity in a given industry may also change over time as entrenched players demonstrate collective change in product pricing strategies. Regulatory actions could also alter the level of competitive intensity in an industry.

### Regulatory Risk

Regulatory intervention in various industries manifests in multiple forms, including the level of taxation, duties and subsidies, price controls, supply controls, import/ export restrictions or outright bans. The intention of increased regulatory activism has ranged from ensuring better consumer protection (*price control of essential drugs*), promoting fair competition (*settling the debate on net neutrality*), improving the industry structure (*cable digitisation*), controlling systemic risks (*restricting gold imports*), protecting the environment (*banning of cars with higher capacity diesel engines in the National Capital Region*), protecting the domestic industry (*anti-dumping duty on steel*) to meeting socio-political objectives (*ban on liquor sales in various states*).

While evaluating the exposure of an industry to regulatory risks, ICRA Nepal evaluates whether the government's role is restricted to that of a facilitator or does the government exercise control over many facets of the industry. Also assessed is the extent of susceptibility of an industry's competitiveness to the government's policies with regard to subsidies, taxation and import-export restrictions and duties. In addition to local or national regulations, heed is also paid to the changes in international regulations and policies that could have ramifications for an industry's participants.

## Business Risk Assessment

The presence of an entity in a low risk industry can support its credit profile, but only so much. It is an entity's own business position that remains one of the primary drivers of credit risk<sup>1</sup>. The strength of an entity's business position in turn is a function of its scale and scope of operations, competitive position in its addressable market, diversity in terms of customers, products, geography and asset base, besides efficiency demonstrated with regard to operations, use of working capital and deployment of fixed capital. How ICRA Nepal evaluates each of these sub-factors is described below:

### Relative Scale

Larger scale is a reflection of having executed an act many times with success. A large scale is generally a reflection of a strong market position, operating and financial flexibility and staying power; 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, ICRA Nepal evaluates the same in relation to the peers of the entity in its addressable market segment.

### Competitive Position

The competitive position of an entity determines the sustainability or fragility of its business model. For evaluating the competitive position of an entity, ICRA Nepal analyses the source of such competitiveness— whether it draws from a strong brand, a wide distribution network, a favourable location, deep customer relationships, superior technology, a cheaper access to raw materials or any other differentiating factor. A solid competitive position leads to superior profitability and higher cash flows, thus lowering credit risks.

In case competitive advantage draws from a strong brand, ICRA Nepal assesses whether the entity concerned runs the risk of losing its position over time as competitors duplicate its methods or develop better propositions. In determining the competitive position of an entity in a commodity business, ICRA Nepal focuses on the comparative cost structure and other possible differentiating factors like distribution network and customer relationships. Even as cost leadership holds greater importance than branding in commodity businesses, bigger players in such businesses are increasingly seen to be making efforts towards creating brands, particularly in the Business-to-Consumer (B2C) space. From a credit perspective, such strategies are viewed positively only if these are expected to build a durable competitive advantage and not run the risk of being ably imitated by key competitors, obviating the case to differentiate.

### Diversification

Diversification is an effective antidote for businesses to deal with cash flow volatility or the risk of possible disruption. Apart from increasing the odds of survival, diversification also often acts as a strategic lever to spur business growth. However, diversification also has a downside to it as it could diffuse management focus or become a cause for below par returns. Overall, adequate diversification, whether in the form of customer diversification, geographic diversification or product diversification, imparts greater long-term stability to earnings and cash flows of an entity.

**Customer Diversification:** An adequate degree of customer diversification reduces an entity's vulnerability to (i) variability in demand associated with a select few customers, and (ii) disruption in the business of a single customer. Entities engaged in B2C businesses, by structure, enjoy a greater degree of customer diversification. While this may not be so for entities involved in B2B businesses, this risk could get largely mitigated if the individual customers are fundamentally strong and have resilient business ties with the entity. While evaluating an entity on the customer diversification parameter, ICRA

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<sup>1</sup> Although this could in turn be constrained by a risky industry character

Nepal does so in the context of the entity's business model—whether B2C or B2B—and factors in the interplay between customer diversification and customer quality.

**Geographic Diversification:** An adequate degree of geographical diversification reduces an entity's vulnerability to (i) variability in demand in a single region, and (ii) demand disruptions caused by force majeure events or adverse regulatory actions in a single geography. One of the lesser emphasised merit of dealing with customers across multiple geographies, say domestic and overseas, is that it likely pushes entities to adopt the best practices in the areas of production, engineering, quality control and so on, and in the process improve their overall competitiveness. On the flip side though, a multiple country business profile exposes an entity to currency risks. It could be argued that an entity that is concentrated towards a high growth single geography is better off than an entity that though diversified geographically, faces demand weakness in select geographies. However, ICRA Nepal does not view the latter negatively as a geographically diversified entity is more likely to demonstrate a balanced performance over a longer time horizon, even if there are intervening periods of lower average growth.

**Product Diversification:** Diversification into new product or service lines is often an essential part of an entity's growth and risk mitigation strategy. Such diversification could be aimed at selling a larger variety of products to the same set of customers (aimed at increasing the 'share of wallet') or towards expanding the breadth of products so as to target new customer segments, or towards extending the existing strong brand to enter into altogether new product segments. ICRA Nepal favourably considers entities that have a more comprehensive range of products or services among the peers and thereby derive revenues and profits from a broader set of offerings than the industry average. However, not much comfort is derived by ICRA Nepal overall if only the array of products is wider with all or most of the products exhibiting a weak competitive position.

**Supplier Concentration:** Consider an entity that has dependence on a single supplier for any of the raw materials or any factor of production. In case of operational disruption at the supplier's end, the rated entity may not be able to develop an alternate source in quick time and hence faces the risk of disruption in its own business. Thus, while assessing supplier concentration risk, ICRA Nepal endeavours to understand the fault lines in an entity's supply chain.

## Operating Efficiency

A high cost producer could be rendered uncompetitive and go out of business if demand falls, because low cost producers could be more price competitive. It is in this context that operating efficiency holds relevance with entities that enjoy a lower per unit variable cost of production and have a lower fixed cost base being relatively better positioned to weather pricing pressures and demand slowdown. This parameter has greater significance in the commodity businesses, where the low cost of production is among the key drivers of competitiveness. 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, vintage of machines, level of backward or forward integration and the interest servicing burden etc.

ICRA Nepal assesses an entity's operating efficiency by undertaking an analysis of the above elements.

## Project Risks

In addition to the above risk factors, a project entity or an entity undertaking a large-sized project capital expenditure (capex) is exposed to other risks, including cost and time over-runs. To ascertain project risks, ICRA Nepal endeavours to understand the entity's rationale for undertaking new investments. 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: (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 contractor and technology/equipment 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 entity's existing operations.

## Financial Risk Assessment

ICRA Nepal analyses long period past financial performance trends as well as makes estimates of future financial performance to assess the financial risk exposure of an entity. The financial metrics provide a useful reference not only to evaluate the performance trends of an entity over a given time period, but also enable a comparison with peers. The various financial metrics assessed by ICRA Nepal could be divided into four categories viz., Profitability, Leverage, Coverage and Liquidity. This document provides a brief summary of these ratios.

### Profitability

Profitability is a measure of the earnings generated by an entity in a given time period in relation to the resources deployed. Profitability could be influenced by multiple factors, including those that are firm specific or those that are related to the industry, economy or regulations. A consistent track record of higher profitability shown by an entity compared with its peers is a reflection of a superior competitive position emanating from one or more factors, including greater brand strength, better distribution reach, attractive product profile, technological superiority or higher cost efficiency (*operating or capital*). Entities with higher profitability have better resilience to economic downturns and are more likely to generate adequate internal resources for re-investment and debt servicing, as also attract fresh capital.

The various ratios which are typically used by ICRA Nepal to analyse an entity's profitability are:

Ratio	Computation
<b>Operating Profit Margin</b>	(Operating Profit) / (Operating Income)
<b>Net Profit Margin</b>	(Net Profit after Tax) / (Operating Income)
<b>Return on Capital Employed</b>	(Profit before Interest and Tax) / (Average Capital Employed)

*Operating Income = Revenues from Operations (net of excise duty)*

*Operating Profit = Profit before Depreciation, Amortization, Interest, Tax and Non-Operating or Non Recurring Income and Expense*

*Capital Employed = Total Debt + Net Worth + Deferred Tax Liability – Capital Work in Progress – Capital Advances*

### Leverage

Financial leverage is a measure of an entity's dependence on borrowed funds. Lower the dependence on borrowings, the lower (better) the leverage. When an entity borrows, it is obligated to pay both interest as well as principal to the lenders as per a defined schedule. This pushes up the fixed cost burden on the borrowing entity and in the limiting case, increases the default risk. While high leverage may mean high risk from a credit perspective, it is an oft-adopted course by shareholder-oriented managements, given that high leverage, in good times, leads to high returns on equity capital. An entity's financial leverage could thus be a function of its management's financial policy and risk tolerance, besides being a point-in-time reflection of an entity's business and financial choices. An entity with lower leverage is better equipped to withstand volatility in cash flow generation in situations of economic downturn, competitive challenges, unexpected costs, changing consumer preferences, or regulatory changes.

The various ratios which are typically used by ICRA Nepal to analyse an entity's financial leverage are:

Ratio	Computation
<b>Gearing</b>	(Total Debt) / (Tangible Net Worth)
<b>Total Indebtedness Ratio</b>	(Total Outside Liabilities) / (Tangible Net Worth)
<b>Debt to Profit Ratio</b>	(Total Debt) / (Operating Profit)
<b>Accruals to Debt Ratio</b>	(Net Cash Accruals) / (Total Debt)

*Total Debt = Long-Term and Short-Term Debt (including subordinated debt) + Off-Balance Sheet Liabilities (such as receivables discounted) + Preference Shares<sup>^</sup> + Optionally Convertible Debentures<sup>^</sup>*

*Shareholder's Funds or Tangible Net Worth = Net Worth - Revaluation Reserves - Net Intangibles - Miscellaneous Expenditure not Written-off + Minority Interest + Compulsorily Convertible Debt + Share Application Money + Preference Shares<sup>^</sup> + Optionally Convertible Debentures<sup>^</sup>*

*Total Outside Liabilities = Total Debt + All Long-Term and Short-Term External Liabilities such as Deferred*

*Tax Liability, Creditors and Operating or Non-Operating Liabilities*

*Net Cash Accruals = Net Profit after Tax + Depreciation – Dividend on Preference and Equity Shares*

<sup>^</sup> *As part of ICRA Nepal's internal adjustments based on the maturity period, coupon rate and priority of claims associated with individual instruments, appropriate equity credit is given to hybrid instruments such as Preference Shares and Optionally Convertible Debentures*

## Coverage

Coverage is a measure of an entity's debt-servicing ability and is calculated as the ratio of profits (or cash flows) to the debt servicing obligations in a given time period. Higher is the ratio, higher the cushion available with an entity to withstand variability in profits (or cash flows), for making good its financial obligations. Coverage is a function of an entity's profits, leverage and debt characteristics (in terms of cost of debt and repayment schedule). Entities with higher profitability and lower leverage will generally have better coverage ratios and thereby healthier financial risk profiles. However, there may be exceptions to this such as in project funding structures for long-dated assets like road projects or power projects where the loan tenures are typically long. In such cases, even as profits may be small in the initial years and leverage ratios may appear onerous, the fact that the long-term debt contracted may have a sufficiently long period of moratorium (*and interest payout during the construction phase may also be funded through the project debt*) along with a ballooning and a spread-out repayment schedule, the coverage ratios may not be as weak.

The various ratios which are typically used to analyse an entity's coverage metrics are:

Ratio	Computation
<b>Interest Coverage Ratio</b>	(Operating Profit) / (Gross Interest expense)
<b>Debt Service Coverage Ratio</b>	(Net Profit After Tax + Gross Interest + Depreciation) / (Gross Interest + Repayment + Dividend on Preference Shares)

## Liquidity and Cash Flows

Liquidity is the measure of an entity's ability to meet its short-term cash obligations from various internal or external resources. Internal resources include cash generated from operations, unencumbered cash and liquid investments on balance sheet or cash generated through asset monetisation. External resources include undrawn lines of credit or equity capital. The short-term obligations include operating liabilities such as salary payable and sundry expenses, margin required to undertake capex or fund incremental working capital requirements, investment commitments and debt servicing obligations. 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. ICRA 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.

The various ratios which are typically used to analyse an entity's liquidity are:

Ratio	Computation
<b>Current Ratio</b>	(Current Assets) / (Current Liabilities)
<b>Gross Cash Conversion Cycle</b>	Debtor Days + Inventory Days
<b>Working Capital Cycle</b>	Debtor Days + Inventory Days – Payable Days
<b>Working Capital Intensity</b>	(Net Working Capital) / (Operating Income)

*Current Assets = Cash + Inventory + Debtors + Other Operating and Non-Operating Current Assets*

*Current Liabilities = Current Portion of Long-Term Debt + Short-Term Debt (including Working Capital Debt) + Creditors + Other Operating and Non-Operating Current Liabilities*

*Net Working Capital = (Current Assets – Cash) – (Current Liabilities – Current Portion of Long-Term Debt – Short-Term Debt – Capital Creditors)*

## Cash Flows

It is cash that is required to service obligations. A cash flow statement reflects the sources from which cash is generated and its deployment. Analysed here are the trends in an entity's Funds Flows from Operations 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 helps in understanding the external funding requirements that an entity has, to meet its maturing obligations.

The various cash flow measures assessed by ICRA Nepal are:

Cash flow measures	Computation
<b>Fund Flows from Operations (FFO)</b>	Operating Cash Flows less Operating Working Capital Changes
<b>Gross Cash Flows (GCF)</b>	FFO plus Non-Operating Income less Non-Operating Working Capital Changes
<b>Retained Cash Flows (RCF)</b>	GCF less Dividends Paid
Cash flow measures	Computation
<b>Free Cash Flows (FCF)</b>	RCF less Capital Expenditure
<b>Cash Cover Ratio</b>	Ratio of Free Cash Flows to obligations

## Other Elements of Credit Risk Assessment

**Foreign currency-related risks:** Such risks arise if an entity's primary costs and revenues are denominated in different currencies. Examples in this regard would include entities selling in the domestic market but having large imports, or export-oriented units operating largely as per the domestic cost structure. Foreign currency risk could also arise from un-hedged liabilities, especially for entities earning most of their revenues in the local currency. ICRA 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 (*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 entity 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 entity 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 entity are adjusted to reflect the impact of such deviations.

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

**Financial flexibility:** An entity's financial flexibility as reflected by its un-utilised bank/ credit limits, liquid investments, and the nature of its relationship with banks, financial institutions and other intermediaries. Financial flexibility could also emanate from other factors such as the entity's large scale operations



with strong financials, large unencumbered cash flows (such as rental income, annuity payments in road projects) or unencumbered assets/ flexibility to borrow against existing assets, or the entity's strong parentage or linkages with a strong group.

## Management Quality & Corporate Governance Assessment

In addition to the industry, business and financial risk analysis, all credit ratings incorporate an assessment of the quality of the rated entity's management, the financial policies and the governance practices.

### Quality of Management; and Financial Policies

As part of its process, ICRA undertakes discussions with the rated entity's management to understand its views on past performance as well as its future plans and strategies and the outlook on the industry. Some of the points assessed are:

- » Experience of the promoter/ management in the industry
- » Commitment of the promoter/ management to the rated entity
- » Risk appetite of the promoter/ management and risk mitigation plans
- » Policies on leveraging, managing interest rate risks and currency risks
- » Management's past success in introducing new projects and managing changes in the external environment
- » Management's plans on new projects, acquisitions and expansions
- » Track record of balancing the interests of shareholders, creditors and other stakeholders

Periodic interactions with the management help in ascertaining the shifts, if any, in their financial policies.

### Governance Practices

Corporate governance remains a complex and an evolving subject and from a risk perspective tends to hold as high an importance as an entity's business strategy. A sound corporate governance structure attempts to make clear the distinction of power and responsibilities between the Board of Directors and the management. The constitution of an entity's Board and the Board of Directors' participation in strategy formulation, besides the entity's adherence to legal and statutory compliance requirements are factored in during credit assessments. ICRA Nepal seeks to gain a qualitative understanding of an entity's commitment to following transparent and credible practices by the way its financial statements are reported, their level of disclosures, consistency in communication and the openness with regard to sharing information during the credit rating exercise. Also assessed are an entity's related party transactions, instances of supporting group entities at the expense of debt holders and executive compensation packages.

### Summing Up

ICRA Nepal'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 rated entity's industry, business and financial risks, its likely cash flows and the adequacy of such cash flows vis-à-vis the debt servicing obligations and other funding requirements. ICRA Nepal's rating approach also involves making an assessment of the entity's management quality and governance practices. In addition to these considerations, an entity's credit rating may also be influenced by its ownership, the nature of linkages with its parent or group entities, degree of financial flexibility, the corporate legal structure, track record of operations and that of debt servicing, and vulnerability (if any) to discrete event risks.

## ICRA Nepal's Ratings Scale and Definitions

### ICRA Nepal's Long-Term Rating Scale

Long-Term rating Scale: All Bonds, Debentures (non-convertible), Bank loan lines and other debt instruments with original maturity exceeding one year.

<b>[ICRANP] LAAA</b>	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.
<b>[ICRANP] LAA</b>	Instruments with this Rating are considered to have high degree of safety regarding timely servicing of financial obligations. Such instruments carry very low credit risk.
<b>[ICRANP] LA</b>	Instruments with this Rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk.
<b>[ICRANP] LBBB</b>	Instruments with this Rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.
<b>[ICRANP] LBB</b>	Instruments with this Rating are considered to have moderate risk of default regarding timely servicing of financial obligations.
<b>[ICRANP] LB</b>	Instruments with this Rating are considered to have high risk of default regarding timely servicing of financial obligations.
<b>[ICRANP] LC</b>	Instruments with this Rating are considered to have very high risk of default regarding timely servicing of financial obligations.
<b>[ICRANP] LD</b>	Instruments with this Rating are in default or are expected to be in default soon.

**Note:**

For the long term Rating categories [ICRANP] LAA through to [ICRANP] LC, 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 [ICRANP] LAA+ is one notch higher than [ICRANP] LAA, while [ICRANP] LAA- is one notch lower than [ICRANP] LAA.

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

<b>[ICRANP] A1</b>	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.
<b>[ICRANP] A2</b>	Instruments with this rating are considered to have strong degree of safety regarding timely payment of financial obligations. Such instruments carry low credit risk.
<b>[ICRANP] A3</b>	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.
<b>[ICRANP] A4</b>	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.
<b>[ICRANP] D</b>	Instruments with this rating are in default or expected to be in default on maturity.

**Note:** For the short-term ratings [ICRANP]A1 through to [ICRANP]A4, the modifier + (plus) may be appended to the rating symbols to indicate their relative position within the rating levels concerned. Thus, the rating of [ICRANP]A1+ is one notch higher than [ICRANP]A1 and so on.

\* Adopted and modified from ICRA Limited's Corporate Credit Ratings Methodology



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