Caribbean Information &
Credit Rating Services Limited

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METHODOLOGY FOR MANUFACTURING & SERVICE COMPANIES

The following rating methodology is the generalized version of the methodology that CariCRIS would use to analyse entities in the manufacturing & service industry. The analysis of entities in specific sectors within the manufacturing & service spectrum will be based on slightly customized versions of this general methodology.

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The CariCRIS framework for assigning a credit rating to debt issued by manufacturing and service companies is built around analysing the risk arising from four broad areas: economy, industry, business, management and finances. At all times, the risk analysis is undertaken with a view to assessing a company's creditworthiness.

Business Risk

Economy Risk

For the Caribbean region in particular, risks must be assessed in the context of small, open economies. Factors such as economic stability, how open the economy is to trade in respect of a particular industry, the performance and potential threat of imports, the extent to which the industry players export their goods, the industry's dependence on government trade support policies and conversely the ability of industry players to overcome trade barriers, and the overall performance and structure of the economy are important inputs to the evaluation of industry risk. The region's vulnerability to natural disasters - in particular hurricanes, must also be taken under consideration.

Industry Risk

The assessment of the risk posed by the industry in which a company operates includes an examination of market attractiveness, extent of competition, bargaining power with customers and suppliers and government policy.

A market is more attractive if it is bigger, more diversified and less cyclical with respect to revenues and/or costs. Questions such as how important the market is to the overall economy, in what stage in its life cycle is the product and is there imminent risk of product obsolescence must also be answered.

When an industry is characterised by high barriers to entry and low threats from substitutes either domestic or imported, then the revenues of entities operating within such an industry are relatively protected. The extent of bargaining power enjoyed by a company with its customers and suppliers also indicates the relative ability to protect margins.

Apart from the foregoing, CariCRIS takes into consideration a government's stated or implied position towards an industry as well as any tendency to intervene.

Market Position

Market position can be broken down into issues that affect a company's pricing power such as market dominance, brand equity and price elasticity of demand, and an examination of issues affecting revenue stability such as diversity across markets, customers and products. Prospects for growth and sources of competitive advantage are also assessed.

Operating Efficiency

Operating efficiency identifies the factors that impact costs such as the cost structure, efficiency of production, and cost efficiencies arising from sourcing, distribution and effective use of technology. Operating efficiency also examines factors that threaten or ensure the continuity of a company's operations such as labour relations, product development skills and research and development.

A company's market position and operating efficiency must be examined in the context of the industry in which it operates. Therefore, competitive dynamics such as number of players, market fragmentation, expansion capacity of key players and indicative operational efficiency measures across the industry are key inputs to the assessment of the rated company's business risk.

Management Risk

The risk arising from management and its actions has the potential to override - for better or for worse - every other source of risk. CariCRIS assesses a company's management across three areas: competence which examines experience and qualifications, ability to cope with crisis and external factors, skills in human resource management and so on; integrity which would include payment record and willingness to introduce and manage change; and risk appetite which looks at management's propensity to borrow and undertake large projects and its tendency to enter new markets and products. CariCRIS also studies the rated company's investment and financing policies as an indicator of management's attitude towards and propensity for risk-taking.

The potential risk from management arises not only from what is does but how it does it - this brings the corporate governance of an entity under scrutiny. In assessing the quality of corporate governance exercised by the management of a company CariCRIS evaluates issues such as systems and structures that ensure checks and balances, transparency and disclosure and adequacy of planning and succession.

Financial Risk

CariCRIS begins its financial risk assessment with an evaluation of a company's accounting policies with a view to determining the degree of transparency and disclosure exercised by management. Some of the factors examined are the company's policies on income recognition, depreciation, inventory valuation and offbalance sheet items and contingent liabilities - and the consistent application of the chosen policies. Wherever required, a company's financial statements are recast to accurately reflect its performance in a format that is comparable over time.

CariCRIS constructs financial projections incorporating its expectations on economy, industry and business variables as well as management's strategic plans. CariCRIS then uses a variety of financial ratios to determine a company's future creditworthiness. In addition to earnings, cash flow is closely examined to determine levels and stability over time and projected into the future. Moreover, CariCRIS examines a company's ability to raise funds from a variety of sources in times of stress or crisis. This would include a company's reserves, relationship with bankers, ability to raise capital from the market and its overall liquidity position.

The key ratio categories analysed by CariCRIS are capitalisation, coverage, profitability, cash flow and liquidity.

Project Risk

If a company is executing or intending to execute a major project CariCRIS evaluates the risks associated with that project as an input into the company's overall credit rating. Risks affecting the implementation and viability of the project such as the likelihood time and/or cost overruns and risks arising from the funding structure of the project are examined. CariCRIS will also take into account the company's track record in implementing projects as well as the possible effect on its reputation of a failed project. The size of the project relative to existing operations as well as its potential impact on existing business indicate to what extent the project risk assessment will impinge on the overall credit rating.

Other factors such as likelihood of system support or support from group companies are factored into the rating on a case-by-case basis.