



CORPORATE RATING METHODOLOGY FOR SMES AND MIDCAPS

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1 SCOPE

This document showcases Inbonis' approach to assigning credit ratings to non-financial corporates. Inbonis has developed a methodology and process specifically targeted at small and medium-sized companies (SMEs) and mid-caps, but it can be used for the rating of any non-financial corporation.

This document mainly covers the following topics:

- ▶ Inclusion of details regarding the risk factors that are considered within each assessment section.
- ▶ Inclusion of details regarding the additional rating factors that are considered in all or certain ratings.

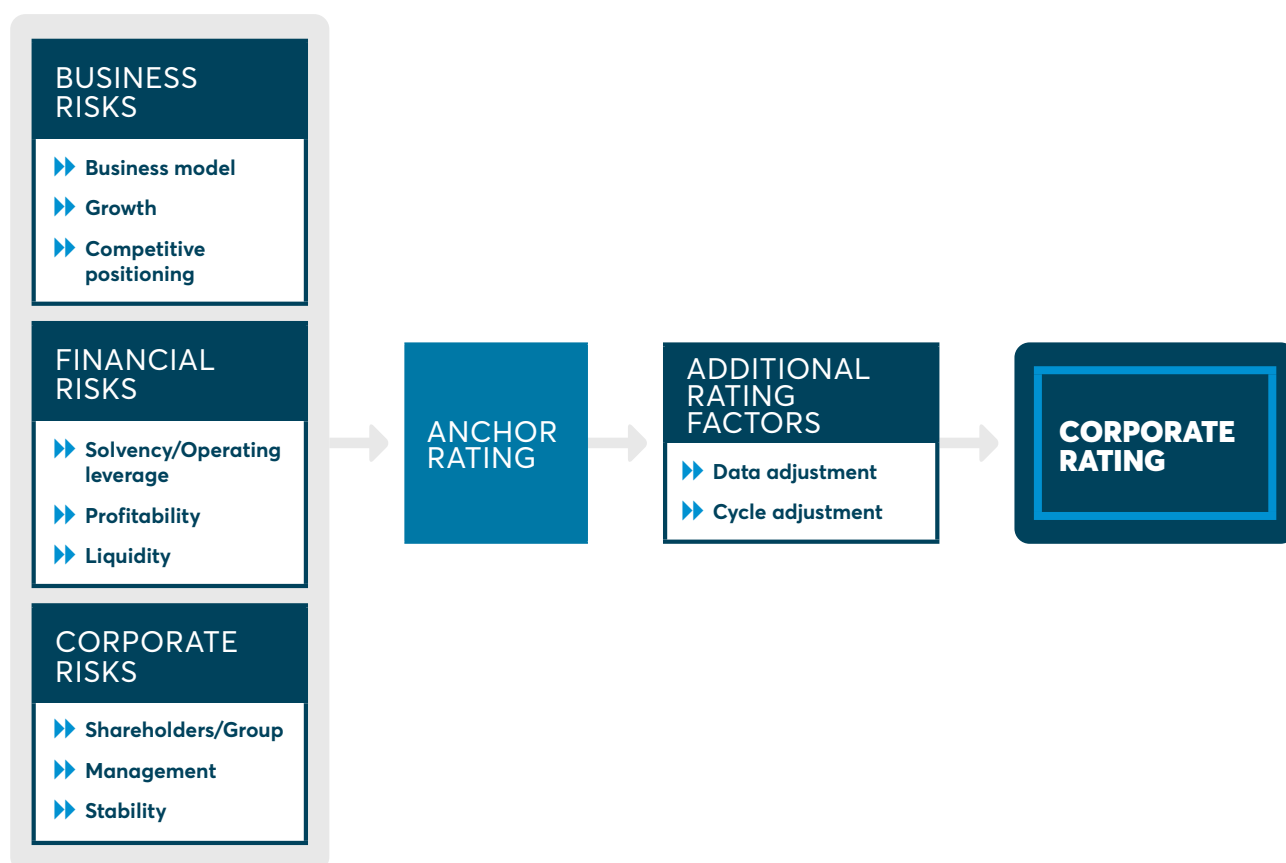
2 CORPORATE RATING METHODOLOGY

2.1 General rating approach

INBONIS' rating methodology consists of the quantitative and qualitative analysis of ten risk factors grouped into three main blocks: business risks, financial risks and corporate risks. Quantitative drivers are generally assessed as a comparison of the company with the economy or its industry, whereas qualitative ones can be assessed as low, medium, high or very high, as yes/no questions or as positive/negative risk drivers. Environmental, Social, and Governance (ESG) factors are also considered in this analysis when they have the potential to materially affect a company's creditworthiness.

This assessment results in the **anchor rating** of the company. Two additional rating factors that can modify the base rating of the issuer (a data adjustment and country and sector adjustment) are then considered, deriving the **final corporate rating**.

Figure 1. INBONIS general rating approach



2.2 Anchor Rating

The anchor rating is obtained through the analysis of the business risks, financial risks and corporate risks of the company.

2.2.1 BUSINESS RISKS

The Business risk aims at evaluating the attractiveness of the activity in terms of business model, estimating the company's performance and its competitive positioning in the industry. This assessment is complemented by the cycle adjustment.

Business model

- ▶ Seasonality/Cyclicity: it is assessed by analyzing historical sales data to identify patterns of demand fluctuation throughout the year and across different years. This involves examining peak and off-peak periods and understanding the factors driving these variations. We also evaluate the capacity of the company to survive during a certain period without revenues.
- ▶ Entry barriers: The assessment of entry barriers involves evaluating the regulatory environment, capital requirements, economies of scale, and brand loyalty within the industry.
- ▶ Industry attractiveness: The industry assessment identifies the macroeconomic factors, competitive forces, and market trends (including technological, demographic, sustainable or behavioral) that influence the industry's overall risk profile and growth potential.

Competitive position

- ▶ Competitive advantages: Competitive advantages include the analysis of the company's market positioning (price, service, quality, brand differentiation...), supply chain positioning (integration, operational excellence) and overall strategy compared to its peers.
- ▶ Client concentration: Client concentration is assessed by analyzing the revenue contribution from top clients and comparing it with the overall revenue base. This involves calculating concentration ratios and evaluating the risk associated with high dependency on a few key customers. Diversification strategies and client acquisition efforts are also reviewed to mitigate concentration risks.
- ▶ Geographical distribution: Geographical distribution is evaluated by analyzing the company's revenue and operational footprint across different regions. This involves assessing the market potential, regulatory risks, and competitive landscape in each geographical area. A balanced geographical distribution can enhance the company's resilience and growth prospects.

Growth

- ▶ Sales growth: assessed by analyzing historical revenue data and comparing it with industry benchmarks. Key metrics such as Compound Annual Growth Rate (CAGR) and year-over-year growth rates are calculated to understand the company's growth trajectory.
- ▶ Ebitda growth: evaluated by examining the company's financial statements over time and comparing them with industry averages. Ebitda calculation can be adjusted to reflect differences in accounting standards/rules.
- ▶ Business plan and projections: The assessment of the business plan involves reviewing the company's strategic objectives, market assumptions, and financial projections. This includes evaluating the feasibility of revenue and expense forecasts and assessing the alignment of the business plan with market trends and competitive dynamics.

2.2.2 FINANCIAL RISKS

The Financial risk evaluates various financial aspects and the key underlying drivers of the company's indebtedness, financial structure, liquidity and profitability.

Solvency / Operating leverage

Assesses the company's debt sustainability and financial structure:

- » Solvency (Own funds / Total Assets)
- » Debt coverage (Financial expenses / Ebit)
- » Operating Working Capital
- » Debt sustainability
 - Ability to adapt costs to income
 - Ability to absorb variations in rates, prices, currency
 - CFO / Debt service
 - Debt / Ebitda
- » Working capital quality
 - High liquidity
 - Balanced collections/payments
 - Resistance to quarters without revenues

Liquidity

Values and benchmarks the capacity of the company for generating liquidity and facing its payments through the following drivers:

- » Acid test
- » Collection period
- » Repayment alternatives
- » Payment behavior

Profitability

Evaluates the company's ability to transform sales into profits and compares it with that of its competitors:

- » Operating margins
- » Cash flow generation

2.2.3 CORPORATE RISKS

The Corporate and Governance risks are analyzed in the light of the ownership and the management structure of the rated entity. Other criteria to assess the stability and ethics of the company are also analyzed.

These factors prove to be especially important when rating smaller-sized, family-owned companies. The following ratios and drivers are assessed:

- » Ownership structure and group influence¹
- » Stability and government influence
- » Shareholders' quality
- » Management experience and differential know-how
- » Management financial judgment
- » Management commitment
- » Company size and age

2.2.4 PEER COMPARISON

A sector and size-specific peer comparison in a series of indicators is performed in each rating, to offer analysts a fair image of the relative performance of the rated company against its peers and ensure consistency across ratings.

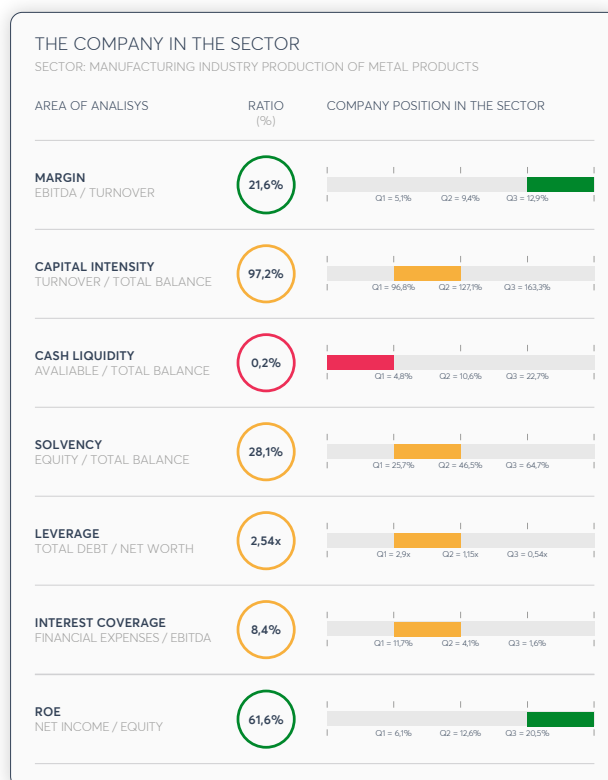
For each KPI, the company's performance is measured by comparing its value to the quartiles of the performance distribution of its peers. These thresholds are obtained from the European database of companies' accounts (Bank for Accounts of Companies Harmonized, BACH).

2.2.5 ESG FACTORS

Environmental, Social, and Governance (ESG) factors are considered when they have the potential to materially affect a company's creditworthiness. Analysts consider ESG-specific rating drivers as part of the criteria for qualitative assessment, based on their positive or negative effect on the creditworthiness of the rated entity.

While these factors do not represent a specific adjustment, they can impact on all three key areas of the rated entities: business risks, financial risks and, especially, corporate risks.

Figure 2. Illustrative example of peer comparison



¹ A detailed analysis on how groups are rated can be found in the Appendix Rating subsidiaries and affiliates within a group

2.3 Additional rating factors

Additional rating factors can upgrade or downgrade the anchor rating of the issuer, or impact how analysts assess the previously mentioned rating factors.

2.3.1 DATA ADJUSTMENT

Analysts grade the quality of the data used for the ratings, considering factors such as exhaustivity of the information (data depth), reliability of the data (audited or not, existence of caveats), data coherence (e.g. public vs private data), existence of a business plan or any possible doubts on the accuracy of hard data.

The data adjustment can have a negative impact of up to three notches but cannot upgrade the rating.

2.3.2 COUNTRY AND CYCLE ADJUSTMENT

The country and cycle adjustment considers the recent evolution of the cycle in the company's country and sector (using data on payment behavior or similar) and compares the proposed rating with the sovereign rating.

The cycle adjustment functions as a multiplier of the assigned PD. It is limited to a potential downgrade of 3 notches (1 full notch) and an upgrade of 1 notch.

While we do not automatically cap the rating of a company to the sovereign rating of its country, we evaluate whether a higher rating is justified.



3 APPENDIX

3.1 Rating scale

INBONIS uses an alphabetical system, similar to S&P Global, to determine the credit rating notch, where AAA is the maximum notch and D the minimum. Each rating notch correlates with a probability of default (PD).

Figure 3. Rating scale definition

RATING CATEGORIES		CREDITWORTHINESS LEVEL
AAA		An entity rated 'AAA' demonstrate excellent capacity to meet its financial commitments.
AA		An entity rated 'AA' has very strong capacity to meet its financial commitments. It differs from the highest-rated entity only to a small degree.
A	A+ A A-	An entity rated 'A' has strong capacity to meet its financial commitments but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than entity in higher-rated categories.
BBB	BBB+ BBB BBB-	An entity rated 'BBB' has adequate capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to weaken the entity's capacity to meet its financial commitments.
BB	BB+ BB BB-	An entity rated 'BB' is less vulnerable in the near term than other lower-rated entities. However, it faces major ongoing uncertainties and exposure to adverse business, financial, or economic conditions that could lead to the entity's inadequate capacity to meet its financial commitments.
B	B+ B B-	An entity rated 'B' is more vulnerable than the entities rated 'BB', but the entity currently has the capacity to meet its financial commitments. Adverse business, financial, or economic conditions will likely impair the entity's capacity or willingness to meet its financial commitments.
CCC	CCC+ CCC CCC-	An entity rated 'CCC' is currently vulnerable and is dependent upon favorable business, financial, and economic conditions to meet its financial commitments.
CC		An entity rated 'CC' is currently vulnerable to nonpayment that would result in an 'D' issuer rating and is dependent upon favorable business, financial, and economic conditions to meet its financial commitments.
C		An entity rated 'C' is currently highly vulnerable. The 'C' rating is used when a default has not yet occurred but Inbonis expects default to be a virtual certainty, regardless of the anticipated time to default.
D		An entity rated 'D' has failed to pay one or more of its financial obligations (rated or unrated), excluding hybrid instruments classified as regulatory capital or in nonpayment according to terms, when it came due. An entity is considered in default unless Inbonis believes that such payments will be made within any stated grace period.

The final rating assigned to the issuer (in rating categories A-CCC) may include a modifier (+/-) to represent the relative position within the rating range and relative differences in the probability of default:

- If the rated entity is in the higher part of the range, a "+" sign is to be added to the rating notch.
- If the rated entity is in the lower part of the range, a "-" sign is to be added to the rating notch.
- Finally, if the entity is within the middle part of the range, no modifier is to be added to the notch.

3.2 Rating subsidiaries and affiliates within a group

For the application of this methodology, a group is defined as the companies included within the consolidation perimeter or, in its absence, the related companies (subsidiaries) in which there is either a majority stake or control and management. The group therefore includes the parent company, which may have its own activity or act solely as a holding company, and the investees and related companies. Group companies may share the same activity or have different activities covering part or all the value chain.

In the case of subsidiary companies, when control is exercised indirectly, through one or more subsidiaries, in the absence of the consolidation perimeter, the analysis must include the organizational chart of the corporate group that certifies their interconnection.

The entries and exits of companies from the perimeter are accounted for in the group for the duration of their presence, although the 'snapshot' to be considered is the one corresponding to the closing of the latest financial year in relation to the time of the analysis. Therefore, there may be post-closing movements that can only be assessed once the financial statements are available at the date of the change.

Based on the above, the general corporate methodology detailed at the beginning of this document is applied for the rating of a group of companies, considering these specificities of what defines a group of companies.

Rating of a specific perimeter or division of activity: Inbonis Rating may also consider issuing a rating on sub-consolidated accounts, when there is a subgroup of companies that share activity and/or synergies and there is an interest in valuing that part of the group independently.

Being part of a group of companies can have two types of impact on a company's rating:

- ▶▶ Positive, if the group has a sound financial situation and a robust positioning in its market.
- ▶▶ Negative, if the group, like or unlike the company, is facing financial difficulties and/or its market prospects are pessimistic or weak.

PROCESS FOR THE ANALYSIS OF THE SUBSIDIARY

First, the subsidiary is analyzed independently based on its business model, history, prospects, growth and competitive position.

Next, its business model, relations with group companies, its dependence or independence from the group as a supplier or customer and its position in the value chain are included in the assessment of its business model. Operational integration is assessed (facilities, resources, work teams, brand, same, complementary or different activity, etc.). By extension, the synergies and positioning of the Group at a global level are analyzed in terms of its history, growth and competitive position.

Then, the financial situation of the company is analyzed individually, based mainly on the financial statement of the last 2 fiscal years. The influence of the group's financial situation is incorporated into the financial analysis, considering the following:

- ▶▶ Historical, current and planned financial support of the group regarding loans, cash pooling, capital contributions, etc.
- ▶▶ Linkage or independence of the group and the subsidiary in terms of external financing (specific guarantees for obtaining financing, loans or joint credit lines, etc.).
- ▶▶ Current financial situation (analysis of the last 2 fiscal years) of the group in terms of financial structure and economic evolution.
- ▶▶ The company's permanence in the future strategy of the group and its divestment policy.
- ▶▶ Relationships between the company and the group.
- ▶▶ Payment situation of the group with financiers and suppliers.

Finally, the company's shareholders, management and stability are analyzed first on an individual level, and then the evaluation of the Group's shareholders, management and stability is incorporated as either weaknesses or advantages. The higher or lower percentage of the group's stake in the company is considered; the influence of the parent company's corporate governance on the decisions of the subsidiary is also assessed (match or mismatch of directors and governing bodies).

In the absence of information on the business model and/or the financial situation of the Group to which the company belongs, an adjustment of the assessment can be made, penalizing the quality of the information, by not having visibility of the context and perspectives in which the company operates.

RELATIONSHIP BETWEEN INDIVIDUAL AND GROUP RATINGS

The company may obtain a lower rating than the Group, generally if it has a limited role in the group's business or, if it does, its contribution to profitability is minimal or negative and/or at a strategic level it is not considered relevant for the future of the group, therefore support from the group is not expected.

The company can obtain a rating equal to that of the Group, generally because it has a significant stake and a high level of business and financial links.

The company may have a higher rating than the Group, if it is the most relevant company within the group or among the most relevant, contributes a high percentage of turnover/assets, has a higher profitability than the other companies in the group, and plays a key strategic role.

The greater the gap between the company's credit quality and that of its group, the more likely it is that their rating will diverge. For the company's rating to align more closely with the group's, it will be necessary to further assess the financial and strategic support that the group provides to its subsidiary or affiliate.



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