

INDUSTRY RISK

Rating Analysis of SME incorporates an assessment of the company's business environment. The degree of operating risk facing an SME almost always depends on the dynamics of the industry in which it participates. Industry analysis focuses on the strength of the industry prospects. Market conditions as well as the competitive factors affecting that industry. The many factors to be assessed include industry prospect for growth, stability or decline and the pattern of business cycles. It is critical for example to determine vulnerability to technological change, labour unrest, regulatory interference, or changes in the supply demand balance.

The industry risk assessment sets the stage for analysing specific SME unit's risk factors/keys to success and establishing the priority of these factors in the overall evaluation. For example, if technology is critical competitive factor, research & development (R&D) prowess is stressed. If the industry produces a commodity, cost of production is of major importance.

BUSINESS & OPERATION

The operation and business risk can be termed as a risk of direct or indirect loss arising due to deficient or unsuccessful internal systems, processes, people or external factors. The Operation and Business Risk assessment of an SME is critical to its overall evaluation.

The purpose of the assessment of Business and Operation risks is to determine the criticality of each of these factors which are the key aspects of the overall business of an SME. The factors can be broadly grouped together into four groups as follows:

- 1) Physical Properties - covering premises, product and purchasing
- 2) People Elements - covering people, the procedures they follow and protection
- 3) Action or Processes - covering processes and performance (against targets)
- 4) Management Issues - covering policies and strategy and planning and organization

MANAGEMENT

For SMEs, management evaluation, which is typically an evaluation of the promoters' competence, is critical to the rating. Unlike most large corporates, which have several layers of professional managers, performance in the case of SMEs often depends on the entrepreneurship and resourcefulness of the promoters.

In assessing a promoter's competence and track record as an entrepreneur, CRAB looks at the past performance of the entity and group companies. This provides an insight into the promoter's ability to successfully manage the entity through business cycles. In addition, the

entity's ability to develop suppliers, integrate with customers, and manage banking and labour relationships, also provide critical inputs to the management evaluation process.

FINANCIAL ANALYSIS

The ratio calculations are broadly the same as those followed in the assessment of the large corporates, but have been fine-tuned to suit the requirements of the SME sector. For example, promoters often bring in investments in the form of unsecured loans instead of equity or capital to take advantage of favourable taxation policies; such loans are treated as quasi-equity while assessing SMEs.

CRAB's assessment of an SME's financial risk profile also attempts to assess the entity's financial flexibility. This is done in two ways - by analysing the promoter's net worth, and by assessing the strength of the SME's relationships with banks. CRAB asks promoters to disclose their personal net worth; based on this declaration, CRAB assesses the additional funds that the promoter will be able to infuse into the SME, in the event of distress.

CRAB also contacts the SME's bankers in order to assess the nature and history of the relationship, and performance of the loans and bank accounts. Bankers can also provide keen insights into the promoters' integrity.

PROJECT RISK

This risk is called project risk which constitutes an important element in the risk assessment of a number of SMEs. However this risk element is only applicable in those cases where there is a significant new project which an SME is embarking upon and not otherwise.