SME RATING METHODOLOGY

NCR's credit risk assessment on Small and Medium Enterprise (SME) is based on two broad factors i.e. Quantitative & Qualitative. NCR believes that SME has its own features like inadequate financial reporting system, insufficient information on industry and fluctuation of commodity price along with competitive environment with low entry barriers. The creditworthiness of entities in this sector, therefore, needs to be assessed based on business risk and financial risk profile & performance, nature of business, entity's market position and business strategy, scale of operations, track record, management quality, succession plan, relationship with the banks, past history of repayment & transaction record and security against loan.

1. Financial Risk Analysis

SMEs are typically set up as proprietorships, partnerships, or private limited companies. NCR performs financial risk analysis based on disclosed financial statements. In addition, projected financials as well as cash flows are also analyses in detail.

1.1 Leverage

NCR analyses leverage position to determine an entities' reliance on external financing and to use of funded debt & non fund based limits. The SME's usually have low long-term loans but relatively higher working capital borrowings, as there are a low investment requirement for fixed asset creation. Use of banking facilities (fund based as well as non-fund based) as a key business differentiator significantly increases the risk profile of the entity. Entities with high gearing have low financial flexibility and more susceptible to any downturn or external shocks as compared to others. Various ratios analyzed include net debt/ net debt plus equity ratio, equity multiplier or overall gearing ratio, interest coverage ratio, coverage ratio debt, payback period etc.

1.2 Liquidity Position

Liquidity ratios such as current ratio and adjusted quick ratio are broad indicators of the liquidity position of a trading entity. Moreover, entities with healthy cash position along with sufficient available bank lines are viewed favorably as they are better placed to meet any adverse market situation or sticky receivables. Further, if the trading entity requires higher working capital intensity, it should have also required adequate liquidity available for financial settlements.

1.3 Profitability Ratios

Profit margins of entities in SME sector varies in the context of size (i.e. small to medium enterprise). NCR analyses the growth in profitability levels and volatility in margins in the light of cyclical nature of the business, macroeconomic stability of the country and Govt. policies towards business environment.

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Entities which have better risk management systems, laid down credit policies, control on overheads and which offer some value added service have generally stable earnings and profitability. Various ratios analyzed include gross margin, operating profit margin, net profit margin, ROA, ROE, etc. Moreover, trend in the growth rate of the entities reflect the entities' ability to sustain its market share, profitability and operating efficiency.

1.4 Cash Flow and Coverage

The cash flow statement analysis reveals the ability of an entity to pay its obligations. Cash flow analysis is an important tool for the assessment of financial risk. The cash flow from operations provides a company with more secure credit protection than dependence on external sources. NCR uses conservative approach to calculate the Debt Service Coverage to measure Indebtedness of an entity. NCR also calculates other credit protection measure such as interest coverage.

2. Business Risk Analysis

Analysis of business risk involves evaluation of trading entity's historical performances with emphasis on assessment of entity’s sales volume track record of business. NCR measures the entity's competitive position within the industry by analyzing the historical performances. Some of the key parameters used for assessing business risk are:

2.1 Size

SMEs usually have a low fixed asset base. NCR examines the investments made by entities in warehouse/ shop (owned or rented) and distribution network, quality and quantity of inventory levels as well as investment in risk management systems.

2.2 Market share

The entity's current market share in its major activities and the historical protection of its position and projected ability for the future are important indicators of the competitive strengths of the entity. Market leader generally has financial resources to meet the competitive pricing challenges.

2.3 Product Diversification

The entity's operation with diversified products entail less risk as diversification results in better sustainability in cash flows. NCR analyses the view and focus of the proprietor on the issue of product diversification.

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2.4 Business insight

NCR scrutinize the profile of the entity's customers, relationships with customers and suppliers, and the level of infrastructure and technology of the business.

3. Management Risk

Management evaluation is one of the most important factors for supporting an entity's credit standing. Besides, experience and educational qualification of promoters in business operations, integration and succession of the promoter and experience in working and understanding of end-user industry is also very crucial. NCR examines promoter's ability to successfully operate the entity throughout the business cycles as well as maintain good team work. The management's knowledge of local as well as global trade and regulations, understanding of various risks and approach/strategy for risk management and risk tolerance levels are of paramount importance. Capability and past track record of the management to perform under stress provides an added level of comfort.

4. Bank Relationship Risk

To initiate the measurement of the bank relationship risk considering factors are - whether the transaction with bank of entity is satisfactory? How long has the client been customer of the bank? Is there any past record of any force loan? Is there any default/ reschedule/ restructure in the history of banking relationship and the reason behind the same?

In addition to the above factors, quality of accounts & disclosures are measured for assessing the overall creditworthiness of the entity. Moreover, NCR also emphasizes on whether the accounts reflecting the actual transactions with the bank or not. NCR also tries to verify the CIB status of the borrower.

5. Financial Security Risk

NCR considers the factors related to relationship with bank and value of collateral against the loan which is important for the business. The type and quality of the collateral -i.e., all assets, property, plant and equipment etc. - are critical because that determine how much stresses the secured assets can absorb and still hold their values. The control over the collateral by the lender, during both pre- and post- default periods, is important. The tighter the monitoring and control of the collateral, the greater likelihood that in the event of default the lenders will actually benefit from the protection against loss that they were counting on when the loan was first made.

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6. Other Factors

Other than the risk factors mentioned above, compliance on legal & environmental issues, insurance policy on assets and Govt. intervention in the sector is also evaluated.

SME RATING SYMBOL

Rating	Description
NSME – 1	Highest Credit Quality
NSME – 2	High Credit Quality
NSME – 3	Adequate Credit Quality
NSME – 4	Moderate Credit Quality
NSME – 5	Inadequate Credit Quality
NSME – 6	Risk-Prone Credit Quality
NSME – 7	Poor Credit Quality
NSME – 8	Lowest Credit Quality

Outlook	
Stable	No major changes in economic / company's position. The existing fundamental remain same in the near future.
Positive	Prospective business growth and believes that the company will be able to maintain the same in foreseeable future.
Negative	Company will not be able to keep the current business performance in foreseeable future.
Developing	Gradually improving business.

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