SME Rating

The rating of Small and Medium Enterprises (SME) indicates relative level of creditworthiness of an SME entity in relation to other SMEs. Emerging Credit Rating Limited (ECRL) considers factors include, among others: industry characteristics, operating efficiency, competitive position, management quality, financial risk characteristics, relationship with lenders and capital structure to evaluate overall risk profile of the SME entity.

INDUSTRY CHARACTERSTICS

The industry assessment aspect of ECRL's business risk analysis considers the operating environment of the ratee, its industry structure, market share and other participants, industry growth rates, government support to the sector, the competitive environment as well as the regulatory environment. ECRL believes that the above factors will determine the ratee's ability to grow, operate profitably and to generate cash flow to service its debt. In addition ECRL consider management capability to withstand adverse industrial environment. ECRL also considers the predictability of the regulatory environment and the extent to which regulation influences the competitive environment of the rate.

OPERATING EFFICIENCY

The rating factors that are covered here will differ according to the industry, but the objective of the analysis is to assess the ratee's operational efficiency and effectiveness, and corresponding implications for cost efficiency, profitability and relative competitive position. A manufacturer could have a more favorable cost structure compared to its peers on the basis of manufacturing efficiency, which may or may not have anything to do with size. The age of plant and equipment in use, together with the quality of systems and processes, will often be the more telling explanation for differences in performance. Similarly, for companies operating in service industries, performance differentials are typically associated with the quality and execution of business strategies.

ECRL's analysis also covers the ratee's business model; it looks at an organization's strengths and weaknesses relative to its peers. In particular, the question analysts must answer is whether the firm's market positions and associated business strategies allow it to favorably differentiate itself from its competitors or, alternatively, limit it to mediocre performances at best. Factors like availability of raw materials, manpower, availability of power, own/ rented premise and technological edge are analyzed to understand operational smoothness of the entity.

Strength and opportunity of the SME unit are also assessed by analyzing products mix, revenue generation, customer profile and relationship with the stakeholders. ECRL also considers

operational initiatives that are currently employed by the rate to improve productivity, cost structure competitiveness, quality, order fulfillment and service standards.
The supplier and buyer profile is required to evaluate in details. Analyst should establish whether the continuation of the operation is dependent on a single supplier or not. In similar way analyst should also consider whether the entity depends on a single buyer to sell the majority of its merchandise.

Location of the operation is very important. The analyst must evaluate the comparative advantages and disadvantages which the company suffers because of the location of the operation.

Last but not the least the compliance related documents are to be evaluated keeping the country's legal system in perspective. Analyst must establish that the business is a going concern and will not be forced to stop its operation due to compliance related problems.

FINANCIAL RISK ANALYSIS

ECRL's financial risk analysis is based on disclosed financial statement. ECRL will evaluate the quality of financial statements as this is the most important parameter to assess the financial strength of the organization.

ECRL considers the ratee's operational profitability, typically over a five-year period to assess the volatility of operating margins and its record of earnings generation. This allows us to incorporate the impact of cyclical demand on earnings and to be able to rate through the cycle as much as possible.

Assessment of financial risk includes an assessment profitability, efficiency in working capital management, financial flexibility and capability to generate enough cash to service debt obligation. Same ratio calculation like large organizations is used. Profitability ratios e.g. gross profit margin, net profit margin, returns on equity and assets, gearing ratios, current and quick ratios and different cash flow ratios are calculated in this regard. The trend of the ratio is analyzed. A rising ratio usually indicates increasing reliance on internally generated funds to fund asset growth. Even though similar ratios are considered but they are used keeping a different objective in mind. In SME rating the dependency on debt is emphasized keeping the cash conversion cycle in mind. Since an SME have a limited source of fund it is important that the business is generating cash quickly enough to pay off its obligations. ECRL considers proprietor or partner's personal assets are of great importance in an SME rating, the analyst need to assess the cash generation capability of the owner's personal assets with respect to repaying the loan. In addition the analyst should also try to estimate the liquidation time of the owner's personal assets.

Revenue is another aspect which needs to be estimated in an SME rating. In order to understand the business volume the analyst should check the bank statements of the entity in discussion. The analyst should also try to find out how much trade discount the firm shall receive if it deals at higher volume in the future.

Debt Servicing Capacity

ECRL will evaluate entity's debt servicing capacity by assessing the relationship it maintains with its Bank. ECRL analysts will also assess the financial strength of the promoters of the SME entity. ECRL will assess past payment history, performance of the loan and bank account, quality of the collateral kept with the bank etc to evaluate the relationship with bank. In an SME rating the willingness to pay is also important; the analyst establishes a payment pattern of the client.

Capital Structure/Financial Flexibility

A firm's Capitalization and Financial Policies are often indicative of its risk orientation. The extent to which a firm decides to finance its operations with debt rather than equity will influence the analyst's rating recommendation. Analysts should recognize, however, that very low financial leverage isn't necessarily the most appropriate strategy. After all, equity financing is usually more expensive than debt financing, and so a balance between the two forms of financing is reasonable.

MANAGEMENT AND OTHER QUALITATIVE FACTORS

Evaluation of promoter's management capability is most important part for SME rating as performance of the entity mostly depends on his entrepreneurship skill. ECRL's assessment of management quality encompasses the track record of management, in particular its performance through different phases of the economic cycle and relative to industry peers as well as execution of its long-term and short-term strategic plans. Additional evidence of management quality is provided by the ratee's past performance. ECRL will also assess the succession plan, organizational structure, business system and processes and employee retention rate etc.

SME RATING SYMBOL

RATI NG	DEFINITION
ESME1	Indicates highest credit-quality with minimal credit risk
ESME2	Indicates a very strong credit-quality with limited credit risk compared to issues rated in the highest category.
ESME3	Indicates adequate credit-quality with low credit risk.
ESME4	Indicates moderate credit-quality with average credit risk.
ESME5	Indicates below average credit-quality with above average credit risk.
ESME6	Indicates low credit-quality with a higher degree of credit risk.
ESME7	Indicates very poor credit-quality with very high credit risk.
ESME8	Indicates lowest credit-quality with highest credit risk.

Rating Outlook	
ECRL's Rating Outlook assesses the potential direction of the SME Rating over the intermediate term (typically over a one to two-year period). The Rating Outlook may either be :	
POSITIVE	Which indicates that a rating may be raised;
NEGATIVE	Which indicates that a rating may be lowered;
STABLE	Which indicates that a rating is likely to remain unchanged; or
DEVELOPING	Which indicates that a rating may be raised, lowered or remain unchanged.

made in the establishment, development or maintenance of business reputation or goodwill, cost of substitute materials, products, services or information, cost of capital, and the claims of any third party, or for any other reason whatsoever, even if ECRL has been advised of the possibility of such damages. Any person making use of and/or relying on the Credit Rating Report and all information contained herein hereby acknowledges that he has read this Disclaimer and has understood it and agrees to be bound by it.
