Annexure -1 : WCRCL SME RATING Methodology

RATING CRITERIA FOR SMALL AND MEDIUM ENTERPRISE

The criteria report contains all the factors affecting the creditworthiness of an SME issuer while assessing the creditworthiness of the issuer, the following are the main factors that are analyzed into detail by WCRCL.

1. Industry Risk Analysis
2. Business Risk Analysis
3. Management Risk Analysis
4. Financial Risk Analysis
5. Lender Relationship Risk Analysis
6. Collateral Risk Analysis
7. Other Factors

INDUSTRY RISK

WCRCL evaluates the industry risk by taking into consideration various factors like strength of the industry prospect, nature and basis of competition, demand and supply position, structure of industry, pattern of business cycle etc. How the industry players are competing with each other on the basis of price, product quality, distribution capabilities etc are also analyzed. Industries with stable growth in demand and flexibility in the timing of capital outlays are in a stronger position and therefore enjoy better credit rating.

BUSINESS RISK

Under business risk, WCRCL assesses the sustainability of the business plan and the long-term viability of the unit. This comprises qualitative assessments of the track record of the business, the profile of the rated entity’s customers, relationships with customers and suppliers, and the level of infrastructure and technology of the business.

In order to assess the SME’s business risks, WCRCL contacts the promoters of the SME to understand their business plans and growth strategies. Most SMEs form part of larger industries’ value chains and are usually not in direct contact with the end users. Moreover, in most industries, the degree of competition is high owing to factors such as the presence of a large number of players, low capital intensity and, in some cases, low technology levels. Hence, SMEs rarely have control over pricing. An SME’s pricing flexibility stems from its relationship with key customers and its strong control over costs. For SMEs, control over costs is a function of the quality of technology and manufacturing facilities, and relationships with employees and suppliers. Assessing the quality of an SME’s relationships with its key customers is a critical part of WCRCL’s assessment of an SME; this parameter is assessed by directly contacting the entity’s key customers. To assess the entity’s manufacturing facilities, WCRCL insists on a visit to the facilities, either by a team of WCRCL analysts, or by WCRCL's business associates. WCRCL also contacts the SME's key suppliers to assess the quality of their relationships with the SME being rated.

Favorable location advantages, management and labor relationships, cost structure, availability of raw-material, labor, compliance to pollution control programs, level of capital employed and technological advantages etc. affect the operating efficiency of every issuer enterprise and hence the credit rating.

The size of business of a enterprise is a relevant factor in the rating decision. Smaller companies are more prone to risk due to business cycle changes as compared to larger companies. Smaller companies operations are limited in terms of product, geographical area and number of customers. Whereas large companies enjoy the benefits of diversification owing to wide range of products, customers spread over larger geographical area. Thus, business analysis covers all the important factors related to the business operations over an issuer enterprise under credit assessment. WCRCL evaluate the market standing of an enterprise regarding- market share, competitive advantages, selling and distribution channel, diversity of products, customers base, developing market positioning of new product as well as obsolete products, quality Improvement programs etc.

New addition in product portfolio or business line may raise high level of project risk that may affect prospective cash flow of the enterprise, capital structure, managerial expertise, financing risk and stabilization issues in operational phase. In WCRCL's view, promoter's past experience and project status including financial closure are equally considerable.

MANAGEMENT RISK

Quality of management is one of the most important parameters that support the credit strength of an SME unit. WCRCL team interacts with the promoters / key management personnel of the SME unit for understanding their business insight, vision, future growth strategy and approach towards the perceived risk factors. Most SMEs are family managed entities and highly dependent on a single person. WCRCL assesses the presence and quality of second line of management, apart from aspects related to succession planning, organization structure and internal control systems.

Promoter's experience in business (including within the relevant industry sector) and track record of operations within the rated entity would act as key criteria for assessing management competence. WCRCL believes that the management having experience of more than one business cycle and familiarity with project implementation would have an edge. Management's skill to add more clientele, new trade initiatives and level of priority to the finance function are equally vital. Promoter's connivance with related or identical business also taken into consideration as this business may also enjoy or avail same quantity of borrowed fund to operate issuer entity.

Financial Risk

WCRCL believes that the quality of accounts is of prime importance as the starting part of financial risk analysis is the reported financial statements and related disclosures. In this regard, audited financial results give more comfort than the unaudited / provisional results. Among the SME units, limited companies tend to have better accounting & disclosure systems as they need to follow regulatory and specific guidelines. In specific legal forms like partnership and proprietorship concerns, risk of withdrawal of capital exists.

WCRCL evaluates financial flexibility of an SME (through gearing ratios, debt protection ratios and hybrid ratios), liquidity (measured by current & quick ratio, proportion of liquid assets, operating cycle, cash cycle, working capital management, cash flow from operating activities, etc.), business efficiency & profitability (indicated by turnover ratios, profitability ratios, return ratios, growth ratios, etc.). Cash flow analysis assumes critical significance while assessing the creditworthiness of a borrower.

Lender Relationship Risk

WCRCL team also interacts with the lenders/ bankers to learn about the loan facilities, tenure & usage, utilization of loan and performance of payment, overdue or rescheduling history, reason against the overdue or rescheduling, security against the loan, control over and quality of the security, and related issues. Restructuring of an obligation or loan classification will considerably disadvantageous to the creditors.

Collateral Risk

Credit rating as well as the lender will not be driven by collateral will keep against loan obtain. Quality of collateral and security against the loan obtain must confirm by respective analyst and may give a comfort in case of lien of FDR, hypothecation, guarantee, collateral, third party guarantee etc. against the loan, while assigning the rating.

Other Factors

Micro level factors or macro level factors as well regulatory and legal various factors like- impact of changes in tax proposition, environmental embargo, and technological development in the industry may cause obsolescence of existing, inadequate insurance coverage or non-insurance, even changes in international regulation also consider during assessment of the rating.