Risk Rating System: Basic Structure

The risk rating system reviews a business in eight basic categories:

1. Management
2. Operating margins and cash flow
3. Balance sheet
4. Competitive advantages
5. Industry and market
6. Credit history
7. Collateral and secondary source of repayment
8. Foreign exchange exposure

For farmers and farmers groups one can add elements about:

1 Yield/ha history for the particular crop in general (area specific) and for the specific farmer or farmer group and association,
2. Information on price fluctuations for the crop,
3. Info on input prices
4. Adoption of new cultivation technics,
5 Reputations within the group, community, and with other value chain actors e.g. input suppliers, nucleus farmers and aggregators

Each area is given a rating between 1 and 5. These ratings are then summed to obtain the business' overall rating, as illustrated below. Loans must be given a clear grade and may not be rated between grades.

RISK RATING

1. Management (1-5)	______
2. Operating margins and cash flow (1-5)	______
3. Balance sheet (1-5)	______
4. Competitive advantage (1-5)	______
5. Industry and market (1-5)	______
6. Credit history of the principals (1-5)	______
7. Collateral or secondary source of repayment (1-5)	______
8. Foreign currency exchange exposure (1-5)	______
Combined numerical rating (sum of ratings of all categories)	______
Letter rating (see key below)	______

Key

8-12	= A – Excellent	28-34	= D - Substandard
13-17	= B – Good	35+	= E - Doubtful
18-27	= C - Satisfactory		

Source: USAID's Lending to the Agriculture Sector Toolkit – December 2012

Risk Category: Management

The loan officer must rate the ability of the company's overall management team. The rating is based on experience in the firm's business, understanding of finance and financial planning, ability to operate the business by following a business plan, leadership, organizational skills, and back-up management succession.

Rating	Description
1	**Very strong management:** Ten or more years of direct experience, excellent management record and financial performance, understanding of budgeting, and the ability to manage the company's working capital. The firm is well led, recognizes the value of a high-quality workforce and provides employee training, benefits, and performance incentives.
2	**Above average management.** Under the control of a management team with proven experience in the same business (five or more years of experience), management experience, and a good professional record. The business must produce adequate financial statements on a timely basis. The management team operates under a financial plan and budget and demonstrates an ability to manage the firm's working capital and term financing. The firm has good management depth and no obvious organizational shortcomings.
3	**Average management.** Under the control of a management team that has the ability to manage firms of this type (one to four years of experience). The business produces regular and adequate financial statements and a budget but occasionally has unexpected needs for working capital or term financing. The firm has adequate management depth and no serious organizational shortcomings.
4	**Below average management.** Under the control of a management team whose ability to manage firms of this type is unproven (less than one year of experience). The business does not produce reliable or timely financial statements. The company doesn't produce a budget or a financial plan. The company has inadequate management depth and organizational shortcomings.
5	**Weak management.** Under the control of a management team with clear deficiencies in skills and experience or no experience in the industry. The business does not produce adequate financial statements or a budget and does not adequately manage its financial resources. The firm has inadequate management and serious organizational shortcomings.

Risk Category: Operating Margins and Cash Flow

Loan officers must remember that loans are repaid out of the cash generated by the business. Therefore, careful consideration of the business' operating margins and cash flow are required.

Rating	Description
1	Highly profitable firms with records of always servicing their debts. Projections indicate that a firm will have no difficulty generating sufficient cash flow to service all existing debt, including the loan being graded. Substantial margins will exist to cover any contingencies that might arise. Debt service coverage (including our loan) based upon projections would be 2x.

Rating	Description
2	Profitable firms that have a record of servicing debt. Projections indicate that such firms will have little difficulty generating sufficient cash flows to service all existing debts and the loan being graded, with margins sufficient to cover contingencies. Debt service coverage (including our loan) based upon projections would be 1.6x to 1.9x.
3	Firm has adequate profitability to service senior debt including ours. Projections indicate that the firm can generate sufficient cash flows to service existing debts, but with little margin for contingencies. Debt service coverage (including our loan) based upon projections would be 1.0x to 1.5x.
4	Improvement in financial performance is necessary, or the firm will be unable to continue routine business operations and service its debts. Any projections that show a debt service capability are probably optimistic. The person grading the loan believes that future cash flows will be insufficient to keep our loan current. Debt service coverage (including our loan) based upon projections would be 0.9x.
5	Business will be unable to make loan payments; will have to rely on guarantors or collateral to pay the debt; it is likely that at least a portion of the debt must be charged off. Debt service coverage (including our loan) based upon projections would be less than 0.9x.

Risk Category: Balance Sheet

The financial condition of the borrower is a measure of the financial strength of the customer as shown on the customer's balance sheet. It is a measure of liquidity, capital, and leverage. Indicators used to score this factor include working capital, current ratio, debt to net worth ratio, and turn periods for inventory, receivables and payables.

Rating	Description
1	The firm must have a low debt-to-equity ratio (less than 1.5), significantly above average working capital, and substantial retained earnings. It must be current in accounts payable as demonstrated by its accounts receivable turn ratio. Trend in these areas should be positive. A 1 rating is reserved for firms with strong balance sheets, with the strength coming from annual capital injections from retained earnings.
2	The firm must a have a better that average debt-to-equity ratio (1.5 or less), satisfactory working capital, and significant retained earnings, and be current in accounts payable.
3	The firm has an average debt to equity ratio (1.5 to 2.0), adequate working capital, and acceptable retained earnings, and is not significantly slow in paying accounts payable.
4	The firm has a higher than usual debt-to-equity ratio (over 2.0), less than adequate working capital, little retained earnings, and is slow in paying accounts payable.
5	The firm has a high debt-to-equity ratio (over 3.0), negative working capital, no retained earnings, and is quite slow in paying accounts payable.

Risk Category: Competitive Advantage

Evaluate the actual state of the borrower's competition in the marketplace to be served. Evaluate any competitive advantages the borrower may offer or promise (better quality, better distribution,

cheaper cost, or better service). In this area, only three ratings are possible.

Rating	Description
1	The firm has a clear and tangible competitive advantage that it has the capacity to defend. This advantage presents significant barriers to new entrants and means of differentiating its product from its existing competitors.
2	*Do not use.*
3	The firm's competitive advantage is based on service and an intangible benefit to the customer. This provides some entry barriers to new competitors and some manner of differentiating its product.
4	*Do not use.*
5	The firm has no competitive advantage. Entry barriers into the industry are weak or nonexistent. Significant competition exists in the industry (or could easily exist), and the firm has no clear way of differentiating its product.

Risk Category: Industry and Market

No business operates without external influences. When evaluating the risk associated with extending finance to a business, the loan officer must consider external risks associated with the quality of the industry and the market.

Rating	Description
1	Business is operating in an environment that is enjoying good economic times. The industry is competitive, most firms operating in this industry are making good profits, and profits would not be significantly impacted by recession.
2	Business is part of a profitable industry that is enjoying good economic health. It is not a cyclical industry and would not be significantly affected by a recession, the closing of a local plant, or a significant change in commodity prices.
3	Business is part of a reasonably profitable industry that is enjoying good economic health, but is a cyclical business and would be affected by a recession, the closing of a local plant, or a significant change in commodity prices. This is a competitive industry, and only the better-managed firms will get through the next recession without suffering significantly.
4	This is a tough business in which to make a profit. It may be a fiercely competitive business, one presently experiencing an economic recession, or a cyclical business in which company profits will suffer if there is a recession, a closing of a local plant, or a significant change in commodity prices. Only the better-managed firms will survive in this industry.
5	Business in serious trouble. It may be commodity price sensitive or interest rate sensitive. Changes in local or national markets such as a military base closing, plant closings or significant competitive changes like a national chain coming to town would be significant.

Risk Category: Credit History of the Principals

Comment on actual credit history of the principals and guarantors. Evaluate credit integrity of principals and guarantors. In this area, only three ratings are possible.

Rating	Description
1	**Good credit history.** Reviews of past bank/supplier credit has shown a solid record of on-time payment. Company/owners do not have negative information in the credit bureau.
2	*Do not use.*
3	**Satisfactory credit history.** Reviews of past bank/supplier credit has shown some problems with on-time payment and/or company/owner may have a listing in credit bureau. The company is able to explain these problems and seems to have taken steps to resolve problems. The company's payment of payables has slowed significantly over past year.
4	*Do not use.*
5	**Unsatisfactory credit history.** Reviews of past bank/supplier credit has shown significant problems with on-time payment and/or company/owner may be listed with negative information in credit bureau. The company is unable to explain these problems, or the explanation is not satisfactory. The company has not taken satisfactory steps to resolve problems and/or there is significant risk of problems reoccurring. Outstanding tax liens or previous bankruptcies are rated unsatisfactory.

The loan officer will also review the owner's personal credit rating, if it is available. Poor individual credit could have a negative impact on the loan repayment and should be considered as part of the business' overall credit history risk.

Risk Category: Collateral or Secondary Source of Repayment

It is the goal of the financial institution to be repaid from the operations of the business that took the debt. However, the reality is that even the best of businesses can face financial difficulties from time-to-time. For this reason, as prudent lenders, the financial institutions consider the strength of other repayment sources.

Rating	Description
1	The financial institution is offered first position on collateral. The collateral coverage is at least 2:1 (liquidation value to loan value), or the company has offered highly liquid collateral (cash in blocked bank account, certificates of deposit, etc.). The company may also have a strong secondary source of repayment (profits from an affiliated business) which can be guaranteed to the financial institution.
2	The financial institution is offered first position on collateral. Collateral coverage of at least 1.75:1 with collateral that is satisfactorily liquid (typically, residential/commercial real estate). The company may also have a strong secondary source of repayment (profits from an affiliated business) that can be guaranteed to the financial institution.
3	The financial institution is offered first position on collateral (with collateral coverage of at least 1.5:1) or for subordinated debt the collateral coverage for the total debt is at least 1.75:1. Collateral may be less liquid or more difficult to control (including equipment, vehicles or inventory).

Rating	Description
4	The financial institution is offered first position on collateral (with collateral coverage of more than 1:1) or for subordinated debt the collateral coverage for the total debt is at least 1.5:1. Collateral is less liquid or more difficult to control (including equipment, vehicles or inventory).
5	Uncollateralized loan, first position collateral coverage of less than 1:1 or may have poor collateral coverage on subordinated debt.

Risk Category: Foreign Exchange Exposure

The loan officer should consider the potential impact of foreign exchange exposure on the business. A company may have currency exposure because it purchases raw materials from a supplier in a foreign country, it sells to customers in a foreign country, or it has debt denominated in a foreign currency. The loan officer must consider the company's ability to manage the risks associated with dealing in foreign currencies. See Section IV in the toolkit above for a detailed discussion of the analysis of currency exposure in the due diligence process.

Rating	Description
1	**No exchange rate exposure.** Company has no USD-denominated debt and does not have expenditures in foreign currency. The company does not have export sales that will be impacted by fluctuations in the currency.
2	**Minimal exchange rate exposure.** Company makes some purchases in foreign currency or has some export sales, but they are a relatively small proportion of the company's operations; therefore, fluctuations in currency will not have a major impact on the cash flow.
3	**Balanced exchange rate exposure.** Company makes regular purchases in foreign currency or has USD-denominated debt, but has counterbalancing foreign currency sales that are sufficient to cover these payments. The exposure is relatively balanced between sales and expenditures, so impact on cash flow should be minimal.
4	**Unbalanced exchange rate exposure.** Company makes regular purchases in foreign currency or has USD-denominated debt and has foreign currency sales, but the expenditures and sales do not balance. The company may not have sufficient export sales to cover the expenditures. The foreign exchange exposure therefore represents a real risk to the cash flow of the business and therefore to the financial institution's financing.
5	**Unaddressed exchange rate exposure.** Company has significant foreign exchange exposure that it has not addressed. It might have a USD-denominated debt or major foreign exchange purchases without any export sales. The foreign exchange exposure therefore represents a real risk to the cash flow of the business and therefore to the financial institution's financing.