

## Risk Profiling

This chapter explains how to develop a risk profile for your business.

This profile will help you to negotiate your interest rate on a business loan.

The risk of a business failing is a pre-occupation of bankers. Their role is to ensure that the bank achieves its appropriate return on investment from the loans made to customers.

This return on investment is impacted dramatically should a loan to a business fail. Just think about it, the bank provides a loan of say \$1M with a calculated return on investment of 15% or \$150,000.

The business fails and the bank is only able to recoup 80% of its original investment (loan), or \$800,000. So, instead of making \$150,000 from this loan on top of the \$1M, they just lost \$200,000 in capital.

The types of risks to a business are varied and each of these individual components are considered by any lender prior to granting approval of a loan. Unfortunately they rarely tell you the types of risks they are considering and this leaves you with very little chance of presenting a loan application with every base covered.

Aside from the fact that you are not advised of the types of risks being considered, you might like to know that the resulting 'Credit Score' or 'Risk Rating' will affect how much you pay for your loan.

You will have seen examples of this previously but may not fully understand the implications of a thorough risk review. For now we will focus on creating a Risk Profile for the business. This exercise is somewhat subjective and can often be based on a person's opinions surrounding risk.

That said, the higher the level of information you can provide to back up your 'risk rating' the better.

Remember this, if someone is inputting this information, it may as well be the person with the most knowledge about the business, YOU.



# How to get a **business loan** in tough economic times

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On this and the following pages you will find a list of Risk Indicators and an explanation of the types of things you need to consider when applying your risk rating. Following these explanations is a table for you to use when applying your results. The table is a simplified version of the outputs that occur when bankers create your risk profile.

The table is separated into the following categories:

Very Low Risk	=1	Low Risk	=2
Moderate Risk	=3	High Risk	=4
Very High Risk	=5		

At the end of your risk profiling you will have a score to contemplate. The key issue here is not necessarily where you start from, but where you finish. If this profile identifies gaps in your business today, you can improve this score by implementing changes in the business prior to or at the same time as applying for your loan.

By creating your own risk profile you have a base on which to stand during your price negotiations with your bank.

### Risk Indicators

#### 1. Age of The Business

How long has the business been in operation? The longer the business has been around, the less risk it poses as a borrower. This is because its more likely the owners have been through different economic cycles including booms and downturns. (Less than 2 years).

#### 2. Type of Business

Does the type of business carried out make it more or less risky than the average business in the market-place? For example, basic food is not as volatile as ladies fashion.

#### 3. Location

What is the relative risk of the location of the business? Is the business location specific vs non-specific? A business that is reliant on its current location such as say a restaurant presents a higher

risk in this category than a wholesale distribution business located near ports and airports.

#### 4. Management Skills

How do the skills of the management team compare with the wider market? Have they consistently achieved their goals, improved the operations of the business and increased their technical skills and financial performance.

#### 5. Product Mix

What is the likelihood that the product mix will satisfy customers and continue to do so? Is the business reliant on only one product or does it have a range of options available to the market.

#### 6. Competition

What is the risk of competition in the market-place and how does the business compare. Are there high entry costs that ensure competition is kept low, or can any-one start up in this arena.

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### 7. Past Performance – Sustainability

How volatile has the performance of the business been in relation to the wider market. For example if trading conditions in the general business market have been stable and yet this business has had a patchy history, are you comfortable they can sustain current results or even grow in the future.

### 8. Inflation

Is the business more or less vulnerable to future inflation changes? Increased inflation may affect manufacturers first (wages increases) and then retailers (costs of product increases) while a business services company may not see any impact for some time (accountant, lawyer).

### 9. Intellectual Property

Is the business reliant on intellectual property more-so than the average business? What is their ability to defend this intellectual property? Do they hold patents, licences etc. For example, a software development firm will obviously have a higher dependence on IP. Their risk is compounded if they have very little cash to instigate legal action against a competitor that copies their product.

### 10. Barriers to Entry

How difficult is it for a competitor to start-up in this industry? The easier it is, the higher the risk. This is the difference between a hair-dressing business and a drilling and exploration business. The first may be started from a home base with very little capital whilst the second requires specialised knowledge (high cost employees) as well as specialised equipment. (large capital requirements)

### 11. Technology

Is the business exposed to technological change and will this impact on its performance. For example the introduction of digital printing had a high impact on those firms that could not or would not reinvest in the new technology.

### 12. Interest Rates

How will changes to interest rates affect this business and will those affects be more or less than the average business in the market. Remember that this is a business risk and is not related to the amount of debt the business carries. For example, if the business is a Real Estate Agency, rising interest rates may have a negative impact on the amount of product (houses) sold.

### 13. Foreign Exchange

Is the business more or less exposed to foreign exchange impacts and does it employ hedging strategies to offset this risk? An importer of stock will have a high risk in this category however an explanation and history of consistent hedging strategies will lower this risk.

### 14. Net Equity

This calculation is taken from the balance sheet. It relates to the difference between your Assets and Liabilities. Over time, retention of profits, repayment of loans and increased values of assets can improve this position.

### 15. Marketability of Equity

This category relates to the ability of the business to sell all or part of its goodwill. In most private companies this risk category will be considered high. The partial listing or presence of investors as shareholders may lower this risk. If the business is run by two partners, with very little succession planning or management team in place, the business will be much more difficult to sell.

## Chapter Summary:

**Risk Profiles are performed by the bank on your business, whether you know it or not.**

**The outputs of these profiles affect the pricing of your loans.**

**Creating your own profile helps you identify areas for improvement and gives you ammunition when negotiating interest rates.**

