

READING

INDUSTRY RISKS TO CONSIDER

By reviewing the risks within the major industry types, a business banker can visualize why one entity may be expected to show a different financial profile from another. The chart below summarizes some of the key financial risks among different industry types.

Industry Risks Summary					
Agriculture	Manufacturer	Wholesaler	Retailer	Service	Construction
Adverse weather	Inability to sell product	Quality of product	Inability to sell product	Quality of service provided	Under-bidding projects
Falling crop prices	Quality of raw material used	Inability to market product	Product quality and mix	Credit approval process	Labor costs and availability
Increasing seed, fertilizer and operating costs	Labor costs and availability	Credit approval process	Service provided by employees	Collection of accounts receivable	Completing a project on time (weather and other disruptions)
Maintenance and repair costs	Collection of receivable	Collection of accounts receivable	Employee theft (shrinkage)	Quality and capacity of fixed assets	Unexpected conditions such as poor soil
Quality of labor	Efficiency of plant operation	Relationship with vendors	Relationship with vendors	Demand for service	Subcontractor work quality
Declining land values	Knowledge of operating costs				Change orders
	Accurately assigning costs to products				Collection of accounts receivable and retainages

As a result of business development calls and credit investigation, a business banker now determines which risks apply to the borrower, then which of the applicable risks are the most critical. In the Dry Supply case, Ann Schippel determines the following possible risks to this wholesaler:

- Quality of product
- Inability to market products
- Credit approval policies
- Collection of accounts receivable
- Relationship with vendors (accounts payable)

Her meetings also have revealed Kaitlyn Nieson’s concerns about commission costs having a detrimental effect on profits. Can her industry research confirm this as an industry-wide trend? Or, is it due to management and operational practices somewhat unique to Dry Supply?

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To better facilitate the development of a credit risk rating, many business bankers consider pertinent industry-specific risks, as shown on the previous page, as well as the following risks that apply to all industries:

- **Cyclical**—The extent to which product demand or other factors tend to move upward and downward with general economic trends. Firms that are highly cyclical can present more risk to profits and cash flow as a repayment source than firms that have more steady performance over economic cycles
- **Capital intensity**—The degree to which fixed assets (real estate and equipment) are necessary to operate in the industry, including costs to upgrade or make technological improvements. This high level of capital costs can affect profits and serve to increase the level of sales needed to simply break-even in terms of net profits. On the positive side, high capital expenditures can serve as a barrier to new entrants in an industry
- **Legal, regulatory and labor outlook**—Some industries are highly regulated, while others have a strong union presence within the workforce. In some cases, lawsuits are a frequent occurrence, reflected in higher liability insurance premiums
- **General outlook**—Often related to cyclical, this is the near-term outlook and key trends for an industry or industry segment

As you study these qualitative risks, the course begins by organizing them in a chart format that resembles the example risk rating grid that will be used later in this curriculum. The industry section is shown in the chart below.

Risk Rating	1	2	3	4
Label ⇒ ↓ area	<b>Minimal risk, (superior)</b>	<b>Modest risk (exceptional)</b>	<b>Average risk</b>	<b>Acceptable risk</b>
Industry/ Industry Segment	<ul style="list-style-type: none"> <li>• Minimal cyclical</li> <li>• Not capital intensive</li> <li>• Favorable legal, regulatory, labor outlook</li> </ul>	<ul style="list-style-type: none"> <li>• Modest cyclical</li> <li>• Modest capital needs</li> <li>• Neutral legal, regulatory, labor outlook</li> </ul>	<ul style="list-style-type: none"> <li>• Average cyclical</li> <li>• Serious industry downturn not likely</li> <li>• Neutral legal, regulatory, labor outlook</li> </ul>	<ul style="list-style-type: none"> <li>• Intensely cyclical industry</li> <li>• Uncertain industry outlook</li> <li>• Low barriers to entry</li> <li>• Demanding legal, regulatory, labor outlook</li> </ul>

This risk rating grid has four “pass” loan categories, ranging from minimal risk to acceptable risk. As you will see later, it will utilize seven factors or rows, where each individual row score will be rated to reach a composite for the borrower.