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Credit Rating Methodology for rating Small and Medium Enterprises A Comprehensive Outline

* Dr. Bheemanagouda

Abstract

Growth becomes meaningful only when its fruits are reaped by common man. This can be achieved by strengthening SMEs. They are basically labour-intensive and thus generate employment opportunities. However, most of the SMEs are, in the wave of sweeping global changes, neglected. They are starved of funds and facilities. A number of times, though they deserve for assistance may find difficult to get required funds because of lack of appropriate mechanism to assess the creditworthiness of SMEs. The SME rating may become a feasible solution for this problem. It offers win-win solution to both SMEs and financial institutions. In the backdrop of significance of this mechanism, this paper tries to throw light on SME rating methodology.

Keywords : SME, SME Rating, CRISIL, CARE, Fitch

Small and Medium Enterprises (SMEs) play a significant role in the Indian Economy. There is a dire need for fostering this sector as it generates employment, encourages entrepreneurship and contributes to the growth of the economy. This sector assumes importance as it utilizes the available indigenous resources. SMEs are basically labour intensive. This is a positive feature particularly in India and that too at the present juncture of global recession where the retrenchment of employees is the order of the day. This sector offers the best solution for this problem. This sector has the potentiality to grow but it requires financial assistance from banks/financial institutions. Hence, the governments (at the State and Central levels) have evolved a number of policies to nurture this sector. Banks and financial institutions are now coming forward to assist the SMEs. Hence, there is a need for a mechanism to evaluate credit-worthiness of SMEs. Therefore, Rating Agencies have come out with a distinct methodology to assess the credit-quality of this sector since SMEs have certain unique features. This paper makes an attempt to throw light on the methodology followed by different rating agencies in India in assigning rating to SMEs.

CRISIL's Rating Methodology¹

CRISIL's ratings on SMEs reflect the rated entity's overall creditworthiness, adjudged in relation to other SMEs. These ratings are entity-specific, and not specific to debt issuances. CRISIL assigns ratings for Small Scale Units which are eligible for subsidy on rating fees from National Small Industries Corporation (NSIC), and other Small and Medium Enterprises (SMEs). The methodology adopted for rating both the kinds of enterprises is same. The methodology covers three broad categories of risk, viz., (1) Business Risk, (2) Management Risk, and (3) Financial Risk.

01. Business Risk

Under this criterion, sustainability of the business plan and the long-run viability of the unit are assessed. It covers track record of business, profile of customers, relationship with customers and suppliers, level of infrastructure and technology of business, etc.

02. Management Risk

It is an evaluation of the promoter's competence. Performance in case of SMEs largely depends on entrepreneurship and resourcefulness of the promoters. CRISIL evaluates promoter's ability to manage the entity through business cycles, to develop relationship with suppliers, customers, workers and banks. Usually, SMEs are managed by first generation entrepreneurs. To sustain growth, formal succession plan, second-tier management and high degree of professionalism are vital.

03. Financial Risk

Financial risk analysis is based on disclosed financial statements. The assessment encompasses accounting quality, size of the unit, profitability, management of capital, credit protection, promoters' net worth, relationship with banks, and promoters' personal net worth.

Rating Scales for SME Sector

CRISIL has two separate scales on which it assigns ratings in SME space. They are (a) NSIC-CRISIL Performance and Credit Rating SSIs, and (b) CRISIL SME Rating Scale for SMEs

01. CRISIL Rating Scale for SSIs

The NSIC-CRISIL scale has been specifically developed for the units registered as SSIs. These SSIs which are eligible for subsidies on rating fees from the NSIC are rated on this scale. This scale can also be used to rate entities that are not eligible for NSIC subsidies.

The NSIC-CRISIL scale has two distinct dimensions viz., measurement of performance capability and financial strength. Performance Capability is measured on a five point scale from 1 to 5 and Financial Strength is measured under three letter grades A to C. The Rating Scale is presented below.

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Table 1: NSIC-CRISIL Rating Scale

Performance Capability	Financial Strength		
	High(A)	Moderate(B)	Low(C)
Highest(1)	SE 1A	SE 1B	SE 1C
High(2)	SE 2A	SE 2B	SE 2C
Moderate(3)	SE 3A	SE 3B	SE 3C
Weak(4)	SE 4A	SE 4B	SE 4C
Poor(5)	SE 5A	SE 5B	SE 5C

02. CRISIL Rating Scale for SMEs

CRISIL, on its own, offers SME rating. The SME Rating Scale is an eight point scale (SME 1 to SME 8) that symbolises the rated entity's credit-worthiness in relation to other SMEs. The following table presents the CRISIL's SME Rating Scale and rating definition.

Table 2: CRISIL SME Rating Scale

CRISIL SME Rating	Definition
SME 1	Highest
SME 2	High
SME 3	Above Average
SME 4	Average
SME 5	Below Average
SME 6	Inadequate
SME 7	Poor
SME 8	Default

CARE's SME Rating Methodology

CARE's rating exercise would take into account the management capability, industry dynamics, operational performance, financial risk characteristics and the future prospects of the entity for arriving at the overall risk profile of the SME unit. The list of detailed criteria is presented below.

1. Industry Dynamics: CARE analyses demand-supply scenario, level of entry barrier, availability of substitutes, government support to the sector, WTO impact, etc in evaluation of industry dynamics with respect to SME.
2. Financial Risk Analysis: Quality of accounts and accounting policies, debt servicing track record, financial ratio analysis, cash flow analysis, financial flexibility and liquidity, validation of projections and sensitivity analysis, etc are the important factors which provide a few indicators as to the financial risk associated with the firm.
3. Operational Performance: Availability of required infrastructure facilities, availability of manpower, manufacturing technology, marketing setup and consumer mix, analysis of cost components, inventory, receivables and payables management, compliance of environmental norms, comparison with other SMEs on the basis of various parameters are a few of the aspects considered to assess the operational performance.
4. Management Capability: Management plays a significant role in steering the firm to success. Assessment of capability of the management is typical and tedious task as there are no readymade tools to measure. Hence, it is the test of quality and capability of rating team. In this process, a few factors like type of management (family owned/professional managed), organization structure, succession planning, management- competency, track record, corporate strategy and road map to achieve corporate objectives, internal control and audit systems, personnel policies, etc are seriously considered.
5. Project Risk Analysis: Size of the projects, project gearing and tie-up of financial resources, project implementation risk are taken into consideration for getting insight into the risks associated with project/s.

Validity of Rating

SME Rating is issuer-specific and one-time assessment of the credit risk of the rated entity. The rating shall incorporate credit risk over one year horizon. The Rating may be

reviewed in case of developments of substantial importance regarding the entity or its environment. This rating is applicable to all types of business enterprises, viz., public/private limited companies, partnership/sole proprietorship firms, co-operative societies, etc. The Rating Scale and fee structure are presented below.

Table 3: CARE's SME Rating Scale

Rating	Definition	
	Credit Quality	Credit Risk
CARE SME 1	Highest	Negligible
CARE SME 2	High	Very Low
CARE SME 3	Above Average	Low
CARE SME 4	Average	Average
CARE SME 5	Below Average	Above Average
CARE SME 6	Low	High
CARE SME 7	Very Poor	Very High
CARE SME 8	Lowest	Highest

Source: CARE SME Rating Criteria

Table 4: Fee Structure

Turnover of SME (Rs. crore)	Initial Rating Fees (Rs.)
Up to 25	40,000
25 to 50	45,000
Above 50	50,000

Note:

01. Service tax would be extra, at applicable rates.
02. Surveillance will be carried out at the discretion of the client at Rs. 25,000 irrespective of the size of unit.
03. The above fees are inclusive of out of pocket expenses.

Source: CARE SME Rating Criteria

Fitch SME Rating

Recognising the importance of Small Scale Industries (SSIs) in the Indian economy and with a view to reap the benefits of expertise of Fitch by the SSI Sector, National Small Industries Corporation (NSIC), the nodal agency, has entered into a MoU with Fitch Ratings for SSI Ratings.

Fitch India's SSI Group rates the entities at a point in time on a separate Rating scale suited to the special features the sector. The rated SSI can use the Rating for various purposes including borrowing working capital loans and term loans. The SSI Rating is, irrespective of the tenure of the loan, an entity Rating.

The SSI Group draws an agency's rating experience in both domestic and international markets. The exercise involves detailed business and financial analysis, besides one-on-one management meetings. The registered SSI units which intend to get them rated shall submit filled application along with fees and preliminary information/documents. The application form contains the details of the amount of fee to be paid and the documents to be submitted. Fitch may ask for additional information, if required, during the course of rating process. The Rating process is expected to be completed in four weeks from the date of submission of duly filled application furnishing complete information. Based on the application received and the documents enclosed to the application by the applicant-SSI, Fitch makes a comprehensive assessment and evaluation. Further, the Agency discusses specific issues with the management. Based on this comprehensive assessment and evaluation, the Agency rates the SSI. Besides, a detailed rationale for grade assigned is enclosed to Rating letter. The rationale addresses all the key issues. The Rating Scale used by Fitch is presented below.

Table 5: Fitch SME Rating Scale

Performance Capability	Financial Strength		
	High	Moderate	Low
Highest	SE 1A	SE 1B	SE 1C
High	SE 2A	SE 2B	SE 2C
Moderate	SE 3A	SE 3B	SE 3C
Weak	SE 4A	SE 4B	SE 4C
Poor	SE 5A	SE 5B	SE 5C

Source: www.fitchratings.com

Based on the above scale of Rating, it may be inferred that the performance capability of SSI unit is the highest and its financial strength is high when a SSI unit is assigned with the Rating 'SE 1A' and the lending institution can extend financial assistance to the unit. When SSI unit is assigned with the Rating 'SE 5C', it is dangerous to extend the credit facilities to such unit as it is suffering from poor performance and very low financial strength.

The fee charged by the Rating Agency and the amount of subsidy provided by NSIC to the SSIs are presented below.

Table 6: Fitch SME Rating Fee Schedule

Particulars	Turnover (Rs. lakh)		
	Less than 50	50 - 200	Above 200
Rating Fees (Rs)	42,000	45,000	50,000
Subsidy from NSIC (Rs)	25,000	30,000	40,000
Net Fee (Rs)	17,000	15,000	10,000

- Note: 1. Service tax on rating fees as applicable
 2. Fee is inclusive of all expenses
 3. Subsidy is given by the Ministry of Small Scale Industry through NSIC.

Source: www.fitchratings.com

It is obvious from the above that the Rating fee is higher for SSIs with higher annual turnover. Even the subsidy provided by NSIC is higher for the SSIs with the higher turnover. But the net fee burden on SSIs is inverse with the turnover - the SSIs which are very small (lower turnover) have to pay higher amount and vice-versa which is not justifiable. NSIC has to reconsider its subsidy scheme.

Conclusion

The paper deliberated on the methodology followed by rating agencies in assigning the rating to SMEs. The rating is useful to both SMEs and financial institutions. A good rating enhances credit-quality of the SMEs and eases the job of financial institutions. Efforts of NSIC and rating agencies lead to overall economic development. However, this initiative needs a little more focus as the awareness of this mechanism is not widespread.

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CRISIL Rating Scan, January 2007, pp 7-9. | CARE SME Rating Criteria, www.careratings.com | www.fitchratings.com



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