

Rating Criteria For Small and Medium Enterprises

Background

SME (Small and Medium Enterprises) segment plays a very vital role in the economic development of our nation. Credit risk assessment in this segment requires a specific approach, as the factors affecting the creditworthiness are somewhat different compared to those of large corporate entities. Hence, to further support the growth for this sector and help the investors to determine the relative creditworthiness of entities belonging to this segment, a need for separate rating product was felt. Accordingly, CARE introduced SME ratings in 2006, which are intended entirely for Small and Medium Scale Enterprises. Further, CARE has signed a Memorandum of Understanding with National Small Industries Corporation Limited (NSIC) to introduce the NSIC – CARE Performance and Credit Rating for SSIs. This is a special rating product for SSIs.

SME Rating

SME Rating indicates the relative level of creditworthiness of an SME, adjudged in relation to other SMEs. It is an issuer specific rating reflecting overall general creditworthiness. It is a one-time assessment of credit risk of the rated entity in comparison with the other SMEs.

NSIC-CARE Performance and Credit Rating for SSI entity

This rating indicates the relative level of financial strength and performance capability of an SSI entity compared to other SSIs. It is an issuer specific rating and not a loan / bank facility specific rating and is a one-time assessment of the entity. This rating helps SSIs to obtain quicker and cheaper credit, facilitate capability assessment of SSIs by their clients and help SSIs enhance their bargaining power from the parties in the supply chain. The Indian Bank Association (IBA)

has been involved in formulating this Scheme. The government has subsidised the fees for this rating up to 75 per cent, enabling SSIs to get the rating at a lower cost.

Rating Methodology

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

Industry Dynamics

No SME unit can isolate itself from the impact of industry dynamics. The industry parameters that affect an SME unit would include overall demand-supply scenario, level of entry barriers and competition, availability of substitutes and technological trends, government support to the sector and cyclical and seasonality of industry. CARE believes that promoters' ability to manage the business and industry dynamics is very crucial.

Operational Performance

Against the backdrop of the industry, CARE assesses the entity's operating strengths and weaknesses vi-a-vis its competitors. SMEs having inherent strength and relatively strong positioning (including market share) in their business segment, are viewed favourably in a credit perspective.

For assessing the business risk, long term sustainability of the business model is very important. Many SME units are part of some large group. In that case, the entity's importance and positioning within the group, its inter-linkages of operations and transaction transparency are also evaluated.

In order to assess the smoothness of functioning of day to day operations, timely availability and sufficiency of raw materials, manpower, utilities are analyzed with the major focus on locational and technological edge over others. The entity's initiatives for clean and green environment are also evaluated, during the site visit.

Business strength is derived by assessing customer profile, product profile, revenue mix and bargaining power with the stakeholders. CARE also seeks feedback from key customers and

suppliers to assess the strength of relationship of these stakeholders with the rated SME unit. Depending on the category of the product, a wide distribution network would be essential to gain competitive advantage.

Financial Risk analysis

CARE 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 ICAI guidelines. In specific legal forms like partnership and proprietorship concerns, risk of withdrawal of capital exists.

CARE 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, 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.

As a part of the due diligence exercise, CARE team also interacts with the bankers / lenders to learn about overall conduct of account in the past.

Management Capability

Quality of management is one of the most important parameters that supports the credit strength of an SME unit. CARE 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. CARE 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. CARE 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.

Project Risk Analysis

High level of project risk can also affect the financial strength of an SME unit. In case of a SME unit implementing a large project, aspects like project feasibility, size, funding mix and stabilization issues in operational phase are a few aspects which are examined., CARE believes that promoter's past track record in project implementation and project status including financial closure are equally vital.

The rating outcome is ultimately an assessment of the above factors and their linkages to arrive at the overall assessment of credit strengths and weaknesses by taking into account industry's cyclicity. While the methodology encompasses comprehensive technical, financial, commercial, economic, and management analysis, credit rating is an overall assessment of all aspects of the issuer.

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