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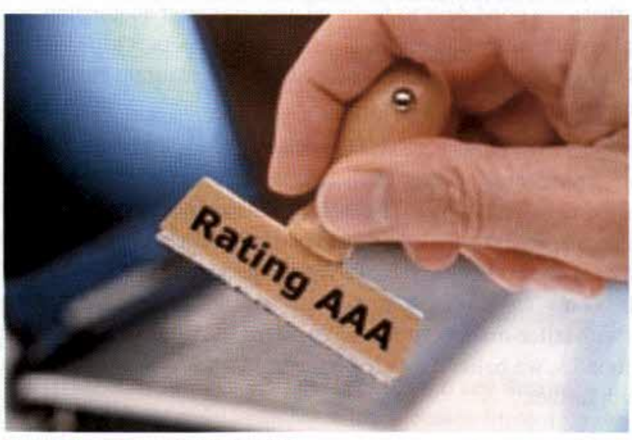
Use of Credit Ratings for SMEs

The Small and Medium Enterprise (SME) sector gains prominence in our economic framework because of its critical role in the growth and development of the economyespecially in terms of economic growth and job creation. India's growth trajectory in coming times would to a large extent be defined by the strength and pace of growth of theSME sector.Not only does the sector promote entrepreneurship and innovation, it provides the necessary inputs/support to the large industries. These entities are vital for the growth of the manufacturing sector of the country and are being relied upon for raising the share of India's manufacturing sector from the current 14% of GDP to 25% of GDP by 2022 (target laid down by the National Manufacturing Policy).

However, despite its inherent growth potential, the segment is significantly constrained by the availability of adequate and timely finance options.The sector is challenged by the high cost of credit and the lack of proper data and understanding of their credit requirements. While SME lending is part of the priority sector pool of banks, the latter tend to charge higher rates as this segment is considered to be relatively high-risk lending. The SMEs require adequate and timely working capital and term loansfor their functioning, growth and expansion. Also their receivables tend to increase when there is an economic downswing which have to be financed by bank loans. Thus, for enabling the sector to attain its optimal growth would necessarily call for developing tools that help the segment in raising finance and meeting its financing requirements.



Sources of Finance for SMEs

As per the 4th census of the SME sector, only 5% of the SME units (registered and unregistered) have availed institutional finance and 2% sought finance from non-institutional sources while an overwhelming majority i.e. 93% of the units had no finance or depended on their own sources.

Bank lendingis the chief *formal* source of finance for the SME segment. Commercial banks account for over 85% of the finance the sector receives from the formal sources. However, owing to the stringent conditions (in terms of share in equity& collaterals) associated with bank finance and given the inability of the entities of the sector to abide by these, banks are found to be unable to lend adequately to the SME sector. In addition to this, as the SME sector in the country is characterized by its very diverse structure, be it in terms of size& growth, technology used, products & services offered,business practices adopted (informal in nature) and lack of transparency (unsatisfactory reporting of firms data), banks often find it difficult to understand the nature of business of the entities, their potential and credit worthiness,further constraining and inhibiting their lending to the sector, leading to sizeable funding gaps.

The SME sector relies heavily on retained earnings and other own sources of funds (personal savings, borrowing from friends and relatives, sale of assetsetc). Entities of the sector have been raising funds through debt instruments. Venture capital, private equity and seed funding also serve as sources of funds for the sector. Given the funding gap, they also seek recourse to borrowing from the unregulated markets.

Recognizing the challenges faced by the SME segment in availing finance, the government, central and state alike, have various schemes to infuse funds into the sector. Nevertheless, the SME sector requires new institutional sources of funds to meet its significant fund shortfall.

How does the credit rating of SME help?

Credit rating agencies play a pivotal role in narrowing the funding gap for the SME segment. Listed here are some of

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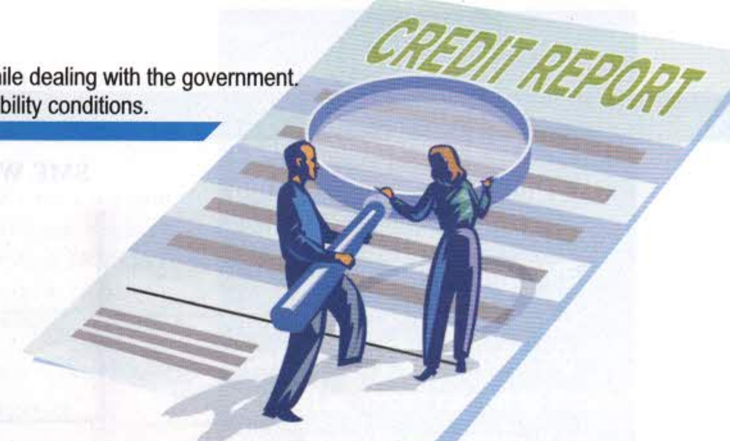

the benefits SME derive from credit rating.

*1. Captures Creditworthiness:*Credit rating is often viewed as being akin to a report card of the financial health of an entity. It helps capture clearly the creditworthiness of the entity, adjudged in relation to other similar entities. Formal institutional lenders would foremost scrutinize the credit rating of the SME while making lending decisions.

2. Easier access and funding on better terms: A favorable rating improves the entities access to funds. It also enables them get credit at lower (even concessional) rates. It also facilitates faster dispersal of funds by financial institutions. Credit ratings helps assuage the problems the SMEs face in seeking finance and supports the growth of the sector. It also makes it easier for the entities to get additional funding.

3. Credibility: With credit ratings being an independent third-party opinion on creditworthiness of the entity carried out by certified credit rating agencies, it greatly helps in building confidence and in the establishment of credibilitywith the various stakeholders.

*4. Self-improvement:*Credit assessment and ratings often serve as a feedback mechanism helping entities improve upon their efficiency and thereby better their financial position in terms of turnover and profits, enabling them to get additional funding and financing at favorable terms. As such it serves as a self-improvement tool.

*5. Increases visibility:*Given that the rating is an independent external assessment of the SME by a recognized and respected agency, it gives the entity greater visibility and improves business opportunities.

6. Easier access to various sources of funds: Credit rating reports help entities tap alternative financing option other than the commercial banks such as private equity, venture capital and other bank and non-bank sources.

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8. Helps negotiate better terms with clients as well as helps retain clients

9. Reduce information asymmetry: Given the diverse nature and structure of the SME segment, information asymmetry abounds for the sector. As the credit rating for an SME entity involves evaluating the creditworthiness of an entity and comparing them with other entities of the segment, it helps reduce the information asymmetry associated with the entities in this segment.

Who uses SME credit rating?

These credit ratings are used by a gamut of institutions and individuals. They include commercial banks, investment banks, investors, issuers, governments, brokers & dealers and all other financial institutions.

In case of commercial banks, the SME credit rating can help them understand the credit requirement needs of the sector. The credit ratings serves as an important benchmark for banks while making lending decisions. Banks refer to the external ratings to check if their internal risk evaluation mechanism is in line with the former. The credit rating of the SMEsalso help investors better access the creditworthiness of the entities of the sector

SME

The credit rating analysis is a continuous evolving process which factors in changing regulations, economic environment, business scenario and conditions. The rating is the outcome of overall credit risk assessment which can potentially affect the general creditworthiness of the entity. It essentially takes into account various parameters including industry dynamics, competitive position of the entity, operating efficiency, management capability, organization systems, customer profile, track record with lenders and other stake holders.

Within the credit rating product basket for SME, CARE Ratings undertakes bank loan ratings, NSIC ratings and SME ratings.

CARE SME Rating is an issuer-specific, one-time assessment of the credit worthiness in comparison with other SMEs. It depicts overall debt-management capability of the entity. The rating takes into account management capability, industry dynamics, operational performance, financial risk and future prospects for arriving at overall risk profile.

National Small Industries Corporation (NSIC) - CARE Performance & Credit Rating is a rating service for DIC registered micro and small enterprises wherein NSIC provides a one-time subsidy to these entities to get rated. The NSIC ratings covers various indicators encompassing the financial, business, operational and management aspects of SMEs. SMEs receive a rating which will highlight strengths and weaknesses of existing operations.

CARE Ratings product basket for the SME segment also includes grading, due diligence, channel partner evaluation and verification services.

It is believed that credit ratings to SMEs are an important brick in the wall that is required to accelerate the pace of flow of funds to this segment. Making this a habit does have an advantage of bringing about self-improvement which is turn will make the enterprises more professional in their approach to business.

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