Credit Rating for SME's –A Bridge Between Indian SME's and Industrial Finance

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Abstract

The MSME's have been an integral part of India's Growth Story. SME's contribute to almost 40% of the gross industrial value added in the Indian economy. SME's have been emerging as a significant contributor in generation of employment, enhanced exports, import substitution and balanced development of regional economies. The biggest challenge to SMEs in India today is access to credit facilities from banks and financial institutions. The main reason for this problem is lack of efficient management tools in place, lack of knowledge of banking guidelines, ineffective mechanism to weigh the credit worthiness of the company and so on. Not to blame the banks and financial institutions alone for not providing required credit facilities, as they too have to cater to lending norms stipulated by the RBI and monitor the asset quality before deciding upon lending to SMEs. It is observed that due to emphasis given to MSME sector by the Government, especially under 'Make in India' initiative, the banks are ready to lend to SMEs on priority basis, provided the SMEs can prove their credit-worthiness and positively ensure the repayment of borrowed sum. To assure that the SMES are able to access banking system more and at the same time the banks are able to monitor their asset quality, SMEs can resort to Credit Rating of their firms. Credit rating is an independent third–party comprehensive assessment of the overall condition of an entity. It takes into account not only the financial condition of the entity but also several qualitative parameters that have bearing on its credit worthiness.

The paper attempts to highlight the need for credit rating for SMEs, the benefits of credit rating, the important policy initiatives taken up by the government towards credit rating of SMEs, the process of credit rating for SMEs and the challenges faced by the SMEs in getting credit rating for their firms.

***Key Words*:** SMEs, Lending Norms, Credit worthiness, Asset Quality, Credit Rating

1. Introduction

SME's are integral part of the economy of any country. In India too the contribution of SME's to the development of the economy is notable over the decades. According to the estimates of the Ministry of MSME, Government of India, the sector generates around 100 million jobs through over 46 million units situated throughout the geographical expanse of the country. With 38% contribution to the nation's GDP and 40% and 45% share of the overall exports and manufacturing output respectively, it is easy to comprehend the important role they play in social and economic restructuring of India. The unique characteristics of SMEs like less capital- intensity and high labor-absorbance, their ability of being established in small towns and cities with less requirement of infrastructure and small size of management, SMEs have proven to be the strength of our country. Recognizing the contribution of the SME's to our economy the government too since long has taken steps to provide the SME's with various facilities and support. However, the statistical data of the past few years indicates that the share of MSMEs in GDP, manufacturing output and exports has been slowly declining over the years. To revitalize the bearish sentiments in manufacturing sector, government has triggered the "Make in India" campaign to boost manufacturing sector, aiming to redesign manufacturing sector as a key engine for India's economic growth.

In spite, of the various policy initiatives of the government the SMEs have been facing several challenges for their successful operations like lack of infrastructure, lack of professional management and the most important being the lack of adequate finance.

For most of the SME's, the financial resources are often limited. This often forces them to select a solution, which appears to be cheap initially. However, the hidden costs will start to emerge during implementation. This sometime causes the project to be abandoned or sometime lead the firm into further financial crisis. The lack of financial resources also stop the SME's from further expansion of their activities even in case of those companies which are earning well. The SME's, due to their limited scale of operations, primarily resort to owner's equity and loans from banks and other financial institutions either for start up or for expansion proposals. The non-availability of capital forces the SME's to stay limited in their operations; only very few SME's are able to access finance from the equity market.

Traditionally, the banks in India were very reluctant or less-enthusiastic to lend to the SMEs. To overcome this problem, the government has taken several policy initiatives to make available adequate and cheap finance to the small and medium enterprises. However, most of the SME's of our country have not been able to access such facilities for reasons like lack of knowledge about government schemes and secondly being unable to convince the banks and financial institutions about their ability to repay the borrowed sum of money. In spite of the rigorous pressure from the government on banks to provide finance to the SME's on priority basis, the banks are still reluctant the do the same. Not to blame the banks alone as they are worried for the quality of their assets, fearing for the huge extent of sickness in SME's. The SME's performing well too are somehow are not able to convince the bankers on their credit-worthiness.

2. What is Credit Rating for SME's?

This is where Credit Rating comes into picture. MSME Rating is a comprehensive and independent third-party evaluation of the MSME. It takes into account the financial position and several qualitative parameters of the MSME that have a bearing on the credit-worthiness of the entity. Rating for SME's reflects the rated entities' overall creditworthiness, adjudged in relation to other SMEs. These ratings are entity specific, and not specific to debt issuances. The company will be analyzed internally and awarded rating according to the particular company's credit- worthiness, its management team, and effective relationship with customers and suppliers. The company will be rated according to the strength and weakness of that company only and will be compared to the sector as whole, which will give increased leverage for the company to work on better platform.

3. Benefits of Credit Rating to SMEs

- **Aids in enhancing the credibility of the MSME units**: MSME units can prove to the lending authorities very easily their financial creditability. A good credit rating helps SMEs to access easy finance from bank and financial institutions. There are examples of SMEs who have also raised equity finance easily once after obtaining good credit rating.

- **Aids in obtaining finance at low cost:** Very high rating for a company will definitely result in reduction in interest rate. Even a small reduction in interest rates brings about substantial benefit for the company and benefit the company.
- **Helps open doors to the corporate sector, especially for MSMEs having a large vendor base**: A good credit rating enables SMEs not only access finance but also helps develop a large vendor base and earn better buying terms.
- **Facilitates international trade and commerce by building confidence amongst potential trading partners**: Credit rating helps SMEs to expand their business even in the global market
- **Motivates MSMEs in adopting good governance practices for long term benefits**: Credit rating process motivates the SMEs to maintain good governing practices, maintain proper documents and resort to best management and control practices.

4. Challenges faced by SMEs in getting Credit Rating for their firms

- Most of the SMEs lack awareness about the credit rating mechanism and the process of credit rating.
- Most of the SMEs in the country lack professional management set up hence do not maintain the adequate documents needed and information necessary to obtain credit rating.
- The SMEs hesitate to obtain credit rating, as they fear that poor rating may diorite their borrowing capacity.

5. Credit Rating Agencies for SME's

There are more than five rating agencies who are now actively involved in the rating of SMEs. CARE, ICRA, SMERA, CRISIL are some of the agencies who are in to the rating of SMEs. Different credit rating agencies adopt different methods and criteria for credit rating of SMEs.

6. General Criteria followed for SME Rating

An analysis of credit rating processes followed by reputed rating agencies over the years suggests that the following factors are prominently considered in the exercise:.

i. **Industry Risk:** The industry in which an enterprise operates plays a crucial role in the credit risk assessment. It is a key determinant of the level and volatility of earnings of any business.

ii. **Business Risk:** Business risk is the possibility of a default on account of circumstances connected with the customer's business activities; Business risk analysis encompasses the following aspects:
   a) Market Risk
   b) Operating Efficiency

iii. **Management Risk:** Management risk refers to the risk of non-payment arising out of a business failure linked to the inefficacies of the management. Management risk assessment involves evaluation of the management quality on the basis of educational qualification, professional experience and business attitude. Majority of the Indian SMEs are essentially managed by one or two key persons. In this scenario, the quality of management personnel becomes critical. The following factors are critical in assessing management quality:
   a) Character
   b) Ability
   c) Capacity

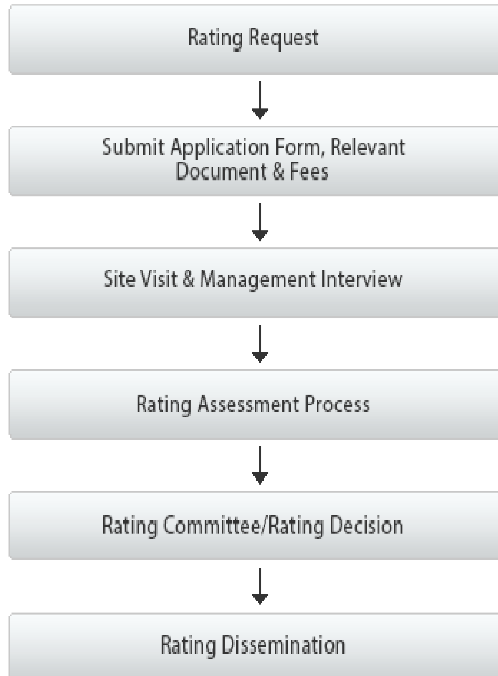
iv. **Financial Risk:** Financial risk analysis involves thorough evaluation of the financials of the SMEs through a careful analysis of the audited financials and auditor's report and notes to accounts. Ratio analysis, financial disclosures and off balance sheet items and their impact on the profitability is studied and analyzed in detail. Further, the source of funding and its impact on the structure of capital employed is also analyzed.

v. **New Project Risk:** The scale and nature of new projects can significantly influence the risk profile of an entity. Unrelated diversifications into new segments are invariably assessed in greater detail. The underlying risks in new projects include time and cost overruns, non-completion operational risks and market risk. Besides clearly establishing the rationale of new projects, the protective factors that are assessed include track record of the management in project implementation, experience and quality of the project implementation team, experience and track record of the technology supplier, implementation schedule, status of the project, project cost comparisons, financing arrangements, tie-ups with suppliers, market outlook and plans

vi. **Other Parameters:** Besides these five broad factors, other parameters like environmental clearances, impact of subsidies and sales tax deferral loans, changes in accounting policies, unabsorbed depreciation and business loss, non-insurance or inadequate insurance of assets, extraordinary or windfall gains and losses, analysis of bank statements, violations of accounting standards if any, change in management, impact of new monetary or fiscal policies or significant development in the industry are thoroughly assessed on case to case basis. Legal risks, foreign exchange fluctuation risk and hedging mechanism (if any) followed by the enterprise is studied in detail

7. Credit Rating Process

Different Credit Rating companies adopt different procedures; however, the general process adopted by most of them is indicated below:



8. Rating Scale adopted by Agencies

Once the credit rating process is completed, the Ratings are granted to SMEs. The differential rating scale generally adopted by one of the well-known agency, i.e., SAMER, is shown below:

Rating Scale	Explanation
MSME 1	Highest
MSME 2	High
MSME 3	Above Average
MSME 4	Average
MSME 5	Below Average
MSME 6	Inadequate
MSME 7	Low
MSME 8	Lowest

Source: SAMERA official website

9. Conclusion:

In spite of the slow acceptance of Credit Rating by SMEs it can be very clearly noticed that the Credit Rating is the best solution available to SMEs to access easy finance from banks, financial institutions and also to raise finance in the form of equity capital. It would also be beneficial to the Banks and financial institutions to grant finance to SMEs easily and at the same time ensure quality of their assets .The Indian government and the Ministry of MSMEs along with their other programs for SME development can also take measures to create awareness about SME Credit Rating among the SMEs in the country so as to positively respond to the problem of inadequate finance faced by the SMEs.

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