IMPLEMENTATION OF CREDIT RATING FOR SMEs (Small & Medium Enterprises)-HOW IS BENEFICIAL TO INDIAN SMEs?

G.Vairava Subramanian*, Dr. S. Nehru**

*Research Scholor, Rural Institute, Gandhigram, Deemed University, Tamilnadu, India.
**Associate Professor, Rural Institute, Gandhigram, Deemed University, Tamilnadu, India.

Abstract- SMEs are integral part of India's growth story. SMEs contribute not only to the domestic market but also to exports significantly, thus earning foreign exchange revenue for the country, thereby making the sector emerge as very strong pillar in India both in terms of GDP and in terms of employment. Today SMEs are contributing more than 16-18% of Indian GDP and if this sector is getting more support, the sector can easily contribute more than 30% to the GDP. The biggest challenge for SMEs in India is, effective financial management both for running of the organization as well as for expansion activities taking in to consideration the global competition. Raising funds from financial institutions like banks, NBFCs for SMEs are till date a big challenge. It is estimated that only 16% of Indian SME sector have been given bank /institutions support and the rest of the sector is unable to get support. The main reason for these lacunae is, not having efficient management tools in place, lack of knowledge of banking guidelines, ineffective mechanism to weigh the credit worthiness of the company.

The current scenario of Indian economy is pushing RBI, to bring in a strict lending policy due to slowdown in growth, which has affected the lending policy to be more conservative with very high interest rate, which is very clearly disturbing the bottom line in the balance sheets of SMEs . This eventually become more difficult for SMEs, not only for their expansion plan but also to make the company to run in difficult situation, when the economy is in slow down mode, thus compelling this enterprise to stay in on even keel in terms of growth or even perform lower than previous years, unlike other bigger corporate which grows rapidly because of their strong measures and support from the banking sector.

Other part of the story is, Bankers are far behind in lending guidelines laid down by RBI, in relation to SME sector, the biggest challenge for Banking sector is, there is no proper mechanism, un like bigger corporates to measure the quality of the organization in terms of asset quality, IP(intellectual properties) and the business through acclaimed private agencies. In order to ensure that the banking system penetrates the SME space more and at the same time, applies caution in terms of asset quality, the system of SME rating got introduced. In this article, we are going to analyze all the information related to SME rating, Why it is necessary?, benefits of rating for SMEs and banking sector, Industry growth opportunities due to rating system, challenges faced by SMEs due to rating system, future growth of SME sector etc.

Index Terms- rating of SMEs, credit rating for SMEs, benefits of credit rating for SMEs, importance of credit rating in SME sector

I. INTRODUCTION

In 2007, Chennai based businessman Mr Kandhasamy, who is in automobile components accessories manufacturer was tired, his bank refused to extend the support for further capital for expanding his business,. "My banker couldn't understand the model of my business and I was also finding it difficult to explain in banking terms.'

Fortuitously, just around this time, he came across newspaper reports of lot small organizations in Coimbatore and Chennai being provided rating certificates. This was very promising. He immediately approached a credit rating agency and the feedback helped him improve his company's efficiency, resulting in a better turnover and profit. The agency provided him with key parameters they gauge the company and its health. He worked on improving certain critical factors in key areas and succeeded in getting a good rating and thereby a bank loan. The debt infused helped the company grow manifold

The above message is a very clear indicator as far as SMEs status today. Most of the SMEs are finding it difficult in approaching the banks and requesting for loan, as the formalities to be complied with banking system is cumbersome and this kills most of their time, leaving very minimal time to concentrate on their business. The resultant factor is non growth in their existing business and they are not in a position to either sustain or expand their business. In a report from MSME, it is informed that only 16% of SMEs have access to bank facilities and other people are finding it difficult in getting the support from the banking sector. To create the uniformity in treating the SME sector as whole, lot of initiatives have been taken up by Government of India and one such strong initiative is credit rating for SMEs. Corporates are required to get rating done for their company to avail any additional borrowing from the banks and this sector has used this as mandatory procedure for getting all kind of support from banking sector. But for SMEs, no such criteria have been there in the past and this resulted in abnormal delay in both sanction and disbursement. The rating mechanism introduced by India, will certainly have its own benefit to SME sector. Let us understand how this rating system has been formed and who are all eligible to rate the company, rating process, rating fee, and the benefits for SMEs due to the newly introduced rating system.

II. WHAT IS CREDIT RATING?

Ratings on small and medium enterprises (SMEs) reflect 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 SME sector has its own unique features: unlike the large corporate, the SME sector has no organized information on industries, their functional details, market shares, competition dynamics, and promoter or management track record. The creditworthiness of entities in the sector, therefore, needs to be assessed using tools and methods that are different from those traditionally used for large corporate. SME Ratings agencies in India have evolved a very unique and new tool in rating the sector. This rating reflects the rated entities' overall credit worthiness, adjudged in relation to other SMEs. These ratings are entity-specific, and not specific to debt issuances. 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.

<u>What does a credit rating agency do?</u>

Approaching a credit rating agency is a good option for small and medium enterprises (SMEs) given the problems they face in seeking finance. According to an RBI report on trends and progress in banking 2010, only 13% of the registered SMEs have access to finance from formal sources. This clearly indicate the need for SMEs to rate their company to have wide access to the banking sector. Practically speaking, lot of SMEs are finding it difficult in reaching the sector, because of their lack of knowledge in the formalities to be complied to avail bank funding for their expansion activities.

Rating agencies assess a firm's financial viability by way of taking all the necessary documents about the company, its management team and the business model etc, analyze the same in terms of their capability to repay the debt in case of going for borrowing from the banking sector. And capability to honour business obligations, provides an insight into its sales, operational and financial composition, there by assessing the risk element, and highlights the overall health of the enterprise. They also benchmark its performance within the industry. The company will be rated according to their industry and how they are positioned in the peer group, how comfortable their business model to make the company to repay the borrowing etc.

There are more than 5-6 rating agencies who are now actively involving in to the rating of SMEs. CARE, ICRA, SMERA, CRISIL are some of the agencies who are in to the rating of SMEs.

Different rating agencies are adopting different style in rating the company. For ex. SMERA has got the rating system for different sector and each sector has got some unique difference in their rating. Some of the rating scales are given below.

III. SME RATING MECHANISM

SME rating scale consists of two parts, a composite appraisal/condition indicator and a size indicator. Normally, rating agency has got the indicator of scale 1 to scale 8, which carries its own weight. Rating categories SMEs based on size, so as to enable fair evaluation of each SME amongst its peers. The SME rating scale is specified below:

SMERA RATING	RATING APPRAISAL INDICATOR
SME 1	Highest
SME 2	High
SME 3	Above Average
SME 4	Average
SME 5	Below Average
SME 6	Inadequate
SME 7	Low
SME 8	Lowest

Source-SMERA

<u>HOW THE PROCESS WORKED IN RATING SMEs?</u>

Rating is a comprehensive assessment of the enterprise, taking into consideration the overall financial performance. Management competence, industry overview, peer group performance, relationship with customer/vendor etc and strong management competence in maintaining the disciplined finance model.

<u>Profitability</u>

The company to be rated will be first analyzed for their past performance and how they generated profit and whether they could able to sustain their profitability amidst their competition and any hitting on profit due to economy slowdown etc. Company with consistently good profit will always have fairly a reasonable rating then those companies with lesser profit in comparison with peer group. If the industry has generated good profit, than the company which is getting rated, then the rating for that company will definitely have small dent in their quality of repayment. Because, any company which gets reasonably good profit, then only they may start repay their loan with the profit. This is the best and important factor which is considered by the rating agency for good credit rating.

Growth rate of the organization

Growth of the organization will be compared with the industry and this determines the capability of the management to take the company in the upward direction. If the growth of the organization is at least in par with the industry growth, the rating will be good and if it is less than the industry average growth, then the rating will be lower with respect to the particular objective. If the company has performed well ahead of the industry average, rated company can expect definitely better scale in the rating.

Scalability and speed of the organization,

Though the above mentioned parameters are playing vital role, it is imperative to ensure the industry's potential for growth in the coming years and how fast the company is able to achieve the milestone set by them to reach and how the company is persistently doing the growth. If the industry is not having enough opportunities for any future growth rapidly in the coming years then their past performance, then the rating will be lowered. Forex; certain industries will have automatic saturation level, and normally the promoter tend to apply their past performance activity for their scaling, which most of the time, due to the new systems and tools in place by their competitor fails. Since the industry is not capable enough to accept that fast growth beyond its saturation level, it is generally to be turn in to negative growth, which may detoriate the liquidity of the company and profitability. This may make the company to enter in to debt trap and it may even lead to the level of closure. Rating agency normally looks on the scalability of the company and industry, its future potential etc to determine the rating.

FINANCIAL PERFORMANCE OF THE COMPANY

Past performance of any company is the mirror for their future activity. Though this is not to be applied strictly to understand any business, in particular with SME, it is also taken in to consideration to analyze the company. The books of the company is very clearly scrutinized by the rating agency and ask for any clarification with the management and after getting satisfied with the details provided by the management, they also tend to verify the authentication of the documents submitted by the management with the concerned authorities if necessary to have double clarity.

If the past performance of the company and its all necessary ratios to be calculated is not up to the mark, then the rating agency may downgrade the rating with respect to the financial performance of the company and may provide good rating if the performance is good.

INDUSTRY & OPPORTUNITIES

As explained in the previous column, rating agency will also have look in the industry as whole and they tend to compare the company to whom rating to be provided along with the other companies in the same sector and if necessary in the same size and analyze, how the other companies have performed in the same sector. If the company to whom rating to be provided has performed well in compare to the industry, then they will start analyze, how this company has performed well and provide the rating accordingly.

OTHER PARAMETERS

Apart from the parameters which will be analyzed, the rating agency will also look in to the efficiency of the management, customer's longevity and customer satisfaction, raw material supplier's satisfaction level and the bank account management. Rating may vary, if poor bank management is done the company and all the banking institutions are expecting their customer to keep their commitments to maintain fair practice. They are strongly recommended to maintain good relationship with all the people responsible for the growth of the organization and it is always better to ensure that payment history is the primary factor; any company should have in mind as, this will have direct effect on the rating. Companies with certification like ISO etc, will certainly have better rating opportunity and any company which has violated the statutory liabilities like PF, ESI etc will definitely have rating in the down ward level. A very strong asset base created by the company in terms of infrastructure, machinery for the development of the company with the profit accumulated in the past, reinvested in the business again will certainly add mileage

IV. IPO Process rating mechanism for SMEs

For example, SMEs when they want to go for Initial public offering (IPO) grading is a five point grading scale. The issuers with strong fundamental relative to its peers are assigned highest score "SME IPO Grade 5" and the issuers with poor fundamentals relative to its peers are assigned lowest score i.e. "SME IPO Grade 1". In IPO process, the same formula and process with increased diligence process will be done by the rating agency.

SMERA IPO GRADE	EVALUATION
SMERA IPO Grade 5	Strong fundamentals
SMERA IPO Grade 4	Above Average Fundamentals
SMERA IPO Grade 3	Average Fundamentals
SMERA IPO Grade 2	Below Average Fundamentals
SMERA IPO Grade 1	Poor Fundamentals

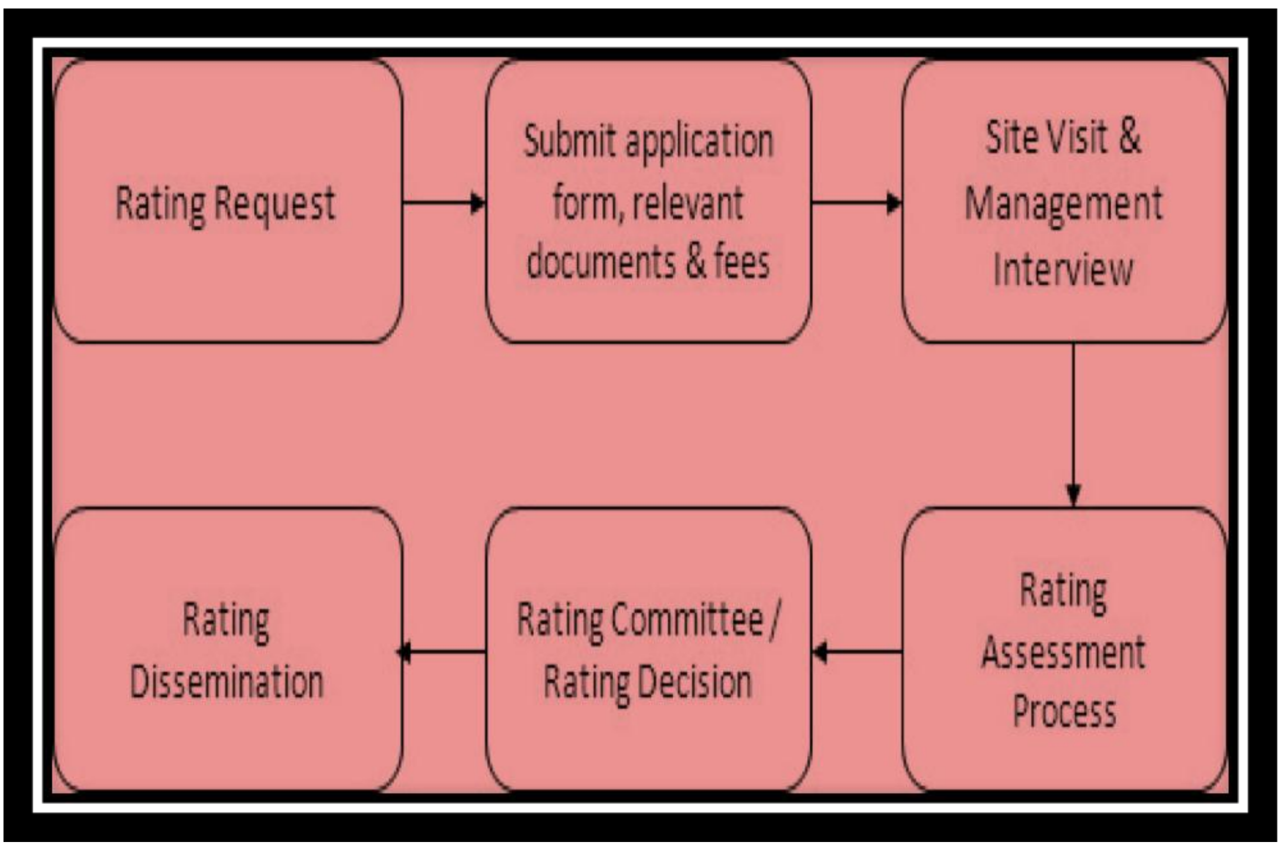
V. Process of Rating

The six stage rating process is the key factor for the company. As this involves comprehensive analysis of the company which can be used by the management, as parameter for the company to strengthen their weakness highlighted by the rating agency and this can be used as tool to have healthy relationship with the banker. The rating process are as follows.

- The Rating process starts from getting the request from the company which need to be rated. The rating agency has got the definite idea of transparent, reliable, time bound and customer friendly. The Rating process begins with the receipt of rating mandate along with the application form and ends with the dispatch of the Rating report and Rating certificate. The Rating process in brief is enumerated below:
- After getting the request from the company, the company has to file the necessary application along with list of documents required for the rating agency to conduct the research about the organization along with the necessary fee. After submitting the documents, the rating agency team will have direct site visit to the company and they will have detailed discussion with the management about their vision, problems, benefits etc to have an over sight about the company. They also will talk to their supplier, customers, bankers about the performance of the company in terms of timely delivery of finished goods and inventory management.
- After their discussion, the rating agency will start do the rating process with the preset conditions laid down for SME with their rating scale.
- Once the rating team has finished the rating module, it will be transferred to the rating committee which will consist of eminent team with industry expertise and they will analyze the rating formula and the company's documents. Once they have verified all the documents, then the rating committee will decide what scal can be allotted to the company. Once that is decided, then the rating agency will complete the rating and send the rating report to the company.
- The company will have rights to accept all the conditions laid down in the rating report or they can provide additional information to prove their company to be upgraded. Once the submitted documents are satisfying the committee, then they will upgrade or maintain the same standard to the company and submit the same to the company.

Once the rating mechanism is over and rating has been done, then the management of SME can take the same to the banker for getting the facility for their business improvement.

<u>PROCESS FLOW CHART IN RATING THE SMEs</u>



Source-SMERA

After rating agency completed the formalities and submitted the final report, the company can approach the banker with the rating report and the banker will keep this rating as key document to extend the facility to the company.

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The interest rate at which the company borrows basically relies upon the rating scale. If the company has go rating as 1, then very attractive interest rate will be extended by the banker to the company and vice versa. Not only that, very good rating for any particular company will have more chance for getting the facility from the banker as this document gives a kind of comfort level to the banker about the asset quality.
Rating agencies usually have eight grades, ranging from SME 1-8, with rating 1 denoting the highest rating and 8 the lowest.

VI. FEE STRUCTURE

Rating agency unlike charging for bigger corporate, for SMEs they charge very nominal fee ranging between INR 30,000-INR 1,20,000/ per report and this report will be accepted by all the bankers in India, if the rating agency is approved by the banker. The fee structure is normally flexible depends on the size and requirement of the company.

These ratings are valid for a year and can be renewed by paying an appropriate fee. It is money well spent. For, a good rating means a higher chance of bagging a loan and chances for getting the loan at very attractive interest rate.

SIDBI has welcomed the rating system introduced and they are very happy that SME sector will have extra mileage due to the rating system since banks will extend their support to this sector against current utilization of 16% to touch more than 30% in other 16-24 months.

"There is a lot of information asymmetry in the market. A good credit rating provides us with the initial confidence for the project. It also acts as a final confirmation," says Sunil Munhot, chairman and managing director, Small Industries Developmental Bank of India (SIDBI).

Support extended by NSIC for getting SMEs rated;

The extension of facility by Government Of India through one of its arm, NSIC(National Small Industries Corporation), which provides support for those companies with the turnover of less than 2 crores has been given reimbursement of money spent by SMEs for getting their company rated in the below mentioned manner, which certainly gives an opportunity for this sector to get their company rated at relatively minimal cost.

Turn Over of SSI	Reimbursement of Fee through NSIC
Upto Rs 50 Lacs	75% of the fee or Rs 25000/- (Whichever is less)
Above Rs 50 to 200 lacs	75% of the fee or Rs 30000/- (Whichever is less)
More than Rs 200 lacs	75% of the fee or Rs 40000/- (Whichever is less)

Approved list of credit rating agency in India

Banks have approved certain credit rating agency to act in SME sector and the report generated by the approved agency will be given due credit for extending the facility to the customer. Some of the rating agencies who have been approved are mentioned below.

1. CRISIL;Crisil has already tied with more than 32 banks for rating their customers for speedy process of loan.
2. SMERA- Has tied with more than 30 banks for rating and in the process of adding more banks in their list
3. ICRA-Already started adding banks in their list and very aggressively started promoting this model in their revenue portfolio.
4. CARE-Credit analysis & Research
5. ONICRA
6. Fitch

VII. BENEFITS FOR SME SECTOR DUE TO RATING MODEL

"If a firm gets a good rating, They can even approach other banks to get a better rate bargain than the one provided by his existing banker," says Munhot. Director SIDBI

- The rating scale places very imminent role in determining the quantum of loan to be provided to the company. For ex; if the company is doing in par with the industry and they want to rapidly expand, the banker may have their discretion to sanction the amount taking in to consideration the industry, management, capability of the company etc and banker may sanction full money requested for expansion or they may ask the management to slow down in their expansion by reducing the capex(Capital Expenditure) investment.
- Very high rating for the company will definitely have an upside benefit of interest rate reduction from anywhere between .5% -1.5%, which may give substantial benefit for the company and it may increase the company's profitability.(An reduction of 1% interest rate for the loan of 2 crores may give the benefit of close to 2 lacs benefit for the company, which will be directly adding to the bottom line of the company(PAT-Profit after Tax))
- High rated company means strong confidence in their entire operation, thus gives the company to attract good talent pool from the big corporate to strengthen their operational viability and retention of employees are possible due to the strong image created by way of high rating.
- Rating also helps the company to push their business very aggressively since the rating agency not only appraises the financial quality, but also it's other performance. This gives to the company an upper edge by way of showing the rating to the other new customers and export also possible, as this will create confidence in the mind of the customer about their delivery capability and financial stability. Very strong rating will definitely make the company to show this rating as their credit worthiness in terms of financial and non financial performance, which will definitely

increase the top line & bottom line of the company.

- Normally, any loan proposal may take more time with bankers, and some time, this may hamper the growth of the company. In some cases, loan status information from bank takes more than 3-6months and due to this delay, SME may be denied for their organic growth. When the company is rated by the listed rating agency, then this gives the comfort level for the banker to speed the process and loan sanction and disbursement time will be reduced substantially. In an analysis, it has been reported that more than 35% of the companies who got the rating certification claims that, processing time for the loan sanction from the banker has come down drastically, and they saved lot of time and money and their growth was thus guaranteed due to timely release of loan.
- More interesting fact is, instead of SMEs approaching banks for getting loan for their expansion activity , high rated SMEs will be approached by the banker directly and they come forward voluntarily for extending the credit facility, since bankers wants to have good asset quality. With good rating, this becomes easy for the banker to understand the credit worthiness of the customer and they are optimistic on their repayment capacity.
- Good credit rating will give confidence to the company(SMEs) to compete with bigger players in terms of quality, better price and they tend to grow in some cases in par with bigger corporate. This will certainly boost the employment opportunities and increase the per capita in India.
- An increase of 7-10% increase in SME sector getting bank support(Currently only 15-17% of SMEs are accessible to the bank funding and other are not getting the benefit from the banking institutions), may increase the GDP growth to the level of anywhere between 1-2% growth. Currently SME sector contribution to GDP is almost close to 16-18% and this can easily touch more than 20-22% if the sector gets recognition due to the rating mechanism.
- Saving in cost of borrowing by way of 100-150 bps may add huge profit to the company when the company gets very high rating, good interest rate will be offered by the banker, thus enables the company to increase profitability, which may be helpful for the company to meet their obligation of bank to meet well in time and some times ahead of time.
- Good and high rating may give an edge to the SME to negotiate with the banker for further reduction in interest rate. If more banks are approached for funding, then reduction in interest rate is highly possible since, no banker will be interested to lose top rated customer. Competition between banks for attracting and retaining the top rated SME may give more gain in bargain and lowest interest rate is almost guaranteed if the company is very strongly negotiating with the banker.
- High rating may attract lot of private equity/venture capital investor as the confidence in company's growth story is certified by the third party rating agency will make the investor more comfortable in looking in the company and there by the company will grow rapidly.
- Better business opportunities: The independent risk evaluation of SMEs by an unbiased third party lends credibility to them and opens doors for them, while dealing with MNCs and corporate. "You can submit credit rating for tenders and make yourself more credible to get bigger orders. The government also favours rated SMEs, restricting certain contracts for such firms. It also operates a performance and credit rating scheme through various credit rating agencies via the National Small Industries Corporation. The scheme provides a one-time subsidy to SMEs to get rated. "The rating agencies have by far done a good job as external ratings have been coinciding with our internal risk evaluation mechanism. This is a very important benchmark while giving loans," says Munhot.
- A regular renewal of ratings not only helps improve a firm's performance, but also builds confidence within the lender fraternity and trading channel.
- It is like a report card for SMEs. The analysis helps them to continuously evolve based on the changing regulation, business requirements and economic scenario," says Patki.
- <u>SMEs are usually deterred by the rigor of rating discipline and fear of low rating, but the latter may not necessarily be the result of weak financials and can be attributed to various reasons. "The issues can be easily pointed out in the rating report. The SMEs that want to run a sustainable business take the feedback positively and try to improvise. It is an opportunity to implement best business practices," says Pai.</u>

In general, rating system introduced by India will definitely give additional boost to SME sector and it is estimated that more and more SMEs will start approaching the rating agency and this will stand as very important miles stone for the SMEs to grow and prosper.

VIII. CONCLUSION

In addition to various measure taken by Government of India to encourage the SME sector and by various other agencies like SME exchange, subsidy by NABARD to boost this sector & Lot of state government owned financial institutions like TIIC, APIIC, KIIC etc to extend lot of benefits to SMEs, rating system is also going to add quality in terms of performance of SMEs and make them to fight for their eligibility, with their Indian banking sector in par with other bigger corporate. SMEs will also start thinking to transform their company from the existing stage to high range to get good rating if the banking system starts insisting on rating as 'MUST' for SMEs. When this becomes compulsion, then the sector will work more professionally and increase their revenue. By making the company internally, structured qualitatively and keep systems in place with decent financial discipline may make SME, to be perfectly fit in getting good rating and which in turn will increase Indian GDP and if SME sector grows from the current GDP contribution of 16-18% to 20-22% of GDP, then India's growth story against the developing nations will be achieved.

Credit Rating for SME and its benefits, if informed and educated to the SME sector more seriously and meticulously by the concerned authorities and SME related organizations, this will definitely become an eye opener for this sector and every company in this sector will start utilizing this golden opportunity and get the finance at relatively low cost, which will boost the sector as whole and create more employment, more revenue by way of tax to government and more importantly export from this sector will certainly witness huge growth leaving to govt more foreign exchange revenue. Encouraging this sector to work qualitatively and more efficiently will certainly make the sector to gain and create new era in Indian Economy. It is necessary to understand that, in spite of various measures taken by all the agencies to educate the SMEs to go for rating, entrepreneurs of this segment should also come forward voluntarily to work with the rating agency, for getting their company rated, not only for using this for, getting the support from financial institutions, but, to have this rating as self analysis tool for their improvement in terms of performance and to compete with bigger players in terms of financial discipline, quality parameters and making very conducing environment for the employees

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AUTHORS

First Author – G Vairava Subramanian, Pursuing PHd in Gandhi gram rural institute, in dept of economics as part time scholor & working as Vice president in The Investment Trust Of India Ltd.Chennai, Tamil nadu India. E Mail id; gvs.chennai@gmail.com, +91 98847 03579

Second Author – Prof S. Nehru, PHd, Associate professor, Gandhi gram Rural Institute, Tamil Nadu, India.

Correspondence Author – G.Vairava Subramanian, +91 98847 03579, gvs.chennai@gmail.com