Emerging Trends for Credit Rating Agencies
SME Ratings – a promising growth area

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Executive Summary

The lack of adequate credit can stifle the growth of the small and medium enterprises (SME) sector, one of the most promising segments of the economy. The recent interest in credit ratings as an enabling mechanism has the potential to ease credit flow to the sector, and therefore act as a critical growth enabler. This commentary explores the benefits that credit ratings can provide to the sector and the economy, and challenges the widely-held perception that SMEs are inherently poor credits. It demonstrates that adequate credit flow to the sector can take place with the help of credit ratings, resulting in a win-win situation for both lenders and SMEs.

A growing role for ratings

Credit ratings have gradually emerged as an integral part of the framework for credit and investment decisions relating to larger enterprises. As the banking sector increasingly focuses on lending and providing other financial services to the SME sector, ratings can play the same pivotal role as they do for larger enterprises. Ratings can make SMEs' access to financial services more efficient by providing benchmarks and improving transparency. Independent agency ratings for SMEs, based on high standards of analytical rigour, can provide greater confidence to lenders, and consequently broaden the range of financial resources available to SMEs.

Benefits for lenders and SMEs

The rapid growth of the SME sector creates exciting lending opportunities for banks and financial institutions. A credit rating takes a significant chunk of the perceived uncertainty out of their lending decisions, and reduces time and transaction costs in the system. The Indian rating industry has established its credibility in providing in-depth and unbiased analysis; ratings are therefore highly respected by lenders.

SMEs can leverage their ratings for negotiating better borrowing rates and strengthening their relationships with bankers. Ratings can also facilitate faster processing of credit facilities, as rating reports provide most of the information banks need for approving loans. Further, SMEs can use ratings to enhance their credibility with other counterparties too, such as technology providers, suppliers, and customers.

Benefits for the sector as a whole

For the SME sector as a whole, ratings can provide an important impetus in raising standards through better financial discipline, disclosure and governance practices. Surveys among larger enterprises clearly show that managements feel ratings have provided value that goes well beyond the rating symbol. In the SME sector too, ratings can be an important feedback tool for managements. An interactive rating process helps managements gain unique perspectives on business and financial issues and on best practices, from rating experts who have in-depth sector knowledge and understanding of risk. A rating exercise can help SMEs better understand what initiatives they need to take to improve their operating and financial positions. Additionally, as the number of rated players in the SME sector increases, there will be greater transparency, as more and more information is demanded and made available.

SME ratings — a viable proposition

There are certain misconceptions about SME credit ratings. Firstly, lenders and investors often assume that SMEs will only get low ratings because of their smaller size. At CRISIL, we recently had an opportunity to analyse the business and management profiles of over 5000 SMEs. Our analysis shows that there were a healthy number of companies with considerable business strengths underpinned by the leadership of first generation entrepreneurs who had built strong brands and demonstrated the ability to withstand competition, including from large global players. The combination of business and management strength, and the results of a separate financial study (profiled below), indicate that there will be several players in the sector with strong credit profiles. Several large and highly successful companies today, were SMEs only a decade ago. Sun Pharma Industries, Moser Baer India, Satyam Computer Services, Marico Industries and Maharashtra Seamless are some examples. Rating agencies are forward-looking in their analysis, and expectations are built into ratings.

Secondly there are several questions on information risk – will SMEs be able to provide quality, reliable information required for a credit rating exercise? Our interaction with SMEs has revealed that most players are willing to share reliable financial and operational information for a credit rating, as they see the tangible benefits that ratings provide. Many SMEs enjoy business relationships with large domestic and global companies, and hence already have a track record of maintaining and providing high-quality business and financial information.

The third misconception is that SMEs will find fees of rating agencies unaffordable. In its efforts to develop the credit markets, the ratings industry in India has never allowed fees to be a constraint. In fact the rating fee is by far the lowest element of the cost of raising funds, and there is no reason why this should not be so for the SME sector as well. The National Small Industries Corporation has recently launched an attractive scheme for Small Scale Industries, providing a subsidy of as much as 75% of the rating fees.

Clearly, ratings have the potential to transform the way SMEs are integrated into the financial system. But rating agencies must recognise the special initiatives they will need to take in this regard. They need to launch outreach initiatives, educating the SME sector on the benefits of ratings. Rating agencies also need to have specialised teams and analytical tools customised for the SME sector.

Having covered the operational and management aspects, let us now examine the financials to see the light they can shed on SMEs' creditworthiness.

Financials: cracking the credit conundrum

Although SMEs account for the bulk of commercial activity in India, they have traditionally been perceived as less creditworthy than larger corporates. To understand how valid this perception is, CRISIL has carried out a study comparing the financial data of over 2500 large corporates[1] and about 32000 SMEs in the Indian manufacturing sector, on the basis of four key parameters used in credit analysis.

CRISIL's study shows that SMEs present a strong financial profile: they compare well with their larger cousins on several debt protection parameters, and are more bankable credits than they are generally perceived to be. Although SMEs do not fare quite as well on the profitability front, possibly on account of the competitive pressures they face, the impact of the poor profitability is offset by more favourable debt-equity levels.

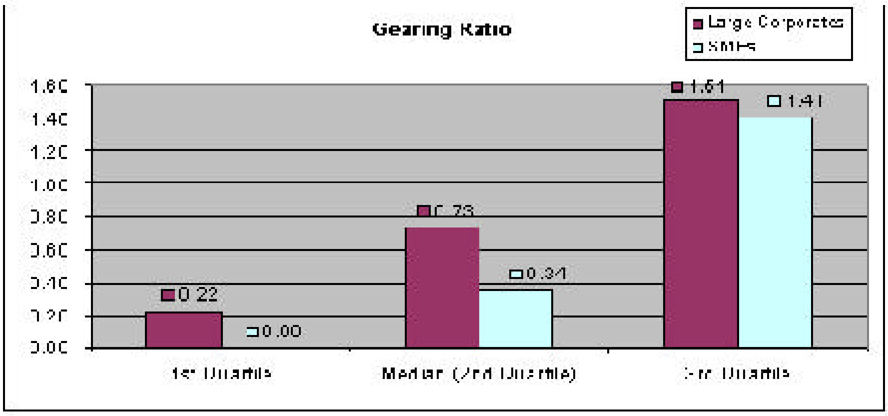
Additionally, SMEs differ widely from one another in performance and credit quality. Therefore, the performance and credit quality of an individual SME cannot be judged on the basis of conclusions drawn from evaluating the performance and credit quality of SMEs in general. We have compared SMEs with larger companies on four key financial parameters:

1. Capital structure

A company's capital structure reflects the extent of borrowed funds in the company's funding mix. Gearing is computed as the ratio of the total debt that the company has taken, to its tangible net worth.

An analysis of the gearing ratios of SMEs and large corporates reveals that, contrary to popular perception, SMEs are much less leveraged than their larger counterparts. Chart 1 presents the 1 st Quartile[2], Median[3] (2nd Quartile) and 3rd Quartile gearing ratio for large corporates and SMEs.

Chart 1



Source: Centre for Monitoring Indian Economy (CMIE)

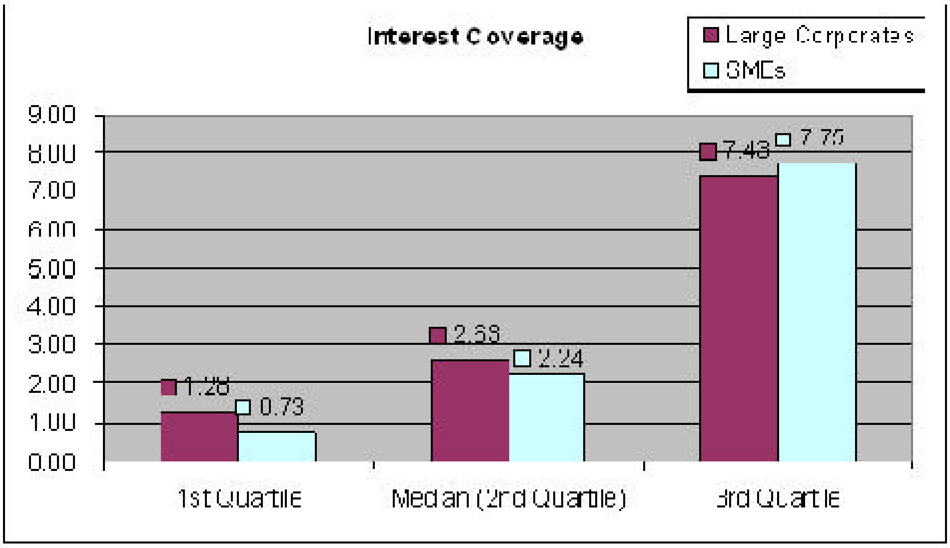
As is evident from the chart, SMEs have a significantly low median gearing of 0.34 times as against 0.73 times for large corporates; in other words, 50 per cent of SMEs have a gearing of 0.34 times or below. Similarly, the fact that 75 per cent of the SME population operates with gearing ratios less than 1.41 times, negates the common perception that SMEs are highly leveraged. The difference in median gearing between small and large entities may partly reflect the limitations that smaller players in the SME segment face in accessing borrowings at attractive rates, due to a misplaced perception of high credit risk in the SME sector. CRISIL believes that because most SMEs have a low gearing ratio, there is significant leeway for banks to extend credit to the sector.

2. Interest coverage ratio

The interest coverage ratio (or interest cover) reflects the extent of cushion or comfort that a company has in meeting its interest obligations from surpluses generated from its operations. It is an important indicator of the credit quality of a company.

As seen in Chart 2, SMEs have a median interest cover of 2.24 times; by implication, 50 per cent of SMEs have an interest cover at this level or better. The median interest cover for large corporates, at 2.63 times, is comparable to that of SMEs. The top 25 per cent of the SME population has interest cover in excess of 7.75 times, significantly stronger than interest coverage ratios of most large corporates. However, the bottom 25 per cent of the SME population has interest cover of less than 1.0 times, indicating a high probability of default. CRISIL's SME ratings help lenders identify such weaker credits in the SME portfolio, and avoid exposure to them.

Chart 2

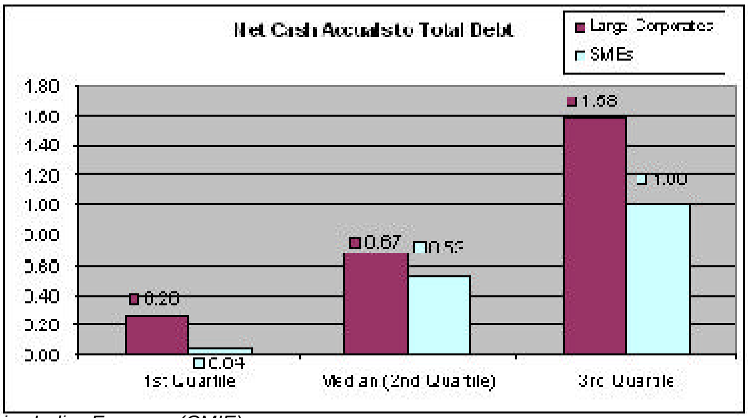


Source: Centre for Monitoring Indian Economy (CMIE)

3. Cash flows in relation to debt:

CRISIL's study also compared the performance and credit quality of SMEs and large corporates on annual net cash accruals[4] in relation to total debt (NCATD). The ratio indicates a company's ability to service its debt obligations, from earnings generated from its operations. Chart 3 shows the results of the comparison.

Chart 3



Source: Centre for Monitoring Indian Economy (CMIE)

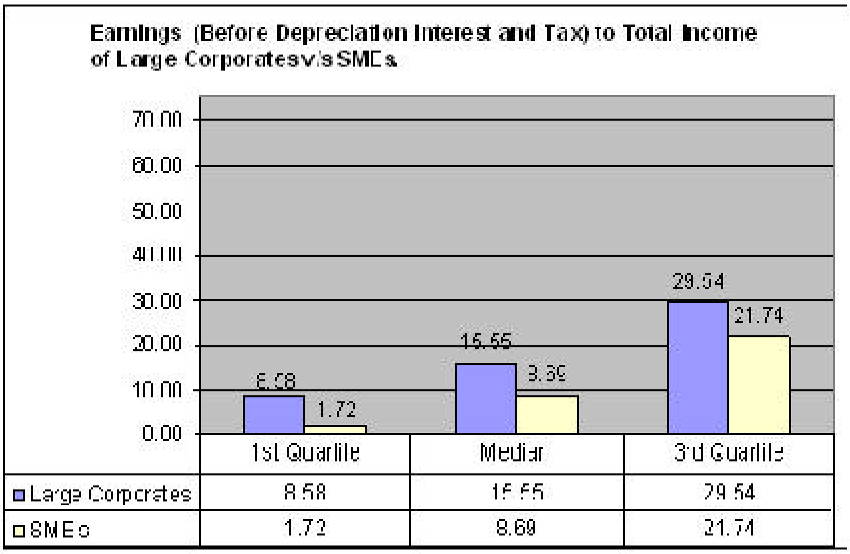
As can be seen from Chart 3, SMEs fare slightly worse than large corporates on this parameter. In CRISIL's assessment, this is a reflection of the lower profitability of SMEs, rather than their high indebtedness.

4. Profitability:

SMEs report significantly poorer profitability than large corporates. Chart 4 compares the EBITDA margins[5] of SMEs and large corporates.

For the SME population, the median value of EBITDA to total income is 8.69 per cent; large corporates have a much higher median of 15.55 per cent. The SME sector, which lacks entry barriers such as brand equity or technology, is exposed to significant competitive pressures, which partly account for the sector's low profitability margins. SMEs' low bargaining power with customers and suppliers also affects profitability and cash flows significantly.

Low profitability margins may also partly result from the reluctance of entrepreneurs to report their firms' true profitability. Many entrepreneurs hesitate to divulge their companies' true profitability in order to protect their margins with key customers, to bargain with the labour force, or to minimise tax outflows. CRISIL believes that such measures reflect poorly on management integrity, an important parameter from a lender's or rating agency's perspective. In its analysis of the creditworthiness of SMEs, CRISIL takes cognisance only of reported profitability and does not factor in any unreported profits.



Similarly, SMEs fare poorly in comparison with large corporates on other profitability parameters. However, profitability parameters of SMEs in the top quartile are comparable with those of large corporates. For instance, the top 25 per cent of the SME population reported EBITDA margins of over 21 per cent and PAT margins of over 6 per cent, both of which reflect healthy profitability, comparable with the figures for the top quartile of large corporates.

A huge opportunity for lenders with the right approach

With the SME sector set to grow rapidly with the rest of the economy, ratings for the sector will quickly attain the volumes needed to become self-sustaining. As rating penetration in the sector grows, more and more lenders will discover that a significant proportion of SMEs are more creditworthy than they are commonly perceived to be.

However, a lender to the sector should never lose sight of the divergence in performance across SMEs. CRISIL has developed a unique methodology to analyse the creditworthiness of SMEs; this methodology captures the key risk elements faced by players in the sector. CRISIL believes that lenders can better exploit the opportunity that SMEs offer, by using tools and services developed specifically for assessing credit risk in this sector.

[1] Large corporates are defined as companies with a net worth greater than Rs. 200 million.

[2] A quartile is a statistical term, referred to in percentile measures. The total (100 per cent) is broken into four equal parts such that First Quartile is the 25th percentile (0.25), the Median Quartile is the 50th percentile (0.50) and the Third Quartile is the 75th percentile (0.75). A percentile is a measure that tells us what proportion of the total population scored at or below that measure. Therefore, the 75th percentile is the point below which 75 per cent of the population lies.

[3] The median of a population is the point that divides the distribution of scores in half. Numerically, half of the scores in a population will have values that are equal to or larger than the median and half will have values that are equal to or smaller than the median

[4] Net Cash Accruals is defined as Profit after Tax – Dividend + Depreciation.

[5] EBITDA margin is defined as the ratio of Earnings before Interest, Taxes, Depreciation and Amortisation to Operating Income