

Rating Criteria for CARE-SME Ratings

Background

Small and Medium Enterprises (SME) 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 with those of large corporate entities. Furthermore, SMEs face difficulty in accessing credit from banks/financial institutions as institutes are facing issues of information asymmetry. Hence, to further support the growth of this sector and help the investors to determine the relative creditworthiness of entities belonging to this segment, a need for separate rating product was considered. Accordingly, CARE introduced CARE-SME ratings in 2006 which are intended entirely for Small and Medium Scale Enterprises. Subsequently during Q1FY21 the SME rating is transferred to CARE Advisory Research and Training (CART) and now this product is offered under CART.

Some of the public sector banks have started use of SME ratings in their credit appraisal, and based on the rating of the entity, they offer various relaxations to the borrowers.

CARE-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 onetime assessment of credit risk of the entity under rating in comparison with the other SMEs.

CARE-SME Rating Symbols and definitions

CART SME Rating Symbols	Definition
CARE SME 1	The level of creditworthiness of an SME, adjudged in relation to other SMEs is the Highest
CARE SME 2	The level of creditworthiness of an SME, adjudged in relation to other SMEs is High
CARE SME 3	The level of creditworthiness of an SME, adjudged in relation to other SMEs is Above Average
CARE SME 4	The level of creditworthiness of an SME, adjudged in relation to other SMEs is

	Average
CARE SME 5	The level of creditworthiness of an SME, adjudged in relation to other SMEs is Below Average
CARE SME 6	The level of creditworthiness of an SME, adjudged in relation to other SMEs is Inadequate
CARE SME 7	The level of creditworthiness of an SME, adjudged in relation to other SMEs is Poor
CARE SME 8	The level of creditworthiness of an SME, adjudged in relation to other SMEs is the Lowest . Such entities may also be in default

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 assessment of the SME unit. The detailed criteria are 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 cyclicity and seasonality of industry. CART believes that promoters' ability to manage the business and industry dynamics is also very crucial.

Operational Performance

Against the backdrop of the industry, CART assesses the entity's operating strengths and weaknesses vis-à-vis its competitors. SMEs having inherent strength and relatively strong positioning (including market share) in their business segment, are viewed favourably from the 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, so in that case, the entity's importance and

positioning within the group, its inter-linkages of operations, transaction transparency and support emanating from the parent are also evaluated.

In order to assess the day-to-day operations including ease and resource access, timely availability and adequacy of raw materials, manpower, utilities are analysed with the major focus on locational and technological edge over others. The entity's initiatives towards environmental compliances and sustainability are also evaluated during the site visit.

Business strength is derived by assessing customer profile, product profile, revenue mix and bargaining power with various stakeholders. CART also seeks feedback from key customers and suppliers to assess the strength of relationship of these stakeholders with the entity under rating. Depending on the need for geographical reach, a wide distribution network would be essential to gain competitive advantage. Further, CART assesses ownership of facility and key human resources, as it also impacts an overall credit profile of an entity.

Financial Risk analysis

CART 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 persists.

CART evaluates financial flexibility of an SME (through leverage 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, CART team also interacts with the bankers / lenders to learn about the overall conduct of account in the past. Further, the team also interacts with the Auditor of the entity and take feedback on the accounting policies, procedures followed by the entity apart from its statutory payment track record.

Management Capability

Quality of management is one of the most important parameters in terms of their resourcefulness and entrepreneurship that supports' the credit strength of an SME unit. CART team interact 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. CART assesses the presence and quality of second line of management, apart from aspects related to succession planning, organisation structure and internal control systems.

The 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. CART 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 for the finance function are equally important from the rating point of view. Relationship with banks as well as labour force is also assessed while assigning the SME rating.

Project Risk Analysis

In case of on-going or proposed project, the rating process also takes into consideration the risk associated with it. Depending on the nature and size of the project, project risk has varied impact on financial strength. In case of implementing a large project, aspects like project feasibility, funding mix and stabilisation issues during operational phase are a few aspects which are critically examined. CART believes that promoter's past track record in project

implementation, stage of project implementation and status of financial closure have significant bearing on the entity's project risk mitigation.

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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In case of partnership/proprietary concerns, the rating assigned by CARE Advisory is based on the capital deployed by the partners/proprietor and the financial strength of the firm at present. The rating may undergo change in case of withdrawal of capital or the unsecured loans brought in by the partners/proprietor in addition to the financial performance and other relevant factors.