



Confederation of Indian Industry

Stairway to funding

Improving MSME access to institutional credit through ratings

August 2016



Ratings

CRISIL

An S&P Global Company

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Message from the Chairman, CII National MSME Council

The MSME sector is a critical component of India's growth story, with significant contributions to GDP, employment and exports. Despite this, these enterprises find it hard to secure adequate and timely credit from banks and other lending institutions at competitive interest rates, which significantly hampers their competitiveness and comparative advantage.

There are several reasons for the poor access to institutional finance – lack of reliable background information and standard accounting practices, delayed payments, high risk perception of banks and other lending institutions, to name some. Formal financial institutions face challenges in credit risk assessment of MSMEs due to absence of information such as historical cash flows, credit track record and tools to assess credit risk and creditworthiness of these enterprises.

Credit ratings, which are a measure of the creditworthiness of an enterprise, can help address this issue. Rating agencies assess a firm's financial viability by collecting all the necessary documents about it, its management team and business model etc, and analysing these to ascertain its capability to repay debt. The ratings also benchmark an organisation's overall health and its performance within the industry. Therefore, adoption of ratings can boost financial discipline, disclosure and governance practices among MSMEs, thereby reducing the risk perceived by lenders in lending to these entities.

The challenge lies in bringing in uniformity in the credit rating parameters being used by various ratings agencies, launching outreach initiatives, and educating the SME sector on the benefits of ratings.

Recognising the potential of credit ratings in enhancing the financial access of Indian MSMEs, the CII Finance Facilitation Centre has launched SME Ratings to its bouquet of services.

This report on SME credit ratings, brought to you by CII in partnership with CRISIL, analyses the unique challenges and bottlenecks in the existing framework for credit rating of MSMEs and their needs vis-à-vis large corporates. It discusses the Performance and Credit Ratings Scheme of the government and its benefits, and also suggests measures MSMEs can adopt to improve their ratings.

We believe all stakeholders should work in synergy to leverage the benefits of credit ratings for Indian MSMEs and making these enterprises globally competitive.



Mr Shreekant Somany
Chairman
CII National MSME Council

Message from CRISIL

The micro, small and medium enterprises (MSME) sector is the second-largest employer after agriculture.

It is imperative, therefore, to ensure policymaking takes into account the sector's views and addresses concerns around access to funds, financial literacy, skilled labour, inclusive growth and infrastructure.

Poor access to institutional funding, in particular, is a pervasive concern.

We believe it is necessary to develop financial infrastructure covering accounting and auditing standards, credit reporting systems, and collateral and insolvency regimes in order to improve MSMEs' access to funds and reduce their dependence on informal channels with usurious interest rates.

The Performance & Credit Rating Scheme (PCRS), the flagship initiative launched in 2005 by the Ministry of Micro, Small and Medium Enterprises to encourage adoption of ratings, aims to address this. The scheme is being implemented by the National Small Industries Corporation Ltd (NSIC) along with stakeholders such as empanelled credit rating agencies, Indian Banks' Association (IBA) and industry associations.

PCRS has improved financial discipline among rated MSMEs and helped these secure funds from partner banks at concessional rates. However, only a wider adoption can ensure the scheme achieves its stated objectives.

Stairway to funding is at once an attempt at taking stock of the sector and a study aimed at identifying action points for the stakeholders involved.

I would like to thank CII and the CRISIL team for taking up this initiative, and express our gratitude to the Ministry of MSME, NSIC, IBA and other stakeholders for their continued support and guidance.



Manish Jaiswal
Business Head-SME Ratings,
CRISIL Ltd



Executive summary

With more than 51 million operational enterprises and 117 million workers, the MSME sector has a significant footprint in the Indian economy, contributing ~37% to GDP.

Yet it gets the short shrift from institutional finance because granular information on enterprises is hard to come by, awareness among entrepreneurs is low, and wherewithal inadequate.

Even so, it is gratifying to see entrepreneurs embrace innovation and technology with gusto.

As we detail all this here, we also trace the evolution of rating products, the need for MSME-specific ratings and bring you an overview of the Performance & Credit Rating Scheme for Micro & Small Enterprises being implemented by National Small Industries Corporation.

There are insights on the benefits and impact of MSME ratings, and an analysis on the best practices that contribute to the success of higher-rated enterprises.

As per the latest census of the sector, the vast majority of these enterprises have no access to formal credit.

A CRISIL study on 12,000 rated micro enterprises with turnover less than Rs 10 million shows that enterprises are forced to seek loans at much higher interest rates through informal channels due to their inability to provide adequate collateral to financial institutions. This impacts their working capital cycle and subsequently their profitability, pushing them into a vicious cycle of high-cost funds that precludes investments in infrastructure and technology upgradation, or hiring of skilled manpower to increase scale of operations.

CRISIL and CII believe there is a dire need to remove the barriers that restrict MSMEs from raising capital from institutional sources. This needs a concerted effort by governments, banks and other financial institutions. What also needs to be enhanced among MSMEs is financial discipline, willingness to share credible information, openness towards third-party risk assessment exercises, and financial literacy.

Ratings industry over the years

Introduction

A credit rating is a current opinion on the likelihood of timely payment of interest and principal on the rated obligation. Ratings are assigned to issuers and debt securities, as well as bank loans.

Investors and other market participants use the ratings as a screening device to match the relative credit risk of an issuer or individual debt issue with their own risk tolerance or credit risk guidelines in making investment and business decisions.

The concept of credit rating originated in the US in early twentieth century – as bond ratings for the American railroads market. It grew to prominence after 1975 when the US Securities and Exchange Commission introduced rules on capital requirements for financial institutions that encouraged investments in rated securities, giving a boost to rating services.

Credit rating was introduced in India by CRISIL, in 1987. The industry picked up pace in the 1990s with the entry of global players. CRISIL got into a strategic alliance with S&P in 1996, culminating in the latter acquiring majority stake in 2005.

Today, six credit rating agencies are registered with the Securities and Exchange Board of India for rating debt instruments and seven with the Reserve Bank of India for rating of bank loans under Basel-II norms.

A credit rating is a current opinion on the relative likelihood of timely payment of interest and principal on the rated obligation

Evolution of rating products in India

Over the years, in addition to credit ratings, several new types of credit and performance assessment products have been developed to bring greater transparency in various sectors and enhance investment decision making process.

CRISIL pioneered credit rating in India

In 2005, CRISIL launched SME Ratings to serve the specialised needs of small and medium enterprises. Then, considering the need for credible assessments in real estate and education sectors – which account for the largest share of expenditure in Indian households – CRISIL launched Real Estate Ratings and

Education Gradings in 2010 and 2011, respectively.

The market has since witnessed significant innovation, going beyond credit rating to performance-assessment, with specialised products such as Solar Energy Gradings, Voluntary Organisation Gradings and Maritime Gradings.



New assessment products/ratings

Credit rating products	Performance assessment products
Rating of bonds/ long-term instruments	MSME ratings
Rating of commercial papers/ short-term instruments	Solar Energy Gradings
Rating of structured finance instruments/ pass through certificates	Microfinance institution gradings
Bank loan ratings (Basel II)	Real Estate Star Ratings
Complexity levels	Education Gradings
	Maritime Gradings
	Fund Ratings
	Voluntary Organisation Gradings
	Broker Quality Gradings
	Financial Strength Ratings
	GVC Ratings
	Project Credit Ratings
	Recovery Risk Ratings

Need for MSME rating

Overview

Micro, small and medium enterprises (MSMEs) are an extremely important segment of the Indian economy. They are key contributors to the gross domestic product (GDP), accounting for a significant proportion of exports. They are also significant employment generators. As per latest estimates, more than 51 million working enterprises employed over 117 million people and contributed nearly 37% to India's GDP by March 2015.

Definition of MSMEs





Under the Micro, Small & Medium Enterprises Development Act, 2006, MSMEs are classified based on the nature of business as:

- 1. Manufacturing enterprises** - engaged in manufacture or production of goods pertaining to any industry specified in the first schedule to the industries (Development and regulation) Act, 1951, or employing plant and machinery in the process of value addition to the final product having a distinct name or character or use.
- 2. Service enterprises** – engaged in providing or rendering of services.

Within these categories, enterprises are classified as micro, small or medium subject to the scale of investment in plant & machinery (for manufacturing enterprises) or equipment (for service enterprises).

Proposed change in definition

The MSME Amendment Bill, 2015, seeks to increase the allowance for investment in plant and machinery in MSMEs. The bill also includes the provision wherein the central government may change these investment limits, up to three times the specified limits, through a notification.

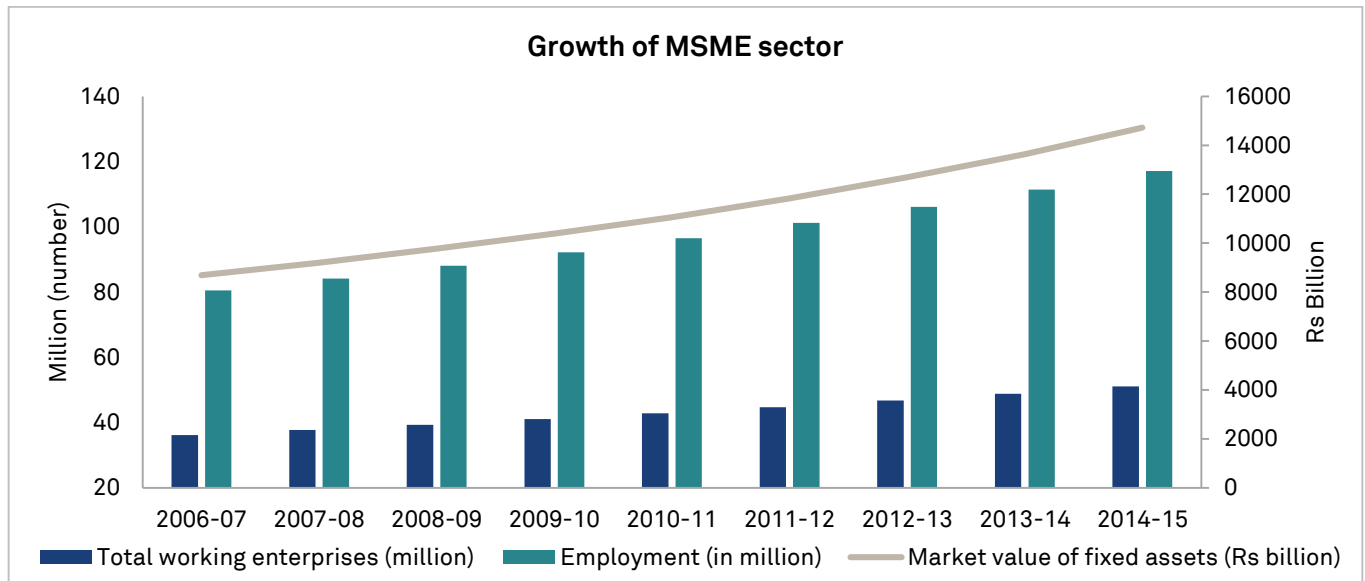
	Current classification		Proposed classification	
	 Manufacturing ¹	 Services ²	 Manufacturing	 Services
Micro enterprise	Up to Rs 2.5 million	Up to Rs 1 million	Up to Rs 5 million	Up to Rs 2 million
Small enterprise	Above Rs 2.5 million to Rs 50 million	Above Rs 1 million to Rs 20 million	Above Rs 5 million to Rs 100 million	Above Rs 2 million to Rs 50 million
Medium enterprise	Above Rs 50 million to Rs 100 million	Above Rs 20 million to Rs 50 million	Above Rs 100 million to Rs 300 million	Above Rs 50 million to Rs 150 million

¹ Classification by investment in plant & machinery

² Classification by investment in equipment

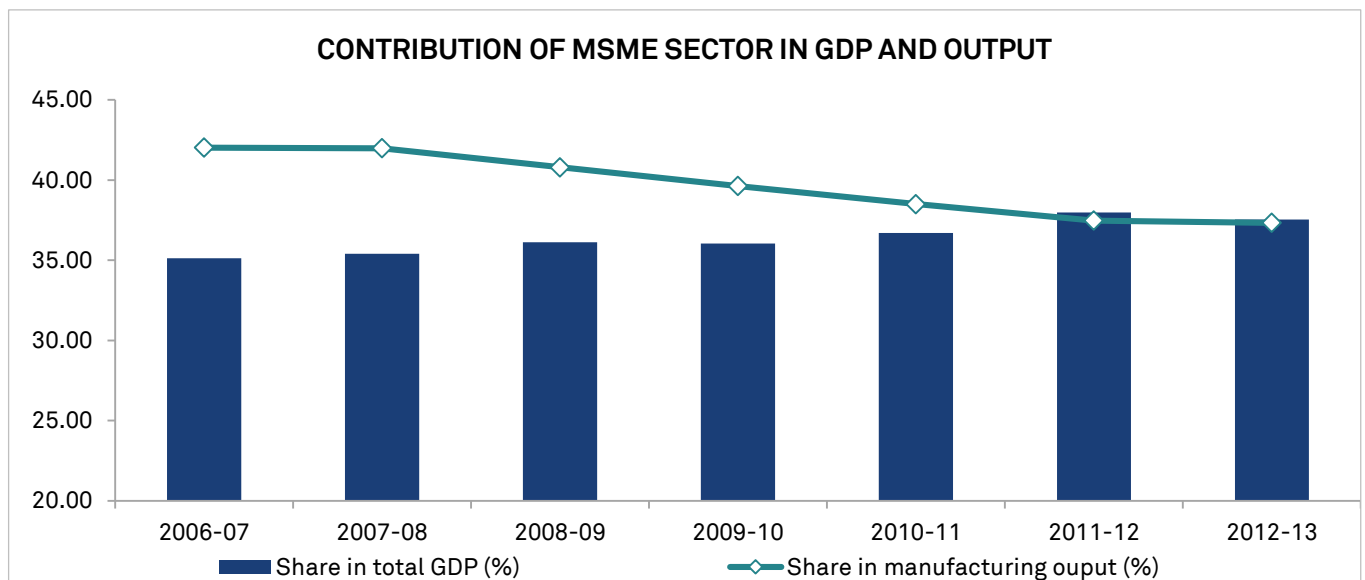


Between 2006-07 and 2013-14, the market value of investment made in fixed assets by MSMEs increased more than 55%. To be sure, the number of MSMEs has grown since, as has employment and investments in fixed assets by them.



Source: MSME annual report 2015-16

However, the sector's contribution to GDP growth and employment is well below the levels seen in developed and other emerging economies. It is expected that the agenda of inclusive growth being executed by the government will lead to more support for MSMEs to flourish.



Source: MSME annual report 2015-16

Recent government programmes such as 'Make in India', 'Start-Up India' and 'Stand-Up India' are expected to strengthen MSMEs and make them competitive. The increase in investment limits proposed in the MSME Amendment Bill, 2015 is a welcome move, considering changes in price index and increase in input costs, and is expected to enable the incremental category of enterprises to avail benefits and become competitive.

The latest census of the MSME sector found that the funding requirement of these enterprises was typically between Rs 0.1 million and Rs 2.5 million, and was largely unmet. Only 5.18% of the units (both registered and unregistered) had availed of finance through institutional sources and 2.05% from non-institutional sources, which means a whopping 92.77% did not have access to credit or depended on self-financing. Additionally, MSMEs often lack management skills, tools, governance and financial planning expertise.

Getting banks to extend credit facilities is a huge challenge, given MSMEs' intrinsic weaknesses, flaws in delivery models and lingering deficiencies in enabling environment for financial services, i.e. the financial infrastructure covering accounting and auditing standards, credit reporting systems, and collateral and insolvency regimes.

**95% of MSMEs
do not have access
to formal credit**

MSME rating is aimed at addressing this need – by providing a reliable risk assessment tool to banks, it aids their decision to extend credit to these units.

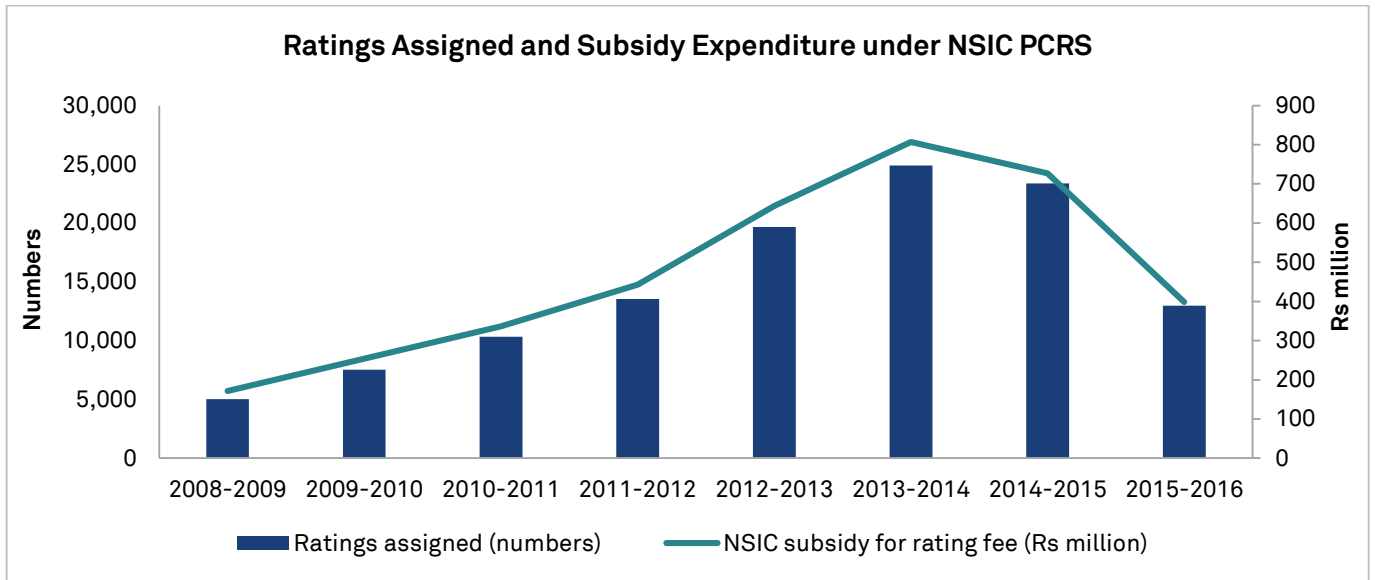
Performance & Credit Rating Scheme

The Ministry of Micro, Small and Medium Enterprises' flagship Performance & Credit Rating Scheme (PCRS) was launched in 2005. It is being implemented by National Small Industries Corporation Limited (NSIC) as the nodal agency in conjunction with stakeholders such as empanelled credit rating agencies, Indian Banks' Association and small industry associations. Experience suggests the scheme has helped micro and small and medium enterprises (MSMEs) improve performance and access to credit from banks/lending institutions.

Under this scheme, the fee to be paid by MSMEs for rating is subsidised by the government to the extent of 75% of the rating fee, up to a maximum of Rs 40,000.

CRISIL is one of the approved rating agencies operating the scheme. The NSIC CRISIL Ratings are entity-specific, unlike credit ratings, which are debt obligation-specific, and reflect the creditworthiness of the MSME rated vis-à-vis other MSMEs.

The rating serves as a trusted third-party opinion on a unit's capabilities and creditworthiness. A good rating enhances the acceptability of the rated unit in the market and gives it access to quicker and cheaper credit, helping economise the cost of credit.



The guidelines on PCRS were revised recently. The guidelines now recommend evaluation of MSMEs on three parameters, each of which would be assessed on an independent scale:

1. Operating performance: A five-point scale to assess business risks such as technology, processes, customer, and management
2. Financial strength: An eight-point scale to assess financial profitability, leverage, and liquidity risk
3. Overall creditworthiness: An eight-point scale that combines operating performance and financial strength

Less than 0.2 million out of an estimated 51 million MSMEs in India have been rated till date

Given the importance of these units and the fact that less than 0.2 million of an estimated 51 million MSMEs in the country have been rated till date, the government has increased the allocation to Rs 2 billion for fiscal 2017.

Revised MSME rating scale

Conforming to the revised guidelines, the new signifiers to be used for operating performance, financial strength and overall performance and credit rating of MSMEs are as follows:

Financial strength	Highest	High	Good	Above average	Average	Below average	Weak	Poor
Operating performance	Highest	High	Average	Weak	Poor			

Overall creditworthiness

Rating symbol	Definition
CRISIL MSE 1	Highest creditworthiness in relation to other MSMEs
CRISIL MSE 2	High creditworthiness in relation to other MSMEs
CRISIL MSE 3	Good creditworthiness in relation to other MSMEs
CRISIL MSE 4	Above average creditworthiness in relation to other MSMEs
CRISIL MSE 5	Average creditworthiness in relation to other MSMEs
CRISIL MSE 6	Below average creditworthiness in relation to other MSMEs
CRISIL MSE 7	Weak creditworthiness in relation to other MSMEs
CRISIL MSE 8	Poor creditworthiness in relation to other MSMEs

Rating methodology

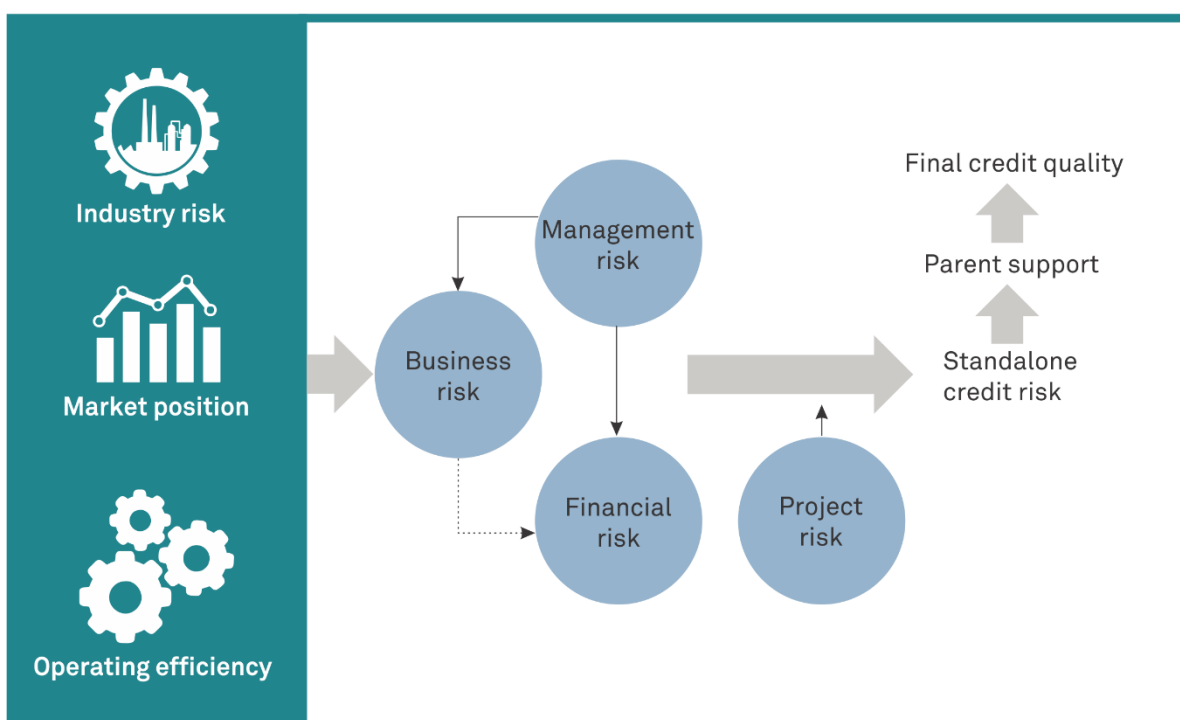
CRISIL’s analytical approach is comprehensive and covers three broad categories of risk – business, management and financial. While this is similar to the credit assessment framework for large corporates, the approach to assessing the risk elements, comparison of peer group, and weightages assigned to each parameter are different.

Business risk – Under business risk, CRISIL assesses the sustainability of the business plan and the long-term viability of the unit. This comprises qualitative assessment of the track record of the business, the profile of the rated entity’s customers, relationships with customers and suppliers, and the level of infrastructure and technology it has. In order to assess an MSME’s operating performance, CRISIL interviews its promoters to understand their business plans and growth strategies.

Management risk – In assessing a promoter’s competence and track record as an entrepreneur, CRISIL looks at the past performance of the entity and group companies. This provides an insight into the promoter’s ability to successfully manage the entity through business cycles. The entity’s ability to develop suppliers, integrate with customers and manage banking and labour relationships also provides critical inputs to the management evaluation process.

Financial risk – CRISIL’s financial risk analysis is based on disclosed financial statements. It includes an assessment of size (sales and net worth), profitability, efficiency of capital and working capital management, and credit protection measures such as interest coverage, debt service coverage, and cash accruals to debt ratios. CRISIL uses proprietary spreadsheets that are developed especially for MSMEs.

Overall rating/ creditworthiness – CRISIL also takes into consideration an MSME’s operating performance and financial strength, as these help ensure sustainability of business and ability to meet financial obligations in a timely manner.





Rating fee and subsidy: For registered MSMEs with audited results of at least three complete years of operations, NSIC pays subsidy up to 75% of the initial rating fee to be paid for the ratings.

Scope and rating validity

The revised rating scale will replace the existing NSIC-CRISIL rating scale and all firms eligible for subsidy under PCRS shall be rated accordingly.

The validity of the rating shall be for one year from the date of publishing, subject to no significant changes/events occurring during this period that could materially affect the business or financial parameters.

However, if such changes/events do take place, CRISIL recommends firms to seek a rating review. CRISIL also encourages entities to undergo an annual review as an outstanding rating can help them ensure easier access to finance and help showcase their performance across user segments. All live ratings published can be accessed from CRISIL's website.

How different is MSME rating?

Each type of rating has its own underlying methodology and set objectives, which make it different from conventional credit rating. This holds for MSME ratings, too.

As mentioned earlier, CRISIL introduced ratings for the sector in 2005 and has completed more than 90,000 such ratings till date, the most by any agency globally. CRISIL's product offerings for MSMEs include NSIC-CRISIL Performance and Credit Rating, CRISIL MSME rating and third-party assessments, which include due diligence reports for banks and dealer/supplier assessments for large corporates. Key differences between MSME rating and rating for mid/large corporates such as bank loan rating (BLR) include:

- 1. Rating definition** – CRISIL's MSME rating indicates an MSME's performance capability and financial strength. It is entity-specific, unlike credit ratings, which are debt-obligation-specific. BLR is essentially a credit rating CRISIL will assign to various facilities provided by banks, such as working capital demand loans, cash credit, project loans, loans for general corporate purposes, and non-fund-based facilities. BLR reflects CRISIL's opinion on the likelihood of the financial obligations (arising out of a rated facility) being serviced on time and in full, as specified in the terms of the facility.
- 2. Regulation** – MSME rating is a part of NSIC-PCR Scheme, while BLR is assigned under Basel-II norms.
- 3. Applicability** – MSME rating is applicable to all small and medium enterprises irrespective of the size of bank exposure of the enterprise, while BLR is applicable to corporate borrowers (small/ medium/ large) with exposure determined by bank.
- 4. Validity** - MSME rating has a validity period of one year, while BLR is continuous, with the unit kept under surveillance till the instrument is outstanding.
- 5. Peer benchmarking** - MSME rating reflects the level of creditworthiness of an MSME, adjudged in relation to other MSMEs only, while BLR can be compared across sectors, including large and mid-corporates.
- 6. Scoring model** – Unlike BLR, MSME rating is a scoring-based model that uses pre-defined weightages for business, management and financial risk. However, the rating parameters are similar.
- 7. Default probability** – In MSME rating, there is no opinion given on default probability, while in BLR, the rating is an opinion on the default probability of the rated instrument.
- 8. Default definition** - Under MSME rating, a one-day, one-rupee delay is not considered as default as it factors the challenges faced by the MSME sector. A default is considered when the rated firm is declared an NPA. In case of BLR, a one-day, one-rupee delay is considered as default.
- 9. Rating scale** - MSME rating has an eight-point scale (MSE 1 to MSE 8), with 1 being the highest. There is an additional two-dimensional scale that measures the **operational capability and financial strength** of the rated MSME. On the other hand, BLR has long-term and short-term scales. The long-term scale is 20-point, including CRISIL AAA (highest rating), CRISIL AA, CRISIL A, CRISIL BBB, CRISIL BB, CRISIL B, CRISIL C, and CRISIL D (default). There is also an outlook given on the rating. Short-term scale is 9-point, from CRISIL A1+ and CRISIL A till CRISIL A4 and CRISIL D.



Use of rating outlook – Rating outlook is not applicable to MSME rating, while BLR carries an outlook with a distinction between long-term and short-term ratings.

Particulars	Bank loan rating	MSE or SSI ratings
Definition	Credit rating of various facilities provided by the banks.	Rating of MSME's performance capability and financial strength.
Rating of	Issue-specific (Facility)	Firm/Company
Acceptance under Basel-II	Accepted	Not accepted
Applicability	Corporate borrowers (small/ medium/ large) with exposure determined by bank	Small and medium enterprises irrespective of the size of bank exposure
Validity and Surveillance	Tenure of the rated facility	1 year
Peer benchmarking	All categories	With MSME
Surveillance	Regulatory requirement of continuous monitoring	Not mandatory
Default probability	Applicable	Not applicable
Default definition	A one-day one-rupee delay	When the rated firm is declared as an NPA
Rating Scale	Long-term rating scale : 'CRISIL AAA' to 'CRISIL D'	SME Rating Scale: 'SME1' to 'SME8'
	Short-term rating scale: 'CRISIL A1+' to 'CRISIL D'	NSIC SSI Rating Scale: 'MSE 1' to 'MSE 8'
Use of rating outlook	Applicable	Not applicable
Distinction	Distinction between long-term and short-term ratings	No distinction between long-term and short-term ratings

Benefits of MSME rating

MSME rating has been introduced with a view to inculcate a sense of financial discipline and operational efficiency among micro and small enterprises, which is crucial for their growth and transformation into larger entities. The ratings provide both tangible and intangible benefits to stakeholders. Key benefits include:

1. Benefits to customers:

- a. **Access to adequate, timely credit at competitive cost** – An independent unbiased opinion on credit risk by CRISIL, through rating, showcases the capabilities of the rated enterprise. It provides significant comfort to banks and enables the rated entity to raise adequate amount of debt. A good rating carries weight with lenders, and may help MSMEs get faster credit at competitive interest rates. The Indian Banks' Association (IBA) has endorsed NSIC-CRISIL ratings and informed member banks as well. **CRISIL has working arrangements with more than 40 banks and financial institutions, many of which extend concessional pricing to borrowers based on these ratings.**
- b. **Independent third-party and unbiased evaluation** – Rating plays a significant role in helping the rated entity identify gaps in its financial performance and operational capabilities. An unbiased independent assessment can provide direction, which can be of significant value to an MSME enterprise in course correction and help expand its operations.
- c. **Benchmarking/ comparison with other MSMEs** – Due to the unorganised nature, lack of adequate and quality research and low information availability in the sector, MSMEs often tend to operate without any clear performance indicator vis-à-vis their peers. Ratings benchmark MSMEs with other MSMEs – not with large corporates –thereby giving a specific understanding to the rated entities on where they stand in relative terms in the MSME space.
- d. **Enhanced credibility among stakeholders** – For lenders, suppliers, customers, employees and other stakeholders, it is very difficult to assess the credibility of an MSME given the low level of information available on their performance track record. This restricts the ability of MSMEs to reach out to new customers across geographies, as stakeholder interest tends to be limited for lack of credibility checks. A rating enhances the credibility of the rated entity by building trust among new stakeholders and also providing additional comfort to existing stakeholders, which can be used to negotiate better trading terms.
- e. **Better visibility** – Rated enterprises get a free listing on CRISIL's website. The rating list is also published by CRISIL in SME Connect³, (a quarterly publication circulated among lenders and MSMEs) which reaches all the leading banks and financial institutions, as well as over 70,000 MSMEs.

Useful as a marketing tool – The ratings are a useful marketing tool as enterprises can display their rating on their websites, brochures, advertisements and marketing material, enabling them to reach out to a larger stakeholder base.

³Link - <https://www.crisil.com/ratings/past-issues.html>



Benefits to MSMEs

Access to adequate credit

Independent and unbiased evaluation

Useful marketing tool

Enhances credibility and visibility

1. Benefits to banks: risk assessment

- a. **Due diligence and detailed rating report** – The report is an independent opinion that provides detailed information about the company’s key strengths, and areas of improvement. This helps bank credit officers in preparing internal credit proposals and taking funding decisions, ensuring faster processing of proposals and thereby helping save on costs as well. Also, renewal and enhancement in credit limits become easier due to the accurate risk assessment available on the rated entity.
- b. **Better risk assessment and differentiation among MSMEs** – The exclusive rating scale for MSMEs provides a clear assessment to bankers on the performance of a particular MSME vis-à-vis peers of similar scale. This would not be possible if the entity was compared with large entities instead. An objective and unbiased opinion on risk at the comparable peer level and an additional level of check besides internal credit assessments provides a valuable tool to bankers in risk assessment.
- c. **Monitoring/ assessment of credit portfolio** - The quality of a bank’s (or branch’s) MSME credit portfolio could be mapped regularly through rating. This provides them inputs on the risk profile of MSMEs in their region and help reach out to better-quality in the target segment.

Improvement in quality of assets – Regular checks help banks track the performance of their assets on a regular basis. Entrepreneurs, too, start owning the rating assigned to their enterprise with greater responsibility. This infuses discipline and good practices in business. And as MSMEs start appreciating the importance of risk management, there is an overall improvement in the asset portfolio of the bank.



Benefits to banks

Improvement in quality of assets

Independent due diligence by third party

Risk assessment on MSME scale

Monitoring of credit portfolio

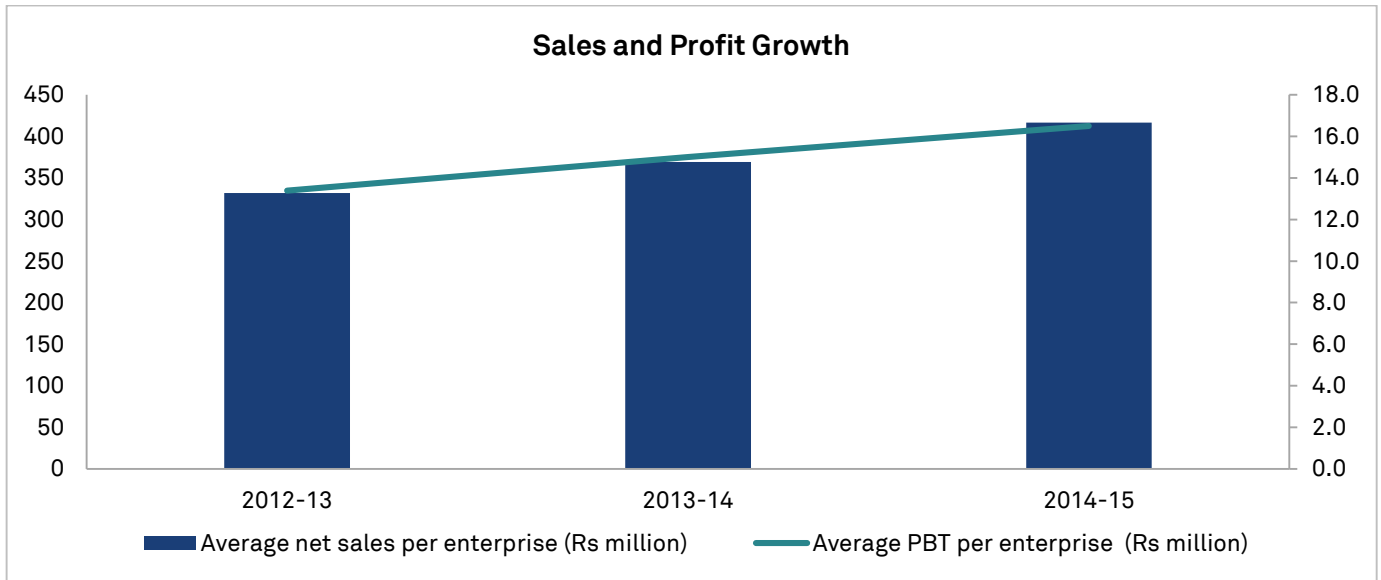
Impact of MSME rating

1. Better performance led to rating upgrades

More than 10% of the MSMEs that sought renewal of ratings between 2014 and 2015 managed to retain their ratings owing to business growth and disciplined debt servicing. More than half of the enterprises were able to improve their ratings because business performance improved, while 38% saw a fall in their ratings due to stretched working-capital cycles, slowdown in demand and high customer concentration. Enterprises that saw a deterioration in ratings were from the engineering and capital goods, electrical components, industrial machinery and auto components sectors.

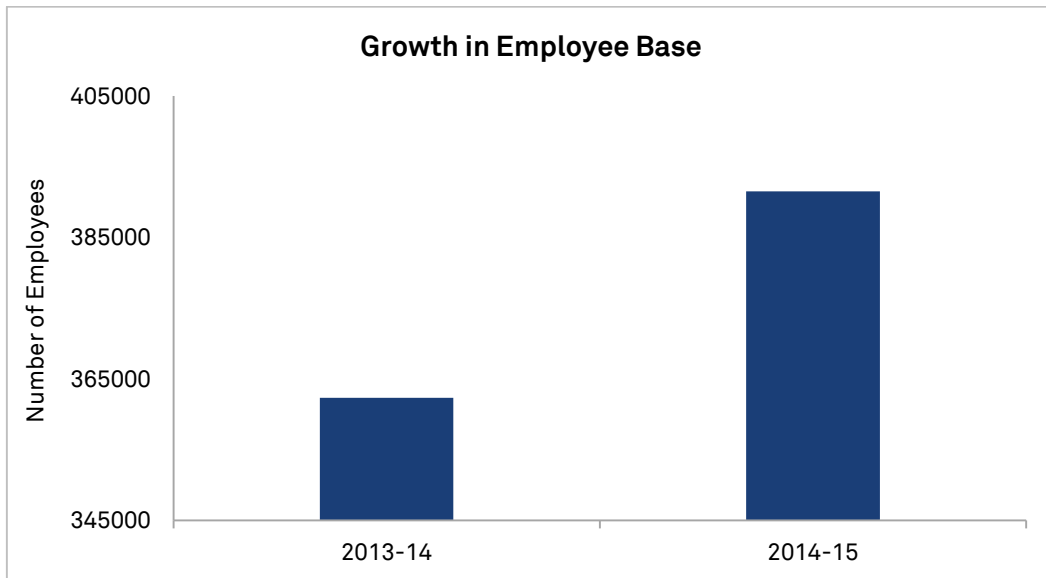
2. Sales and profits grew faster

For rated enterprises, the average net sales per enterprise grew at 12% CAGR from Rs 331.6 million in fiscal 2013 to Rs 416.5 million in fiscal 2015. Similarly, profit before tax (PBT) rose to Rs 16.4 million from Rs 13.3 million in the period – a CAGR of 11%.



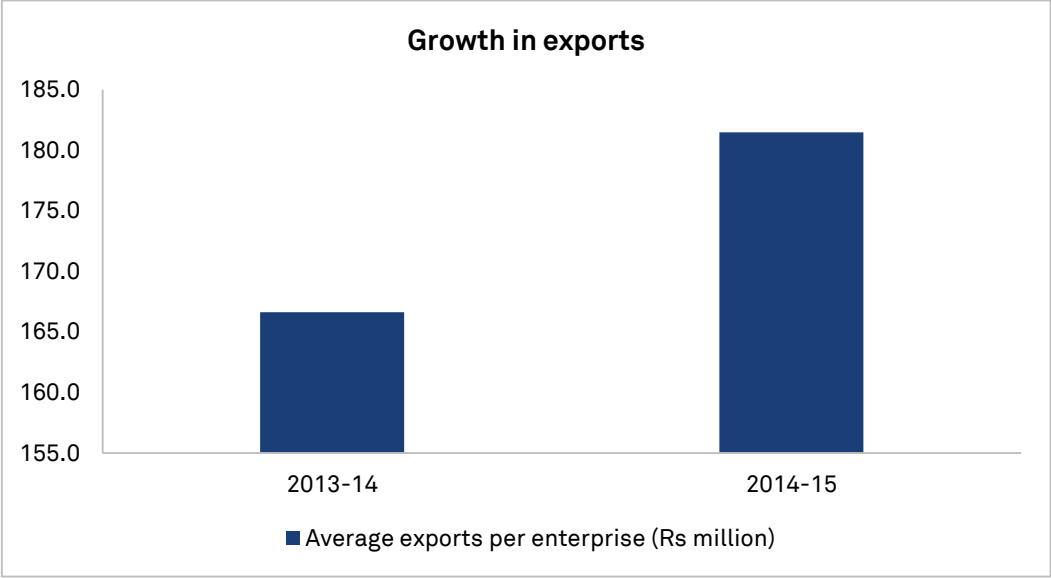
3. Despite economic slowdown, rated MSMEs were net employers

Cumulatively, MSMEs which went for a rating renewal added 29,225 jobs between fiscal 2013 and 2015. This came even as the economic slowdown during the period meant fewer job opportunities across India.



4. Exports grew despite challenging global economic environment

Nearly 12% of the 2,250 MSMEs analysed are exporters. These enterprises saw significant growth in business during the period of study. Average exports per enterprise grew from Rs 166.6 million in 2013-14 to Rs 181.5 million in 2014-15. Cumulatively, their contribution to exports rose more than Rs 13.3 billion during the period, despite turmoil in global markets.

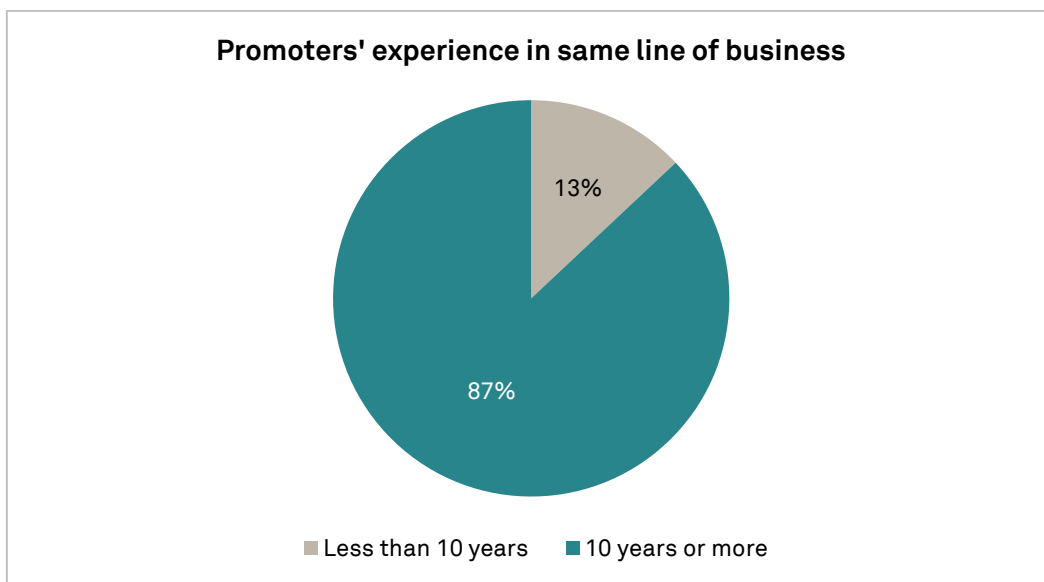




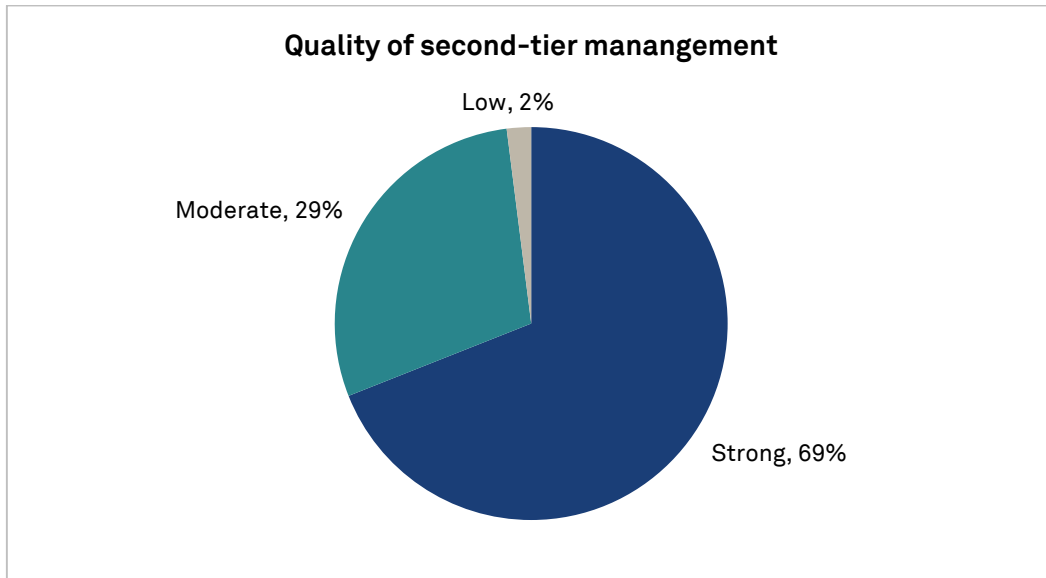
Best practices among MSMEs

CRISIL's experience of rating a wide universe of MSMEs shows higher rated units follow practices that lay the foundation of sound financial and operational management and help them outperform peers. Some of these practices are:

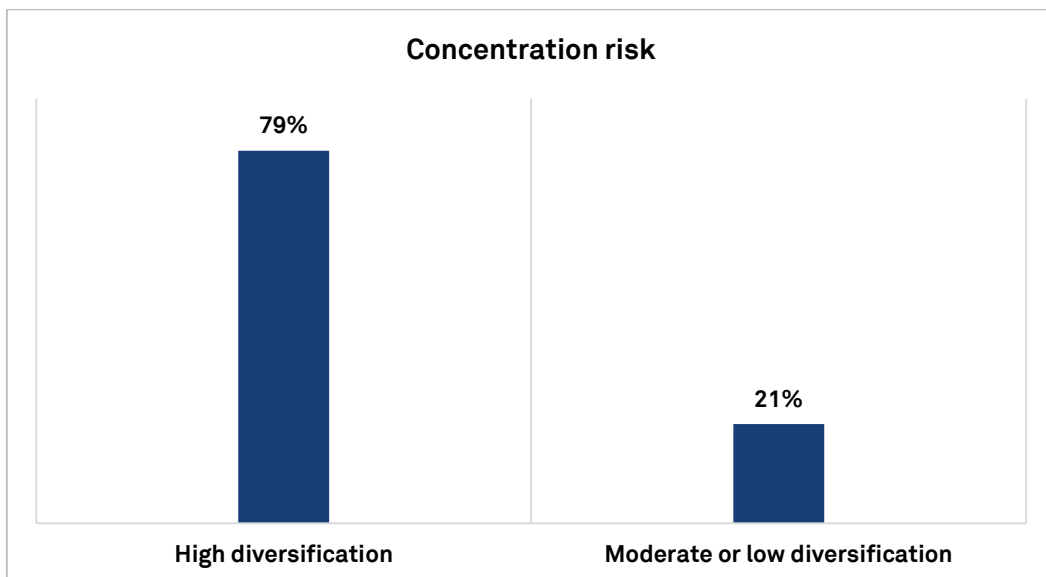
1. **Experienced promoters** – High rated MSMEs have a sound performance track record backed by a good vintage of the company or fair amount of experience of promoters in the same line of business. Over 85% of the highest rated MSMEs are operated by promoters with a strong track record in the same line of business.

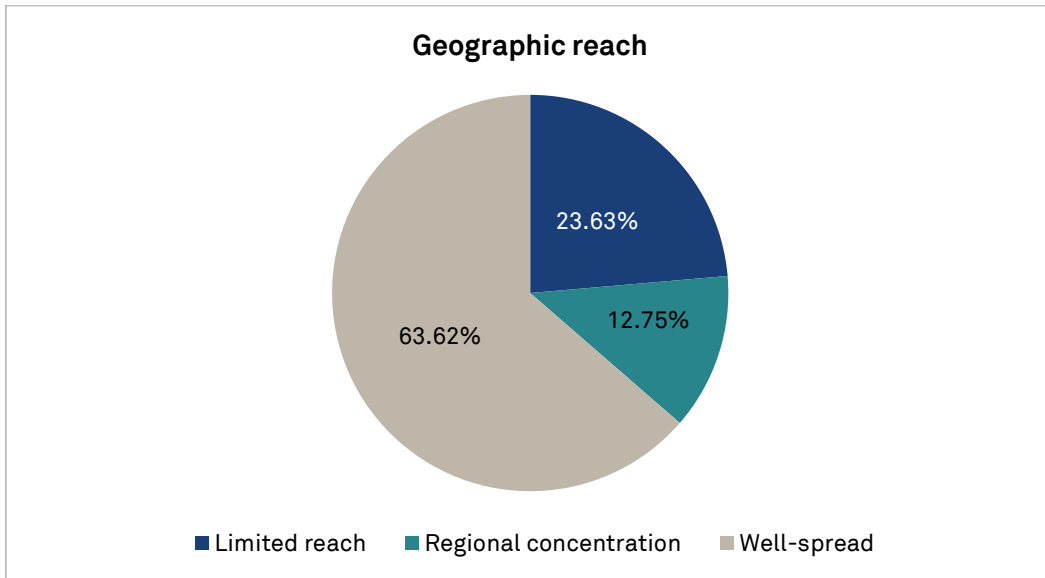


2. **Reliable second-tier management** – Most MSMEs are managed by first generation entrepreneurs, whose continued presence is crucial to the very existence of the business. CRISIL believes that factors such as the presence of a second-tier management, a formal succession plan, and a high degree of professionalism, are vital to long-term sustainability of the entity. CRISIL, therefore, critically assesses the organisational structure of the entity and the quality of its systems and processes. Higher rated MSMEs develop second-tier management with clearly defined roles and decision making powers. Professionals introduce prudent risk mitigation strategies in the company policies, such as hedging against forex prices, commodity prices, adequate insurance, managing losses and non-performing assets. Nearly 98% of the highest rated MSMEs have a moderately empowered or highly empowered second-tier management with key decision making powers.

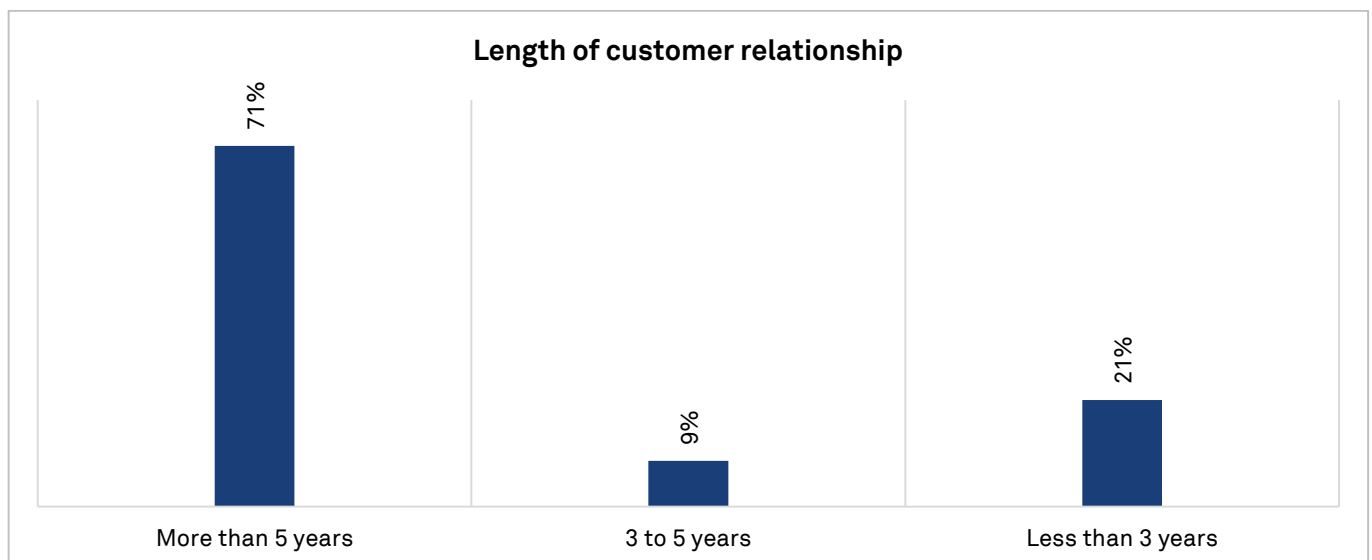


3. **Diversified business** – Higher rated MSMEs generally have wide product ranges catering to different industries and customer base spread over multiple geographies. There is low dependence on any single customer or region to mitigate risks from product, customer and geographic concentration.



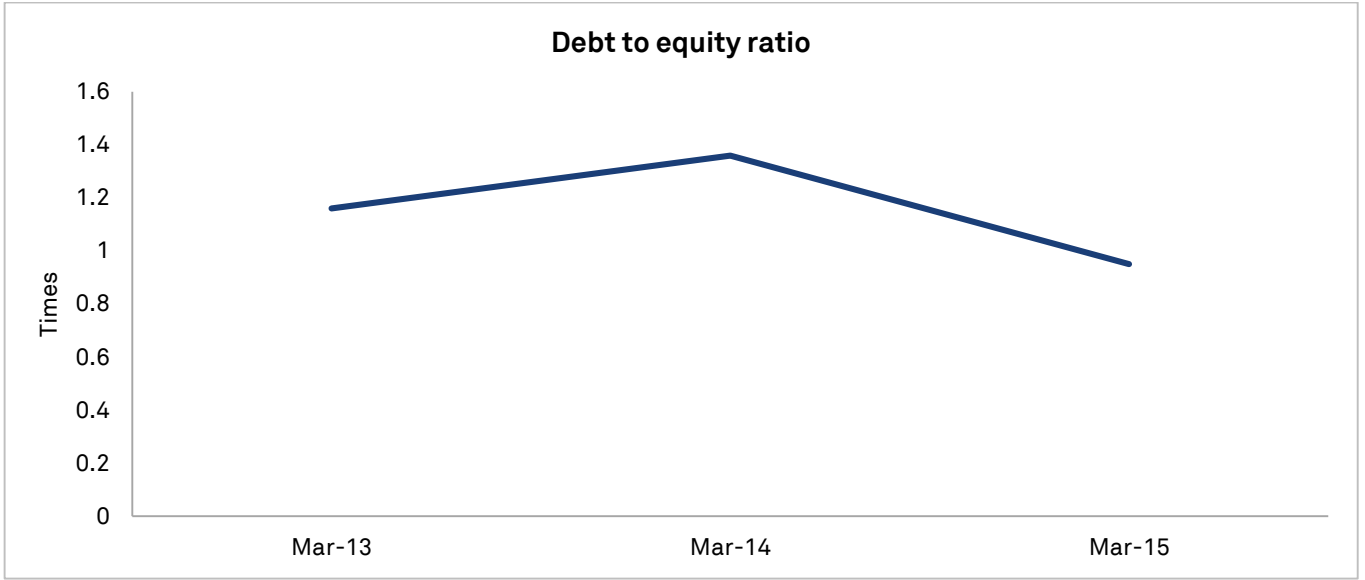


- 4. **Strong growth opportunities** – Higher rated MSMEs cater to growing markets with high long-term potential. Under business risk, CRISIL assesses the sustainability of the business plan and the long-term viability of the unit. This comprises qualitative assessments of the track record of the business, the profile of the rated entity’s customers, relationships with customers and suppliers, and the level of infrastructure and technology of the business.
- 5. **Healthy stakeholder relationships** – Higher rated MSMEs have strong visibility of future cash flows. This ensures that both receivables and payables are within the credit limits and hence do not stress balance sheets. An MSME’s pricing flexibility stems from its relationship with key customers and its strong control over costs. Assessing the quality of an MSME’s relationships with its key customers is a critical part of CRISIL’s assessment of an MSME. This parameter is assessed by directly contacting the entity’s key customers. Higher rated MSMEs also have good relationships with bankers as they make timely interest repayment, have transparency in information sharing, maintain good credit ratings and share credit reports on timely basis.



6. **Adequate implementation of technology backed by good quality infrastructure** – For MSMEs, control over costs is a function of the quality of technology and manufacturing facilities, and relationships with employees. Higher rated MSMEs deploy latest technology to improve productivity and reduce variance in output due to manual labour. They develop sound infrastructure, ensuring regular availability of power, water, transport facilities and labour.
7. **Constitution** – MSMEs are typically set up as Proprietorships, Partnerships, or Private Limited companies. MSMEs constituted as Companies are mandated to follow accounting standards prescribed by the Institute of Chartered Accountants of India and the guidelines of the Companies Act, 1956. CRISIL's experience suggests that entities whose financial statements are governed by regulation are generally stronger in accounting quality, disclosure, and transparency.
8. **Regular quality assessments backed by effective control systems** – Higher rated MSMEs undergo regular quality checks, including third-party certifications from reputed agencies such as International Organisation for Standardization, or ISO, and Food Safety and Standards Authority of India, etc. They implement systems for effective management of information through deployment of enterprise resource planning, computerised and regular updation of information management systems and compliance of statutory requirements/ accounting standards/ bank requirements.
9. **Good scale of business, with healthy margins** – CRISIL's financial risk analysis is based on disclosed financial statements. CRISIL's assessment of financial risk includes an assessment of size (sales and net worth), profitability, efficiency of capital and working capital management, and credit protection measures such as interest coverage, debt service coverage, and cash accruals to debt ratios. Higher rated MSMEs generally have good scale of operations with healthy operating and profit after tax margins.
10. **Healthy network, with prudent leverage management** – Higher rated MSMEs are generally backed by promoters and companies with strong reserves. A recent CRISIL study of MSMEs shows that promoters contribute 50-60% of the net working capital requirement – double the level globally – because of restricted access to formal financial institutions. Delays in receivables is a widespread affliction in the sector, forcing promoters to regularly infuse funds to keep the operations going. Promoters have to also infuse funds during business exigencies such as unexpected spikes in raw material prices, foreign exchange losses, unanticipated large orders or delays in insurance claims after calamities such as floods or fire or strikes, and ensure timely productions and deliveries. Since the dependence on promoters' ability to infuse timely finance during financial distress of MSMEs is high, their network is critical to credit assessments.
11. As for leverage management, it is observed that higher rated MSMEs have low reliance on debt (debt preferably not exceeding 1.5 times the equity available with the company). Similarly, a current ratio of greater than 1.5 lends strength to the balance sheet.

Other prudent financial management practices followed by higher rated companies include maintaining adequate inventory levels and ensuring lower dependence on short-term working capital loans.



Dos for MSMEs to improve ratings

- **Share credible and adequate information with rating agencies:** Information is the Holy Grail of ratings, so make sure all relevant information on group companies, promoter track record, audited financial statements and legal issues, etc are furnished.
- **Invest in people to build a sound organisational structure:** Among other measures, empower employees to take business decisions and mitigate dependence on promoters to build the organisation.
- **Increase diversification to mitigate concentration risk:** Deepening product portfolios catering to a larger and well-spread customer base will ensure businesses are cushioned against adverse events in any specific line of business.
- **Seek opportunities through products/services to cater to high-growth markets:** A healthy sector outlook lends strength to the assessment of business performance of the enterprise in near future.
- **Improve business cycles to ensure supplier and client credit is within company's credit policy:** Enterprises should focus on reducing the days receivable and days payable by focusing on improving their working relationship with suppliers through timely payment of dues and similarly, ensuring that clients can pay their dues without delay.
- **Invest in improving productive assets and increasing manpower productivity:** Improvements in infrastructure, basic utilities and adoption of latest technology leads to a better output, thereby impacting business performance.
- **Improve compliance, legal obligations and quality controls:** Ensuring there are no delays in filing income tax, adopting a superior constitutional structure, getting certifications from recognised independent bodies and improving internal quality checks play a significant role in assessing improvements in an enterprise's performance.
- **Scale up operations and improve margins:** Improvements in revenue and margins have a significant impact on ratings. Improvements in operating profit margin, profit after tax margins and interest cover indicate a healthier financial performance of the enterprise, thereby improving chances of a rating upgrade.
- **Optimise leverage:** Better handling of debt through increased capital infusion or reduced debt is often reflected in improved leverage ratios such debt-to-equity ratio, current ratio, and return on capital employed, which directly impact rating movements of an enterprise.



Action points to increase acceptability of ratings

Ratings have a key role to play in shaping the future of MSMEs. Yet, the impact of ratings has been limited to 0.25% of MSMEs in India due to low level of awareness and use of such ratings. The following steps are essential to increase acceptance of ratings:

- Stronger incentives should be linked to the rating exercise, beyond just funding requirements, to encourage more MSMEs to undertake rating.
- Greater transparency should be mandated in terms of information shared with rating agencies. This will reduce MSMEs' reluctance to undergo rating.
- Trade bodies should help popularise MSME ratings by educating their members about the benefits.
- MSME ratings should be made mandatory for banks while assessing loans to these units.
- Banks should encourage their unrated MSME clients to get ratings.

About Confederation of Indian Industry

The Confederation of Indian Industry (CII) works to create and sustain an environment conducive to the development of India, partnering industry, Government, and civil society, through advisory and consultative processes.

CII is a non-government, not-for-profit, industry-led and industry-managed organization, playing a proactive role in India's development process. Founded in 1895, India's premier business association has over 8000 members, from the private as well as public sectors, including SMEs and MNCs, and an indirect membership of over 200,000 enterprises from around 240 national and regional sectoral industry bodies.

CII charts change by working closely with Government on policy issues, interfacing with thought leaders, and enhancing efficiency, competitiveness and business opportunities for industry through a range of specialized services and strategic global linkages. It also provides a platform for consensus-building and networking on key issues.


Extending its agenda beyond business, CII assists industry to identify and execute corporate citizenship programmes. Partnerships with civil society organizations carry forward corporate initiatives for integrated and inclusive development across diverse domains including affirmative action, healthcare, education, livelihood, diversity management, skill development, empowerment of women, and water, to name a few.

The CII theme for 2016-17, **Building National Competitiveness**, emphasizes Industry's role in partnering Government to accelerate competitiveness across sectors, with sustained global competitiveness as the goal. The focus is on six key enablers: Human Development; Corporate Integrity and Good Citizenship; Ease of Doing Business; Innovation and Technical Capability; Sustainability; and Integration with the World.

With 66 offices, including 9 Centres of Excellence, in India, and 9 overseas offices in Australia, Bahrain, China, Egypt, France, Germany, Singapore, UK, and USA, as well as institutional partnerships with 320 counterpart organizations in 106 countries, CII serves as a reference point for Indian industry and the international business community.

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Confederation of Indian Industry

About CRISIL Limited

CRISIL is a global analytical company providing ratings, research, and risk and policy advisory services. We are India's leading ratings agency. We are also the foremost provider of high-end research to the world's largest banks and leading corporations.

CRISIL is majority owned by S&P Global Inc., a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

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CRISIL Ratings is part of CRISIL Limited ("CRISIL"). We pioneered the concept of credit rating in India in 1987. CRISIL is registered in India as a credit rating agency with the Securities and Exchange Board of India ("SEBI"). With a tradition of independence, analytical rigour and innovation, CRISIL sets the standards in the credit rating business. We rate the entire range of debt instruments, such as, bank loans, certificates of deposit, commercial paper, non-convertible/convertible/partially convertible bonds and debentures, perpetual bonds, bank hybrid capital instruments, asset-backed and mortgage-backed securities, partial guarantees and other structured debt instruments. We have rated over 24,500 large and mid-scale corporates and financial institutions. CRISIL has also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and microfinance institutions. We also pioneered a globally unique rating service for Micro, Small and Medium Enterprises (MSMEs) and significantly extended the accessibility to rating services to a wider market. Over 95,000 MSMEs have been rated by us.

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