

# **CRISIL's performance rating methodology for small and medium enterprises (SMEs)**

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## **Analytical contacts**

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## Executive summary

CRISIL has been assigning ratings to micro, small and medium enterprises (MSMEs) since 2005. The ratings assigned to the MSEs were called the 'NSIC-CRISIL Ratings' under the Performance and Credit Rating Scheme of the National Small Industries Corporation (NSIC), while the offerings to SMEs were called the 'CRISIL SME Ratings'. Till date, CRISIL has rated and assessed over 1,25,000 MSMEs.

CRISIL offers performance ratings to SMEs, on an eight-point scale, where 'SME 1' signifies the 'highest' level of creditworthiness in relation to other SMEs, while 'SME 8' signifies 'poor' creditworthiness in relation to other SMEs (Table 1 defines the SME rating scale with signifiers).

**Table 1:**

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

The MSE rating scale follows the guidelines of the Ministry of MSME, wherein there are signifiers for operating performance, financial strength parameters, overall performance and credit ratings. (*The detailed methodology for MSE rating is available at [www.crisil.com/www.smefirst.com](http://www.crisil.com/www.smefirst.com)*).

## Rating validity

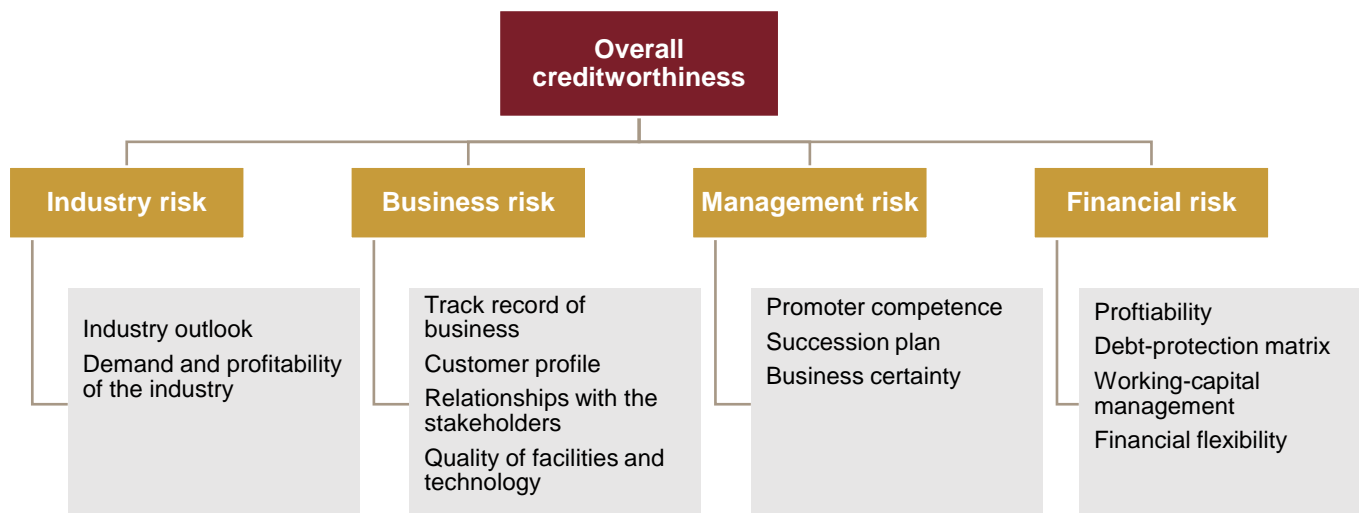
The validity of CRISIL's ratings shall be for one year from the report date, subject to no significant changes/events occurring during this period that could materially affect the business or financial parameters. The rating is a one-time exercise and is not kept under surveillance.

However, if such changes/events do take place, CRISIL recommends to seek a rating review. CRISIL also encourages entities to undergo an annual review of ratings, as an outstanding rating enables easier access to finance and helps in showcasing their performance across various user segments.

All live published ratings can be accessed from CRISIL's website.

## CRISIL's performance-rating methodology for SMEs

CRISIL has evolved a robust framework for the credit assessment of SMEs, reflecting the learning gained by analysing SMEs for more than a decade. CRISIL's analytical approach remains comprehensive and covers four broad categories of risk – business, industry, management and financial. While this is similar to the credit-assessment framework for large corporates, the approach to assessing the risk elements, comparison of the peer group, and significance of parameters take into account the nuances of this segment.



## Industry risk

SMEs form an integral part of the larger value chain and are typically the Tier II and Tier III suppliers to large corporates. Hence, the broader industry factors play a crucial role in determining the growth and stability of these entities. CRISIL factors in the industry risk, which plays a crucial role in the overall assessment of the entity.

## Business risk

CRISIL assesses the sustainability of a business plan and the entity's long-term viability by studying the track record of the business, customer profiles, the entity's relationships with customers and suppliers, geographical reach, customer base, product diversification, and infrastructure and technology in the business.

To assess an SME's business risks, CRISIL understands from its promoters their business plans and growth strategies.

Assessing the quality of an SME's relationship with its key customers and suppliers is critical; hence, CRISIL attempts to contact them to obtain their feedback.

CRISIL also evaluates the credit history and repayment track record by assessing third-party documents, such as credit bureau reports.

Thorough interactions with management, suppliers, customers and bankers provide crucial insights, which are critical to the assessment of the business risk profile.

Considering that SMEs form a part of the larger industries' value chains, they face higher competition due to the presence of many players with limited pricing flexibility. It becomes crucial to understand their ability to control the costs with the level of automation, quality of facilities and infrastructure.

To assess manufacturing facilities, CRISIL insists on site visits by its analysts or business associates.

## Management risk

Unlike large corporates, which have several layers of professional management, SMEs depend on the entrepreneurship and resourcefulness of their promoters. Hence, under management risk assessment, the promoter's track record in running a business successfully is an important element to assess.

The promoter's ability to manage the business effectively and ensure long-term sustainability is also evaluated by analysing revenue and profitability growth.

Assessing the competence of promoters, his/her track record as an entrepreneur, and past performance of the entity – and that of group concerns, if any – provides insight into the promoters' ability to successfully manage business cycles.

Most SMEs are managed by first-generation entrepreneurs, so their continued presence is often crucial to the business. The presence of a second-tier management, a formal succession plan and a high degree of professionalism are vital to long-term sustainability. In addition to these factors, CRISIL assesses the organisational structure and the quality of systems and processes.

## Financial risk

CRISIL's financial risk analysis is based on disclosed statements. The financial risk assessment includes assessment of size (net worth), profitability, leverage, working capital management, liquidity and credit protection metrics, such as interest coverage. Profitability trends help understand the overall efficiency of a business. An SME with prudent working capital management will be able to deal with stakeholders better and maintain comfortable liquidity. A good track record of working capital management is crucial to SMEs, given that they have low bargaining power compared with larger entities. Debt and debt-protection metrics indicate adequacy of cash flows to pay interest and repay principal, and are important tools to assess the overall financial health of an SME.

CRISIL uses proprietary models developed for SMEs. The calculation of ratios is broadly along the same lines as what's followed when assessing large corporates, but have been fine-tuned to suit the requirements of SMEs. For example, promoters often bring in investments in the form of unsecured loans, instead of equity or capital, to take advantage of tax policies. Such loans are neither treated as debt nor equity when assessing SMEs.

CRISIL checks the credit record of the entity and also contacts the SME's bankers to assess the nature and history of the relationship, performance of their loans and bank accounts. Bankers can also provide keen insights into the promoters' integrity.

## Overall rating/creditworthiness

To assess the overall rating of an SME, CRISIL takes into consideration its business and management performance, industry risk and financial strength. CRISIL believes these are critical to evaluating the overall creditworthiness, because they help ensure the business' sustainability and ability to meet financial obligations in a timely manner.

In addition, project risk related to any diversification/expansion of business undertaken by management is also factored in the overall rating of an SME. This includes any related or unrelated diversification/expansion, sources of funding, project execution timeline and impact on the credit profile.

## Conclusion

CRISIL's rating framework factors in the nuances of SMEs, such as high susceptibility to business and economic cycles, and dependence on promoters. It includes robust metrics developed by CRISIL to evaluate management, business and financial risks. These metrics are the result of an illustrious legacy and institutional intelligence in assessing of credit for over three decades.

## About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better.

It is India's foremost provider of ratings, data, research, analytics and solutions, with a strong track record of growth, culture of innovation and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

It 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.

## About CRISIL Ratings

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 1,25,000 MSMEs have been rated and assessed by us.

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