



## Small and Medium Enterprises: Reviewed, Rated and Rewarded

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Globally, Small and Medium Enterprises (SMEs) form the backbone of all economies in terms of contribution to economic growth, employment and promotion of entrepreneurship. In India, SME units account for nearly 40 per cent of industrial production, close to 50 per cent of exports and 45 per cent of industrial employment. The significance of this sector cannot be further emphasised. Concurrently, the importance of finance in escalating business growth of this sector cannot be ignored in any way. The business of business is business. To be preoccupied by concerns of meeting capital needs and expanding operations is not what SME units should be anxious about. It is the responsibility of all the stakeholders to work together towards addressing the just needs of the SME units.

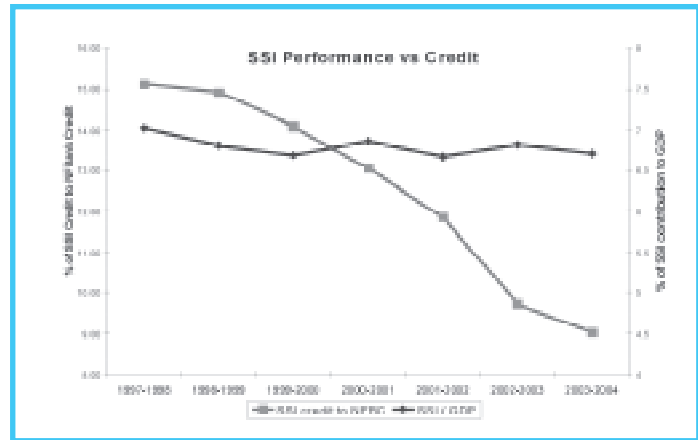
In recent times, the very approach to small business banking has been revolutionized, with banks offering customised product sets, minimising documentation and encouraging decentralised decision making to speed up the process. Lower credit requirement from large corporates due to higher internal generation of funds by them has resulted in banks shifting their focus to other alternatives, including SME financing. They are offering customized financial solutions to provide for the funding needs of the SMEs. Most banks have set up special units and cells to target these enterprises. Units which were once pursuing financial institutions for credit requirements are now being made the focus of credit strategies.

Records show that notwithstanding a healthy growth of bank credit to SSI units in the recent years, the share of bank credit to SMEs is actually on the decline. At end-March 2006, the credit to SSI sector stood at 6.4 per cent of outstanding non-food gross bank credit as against

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11.8 per cent in 2002 despite the fact that their contribution to GDP remained almost constant (See Chart).

Risk that is normally associated with lending to SMEs is relatively higher and impediments to finance persist. The areas of concern for the financial institutions include, largely insufficient information disclosure, questionable reliability, timeliness and frequency of the financial information, uniqueness of each unit so as not to group such units, lack of expertise at the institution level itself and difficulty in studying qualitative factors of the unit.



SME Rating Agency of India Limited (SMERA) is a joint initiative by SIDBI ([www.sidbi.in](http://www.sidbi.in)), Dun & Bradstreet Information Services India Private Limited (D&B) ([www.dnb.co.in](http://www.dnb.co.in)), Credit Information Bureau (India) Limited (CIBIL) ([www.cibil.com](http://www.cibil.com)) and several leading banks in the country. SMERA is the country’s first rating agency that focuses primarily on the Indian SME segment. SMERA’s primary objective is to provide ratings that are comprehensive, transparent and reliable. This would facilitate greater and easier flow of credit from the banking sector to SMEs. SMERA ratings take into account industry dynamics by factoring in a system through which an SME could compare its strengths and weaknesses with those of other companies in the same line of business. This is done through statistically derived industry benchmarks for various ratios.

**D-U-N-S NO:** Each unit availing of SMERA ratings is assigned a unique 9 digit number DUNS NO. The Number is a unique nine-digit identification sequence, which provides unique identifiers of single business entities, while used by the world’s most influential standards-setting organizations, it is recognized, recommended and/or required by more than 50 global, industry and trade associations.

**MOU with Banks:** SMERA has taken the initiative of entering into MOUs with 14 Banks, viz., State Bank of India, Punjab National Bank, Syndicate Bank, Canara Bank, State Bank of Bikaner and Jaipur, Dena Bank, Corporation Bank, Union Bank of India, UCO Bank, CitiGroup, Bank of India, Vijaya Bank, Allahabad Bank and Bank of Baroda. Further a number of banks have announced favourable credit terms including reduction in interest rates to units rated by SMERA. Andhra Bank, Bank of India and SIDBI has already announced reduction in interest rates for units rated by SMERA.

SMEs need to appreciate this fact and incorporate these practices in their working style to be a leader in their space and increase their competitiveness. Moving up the value chain and aspiring to emerge as an ME (medium enterprise) from an SE (small enterprise) is the kind of growth prospects that units aspire for. An entrepreneur is an expert in his field, he

has full knowledge about the environment in his business sector, be it forward or backward linkages effect, regulations and its effects thereof, innovation, etc. Nevertheless, in the backdrop of increased competition, it has become imperative to go beyond their immediate location, anticipate the fast changing business and keep pace with it. The fast changing

business environment is demanding a more professional set up, a move from a family run business to one that is proficiently managed. Showcasing such a working style would, apart from business results, create an interest in the setup of SMEs. Openness and transparency are two key differentiating factors which would influence the decisions of the credit suppliers. Improved disclosure about business will always encourage people to associate with the unit. Having certified assessment from an external expert agency and emphasis on best business practices would only make it that much easier for an SME to be unique.

An independent third party assessment of business operations would assist the entrepreneur gain deeper insights into his business and leverage his strengths and address his weakness. The results of a study conducted by SMERA highlights the need of the SMEs to stand out in the mob, distinguish themselves among their peers and create their identity. Globally, a recent ASEAN study of the region revealed that 71 per cent of the banks would appreciate such a service from a rating agency. A World Bank cross-country study has found financiers prefer to have access to good credit information of a prospective client over collateral to extend finance.

Rating, as a concept and practice, has by now well entrenched itself, at least in the urban areas, as a business application when it comes to issue rating. For undertaking an enterprise rating or an issuer rating, the rating culture has yet to be propagated. Both entrepreneurs and the banks will have to be educated about this concept and its benefits accruing to them. Rating of SMEs involve, uniquely, evaluating the company as a whole as against the usual practice of ranking debt issue/project finance of the company. The rating process is a vigorous and intensive exercise using a comprehensive model.

The model includes an evaluation of all dimensions of business including financial history as also qualitative factors like management profile, insurance cover, capacity utilisation, etc. Further, within each broad aspect, weights are assigned to cover each parameter adequately. Different industries have their unique dynamics and, therefore, these models itself are dynamic wherein importance given to various issues is continuously shuffled as per the industry requirements. In the case of many manufacturing industries, we have found that a quality and environmental certificate is of utmost importance for business and, therefore, these issues are closely considered and are given higher weights as compared to when other industries are being rated.

Weights given to rating parameters will differ even in the case of individual cases. For instance, in one case the legal expenses was disproportionate to the size of the firm and on careful examination and further enquiry, it was found that the enterprise was fighting a lawsuit that could result in closure. In another instance, on studying the balance sheets of all concerns together, investment in related concerns informed the analyst about the integrity of the entrepreneur. Further, in certain instances, the provision of a succession plan may prove an important aspect and will have high consideration during review.

The rating process involves extensive interaction by experts with not only the company in question but also its bankers, its vendors, its customers and other stakeholders of the business. Agencies interact with buyers and suppliers to learn about the management practices, relationships maintained and the method of conducting business. SMEs are rated based on size, be it turnover or net worth. Unique in the case of SME space, is the case of services segment. In the case of service industry, a huge negative tangible net worth was observed and certain intangibles had to be included to calculate the net worth. Like, cost of all computers inclusive of hardware and software in the case of IT companies, brand names and drugs and patents in the case of pharmaceuticals and technical know-how is counted as part of net worth in the case of R&D companies.

New Capital Accord or Basel II has provided a major fillip to rating. Under the standardised approach, which is going to be followed by Indian banks in the near future, retail SMEs are viewed as less risky based on the principle of risk diversification. Therefore, the risk weight associated with lending to retail SMEs has been fixed at a lower level. Non-retail SMEs, like other corporates, can have risk weights varying from 0 per cent to as high as 150 per cent. Higher or better rated non-retail SMEs enjoy the benefit of lower risk weights and lower capital requirements for the banks. This would translate to cheaper credit to these SMEs. Thus, a country having a higher SME exposure would benefit by adopting Basel II through lower capital requirements and better quality of SME exposure.

Units and entrepreneurs should be familiarised with the rating process so as to welcome and cooperate with it and not fear it. Promotion of awareness amongst the SME units, banking officials, vendors and government agencies of the true picture at the ground level would contribute to a great extent.

### What is SME Rating?

- ❖ SMERA Rating is an independent, third-party, comprehensive assessment of the overall condition of the SME, conducted by SME Rating Agency of India Limited
- ❖ It takes into account the financial condition and several qualitative factors that have bearing on credit worthiness of the SME
- ❖ SMERA Rating consists of 2 parts, a Composite Appraisal/Condition indicator and a Size Indicator
- ❖ SMERA Rating categorises SMEs based on size, so as to enable fair evaluation of each SME amongst its peers
- ❖ An SME unit having SMERA Rating would enhance its market standing amongst trading partners and prospective customers

### Benefits

**1. Wide Recognition and Acceptance:** With each bank having separate rating processes and disclosure requirements for the purpose of disbursing loans, SMEs find themselves spending significant time, effort and money while approaching different banks for credit. As SMERA has adopted a comprehensive, transparent and reliable rating process, it would have a wider acceptance within the banking system of the country. In addition to this, SMERA would be supported by SIDBI and a large number of public and private sector banks in the country. Such wide acceptance would result in SMERA ratings becoming a key requirement in the loan application process. It will also simplify the process of credit requests and make the process more cost-effective.

**2. Favourable borrowing terms :** Better ratings from SMERA has already started benefiting units by way of (i) more favourable credit terms in terms of interest rebates (ii) lower collateral requirements (iii) reduced interest rates and (iv) simplified lending norms

**3. Faster Access to Credit:** SMERA ratings facilitate banks/lending institutions in reducing the turnaround time in processing credit applications, thereby providing SMEs access to timely and adequate credit.

**4. Benefit to SME & SSI Units:** (i) SMERA rating adds credibility to the status of the SME unit (ii) It also helps open doors to deal with large companies especially. those who deal with a big number of vendors (iii) SMERA ratings serve as motivation to adopt good governance practices which are beneficial in the long run (iv) SMERA ratings also help in international trade and commerce and serve as first point to generate interest among potential trading partners and (v) ratings also acts as a tool for self correction and self improvement. In the event of a 0.25 % interest reduction to a unit getting rated by SMERA the reduction in interest cost comes to Rs. 25000/- on a loan of Rs 1 crore for 1 year thereby outweighing the cost of rating from SMERA.

**5. Benefit to Banks:** (i) SMERA ratings facilitates pricing of loan products / attractive terms (ii) useful in compliance with regulatory and capital adequacy norms and (iii) help the banker through early warning signals through review ratings as mandated by it.

## SMERA Rating Scale

