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**RATINGS**

*The Most Reliable Opinion on Risk*

# Rating Criteria for Small and Medium Enterprises

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# Rating Criteria for Small and Medium Enterprises

CRISIL's ratings on small and medium enterprises (SMEs) reflect the rated entities' overall creditworthiness, adjudged in relation to other SMEs. These ratings are entity-specific, and not specific to debt issuances.

The SME sector has its own unique features: unlike the large corporates, the SME sector has no organised information on industries, market shares, competition dynamics, and promoter or management track record. The creditworthiness of entities in the sector, therefore, needs to be assessed using tools and methods that are different from those traditionally used for large corporates. CRISIL's SME Ratings group has evolved a robust framework for the credit assessment of SMEs, reflecting the learnings gained from CRISIL's ratings and research experience of about two decades.

## Two rating scales for the SME sector

CRISIL has two separate scales on which it assigns ratings to SMEs: the NSIC-CRISIL Performance and Credit Rating (NSIC-CRISIL) scale for small scale industries (SSIs), and the CRISIL SME Rating scale.

### For SSIs

The NSIC-CRISIL scale has been specially developed for units registered as SSIs. Typically, SSIs that are eligible for subsidies on rating fees from the National Small Industries Corporation Limited (NSIC, owned by Ministry of SSIs, Government of India) are rated on this scale. However, it can also be used to rate entities that are not eligible for NSIC subsidies.

The NSIC-CRISIL scale measures performance capability and financial strength as two distinct dimensions. Performance capability is measured on a five-point scale (from 1 to 5), and financial strength is measured in three categories (A to C). The rating symbolises the relative positioning of the rated entity adjudged in relation to other SSIs. Table 1 outlines the rating matrix of the NSIC-CRISIL scale:

Table 1: The NSIC-CRISIL rating matrix

		Financial Strength		
		High	Moderate	Low
Performance Capability	Highest	SE 1A	SE 1B	SE 1C
	High	SE 2A	SE 2B	SE 2C
	Moderate	SE 3A	SE 3B	SE 3C
	Weak	SE 4A	SE 4B	SE 4C
	Poor	SE 5A	SE 5B	SE 5C

### For SMEs

CRISIL also offers SME Ratings to the larger domain of SMEs, of which SSIs are a subset. The SME Rating Scale is an eight-point scale (SME 1 to SME 8) that symbolises the rated entity's creditworthiness in relation to other SMEs. Table 2 outlines the CRISIL SME Rating Scale and rating definitions:

*Table 2: CRISIL SME Rating Scale and definitions*

CRISIL SME Rating	Definition
SME 1	Highest
SME 2	High
SME 3	Above Average
SME 4	Average
SME 5	Below Average
SME 6	Inadequate
SME 7	Poor
SME 8	Default

### Rating methodology

Outlined below is the rating methodology used to assess the creditworthiness of SMEs with on-going business units and without any large projects. The rating methodology for assessment under both rating scales is the same. The methodology is comprehensive and covers three broad categories of risk - business risk, management risk, and financial risk. Although these are similar to the credit assessment framework for large corporates, the approach to assessing the risk elements, peer group comparisons, and weightages for the various parameters, 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 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.

In order to assess the SME's business risks, CRISIL contacts the promoters of the SME to understand their business plans and growth strategies.

Most SMEs form part of larger industries' value chains and are usually not in direct contact with the end users. Moreover, in most industries, the degree of competition is high owing to factors such as the presence of a large number of players, low capital intensity and, in some cases, low technology levels. Hence, SMEs rarely have control over pricing. An SME's pricing flexibility stems from its relationship with key customers and its strong control over costs. For SMEs, control over costs is a function of the quality of technology and manufacturing facilities, and relationships with employees and suppliers.

Assessing the quality of an SME's relationships with its key customers is a critical part of CRISIL's assessment of an SME; this parameter is assessed by directly contacting the entity's key customers. To assess the entity's manufacturing facilities, CRISIL insists on a visit to the facilities, either by a

team of CRISIL analysts, or by CRISIL's business associates.

CRISIL also contacts the SME's key suppliers to assess the quality of their relationships with the SME being rated.

### **Management risk**

For SMEs, management evaluation, which is typically an evaluation of the promoters' competence, is critical to the rating. Unlike most large corporates, which have several layers of professional managers, performance in the case of SMEs often depends on the entrepreneurship and resourcefulness of the promoters.

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. In addition, the entity's ability to develop suppliers, integrate with customers, and manage banking and labour relationships, also provide critical inputs to the management evaluation process.

Most SMEs 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 the long-term sustainability of the entity. CRISIL, therefore, critically assesses the organisational structure of the entity and the quality of its systems and processes.

### **Financial risk**

SMEs are typically set up as proprietorships, partnerships, or private limited companies. SMEs that are constituted as companies are mandated to follow accounting standards prescribed by the Institute of Chartered Accountants of India (ICAI) 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.

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. CRISIL uses proprietary spreadsheets that are developed especially for SMEs. The ratio calculations are broadly the same as those followed in the assessment of the large corporates, but have been fine-tuned to suit the requirements of the SME sector. For example, promoters often bring in investments in the form of unsecured loans instead of equity or capital to take advantage of favourable taxation policies; such loans are treated as quasi-equity while assessing SMEs.

CRISIL's assessment of an SME's financial risk profile also attempts to assess the entity's financial flexibility. This is done in two ways - by analysing the promoter's net worth, and by assessing the strength of the SME's relationships with banks.

CRISIL asks promoters to disclose their personal net worth; based on this declaration, CRISIL assesses the additional funds that the promoter will be able to infuse into the SME, in the event of distress.

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

### **Rating validity**

CRISIL's ratings on the SME and NSIC-CRISIL scales are valid for a period of one year from the date of being assigned, if no significant changes/events occur during this period that could materially affect the business or financial parameters of the organisation.

The rating is a one-time exercise and is not kept under surveillance. CRISIL, however, recommends that the user of the rating seek a review of the rating if the organisation experiences significant changes/events during this period which could impact the organisation or its rating. All live ratings assigned by CRISIL in the SME space may be accessed from CRISIL's website [www.crisil.com/ratings](http://www.crisil.com/ratings).