

## SMEs present a strong financial profile



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Small and medium enterprises (SMEs) account for the bulk of commercial activity in India. Yet, for a variety of reasons, SMEs have traditionally been perceived as less creditworthy than larger corporates. To understand how valid this perception is, CRISIL has carried out a study comparing the financial data of over 2500 large corporates<sup>1</sup> and about 32000 SMEs in the Indian manufacturing sector, on the basis of four key parameters used in credit analysis.

CRISIL's study shows that SMEs present a strong financial profile: they compare well with their larger cousins on several debt protection parameters, and are more bankable credits than they are generally perceived to be. Although SMEs do not fare quite as well on the profitability front, possibly on account of the competitive pressures they face, the impact of the poor profitability is offset by more favourable debt-equity levels.

Additionally, SMEs differ widely from one another in performance and credit quality. Therefore, the performance and credit quality of an individual SME cannot be judged on the basis of conclusions drawn from evaluating the performance and credit quality of SMEs in general. It is to address this need that CRISIL introduced SME Ratings, which have found tremendous acceptance among SMEs and prospective lenders. These entity-specific ratings help lenders better evaluate credit quality.

In this commentary, CRISIL compares the performance and credit quality of SMEs in general vis-à-vis the large corporates on several key parameters.

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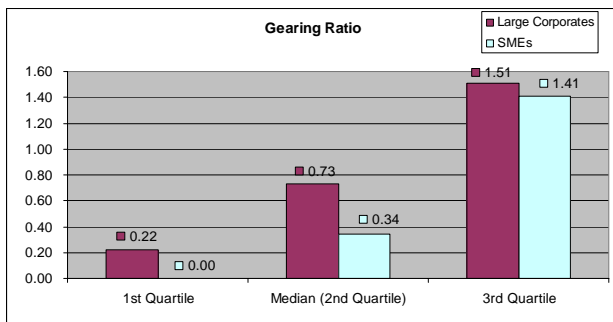
<sup>1</sup> Large corporates are defined as companies with a net worth greater than Rs. 200 million.

### Capital structure:

A company's capital structure, commonly referred to as gearing, leverage, or debt-equity ratio, reflects the extent of borrowed funds in the company's funding mix. Gearing is computed as the ratio of the total debt that the company has taken, to its tangible net worth.

An analysis of the gearing ratios of SMEs and large corporates reveals that, contrary to popular perception, SMEs are much less leveraged than their larger counterparts. Chart 1 presents the 1<sup>st</sup> Quartile<sup>2</sup>, Median<sup>3</sup> (2<sup>nd</sup> Quartile) and 3<sup>rd</sup> Quartile gearing ratio for large corporates and SMEs.

Chart 1:



Data Source: Centre for Monitoring Indian Economy (CMIE)

As is evident from the chart, SMEs have a significantly low median gearing of 0.34 times as against 0.73 times for the large corporates; in other words, 50 per cent of SMEs have a gearing of 0.34 times or below. Similarly, the fact that 75 per cent of the SME population operates with gearing ratios less than 1.41 times, negates the common perception that SMEs are highly leveraged. The difference is more evident if promoter loans to SMEs are considered as quasi-equity. The difference in median gearing

<sup>2</sup> A quartile is a statistical term, referred to in percentile measures. The total (100 per cent) is broken into four equal parts such that First Quartile is the 25th percentile (0.25), the Median Quartile is the 50th percentile (0.50) and the Third Quartile is the 75th percentile (0.75). A percentile is a measure that tells us what proportion of the total population scored at or below that measure. Therefore, the 75<sup>th</sup> percentile is the point below which 75 per cent of the population lies.

<sup>3</sup> The median of a population is the point that divides the distribution of scores in half. Numerically, half of the scores in a population will have values that are equal to or larger than the median and half will have values that are equal to or smaller than the median

between small and large entities may partly reflect the limitations that smaller players in the SME segment face in accessing borrowings at attractive rates, due to a misplaced perception of high credit risk in the SME sector.

CRISIL believes that because most SMEs have a low gearing ratio, there is significant leeway for banks to extend credit to the sector.

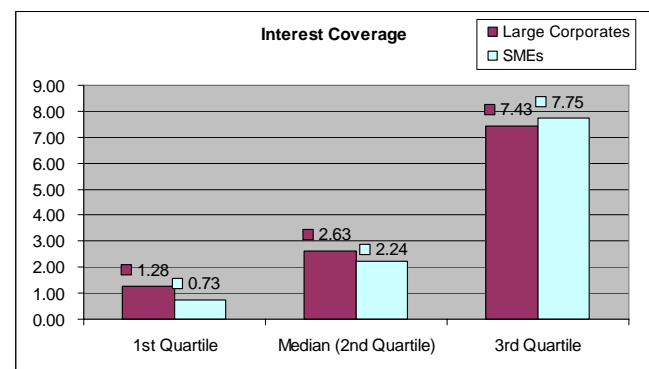
### Interest coverage ratio:

The interest coverage ratio (or interest cover) reflects the extent of cushion or comfort that a company has in meeting its interest obligations from surpluses generated from its operations, and is an important indicator of the credit quality of a company.

As seen in Chart 2, SMEs have a median interest cover of 2.24 times; by implication, 50 per cent of SMEs have an interest cover at this level or better. The median interest cover for large corporates, at 2.63 times, is comparable to that of SMEs.

The top 25 per cent of the SME population has interest cover in excess of 7.75 times, significantly stronger than interest coverage ratios of most large corporates. However, the bottom 25 per cent of the SME population has interest cover of less than 1.0 times, indicating a high probability of default. CRISIL's SME ratings help lenders identify such weaker credits in the SME portfolio, and avoid exposure to them.

Chart 2:

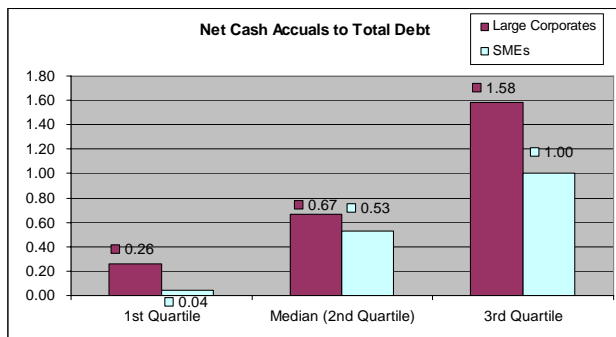


Source: Centre for Monitoring Indian Economy (CMIE)

### Cash flows in relation to debt:

CRISIL's study also compared the performance and credit quality of SMEs and large corporates on another important debt protection measure: annual net cash accruals<sup>4</sup> in relation to total debt (NCATD). The ratio indicates a company's ability to service its debt obligations, from earnings generated from its operations. Chart 3 shows the results of the comparison.

**Chart 3:**



Data Source: Centre for Monitoring Indian Economy (CMIE)

As can be seen from Chart 3, SMEs fare slightly worse than large corporates on this parameter. In CRISIL's assessment, this is a reflection of the lower profitability of SMEs, rather than their high indebtedness. The next section compares the performance of SMEs and large corporates on the profitability parameter.

### Profitability ratios:

SMEs report significantly poorer profitability than large corporates. Chart 4 compares the EBITDA margins<sup>5</sup> of SMEs and large corporates.

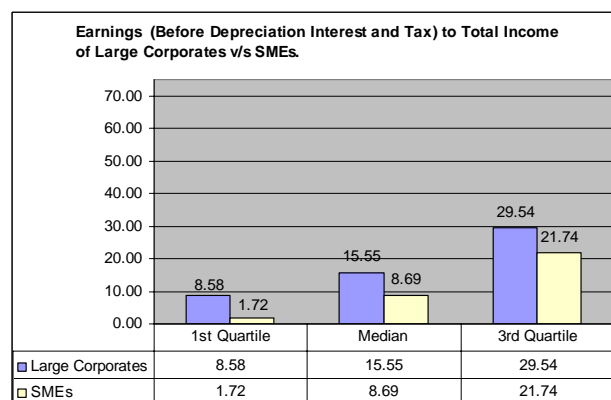
For the SME population, the median value of EBITDA to total income is 8.69 per cent; large corporates have a much higher median of 15.55 per cent. The SME sector, which lacks entry barriers such as brand equity or technology, is exposed to significant competitive pressures; these pressures partly account for the sector's low profitability margins. SMEs' low bargaining power with customers

and suppliers also affects profitability and cash flows significantly.

Low profitability margins may also partly result from the reluctance of entrepreneurs to report their firms' true profitability. Many entrepreneurs hesitate to divulge their companies' true profitability in order to protect their margins with key customers, to bargain with the labour force, or to minimise tax outflows.

CRISIL believes that such measures reflect poorly on management integrity, an important parameter from a lender's or rating agency's perspective. In its analysis of the creditworthiness of SMEs, CRISIL takes cognisance only of reported profitability and does not factor in any unreported profits.

**Chart 4:**



(Figures in %)

Similarly, SMEs fare poorly in comparison with large corporates on other profitability parameters, such as return on capital employed (RoCE) and net profit margin (profit after tax / operating income). SMEs have a median RoCE of 1.4 per cent and a median PAT margin of 0.46 per cent; in comparison, large corporates have a median RoCE of 15.61 per cent, and a median PAT margin of 4.42 per cent. However, profitability parameters of SMEs in the top quartile are comparable with those of large corporates. For instance, the top 25 per cent of the SME population reported EBITDA margins of over 21 per cent and PAT margins of over 6 per cent, both of which reflect healthy profitability, comparable with the figures for the top quartile of large corporates.

<sup>4</sup> Net Cash Accruals is defined as Profit after Tax – Dividend + Depreciation.

<sup>5</sup> EBITDA margin is defined as the ratio of Earnings before Interest, Taxes, Depreciation and Amortisation to Operating Income

**Conclusion:**

CRISIL's study conclusively establishes that, contrary to the common perception, a significant number of SMEs display credit protection parameters comparable to those of large corporates. On profitability, though the average SME fares poorly, CRISIL finds that a large number of SMEs report healthy profitability, comparable to that of large corporates; also, the impact of low profitability is offset by the more favourable gearing ratios that SMEs, on an average, exhibit.

However, it also needs to be kept in mind that the SME population displays wide divergence in performance. This divergence can be adequately captured in a complete analysis of the business and management risks associated with individual SMEs. CRISIL has developed a unique methodology to analyse the creditworthiness of SMEs; this methodology captures the key risk elements faced by players in the sector. CRISIL believes that lenders can better exploit the opportunity that SMEs offer, by using tools and services developed specifically for assessing credit risk in this sector.

## CRISIL Ratings

CRISIL Ratings is India's most influential and the world's fourth largest ratings agency - **the most reliable opinion on risk**. It is the market leader in India - shaping the development of the debt markets having rated over 5,600 debt instruments worth over Rs.7.79 trillion, issued by about 2,200 companies. CRISIL Ratings has created rating methodologies for debt instruments and innovative structures across sectors. It is the only rating agency in India operating on the basis of sector specialisation. CRISIL Ratings has a strategic working relationship with Standard & Poor's, CRISIL's majority shareholder and the world's foremost provider of independent credit ratings, indices, risk evaluation, investment research, data and valuations.

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