

# CRISIL revises rating scale for micro and small enterprises

As per new guidelines issued by the Ministry of MSME

## Executive summary

The Ministry of Micro, Small and Medium Enterprises (MSME) has revised its guidelines on the Performance and Credit Rating Scheme (PCRS) implemented by the National Small Industries Corporation (NSIC).

The guidelines now recommend evaluation of micro and small enterprises (MSEs) on three parameters. Each parameter will be assessed on an independent scale. These are:

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 both these parameters, namely, operating performance and financial strength

Till now, CRISIL used two scales for its assessment:

1. **NSIC-CRISIL:** Under this, we evaluated firms on two parameters – business performance and financial strength – that were measured on five- (1 to 5) and three- (A to C) point scales, respectively
2. **CRISIL SME:** Methodology for evaluating entities was similar but they were rated on an eight point scale

# 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.

Additionally, CRISIL micro and small enterprises (MSE) ratings may be assigned to all entities that request CRISIL for it, including medium-sized entities. The validity of the ratings 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, we recommend firms to seek a rating review. We also encourage entities to undergo an annual review of ratings as an outstanding rating shall enable them easier access to finance and help showcase their performance across various user segments.

All live ratings published can be accessed from our website.

**As for existing NSIC-CRISIL rating matrix, please refer to annexure.**

## CRISIL's revised MSE rating scale

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

### Overall rating

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

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**Financial strength**

Highest
High
Good
Above average
Average
Below average
Weak
Poor

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**Operating performance**

Highest
High
Average
Weak
Poor

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## **CRISIL's rating methodology**

CRISIL's analytical approach continues to be 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 various parameters are different.

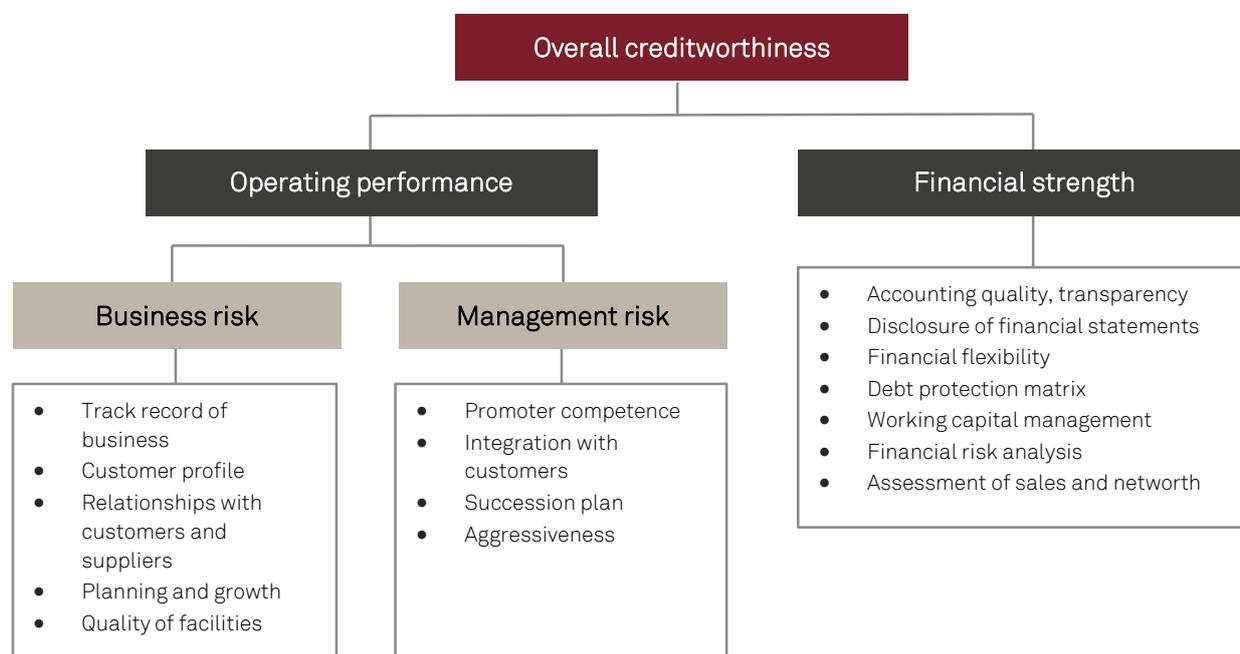
## **Operating performance**

CRISIL's methodology for assessing operating performance entails rigorous scrutiny of business and management risk.

# Ratings

## Business risk

CRISIL assesses the sustainability of a business plan and a firm's long-term viability by studying the track record of the business, the profiles of customers, the relationships with customers and suppliers, and level of infrastructure and technology in the business.



In order to assess an MSE's business risks, CRISIL understands from its promoters their business plans and growth strategies. Typically, MSEs are a part of the value chain of larger industries and are usually not in direct contact with the end-users.

Assessing the quality of an MSE's relationship with its key customers is critical, so CRISIL does this by contacting them directly.

To assess manufacturing facilities, CRISIL insists on a site visit by its analysts or business associates. We also contact key suppliers to assess the quality of their relationships with the MSE being rated.

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

## Feedback from stakeholders



## Management risk

For MSEs, management evaluation, which typically involves assessing promoter competence, is critical to the rating exercise. Unlike large corporates, which have several layers of professional managers, MSEs depend on the entrepreneurship and resourcefulness of their promoters.

We look at the past performance of a firm -- and group companies, if any -- when assessing the competence of its promoter, and his/her track record as an entrepreneur, which provide insights into his/her ability to successfully manage business cycles.

Additionally, a firm's ability to develop supply chain, integrate with customers and manage banking and labour relationships also provide critical inputs to the management evaluation process.

Most MSEs are managed by first-generation entrepreneurs so their continued presence is often crucial to the business. We believe factors such as the presence of a second-tier of management, a formal succession plan and high degree of professionalism are vital to long-term sustainability. CRISIL, therefore, critically assesses the organisational structure and the quality of systems and processes.

# Ratings

## Financial strength

MSEs are typically set up as proprietorships, partnerships or private limited companies. Those constituted as companies have to follow accounting standards prescribed by the Institute of Chartered Accountants of India (ICAI) and the Companies Act, 1956. CRISIL's experience suggests that firms where financial statements are governed by regulation are generally stronger in accounting quality, disclosure, and transparency.

CRISIL's financial risk analysis is based on disclosed statements. We assess size (sales and net worth), profitability, efficiency of capital and working capital management, and credit protection metrics such as interest coverage, debt service coverage, and cash accrual to debt ratios.

CRISIL uses proprietary spreadsheets developed specially for MSEs. 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 MSEs. 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 treated as quasi-equity when assessing MSEs.

CRISIL also evaluates financial flexibility by analysing the networth of promoter/s and relationships with banks.

## Overall rating/ creditworthiness

In order to assess the overall rating of an MSE, CRISIL takes into consideration its operating performance and financial strength. CRISIL believes these are critical to evaluating overall creditworthiness because they help ensure sustainability of business and ability to meet financial obligations in a timely manner.

## Conclusion

CRISIL has revised its criteria for rating MSEs in accordance with the PCRS guidelines of the Ministry of MSME that's implemented by the NSIC. Under the guidelines, the evaluation includes an assessment of operating performance, financial strength and overall creditworthiness. However, the methodology and broad assessment of key risks -- business, management and financial -- that were part of the CRISIL-NSIC framework, remain unchanged. The validity of the ratings shall continue to remain at one year from the date of publication.

## Annexure

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

## About CRISIL

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.

## About CRISIL Ratings

CRISIL Ratings is India's leading rating agency. We pioneered the concept of credit rating in India in 1987. With a tradition of independence, analytical rigour and innovation, we have a leadership position. We have rated over 95,000 entities, by far the largest number in India. We are a full-service rating agency. We rate the entire range of debt instruments: bank loans, certificates of deposit, commercial paper, non-convertible debentures, bank hybrid capital instruments, asset-backed securities, mortgage-backed securities, perpetual bonds, and partial guarantees. CRISIL sets the standards in every aspect of the credit rating business. We have instituted several innovations in India including rating municipal bonds, partially guaranteed instruments, microfinance institutions and voluntary organizations. We pioneered a globally unique and affordable rating service for Small and Medium Enterprises (SMEs). This has significantly expanded the market for ratings and is improving SMEs' access to affordable finance. We have an active outreach programme with issuers, investors and regulators to maintain a high level of transparency regarding our rating criteria and to disseminate our analytical insights and knowledge.

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