

# **CRISIL's rating methodology for micro and small enterprises (MSEs)**

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## Executive summary

CRISIL has been assigning ratings to micro, small and medium enterprises (MSMEs) since 2005, and has rated and assessed over 125,000 MSMEs to date.

The offerings include the 'NSIC-CRISIL Ratings', assigned to the micro and small enterprises (MSEs) under the Performance and Credit Rating Scheme (PCRS) of the National Small Industries Corporation (NSIC), and the 'CRISIL SME Ratings', assigned to small and medium enterprises (SMEs).

The MSE rating scale is as per the guidelines prescribed by the Ministry of Micro, Small and Medium Enterprises on the NSIC-PCRS.

Evaluation of MSEs is done on three parameters, each assessed on an independent scale. The parameters are:

1. Operating performance: A five-point scale to assess business risks such as technology, processes, customer, and management and industry
2. Financial strength: An eight-point scale to assess financial profitability, leverage, and liquidity risk
3. Overall creditworthiness: An eight-point scale that combines the first two parameters, namely, operating performance and financial strength.

Conforming to the revised guidelines issued by the MSME ministry in 2016, the signifiers used for operating performance, financial strength and overall performance and credit rating of MSEs are:

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

Financial strength	Operating performance
Highest	Highest
High	High
Good	Average
Above average	Weak
Average	Poor
Below average	
Weak	
Poor	

## Rating validity

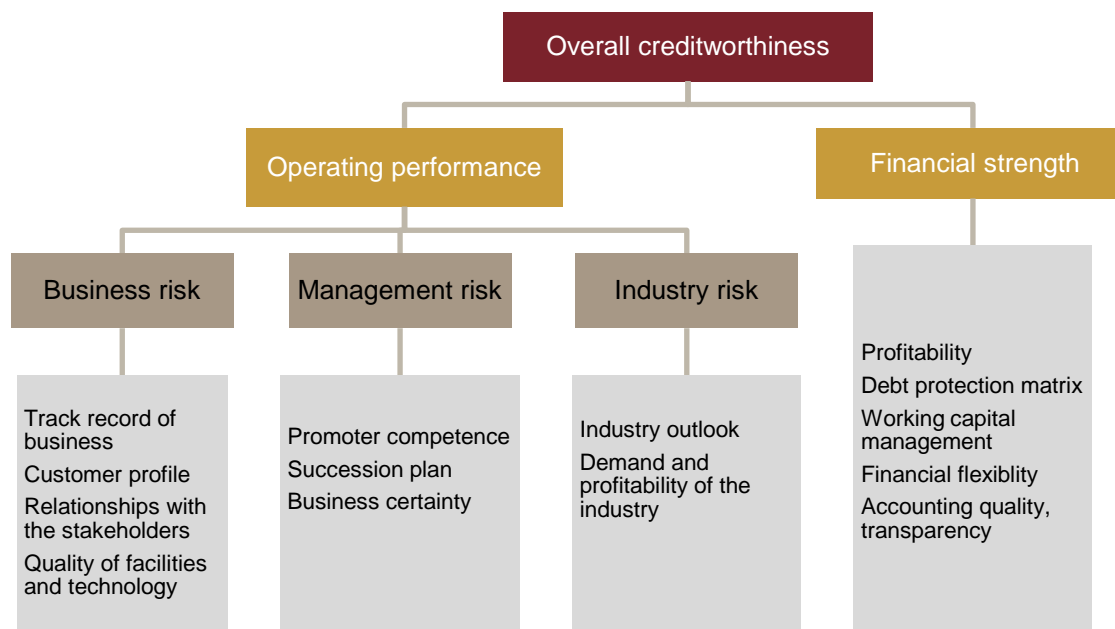
The validity of CRISIL MSE ratings is for one year from the report date, subject to no significant changes/events occurring during this period that could materially affect the business or financial parameters. It is a one-time exercise and is not kept under surveillance.

However, if such changes/events do take place, CRISIL recommends seeking 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 performance across various user segments.

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

## CRISIL's rating methodology for MSEs

CRISIL has evolved a robust framework for the credit assessment of MSEs, reflecting the learnings from analysing MSMEs 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.



### Business risk

To assess the business risk of an MSE, CRISIL ascertains the sustainability of the business plan and the entity's long-term viability. The evaluation factors the track record of the business, the quality of its customer profiles, relationships with customers and suppliers, geographical reach, customer base, product diversification, and infrastructure and technology in the business.

The process includes understanding from the promoters of an MSE their business plans and growth strategies.

Assessing the quality of an MSE's relationship with its key customers and suppliers is critical, too. 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.

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

MSEs are a part of larger industry value chains and face higher competition due to the presence of many players with limited pricing flexibility. It thus becomes crucial to understand their ability to control costs with the level of automation, quality of facilities and infrastructure.

To assess manufacturing facilities, CRISIL's analysts or business associates conduct site visits.

## **Management risk**

For assessing the management of an MSE, it is important to evaluate its promoters' competence. This is because, unlike large corporates that have several layers of professional management, MSEs depend on the entrepreneurship and resourcefulness of their promoters.

Hence, under management risk assessment, the promoters' track record in running a business successfully is an important element to assess.

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.

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

Most MSEs 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.

## **Industry risk**

MSEs have small scale of operations, are exposed to intense competition, and are vulnerable to business and economic cycles. They, however, form an integral part of the larger chain and are typically the tier-II and tier-III suppliers to large corporates. The growth and stability of these entities is largely dependent on the industry's prospects, including the demand and profitability of the sector.

## **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 MSE with prudent working capital management would be able to deal with stakeholders better and maintain comfortable liquidity. A good track record of working capital management is crucial to MSEs, 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 MSE.

CRISIL uses proprietary models developed for MSEs. The calculation of ratios is broadly along the same lines as that followed when assessing large corporates, but has 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 neither debt nor equity when assessing MSEs.

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

## Overall rating/creditworthiness

CRISIL takes into consideration the business and management performance, industry risk, and financial strength in order to assess the overall rating of an MSE. CRISIL believes these are critical to evaluating the overall creditworthiness, because these 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 MSE. This includes any related or unrelated diversification/expansion, sources of funding, project execution timeline and impact on the credit profile.

## Conclusion

CRISIL's criteria for rating MSEs are in accordance with the PCRS guidelines of the MSME ministry, implemented by the NSIC. The evaluation includes an assessment of operating performance, financial strength and overall creditworthiness. However, the methodology and broad assessment of key risks -- business, management, industry and financial -- are part of the CRISIL-MSE framework.

CRISIL's rating framework factors in the nuances such as MSEs' high susceptibility to business and economic cycles, and dependence on promoters. It includes robust metrics developed by CRISIL – backed by three decades of institutional intelligence in assessing credit – to evaluate management, business and financial risks.

## 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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