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CIMSME
Chamber of
Indian Micro Small & Medium Enterprises

CARE Ratings
Professional Risk Opinion

Message from

Mukesh Mohan

President, CIMSME

MSME is perhaps the biggest and most vibrant segment of the economy that drives creation of employment at the lowest cost. Similarly Banks with enormous capacity to finance the industry and trade play a very pivotal role in meeting the credit demands of a very large section of the enterprise. The strong bond that exists between the industry and banks, has been well understood and appreciated but seldom seen in proactive spirit. The growth of MSME sector has been phenomenal but for the support of the banks. This has been recognized and Chamber of Indian Micro Small and Medium Enterprises (CIMSME) is organizing MSME Banking Excellence Awards 2013 to recognize and showcase the exceptional performance of banks towards supporting MSME sector.

In this background CIMSME jointly with CARE Rating have come out with a Special Study on MSMEs showcasing their strength to withstand the economic slowdown, right size business plans , innovate and manage finances prudently. We hope that this study will give a bird's eye view of the strengths and opportunities facing the MSME segment and how rating could provide comfort to lenders. It also clears the myth that financing to SMEs is risky.

We appreciate the efforts of CARE Rating team and CIMSME for this empowering exercise.

We convey our best wishes.

Best Wishes

New Delhi
9th January 2014

Message from

D.R. Dogra

Managing Director and CEO, CARE Ratings

About the theme paper

Banking in SME segment requires a different approach not only because we need to reach out the wide spread entities across the country and manage a trade-off between growth & margins, but also the quality of advances has to be proper with a system of continuous monitoring of the large portfolio. Bank credit in this segment has grown at a Compounded Annual Growth Rate (CAGR) of 30% in last five years from FY08 to FY13. On the other hand, SME entrepreneurs faced market challenges due to many external factors including higher inflation and interest rates, volatility in foreign currency exchange rates and overall industrial slowdown.

The attached theme paper is based on studies conducted by CARE Ratings and CIMSME, which has tried to highlight the way in which the credit profiles of SMEs have moved during this period and how they have managed their business and financial profile. The studies also highlight the fact that Impaired Asset Ratio (IAR) is interestingly better in SME segment compared to large corporates. It also brings out a conclusion that higher rated SMEs have followed a better credit discipline and had relied less on the borrowings and managed their operating cycle efficiently.

I hope these studies will initiate a different thinking for those who believe SME lending is intrinsically riskier. I also believe wider acceptance of credit rating in this segment will further improve the quality of assets for banks. We convey our best wishes to the award winners as well as shortlisted banks setting benchmarks for banking in MSME segment.

Best Wishes

Higher Rated MSMEs stayed resilient amid adversity: CARE Study

Overview

Micro, Small & Medium Enterprises (MSMEs) have been playing a pivotal role in country's overall economic growth and have achieved sturdy progress over the last couple of years. However, at the present time, MSMEs have been hard hit by the global crisis. Further, on a domestic front as well the prolonged economic slowdown together with high inflation, rising lending rates and substantial depreciation of the domestic currency against all major foreign currencies are putting an extra burden on these small entities.

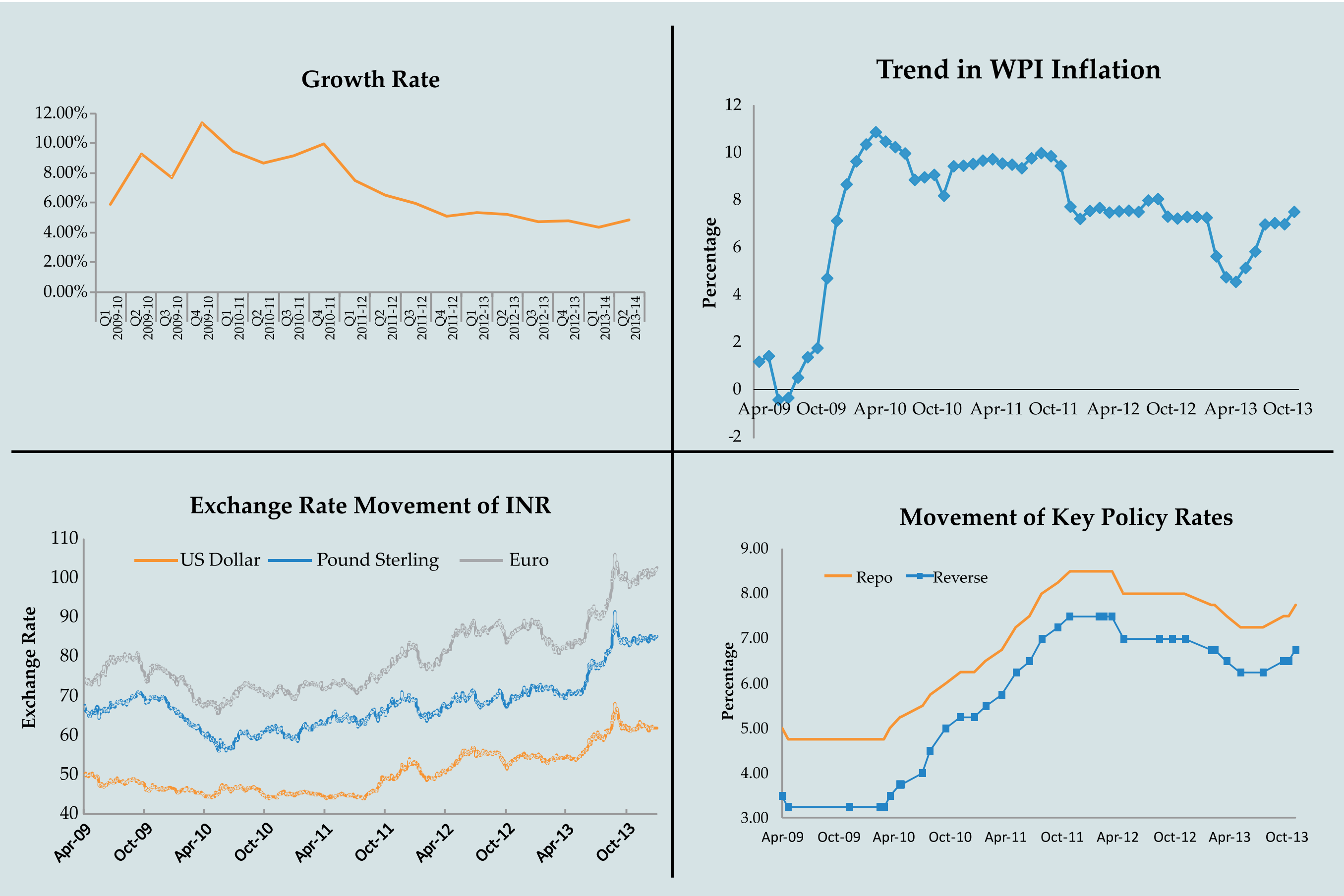


Figure 1; Source: Reserve Bank of India

In this tough time the key challenges that they face are:

- Difficulty in downsizing the business as they are already small;
- Less diversified;
- Have lower capitalization;
- Heavily dependent on credit;
- Fewer financing options and
- Many do not have credit rating.

Sample Selection and Scope of Study

With an objective to assess the financial impact of the ongoing economic turbulence on the MSMEs during the past four financial years ended FY13, CARE has undertaken this study.

The study covers the analysis of 550 CARE rated MSMEs which are operational for at least past four years and has total operating income (TOI) up to Rs.100 crore and total debt up to Rs.50 crore in the financial year ending FY13.

The study covers comparison of the key financial ratios of such entities within different rating categories and also analyses the trend of financial performance of MSMEs over the past four years ended FY13.

Sample Distribution

Out of total sample size of 550 CARE rated entities, 87% of the entities belong to manufacturing sector, 7% to service sector and rest 6% belong to the wholesale and retail trading activities. Further, 75% of entities fall under the sub-investment grade rating category (i.e. entities having credit rating of 'CARE BB+' and lower) while only 25% falls under the investment grade rating category (i.e. rated 'CARE BBB-' and higher).

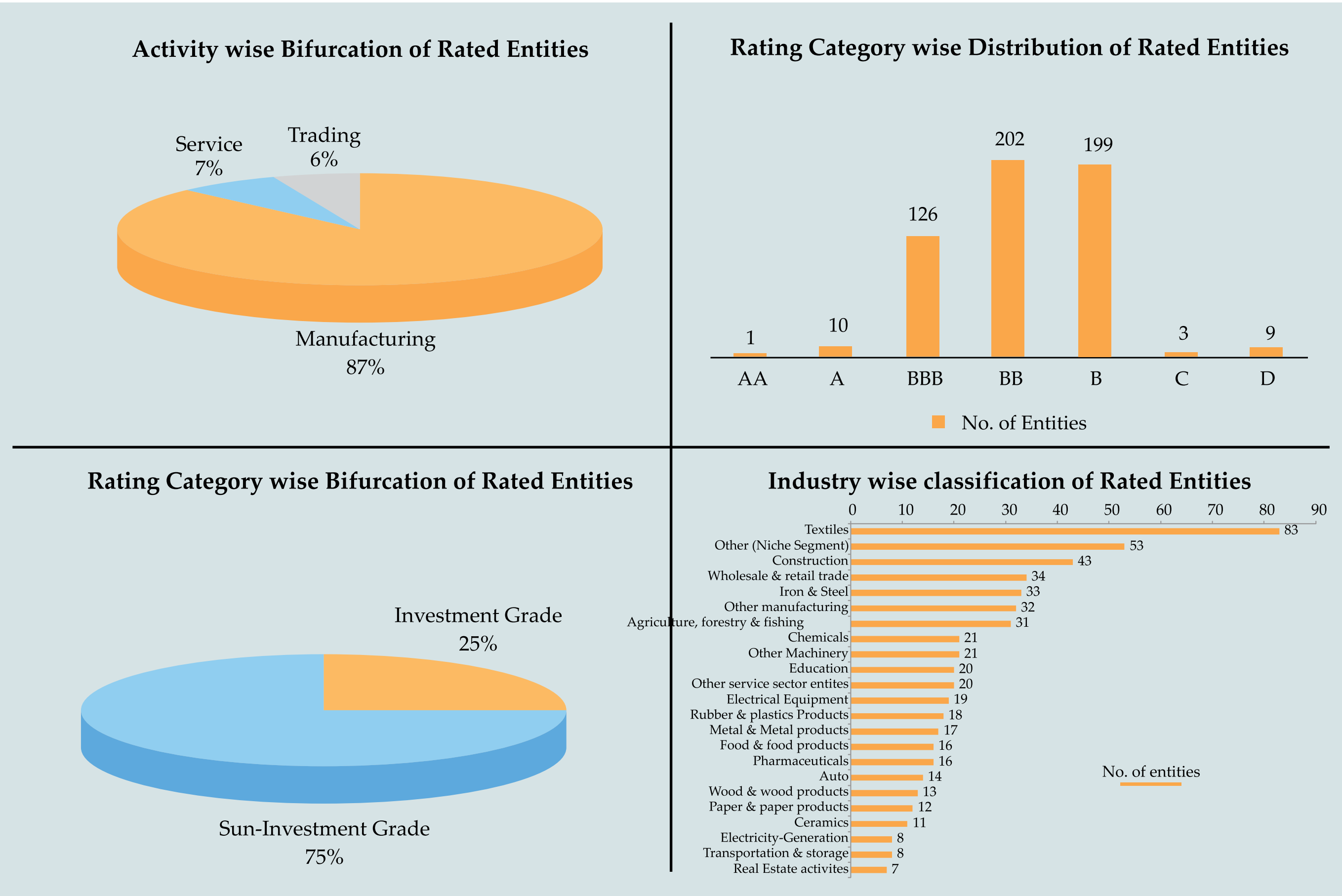


Figure: 2

MSME performance summary:

Exhibit 1: Aggregate Metrics by Rating Category

Financial Parameters/Rating category	Investment grade category					Sub-investment grade category				
Financial Year	FY10	FY11	FY12	FY13	Change	FY10	FY11	FY12	FY13	Change
	Aggregate Details									
TOI (Rs.Crore)	5,856	7,028	7,645	8,184	*12%*	11,394	14,734	17,174	18,624	*18%*
Total Debt (Rs.Crore)	2,344	2,742	2,679	2,611	*4%*	4,367	5,154	6,039	6,581	*15%*
Networth level (Rs.Crore)	2,966	3,528	4,130	4,668	*16%*	2,968	3,771	4,087	4,606	*16%*
Gross Asset Block (Rs.Crore)	4,581	5,220	5,351	5,828	*8%*	4,467	5,165	5,835	6,590	*14%*
	Median Ratios									
PBILDT Margin (%)	13.89	15.30	15.00	14.61	*72 bps*	7.36	7.73	8.12	7.84	*48 bps*
OPBT Margin (%)	7.20	7.90	7.56	6.11	*-109 bps*	1.58	1.55	1.56	1.50	*-9 bps*
APAT Margin (%)	5.91	5.78	5.29	4.84	*-107 bps*	1.13	1.17	1.18	1.10	*-3 bps*
Debt to Equity ratio (times)	0.25	0.31	0.26	0.25	*0 bps*	0.37	0.49	0.52	0.49	*12 bps*
Overall Gearing (times)	0.77	0.78	0.74	0.67	*-10 bps*	1.76	1.72	1.87	1.76	-
TDGCA (times)	3.00	3.25	3.00	2.90	*-10 bps*	8.19	8.73	9.04	9.08	*90 bps*
PBILDT to Total Debt (times)	0.48	0.44	0.49	0.45	*-2 bps*	0.21	0.22	0.22	0.23	*3 bps*
Interest Coverage (times)	4.74	4.90	4.35	3.83	*-91 bps*	2.10	2.11	1.95	1.97	*-13 bps*
Working Capital Borrowings/ NWC (times)	29	38	35	35	*6 %*	53	57	60	59	*6 %*
Working Capital Borrowings/Total Debt (times)	36	41	45	43	*7 %*	45	55	56	58	*14 %*
Gross Current Asset (days)	107	116	125	134	*27 days*	108	113	121	131	*23 days*
Operating Cycle (days)	56	68	81	77	*21 days*	65	72	80	84	*19 days*

Exhibit 1 presents the changes in the key financial parameters over the past four years ended on FY13 for sample entities having investment grade and sub-investment grade ratings.

Key Findings:

➢ Decent Growth in the Total Operating Income but decline in the net profit margins

It is interesting to observe that growth of sub-investment grade entities was more than investment grade entities. While the aggregate income of all the entities having investment grade ratings grew at a Compounded Annual Growth Rate (CAGR) of 12% during FY10-FY13, the entities having sub-investment grade rating reported a decent CAGR of 18% over the same duration.

On the profitability front, there has been improvement in PBILDT margins of both investment grade entities as well as sub-investment grade entities, however the volatile foreign exchanges rates and high interest rates seems to have take a toll on the operating profit before tax margin and the net profit margin.

➢ Consistent increase in the working capital requirements at a time when interest rates are also at an elevated level

All the MSME entities in the sample, irrespective of rating band, have been severely affected on liquidity front. Majority of the MSMEs are procuring material from large suppliers which extends shorter credit period and in many cases, they ask for the advance payment or payment on delivery basis. However, on the other hand, MSMEs are required to extend longer credit to their customers due to their lower bargaining power. Further, majority of them are operating in a fragmented and highly competitive industry where the product differentiation is very low. Thus, in many cases, MSMEs try to attract its potential customers by way of offering longer credit period.

The study also shows that the working capital intensity has increased during FY10-FY13 as reflected by deterioration in operating cycle by 21 days for investment grade entities and 19 days for sub-investment grade due to the elongated inventory holding and receivables period. Increased scale of operations coupled with elongated operating cycle had a multiplier effect on the working capital requirements of MSMEs. Furthermore, consequent to the increase in the lending rates by the banks over the past four years, the borrowing cost has also gone up. Hence, the critical issue for such MSMEs was to decide the source of financing to fund the growing working capital requirement.

➢ Investment grade entities managed their liquidity efficiently

It was observed that due to higher capitalization level and comparatively better cash flows, the investment grade entities have managed to fund majority of their incremental working capital requirements through internal accruals and accumulated reserves as against the sub-investment grade entities having low capitalization and thin profitability. This can be seen from a comfortable and consistently lower median W.C Borrowing/NWC ratio of 35% as against 59% for the sub-investment grade entities.

While on one hand, the investment grade entities managed to restrict the excessive use of working capital borrowings as reflected by the proportion of working capital borrowings in the total debt of 43% in FY13. On the other hand, the proportion of working capital borrowings in the total debt has rapidly increased from 45% in FY10 to 58% in FY13 for the sub-investment grade entities on account of their heavy dependence on the bank borrowings to fund the incremental working capital requirements.

➢ Investment grade entities were able to maintain better capital structure

Despite the challenging macro-economic environment, the majority of the investment grade entities have managed to maintain comfortable capital structure by way of going-slow as far as new capex plans are concerned. During FY10-FY13, the CAGR of the new asset additions on an aggregate level has remained modest at 8% as against 14% in case of sub-investment grade entities. It seems that, rather than going for major expansion in the uncertain times, investment grade entities have chosen to invest the cash flows to reduce the dependence on the debt to the extent possible. Hence, over the past four financial years ending FY13, the median gearing ratio stood comfortable at 0.67 for investment grade entities as against 1.76 times for sub-investment grade entities.

➢ Sub-investment grade entities have weak debt servicing capacity

The study reflects that the debt coverage indicators of the sub-investment grade entities have worsened in past four years as reflected by the median total debt to gross cash accrual ratio of 9.08 times as against 2.90 times for the investment grade entities. Further, the interest coverage ratio has also deteriorated over the past four years making sub-investment grade entities more vulnerable to any further weakness.

Exhibit 2: Aggregate Metrics by Rating Category

	Median Ratios for FY13			
Financial Parameters/Rating category	Investment grade		Sub-investment grade	
	A	BBB	BB	B
PBILDT Margin (%)	30.73	13.77	8.62	6.68
OPBT Margin (%)	18.50	5.40	2.27	0.99
APAT Margin (%)	13.42	4.57	1.73	0.77
Debt to Equity ratio (times)	0.06	0.29	0.48	0.51
Overall Gearing (times)	0.10	0.74	1.59	2.21
TDGCA (times)	0.54	3.19	6.86	12.54
PBILDT to Total Debt (times)	1.23	0.43	0.26	0.20
Interest Coverage (times)	15.74	3.62	2.19	1.73
Working Capital Borrowings/ NWC (%)	-	38	56	62
Working Capital Borrowings/ Total Debt (%)	7	45	53	62
Gross Current Asset (days)	162	135	138	129
Operating Cycle (days)	84	78	83	86

Exhibit 2 presents the median ratios of sample entities falling under the investment grade category and sub-investment category for the year ended FY13.

➢ High rated entities managed to maintain better financial profile

It is observed that, despite the weaker macro-economic scenario the investment grade entities have reported a healthy profitability margins during FY13. Their solvency position as reflected by the median long term debt/ equity ratio and median gearing ratio has also remained very strong as on March 31, 2013 as against non-investment grade entities. It is very much evident from the median interest coverage ratio that lower rated entities have comparatively much lower level of operating profits available to them to cover the interest obligations as compared to higher rated entities and hence any further increase in the interest cost or decline in operating profits could challenge their ability to serve the debt obligations on time.

Higher Rated SMEs demonstrated better credit discipline

CARE had undertaken a default study for Micro and Small Enterprises (MSEs) Rating for FY13. CARE undertook the study of its clients (rated during April 01, 2012 to March 31, 2013 period) to assess the impact of the economic situation to CARE rated MSE entities.

MSE rating scales are two dimensional in nature and covers performance capability (measured on a scale of 1to 5) and financial strength (measured on a three point scale A, B & C) rating on separate scales.

NSIC-CARE MSE Rating Scale & Definitions

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

It was observed that in spite of a challenging economic environment, CARE experienced no corporate defaults during this period from the highest rating categories on financial strength indicators viz. SE 1A, SE 2A … SE 5A. However, there was a clear trend of increasing default rate among the lower financial strength rating categories. The following table shows the analysis of each default vis-à-vis the rating category on both the scales. Only those rating categories are mentioned from which the default happened. For all the other categories, no default was reported.

Rating	Total	NPA	Restructured	Total Defaults	Default Rate
2B	155	3	1	4	2.6%
3B	289	4	7	11	3.8%
2C & 3C	121	24	6	30	24.8%
4C	27	7	6	13	48.2%
5C	6	5	1	6	100.0%

It was observed that the default rate had shown ordinality with an increasing trend once it moves lower down the rating category, thereby indicating better creditworthiness of higher rated entities compared with the lower ones. Thus banks, can take help of such credit ratings in order to have an idea of the current credit profile of an entity and take appropriate measures to reduce NPAs.

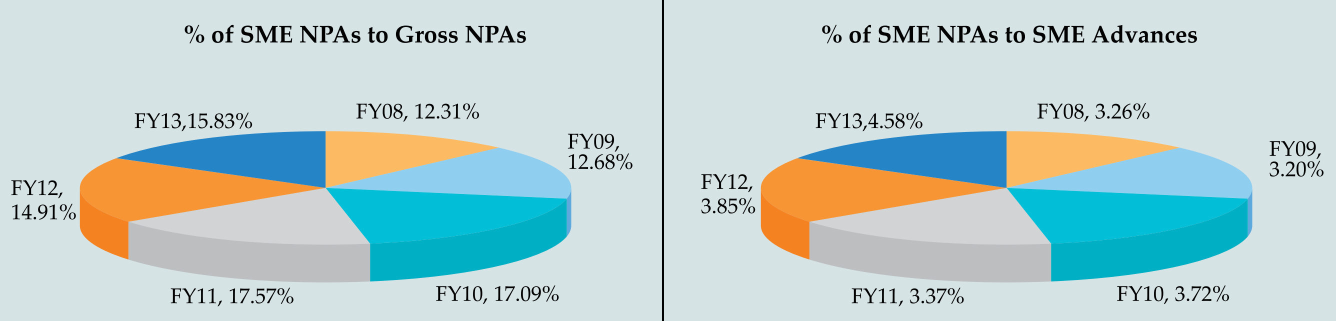
Is SME lending too risky?: CARE Study

In a separate study, CARE tried to analyze from the various data sources for the period FY08-FY12, which have been sourced from RBI's annual bank studies whereas for FY13, CARE has gathered from Annual Accounts of 37 banks (i.e. 21 public sector banks and 16 private sector banks, which are most active in SME lending). Further, some data is sourced from presentations of senior RBI officials at various forums. The analysis of this figures provided enlightening facts, which may be of interest to lending banks which are not yet active / aggressive in SME business.

Measuring credit quality

Credit quality of the segment can be measured by the level of Non-Performing Assets (NPA) in the segment, proportion of restructuring of business loans and impaired asset ratio. Impaired assets, in banking, applies to all problem assets which banks hold, and is not limited to problem loans. In addition to loans, it also captures off-balance sheet exposures and assets which have come onto bank's balance sheets through enforcement of security conditions. Impaired assets ratio (IAR) refers to {Gross NPA+ Restructured Standard Advances+ Cumulative write off}/ {Total Advances + Cumulative write off}.Thus, it is the impaired assets ratio is a better indicator of advances to a particular segment.

Small proportion in total banking NPA

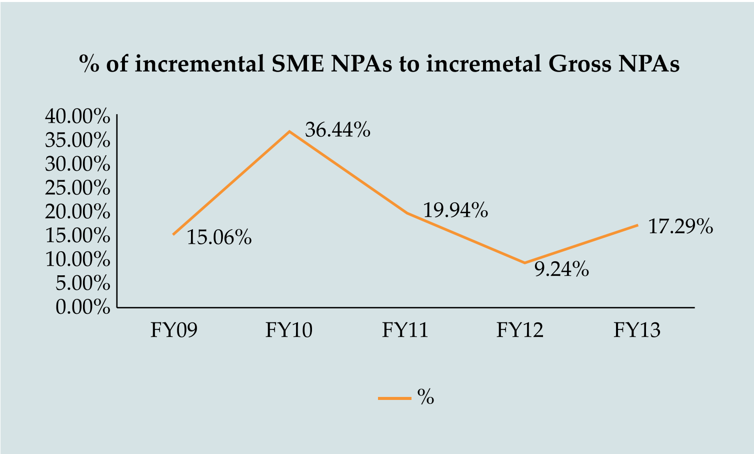


It can be noted from the aforesaid chart, that the composition of SME NPAs in Gross NPAs has been fluctuating over the aforesaid period. The same has continuously increased from FY08-FY11, improved in FY12 and has again deteriorated in FY13 reflecting the sluggish growth of the domestic economy impacting the SME segment. The Indian economy grew 5% in FY13, the slowest pace in a decade, as high borrowing costs forced companies to put fresh investments on hold and consumers to cut spending. Delays in securing mandatory government approvals and problems in land acquisition have stalled many big ticket projects, stopping the cash flows of companies and dented their ability to repay debt. This has led to increase in NPAs in banks in the recent time which is more so in case of the SME sector.

It can be seen from the aforesaid chart, that the composition of SME NPAs in SME Advances has fluctuated over the aforesaid period. The same has continuously deteriorated in the last three years (i.e. FY11 to FY13) mainly due to deterioration in the financial risk profile of SMEs both on account of sluggish growth being witnessed in the western economies (i.e. US & Europe) in addition to sluggish growth being witnessed in India.

Lesser incremental NPA

The graph showing the percentage of incremental SME NPAs to incremental Gross NPAs over FY09-FY13 has been covered below.



The graph reflects that the percentage of yearly increase in SME NPAs to Gross NPAs has been fluctuating over the period with major increase in FY10, caused more as an after-effect of the US financial crisis in October, 2008 affecting the domestic export market catered largely by SMEs resulting in the deterioration in its credit profile. The same had started improving thereafter, but it has again deteriorated sharply in FY13 more on account of the sluggish domestic economy resulting in weakening credit profile of SMEs.

Low restructured accounts in SME segment

While the NPA growth rate are higher in this segment, if one reckons the extent of restructuring and write-offs that are resorted to the large corporate segment, the credit risk would appear to be much lower in the SME segment. According to RBI, there has been a 52% jump in the restructured loan amount under the CDR (corporate debt restructuring) scheme in FY13 to Rs.2,29,000 crore from Rs.1,50,500 crore in FY12, which majorly comprised of large corporate entities. Further, two comparative tables indicating the extent of NPAs, restructuring and write-offs in SME vis-à-vis large corporates during last five years given below, also suggests that in the recent scenario of rising impairment of assets in the banking sector, it is the SMEs that have demonstrated better credit discipline.

Restructuring in SME Segment (in per cent)

Segment	FY09	FY10	FY11	FY12	FY13
SME	2.99	2.67	2.05	1.69	1.68
Large Corporates	4.80	6.39	5.04	7.52	9.80

** Figures Represent Restructured Standard Advances / Total Gross Advances*

It can be observed from the aforesaid table that the percentage of restructuring out of total gross advances in the SME segment has continuously declined over the aforesaid period, while the same for the large corporates has been fluctuating with continuous increase over the last three years. Further, the percentage is also much higher for the larger corporates as compared to the SMEs. This reflects the fact that the credit profile of large corporates has also deteriorated and at a much higher rate as compared to SMEs.

Significantly better IAR in SME segment

Impaired Assets Ratio (in per cent)					
Segment	**FY09**	**FY10**	**FY11**	**FY12**	**FY13**
SME	10.7	10.6	9.4	9.7	10.6
Large Corporates	7.8	9.4	8.0	11.2	14.8

It can be noted from the aforesaid table that the impaired assets ratio (IAR) i.e. all the problem assets which the banks are holding, is much lower for the SME segment as compared to the large corporates over the past two years. Impaired assets ratio has been higher for the SME segment as compared to the large corporates during FY09-FY11; however, the trend has reversed during FY12-FY13. Hence, one can conclude that in the last two years it is the SMEs that had a better credit profile as compared to the large corporates and has shown better financial discipline

Conclusion

Given the level of financial discipline demonstrated as compared to the large corporates and the extent of financial exclusion in the SME sector apart from the importance of the sector for the overall economy, banks need to urgently step up lending to the sector. For evaluating loan proposals and for facilitating SME financing, banks need to employ low cost and quick decision making alternatives which would help accelerate credit flow to this sector. It is increasingly being recognised by the policy makers that if India has to regain its high growth trajectory, it needs a vibrant SME sector.

About CARE Ratings

- One of India's leading Credit Rating Agencies
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- Registered with SEBI under the Securities & Exchange Board of India (Credit Rating Agencies) Regulations, 1999
- ECAI Recognition by RBI for Basel II implementation.
- Majority shareholding by leading public sector banks
- Rating volume of debt of around Rs.52,443bn (as on September 30, 2013)

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  Bank Loan Ratings

  NSIC-CARE Performance & Credit Rating for MSEs

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- Channel Partner Evaluation
- Verification Services
- SME Digest - Publication

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- MoU with leading banks for rating of their MSME clientele

Notes