"Value Proposition and SME Competitiveness through Enterprise Ratings – Recent Indian Experience with particular reference to SMERA"

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Abstract

SMEs contribution to India's economy can hardly be over emphasised. From being the second largest provider of employment to enabling geographical spread of enterprises, they are the key to sustain India's ambitious growth targets. There are certain areas of concern which the SMEs are beset with, the availability of 'timely' and 'adequate' flow of credit being one of them. Added to that, because of the risks 'perceived' to be associated with the sector, the 'pricing' is an issue. With a large percentage of small enterprises still being in the domain of 'proprietorship' or 'partnership', there is often lack of reliable structured information. This results in information asymmetry which affects credit quality. India has recently undertaken a number of initiatives to overcome these constraints including creation of institutional infrastructure for information (Credit Information Bureau of India Ltd.) and rating for SMEs (SME Rating Agency of India Ltd.), the objective being to bring out the intrinsic strengths of the enterprises to help banks take informed credit decisions. This is helping the SMEs to negotiate with the banks for quality credit and the system has positively responded to this. The impact has started to percolate and ranges from softer credit terms to enhanced credit limits. With the 'demonstration effect' taking over, the rating is getting more and more acceptability from the banking system and the SMEs alike. The SMEs, by embracing transparency and getting their enterprises rated are able to get better deals from the banks. This value proposition of transparency offered by SME Rating Agency of India Ltd is contributing to the competitive advantage of SMEs.

Key words - SSIs (Small Scale Industries), Small & Medium Enterprises (SMEs), Competitiveness, SME Rating

I

Introduction

Small and Medium Enterprises (SMEs) have played an important role in economic progress and 'are the backbone of many successful developed nations'(RAM Consultancy Services Sdn Bhd, July 2005). The Bologna Charter on SME Policies adopted on 15 June 2000 by OECD countries recognised "the increasing importance of Small and Medium sized Enterprises (SMEs) in economic growth, job creation, regional and local development and social cohesion". It also recognised "that entrepreneurship and a dynamic SME sector are important for restructuring economies and for combating poverty". "While SMEs' share in total economic activity varies across countries, they play a significant role in virtually all economies and represent

[1]Views are personal and may not necessarily be that of the organisation the author represents.

a large segment of the private sector. In low-income countries with GNP per capita between $100 and $500, SMEs account for over 60 percent of GDP and 70 percent of total employment; in middle-income countries they produce close to 70 percent of GDP and 95 percent of total employment"(Fan, Criscuolo, Ilieva-Hamel). "SMEs are an essential source of jobs, create entrepreneurial spirit and innovation in the EU and are thus crucial for fostering competitiveness and employment" (Verheugen Gunter, July 2005)[2]. At the same time, SMEs face a number of disadvantages due to their small size of operations including high overheads (absence of economy of scale), high fixed costs for accessing marketing information and markets (lack of market access), difficulties in arranging financing etc. Product innovation is in the end of priority list of entrepreneurs owing to difficulties in dedicating resources to research and development.

India is no different - Small and Medium Enterprises (SMEs) significantly contribute to Exports and add value to domestic supply chains, employment generation, expansion of entrepreneurial base and diversification of the industrial sector. With a view to building a sound industrial base and a strong village and cottage industry sector, Govt of India, shortly after independence, announced an Industrial Policy during 1948. Over the last over five decades, Government policies have been formulated to develop a framework for the development of cottage, tiny and modern Small Scale Industries (SSI). With a view to determining the types of industrial units which needed special support, it was considered necessary to develop an appropriate classificatory definition for SSI units under the Industries (Development and Regulation) Act, 1951. The first official definition of SSI was coined though, in 1950, in terms of the size of gross investment in fixed assets (plant & machinery, land, building) as well as the strength of the workforce in the unit concerned[3]. Over the years, this classification has undergone several changes and as things stand today, the SSI[4] sector is defined in terms of its investment in Plant and Machinery upto INR 10 million.

The SSI sector in India covers a wide spectrum of industries categorised under small, tiny and cottage segments ranging from small artisans / handicraft units to modern hi-tech units with significant investments. This acts as 'nursery' for the development of entrepreneurial talent and produces a wide range of over 7500 products. The Small Scale Industries sector alone accounts for around 95 per cent of Industrial units, over 40 per cent of manufacturing sector output, 36 per cent of exports and provides direct employment to over 28.3 million persons[5]! In absolute terms, about 1.2 billion SSI units give production output of Rs.4712 billion at current prices during 2005-06. The performance of SSI sector over last 10 years is given in Table 1.

Table 1 : Performance of SSI sector in India

Year	Units (million)	Production		Employment (million)	SSI Exports	
		At 1993-94 prices (Rs.billion)	At current prices (Rs. billion)		Rs. billion	US $ million
1993-94	7.65	987.96	987.96	18.26	253.07	8,068
1994-95	7.96	1087.74	1221.54	19.14	290.68	9,258

[2]Vice-President of the European Commission, Responsible for Enterprise & Industry

[3]SIDBI Report on Small Scale Industries Sector, 1999

[4]In India, till 2005, small enterprises were referred to as Small Scale Indstries. SME is a recent phenomenon. Recently, Indian Parliament have enacted a comprehensive Micro, Small & Medium Enterprises Act [MSMED], 2006 which defines Small Scale Industries in manufacturing sector as industries having investment in Plant and Machinery upto INR 50 million and pegs the same for SMEs at INR 100 million.

[5]16th Annual Report, SIDBI, 2005-06

1995-96	8.28	1211.75	1477.12	19.79	364.70	10,903
1996-97	8.62	1348.92	1678.05	20.59	392.48	11,056
1997-98	8.97	1462.63	1872.17	21.32	444.42	11,958
1998-99	9.34	1575.25	2104.54	22.06	489.79	11,642
1999-00	9.72	1703.79	2337.60	22.91	542.00	12,508
2000-01	10.11	1844.01	2612.97	23.91	697.97	15,278
2001-02	10.52	1956.13	2822.70	24.91	712.44	14,938
2002-03	10.95	2106.36	3119.93	26.01	860.13	17,773
2003-04	11.4	2287.30	3577.33	27.14	976.44	
2004-05	11.86	2490.64	4124.50	28.29	1,244.17	
2005-06[p]	12.34	2755.81	4712.44	29.49	n.a.	

Source : Ministry of Small Scale Industries, Govt. Of India; p-provisional

A combination of desk research and primary research in terms of collecting information on benefits of ‘enterprise ratings’ from SME units was employed for this paper. This paper is organised into six sections. While Section I details the contribution of SMEs across countries, Section II presents the competitiveness of SMEs and analyses parameters of competitiveness. It deals with the importance of credit for SMEs and presents the dichotomy of share of SME credit in Net Bank Credit vis-a-vis their increasing contribution to GDP. Section III deals with the SME financing and role of information and and Section IV deals with measures to bridge the information gap. Section V details the perspective of SME Rating Agency of India Ltd and its role in contributing to value proposition and competitiveness in SMEs. Section VI offers concluding remarks.

II

Competitiveness and Credit to SSIs

‘Competitive advantages, which must be measured in relation to rivals in markets, are determined by how efficient and effective the prevailing markets for products, labor and capital are. Entrepreneurship capacity refers to the introduction of new productive combinations and innovations acting as driving forces, which continually create new competitive advantages and opportunities for profit and growth’ (UNCTAD 2004). Korean SME Agency notes that, “...enhancing the competitiveness of all SMEs is vital to the objective of increasing national competitive power”[6]. Meyer-Stamer (1995) concurs with the view that competitiveness is created at the firm level, but that it is partly derived from a systemic context. Since an enterprise does not produce in a vacuum, its competitiveness can only be measured within various types of market territories at the subnational, national and supra-national levels (UNCTAD 2004). Metcalf, Ramlogan and Uyarra (2003) maintain that competitiveness is embodied in the characteristics of the firm, namely through (a) efficiency and effectiveness of the use of resources, (b) willingness and ability to relate profitability to growth of capacity through continued investment and (c) ability to innovate in technology and organization and thus improve efficiency and effectiveness of production.

Availability of quality credit is a very critical component for competitiveness of firms, be it for enhancing efficiency by technology upgradation or investing in innovation efforts. The “Istanbul Ministerial declaration on fostering the growth of innovative and internationally competitive SMEs” reaffirmed the need to support the development of the best set of public policies that will foster the creation and rapid growth of innovative SMEs. It recognised “the need to improve access to financing for SMEs on reasonable terms. While SMEs financing requirements differ at each stage of their development, policies should aim to ensure that markets

[6]Annual Competitiveness Report, 1998 : SME performance ; National Competitiveness Council, Ireland.

can provide financing for credit-worthy SMEs and that innovative SMEs with good growth prospects have access to appropriately structured risk capital at all stages of their development".

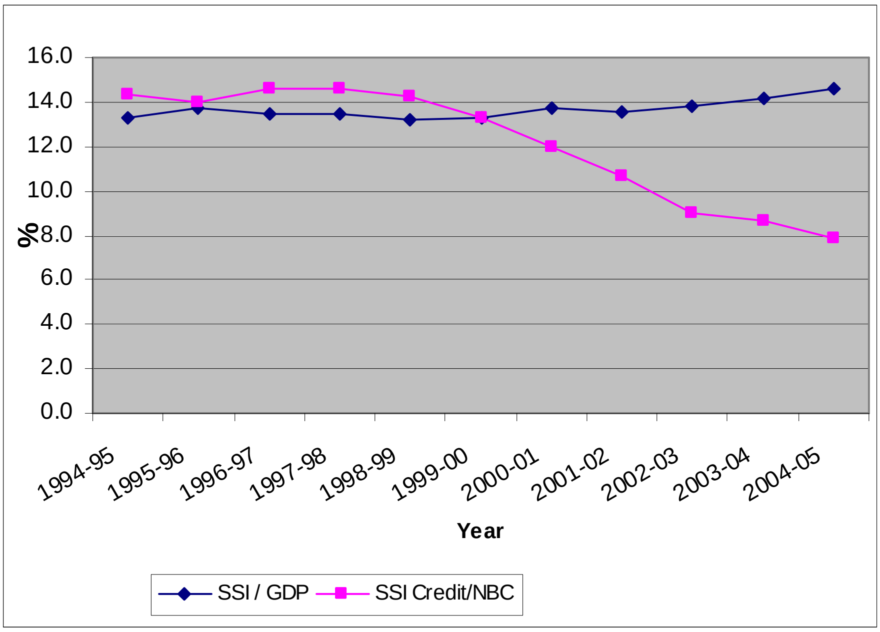
Availability of "timely" and "adequate" finance is "sine-qua-non" to the healthy growth of any sector and SME sector in India is no exception. The Reserve Bank of India 'Report on Trend and Progress of Banking in India, 2004-05' (p.208) summarises the status of credit flow to the SMEs by putting it as "while the credit to agriculture has tended to move upwards, lending to SMEs has stagnated. This could possibly be due to the perception of higher levels of risk in the sector. Financing the growth of a healthy SME sector is essential for the future sustained growth of the economy". Statistically put, in India, while the share of Small Scale Industries to the GDP has grown over the years, its share in the Net Bank Credit (NBC) has come down from 14.4 per cent in 1994-95 to 7.8 per cent in 2004-05. The percentage contribution of SSI output to GDP and the credit to SSI as a percentage of net bank credit are given in Table 2.

Table 2 : SSI output vs. Credit to SSI

Financial Year	SSI output/GDP	Credit to SSI/NBC*
1995	13.3	14.4
1996	13.8	14.0
1997	13.5	14.6
1998	13.5	14.6
1999	13.2	14.3
2000	13.3	13.3
2001	13.7	12.0
2002	13.6	10.7
2003	13.8	9.0
2004	14.2	8.6
2005	14.6	7.8

*Source - Trend & Progress of Banking in India, RBI

Graph 1 : SSI output vs. Credit to SSI



"As per the Government of India's tenth Five Year Plan (2002-2007), achieving and sustaining high rate of growth and employment will require a sharp step-up in industrial and services growth, spurred by Small & Medium Enterprises which have greatest potential to provide high wage employment"[7]. With a view to obliterate the anomaly of output vs credit availability to SMEs and give a thrust to their overall development, Government of India announced a comprehensive policy package to address the supply side of credit. The policy summarised the problems faced by the SMEs as the following[8] :

1. Small and medium enterprises (SME), particularly the tiny segment of the small enterprises, have inadequate access to finance due to lack of financial information and non-formal business practices. SMEs also lack access to private equity and venture capital and have a very limited access to secondary market instruments.
2. SMEs face fragmented markets in respect of their inputs as well as products and are vulnerable to market fluctuations.
3. SMEs lack easy access to interstate and international markets.
4. The access of SMEs to technology and product innovations is also limited. There is lack of awareness of global best practices.
5. SMEs face considerable delays in the settlement of dues/payment of bills by the large buyers.

Having outlined the diagnosis, the policy envisaged to put in place an enabling framework for meeting the objective of enhancing the flow of credit to SMEs. The policy adds, "with the deregulation of the financial sector, the ability of the banks to service the credit requirements of the SME sector depends on the underlying transaction costs, efficient recovery processes and available security. There is an immediate need for the banking sector to focus on credit and finance requirements of SMEs. Public Sector Banks will be advised to fix their own targets for funding SMEs in order to achieve a minimum 20% year-on-year growth in credit to the SME sector. The objective is to double share of SME credit from the current level of Rs. 6760

[7] Annual Report, SIDBI, 2005, 2006

[8] Policy Package for stepping up credit to small and medium enterprises, Govt of India, 2005

billion in 2004-05 to Rs.13,000 billion to the SME sector by 2009-10, i.e. within a period of five years.”. Taking the policy forward, recently, the Indian Parliament has enacted a legislation viz. “The Micro, Small and Medium Enterprises Development Bill 2006” which has clearly defined these enterprises including those in the business of services and advocated suitable policy measures.

III
SME financing and role of information

SMEs depend on various sources of finance ranging from internal accruals to capital markets depending upon the need, size of operations and market sophistication. However, quite a number of SMEs, because of structural issues, either donot have sufficient internal accruals or quite a few are in a position to approach capital market for their financing needs. Thus, Bank financing remains as the most important source of funding for SMEs.

However, while the importance of SME sector in the economic growth of India is well established, because of their heterogeneous nature, with units ranging from micro enterprises to high end hi-tech manufacturing units, their assessment processes by the lenders becomes a complex one. This has a bearing on credit delivery in terms of timeliness and adequacy. One of the perceived reasons of bankers not preferring credit to SME sector could be lack of credible information on the state of affairs of the SME units. Due to asymmetry of information which is on account of the fact that the strength of units do not reflect properly, pricing gets affected and this also tends to make the lenders conservative.

One of the key ingredients for availability of funds to the SME sector is the availability of authentic information about individual business entities which helps in objectively analysing the merits of individual proposals. “[9]This becomes evident when one considers the credit and equity market performance in countries having superior information infrastructure and contrast it with those that lack a suitable mechanism for capturing and sharing information. As was observed in a study published by the National Bureau of Economic Research in the US, private credit to GDP in the US stood at about 1.46, while in the UK, the ration stood at 1.4. The information collating and disseminating mechanisms in these countries are well established. However, in countries like Bangladesh, Indonesia, Oman and India, private capital to GDP ratio is less than 0.5 (Bangladesh 0.26, Indonesia 0.2, Oman 0.4 and India 0.3) where the information infrastructure is rudimentary. This seems to suggest a strong relation between credit penetration and the presence of a robust information infrastructure in a country.”

IV
Bridging the information gap : The Rating route

The banks subdued enthusiasm in lending to the SMEs is for a number of reasons, most prominent being, the information asymmetry that arises from small businesses' lack of financial information and standardised financial statements, in addition to the bank's limited knowledge about the borrower company. In this context, there did exist a need for independent third party credible assessment of SME units, upon which Banks can rely and base their decisions. While, Credit Information Bureau of India Limited [CIBIL] had been set up to build up a data base of borrowers including SME borrowers, there existed a void in compiling the information and rate the creditworthiness of SME borrowers which would enhance the comfort level of individual bankers. The foremost advantage of enterprise ratings for SMEs is that, it can induce transparency within SMEs. Though at the face of it, it is going to help the SMEs access bank finance at easier terms, it can also address the issue of equity access and other sources of financing for SMEs.

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[9]Vaish, Manoj Dr., SMEs in stock exchanges, BSE Annual Capital Market Review, 2005

DP Information Group (DP Info), Singapore's leading provider of credit and business information services has made several recommendations[10] to help companies stay competitive and improve their efficiency. The recommendations, *inter alia*, included:

- SME Credit Rating – SMEs should be encouraged to get an annual credit rating. Credit Rating can also be a differentiating factor to help companies expand into new markets and improve their competitiveness.

- Technology Adoption and Automation - SMEs must leverage technology and where possible automate processes. One possible approach is to form a partnership with leading technology companies to assist SMEs as a group in their expansion plans.

- Innovation –DP Info recommends the introduction of the concept of cluster development to offer new insights into the potential roles of SMEs in enhancing their access to new technology.

In India, in order to overcome the information asymmetry which affects the flow of credit to SMEs, creation of an independent agency to provide comprehensive & credible information to the lending institutions was envisaged. Towards creating a formal institutional infrastructure for the same, an independent rating agency for the SME sector viz. SME Rating Agency of India Ltd. [SMERA] has been promoted by SIDBI, Dun and Bradstreet Information Services India Private Limited [D&B], CIBIL, several public and private sector Banks. The broad objective of SMERA is to fill the information gap for SMEs through 'ratings and other information' which would help them, *inter alia*, to get quality credit at better terms and build capacity in the sector. SMERA is already operational with its registered office at Mumbai. The authorised share capital of SMERA is INR 1,00 million and the initial paid up capital is INR 50 million. The ratings provided by SMERA are in the form of comprehensive assessment of the overall condition of the SMEs. The ratings take into account the financial condition and several qualitative factors that have bearing on creditworthiness of the SME. As part of the rating process, an in-depth due diligence exercise is carried out which takes into account various qualitative factors having a bearing on the SME's performance. These factors, *inter alia*, include, management quality, business plan, business environment, market standing, dependency on suppliers, quality of customers etc. SMERA has been rating SME units, as an enterprise on an 8 point scale, in 4 categories depending on their net worth size, to enable a fair peer evaluation possible.

The independent, third party ratings obtained from a professional credit rating agency like SMERA is expected to not only help SMEs in getting credit from banking sector at favorable terms, but also assist them in trade and commerce, both domestic and international. The benefits out of interventions from SMERA, performed and perceived are as under :

1. Enhancing the flow of fair priced funds to SMEs from the banking sector,
2. Enable SMEs negotiate better credit terms from alternate lenders,
3. Enable the entrepreneurs to mirror their operation & gain inputs for self-improvement,
4. SMEs will be able to take advantage of spurt in global outsourcing requirement with the use of internationally accepted D&B number viz., DUNS number provided in SMERA rating report,
5. Sketching, on a continuous basis, the risk profile of different SME sub-segments especially those operating in clusters for improving the quality of SME assets with the banks,
6. Integrate CIBIL score for providing a comprehensive and robust touch to the rating process, thus enhancing the reliability factor of SMERA rating. This will provide comfort to banks for speedy turnaround of proposal at an appropriate price,

[10] http://www.dpgroup.com.sg/news/press/2005/051107.html

7. Banker's will be able to free capital for further lending, as better rated SMEs will attract lower capital adequacy under the Basel-II norms,

8. Improve transparency in the economy as the benefits of the ratings gets wider publicity thus leading to creation of a rating culture,

9. Improve the information infrastructure on the SMEs for the benefit of the banks as well as the SMEs.

The journey towards the new capital accord [Basel II] has provided to a major fillip to rating in general and enterprise rating in particular. Basel II has evolved in response to the need and scope for risk sensitivity of the banking system. To make the capital requirements of the banks sensitive to the riskiness of borrowers, rating is to be used for deciding the risk weights and amount of capital required to be maintained.

V

Rating of SMEs - A perspective of SME Rating Agency of India Ltd.

While Indian SMEs are evolving to be a part of global supply chain, transparency and best business practices are going to be the cornerstone. The experience of SME rating at SMERA so far, has been very encouraging. The concept of ratings amongst SMEs have established its credibility and banks have increasingly exhibited their preference for ratings from external rating agencies. This has been manifested in interest rate rebates offered to enterprises getting acceptable ratings from SMERA. In instances, there has been interest rate rebates to the tune of 450 basis points! This has strengthened the belief that transparency pays and benefits in the long term. Transparency brings out the intrinsic strengths of the enterprise. This, when articulated properly through the rating reports, proves beneficial to the lender and the borrower alike.

To quote the CEO of a successful enterprise in SME space rated by SMERA[11], "with quality as our brand and ethics as our base, we continue to fortify our relationship with our customers....we never short circuited our route to prosperity". He admits to have gained deeper business insights during the process of discussions with analysts from SMERA. This unit, after obtaining satisfactory rating from SMERA has renegotiated the pricing of its loan and has managed to obtain substantial softer terms. A banker puts risk premium on a benchmark rate to arrive at a 'lending rate' applicable to an SME. This risk premium is a factor of the risk perception and more the perceived risk, more is the applicable lending rate. Well rated SMEs 'perceived risk' comes down in the eyes of the bankers which results in reduction in applicable interest rate. As per an assessment, over 25 per cent of the SME units rated so far by SMERA have got direct benefits in terms of reduction of cost of borrowing. With the cost of borrowing coming down, the price competitiveness of SMEs is enhanced. This also enables SMEs to invest in product innovation.

To sum up, the rating mechanism set up in India is a strategy to empower the SMEs by bringing out their intrinsic strengths to overcome the problem of information asymmetry, to enhance the confidence level of lenders by providing them with inputs which could act as decision support system and to bring out the areas of concern to focus on and to help banks decide the appropriate risk premium. This step is proving to be the right step in the right direction by enabling the flow of fair priced funds to the SMEs and mirroring the SMEs about the areas to focus on thus catalysing competitiveness.

In order to help the Banks in their efforts to reach out to a large number of SMEs, as well as to enable them understand the special needs of SMEs in clusters, SME Rating Agency of India Ltd has initiated 'Risk profiling' of SME industrial clusters. With the 'cluster based financing approach' being adopted by the

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[11] Dubey, Rajesh., 'Ratings help units gain deeper business insights' - The Financial Express, Mumbai, June 09, 2006

Banks, the risk profiling studies are geared to bring forth the risks and opportunities associated with the clusters and also suggestive risk mitigation measures. This would also help banks to design suitable product interventions. As a sequel to the Cluster studies, SMERA would endeavour to evolve a logical framework for delinquency and / or success for SMEs operating in comparable geographical or industrial environment.

VI

Concluding remarks

Bank finance would continue to remain the major source for SMEs and information availability is going to be the key. The enterprise ratings for SMEs offered by SMERA in India are proving to be value propositions for the SMEs by way of leveraging their intrinsic strengths to get softer credit terms from the Banking system. The ratings are not only contributing to the understanding of the bankers, but also encouraging the SMEs to do still better by bringing out a detailed analysis of the enterprise thereby pointing to the arena needing special attention by the management. These factors, which are resultant of the service offerings from SMERA are offering unique value proposition to SMEs and adding to their competitive strengths. With increased transparency and enhanced information availability, SMEs could soon have better access to equity markets and private capital.

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