

CedarView

Credit in the Indian SME Context

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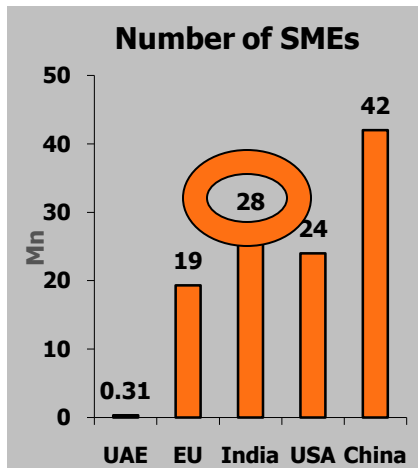
NEW YORK CHICAGO LONDON PARIS DUBAI MUMBAI SINGAPORE SHANGHAI

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Content

- ***SME Overview***
- Credit & Risk

Global SME significance



Source: Cedar Research

GDP Contribution

- ~50-70% of GDP globally contributed by SMEs
- Growth driver

Large SME Market Size

- ~ 90% of all enterprises

Employment

- ~ 90% of global workforce

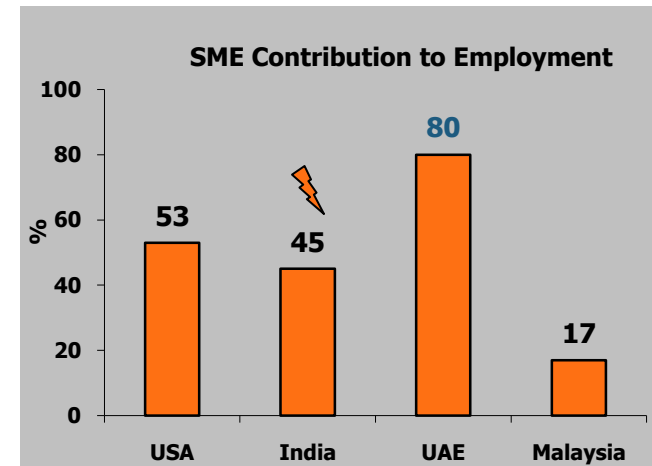
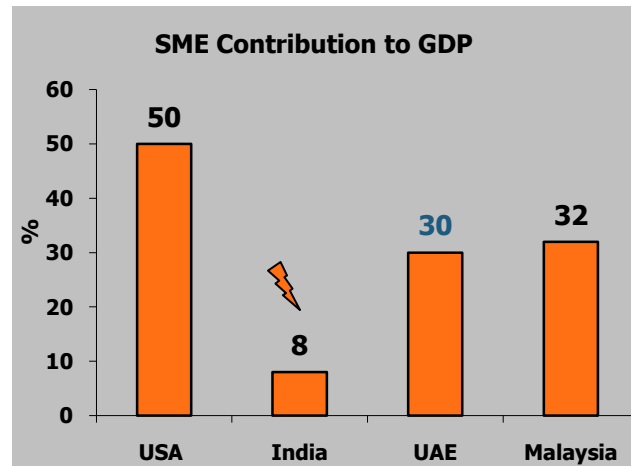
Steady Growth

- # of SME's growing ~20% last 3 years

SME Contribution



Significant contribution by SMEs to GDP and employment

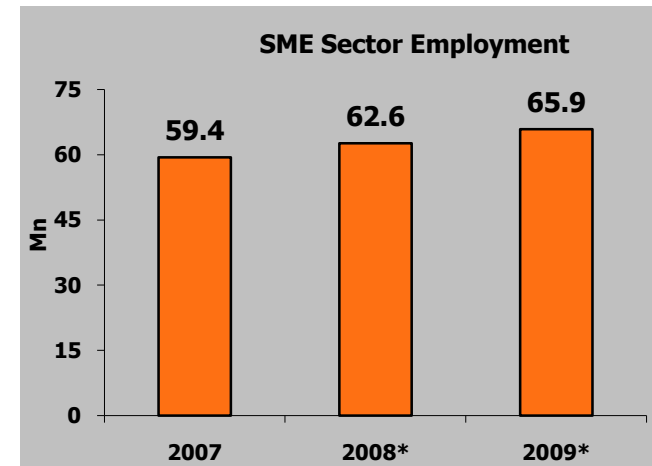
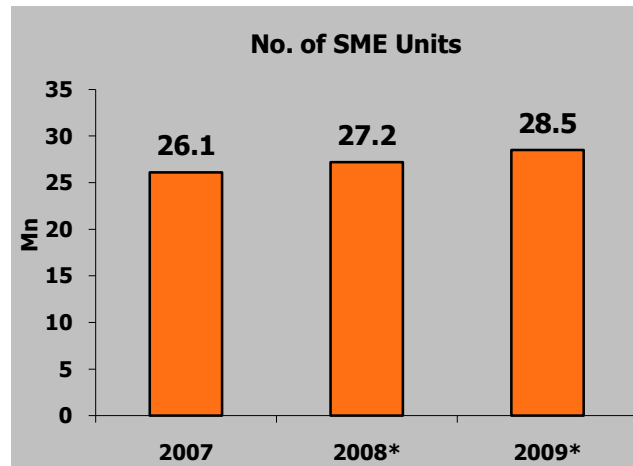


India - SME Opportunity



Source: Gov. of India, Cedar Analysis

28.5 Mn SME units employing ~ 66 Mn people



- SME sector growing at ~ 5% p.a.
- SMEs increasingly spreading operations overseas

Select Country SME Definitions

World Bank Definition

Firm Size	Annual Sales	Employees
Small	<\$3 Mn	<50
Medium	<\$15 Mn	<100

Segmentation based on sales/employee nos.

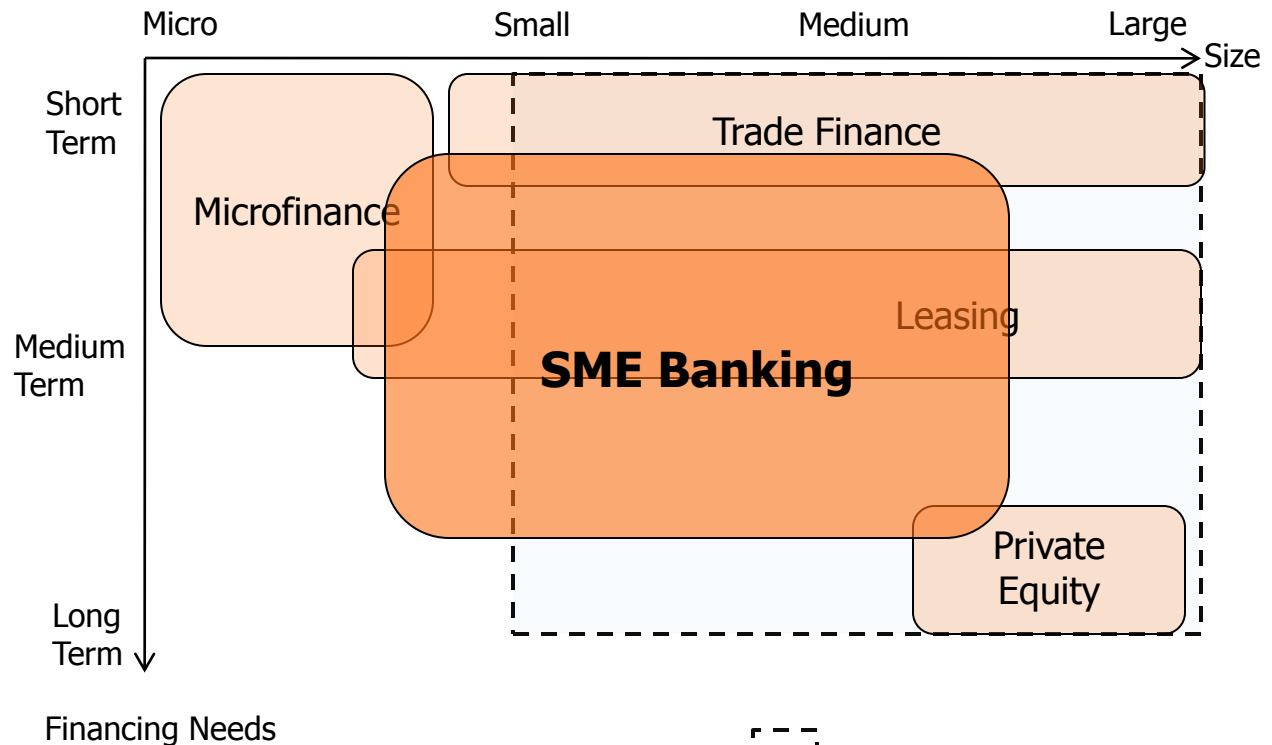
Country	Annual Sales (USD Mn)	Employees
USA	0.75 - 33.5	< 500
UK	8.4 - 34.2	< 500
China	4.2 - 42	< 2000
Malaysia	0.06 - 1.6	< 50
India	0.05 - 2.2 (Investment)	-
UAE	2.5 - 68.5	< 250

- India definition based on investment in plant/equipment – not great.

SME Financing - Global

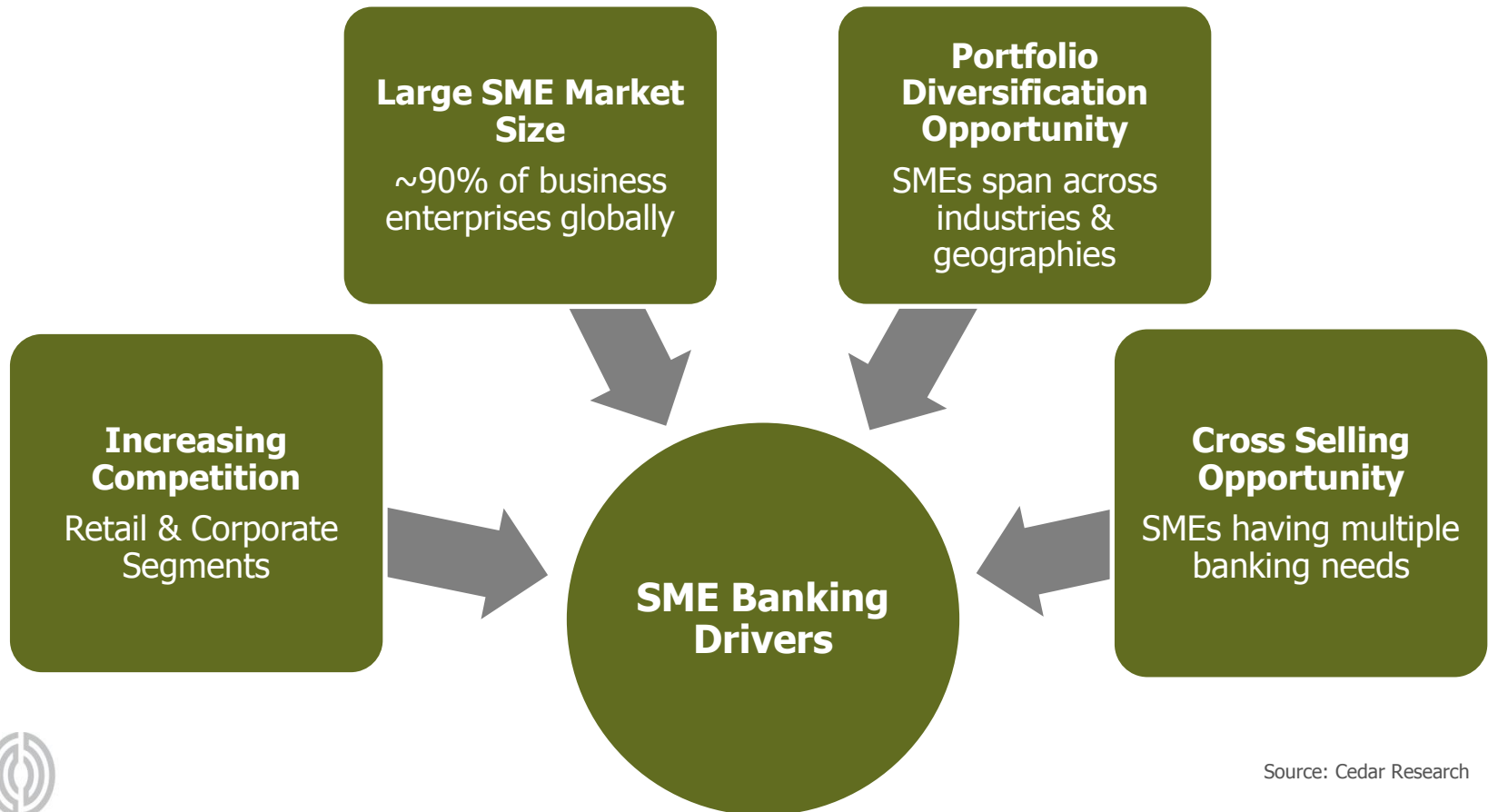


SME banking focuses on Short to Medium term financing



Formal, targeted by banks

SME Banking Drivers



Source: Cedar Research

Bank Challenges in SME Segment



Credit Risk

- **Obstacles to assess SME credit worthiness due to lack of formal accounting practices / credit ratings**
- **Unable to assess SME performance for young / startup SMEs**

Cost Risk

- **Higher volume & lower value transactions - higher cost**
- **Higher cost in providing customized products & services**

Increasing Competition

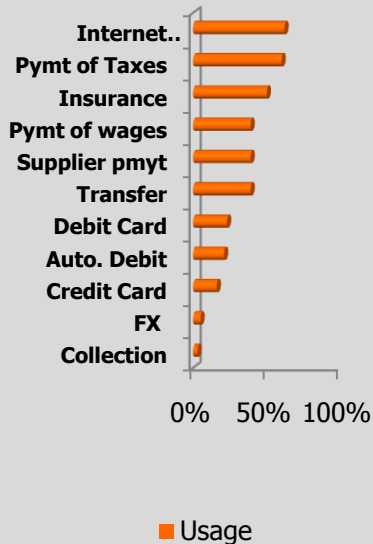
- **Major banks focusing on SMEs**
- **Govt. backed lending organizations offer better rates & terms. Also technology, advisor.**

SME Segmentation

- **Wide range of industries & operational scales within SME**
- **Need to study & continuously evolve SME segmentation**

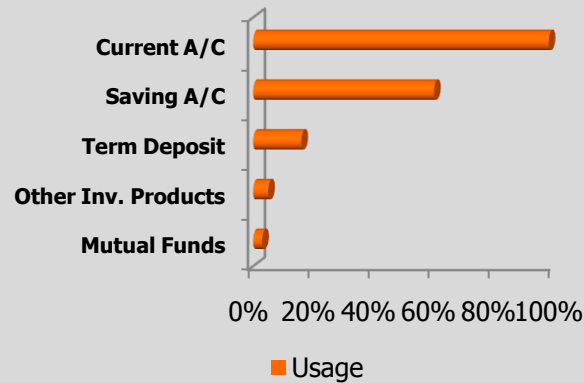
Global - SME Products

Transaction & Other Products

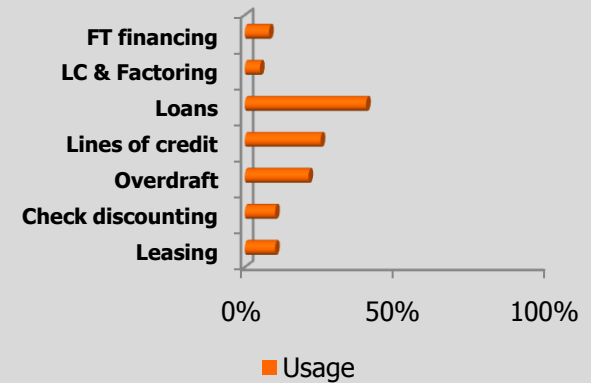


Deposit & Transaction products most used by SMEs

Deposit Products



Lending Products



Usage figures are of Latin America but are indicative of global trend

- Current & saving accounts required by all SMEs
- Cash management products like payroll management, supplier payment required by ~50% of SMEs

Source: IFC SME Banking guide 2009

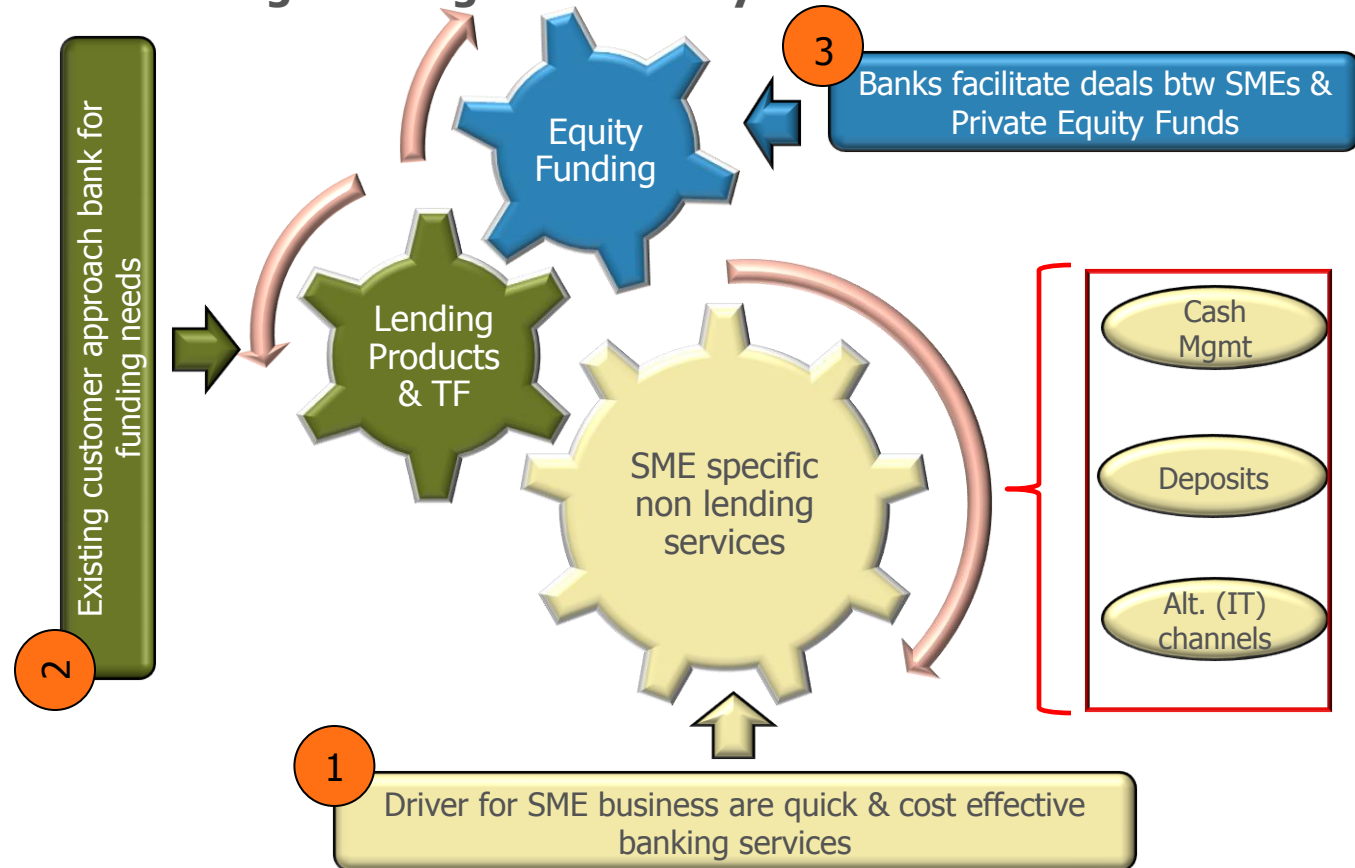
India – SME Product Trends

Non lending banking services key driver for SMEs in India

SME require seamless banking facilities like fund transfer, FX deals, TF services to enhance business

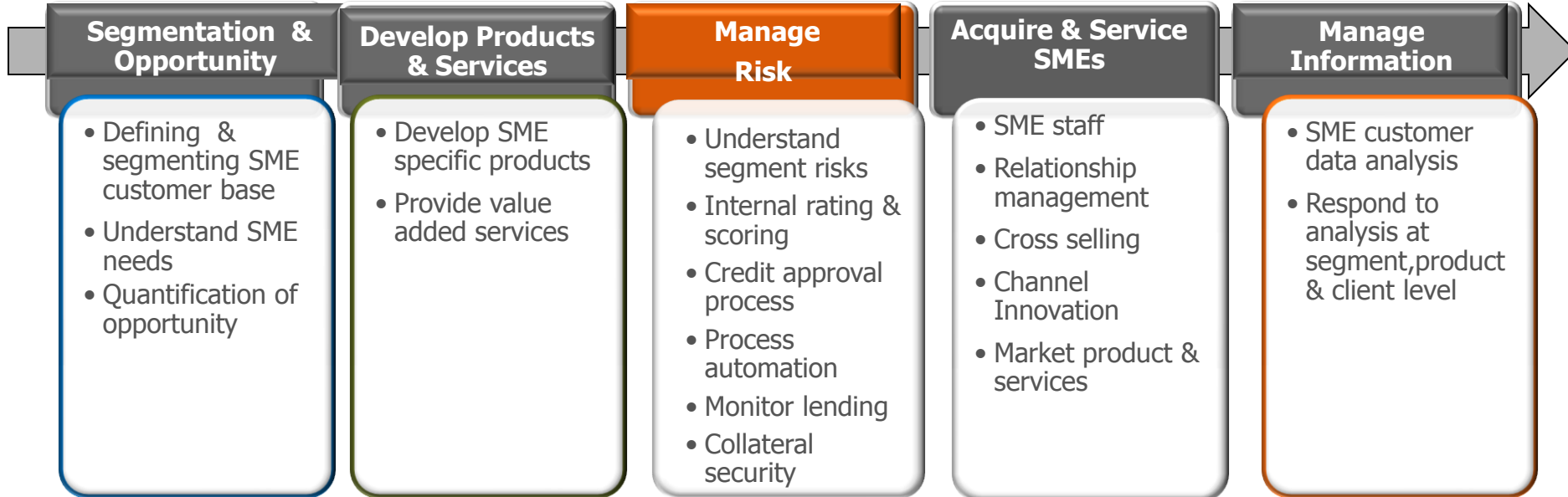
Existing relationship with Bank key driver for SMEs to borrow for short & long term funding

Banks innovating through facilitating PE lending where size and scale permits



SME Banking – Framework

Key activities at each of the 5 stages of SME business development



Content

- SME Overview
- ***Credit & Risk***

SME Credit & Risk Overview

Need

- SMEs lack reliable/ complete financial information
- External credit rating agencies missing in many markets

Approach

- Separation of credit underwriting from sales
- Using credit rating and scoring tools

Best Practices

- Proxy for missing information – mkt reputation, tax returns.
- 360 degree evaluation - qualitative & quantitative
- Private Equity Approach – Promoter is key

Country Comparison- Credit & Risk





















Source: Cedar database

-  Good
-  Above Average
-  Below Average



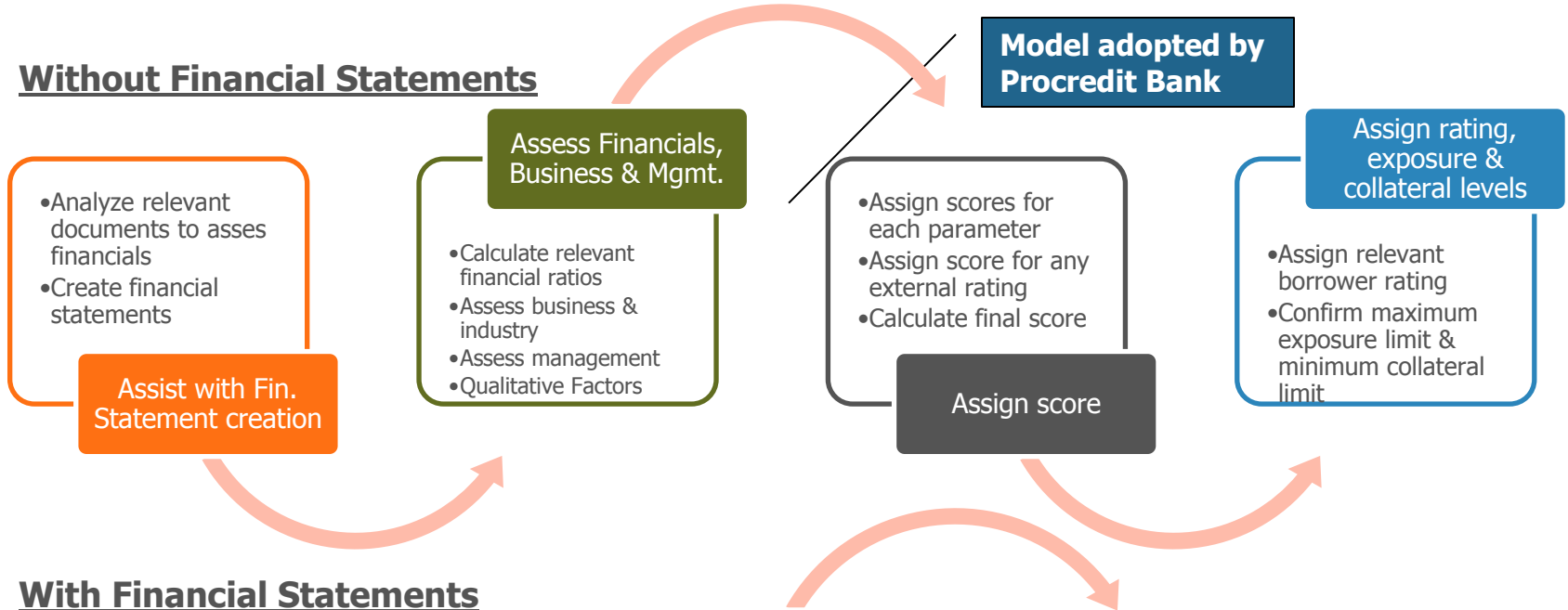
Scope for improvement

Parameters	USA	India	UAE
Documentation			
Evaluation Process			
External Credit Rating			
Technology			
Scoring Model			
Regulation			

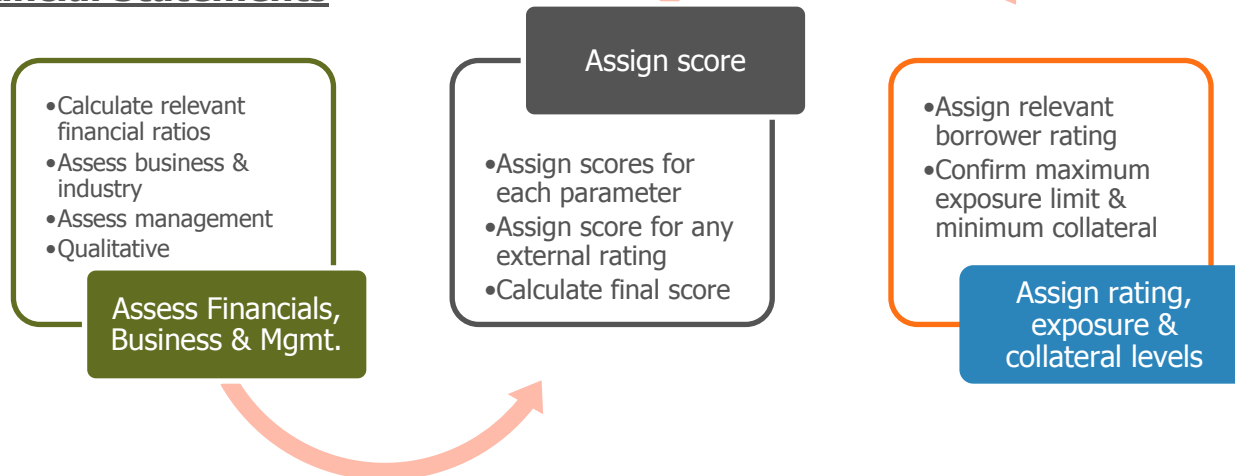
- Opportunity
 - Build strong evaluation process backed with robust scoring model
 - Working closely with SME clients to develop information requirements

Best in Class Credit Risk Assessment

Without Financial Statements



With Financial Statements

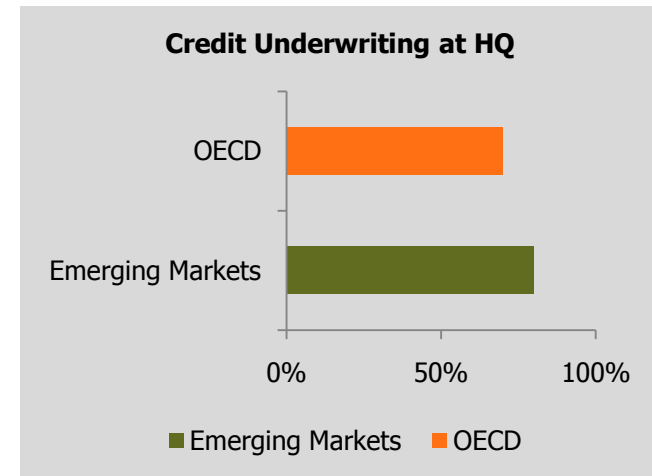
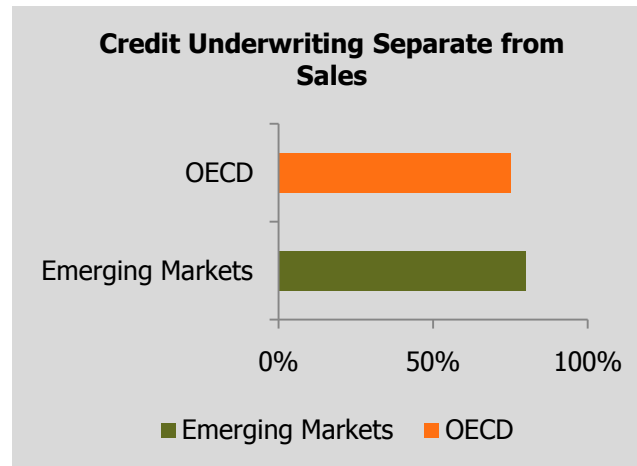


Global – SME Credit Underwriting



Source: IFC report on SME global best practice

> 70% banks credit underwriting at HQ/ separate from sales



- Key reasons for centralization/ separation from sales:
 - SME missing information requires use & objective interpretation of proxy and qualitative data
 - Requires significant credit evaluation expertise & experience
- Branch scoring model adoption can reduce HQ dependence & improve TAT

Credit Rating Framework



Multiple parameters evaluated to assess credit worthiness

#	Main Parameters of Credit Scores	Weight Assigned (Customer Relationship)
1	Management Risk	10% - 20%
2	Industry & Business Risk	20% - 40%
3	Financial Risk	40% - 60%
4	Transaction history	10%
Total		100%

Management Risk



Evaluate ability and willingness of mgmt. to fulfill obligations

Experience

- Management's education, technical expertise & extent of experience in particular business line
- Indicates resilience of firm to survive in various phases of economical and business cycle

Reputation

- References from borrower's suppliers, non-trade creditors, competitors, bankers, etc
- Length of relationship with bank
- Reflects capacity, creditworthiness and creditability of the management

Depth of Mgmt.

- Second line of management & succession planning
- Reflects firm's stability & continuity of leadership

Personal net worth

- Measured as amount of investments / deposits / properties owned by promoters
- Indicates financial flexibility of firm
- Reflects extent of group's access to alternative funds in time of need

Industry & Business Risk



Target businesses with income potential & growth prospects

Industry

- Size of market, industry lifecycle
- Demand growth
- Cyclicalities
- Regulatory environment
- Competition in the industry
- Ease of entry & exit

Market Position

- Market share
- Product range
- Concentration risk (product, customer, geographic)
- Contracts in hand
- Innovation
- Brand
- Distribution strength & dealer loyalty

Operational Efficiency

- Capacity utilization
- Technology
- Access to raw material, power etc.
- Capital / labour intensive
- Consumption of raw material & Conversion rate
- Age of machinery, obsolescence of technology

Financial Risk



Detailed analysis to determine financial stability of borrower

Financial Position

- Business turnover
- Financial statements
- Cash flow adequacy
- Key ratios: Income, profitability, liquidity, Working capital, long term analysis, coverage, leverage

Financial Flexibility

- Liquid assets
- Collateral / land
- Ability to liquidate investments
- Length of banking relation
- Access to capital markets
- Other forms of financial support

Accounting Policies

- Rating of auditor, quality of audit
- Standard accounting policies
- Corporate governance
- Depreciation & revaluation norms

Data Summary (1/2)

Sample of 24 Listed Healthy and 24 Listed Distressed companies was chosen



#	Sector	Distressed Companies#	Healthy Companies	Total
1	Textiles	14	1	15
2	Ceramics/Tiles	1	0	1
3	Ship - Docks/Breaking	1	0	1
4	Multi Media	3	1	4
5	Forgings	1	0	1
6	Cables	1	0	1
7	Paper	1	0	1
8	Paper & Paper Boards	1	0	1
9	Fertilisers	1	0	1
10	Auto	0	1	1
11	Medical Accessories	0	1	1
12	Services	0	2	2
13	Computers - Software	0	3	3
14	Food Processing	0	1	1
15	Metals	0	1	1
16	Resorts	0	1	1

#Distressed Company: With 2 consecutive years of negative profits

Data Summary (2/2)



#	Sector	Distressed Companies	Healthy Companies	Total
15	Metals	0	1	1
16	Resorts	0	1	1
17	Pharmaceuticals	0	2	2
18	Vanaspati	0	1	1
19	IT Enabled Services	0	1	1
20	Beverages	0	1	1
21	Hotels	0	1	1
22	Real Estate	0	1	1
23	Telecommunications	0	1	1
24	Pesticides/Agro Chemicals	0	1	1
25	Personal Care	0	1	1
26	Transport	0	1	1
27	Compressors	0	1	1
	TOTAL	24	24	48

$$Z''\text{-Score} = 3.25 + 6.56 * \frac{\text{Working Capital}}{\text{Total Assets}} + 3.26 * \frac{\text{Retained Earnings}}{\text{Total Assets}} + 6.72 * \frac{\text{EBIT}}{\text{Total Assets}} + 1.05 * \frac{\text{BV of Equity}}{\text{BV of Liability}}$$

Z" Score SME Results Summary

Z" Score accurately categorises the companies across various zones and ratings

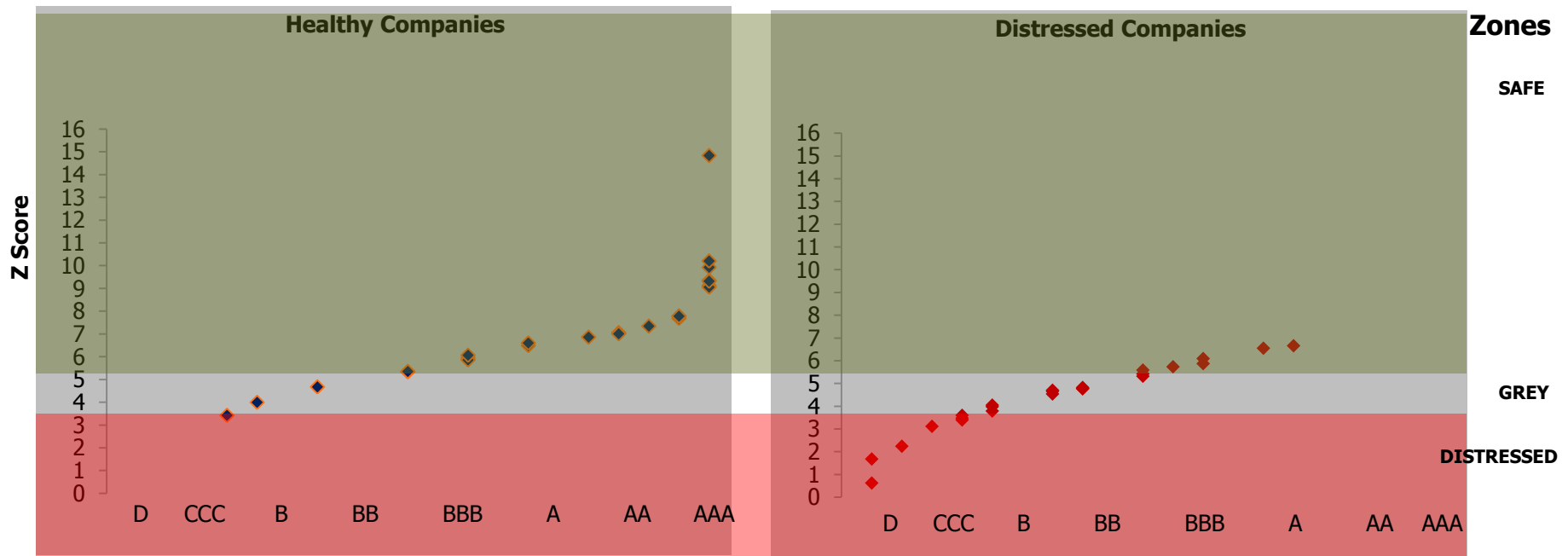


S.No.	Zone	Rating	No. of companies	
			Distressed	Healthy
1	Safe	AAA	0	7
2		AA+	0	3
3		AA	0	1
4		AA -	0	2
5		A+	0	1
6		A	1	0
7		A-	1	2
8		BBB+	0	0
9		BBB	2	3
10		BBB-	1	0
11	Grey	BB+	3	2
12		BB	0	0
13		BB-	3	0
15		B+	3	1
16		B	0	0
17		B-	3	1
18	Distress	CCC+	3	1
19		CCC	1	0
20		CCC-	1	0
21		D	2	0
	TOTAL	0	24	24

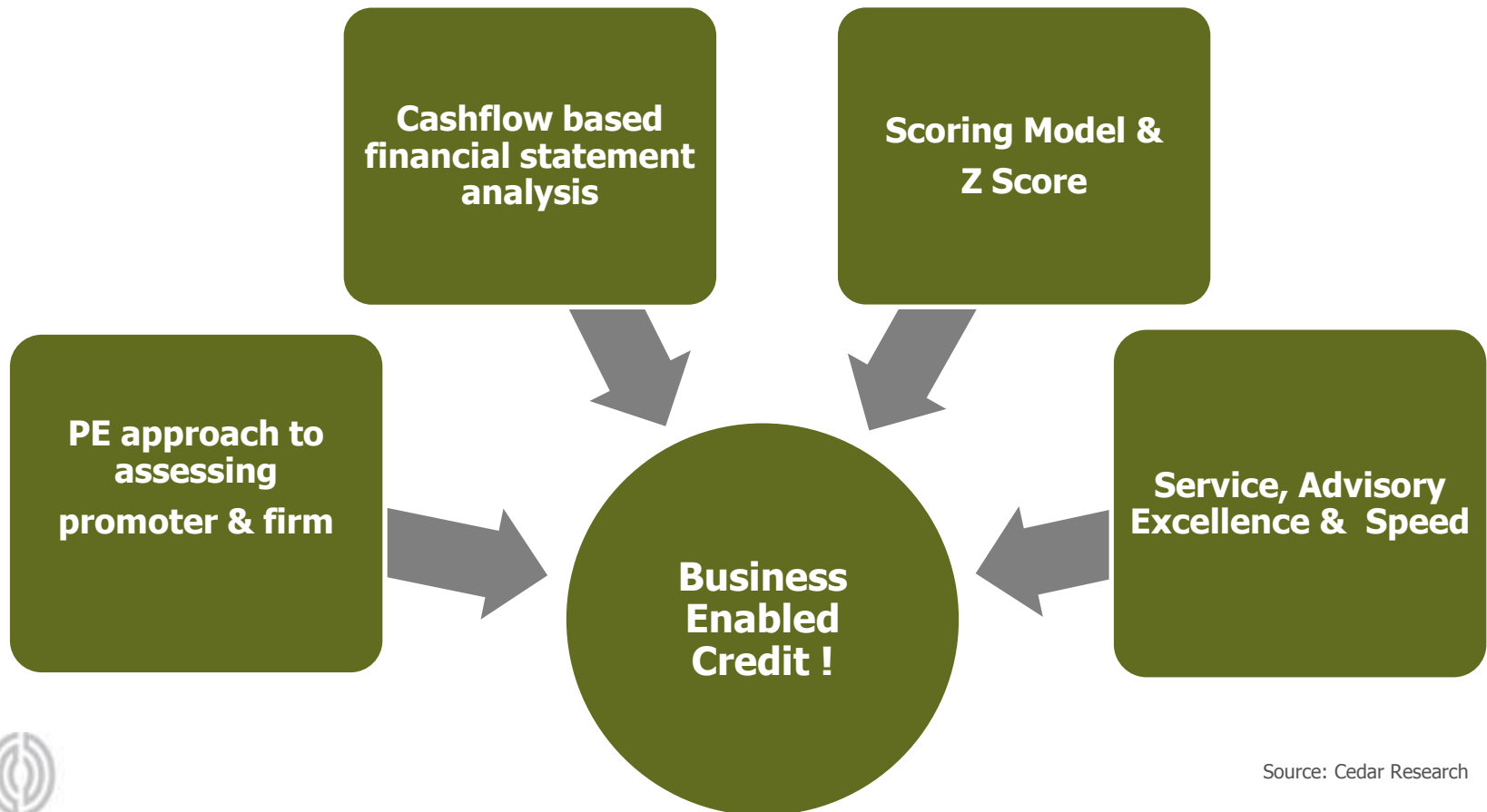
Z Score Scatter Distribution

Healthy companies fall in Safe zone and Distressed companies in Grey/
Distressed zone

Distribution of Z"Scores across various zones



Conclusion





We Make Strategy Work