

CARE Ratings Maldives - SME Rating

Rating Methodology

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RATING APPROACH FOR SME RATINGS IN MALDIVES

BACKGROUND

Maldives, though a small island economy, is one of the fastest growing in the world, driven by leading sectors of tourism, construction and fishing. These sectors have also given a hand to subsectors like local handicrafts, transport, boatbuilding, agriculture & real estate and other tourism based allied services, which are essentially Small and Medium Enterprises (SME). SME segment being an important element for the Maldives economy also provides good opportunity for further growth, provided some of the basic business constraints are addressed.

The Investment Climate Assessment (ICA) of the Maldives points to a number of areas in the operation businesses that require attention (World Bank, 2006). Out of the top five obstacles identified by the businesses surveyed, lack of access to finance and high cost of finance were in topmost category. In fact, these are also the major hindrances to businesses in the SME segment.

MSMEDP ACT

Government of Maldives (GoM) also is under taking various measures to organize the MSME sector and facilitate financing for MSMEs. In this regard, GoM is enacting “The Micro, Small And Medium Enterprises Development And Promotion Act” with a stated objective of “promotion and development of disadvantaged micro, small and medium enterprises in the Republic of the Maldives, to ease the cost and complexity of doing business for such enterprises and to enhance the entrepreneurial spirit amongst all Maldivians.” The Act also aims at creating an enabling environment for the promotion and development of MSME in the country “with a view to reducing poverty and related vulnerabilities as well as making the sector broad based, innovative, resilient and internationally competitive.”

DEFINITION OF MSME

The Act has defined MSME as an individual or other legal entity carrying on a business enterprise in one of the following categories:

- (i) **Micro:** businesses with upto 5 employees and an annual income of 500,000 Maldivian Rufiyaa (MRF);
- (ii) **Small:** business employing between 6 and 30 persons and an annual income between 500,001 and 5,000,000 MRF; and
- (iii) **Medium:** business that employs between 31 and 100 persons and an annual income between 5,000,001 and 20,000,000 MRF,

The Act has also specified certain qualifications for eligibility of benefits, including engagement in priority sector, should be run predominantly by Maldivian citizens etc.

SPECIAL FEATURES OF ACT

Business Development Services: The Act also provides for creation of “MSME Business Service Development Centre” To provide business development services to MSMEs and support the development of related clusters, value chains and innovative market developments;

MSME Loan Scheme: The Act also envisages a MSME Loan scheme whose objectives are to

- a) deal with *improving access to credit* by productive MSMEs by improving the quality of the relevant credit pool and encouraging and rewarding banks for lending to MSMEs;
- b) provide a *mechanism* whereby borrowers can improve and demonstrate their creditworthiness and access to credit; and
- c) *minimize* the obstacles which apply to MSMEs seeking to enter the financial sector.

It has also been envisaged that all Banks operating in Maldives must set aside a portion of its loan portfolio applicable to the Maldives for loans to MSMEs which have been certified as eligible and at least 50% of which are to be made available to MSMEs owned by women.

CARE MALDIVES SME RATINGS

As a move towards facilitating the orderly development of MSMEs in the country and encourage larger levels of transparency and credit discipline, CARE Maldives proposes to launch **SME Ratings** in Maldives. The credit risk assessment in this segment requires a specific approach, as the factors affecting the creditworthiness differ from those compared to large corporate entities. Hence, to further support the growth for this sector and help the investors to determine the relative creditworthiness of entities belonging to this segment, CARE's SME Ratings will play a helping hand.

RATING METHODOLOGY

SME Ratings indicate the relative level of creditworthiness of an SME, adjudged *in relation to other SMEs*. It is an issuer specific rating reflecting overall general creditworthiness. It is a one-time assessment of credit risk. The rating exercise would take into account the industry dynamics, operational performance, financial risk characteristics, management capability and the future prospects of the entity for arriving at the overall risk profile of the SME unit. The detailed list of criteria is given below:

INDUSTRY DYNAMICS

Macro-Economy Impact

The Maldives is a small open economy and is, therefore, vulnerable to potential shocks, including changes in tourism flows, fluctuations in the prices of key commodities, such as food and fuel (both of which are mainly imported), and fluctuation in exchange rate and capital inflows. The country's revenues and foreign exchange reserves are directly or indirectly tied to the performance of tourism and any changes to tourist arrivals can undermine macroeconomic stability, which can have impact on the SME unit. CARE would carefully analyze macro economic developments and evaluate the possibilities of their impact on SME unit.

Industry Impact

No SME unit can isolate itself from the impact of industry dynamics. The industry parameters that affect an SME would include overall demand-supply scenario, competition level, and

government support to the sector, cyclical and seasonality of industry. Therefore, CARE believes that promoters' ability to manage the business on industry impact is very crucial.

OPERATIONAL PERFORMANCE

Against the backdrop of the industry, CARE assesses the entity's strengths and weaknesses vis-à-vis its competitors. Many SMEs have inherent strength and relatively strong positioning (including market share) in their business segment, which is considered as credit positive.

For assessing the business risk, long term sustainability of the business model is very important. Many SME units are part of some large group. In that case, the entity's importance and positioning within the group, its inter-linkages of operations and transaction transparency are also evaluated.

In order to assess the smoothness of functioning of day to day operations, owned premises (as Maldives has shortage of land), timely availability and sufficiency of raw materials (as Maldives depends on imports for most of the items), manpower (as there is shortage of skilled labour), utilities (high utility prices is among the top external business constraints as cited by entrepreneurs) are analyzed with the major focus on locational and technological edge over others. Entity's initiatives for clean and green environment are also evaluated, during the plant visit.

Business strength is derived by assessing customer profile, product profile, revenue mix and bargaining power with the stakeholders. An interaction with key customers and supplies also provides input for strength of relations with the rated SME unit.

FINANCIAL RISK ANALYSIS

Maldives lacks extensive coverage of audit of accounts. CARE believes that the quality of accounts is of prime importance as the significant part of financial risk analysis is based on the reported financial statements, disclosures and information submission. Audited financial results give more comfort than the unaudited / provisional results. CARE believes that among the SMEs, limited companies have better accounting & disclosure systems as they need to follow regulatory and specific accounting guidelines.

CARE evaluates financial flexibility (through gearing ratios, debt protection ratios and hybrid ratios), liquidity (measured by current & quick ratio, proportion of liquid assets, operating cycle, working capital management, cash flow from operating activities, etc.), business efficiency & profitability (indicated by turnover ratios, profitability ratios, return ratios, growth ratios, etc.). While evaluating gearing ratios for SME units, CARE also sees the proportion of bank funds (excluding unsecured loans by promoters, friends and relatives) as dependency on external funds may be lesser in certain SMEs, which is considered as credit positive.

In order to evaluate the track record and relations with the banks, CARE team interacts with the bankers / lenders to know overall conduct of account. Cash flow analysis is the most important parameter for assessing the creditworthiness.

MANAGEMENT CAPABILITY

CARE critically evaluates quality of management as one of the most important parameters that supports the credit strength of an SME unit. CARE team interacts with the SME promoters / key management personnel for understanding their business insight, vision, future growth strategy and approach towards the perceived risk factors. Most SMEs are family managed entities and highly dependent on single person. To assess the depth of the management, CARE analysis the quality of the second line management, succession planning, organization structure and internal control systems.

Promoters' experience in business (including within the relevant industry sector) and track record of operations of the rated entity would act as key criteria for assessing management competence. CARE believes that the management having experience of several business cycles and familiarity for project implementation would have an edge. Management's skill to expand clientele, new trade initiatives and level of priority to the finance function are equally vital.

PROJECT RISK ANALYSIS

High level of project risk can also affect the financial strength of an SME unit, which can be assessed by project feasibility, size, and project gearing and stabilization issues, post implementation. CARE gives weight promoter’s track record in project implementation and status of project including achievement of financial closure.

CARE MALDIVES SME RATING SCALE

The following Rating Scale is proposed for SME Ratings in Maldives:

SME Rating	Definition
CARE MLD SME 1	The level of creditworthiness of an SME, adjudged in relation to other SMEs is the Highest
CARE MLD SME 2	The level of creditworthiness of an SME, adjudged in relation to other SMEs is High
CARE MLD SME 3	The level of creditworthiness of an SME, adjudged in relation to other SMEs is Above Average
CARE MLD SME 4	The level of creditworthiness of an SME, adjudged in relation to other SMEs is Average
CARE MLD SME 5	The level of creditworthiness of an SME, adjudged in relation to other SMEs is Below Average
CARE MLD SME 6	The level of creditworthiness of an SME, adjudged in relation to other SMEs is Inadequate
CARE MLD SME 7	The level of creditworthiness of an SME, adjudged in relation to other SMEs is Poor
CARE MLD SME 8	The level of creditworthiness of an SME, adjudged in relation to other SMEs is the Lowest . Such entities may also be in default .

The rating outcome is ultimately an assessment of the above factors and their linkages to arrive at the overall assessment of credit strengths and weaknesses by taking into account industry’s cyclicity. While the methodology encompasses comprehensive technical, financial, commercial, economic, and management analysis, credit rating is an overall assessment of all aspects of the issuer.

Disclaimer

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