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Rating Critiera for Trading Entities

Executive Summary:

Trading entities are engaged in the business of buying and selling commodities, products or services. These are intermediaries between manufacturers/suppliers and the retailers/distributors. Such entities have substantial inventories of stock, add limited value to the products and occupy a key position in the supply chain since they understand customers' requirements and engage in merchandising and distribution of the products.

Trading businesses are characterised by thin profitability and relatively low level of capital expenditure. The bulk of balance sheet assets constitutes receivables and inventories. Balance sheet liabilities comprise mainly short term borrowings and payables. Working Capital management is critical in such businesses. Traditionally, such businesses have been dominated by the unorganised and fragmented sector with mostly family run entities, though the share of organised players is increasing.

Methodology:

BWR's framework for assessing the credit quality of the trading companies covers Business Risk, Industry Risk, Financial Risk and Management Risk. Each of these broad risk factors are subdivided into various parameters, which may be different for different types of businesses.

Business Risk:

The components of business risk assessed by BWR are Scale, Market position & sustainability, Inventory risk and policy, Relationships with Suppliers, Relationships with Customers and bargaining power, Forex risk and Regulatory risk, etc. The risks are analysed based on each firm and information availability.

Industry Risk:

The business of a trading entity depends on the performance of the underlying industry, the industry demand – supply dynamics, government regulations, extent of competition, entry/exit barriers and other external factors that affect the target entity (may be individual customers or other businesses where the entity is sourcing its products).

Scale, Market Position & sustainability

Generally, the parameters analysed are Size and scale of operations of the entity, level of trading volumes, extent of product and market diversification, level of business integration and market position, volatility in commodity prices, volatility in earnings from core business segments, which determine its competitive strength in end user industries. Traders with substantial market share, established track record and experienced management are critical in the value chain and have better business sustainability.

Inventory risk and policy:

BWR evaluates parameters such as holding policy, payment terms followed by the suppliers and customers, price risk and obsolescence risk. Inventory holding period influences the market risk of the business and inventory risk arises because of price fluctuations. The assessment is primarily on the probable decline due to a fall in commodity prices during the holding period or product obsolescence and the ability of the business to absorb such impact. The risk mitigation strategies such as hedging policies, ability to pass on price increases to customers, just in time procurement etc may also be considered.

Relationships with Suppliers:

Established relationships with suppliers are critical in ensuring business continuity. Other parameters considered are supplier's brand equity and credit policy. Flexibility in credit policy may help in better management of liquidity of the trading business.

Relationships with customers and bargaining power:

Receivables management is an important part of the operations of trading entities. The length of relationship with customers, the customer concentration and credit quality of the customers are factors part of receivables management. As receivables constitute a significant portion of the traders' income, the collection efficiency, credit policy of the traders and extent of bargaining power with its customers can affect the financial risk profile of the trading entity.

Involvement of multiple counterparties exposes an entity to credit risk with respect to their customers and suppliers. Implementation of risk mitigants such as risk weighted exposure limits, customised credit terms, third party guarantees, collateral agreements and trade insurance covering risk of loss or damage during storage or transit, if adopted would lead to better management of the credit risk.

Forex Risk:

Businesses that have overseas suppliers or customers are exposed to foreign currency risks. The strategy of the trading entities for risk mitigation through consistent forex hedging policies such as hedging of such exposure through derivatives contracts or through natural hedging are studied as necessary.

Regulatory Risk:

Trading entities are exposed to potential change in regulations related to commodity trading relating to sourcing and pricing, free trade, warehousing and restrictions in imports/exports depending upon market conditions. Changes in such policies may cause fluctuation in earnings. Political risks such as war, export restrictions, blockage of funds, restrictions on forex transfer and such measures could also affect the operations. Suitable insurance policies and risk management mechanisms should be considered by the trading businesses.

Financial Risk:

BWR assesses the current and future financial performance of the entity, leverage, its liquidity management and financial flexibility. BWR analyses the level and sustainability of the credit protection through ROCE (Return on Capital Employed), Gearing ratio, Interest service coverage ratio and Tangible Net worth. Liquidity management is evaluated by analysing the Cash Flow and financial flexibility of a company to assess the financial risk. Trading business is characterised by earnings and cash flow volatility due to fluctuations in commodity prices and changes in demand supply conditions. The entity's ability to meet the short term borrowings and whether the current assets of the entity are sufficient to meet short term obligations of the entity are analysed through the Current Ratio. Generally, a healthy ratio implies that mainly long term borrowings are used for capital investment and short term borrowings are used for working capital management, thus ensuring sufficient liquidity for normal operations.

Management Risk:

BWR evaluates the quality and experience of the management, promoters' commitment to the business, past track record and integrity, competence, risk appetite, growth plans and corporate governance. The strengths and weaknesses arising from being part of a large group are also considered in addition to the ability and willingness of the group to support the entity through capital infusion.

Conclusion:

BWR's rating methodology for trading entities involves analysis of Business risk, Management risk and Financial risk and analysis of related financial ratios.