Rating Criteria for Trading Entities

Executive Summary:

Trading entities are engaged in the business of buying and selling large volumes of basic commodities such as agricultural products, metal and metal products, auto components, building and construction material, oil and energy sources, and products. These are intermediaries between manufacturers/suppliers, retailers/distributors and offer limited value addition. Resultantly, these entities work on thin margins and hold high inventory and receivables, which result in high working capital requirements.

The receivables and inventories are the major items on the Assets side of the balance sheet whereas short-term borrowings and payables comprises the balance sheet liabilities. Hence, as against the manufacturing entities which require term debt, Trading entities usually have a high dependency on working capital debt.

Traditionally, in India, trading businesses have been dominated by small, unorganised sectors and family-run businesses, except highly capital-intensive businesses such as oil and gas, energy. Due to various policies and benefits offered by the Indian government, the share of organised players has been on the rise, even as trading businesses remain largely unorganised.

Scope of the Criteria:

The document contains the broad parameters assessed by Brickwork Ratings (BWR) while rating entities in the trading sector. Since the sector is highly working-capital-intensive and is driven by large trading volumes, the demand-supply dynamics of the product, commodities portfolio and distribution network, risk is assessed separately for entities engaged in trading activities, in addition to general broad risk parameters of business, Industry, Financial and Management risk.

Risk Assessment and Methodology:

BWR's framework for assessing the credit quality of trading entities 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:

This includes risks related to the environment that the entity operates in, which affect its turnover, margins, market position within the industry and operational efficiencies, and relationship between the client and suppliers or buyers. BWR assesses the stability and sustainability of the business.

1. **Market Position:**

   Invariably, the size of the entity plays an important role while assessing its market share. A higher market share generally results in a better market position and thus gives an entity bargaining power among its suppliers and customers. BWR assesses factors such as Scale of operations and its market position vis a vis peers, market reputation, brand recognition, the demand and supply scenario and its bargaining power with suppliers and customers,

2. **Diversification:**

   Generally, the entity which has a diversified product folio and diverse geographical locations is looked at favourably as it lends better stability to the business profile across different business cycles.

3. **Relationship with Suppliers and Customers:**

   Generally, entities enter into long-term contracts with suppliers, as well as with buyers, to enjoy benefits such as better prices and consistent raw material/commodity supply. Depending on relationship with suppliers and customers and the bargaining power of the trading entity, these long-term contracts may be favourable for the entity, or otherwise, will be assessed.

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

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

   BWR analyses the supplier concentration risk arising out of dependence on a limited number of suppliers or when the entity must rely on spot purchases to cater to its customer commitments, exposing it to the price volatility risk. Reliance on a few customers for sales/revenue also limits the entity’s bargaining power.

4. **Business Integration and Trading Volume:**

   Trading entities strengthen their business profile by vertically integrating their operations. For instance, entities engaged in the trade of edible oils have strengthened their sourcing by acquiring processing units on the one hand and have also created marketing brands on the other hand, with the objective of absorbing value across the chain. Besides improving profitability, such measures also help entities mitigate the impact of fluctuations in commodity prices to some extent.

   While backward integration measures prima facie add strength to an entity’s business model, the extent of investments required in backward integration and the ability of an entity in doing so gain critical importance to transform a business model.

Trading volume risk is the risk arising from changes in a commodity's supply or consumption volumes, which often causes volatility. Prices tend to move at more extreme levels in commodity markets during volatile trading conditions than they do with other asset classes such as stocks.

5. **Supply Chain Infrastructure:**

BWR assesses the supply chain infrastructure in terms of integrated distribution, storage and transport systems, since these factors directly influence operational efficiencies and, therefore, merchant profitability and sustainability.

6. **Inventory Risk:**

For any trading entity, inventory plays a major role in and acts as a major part of the working capital. Inventory risk arises due to fluctuations in product prices. Any variation in price can make significant differences in margins. entities dealing in commodities with highly volatile prices or with long inventory holding periods are expected to have larger net owned funds to absorb the impact of price decline.

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

7. **Counterparty Credit Risk**

The credit profile of the principal (contract owner) invariably determines the timely flow of funds and thus, has a direct impact on the on-time execution of contracts. BWR also assesses concentration risk in the sense that a high exposure to a few smaller counterparties may have a negative impact on the rating as against concentration to an entity with a better credit profile.

This is one of the major risks associated with the entity as a failure by customers to provide payment on time will affect its profitability. The number and profile of the majority of customers (end-users or trader), track record of the relationship with customers, credit rating of customers, mode of collection of payments (which can be either advance, against letter of credit or cash against documents) and transactions with associate entities/affiliates are also analysed in detail.

8. **Foreign Currency Risk**

In case wholesale traders deal in foreign currency on account of exports, imports, investments, loans, advances or otherwise, an impact analysis of changes in foreign exchange rates is conducted to check the impact of adverse fluctuations in foreign exchange rates on an entity's profitability. Businesses that have overseas suppliers or customers are exposed to foreign currency risks. The strategy of trading entities for risk mitigation through consistent forex hedging policies such as the hedging of such exposure through derivatives contracts or through natural hedging are studied as necessary.

9. Sovereign Risk

Operations in various risky countries would lead to disruption of business. BWR assesses the entity's business operations from various countries to assess the risk associated with it.

Industry Risk:

The business of a trading entity depends on the regulatory environment of the underlying industry, 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).

1. Regulatory Risk: Change in Trading Regulation, Import–Export Duties

Trading entities are exposed to potential changes in regulations related to commodity trading in terms of sourcing and pricing, free trade, warehousing and restrictions in imports/exports depending on market conditions. Changes in such policies may lead to fluctuations in earnings.

2. MSP Effect on Entity

In an attempt to strike a balance between the welfare of the agricultural community and ensuring supplies at competitive rates, the government also engages directly in the sourcing and pricing (by setting minimum support prices) of essential commodities.

3. Commodity Price Fluctuation Risk

Risk arising out of commodity price fluctuations is one of the key risks faced by entities engaged in trading operations. The exposure to commodity price fluctuation of trading entities (on traded commodities) is either through physical stock or through financial derivatives. The risk of exposure can be mitigated through back-to-back sales orders or by taking the hedging position on exchanges.

4. Cyclicality, Seasonality and Demand-supply dynamics

Trading entities engaged in trading activities of agricultural products such as rice, wheat, sugar etc are prone to cyclicality and seasonality in the business, where requirements of funds will be substantially high during procurement season and very low during lean time or rest of the year. This will cause uneven cash flows during different points in time of the year. That said, the sustenance of cash flows over the longer term remains the basic premise of the rating.

A change in the demand-supply dynamics due to changes in customer preferences could affect the revenue trends of trading entities. Demand-supply gaps can lead to an increase in the inventory holding period in cases where demand falls short of supply. BWR assesses the management's hedging strategies to mitigate the impact of such a demand-supply gap.

Financial Risk:

BWR assesses an entity's financial risk through the evaluation of previous and projected future financials, particularly the availability of cash flow and debt servicing capability. Financial accounting policies, especially those related to inventory, and liquidity analyses are additional considerations for trading entities. While funds from operations denote stronger debt servicing ability, the cash flow from operations indicates an entity's ability to efficiently manage its suppliers and debtors. The resultant leverage and coverage ratios ascertain the ability to pay-off debt obligations. Followings are some of the key ratios that

BWR assesses to rate trading entities:

1. **Profitability Ratio:**

   Notwithstanding the sales volumes of the rated entity, the profit that a trading entity generates to offer value to its shareholders determines its financial well-being and performance. BWR assesses the operating and profitability margins to assess the trading entity's performance vis a vis the peers. Better margins identify the entity's competitive position, cost competitiveness and product demand in the market.

2. **Capital Structure, and Leverage and Coverage Ratios:**

   Keeping in mind the stability of revenue generation, leverage ratios help ascertain the level of debt held by entities to gauge their ability to pay-off their interest and principal debt obligations and their track record of debt servicing. BWR also considers non-fund-based facilities available with the trading entity. These are reflected in payables in the books of account rather than debt. Therefore, BWR analyses the Total Outside Liabilities to Tangible Net Worth (TNW) to assess capital structure. The interest and debt service coverage indicator reflects the entity's ability to repay its borrowing and interest cost after meeting operating expenses.

3. **Turnover and Liquidity Ratios:**

   These will identify risks related to the payment to/from debtors/creditors, contingent liabilities, cash availability and liquidity position of an entity to service working capital requirements. Trading activities are working-capital-intensive in nature. Liquidity analysis is an integral part of a entity's assessment, which identifies its liquidity availability in the form of unencumbered liquid investment, cash available with the entity and the availability of undrawn lines, the utilisation of bank limits as against meeting its short-term debt servicing obligations and Non-Fund-Based (NFB) obligations.

4. **Financial Flexibility:**

   It defines the entity's ability to raise funds or alternate sources of funding availability in case need arises. In the case of a stress scenario, the entity's ability to raise funds determines its strong financial position. Some factors seen positively while assessing the entity include access to banks/capital markets, the availability of parent support, continuous bank undrawn limits and the timely monetisation of non-core assets.

Management Risk:

BWR assesses the relevant track record of the key promoters in the line of business, consistency of performance and the quality of corporate governance adopted by the entity as also the performance of other group concerns. Red flags, if any, highlighted by internal or external stakeholders, would negatively reflect in the rating. The financial flexibility of the management, tested by the empirical evidence of successfully supporting the group entities, past track record of successfully running trading businesses, and quality of corporate governance practices followed by the entity, are factored in while assessing the entity's overall credit profile.

Conclusion:

BWR carries out a critical evaluation of the entity across the aforementioned risks to assess the business, financial and management profile of the entity and arrive at the overall assessment of a trading entity's credit quality.

The previous version of this document can be found in *www.brickworkratings.com/download/Criteria-TradingEntities.pdf*

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