CARE's Rating Methodology - Wholesale Trading

[In supersession of "CARE's Rating Methodology - Wholesale Trading" issued in June 2017]

Overview

The increase in global trade in general and stable growth prospects of local economy has brought significant opportunities as well as risks to the entities engaged in the wholesale trading. The wholesale trading industry's general business and financial risks are high, given commodity price risks, foreign currency fluctuation risks, low margins earned and a competitive environment with low entry barriers. CARE's credit risk assessment is based on entity's market position and business strategy to deal with the above factors and hence, entities with established track record, larger scale of operations and appropriate risk management systems tend to be more favourably placed than others, from a credit perspective.

The broad areas of CARE's credit risk assessment for wholesale trading entities encompass evaluation of business/market risks, risk management framework to deal with the same, management quality and financial risk profile and financial performance.

A. Business / Market Risk Analysis:

A1. Commodity Profile: CARE Ratings undertakes a detailed study of the traded commodities portfolio of the entity being rated. In addition to the factors related to the different commodities per se such as availability/seasonality and volatility in prices, the general economic environment and trade restrictions if any, are also taken into consideration. The price and demand of the commodities, which are an intermediate product in a value chain or not directly consumed have a direct relationship with the demand of the end product/industry where it finds application and the risks factors regarding the same are also studied.

Commodities with good marketability are usually those with ready information with respect to prices, being traded on the local or global commodity exchanges. With superior information on production and prices in respect of such commodities, the entities with better sourcing arrangements and knowledge of the local markets are more suited to meet the customers' requirements in time, sustain reasonable margins as well as hedge their positions effectively. However, such entities can also be vulnerable to sudden adverse market variations if they happen to carry large inventory position.

The benefit of a diverse trading portfolio is that it reduces the concentration risks–regional demand supply dynamics, weather factors as well cyclicality associated with a particular commodity or industry. Generally, entities with demonstrated track record of efficiently dealing in multiple commodities and having large scale of operations are viewed favorably since they are considered better equipped to withstand any external shocks.

A2. Supply Chain / Logistics Management: Wholesale trading is a business which is generally characterized by low entry barriers and a competitive environment, both domestic as well as external. The factors which differentiate one entity over another are established and well spread out organization (including network of brokers and agents), logistics assets/capabilities, adequate warehousing/stocking arrangements as well as an established distribution system. CARE Ratings also analyses the number of suppliers as well as dependence of the entity on a few suppliers, if any. Similarly, the profile of customers, including dependence on a few customers (if any) is also analysed. The entities with good supply chain management are more capable of understanding and meeting consumer needs better by offering the desired quantity and quality of the commodity at the desired price and time and also create synergies throughout the value chain. CARE gives due weightage to companies which have sourcing arrangements near to the place of procurement/production, lower overhead costs, bulk procurement and handling capability as well as adequate warehousing arrangements near to the place of export or dispatch. Adequate transportation arrangements, either through own fleet or arrangement with other rail/road/shipping players gives an entity a competitive edge over others. CARE's assessment takes into account the value addition the entity brings to the commodity/trade through its organization and network capabilities.

A3. Risk Management Practices and Strategy: A trading entity faces plethora of risks relating to price fluctuations, foreign exchange fluctuations, counterparty risks as well as market risks relating to competition, change in government policies etc. Risk management is a dynamic process and wholesale trading entities need to be prepared for constantly managing both physical and financial flows to sustain their business position over the longer term. The risk management systems should broadly encompass management of operational risks, commercial position, and financial position of the entity. The analysis includes quantification of various risk parameters and evaluation of the risk parameters vis-à-vis the net-worth and operating size of the company. The risk profile assessment gives importance to inventory risk and credit risk arising out of various counterparties.

Inventory Risk

The entities which undertake trade against confirmed orders or on a back-to-back basis have lower operational risks as against those entities which maintain an inventory position (stock and sale). Presence of precise guidelines and policies with respect to selection and control on traded commodities, systems for monitoring of prices, measuring and evaluating market risks through techniques such as marking-to-market, Value at Risk etc. are viewed positively. The hedging policies followed by the management and level of hedging (against both currency risks as well as commodity price risk) using forward or futures market is also an important factor for evaluating the market risks and the same are also examined in detail.

Credit Risk

The entities with well laid out credit policies are more insulated from counterparty risks. The credit policies can broadly cover limits on credit lines extended to counterparties, method of computation of credit limits, limits on trade volume, duration of contracts etc. The number and profile of majority of customers (end users or trader), track record of relationship with customers, credit rating of the 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.

B. Management Evaluation:

Management evaluation is one of the most important factors supporting an entity's credit standing. Besides experience of promoters in trading operations, experience in working and understanding of end-user industry is also very crucial. CARE examines the organization structure, and relevant qualifications and experience of senior executives. Besides, extent of support of parent company or group in terms of financial and/or operations is also examined in detail.

Companies with clear demarcation into separate departments, implementing guidelines for monitoring trading activities, credit policies as well as risk management activities with a clear reporting structure and control systems would be better placed to weather unfavourable conditions. The management's knowledge of local as well as global trade and regulations, understanding of various risks and approach/strategy for risk management and risk tolerance levels are of paramount importance. In addition, the use of financial and commodity derivatives is also taken into consideration and the management strategy of using the same, whether only to protect its financial results or for speculation is analyzed. Besides, given the high risk environment of trading operations, the management needs to continuously evaluate various stress test scenarios and pose 'what -if' questions to be better prepared for any adversities. Capability and past track record of the management to perform under stress provides an added level of comfort. A strong internal audit system and dedicated operational risk team regularly reviewing operating processes on a global basis is crucial.

C. Financial Risk Analysis:

CARE Ratings examines the past track record of income generation, size of operations, profitability levels, capital structure, operating cycle, dependence on working capital borrowings for operations, capital expenditure plans, off balance sheet items as well as understanding the accounting policies followed by the entities. In addition, projected financials as well as cash flows are also analysed in detail.

C1. Profitability: Wholesale trading entities usually operate on wafer thin margins. CARE analyses the growth in profitability levels, volatility in margins and reasons thereof, geographic as well as commodity wise breakup of revenue and profitability in detail. Entities which have better risk management systems, laid down credit policies, control on overheads and which offer some value added service have generally stable earnings and profitability. Various ratios analysed include PBILDT margin, PAT margin, RoCE etc.

C2. Asset Base: Trading entities usually have a low fixed asset base. CARE Ratings examines the investments made by entities in warehousing (owned or rented) and distribution network, quality and quantity of inventory levels as well as investment in risk management systems.

C3. Capital Structure: The extent of financial leverage is analysed to assess the risks arising from the use of debt funds and non-fund based limits. As there is a low investment requirement for fixed asset creation, the trading entities usually have low long-term loans but higher working capital borrowings. Use of banking facilities (fund based as well as non-fund based) as a key business differentiator significantly increases the risk profile of the company. The growth in net worth base, dependency on working capital borrowings for funding the operations is seen in light with management strategy for growth. Adequacy of capital base to cater to specific operational, credit or market risks is seen in light with management strategy for growth. Entities with high gearing have low financial flexibility and more susceptible to any downturn or external shocks as compared to others. Various ratios analysed include debt/equity ratio, overall gearing ratio, interest coverage ratio, Total Debt/Gross Cash Accruals ratio etc. The gearing computation includes “acceptances” and “creditors backed by bank limits”. CARE considers the creditors on Letter of credit / Acceptances as part of total debt while calculating the overall gearing ratio.

C4. Liquidity position: Entities with healthy cash position along with sufficient available bank lines are viewed favorably as they are better placed to meet any adverse market situation or sticky receivables. Further, if the entity relies on future contracts to make actual delivery, it should have adequate liquidity available for financial settlements.

C5. Working capital management: Higher working capital intensity results in negative cash flow from operations which result in higher debt. The working capital intensity of operations is analysed by studying the inventory management and holding levels, credit period extended by suppliers as well as average receivable days keeping in focus the nature and availability of commodities traded as well as a general price direction. For entities with large inventory holdings, the working capital requirements are higher; and these entities carry higher risk of inventory losses in case of downward movement in prices. Also, in case of increase in prices, the working capital requirements for the entities also increase.

In addition to the above factors, various other factors such as past debt servicing track record, the company's position in the industry, quality of accounts and disclosures and corporate governance practices are seen for assessing the overall creditworthiness of an entity.

Conclusion

The rating process is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. Rating determination is a matter of experienced and holistic judgment, based on the relevant quantitative and qualitative factors affecting the credit quality of the issuer.

[Last updated on August 29, 2018. Next review due in August-September 2019]

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