Rating Methodolgy - Wholesale Trading

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Characteristics of Wholesale Trading Companies

CARE Ratings Limited (CARE Ratings) defines wholesale trading companies as companies engaged in large-volume trading of commodities. Generally, the trading entities hold the inventory for mercantile trade, and the value addition undertaken on inventory for trade is minimal in nature, resulting in thin operating margin. The inventory and receivables constitute majority of the assets of wholesale trading companies resulting into high working capital intensity. The trading entities may also have logistical assets (like silos, warehouses, storage tanks, port facilities, etc.) for holding inventory or creating last mile connectivity.

Rating Methodology

CARE Ratings has a standard methodology for credit rating of companies belonging to the Service sector. It encompasses an assessment of the various risk factors, which could potentially affect the credit risk of an entity such as: economy and industry risk analysis, business risk, financial risk and management quality. However, considering the size and diversity of the service sector, CARE Ratings has devised methodologies specific to various industries within the sector. These methodologies attempt to point out factors, over and above those mentioned in the broader methodology devised for the service sector, which are considered while analysing entities belonging to a particular industry. The additional factors considered by CARE Ratings, along with their analytical implications, while arriving at the rating of an entity that operates in the wholesale trading segment have been discussed below.

A. Management evaluation

Management evaluation is one of the most important aspects of overall credit rating evaluation. CARE Ratings interacts with the management of the entity to understand the management's vision, focus and growth strategy. Management evaluation includes evaluation of composition of the Board, experience of the management in the industry, quality of accounts and nature of related party transactions, among others. Management's knowledge and past track record of managing the business during the commodity cycles are of paramount importance.

In case, if trading entities are part of conglomerates, the extent of linkages, support of the parent company or group in terms of financial and/or operations is also analysed (refer to CARE Ratings's Methodology-Notching by factoring linkages in Ratings (Parent-Subsidiary linkages, Group linkages and Joint venture), which is available on our website www.careedge.in).

For more details on management evaluation, please refer to CARE Ratings's 'Rating Methodology on Service Sector Companies', which is available on CARE Ratings's website.

B. Industry risk analysis

CARE Ratings' analysis of the industry risk focuses on the current industry scenario of the major products traded, demand-supply factors, the size of the industry, key players in the industry and competitive factors, cyclicality and seasonality associated with the industry, among others. Depending upon the commodity traded, the regulatory risk becomes one of the prominent risks for companies engaged in the trading of essential commodities. There have been numerous instances when government has imposed the restriction on free trade of certain agro-commodities so as to maintain the pricing and availability in the domestic market. Similarly, import duties have often been changed in favour of domestic industry incumbents. CARE Ratings analyses the current regulatory framework and also tries to ascertain the value at risk in case the regulatory stance changes in short or medium term.

C. Business risk analysis

Commodity and geographic diversification

CARE Ratings undertakes a detailed study of the traded commodities portfolio and the geographical presence of the entity being rated.

Generally, the entities having diversification in terms of product portfolio and geography are viewed favourably, as it insulates them from regional demand-supply issues, and economic cycles in a particular product or market.

CARE Ratings favourably views the entities where the concentration in trading portfolio is less. However, the concentration risk can be alleviated for entities that are dealing in commodity catering to particular segment of customer (i.e. established niche). Typically, these are sole traders associated with global producers of niche commodity and catering to specific commodity needs of downstream customers or there are entry barriers in terms of knowledge of trading.

Size and market position

Generally, entities with demonstrated track record of efficiently dealing in multiple commodities and having large scale of operations are viewed favourably since they are considered better equipped to withstand any external shocks.

For assessing a trading entity, relative size in terms of its total operating income, and retained earnings (tangible net worth base) is important criteria, mainly because it indicates the entity's competitive position and ability / cushion to sustain the sudden economic downturn. It is believed that large-size trading entities have higher market share, which enables them to have relatively superior bargaining power with both suppliers and customer enabling them to earn relatively better trading margins over the period. The better trading and risk management systems help trading companies during the high price volatility scenario.

Relationship with suppliers & customers and diversity

Generally, the commodity traders enjoy extensive relationship with both commodity suppliers and commodity consumers. In some cases, traders also enter into the formal agreement with commodity suppliers so as to have the consistent stream of commodity supply. Depending upon the market conditions, the effect of formal agreement may be beneficial or otherwise. CARE Ratings assesses the impact of all such formal agreements on the business profile of the trading entity.

CARE Ratings assesses the supplier concentration risk arising out of limited number of suppliers. The risk is particularly evident during supply disruptions at supplier's end, where trading entity has to rely upon spot purchases to cater its customer commitments, exposing it to the price volatility risk. Concentration of customer is also viewed negatively, as it indicates the entity's dependency on less number of customers. Customer concentration also indicates the limited bargaining power of trading entity against its customers.

Supply chain infrastructure

Despite limited value addition to the product, wholesale traders are key link in the value chain, and depending upon the commodities traded and counterparties catered to, traders operate with varied degree of business integration. CARE Ratings evaluates the supply chain infrastructure in terms of the integrated distribution, warehouse and transportation systems, as these factors have a direct bearing on the operational efficiencies and hence the profitability and sustainability of the trader.

Although CARE Ratings favourably factors in the extent of integration, it also critically assesses the extent of investment made / required and return generated on those investments in terms of competitive advantage achieved. As a result, the traders achieving business integration with asset light model fare better as compared to the entities having asset heavy model.

Commodity price fluctuation risk

The risk arising out of commodity price fluctuation is one of the key risks faced by the entities engaged in the trading operations. The exposure 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. CARE Ratings believes the entities undertaking trading against confirmed orders or on a back-to-back basis have relatively lower exposure to commodity price fluctuation risk, as against those entities, which maintain an inventory position (stock and sale).

The pricing and 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.

Inventory risk:

As wholesale trading business is highly working capital intensive in nature, mainly on account of high level of inventory required to be maintained to ensure ready availability of stock, inventory management becomes important. The entities dealing in commodities with highly volatile prices or with long inventory holding period are expected to have a larger networth to absorb the impact of price decline. Besides, the quality of inventory in terms of its ageing schedule (wherever critical) in the context of changing needs of the consumers or short product life cycle is analysed.

Counterparty credit risk

The entities with well laid-out credit policies are more insulated from the 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.

Foreign currency (forex) risk

In case wholesale traders deal in foreign currency on account of exports, imports, investments, loans, advances or otherwise, an impact analysis of change in foreign exchange rates is conducted to check the impact of adverse fluctuations in foreign exchange rates on profitability of an entity. CARE Ratings takes into account the foreign exchange risk policy and hedging policy adopted by the entity to mitigate the foreign exchange risk. The entities having a consistent and conservative forex hedging policy are viewed positively during the analysis.

D. 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.

As indicated earlier, CARE Ratings in its management discussion also tries to understand the leverage philosophy and growth strategies (organic / inorganic) of management which might impact the financial risk profile, going forward.

Profitability

The profitability analysis consists of two factors, i.e., level of profitability and consistency in profitability. For analysing the level of profitability, CARE Ratings uses return on capital employed (RoCE) as key measure, and gross margins. RoCE is a more effective indicator as traders deploy the capital into inventories and earn out of the price / availability arbitrage, thus generating income on capital deployed (for traders, large part of their capital employed is deployed in net working capital) in business.

For analysing the volatility in profitability, CARE Ratings analyses the historical trend in profitability indicators. It can be inferred that high volatility in profitability margin can be on account of the entity being engaged in unhedged speculative trade. This inference is to be further probed in comparison to the movement in profit margins of its industry peer group.

Capital structure and debt protection measures

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 (using fund-based as well as non-fund-based limits). For analysing financial leverage, CARE Ratings analyses the ratios like total debt (long + short-term debt + acceptances / non-fund-based facilities) to TNW, total debt to PBILDT, total outside liabilities (TOL) to TNW and total debt to cash flow from operations. CARE Ratings considers the creditors on Letter of credit / Acceptances as part of the total debt while calculating total debt for deriving leverage indicators. The entities with high leverage have low financial flexibility and are more susceptible to any downturn or external shocks as compared to others.

For analysing the debt coverage indicators, CARE Ratings looks at the coverage indicators including interest coverage, term debt/gross cash accruals (GCA), total debt/GCA and debt service coverage ratio (in case of repayment for long-term debt).

Liquidity and working capital management

CARE Ratings analyses the liquidity factoring in the cash generating capability of entity as against the fixed obligation due during next 12 months, latest available unencumbered cash / investment balance, available unutilised bank lines or financial flexibility to raise the debt from the capital markets.

CARE Ratings also analyses the trend in the operating cycle and gross current asset days, as it directly impacts the intensity of working capital borrowings. Elongating trend in the operating cycle indicates that higher capital is being blocked in funding inventory or debtors. Furthermore, CARE Ratings also analyses the debtor realisation track record by seeking granular data on debtor ageing.

CARE Ratings also looks into short-term liquidity indicators like current ratio.

For more details on financial ratios, please refer to CARE Ratings' methodology on 'Financial Ratios-Non financial sector entities' which is available on CARE Ratings' website.

E. Environmental, Social and Governance risk analysis

CARE Ratings, in its overall credit rating framework, analyses the critical Environmental, Social and Governance (ESG) risks, the materiality of ESG risk factors and mitigating factors, if any, being implemented by the entity and their impact on the credit profile of the entity.

The environmental impact is assessed depending on the products being traded. CARE Ratings analyses the social impact of the trading industry based on its workforce and customer base. CARE Ratings looks at the composition of the board of directors and track record of legal and statutory compliance by its management/ directors to understand the corporate governance structure. Furthermore, the quality of disclosure related to financial statements, related-party transactions and transparency in sharing information with various stakeholders are also helpful to gauge the corporate governance practices.

Conclusion

The rating outcome is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. The Rating Committee of CARE Ratings analyses each of the above factors to arrive at the overall assessment of credit quality of the issuer based on its holistic judgement.

[For previous version please refer 'Rating Methodology – Wholesale Trading' issued in August 2022**]**

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About:

CareEdge is a knowledge-based analytical group that aims to provide superior insights based on technology, data analytics and detailed research. CARE Ratings Ltd, the parent company in the group, is one of the leading credit rating agencies in India. Established in 1993, it has a credible track record of rating companies across multiple sectors and has played a pivotal role in developing the corporate debt market in India. The wholly-owned subsidiaries of CARE Ratings are (I) CARE Advisory, Research & Training Ltd, which offers customised advisory services, credible business research and analytical services (II) CARE Risk Solutions Private Ltd, which provides risk management solutions.