Rating Methodology - Wholesale Trading

[In supersession of "Rating Methodology - Wholesale Trading" issued in August 2018]

CARE Ratings defines trading companies as companies engaged in large volume trading of basic commodities, such as agricultural commodities, edible commodities, Metals/ precious Metal, Chemicals, Oil / Energy, etc. Generally, the trading entity holds the inventory for mercantile trade and the value addition undertaken on inventory for trade is minimal in nature. Trading entity may have logistical assets (like silos, warehouses, storage tanks, port facilities, etc.) for holding inventory or creating last mile connectivity.

CARE Ratings (CARE) has a standard methodology for credit rating of companies belonging to 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 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 analyzing entities belonging to a particular industry.
Such additional factors considered by CARE, along with their analytical implications, while arriving at the rating of an entity that operates in the wholesale trading segment have been discussed below.

Business Risk Factors

Commodity and geographic diversification

Generally, the entities having geographical diversification and diverse traded portfolio are viewed favorably as it insulates them from regional demand supply issues, and economic cycles.
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, such as the availability/seasonality and volatility in prices, the general economic environment and trade restrictions if any, are also taken into consideration.

Each traded commodity has its own demand-supply dynamics and trading patterns, we believe, the entities having the diverse trading portfolio where, there is no co-relation between the prices of each commodity (traded by entity) exhibits stable earnings.

CARE favorably 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 trader 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.

In order to alleviate the concentration risk, CARE looks for following factors in traded entity.

A. The traded commodity should be highly liquid (i.e. easily disposable / can be sold off in any market situation) in terms of it being easily traded on the local or global commodity exchanges.
B. Management's adoption of superior risk management practices pertaining to hedging the commodity price and foreign exchange fluctuation risk.
C. Management's knowledge and past track record of managing the business during the commodity cycles

Size and Market Position

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.

For assessing a trading entity, relative size in terms of its Total Operating Income, Asset base, and Retained earnings (Tangible Networth base) is important criteria, mainly because it indicates 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 large trading companies during the high price volatility scenario.

Relationship with Suppliers & Customers and diversity

Generally, the commodity traders enjoy long standing 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 assesses the impact of all such formal agreements on business profile of trading entity.

CARE 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 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.

Extent of integration in trading value chain

Depending upon the commodities traded and counterparties catered to, traders operate with varied degree of business integration. Large traders have a tendency to integrate vertically by maintaining logistical assets such as warehousing facilities, storage and transport facilities. Higher level of integration helps traders to provide end-to-end solution to customers and garner better operating margins by catering services related to entire value chain. Further, providing incremental services improves the supplier / customer relationship and provides traders with enhanced capability to absorb the fluctuation in commodity prices to certain extent.

Although, CARE favorably 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, traders achieving business integration with asset light model fare better as compared to entities having asset heavy model.

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 commodity and financial risk to sustain their business position over 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.

Commodity Price fluctuation risk

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

CARE evaluates the laid down guidelines and policies of trading entity with respect to 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.

Counterparty 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 analyzed in detail.

Industry Risk

Scope of government intervention in trade and pricing

Depending upon the commodity traded, the regulatory risk becomes one of the prominent risk for companies engaged in trading of essential commodities. There have been numerous instances when government has imposed the restriction on free trade of certain agro-commodity so as to maintain the pricing and availability in domestic market. Similarly, import duties have often been changed in favor of domestic industry incumbents. CARE 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. Further, the trade agreement pacts with various countries is also one of the factor analyzed during credit rating evaluation process.

Management Evaluation & Governance practices

Management Evaluation

Management evaluation is one of the most important aspect of overall credit rating evaluation. 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.

In case if trading entities are part of conglomerates, the extent of linkages, support of parent company or group in terms of financial and/or operations is also examined in detail *(refer to CARE's - Factoring Linkages in Rating methodology).* Besides, the detailed discussion is undertaken with management to understand their risk management philosophy and strategy for business going forward.

Key factors that are analyzed under management evaluation are as follows

- Experience of management in commodity trading business, their involvement in day to day operations and their understanding of financial tools for risk management practices and adherence to laid down risk management practices of entity.
- Companies having well laid out organizational structure, with 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.
- Managements philosophy on leverage, growth plan and strategy for organization

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.

Corporate Governance

CARE analyses the governance practices followed by companies while undertaking the credit rating exercise especially public listed entities. Governance practices are the laid down rules and processes that govern the way any entity is directed, it encompasses each and every aspect of management including internal controls and corporate disclosure.

CARE analyses following factors for governance practices followed

Parameters	Remarks
Ownership structure of entity and group (if any)	- Ownership structure of entity and constitution is analyses. - Entities with proprietorship or partnership constitution are viewed unfavorably as compared to Limited or Private Limited entities, owing to risk of capital being withdrawn in former. - Complex group ownership (having more than three layers) structure is viewed unfavorably.
Constitution of Board and its oversight	- Composition of Board with presence of requisite independent directors having relevant experience for effective oversight is viewed favorably.
Transparency and Disclosures	Extent of transparency in the entity’s dealings with various stakeholders, financial prudence and compliance with extant laws and regulations is seen closely; Effort of company to go beyond the regulations is also viewed positively. Audited results and the information published on exchanges are the key source of disclosures made by company.

Financial Risk Analysis

CARE 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 analyzed in detail.

As indicated earlier, CARE in its management discussion also tries to understand the leverage philosophy and growth strategies (organic / inorganic) of management which may 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 analyzing the level of profitability, CARE uses Return on Capital Employed (RoCE) as key measure, and gross margins. RoCE is 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 analyzing the volatility in profitability, CARE analyses the historical trend in profitability indicators. It can be inferred that high volatility in profitability margin can be on account of 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. High volatility in profitability indicators also indicates the managements appetite to deviate from prudent risk management practices and their intensity to undertake the speculative trading.

Financial Leverage & debt coverage

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 analyzing financial leverage, CARE analyzes the ratios like Total Debt (Long + Short term debt + Acceptances / non fund based facilities) to Tangible Networth (TNW), Total Debt to EBITDA and Total Debt to Cash flow from Operations before working capital changes. CARE considers the creditors on Letter of credit / Acceptances as part of total debt while calculating Total Debt for deriving leverage indicators. Entities with high leverage have low financial flexibility and more susceptible to any downturn or external shocks as compared to others.

For analyzing the debt coverage indicators, CARE uses Interest cover and Debt Service Coverage Ratio (in case of repayment for long-term debt).

Liquidity

CARE analyses 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 unutilized bank lines or financial flexibility to raise the debt from capital markets.

CARE also analyses the trend in operating cycle as it directly impacts the intensity of working capital borrowings. Elongating trend in operating cycle indicates that higher capital is being blocked in funding inventory or debtors. Further, CARE also analyses the debtor realization track record by seeking granular data on debtor aging.

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