

## Characteristics of Wholesale Trading Companies

Wholesale trading companies are businesses engaged in large-volume trading of commodities. They serve as vital intermediaries in the supply chain, purchasing goods in bulk from manufacturers or producers, and selling them to retailers or other businesses. The wholesale trading industry is highly fragmented, characterised by a large number of small and medium-sized enterprises operating alongside a few large players, generally backed by strong promoter group. Generally, 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 assets of wholesale trading companies resulting into high working capital intensity. The trading entities may also have logistical assets (such as silos, warehouses, storage tanks, and port facilities, among others) for holding inventory or creating last mile connectivity. Entities leverage their market knowledge, storage capabilities, and logistical expertise to optimise margins.

## Rating Methodology

CARE Ratings Limited (CareEdge Ratings) has a standard methodology for credit rating of companies belonging to the Service sector. It encompasses an assessment of the 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, CareEdge Ratings has devised methodologies specific to 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 CareEdge Ratings, and their analytical implications, while arriving at the rating of an entity operating 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. CareEdge Ratings interacts with the entity's management 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 track record of managing the business in the commodity cycles are of paramount importance.

Risk management is an essential aspect for trading entities as they operate with thin profit margin, making them vulnerable to market fluctuations and operational disruptions. Absence of a well-defined risk management policy is viewed negatively by CareEdge Ratings.

In case, if trading entities are a 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 CareEdge Ratings' Criteria on Notching by Factoring Linkages in Ratings (Parent-Subsidiary linkages, Group linkages, Joint Ventures, and Private Equity), which is available on our website [www.careratings.com](http://www.careratings.com)).

**B. Industry risk analysis**

CareEdge Ratings' analysis of the industry risk focuses on the current industry scenario of the major products traded, demand-supply factors, industry size, key players in the industry and competitive factors, and cyclical 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 trading 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. CareEdge 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**

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

Generally, 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.

CareEdge Ratings views the entities favourably when there is concentration in trading portfolio. However, the concentration risk can be alleviated for entities dealing in commodity catering to particular segment of customer (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 external shocks.

For assessing a trading entity, relative size in terms of its total operating income (TOI), 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, enabling 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 in the high price volatility scenario.

**Relationship with suppliers and customers and diversity**

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

CareEdge Ratings assesses the supplier concentration risk arising out of limited number of suppliers. The risk is particularly evident in 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. Pandemics, adverse geo-political scenario lead to higher freight costs and delay in shipments, causing supply disruption for importers. In such scenario, diversified supplier base reduces dependency on a single region and are viewed favourably. Customer concentration 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. The entity's exposure to a particular country for purchase and/or sale of products is also analysed, given the increasing geo-political uncertainties.

### **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. CareEdge 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 CareEdge 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. Traders achieving business integration with asset light model fare better compared to entities having asset heavy model.

### **Profitability**

The profitability analysis consists of two factors, level of profitability and consistency in profitability. For analysing the level of profitability, CareEdge 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, CareEdge Ratings analyses the historical trend in profitability indicators. It can be inferred that high volatility in profitability margin can be considering 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.

### **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 commodity derivatives. The risk of exposure can be mitigated through back-to-back sales orders or by taking the hedging position on exchanges. CareEdge 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, 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 and 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 considering high level of inventory required to be maintained to ensure ready availability of stock, inventory management becomes important. Entities dealing in commodities with highly volatile prices or with long inventory holding period are expected to have a larger net worth 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, and duration of contracts, among others. The number and profile of majority 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 considering 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 an entity's profitability. CareEdge Ratings considers the foreign exchange risk policy and hedging policy adopted by the entity to mitigate the foreign exchange risk. Entities having a consistent and conservative forex hedging policy are viewed positively in the analysis.

**D. Financial risk analysis**

CareEdge 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, and understanding the accounting policies followed by the entities. In addition, projected financials and cash flows are also analysed in detail.

As indicated earlier, CareEdge 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.

**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 and non-fund-based limits). For analysing financial leverage, CareEdge Ratings analyses the ratios such as total debt (long + short-term debt + acceptances / non-fund-based facilities) to TNW, total debt to profit before interest, lease rentals, depreciation and taxation (PBILDT) , TOL/ TNW, and total debt to cash flow from operations. CareEdge 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 downturn or external shocks compared to others.

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

**Liquidity and working capital management**

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

CareEdge 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. Seasonality and growth plans are also factored while assessing the Company's liquidity needs. CareEdge Ratings also analyses the debtor realisation track record by seeking granular data on debtor ageing.

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

For more details on financial ratios, please refer to CareEdge Ratings's methodology on 'Financial Ratios-Non financial sector entities', which is available on CareEdge Ratings's website [www.careratings.com](http://www.careratings.com).

**E. Environmental, Social, and Governance risk factors**

In the last few years, Environmental, Social, and Governance (ESG) risks have been gaining importance across the globe and are increasingly influencing investment decisions. In its overall credit rating framework, CareEdge Ratings directly or indirectly, analyses the critical ESG risks, and their impact on the credit profile of the entity. CareEdge Ratings analyses materiality of ESG risk factors and mitigating factors being implemented by the entity.

**Environmental risk**

The environmental impact is assessed depending on the products being traded. The wholesale trading industry, generally, has low environmental impact, mainly because of low emissions and water utilisation due to trading nature of operations.

**Social risk**

CareEdge Ratings analyses the social impact of the trading industry based on its workforce, supplier, and customer base. Hence, compliance with Government norms and adequate safety measures for manpower provide long-term sustainability.

**Governance risk**

CareEdge Ratings analyses 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. The quality of disclosure related to financial statements, related-party transactions and transparency in sharing information with stakeholders are also helpful to gauge the corporate governance practices.

## **Conclusion**

The rating outcome is ultimately an assessment of fundamentals and the probabilities of change in the fundamentals. CareEdge 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 [February 2023](#)]**

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