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Criteria For Rating Of Trading Entities

24-01-2024 (Version 5)

PREAMBLE

Trading entities are engaged in distribution, bulk breaking, retailing and trading of basic commodities, as well as products/ finished goods. These entities differ from manufacturing entities primarily in two aspects- the degree of value addition & requirement for long-term funding. Typically, a trading entity will have a low degree of value addition and low profitability margins vis-à-vis a manufacturing entity. Hence, it is imperative that the trading entities be evaluated on a distinct framework which addresses these nuances of a trading activity. This rating methodology explains the approach adopted by Acuité to evaluate the credit profiles of trading entities.

BASIC APPROACH

Trading entities are exposed to risks such as commodity / product price risks, foreign currency fluctuation risks and a competitive environment with low entry barriers. Acuité's credit risk assessment is based on the entity's scale of operations, level of supplier and customer concentration, value addition, if any (in terms of logistics, branding, retailing, among others), exposure to forex fluctuation and extent of mitigation, inventory holding policy and volatility in the commodities being traded.

While evaluating a trading entity, business and financial risks are assessed from the perspective of resilience of the business to absorb abrupt shocks on account of changes in the operating conditions for the trading entity.

I. BUSINESS RISK ASSESSMENT

While evaluating a trading entity's business risk analysis, Acuité considers the following factors:

A. Size of Business and Sustainability – The size of business assumes criticality as a higher scale adds to the entity's negotiating power with its customers and suppliers, adding to its ability to navigate the business successfully across a cycle. With greater scale, usually the trading entity's diversification over geographies, products, suppliers and customers is high. While the size and wide distribution network of existing players is difficult to replicate for newer players, the recent increase in digital commerce has become a great disruptor for the existing players operating in the physical mode. The online initiatives of the manufacturers and the increasing penetration of e-commerce players have increased the competitive intensity in trading activity. Although the product coverage through e-commerce platform is currently limited to a particular category of products, the sustainability of a physical presence over the medium term has to be examined against this backdrop.

B. Supplier Risk - Acuité assesses the supplier profile, length of relationship with the supplier, credit terms, etc. Acuité believes that the dependence on a few large suppliers could impact the business profile of the entity, although the same is mitigated to a large extent by the length of the relationship and the criticality of the

relationship to the supplier. Hence, for a clear evaluation of the risk, it is more important to understand the nature of the relationship. For instance, in case of an auto dealer, invariably there will be a limited supplier base. However, in such cases, the auto dealer becomes a critical part of the principal distribution network in that geography, and with regard to competition in the industry, the principal will also support the dealer wherever necessary. The support may be in the form of an inventory funding line of credit under channel financing tie-ups with banks/ NBFCs. On the flip side, the key risk here is that if the trader's business prospects are linked to the principal's market performance and if the principal loses market share, then the auto dealers may also exhibit a subdued performance.

C. Inventory Risk – As is customary to the nature of business, trading entities are required to hold significant levels of inventory of the commodity being traded. The inventory held by the trading entity, therefore, will be subjected to 'Price Risk', 'Risk of Obsolescence' and 'Foreign Exchange Fluctuation Risk'.

The Inventory Holding Policy of the trading entity determines the extent of gain/loss on account of the price moment in the commodity being traded. The nature of the inventory assumes importance here. A trading entity engaged in trading of standard products with limited variants, procured domestically, will generally tend to have lower requirements, whereas entities in retailing, distribution and trading in products with wide variations are generally seen to have higher inventory holding requirements. For instance, a footwear dealer will typically have a large inventory to cater to the varied requirements of its clients. Similarly, a franchisee of a reputed retail jewellery chain will typically have a higher inventory holding requirement in order to attract clients with a wide variety of designs. On the flip side, for entities that have order-backed trading operations or a back-to-back trading model, the inventory risk is low. In case of entities with imports, players with a large proportion of high-seas transactions tend to have lower inventory levels vis-à-vis other importers.

a. Price Risk: Volatility in the commodity being traded and hedging mechanism: Acuité observes the volatility in commodity prices being traded in conjunction with the entity's inventory holding levels. The higher the volatility higher is the risk of inventory holding. Any significant adverse movements in the commodity prices can result in mark-to-market losses for the existing players holding large inventory. Acuité also evaluates the hedging mechanism the trading entity employs, such as booking futures contracts on the commodity exchanges /back-to-back pass-through arrangements with its customers.

b. Risk of Obsolescence: A trading entity where the business model is not under a back-to-back procurement arrangement is subject to risk of obsolescence. This is particularly applicable to products with a short life cycle or a rapidly evolving landscape in the industry. For instance, a trader of garments will be subjected to the risk of obsolescence.

c. Forex Risk: While analysing the trading entity's business risk profile, Acuité evaluates the entity's exposure to currency fluctuation risk. A trading entity is exposed to exchange fluctuation risk when it has payables in one currency and

receivables in another currency. For instance, foreign currency risk is pronounced when it imports goods on credit (denominated in USD) and sells the same domestically (denominated in INR) or procures domestically (denominated in INR) and exports (denominated in USD). In such cases, the trader is exposed to the exchange rate fluctuation risk in the time lag between procurement and ultimate sale. Acuité evaluates the various hedging mechanisms employed by such entities to mitigate significant fluctuation in forex rates.

Acuité also evaluates the trading entity's ability to pass on a significant price increase to customers. Entities that have well-defined price escalation clauses with their customers or arrangements with their suppliers to share the downward price movements in the traded commodities generally have better stability in profit margins.

D. Customer/ Debtor Risk: A trading entity may be required to extend significant credit to its customers in line with industry practices to retain its competitive advantage. Hence, the trading entities are exposed to the risk of counterparty risk, i.e. risk of the customers not paying on time. This results in a build-up in receivables, translating into liquidity pressures for the trading entity. Hence, in this context, Acuité understands the clientele profile and the extent of customer concentration risk. Besides the risk of non-payment, the trading entity is also exposed to the risk of non-acceptance/ delayed acceptance of goods. For instance, a trading entity engaged in the import of goods may have back-to-back arrangements with its domestic customers. In such cases, if a large customer delays taking delivery of his order due to reasons like liquidity stress, business slowdown, etc. then the trading entity may be required to find an alternate buyer for these goods. This may not always be feasible and could affect its cash flows and profitability. Hence, the credit profile of customers becomes a key input while assessing the business risk profile of a trading entity.

Acuité observes that the trading entities generally follow policies such as setting single-party exposure limits to mitigate counterparty risks. In this regard, Acuité also assesses the payment terms, such as Letter of Credit, post-dated cheques, etc. Generally, in case of sales under LC, the trading entity will be insulated from the credit risk since the LC opening bank is committed to making the payment on fulfilment of certain conditions.

E. Level of Value Addition: Acuité evaluates the level of value addition of the trading entity in the entire value chain that would lead to higher margins and better return indicators. Trading entities involved in packaging and retailing (both online and the conventional models), branding, distribution, logistics and basic levels of processing, would have higher margins vis-à-vis other players.

F. Regulatory Risk: In India, the regulatory environment has a significant bearing on the future growth plans of the existing players. The Government rules regarding FDI in retail will have a bearing on the performance of existing retail players. Similarly, for certain products such as essential commodities, the government may frame rules for the inventory levels to be maintained by the traders, in order to ensure smooth domestic supplies, thereby affecting the performance of the traders. The government also engages directly in sourcing and pricing (by setting minimum

support prices) of essential commodities. Given these considerations, Acuité carries out a detailed analysis of the regulatory framework and factors it in the overall business risk profiles of the trading entities.

II. FINANCIAL RISK ASSESSMENT

The operations of a trading entity are characterised by high working capital intensity and low fixed asset intensity. Hence, the debt contracted by a trading entity is generally short-term, self-liquidating in nature, to fund its inventory and debtor requirements with minimal long-term debt. Besides fund-based limits, the reliance on non-fund-based limits, such as letter of credit, forms a large part of the entity's indebtedness. Acuité considers these factors while analysing the entity's financial risk profile.

Acuité assesses the entity's adequacy of cash flows vis-à-vis its overall indebtedness, while also assessing the management's policies with regard to financial risk. The historical financials, fund and cash flow statements and financial projections provide essential information about the entity's operations. Some of the sub-factors considered in financial risk analysis are:

- Margins: EBITDA margins, PAT margins amongst others
- Liquidity: Current ratio, Inventory days, Receivable / Payable / Working capital days
- Return Measures: Return on Adj. Tangible Networth & Adj. Return on Capital Employed
- Debt and Debt Coverage: Adj. Total outside liabilities (TOL) to Tangible Net worth ratio, Adj. Interest coverage ratio.
- Risk Coverage Ratio: The risk coverage ratio attempts to understand the impact of adverse variation in inventory/receivables on the Net worth.

$\text{Risk Coverage} = \text{Adj. Tangible Net worth} / \text{Value at Risk (VaR)}$

$\text{VaR} = (\text{Loss on inventory} + \text{Loss on Receivables})$

Acuité's financial risk evaluation also includes trend analysis and peer comparison to understand the relative risk standing of the entity. Understanding an entity's financial and accounting policies is a must to ascertain the accounting quality.

III. MANAGEMENT RISK ASSESSMENT

This is a very important aspect of the evaluation. The quality of management has a crucial bearing on the performance of an enterprise. The assessment focuses on management integrity, competence, governance and risk appetite. The risk framework for assessing the same is laid down below:

A. Integrity

The integrity and credibility of the management is a key aspect influencing the decisions of any lender or investor. In the absence of credibility, the management will always face a certain level of trust deficit, which will have a bearing on its access to credit and pricing of loans. The manner in which a company conducts business has a bearing on perception of the market's perception about the company and its standing. The key aspects examined here are:

- Instances of delays/ defaults/ compromises with lenders/ investors.
- Legal proceedings against key promoters of key management personnel.
- Instances of frequent investigations by regulatory authorities
- History of litigation of a material nature
- Recurrent instances of non-adherence to local laws and environmental norms triggering regulatory action.
- Instances of significant default on statutory obligations
- Adverse news about the company/ management regarding serious non-compliance with any laws.

B. Competence

Promoters influence management selection, decision-making and future course of the company. The promoters demonstrated ability in navigating the business across various business cycles is examined under this parameter. The various points examined are as under:

- Ability to maintain growth along with profitability across a cycle.
- Ability to attract and retain marquee clients and skilled employees at the senior level.
- Ability to initiate course corrective measures in response to a changing business landscape.
- Ability to lead the company into different segments and successfully execute diversification/ expansion initiatives.
- Ability to balance and manage the expectations of various stakeholders including customers, employees, lenders, creditors, channel partners, investors, society and government.

C. Risk Appetite

The management's risk profiling is extremely critical from a lender's perspective. The key aspect to be examined and understood here is whether the management is a

risk seeker, risk averse or risk neutral. This can be gauged from the management's approach to debt (gearing), hedging of currency/ commodity exposures, etc. The management's approach to growth vs profitability is to be understood from the risk standpoint. An aggressive management will pursue growth at any cost, irrespective of its impact on profitability, whereas conservative management will focus on profits and cash flows. Again, some managements may prefer organic growth rather than inorganic initiatives, which reflects their risk disposition.

D. Corporate Governance Practices

Along with a capable management team and an effective strategy, it is necessary for the management team to adopt best practices in corporate governance. This gets reflected in the composition and functioning of the board, attitude towards stakeholders and disclosures, among others. It is also important for the management team to undertake a systematic planning exercise that sets organisational priorities and ensures that those priorities percolate to the middle and lower management helping the organisation's review mechanisms and track progress of plans and re-evaluate strategies and goals.

The Key Factors to be considered are:

- Independence of the board, the functioning of various committees
- Quality and adequacy of corporate disclosures
- Soundness & Stability of accounting practices
- Extent of intra-group transactions / related party transactions.
- Perceptions regarding governance practices
- Stability of top management
- Alignment of organisational goals with employee targets and remuneration.
- Quality and adequacy of performance and market feedback to top management.

Group and Parent Support

The rating based on analysis of above-mentioned parameters is a standalone rating. However, it is commonly observed that an enterprise belonging to an established business group or a company is on a different footing compared to a stand-alone entity. The former could benefit from the parent/ group in terms of credibility, brand equity, managerial, business and financial support. Notching the standalone ratings of individual companies up is based on the assumption that a company's creditworthiness, apart from its own business and financial strengths and weaknesses, is also dependent on the backing it enjoys with the group/ parent/ government.

The degree of linkage between the entity and its group companies/ parent/ government needs to be ascertained to decide the extent of notching. Some of the factors influencing the degree of association are usage of common name, size of investment and holding in the entity by its parent/ group/ government, past instances of support, etc.

Please [click here](#) to access the criteria on "Group and Parent Support".

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