Rating Methodology for Cement Companies*

Introduction

Indonesian cement industry has an important role in the domestic economy as it strongly supports the construction sector including infrastructure. Nevertheless, other non-metallic mineral products industry (including cement) grew by only 2.4% in 2014 amidst the slowdown in the GDP growth of 5.0%. Total cement consumption in that year increased slightly to about 59.9 million tons, from 58.6 million tons a year earlier.

Cement, like other commodities, exhibits strong cyclicality in volume of offtake and price realizations. However, the industry is relatively insulated against global trends as the large freight component makes voluminous imports unviable. Thus, competition in the Indonesian cement industry is largely restricted to domestic manufacturers. Cement producers are not immune to the cyclicality inherent in this business. However, cement producers with strong fundamentals are able to withstand the cyclicality better as compared with others. In addition to industry risks, ICRA Indonesia's rating methodology, therefore, attempts to identify such company-specific factors as location advantages, proximity to consuming markets, regional supply-demand position, cost efficiencies arising out of access to key inputs at competitive prices, and operating efficiencies.

ICRA Indonesia's methodology evaluates:

- Market related factors
- Operational strengths
- Management quality
- Financial strength and future cash flows
- Government policies

Market Related Factors

Geographical diversity and regional supply-demand scenario: Cement being a bulky low-value commodity is highly freight sensitive, and bulk of the cement produced within a region is usually consumed within the region itself, with excess being transported to the adjacent regions. Thus, price trends and capacity utilization levels are determined more by regional supply-demand dynamics than by the national supply-demand balance. Therefore, while rating a cement manufacturer, ICRA Indonesia projects the likely supply-demand scenario for the region in which the manufacturer operates as well as for the adjoining regions.

While projecting demand, ICRA Indonesia takes into account past trends, the underlying economic growth drivers, and the cement-intensity of infrastructure projects planned and being implemented in the region. Similarly, ICRA Indonesia attempts to project the likely supply position by looking at greenfield and brownfield expansion plans of manufacturers, besides low-cost supply additions through debottlenecking of existing capacities and blending[1]. ICRA Indonesia takes a favourable look at manufacturers with plants in different regions, as geographical diversification usually allows players to better cope with local downturns.

Locational economics: A cement plant has to be set up close to both the source of the main raw material, i.e. limestone --which is a very bulky item, as well as the consuming centers so as to have low freight costs and ready market access. Indonesia's cement production is mainly concentrated along the Java Island which is considered as the biggest market due to the country's economic concentration, in addition to the availability of limestone, within this region. Another big market for cement is Sumatera whilst other islands like Kalimantan, Sulawesi and Nusa Tenggara still book relatively marginal cement consumption.

In analyzing the locational economics, ICRA Indonesia also evaluates the strategies adopted by individual companies to offset their locational disadvantages, if any. One strategy, for instance, is to set up stand-alone grinding units close to the consuming markets and the clinkerising unit near the limestone quarry. This helps the manufacturers to save the freight cost as clinker can be transported in open wagons or trucks. Thus, ICRA Indonesia assesses the company's policy on setting up integrated cement plant vis-à-vis having grinding units and clinkerising units at different locations, and the cost versus benefits of the company's approach.

Market structure: The domestic cement industry has seen some consolidation following a number of mergers and acquisitions. Such consolidation has also brought in a degree of supply rationalization among manufacturers impacting to relatively steady cement prices. Thus, while rating a cement manufacturer, ICRA Indonesia also takes into consideration the degree of consolidation that exists in the region(s) concerned, as that determines the extent of supply rationalization and the intensity of pricing pressures.

Operational Strengths

Cost efficiencies: Cement being a commodity item does not allow much premium pricing and thus most manufacturers are price takers in the markets they operate. In such a scenario, control over operating expenses is essential not only to maintain cost competitiveness and maximize profitability, but also withstand cyclical downturns, and is therefore one of the most important rating determinants. The major operating cost head for cement companies (apart from freight) is power & fuel. Power & fuel expenses in turn depend on two factors: the consumption norms and the cost per unit of input consumed. Thus, ICRA Indonesia analyses consumption norms such as kCal/kg clinker, kwh/kg clinker and kwh/MT cement produced for the manufacturer being rated. ICRA also assesses the manufacturer's efforts at reducing input costs through measures such as setting up captive thermal power plants[2], using economic cost power from mini-hydroelectric plants, etc., and using alternative fuels that are available locally.

The vintage of a cement plant also influences its cost structure significantly. While an older plant enjoys the advantage of lower capital cost, such benefit is usually offset by higher power & fuel costs, significant repair and maintenance expenses, and generally higher manpower expenses. Size is another factor that determines the overall cost structure of a cement plant, as larger plants usually enjoy better control over infrastructure and overhead expenses.

Product diversity and blending: Ordinary Portland Cement (OPC) enjoys a premium over blended cement because of greater acceptability. Cement companies have popularized the use of blended

[1] Clinkerisation capacity is often a constraint in the production of cement. Blending allows a company to produce more cement using the same amount of clinker

[2] as the full cost of producing thermal power based on either domestic or imported coal is substantially lower than grid power

cement, with the result that the proportion of blended cement in the total production has increased over the years. The cost of production of blended cement is lower vis-à-vis OPC as the cost of additives such as fly-ash and slag (which are used in blended cement) is usually lower than the cost of clinker. Further, blended cements allow a manufacturer to produce more cement using the same amount of limestone and clinkerisation capacities.

Logistics: Cement manufacturers can use a mix of rail, road and coastal sea transport to distribute their product. While rail transportation is more economical over longer distances, for shorter hauls road transportation is more cost-effective and reliable. ICRA Indonesia assesses a manufacturer's logistics development efforts in terms of reliability and costs. This apart, ICRA Indonesia assesses the strength of a manufacturer's dealer network as much of the sales takes place in the retail segment. ICRA Indonesia looks at the strength of the dealer network and its geographical coverage while assessing a company's distribution network.

Brand development: Brand equity also remains a largely regional factor (given that sales are regional), with some local players enjoying considerable brand equity in their areas of operations. ICRA Indonesia views favourably sustained efforts by manufacturers towards brand development, as it expects brand strength to allow market acceptance in the long term.

Management Quality

As with most other businesses, management quality is one of the most important factors considered by rating companies to access cement producers. Of particular importance in assessing management quality is the management's track record on project implementation, the performance of group companies, the company's exposure to such group entities, and the management's ability to implement cost-reduction programs. ICRA Indonesia also assesses the company's strategy for growth and possible acquisitions, besides its likely capital outlay for the same. Clearly, consistent operating performance and the observance of conservative financial policies, which however do not compromise the company's ability to grow, provide additional comfort.

In assessing management quality, ICRA Indonesia also looks at the track record of the company's management during past cycles, particularly the use of surplus cash flows during up-cycles. ICRA Indonesia views favourably companies that use these surpluses to lower debt, invest in cost-cutting measures and setting up of captive power plants, and engage in low-cost capacity addition through measures such as de-bottlenecking. ICRA Indonesia takes an unfavourable view of companies that use surpluses for unrelated diversification or investment in group companies.

Financial Strength and Future Cash Flows

The financial strength of a cement manufacturer is an important rating consideration. While assessing the financial position of a cement company, ICRA Indonesia reviews the Accounting Policies followed by the company, Notes to Accounts, and Auditors' Comments that are part of the Annual Report. Any deviation from the Generally Accepted Accounting Practices is noted and the financial statements of the issuer are adjusted to reflect the impact of such deviations. Apart from balance sheet strengths which determine a player's ability to withstand a deep down cycle, ICRA Indonesia also evaluates the profitability and cash generating ability of the business as well as other sources of financial flexibility available to an entity to evaluate its overall financial risk profile.

Profitability: Profitability of a cement manufacturer is primarily a function of its cost structure and product mix. However, since cement is a cyclical industry the profitability of the companies in this industry varies significantly along the cycle. Nevertheless, producers having cost structures better than the industry median level can generally be expected to remain profitable across cycles.

Leverage and cash flows: As with companies in other commodity industries exhibiting cyclical price trends, a low financial leverage is viewed as a credit quality positive for cement players. Besides protecting the cash flows of players by imposing a lower debt service burden, especially during periods of cyclical stress, a low gearing also imparts greater financial flexibility to cement producers to access funds from institutional sources.

Besides capital structure, ICRA Indonesia pays special attention to coverage indicators including interest coverage, operating profit and net cash accruals relative to the total debt while evaluating the financial health of a candidate company. ICRA Indonesia is particularly concerned with a company's capability to honour its contractual obligations under stress conditions. The more robust a company's performance is likely to be under a range of reasonable projections; the better it is from a credit evaluation perspective. ICRA Indonesia also critically looks at other sources of financial flexibility available to an issuer, which could be in the form of, among others, availability of a portfolio of liquid financial assets, strategic importance of the entity to the group to which it belongs along with the financial strength of group entities.

Tenure mismatches, and risks relating to interest rates and refinancing: Large dependence on short-term borrowings to fund long-term investments can expose an issuer to significant re-financing risks, especially during periods of tight liquidity. The existence of adequate buffers of liquid assets/bank lines to meet short-term obligations is viewed positively. Similarly, the extent to which an issuer could be impacted by movements in interest rates is also evaluated.

Debt servicing track record: The debt servicing track record of a company is an important input for any credit rating exercise. Any delays or defaults in the past in the repayment of principal or interest payments reduce the comfort level with respect to the candidate company's future debt servicing capability and willingness.

Contingent liabilities/Off-balance sheet exposures: In this case, the likelihood of devolvement of contingent liabilities/off-balance sheet exposures and the financial implications of the same are evaluated.

Consolidated financial analysis: In case of groups consisting of companies with strong financial and operational linkages, various parameters such as capital structure, debt coverage indicators, and future funding requirements are assessed at the consolidated/group level.

Adequacy of future cash flows: Since the prime objective of the rating exercise is to assess the adequacy of the issuer's debt servicing capability, ICRA Indonesia draws up projections on the likely financial position of the issuer under various scenarios. Besides, ICRA Indonesia takes into account the commitments of the company towards other group companies, new ventures, and its investments in subsidiaries/SPVs. Subsequently, future cash flows are projected after taking into account the company's capacity utilisation levels and the likely prices of raw materials and finished products, the growth it envisages for itself, debt repayment schedule, its funding requirements, and the funding options available to it. These cash flows are then used to determine the company's future debt servicing capability under various scenarios. Apart from cash flow projections, the other ratios used to assess cash flows are Fund Flow from Operations (FFO) interest coverage, FFO debt coverage, and FFO capital expenditure coverage.

Government Policies

Government policies influence cement manufacturers in several ways. In terms of cement product, the government through ministry of industry regulates the mandatory implementation of national cement standard (SNI). Cement producers are obliged to own this standardization and attach their SNI number on its each of cement packages. Elsewhere, the Ministry of Trade (MOT) also stipulates certain types of imported clinker and cement that are allowed under the regulation No. 40/M-

Dag/PER/8/2013.This import activity can be conducted by cement producers as well as registered cement importers and subject to MOT's import approval. Furthermore, the government also has a strong commitment to secure national cement supply to fulfill domestic consumption as stipulated by Presidential Regulation No. 28 Year 2008 on national industry policy. The government also aims to secure the coal supply for cement industry especially for cement producers developing coal based power generation.

Summing Up

ICRA Indonesia's credit ratings are a symbolic representation of its current opinion on the relative credit risk associated with the instrument being rated. This opinion is arrived at following a detailed evaluation of the issuer's business and financial risks, its competitive strengths, its likely cash flows over the life of the instrument being rated, and the adequacy of such cash flows vis-à-vis its debt servicing obligations. As the note has highlighted, for cement companies, special attention is also paid on the company's geographical diversity, raw material security, cost competitiveness, product diversity, management strategies for managing cyclical downturns and an overall approach towards investment and growth.

*Adopted and modified from ICRA Limited's Rating Methodology for Indian Cement Companies