Rating Methodology for Trading Companies*

This rating methodology explains ICRA Indonesia's approach in analyzing business and financial risk for trading companies. ICRA Indonesia defines such trading companies as companies whose primary business activity involves the merchandising and distribution of large volumes of basic commodities, such as agricultural, metals, building & construction material and oil/energy. Such companies have substantial physical inventories of commodities and assets that may be utilized for value addition or logistics.

The objective of the rating methodology is to provide a reference tool that can be used to evaluate the credit profiles of companies engaged in trading businesses. It aims to help issuers, investors and other interested market participants understand ICRA Indonesia's approach in analyzing quantitative and qualitative risk characteristics that are likely to affect rating outcomes. This methodology does not include an exhaustive treatment of all factors that are reflected in ratings but would enable the reader to understand the rating considerations that are most important.

Overview

Indonesia is considered as one of the largest and most attractive markets in the world sustained by its large population, reaching around 248.8 million in June 2013 (Statistics Indonesia or Badan Pusat Statistik/BPS), coupled with accelerating GDP per capita. According to BPS, GDP per capita has showed an improving performance as it climbed to around Rp36.5 million in 2013 (vs. Rp23.9 million in 2009). BPS also reports that percentage of household expenditure for food is in a declining trend as it dips to 47.19% (September 2013) from 50.62 in 2009, paving the way for improving percentage of household expenditure for non food to 52.81% compared to 49.38% in the same period which indicates more products to be consumed.

Basically, there are three main categories of trading business in Indonesia, namely traditional markets, shopping centers and modern stores. According to ministry of trade, there are currently about 9,599 traditional markets – with number of total traders reaching about 2.6 million --, of which only about 461 had been revitalized by the government. Moreover, based on the Indonesian Shopping Center Management Association, there are about 240 malls and shopping centers and the number is predicted to grow in the future in line with the robust growth of GDP per capita. Meanwhile, according to Indonesian Retailers Association, modern retailers during 2007-2012 had grown at the average of 17.6% per year to around 18,521 outlets in 2012 (vs. 10,365 in 2007).

Some of the retail businesses may also be engaged in trading of branded products such as auto components, medical equipment, electrical equipment, building & construction materials and even franchisee of branded apparels. For analyzing such companies, ICRA Indonesia looks at various parameters that may be specific to an individual business. Some of the common ones would be a) the level of gross margins offered by original equipment manufacturer (OEM), b) quality of retail presence, c) relationship with the OEM, d) nature of contract (related to exclusivity, region or buyback arrangements).

Given the fact the trading business operates on wafer thin profitability and provides limited scope of differentiation or value addition, ICRA Indonesia considers risk management as a crucial factor for commodity supply chain companies. However, given the fragmented nature of the business, most of the players in the unorganized segment lack proper framework for risk management and information systems. Despite the promoters of these businesses having vast experience, dearth of standardized business management practices exposes them to market risk.

Scale, Market Position & Diversification

In line with the rating methodology for most of the other corporate sectors, assessment of a trading company's scale, market position and business diversification play an equally important in reflecting a company's competitive strength in the markets it serves, its bargaining power with suppliers and customers. Trading has traditionally been a fragmented business with exception of few sectors.

Most of the trading businesses be it agricultural commodities, building & construction material have traditionally been managed by family run businesses. Such business outfits though have vast experience in their fields generally lack strong market position and even diversification. Such business traits may however vary from business to business. For instance, the share of organized segment in trading of agricultural commodities, especially rice may have attained a reasonable share of the market over the years, while some of the businesses continue to remain highly fragmented. With significant export opportunities, many of the players have gradually attained meaningful scale and market position in agricultural commodity trading and have also explored both backward & forward integration measures to strengthen their business profiles.

Nevertheless, the importance of scale and market position may command different weighting across sectors and qualitative factors such as experience of the promoters and their understanding of the business may be acknowledged while assessing the business risk.

Some of the key parameters analyzed by ICRA Indonesia include:
- Level of trading volumes
- Relationship with suppliers (producers, farmers etc.)
- Relationship with customers, share of business & bargaining power
- Presence – regional or nationwide
- Customer concentration
- Presence in backward supply sources or front-end marketing/distribution.

Companies that score highly on the above parameters are often able to source products at competitive prices, spend less on logistics and provide quicker delivery of products. As a result, companies with larger market share are able to generate higher margins over time by exploiting any regional discrepancies in price and short-term imbalances in supply and demand.

Level of business integration

Apart from enjoying strong market position and diversification, trading businesses also strengthen their business profile by vertically integrated their operations. Some of the larger players in the trading business, especially the ones engaged in agricultural commodities such as edible oils, wheat, rice etc. have also integrated their businesses by exploring possibilities of both backward and forward integration. For instance, companies engaged in trading of edible oils have strengthened their sourcing by acquiring processing units on one hand and have also created marketing brands on the other with the objective to absorb value across the chain. Besides improving profitability, such measures also help companies in mitigating the impact of fluctuation in commodity prices to some extent.

While backward integration measures prima facie add strength to a company's business model, the extent of investments required in backward integration and the ability of a company gain critical importance in an attempt to transform a business model. For instance, a steel trading outfit or a business engaged in trading in rubber may not have adequate balance sheet strength or capabilities for setting up a steel mill or tire manufacturing unit, respectively. As a result, certain businesses by their very nature have limited vertical integration opportunities. Thus, ICRA Indonesia differentiates its approach depending on the sector the business belongs to and follows a comprehensive benchmarking evaluation with peer group, while assigning ratings.

Business Risk

Just like any other sector, trading business is also exposed to multiple types of risks arising out of market risks from change in commodity prices, credit risk from exposure to multiple counterparties, risk from hedging and trading activities, and risk of loss during storage or transit etc. Given the volatility in margins arising out of these variables, risk management is an important competency and a key rating driver in this industry. ICRA Indonesia's assessment of the risk management practices includes, but not limited to, the following:

A) Market Risk

One of the key risks those trading companies face is the market risk arising out of volatility in commodity prices which may be influenced by trends in international commodity prices, demand supply dynamics and macro-economic trends. Exposure to a commodity is either taken through physical possession or through financial derivatives and the risk may be hedged through back-to-back transactions or through counter purchase agreements on local/global exchanges. In assessing market risk, ICRA Indonesia evaluates the company's trading and hedging strategies, management's track record in the business, volatility in earnings from its core business segments and longevity of the company's operations in each of its major market segments. In addition, the extent of market risk in a business is also influenced by inventory holding period. Business with relatively higher inventory holding periods owing to factors like processing, logistics etc may face higher market risk compared to the ones where turnaround is faster like trading in metals etc.

B) Regulatory Risk

After market risk, the other prominent challenge that trading companies face is the potential change in regulations related to commodity trading. The regulatory environment is fairly stringent, restricting free trade, sourcing, warehousing and even pricing of essential commodities. In an attempt to strike a balance between the welfare of the agricultural community and ensuring supplies at competitive rates, the Government also engages directly in sourcing and pricing (by setting minimum support prices) of essential commodities. Besides, the Government also implements restrictions in imports/exports from time-to-time depending upon the prevailing market conditions. Import/export duties are often altered to align with the interest of the local industries. Such risk exposes companies engaged in trading of essential commodities to regulatory risk further emphasizing the importance of diversification. Given these considerations, ICRA Indonesia carries out detailed analysis of the regulatory framework and makes appropriate adjustments to the analytical framework for trading companies. For instance, often, businesses engaged in exports of certain commodities such as palm oil etc. tend to take a disadvantage from an export-duty, wherein substantial proportion of the profitability is driven by such trade policies, resulting in fluctuation in earnings with change in policies.

In general, the government has an important role in the trading industry. For example, it issued a specific regulation to encourage competitiveness of retail sector as well as to protect small business players especially the traditional markets. Minister of trade's regulation No. 70/M-DAG/PER/12/2013 which was issued at the end of 2013 provides guidelines for arrangement and development of traditional markets, shopping centers and modern stores. Selected key provisions of this regulation include a cap on number of modern store outlets that can be owned and managed by a single company of 150 outlets. If players intend to establish more outlets, they are required to enter a partnership with a local small or medium enterprise. Another provision is cap on sale of foreign goods of 20% which means at least 80% of goods sold at each modern store must be locally produced. In terms of selling area, the regulation stipulates criteria for modern stores like minimarkets (less than 400 m2), supermarket and department stores (more than 400 m2), and hypermarket and grocery stores (more than 5,000 m2)

C) Counterparty/Credit Risk

Involvement of multiple counterparties in trading transactions also exposes a company to credit risk, and necessities a comprehensive credit risk management system for identifying, assessing and monitoring credit risk with respect to their customers and suppliers. Credit risk can be mitigated by managing counterparty exposure through risk weighted limits and customized credit terms determined following a credit appraisal process. Additional risk mitigates may include third party guarantees, collateral agreements, margin deposits and trade insurance measures. The implementation of such measures in a tightly monitored environment is considered favorably by ICRA Indonesia.

The trading companies are exposed to multiple other risks across the supply chain, including but not limited to, risk of loss or damage during storage or transit, foreign exchange risk or events of political risks. While the loss on physicals can be addressed by taking adequate insurance cover for general and specific liability, a company can hedge its foreign currency exposure through derivatives contracts. In addition, political risk insurance provides cover for events such as war, export restrictions, seizure or blockage of funds, prohibition of transfers in foreign currency among others. ICRA Indonesia's evaluation is based upon the importance given by a company to these risks and is reflected by its insurance and forex policies.

Financial Policies

Apart from analyzing business strengths, tolerance for financial risk is another key rating consideration while rating trading companies. This factor seeks to assess how financial policies will impact future decisions on leverage and liquidity management. However given the unorganized nature of most trading oriented businesses, financial policies are often not well defined among companies. As a result, it becomes challenging to assess a company's risk taking capabilities and its impact on creditworthiness. With these constraints, ICRA Indonesia gives higher weightage to qualitative aspects resulting from management meetings. Key issues include a) target return and leverage indicators, b) in-organic growth plans (size of potential acquisitions etc.), c) funding plans and d) future plans to improve capital efficiency and liquidity.

In assessing a company's credit profile, ICRA Indonesia analyses financial leverage on both unadjusted and adjusted basis. The two material adjustments applicable to the calculation of adjusted ratios include impact of operating leases (related to warehouse leases, vessel chartering etc.) and loans from promoters/group companies. ICRA Indonesia observes that most of trading businesses being family run tend to rely on promoter funding (usually in the form of loans) in addition to bank borrowings. As part of working capital management, companies also discount receivables. In most cases, such trade receivable financing is not recognized on a company's balance sheet. Thus, ICRA Indonesia includes such financing arrangements as part of debt.

Some of the key indicators observed by ICRA Indonesia include:
- Leverage (i.e. Total Debt/Net Worth)
- Total Debt/OPBDITA
- Fund Flow from Operations (FFO)/Interest Expenses and
- Retained Cash Flows (RCF)/Total Debt.

Assessment of Liquidity

Trading business is characterized by volatility in earnings and cash flows due to inherent volatility in the prices of commodities and changes in market demand and supply conditions, which results in fluctuations in working capital requirements. Business engaged in trading of agricultural commodities such as wheat, rice, sugar, cotton etc. tend to also have seasonality in their business, which also results in funding requirements being exceptionally high during the procurement season and relatively low during other parts of the year. This is particularly common across companies/trading firms with limited diversification. Further, funding requirement also tend to be a function of a company's growth plans.

Trading firms generally rely on banking system to meet their working capital requirements and have limited access to capital markets. Given the stringent lending norms, access to bank funding at times becomes a time consuming process, especially for start-up or fast-growing companies, resulting in liquidity issues or even delays in timely servicing of debt obligations. Given the critical importance of liquidity in this industry, we consider management's approach and track record on proactively maintaining sufficient excess liquidity to absorb any reasonable increase in commodity prices or other events that could stress liquidity.

Management Quality & Bandwidth

All debt ratings necessarily incorporate an assessment of the quality of the issuer's management, as well as the strengths and weaknesses arising from an issuer being part of a conglomerate or large group. In case the issuer is among the stronger entities within the group, its past track record and future plans in supporting other group companies are analyzed. Usually, a detailed discussion is held with the management to understand the business objectives, plans and strategies, besides the outlook on the issuer's industry. Some of the other points assessed are:

- Experience & commitment of the promoter/management in the line of business
- Ability and willingness of the group to support issuer through capital infusion etc.
- Management's policies on leveraging and hedging commodity & foreign exchange risk
- Growth plans, investments/acquisition plans in new areas/projects
- Business & financial strengths of other companies within the group.

Other Rating Considerations

Apart from quality and experience of the management, assessment of corporate governance, quality of financial reporting and information disclosures are given considerable weightage while assigning ratings. Among the areas of focus in corporate governance are presence of an audit committee, financial expertise and level of board oversight and thought process on the company's measures of managing trading risk, the incentives created by executive compensation packages, related party transactions, interactions with auditors, and ownership structure.

The assessment of these factors can be highly subjective and variable over time. Ratings may include additional factors that are difficult to quantify or that only have a meaningful effect in differentiating credit quality in some cases. Such factors include the usage of technology in business, reputational risk, changes in consumer and business spending patterns, competitor's strategies, and possible government interference and last but not the least macro-economic trends. The analysis of these factors remains an integral part of our rating process.

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