

Criteria for rating trading companies

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Executive summary

Trading entities are intermediaries between manufacturers/ suppliers and distributors/ retailers. They add limited value to products, but have a place in the supply chain because of their understanding of customer requirements in terms of quantity and quality. They can sell goods in small consignments and also reduce the credit risk for suppliers.

Limited value addition and commoditised nature of business mean margins are thin for traders. The bulk of their balance sheet assets comprises inventory and receivables, with fixed assets forming a small part. Consequently, traders rarely contract term debt for capital expenditure, and mostly have working capital debt.

Thus, unlike manufacturers, for whom adequacy and sustainability of cash flow play a critical role in servicing of term debt, for traders, working capital management is paramount. Any stretch in the working capital cycle due to inventory pile-up (because of slowdown in demand) or write-down of receivables can wipe out margins and impact their credit risk profiles.

CRISIL's analysis of the business risk of trading entities focuses on inventory and receivables management, and also takes into account business size and sustainability, supplier concentration, and foreign exchange (forex) risk if there are overseas suppliers or customers.

The analysis of financial risk takes into account both the financial position and its flexibility.

To assess the financial position, credit protection metrics and their sustainability, CRISIL uses following parameters: return on capital employed (RoCE), interest coverage, total indebtedness ratio and cash to indebtedness ratio.

To assess financial flexibility, the working capital cycle and availability of internal and external fund sources (such as payables, unencumbered cash, unutilised bank lines, and funds from promoter to tide over unanticipated stretch in working capital) are evaluated.

CRISIL also factors management risk, which covers the management's competence, integrity and risk appetite

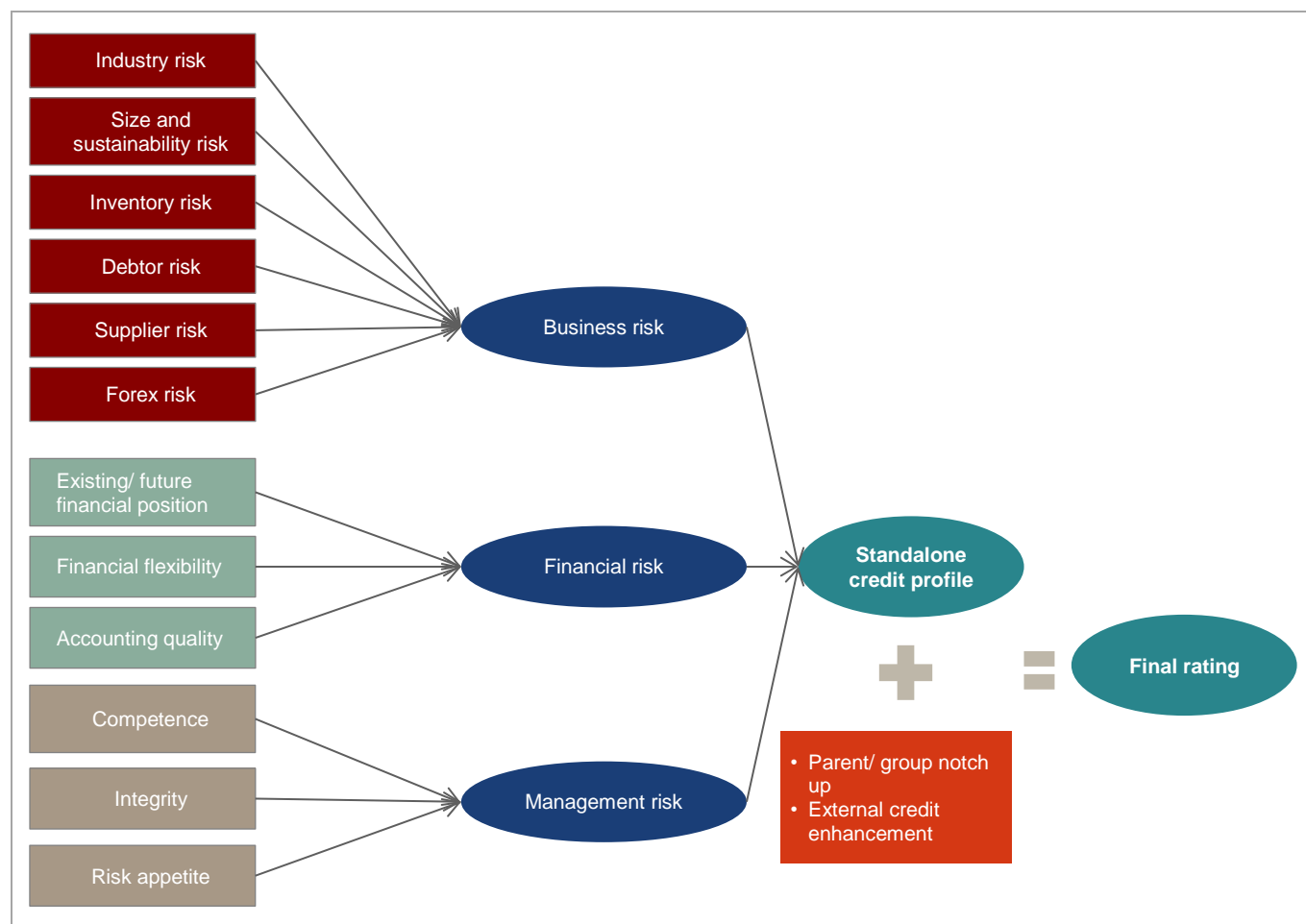
Scope of the criteria

The article focuses on the risks that traders face and CRISIL's methodology for assessing their credit risk profiles. The criteria¹ do not apply to entities trading in financial assets (such as equities and bonds), and have limited applicability for entities that also have significant manufacturing operations.

Methodology

CRISIL's framework for assessing the credit quality of traders covers analysis of business risk, financial risk, and management risk (*Chart 1*).

¹ For accessing previous version of the document , kindly follow link:
https://crisil.com/content/dam/crisil/criteria_methodology/traders/archive/V6-External-criteria-for-rating-trading-companies.pdf

Chart 1: Framework for rating trading companies


Business risk

This section outlines the risks inherent to the trading business and components of business risk evaluated by CRISIL.

1. Industry risk

While assessing the industry risk of a trader, CRISIL looks at the demand-supply dynamics of the product the trader specialises in. With cross-border trade, these dynamics could take on a global scope, and government regulations come into play. For example, China's domestic sourcing policy affects India's textile export, or import restrictions on steel in India prevent glut of cheap imports. These factors affect the growth prospects of the industry, the barriers to entry and exit, and the extent of competition, which form the basis of CRISIL's evaluation of industry risk.

2. Business size and sustainability risk

The business viability of a trading entity depends on its criticality in the value chain. Though traders add limited value to products, they provide important services such as enhancing the distribution network and geographical reach of the supplier. Although the business of a trading entity depends on the performance of the underlying industry, its own ability to sustain a viable business model is vital. All else being equal, a trader with a large scale of operations (and hence, a considerable market share) is more critical to the value chain than a smaller entity, leading to more bargaining power with suppliers and customers, and consequently, better sustainability. CRISIL

also compares a trader's operating margin with that of its peers because it will reflect its bargaining power and market position.

A long track record (or promoter's experience) is an important indicator of the ability to weather business cycles. Diversity in products and markets (both geographies and end-use industries) insulates the trader's business from downturn in any one product line or market.

3. Inventory risk

For traders, inventory accounts for a large part of working capital. Inventory risk arises because of fluctuations in product prices. Due to thin margins, any significant fluctuation in price can have a substantial impact on the trader's credit risk profile. CRISIL's assessment of inventory risk focuses on the potential decline in the value of inventory, and the ability of the trader to absorb the impact. The inventory value could decline due to a fall in the commodity price during the holding period, or because of product obsolescence. CRISIL evaluates the following factors when assessing inventory risk:

Holding policy: For traders, the risk of price volatility is directly proportional to the inventory holding period. Therefore, CRISIL analyses the historical inventory holding philosophy of the firm and the intent of its management to take speculative positions. It also assesses the track record of the management to insulate the company during times of excessive volatility in commodity prices.

Price risk refers to the decline in the price of a product during the holding period. A sharp drop in price can lead to a steep fall in the trader's networth. CRISIL looks at historical price data to determine the value at risk (VaR) of a commodity so as to quantify the price risk. The trader's ability to absorb the impact of unanticipated price fluctuation is also assessed, in addition to the potential decline in the value of the inventory because of price fluctuation.

CRISIL quantifies the inventory risk through inventory risk cover, which assesses whether the networth of the trader can adequately cover the loss arising from dip in value of held inventory in event of extreme price fluctuations. Traders of commodities with highly volatile prices, or with long inventory holding period, are expected to have a larger networth to absorb the impact of price decline.

Obsolescence risk is common in industries with short product life cycle or dynamic markets. CRISIL takes into account the nature of the product to assess the obsolescence risk. Examples of products with high obsolescence risk are mobile phones and garments.

To assess the inventory risk, CRISIL also considers the trader's risk mitigation strategies, such as hedging on commodity exchanges, on-demand procurement, and passing on increase in price to customer.

4. Receivables risk

As receivables also constitute a sizeable proportion of the current assets of traders, credit policy and collection efficiency are significant determinants of business risk. These factors also impact the financial risk profile. Delays in receivables can impact business considerably, especially if the capital employed is small. CRISIL analyses the amount of receivables in proportion to the trader's scale of operations to understand collection efficiency and receivables management.

For assessing receivables risk, CRISIL analyses the customer profile of traders — such as length of relationship, extent of revenue dependence, and credit risk profiles of customers.

Ceteris paribus, traders will be able to avoid cancellation of orders from longstanding clients, which is important especially in times of falling product prices. Customer concentration is a significant risk as during downturns, delay in payment by a single large customer may lead to severe stress on the trader's financial position. It also matters whether the customers are large firms with good creditworthiness, or small enterprises with modest credit

quality. Furthermore, sales against letter of credit (LC), bank guarantee (BG) or post-dated cheques are positive factors, as they reduce the risk of losses due to default.

5. Supplier risk

Excessive dependence on a few suppliers can expose traders to business continuity risk. Though they can get discounts by ordering in bulk, it is preferable to have a diverse supplier base to prevent slowdown in business because of problems at the supplier's end. CRISIL also looks at qualitative parameters such as the supplier's brand equity and credit policy, and length of relationship with the supplier. A longstanding relationship or criticality to the supplier's operations could lead to flexibility in obtaining favourable credit terms, allowing the trader to manage liquidity better in case of a stretch in working capital.

6. Forex risk

Often, traders with overseas suppliers or customers do not have a defined policy for mitigating forex risk. CRISIL views the credit risk profile of traders that either consistently hedge their forex exposure through forward currency contracts, or through a natural hedge (imports matched against exports) positively. Instances where management has documented and demonstrated a consistent forex hedging policy are also viewed positively.

Financial risk

The financial risk analysis covers how an entity's business strengths translate into current and future financial performance, and financial flexibility.

Existing and future financial position

To gauge past and future profit potential, and to understand the level and sustainability of the credit protection available, CRISIL looks at two key ratios: RoCE and interest coverage.

- **RoCE:** This ratio captures how well an entity is run by its managers, irrespective of leverage or the nature of industry. A consistently low RoCE reflects poorly on long-term business viability.

$$\text{RoCE} = \text{Profit before interest and tax (PBIT}^2) / (\text{Total debt} + \text{Tangible networth} + \text{Deferred tax liability})$$

- **Interest coverage:** It represents the cushion for meeting interest obligation from surplus generated, and reflects the ability to service debt on time. Entities with high coverage ratio can better absorb financial adversity and still pay interest on time. The interest coverage ratio is a factor of profitability, capital structure, and cost of borrowings.

$$\text{Interest coverage} = \text{Profit before depreciation, interest and tax (PBDIT)} / \text{Interest and finance charges}$$

The other aspect of financial assessment is balance sheet analysis, which determines financial position. For this, CRISIL takes into account:

- **Total indebtedness ratio:** Most of the debt of traders is short-term and self-liquidating. Also, trading entities tend to avail of a substantial non-fund-based financing (such as LC), which is reflected as payables on their books and not as debt. Therefore, total outside liabilities, which also include current liabilities, offer a more holistic view of a trader's indebtedness. Hence, CRISIL uses the total indebtedness ratio to assess the capital structure.

$$\text{Total indebtedness ratio} = \text{Total outside liabilities (TOL)} / \text{Tangible networth}$$

- **Cash-to-indebtedness ratio:** Traders having higher proportion cash³ in relation to its outside liabilities are able to effectively manage obligations, especially payment to creditors, and have extra cushion to weather adversity.

² CRISIL, in its calculation for PBIT and PBDIT, includes recurring non-operating income, but excludes extraordinary income or expenses

³ Includes cash, cash equivalent, and marketable securities

Hence, CRISIL considers cash-to-indebtedness ratio as an important metric to ascertain a trader's financial position.

$$\text{Cash-to-indebtedness ratio} = \text{Cash (and equivalents)} / \text{Total outside liability}$$

In addition to the abovementioned parameters, CRISIL also assesses risk coverage. In CRISIL's view, the biggest risks for traders are of inventory and receivables. Risk coverage is designed to assess how well a trader can absorb unanticipated shocks due to a fall in commodity priced, adverse forex movements, or stretch in receivables, without materially impacting its financial position. Entities having healthy risk coverage ratio on account of comfortable networth, or low inventory or receivables, have the ability to absorb business shocks and volatility without compromising their liquidity. Lower ratio could act as a constraining factor.

$$\text{Risk coverage} = \text{Tangible networth} / (\text{Potential loss on inventory} + \text{Potential loss on receivables} + \text{Potential loss on forex exposures})$$

Cash-flow adequacy and financial flexibility

As trading operations are working capital-intensive, liquidity assessment becomes a critical factor to determine financial risk. CRISIL considers both internal and external sources of liquidity, and assesses the ability to manage liquidity in case of a sudden increase in working capital requirement, especially during slowdown or extreme fluctuation in prices, and to generate funds through alternative sources in case of financial distress.

Among external sources of funding, traders are more likely to depend on working capital debt or payables. Flexibility in obtaining extended credit from suppliers is considered a positive, while unutilised bank lines enhance ability to meet unanticipated increase in working capital requirement. Adequacy of current assets and ease of converting these assets into cash to meet maturing LC obligations are also assessed to evaluate the overall financial flexibility of the entity.

Other liquidity indicators assessed by CRISIL are:

- **Current ratio:** This ratio indicates whether short-term assets are sufficient to meet short-term obligations. A healthy current ratio implies that long-term liabilities are financing long-term assets and a proportion of short-term assets, leaving sufficient liquidity for normal operations.

$$\text{Current ratio} = \text{Current assets (including marketable securities)} / \text{Current liabilities (including current portion of long-term debt)}$$

- **Gross current assets (GCA) days:** An indicator of working capital intensity, GCA days signify how quickly an entity can convert its current assets into cash. A large value signals either inability to sell inventory, or stretched receivables.

$$\text{GCA days} = \text{Total current assets related to operations} / \text{Operating income}$$

Management risk

CRISIL evaluates how well an entity's management operates the business, its credit policies, and history of speculative intent. The presence of risk management systems is viewed positively, as they can track product prices and flag sharp movements, enabling quick liquidation if required.

CRISIL assesses management in three broad areas: integrity, risk appetite, and competency. For more details please refer to CRISIL's article titled 'Rating Criteria for Manufacturing Companies' available on www.crisil.com.

Conclusion

CRISIL's rating methodology for trading entities involves intensive analysis of their business, financial, and management risk profiles, and is primarily aimed at determining the extent of inventory and receivables risk. CRISIL uses various financial ratios that it believes capture these risks appropriately.

CRISIL may also factor in parent/group support when assigning credit ratings. The criteria for factoring in parent/group support, and that for manufacturers (which share a few key aspects with criteria for rating traders) are covered under other articles on CRISIL's website.

About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better. It is India's foremost provider of ratings, data, research, analytics and solutions, with a strong track record of growth, culture of innovation and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

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