CRISIL Ratings' criteria for the consumer staples and discretionary sector

Criteria contacts

Somasekhar Vemuri
Senior Director
Rating Criteria and Product Development
Somasekhar.vemuri@crisil.com

Ramesh Karunakaran
Director
Rating Criteria and Product Development
ramesh.karunakaran@crisil.com

Rama Patel
Director
Rating Criteria and Product Development
rama.patel@crisil.com

Chaitali Nehulkar
Associate Director
Rating Criteria and Product Development
chaitali.nehulkar@crisil.com

Venkata Sumanth Devarapalli
Analyst
Rating Criteria and Product Development
Venkatasumanth.devarapalli@crisil.com

In case of any feedback or queries, you may write to us at Criteria.feedback@crisil.com

Executive summary

Consumer-oriented sectors such as fast-moving consumer goods (FMCG), consumer durables, and organised retail play a significant role in the economic growth of a country. Private final consumption expenditure, which accounts for 60% of India's GDP, indicates the demand in these sectors. These sectors are largely stable, however demand elasticity varies based on the discretionary nature of products.

For rating companies operating in the consumer staples and discretionary sector, CRISIL Ratings evaluates their business, management and financial risk profiles. The key parameters considered for analysing the business risk profile are market position and operating efficiency. Market position covers market share, brand equity, diversity in product portfolio, and innovation and product differentiation capabilities. Operating efficiency covers efficiency of distribution networks, supply chain management, manufacturing facilities (both in-house and outsourced) and sourcing.

For financial risk assessment, CRISIL Ratings follows the standard criteria used for all manufacturing companies, which assesses the sustainability and adequacy of the company's cash flows with particular emphasis on debt servicing ability. It includes an assessment of how the business strengths of the rated company are translated into its current and future financial performance and its financial flexibility, with particular emphasis on its liquidity.

For management risk assessment, CRISIL Ratings follows the standard criteria used for all manufacturing companies, which includes evaluating the management philosophies, strategies/policies, and risk appetite.

These are covered in detail in the CRISIL Ratings publications 'Rating criteria for manufacturing and services sector companies' and 'CRISIL's approach to financial ratios'.

Scope

While the broader criteria for rating manufacturing companies is applicable to the consumer staples and discretionary sectors, this article details the industry-specific factors impacting the business risk profile of different industries in the consumer sectors.

It covers the following industries:
- FMCG
- Consumer durables
- Sugar
- Cotton textiles
- Organised retail

CRISIL Ratings' criteria for the FMCG industry[1]

Background

CRISIL Ratings analyses the aspects like product mix, track record of innovation, differentiation, market share, pricing power and brand equity in market position. In operating efficiency, CRISIL Ratings considers key aspects such as distribution network, raw material sourcing, supply chain management, and manufacturing facilities.

Market position

Product mix

The product mix determines the categories in which a player operates. Players in segments such as toothpastes, soaps, and detergents that are essential items, and therefore, in frequent demand, tend to have stable sales; those present in discretionary segments such as perfumes and cosmetics, on the other hand, often report declining sales during times of recession. Presence in niche categories, where competition is fairly low, strengthens market position.

For each product category, the expected drivers of volume growth and their long-term sustainability are taken into account. New products that are closely linked to consumer needs, values and lifestyles tend to exhibit strong volume growth. The domestic market is extremely price-sensitive. Products in the popular segment are targeted at the low- and middle-income groups and typically, present a value-for-money proposition, whereas those in the premium segment are targeted at high-income customers. To cover the gap between these segments, players launch products at new price points, thus adding to the competitive pressure for products in the premium segment. The price sensitivity necessitates prudent product management, especially during a recession. A diversified portfolio, with products at a variety of price points, helps mitigate risks associated with any one segment.

A wide range of products enables balancing of growth objectives and competitive pressure. However, a small product portfolio is not necessarily viewed as an absolute negative since companies may dominate their chosen segments or straddle a niche. The success of players with smaller portfolios indicates that other factors also critically influence performance.

Innovation track record

To maintain customer interest and to stay ahead of the competition, companies need to periodically introduce new and better products. Product innovation capabilities and track record in creating successful brands are, therefore, taken into account. One good indicator of innovation is the contribution to revenue of brands introduced in the past three to five years. Product launches that provide an early-mover advantage in any category offer greater cash flow benefits than those that are minor variations of existing products.

Differentiation

A product's perceived benefits and differentiation over competing products is a key consideration. A product may be said to command a premium only if consumers are convinced of its superiority.

[1] Updated: February 2021; *For accessing the previous published criteria, refer to the following link: https://www.crisil.com/content/dam/crisil/criteria_methodology/consumer-staples-and-discretionary/archive/CRISIL-Ratings-crieria-fmcg-industry_2007.pdf*

Market share

CRISIL Ratings looks at the market share trends of each product. A consistently high market share has several advantages. It ensures a stable relationship with and better control over the distribution channel. Also, the company does not need to offer very high margins to the trade since this is compensated for by higher volumes. Established products with a large market share also have lower marketing and advertising expenses as it is cheaper to maintain an established brand than to create a new one.

Acquisitions in the FMCG industry tend to outnumber those in other industries. Acquisitions strengthen the acquirer's business risk profile by enhancing product offerings and geographical reach. However, ability to integrate operations with those of the acquired firm is a critical factor considered.

Pricing power

Sizeable market shares do not necessarily translate into price protection. Players with small market shares can pose strong price competition to market leaders. CRISIL Ratings, therefore, evaluates not only the published market shares, but also the market dynamics, to determine pricing power.

Brand equity

Brand equity is the degree of consumer loyalty that a company's products maintain. The presence of established brands serves as a formidable entry barrier for new brands. If brand loyalty is strong, consumers tend to be willing to pay a high price for the product, and are reluctant to switch to competing products.

Brand-building capabilities are a key consideration. Factors such as the management's willingness and ability to spend on advertising and brand-building are examined. During periods of slow growth and economic recession, players tend to slash their advertising expenditure to boost short-term profits. Companies with successful brands have an edge over the competition, thanks to greater association with customers and lower advertising expenses.

Operating efficiency

Distribution reach, optimisation of cost-cutting initiatives and of use of manufacturing capacity, and efficiency in raw material sourcing are critical elements considered under operating efficiency.

Distribution network

The distribution network's reach is assessed to ascertain the geographical diversity of sales. Greater sales diversity reduces geographical risks, especially those arising from changes in customer preferences in some areas. In India, a good rural-urban sales mix helps even out the effect of an uncertain monsoon on the consumers' purchasing power. A wide dealer network enhances the reach of products. Companies that can use the same network to distribute new products benefit from a head start. Those with products that have a strong export potential also have an advantage, especially during downtrends in the domestic market.

Supply chain management

Ability to offer a product when the consumer wants to purchase it is the most important factor that drives sales and promotes consumer loyalty. This is even more essential for products that are in seasonal demand. It also motivates retailers and wholesalers to stock the product. Several FMCG players in India have invested in supply chain-related information technology (IT) initiatives in recent years, enhancing inventory management and collection efficiencies.

Manufacturing facilities

Manufacturing is not capital intensive in the FMCG industry. Most companies have a combination of in-house production and outsourcing. The decision to outsource or produce in-house depends on issues such as transportation costs and access to raw materials. Typically, high-technology products are made in-house, while others are sourced from vendors. The product's shelf-life determines whether a company will opt to set up a production facility on its own or to outsource production.

Raw material sourcing

Efficiency in management of raw material costs is an important consideration for FMCG companies, especially in the case of products that depend on commodities such as sugar, cereals and oil. Ability to source raw material is essential, especially for businesses where the margins are thin. For items such as edible oil that are largely imported, effective risk management systems in procurement are critical, and are, therefore, analysed in detail. A wide sourcing base optimises the quality, quantity and pricing of purchase, and is considered a positive factor in the rating analysis. It also facilitates inventory management and reduces the impact on profitability, of fluctuation in raw material price.

CRISIL Ratings' criteria for the consumer durables industry[2]

Background

Consumer durables comprise product categories such as televisions, refrigerators, air conditioners, washing machines, and microwave ovens. The sector is intensely competitive, with new companies and technologies challenging incumbents. Demand for the products under this sector are driven by rising disposable incomes, growing consumer awareness, availability of credit, and shift in the perception of consumer durables as utility items rather than as luxury items.

While the growth will be driven largely by imports, many players in the sector have either set up local capacities or are undertaking capacity expansions to cater to domestic and global demand. On account of low penetration, rural India has emerged as a major market for several large players. The expansion in retail network and online retail has increased product accessibility even to the remotest areas of the country.

CRISIL Ratings analyses the aspects like product mix, demand-supply equations, competitive landscape, innovation and brand equity in market position. In operating efficiency, CRISIL Ratings considers key aspects like raw materials, distribution network, working capital management, and operating margin.

Market position

Product mix

Growth rates and prospects may continue to vary from one product category to the next. Intense competition has spawned the proliferation of products with varying features and aesthetics. CRISIL Ratings' analysis of the product portfolio includes evaluation of categories, features, and track record of products launched. Diversity in the product mix minimises dependence on any single product for revenue, and helps maintain a steady operating income.

Demand-supply equations

CRISIL Ratings factors in the product categories in which capacities are being expanded, and the growth rates across categories, to assess their future competitive positions.

Competitive landscape: market share and price protection

The trends in market shares of products are analysed, both by value and volumes. A consistently high market share helps maintain a stable relationship with, and better control over, the distribution channel. Players do not need to offer high margins to traders, since these may be compensated by higher volumes. Established products with high market shares require lower marketing and advertising expenses, since it is cheaper to maintain an established brand than to create a new one. Nevertheless, new products with small market shares may also pose strong competition to the market leaders. CRISIL Ratings, therefore, analyses the perceived benefits of the product over similar products in the market. A product may be said to command a premium only if consumers are convinced of its superiority.

Innovation track record

To sustain customer interest, companies need to launch new and better products, ahead of the competition. CRISIL Ratings, therefore, examines players' product innovation capabilities and track record at establishing successful brands. One good indicator of innovation capability is the share of recent sales of brands launched in

[2] Updated: February 2021; *For accessing the previous published criteria, refer to the following link: https://www.crisil.com/content/dam/crisil/criteria_methodology/consumer-staples-and-discretionary/archive/CRISIL-Ratings-crieria-consumer-durable-industry_2007.pdf*

the last three-to-five years. Innovation should help players raise profitability, because consumers are willing to spend more for added features and capabilities.

Brand equity

Brand equity indicates the degree of consumer loyalty a player's products enjoy. It is an important factor that CRISIL Ratings evaluates, since the presence of established brands acts as a high entry barrier. If brand loyalty is strong, consumers are willing to pay a higher price for the product, and consumers are less likely to switch to competing brands. CRISIL Ratings examines factors such as the management's willingness and ability to spend on advertising and brand building. Also, the success of one brand may help grow similar products, by giving them an edge over the competition, and thus, lower advertising expenses. Established mother brands may be extended to other price points, thus helping create an umbrella portfolio that is much stronger than individual brands.

Operating efficiency

Product design and development capabilities

The ability of players to launch products to serve new needs and develop new markets is an important criterion in evaluating operating efficiency. In the past, market segments and client profiles were clearly defined. Now, however, the needs and requirements of consumers are forever changing. In the television segment, for instance, the last decade has seen a sharp proliferation of panel TVs and the near exit of cathode ray tube TVs. It has, therefore, become imperative for players to re-engineer their products to meet the changing needs of the consumer on pricing, design, or product specification. Research and development (R&D) plays an important role here, since products need to be updated on technology, so that innovations are meaningful and beneficial to the consumers.

Distribution network

The distribution network's reach is assessed in ascertaining the geographic diversity in sales. A greater diversity in sales mitigates geographical risks, such as those on account of changes in customer preferences in some areas. A wide dealer network enhances the products’ reach. A company may use the same network to launch new products, and thus maintain a distinct competitive advantage. The advantages of having company-owned retail outlets over selling through multi-brand outlets are also factored in. Single-vendor retail stores attract a dedicated customer base and promote brand equity, leading to higher bargaining power and lower working capital requirement.

Raw material sourcing and cost structure

Raw material sourcing is an important aspect for consumer durables companies. A wide sourcing base helps optimise the quality, quantity and price of purchases. A low-cost structure strengthens the player’s business risk profile, improves its pricing ability, and helps optimise capacity utilisation even during downturns. CRISIL Ratings analyses past data to ascertain the ability of the company to pass on cost increases to its consumers.

Capacity utilisation is analysed as a means of evaluating operational efficiency. Flexibility to switch production between a range of products is evaluated. Outsourcing of manufacturing operations, for instance, allows flexibility to ramp-up production quickly during festive seasons while maintaining a low-cost structure. As several countries are covered under Free Trade Agreements, the cost differential of outsourcing from such countries is also ascertained.

Working capital management

As in the case of other manufacturing companies, efficiency in working capital management is critical for players in the consumer durables industry. Ability to manage inventory, demand, and payables (given the multiple channels involved) and the credit obtained from suppliers is evaluated. MNCs typically receive substantial credit from their parents, a factor that is often a key rating strength.

Quality and customer orientation

CRISIL Ratings evaluates consistency and improvement in quality, both in terms of costing and usability. Quality—of the product, and of the services in areas such as pre-sales, sales, installation, and after-sales—is a major challenge for consumer durables players, and thus, a critical criterion in the rating analysis.

CRISIL Ratings' criteria for the cotton textiles industry[3]

Background

India's cotton textile industry consists of the entire textile value chain—from cotton production to garment manufacturing. The cotton yarn spinning industry is highly capital intensive, faces acute cyclicality, has extremely fragmented capacities, and is intensely competitive on account of the commoditised nature of the product. Garment manufacturing, on the other hand, is not as capital intensive as yarn spinning; however, capacities in this category are fragmented, resulting in lower economies of scale. The fabric weaving and knitting sector has both large integrated players, and small operators.

CRISIL Ratings has rated a number of companies across the textile value chain. CRISIL Ratings' experience shows that some players fare better than others at managing the inherently cyclical nature of the industry, and simultaneously, at adding value by diversifying the product range. For instance, the established, vertically integrated companies have modernised their manufacturing facilities, and have therefore, been able to enter new global markets.

Under business risk profile, CRISIL Ratings factors in the market position and operating efficiency. The quality and count range of cotton, degree of diversification in product, customer and geographical profiles, and ability to capture new markets are evaluated under market position. While assessing operating efficiency, efficiency in raw material procurement and cost structure (mainly of labour and power), degree of modernisation in manufacturing facilities, and benefits from economies of scale are considered.

Market position

Product diversity and presence across the value chain

Companies that produce both cotton and blended yarn (blend of cotton and synthetic fibre) are better able to manage cyclicality than pure cotton yarn units. A diversified product mix with textile variants in addition to yarn and forward integration reduces the impact of cotton price fluctuations on profitability, CRISIL Ratings takes a positive note of value addition in products, including twisted yarn, dyed yarn, gassed and mercerised yarn, and compact and melange yarn, as these fetch better realisations, and help to capture niche markets, thereby strengthening the market position. Likewise, a wider range of fabrics, colours, and designs helps forge strong relationships with garment exporters and international retailers, resulting in a preferred vendor status. In garmenting (the stitching of fabric into garments), the key strengths required are strong design capabilities and grasp of fashion trends and needs.

Quality and range

A key factor distinguishing players in the commodity yarn market is their count range. A tilt towards finer counts partly shields them from cotton price fluctuations; this is because yarn realisations in the finer counts are generally less elastic than cotton prices, and are substantially higher than those in coarser counts. Though the higher counts fetch better realisations, their demand is lower than that of the medium counts. CRISIL Ratings views positively a presence across a wide count range. The key factors distinguishing players in the commodity fabric segment are the texture and colour ranges. The fabric that needs least processing before it can be used in garmenting will have the least price elasticity. This is applicable for woven and knitted fabrics. Garmenting is the final stage of

[3] Updated: February 2021; *For accessing the previous published criteria, refer to the following link: https://www.crisil.com/content/dam/crisil/criteria_methodology/consumer-staples-and-discretionary/archive/CRISIL-Ratings-crieria-cotton-textile-industry_2007.pdf*

manufacturing in the textile industry. This segment is generally not commoditised, and adding variety to the product range catering to changing consumer preferences is key.

Geographical and customer profiles

CRISIL Ratings believes geographical diversification helps minimise risks associated with a particular market or geography; such risks include political unrest or economic slowdown in any particular region

CRISIL Ratings also assesses the ability to capture new markets during periods of downturn in existing markets. Geographical diversification, recognition by large garment and fabric houses, and a steady customer base are key factors for long-term success in exports. Companies that have economies of scale, modern plants, effective cost-control measures, and export thrust are better placed. In the fabric segment, manufacturers that offer services such as design development and weaving/knitting as per the requirements of garment exporters stand to benefit. CRISIL Ratings expects garment exports to drive overall textile export growth, and integrated players to benefit on account of consistent quality and adherence to time schedules.

CRISIL Ratings also views a diversified customer base positively considering the minimal counterparty risks. If, for instance, the bulk of revenue is derived from a particular customer and the latter delays payment due to financial difficulties, overall working capital requirement may be stretched. In addition to the quality of the customer base, the length of relationship with key customers is also considered.

Operating efficiency

Cotton procurement

Most profitable textile companies are distinguished by their efficient cotton procurement strategies. Raw cotton, the primary input for spinning units, is the single largest cost component, and has a significant impact on operational performance. As cotton is an agricultural commodity, it is exposed to factors such as crop area, monsoons, and pest control. All other conversion costs and realisations remaining constant, fluctuations in cotton prices will result in a corresponding swing in operating profits.

CRISIL Ratings also looks closely at factors such as the expertise of the cotton unit in cotton crop estimation, proximity to procurement areas, modes of purchase (whether in bulk with an assured uniform quality or staggered throughout the season), and stocking and price positions adopted. While cotton arrivals are spread over a six-month period from October to March, quality cotton is usually available in the first few months. After the inventory losses incurred in the past, cotton spinners are cautious on stocking cotton for long periods. Thus, most have shifted to a leaner inventory cycle of 2-3 months since fiscal 2017, as against the earlier norm of 6 months. CRISIL Ratings assesses the inventory policy and also the ability to withstand the impact of sharp movements in cotton prices.

CRISIL Ratings' experience shows that companies with strong financial positions and liquidity are able to source bulk quantities of quality cotton at the beginning of the season—a key factor that results in economies of scale.

Cost structure

Power and labour form the second largest chunk of cost elements. The cotton spinning industry is more power intensive than the other parts of the value chain such as weaving, processing, and garmenting, which are more labour intensive.

Labour: Unlike in developed countries, India's textile industry is only partly mechanised and continues to employ a large workforce. Given the labour-intensive nature of the industry, an optimal workforce and a cordial labour relationship help ensure uninterrupted operations and controlled labour costs. Companies with frequent labour problems have poor labour efficiency, and therefore, low profitability.

However, due to the faster rise in costs and higher government incentives for modernisation through the Technology Upgradation Fund Scheme, the labour intensity has gradually declined. This has had only a minimal impact on operating margin, as several parts of the process chain, such as inter-process material transfer and packaging, remain labour intensive.

Power: For spinning mills, power costs typically account for 8-10% of the operating income; an uninterrupted supply of power is critical for consistent yarn quality. Power is a critical factor even for fabric manufacturers. Some large manufacturers also set up captive power plants, including windmills, to reduce power costs. CRISIL Ratings considers factors such as efficiency in power consumption, captive generation facilities, power cost-reduction measures, and the resulting impact on overall operations. Apart from captive generation, companies have also begun to explore other avenues to reduce power costs. Some CRISIL Ratings-rated textile units also enjoy concessional power from the state governments, which help them manage increases in per unit costs.

Modernisation

Modernising a textile unit is fairly capital intensive, and in general, the industry has lagged behind other cotton exporting nations in this respect; only a few financially strong companies resort to continuous modernisation. The spinning sector is more modernised than the weaving sector—capacity additions in the spinning sector were higher due to availability of higher subsidy in spinning, through technology upgradation fund. Also, many states have provided attractive incentives to promote modernization of plants and encourage setting up new capacities by offering various capital subsidy schemes.

However, the Indian spinning sector compares poorly with that of China and Southeast Asian countries, thus constraining global competitiveness. CRISIL Ratings favourably evaluates companies in the spinning sector that have constantly focused on modernisation as a strategy to retain global competitiveness. CRISIL Ratings positively views investments that provide value addition or reduce dependence on labour

Economies of scale

While scale of operations is a key factor in any industry, it assumes criticality in commodity industries such as cotton textiles, where profitability is dependent more on volumes than margins. Companies with higher capacities are likely to derive benefits of economies of scale. Large capacities also make future value additions economically viable. Furthermore, higher capacities in a single or near-by location can save costs. Hence, CRISIL Ratings assesses the capacities of textile units, and their ability to speedily shore up capacities in order to cash in on potential upswings in the market. Large-scale operations are also beneficial in fabric making and garmenting as they help in costing and in gaining competitive advantage. Quicker turnaround is a key differentiator for facilities with large capacities.

CRISIL Ratings' criteria for the organised brick and mortar retail industry[4]

Background

Retailing is a distribution channel through which goods are sold in small quantities to the final consumer. A retailer is typically a reseller, who buys products from a manufacturer/supplier/distributor and sells them to customers, without altering the characteristics of the product significantly. Generally, retailers are at the end of the distribution channel. However, a manufacturer may also be a retailer if he sells products directly to customers.

'Organised brick and mortar retailing' can be defined as a form of retailing wherein the consumer can buy goods in a similar purchase environment, across more than one physical location. There are different 'verticals' in organised brick and mortar retailing including food & grocery, apparel, household appliances, and footwear. Retailers operate through various formats such as specialty stores, department stores, supermarkets and hypermarkets.

The industry is characterised by intense competition from other organised retailers, local stores and the recently booming e-retailing segment. Increase in disposable incomes, growing urbanization, higher GDP growth over the medium to long term, and implementation of goods and service tax (GST) are key macro-economic factors aiding this growth.

CRISIL Ratings' analysis of business risk comprises of factors like demand-supply dynamics, segments of presence and competition, pricing and brand equity, geographical coverage and scope of expansion, store profitability and overall profitability, leased vis-a-vis owned stores, and share of private labels.

The analysis covers different store formats, including single product stores, departmental stores, cash and carry and malls. The analysis of goods retailed includes different product categories such as food and grocery, apparel, consumer durables, FMCG, footwear etc.

Market position

Demand-supply dynamics

These form an important constituent of CRISIL Ratings' analysis of business risk of players in the retailing industry. Key demand-side factors include favourable demographics, rising disposable incomes, increasing penetration of internet, changing consumer preferences, improving standard of living, better credit availability, increasing use of plastic money and rising urban population. These factors increase the spending power of consumers and encourage them to move from unorganised segment towards organised segment. Key supply side factors include rapid real estate infrastructure development, easier access to corporate credit and increased efficiency of supply chain.

CRISIL Ratings also believes that moves by government can have implications for the sector. For example, any changes in foreign direct investment (FDI) policy for brick & mortar retail sector or changes in regulations for online retail impacting competition.

While evaluating the industry risk, CRISIL Ratings considers demand-supply dynamics of the product category in which the company has a presence, as these affect growth prospects, barriers to entry and exit, and extent of competition.

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[4] Updated: February 2021; *For accessing the previous published criteria, refer to the following link: https://www.crisil.com/content/dam/crisil/criteria_methodology/consumer-staples-and-discretionary/archive/CRISIL-Ratings-crieria-retailing-industry_2008.pdf*

Segments of presence and competition

Players in organised retail are present across multiple segments. Setting up shop in one vertical would expose the retailer to the risk of cyclicality. Selecting the right format for a particular location and with the right sized store is also a key success factor for players. Analysis of competition is an important input in the analysis of market position. CRISIL Ratings analyses the extent of competition, and the market position of players in different retailing segments. CRISIL Ratings also estimates the present and future competition

Brand equity and private labels

CRISIL Ratings believes that since organised retailing is a business to consumer (B2C) activity, brand equity and positioning are crucial factors in attracting the right customers. For example, apparel retailers may position themselves as lifestyle or value players and food and grocery retailers may position themselves as offering value for money.

CRISIL Ratings also considers share of private labels to overall sales as private labels tend to generate better profitability, than branded products of other manufacturers. Players with higher share of private labels have consistently seen their profitability expand, as their brands also get established in more geographies through expansion.

In the non-food retail segment, retailers with strong brand portfolios or portfolios of private labels offering value for money tend to see strong demand and therefore maintain steady same-store performance and store productivity. However, demand and store productivity for food and grocery retailers are determined by ability to provide value (discount), ability to realign with local consumer preferences, reputation and strong control over cost and procurement.

Entry barrier

Value retailing, which is built on price-based value propositions, may face higher competition as against lifestyle retailing, which requires strong brand and customer franchise; this takes a longer time to build and thus acts as a strong entry barrier. The current plans of large corporates in the retailing segment involve substantial capital outlay in the near future. Thus, any new player entering the retailing industry will require very large capital outlay to compete with the existing players. This can constrain the number of new players likely to enter the segment. Also, the amount of capital and effort required for the development and implementation of a good supply chain management system successfully, in case of value retailing, will also add to the challenges for a new entity.

Presence in e-retailing segment

The e-retailing industry, although nascent in India, is likely to grow robustly on the back of increase in internet (broadband and 4G) penetration and changing consumer perception towards e-commerce. Consumers are developing confidence in online transactions, with many e-retailers providing the cash-on-delivery option.

The segment is expected to gain traction due to availability of a wider product portfolio, convenience to consumers, ability to compare products and also look for deals and discounts offered by sellers.

CRISIL Ratings recognises the risk of increase in competition from this segment. To mitigate the risk, brick and mortar entities have entered the e-commerce space and are going omni-channel. However, the current entry of brick and mortar players into e-commerce segment is only a reaction to online retailers and these entities are yet to unleash the full potential of this channel which includes augmenting physical location experience, use of analytics and using the internet to lure customers.

Geographical coverage and expansions

Location and geographical coverage are critical aspects of market position; this is because sales patterns are likely to vary from region to region. The player's geographical coverage is likely to determine its volume of sales, products sold, and growth potential. Under geographical coverage, CRISIL Ratings also factors in the entity's business model and business location — urban, semi-urban, or rural. Strategic expansion can yield long-term benefits in the form of economies of scale and lower cost of sourcing from suppliers, in addition to customer loyalty. CRISIL Ratings also considers the pace of store additions and method of funding. CRISIL Ratings recognises that sustainable growth is the key to a healthy credit profile.

Operating efficiency

Store level dynamics

CRISIL Ratings considers the stores as a microcosm of the entity. Hence, factors such as like-to-like sales growth, revenue per square foot, inventory turnover, proportion of stores which have achieved break even, time to break even for new stores, growth in footfalls, profitability of stores and aging of stores are considered. These parameters highlight the structural parameters of the retailer. For example, an entity may have strong overall revenue growth on account of addition of new stores, but same store revenue growth may be low highlighting the risk of slowdown in revenue growth if new store additions reduce. Similarly, faster break-even of new stores will be lesser of a drag on overall profitability.

Good catchment area, strong brand equity along with value proposition will not only determine store productivity i.e. sales per square foot, inventory turnover but also help replicate it in various geographies generating the benefits of economies of scale.

Ability to adapt to regional customer preferences

India has very high regional diversity and the ability of a retailer to adapt to this diversity and provide customers with the right products at the right price can be a key success factor. A retailer can decide on size of the store and merchandise, based on the tastes and preferences of customers in a particular location. A study of the consumption pattern can help retailers adopt a suitable product mix and also offer services to generate brand loyalty, thereby countering competition.

Marketing initiatives

CRISIL Ratings considers marketing as both a method to increase sales and improve brand positioning, and a cost centre impacting profitability. Success of a marketing campaign is judged based on past performance of marketing campaigns, impact of marketing campaign on revenues in subsequent financials and increase in repeat sales seen via loyalty programs.

Supply chain management:

CRISIL Ratings' analysis of supply chain management considers factors such as supplier network, inventory and working capital management and the ability to negotiate with suppliers.

Supplier network and infrastructure

One of the most important factors affecting retailers is the strength of the supplier network. The ability of suppliers to cater to the requirements of the retailing entity, including their ability to adapt quickly to changing needs, is critical. To gauge the effectiveness of a retailer's supplier network, CRISIL Ratings analyses factors such as the number of suppliers and the extent of the retailer's dependence on a few critical suppliers. CRISIL Ratings also factors in the existence of strong infrastructure facilities in the form of a well-connected, enterprise resource planning (ERP)-based network of suppliers that would be within easy reach of the retailer's stores. Another key factor considered is shortening of supply chain which enables efficiency in procurement, reduction in wastages, improved margins for participants in the chain and low prices for the final consumer.

Inventory and working capital management

CRISIL Ratings analyses the supply chain management systems of companies and the infrastructure available for the same; this includes the ability to ensure the ready availability of stocks at all times. Large inventories, however, tend to increase working capital requirements. Players, therefore, need to optimise their inventories so as to minimise working capital levels, while ensuring the ready availability of stocks at all times; this is a critical factor as it can significantly impact the profitability of the retailing entities. Inventory management also includes tackling obsolescence in stock; which impacts an entity's operations, especially in times of changing customer preferences. Information technology solutions help in timely dissemination of information across all levels, besides aiding sound inventory management. This enables a retailer to deal with stock-outs, seasonality of demand, and transfer of stocks from one store to another and ensure lower levels of slow-moving or dead stock.

CRISIL Ratings, therefore, analyses the entity's ability to determine and maintain its optimal inventory level.

Ability to negotiate with suppliers

The ability of a retailer to negotiate and obtain better prices will affect its profitability.

Availability of skilled personnel: The ability to attract and retain skilled personnel is important for ensuring smooth operations. Given the increasing competition and expansion in the retailing industry, employee costs are expected to increase rapidly; retaining employees and containing costs are, therefore, likely to be twin challenges for players in the retailing industry over the medium to long term.

Pricing power and profitability: Sustainability of retailing businesses, especially in models such as supermarkets, depends on the player's ability to price products at a discount and still maintain profitability. For a specialty store, the ability to attract a premium for products will be determined by the degree of brand equity the player acquires over time, and its ability to maintain quality of service. The long gestation period required to build a customer franchise leads to a longer break-even time. The ability of the entity to establish strong private labels will impact its profitability; private labels have a higher margin as compared to branded products. CRISIL Ratings considers improvement in both overall profitability and store level profitability for its aalysis. It also considers cost reduction measures undertaken by company such as reduction in cost through supply chain management and use of better technology, reduction in advertisement cost while maintaining revenue growth and controlling rental expenses

CRISIL Ratings’ criteria for the sugar industry[5]

Background

Sugar is the most important agriculture-based industry in India after textiles. India is the largest producer, after Brazil, and the largest consumer of sugar. Sugar production depends on sugarcane output, which depends on rainfall. Moreover, sugarcane prices are regulated by the government while sugar prices are market-driven however partly supported by minimum support prices since 2018. Also, the industry is cyclical and is susceptible to price fluctuations and trade regulations. While cane production is concentrated between September and April, demand for sugar lasts through the year.

CRISIL Ratings evaluates the market position of a sugar company by its size, diversity in geography, recovery rates, and proximity of the plant to sugarcane farms and sugar-deficient regions and extent of diversity through distillery or power generation. CRISIL Ratings considers forward integration into power and/or distillery as key differentiating factor while assessing sugar companies. In CRISIL Ratings' experience, companies with strong businesses and operational efficiency, and low interest cost, have consistently withstood sugar price downturns.

Market position

Government policies

The sugar industry is regulated extensively by the government. Hence, CRISIL Ratings believes a sugar company's credit risk profile is significantly vulnerable to government policies. These policies influence cost through cane pricing and cane availability through the command area concept. The government also controls import/export of sugar through imposition duty.

Consequently, sugar companies do not have much control over the quantity, quality, or cost of sugarcane they procure, or the quantity of sugar they sell. These factors significantly affect the economics of their operations.

Market share

In the highly fragmented sugar industry, size is an important determinant of a company’s market position. Large companies typically have greater ability to withstand external shocks, easier access to capital markets, and greater bargaining power, and consequently, tend to have strong credit risk profile. However, the benefit of size may be nullified by a weak capital structure or poor cost position.

Location

Freight is an important cost element. Companies with factories close to sugar-deficit regions command a better price and save on freight costs. Factories close to high-yielding sugarcane farms are also in a better position. Similarly, the longer crushing season in southern India enables better utilisation of fixed assets.

Proximity to ports is also a critical factor. Easy accessibility to ports enables import of raw sugar for processing during cyclical upturns, when sugarcane availability is expected to be lower. It also provides companies with greater flexibility to export during periods of low domestic prices.

[5] Updated: February 2021; *For accessing the previous published criteria, refer to the following link: https://www.crisil.com/content/dam/crisil/criteria_methodology/consumer-staples-and-discretionary/archive/CRISIL-Ratings-crieria-sugar-industry_2007.pdf*

Customer profile

Traditionally, sugar sales have been routed through dealers. Relationships with institutional customers may be viewed favourably, partly due to the benefits of regular liquidation of inventory outside the government's release mechanism.

Relationship with farmers

Variability in monsoon and changing crop patterns impact cane output and consequently sugar production. This makes healthy relationship with farmers a crucial requirement for sugar companies, to ensure availability of cane. Hence, investments in sugarcane development activity and timely payments for sugarcane are considered pre-requisites for timely and adequate availability of cane.

Operating efficiency

Size of the plants

With prices of sugarcane being regulated through fair and remunerative price (FRP) mechanism, operating efficiency (determined by recovery rate) and processing cost will determine ability to withstand downturns. CRISIL Ratings believes larger plants are better placed, as their conversion cost will be low.

Level of Integration

Standalone sugar units are seldom viable, and therefore integrated sugar units, with distillery and power operations are the preferred option. Optimal utilisation of by-products such as molasses (used to produce ethanol) and bagasse (used to generate power), are the key differentiating factors among sugar units. It will enable companies to capture value across the production chain. An integrated sugar company functions on a de-risked model, which results in more stable revenue and less volatile profitability.

Working capital management

While cane production is concentrated between September and April, demand for sugar lasts through the year. Therefore, sugar producers have to efficiently manage their seasonal working capital requirements amidst fluctuating prices, a crucial credit differentiator.

Conclusion

In CRISIL Ratings' opinion, the key determinants of success for consumer staple and discretionary entities include sound pricing and branding strategy, strong brand equity, diverse product portfolio, well-managed supply chain management systems, diversified geographical presence, distribution reach, strong understanding of customer preferences, and ability to respond to changes in consumer behaviour.

About CRISIL Limited

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