Trading Entity Rating Methodology

1.0 Overview and Scope

Trading concerns are engaged in the business of buying and selling of commodities, products or services. Such entities have substantial inventories of stock, add limited value to the products and occupy a key position in the supply chain since they understand customers' requirements and engage in merchandising and distribution of the products. Trading business is characterized by low bottom line profitability. The major portion of their balance sheet & income statement constitutes receivables and inventories. Balance sheet liabilities mainly constitutes of short-term borrowings and payables. Working capital management efficiency is critical in such business. The two broad area of credit risk assessment for trading entities encompasses evaluation of qualitative factors comprised of management risk, industry risk, & some parts of business risk and quantitative factors comprised of quantifiable business risk and financial risk. Besides, NCRL sincerely recognizes the consequence of the impact of any pandemic or chronic situation on the respective business.

2.0 Management Risk

Management evaluation is one of the most important factors for supporting a trading entity's credit standing which includes

- Experience of the promoters/proprietor/entrepreneurs in trading operations
- Track record of operations
- Owners' commitment to the business
- Succession of the owner
- Experience of the senior management working in the organization
- Support of the group companies and
- Business knowledge regarding trade, regulations etc.

3.0 Industry Risk

The business of trading entity depends on the performance of the underlying industry factors like

- Industry demand supply dynamics
- Regulatory framework which is dictated by government policy
- Environmental compliance issue
- Growth potential, Industry life cycle and
- Other competitive factors such as availability, seasonality, variability in commodity price, alongside counterparty risks are also measured.

4.0 Business Risk

The components of business risk assessed by

- Size and scale of operations of the business
- Trading volume of the business
- Ownership status of the office & warehouse
- Distribution network
- Geographical location
- Backward supply sources
- Possible risk of loss or damage during storage or transit
- Changes in consumer spending patterns
- Possible government interference

- Earnings from core business segment etc.
- Relationship and bargaining power with buyers & suppliers

5.0 Market Risk:

One of the key risks those trading concerns 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 macroeconomic 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 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.

6.0 Credit Risk:

Involvement of multiple counterparties in trading transactions also exposes a concern 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.

These risks are analyzed based on the entity nature of business and availability of information.

Earning / Profitability Ratios

Trading entities usually operate on narrow profit margin. Entities which have better risk management systems, laid down credit policies, control on overheads and offer some value-added services have generally stable earnings and profitability. Moreover, trend in the growth rate of the trading entities reflect the entities' ability to sustain its market share, profitability and operating efficiency. To assess the earning /profitability rations NCR considers

- Growth in profitability levels
- Volatility in margins and reasons thereof and
- Various ratios are

7.0 Financial Risk

Financial risk analysis examines the track record of income generation, profitability levels, capital structure, operating cycle, dependency on working capital for operations, capital expenditure plans, accounting policies followed by the entities etc. However due to the unorganized nature of most trading-oriented business, their accounting policies are often not well defined. NCR prefers audit reports in order to assess the historical earning position of the entity. However, in several cases NCR reviews management reports. Moreover, projected financial statements are also analyzed in detail.

Cash flow and coverage

The cash flow statement analysis reveals the ability of a trading entity to pay off its' obligations. Cash flow analysis is an important tool for the assessment of financial risk. The cash flow from operations provides a company with more secure credit protection than dependence on external sources. Various ratios are considered are interest coverage ratio, debt service coverage ratio, debt payback period etc.

Asset Base

Trading entities usually have low fixed asset base. NCR considers

- Investment made by the entities in business offices & warehouse facility
- Development of distribution network

Capital Structure

NCR analyses the capital structure

- To determine an entity's reliance on external financing. The trading entities usually have low long-term loans but higher working capital borrowings. Entities with high gearing have low financial flexibility and more susceptible to any external adverse shocks
- Various ratios are analyzed including net debt/net debt plus equity ratio, overall gearing ratio etc.

Liquidity Position

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. Moreover, entities with healthy cash position along with sufficient available bank lines are viewed favorably as they are better placed to meet any adverse market situation or sticky receivables.

Liquidity ratios such as current ratio and adjusted quick ratio and cash cycle are broad indicators of the liquidity position of a trading concern. The working capital intensity of operations is analyzed by studying the inventory management and holding levels, credit period extended by suppliers as well as average receivable days.

Apart from the above discussed factors working capital management efficiency, quality of financial reporting and information disclosures, past debt servicing track record, transactions in the loan account as well as current account are given considerable weightage in different cases.

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