ICRA

ICRA Rating Feature

Rating Methodology for Rice Millers

Overview

This rating methodology describes ICRA's approach to assess the credit quality of entities engaged in the Indian rice industry, and supersedes ICRA's earlier methodology note on the sector, published in March 2016. While this revised version incorporates a few modifications, ICRA's overall approach towards rating entities in the sector remains materially similar.

This rating methodology is meant to help investors, issuers and other market participants understand the key factors considered by ICRA in assessing the creditworthiness of issuers belonging to the Indian rice industry, including entities involved in some or all the various stages such as milling, sorting, grading, processing and marketing.

Industry Structure

Rice ranks among the top three food grains in terms of worldwide production and is the staple diet for a significant part of the world population. However, global trade of rice is restricted to only up to 10% of the production, given that most of the producers face matching domestic consumption. Over 90% of the global rice output and consumption is centred in Asia, led by China and India, which are the world's largest rice producers as well as consumers. India is among the three largest exporters of rice in the world and rice export is a significant contributor to India's foreign currency reserves.

In India several rice varieties are grown and consumed; however, there are two broad categories, namely basmati and non-basmati. Basmati rice is the world's finest rice because of its aroma, flavour and non-stickiness, and hence it commands premium pricing. It is a specialised rice variety with a Geographical Indication (GI) tag and has limited areas of production. Thus, basmati rice has different industry dynamics than non-basmati rice in terms of demand, supply, regulations, market participants etc. India's annual rice production is estimated at around 110 million tonnes, of which, basmati rice accounts for around 5%. Much of the basmati rice production of India (Pakistan being the only other producer) is exported, although its domestic consumption is increasing at a healthy pace.

The more widely produced non-basmati rice is largely consumed domestically as a staple. Given the commoditised nature of the product, the rice industry is highly fragmented in nature, with intense competition, which is further accentuated in the global market due to strong competition from other key rice producing/exporting nations such as Pakistan (for basmati), Thailand and Vietnam (for non-basmati). Given that non-basmati rice is cultivated across the country, the number of industry participants in this segment are significantly higher than that for basmati rice, which is only cultivated in the northern states of India. Like other agro commodities, rice witnesses' periods of over and under supply as agro-climatic factors and farmers' preferences impact its cultivation. This is amongst the key drivers of volatility in prices prevalent in the industry.

Rating Methodology

This rating methodology aims to help entities, investors and other interested market participants understand ICRA's approach in analysing quantitative and qualitative risk characteristics that are likely to affect ratings of rice entities. This methodology does not include an exhaustive treatment of all factors that are reflected in ratings, but enables the reader to understand the rating considerations that are usually the most important. ICRA's risk analysis framework for rice entities can be broadly divided into the following elements –

Industry risk drivers

- Demand-supply dynamics
- Regulatory risk
- Competitive intensity

Business risk drivers

- Scale of operation and level of integration
- Brand strength and distribution network
- Geographic diversification of revenue
- Inventory risk
- Cost efficiencies

Financial risk drivers

- Profitability
- Leverage & debt coverage metrics
- Liquidity and financial flexibility
- Foreign currency-related risks
- Contingent liabilities/Off-balance sheet exposures

Management Quality and Corporate Governance

Parentage

1.0 Industry Risk Assessment

1.1 Demand-supply dynamics

The demand for rice generally remains stable, given that rice is a staple for a large segment of the population. With the increase in disposable incomes over the years, the domestic demand for basmati rice too has witnessed a healthy growth. Basmati rice is produced largely in India and Pakistan, hence it faces little competition from other fragrant rice varieties from other countries. However, non-basmati rice faces stiff competition from other rice exporters - primarily Thailand and Vietnam. Moreover, the export of non-basmati rice depends on the Government policy as exports could be banned in periods of crop shortage (ban on export of non-basmati rice imposed in FY2008 and subsequently lifted in FY2012). Apart from regulations in India, exports from India are also impacted by the trade policies of key importing countries.

A large proportion of basmati rice production in India gets exported and thus remains dependent on multiple factors such as - trade policies in the importing countries, the economic situation and consumption patterns in the importing countries, socio-political dynamics of international trade and the prevailing foreign exchange rates. These factors are assessed to estimate the demand for rice in the domestic and international markets to see the future revenue and profitability potential of the industry.

From a supply perspective, the key input for the rice industry is paddy. The supply of paddy depends on the agro-climatic conditions, as a large portion of the area under cultivation is dependent on the monsoon rains. In the years of weak/deficit monsoon, the production can decline, causing an increase in the prices. Further, depending on the market demand, farmers may shift towards or away from rice cultivation, impacting the overall supply. This factor is more pronounced for basmati rice, which has a much smaller area under cultivation, wherein the prices tend to exhibit higher volatility, depending on export demand. For non-basmati rice, there is some degree of stability in production, given its status as a key crop and its staple nature in the food basket. The prevailing supply scenario and the anticipated supply, especially depending on the status of the monsoon rainfall, is also assessed for ascertaining the demand-supply scenario over the medium term.

1.2 Regulatory risk

Basmati rice being a premium commodity faces limited Government intervention domestically; whereas non-basmati rice, being a staple diet for a large part of the population, faces Government regulations. The non-basmati paddy is procured by millers/traders from farmers on or above a Government-declared minimum support price (MSP). Further, the Government-owned Food Corporation of India (FCI) procures paddy directly from the farmers at MSP and subsequently gets the same milled by rice millers in different states under the custom milled rice mechanism. This rice is used by FCI for distribution under the Public Distribution System (PDS). The quantum of paddy to be milled and supplied to the FCI varies from state to state as it is determined by the respective state governments being a key factor impacting the profitability of any miller. The exports of non-basmati rice are permitted, depending on the status of the buffer stocks in the country. Further, players catering to the export market are exposed to the regulations prevailing in the respective geographies being catered to by them.

1.3 Competitive Intensity

The rice industry, more so for the non-basmati variety, is characterised by intense competition as the low entry barriers have led to numerous industry players, both in domestic as well as the export markets. This is because of low upfront capital investment requirements, low technical intensity with largely standardised equipment, low skilled manpower requirement, easy availability of raw material and steady demand. This in turn limits the pricing flexibility of the industry participants, both for domestic and export sales. The competition is accentuated in the export market by other key exporting countries such as Thailand, Vietnam and China in case of non-basmati rice and Pakistan in case of basmati rice. In this context, ICRA evaluates some of the factors, which can enable a company to differentiate itself such as the management quality, operational track record of the company, scale of operations, level of integration, brand strength, and geographical diversity.

2.0 Business Risk Assessment

2.1 Scale of operation and level of integration

Commodity prices tend to be cyclical, driven by movements in demand-supply trends. This leads to earnings volatility for rice companies. An entity with a larger scale is associated with a greater ability to withstand commodity downcycles, given certain advantages like a) greater pricing flexibility because of benefits derived from economies of scale, b) better access to raw materials as well as customers c) level of integration and d) easier access to capital. The scale and the profitability of a rice company depends on its positioning in the value chain. A rice player can be a miller (converting paddy to semi-processed rice), a processor (converting semi-processed rice to finished rice), or an integrated player carrying out end-to-end conversion of paddy to finished rice along with processing of by-products like bran oil extraction and captive power generation etc. In addition, the industry also includes traders. An integrated player is likely to have a greater scale as well as higher operating profit margins but may require sizeable investments. However, while an integrated player is likely to benefit more during an upturn in the industry cycle, an asset light model might be more favourable in case of an industry downturn.

2.2 Brand strength and distribution network

In India, rice sales are largely unbranded in nature. However, with the increasing penetration of organised retail and customer awareness, players are establishing brands. This is true, especially in the basmati rice industry owing to its premium position. ICRA favourably views sustained efforts by manufacturers towards brand development, as it allows for differentiation in a commoditised industry, makes way for greater market acceptance, and provides a partial hedge against raw material volatility.

Further, the success of rice players depends upon their ability to reach the consumers. Domestically, this would mean a B2C channel and internationally it can be a B2B. Thus, a well-established distribution network and wide reach of products is an important rating determinant. A rice player with access to a large market is viewed favourably as it helps cope with the competition. ICRA evaluates an issuer’s access to distributors and/or direct buyers (both domestic and international), presence in the modern retail format and the depth of the distribution network. The profile of export customers (prominent distributors or branded players vs. small to medium sized distributors) is also assessed to evaluate the credit risk.

2.3 Geographical diversification of revenue

The rice industry, both basmati and non-basmati, caters to a wide market internationally. ICRA evaluates the geographic diversification of sales and the profile of the countries that a player is supplying to. Also, in case an entity is only present in the domestic market, then its sales diversification in terms of presence in multiple states is evaluated. This is crucial in case of high revenue concentration on geographies with greater demand volatility. This is especially true in case of basmati rice, which is largely export-oriented. This helps in ascertaining the exposure to regulations regarding the trade policies of respective countries, the risk of delayed payments or bad debts, and ease of the trade/fund movement etc. This has been demonstrated in recent years in case of basmati rice, wherein a key importing country intermittently bans its imports and trade sanctions being imposed on it, leading to volatility and another major importing region imposes strict quality parameters, resulting in a decline in exports from India. These factors led to some players facing challenges in managing the volatility as well as their liquidity.

2.4 Inventory-holding policy

A key determinant of the financial health of a rice mill is its inventory-holding. Majority of the rice paddy is grown in the kharif season, and the paddy reaches the market during the October-December period. A mill may decide to stock most of its full-year paddy requirements during this period or buy throughout the year from traders/middlemen (paddy is stocked by intermediaries who then supply semi-processed rice to the industry). The decision to stock paddy/rice inventory is also determined, among other factors, by the fact that the quality of paddy/ rice improves with ageing (relevant for the basmati variety). In addition, the issuer would have to consider its inventory holding costs and access to capital while formulating its strategy. Usually the issuers fund inventory purchases through cash credit limits and loans against warehouse receipts. Depending on the inventory holding policy, the company's working capital intensity and thus leverage levels get determined. Most of the large to medium-sized players or those intending to grow in scale try to stock a significant quantity of paddy. Sizeable debt-funded inventory exposes a company to the slowdown in demand, decline in prices, and adverse movement in interest rates.

ICRA analyses the company's policy regarding the levels of inventory it maintains at different times during the year. This is evaluated against the experience of the management, track record of the company across cycles, certainty of customer orders, strength of the brand to absorb fluctuations, and access to financing. Prudence on these parameters and an inventory policy, which is not driven by price cycles, is viewed favourably.

2.5 Cost efficiencies

Rice being a commodity does not allow much premium pricing and thus most manufacturers are price takers. In such a scenario, control over the operating expenses is essential to maintain competitiveness and maximise profitability and is, therefore, one of the important rating determinants. The major operating costs for a rice miller are the cost of its raw material i.e. paddy/semi-processed rice and the cost incurred in holding inventory for long periods for ageing (relevant for the basmati variety) other than the processing costs. Thus, ICRA analyses input/output norms for millers such as paddy-milled to rice-produced ratio. ICRA also assesses the manufacturer's efforts at reducing input costs through measures such as captive husk-based power plants and increasing automation to reduce wastage. For a trader, cost efficiency comes from better sourcing, efficient distribution network and ability to minimise inventory price risk through fast inventory rotation.

3.0 Financial Risk Assessment

Since the prime objective of the rating exercise is to assess the adequacy of the entity's debt-servicing capability, ICRA draws up projections on the likely financial position of the entity under various scenarios. Besides, ICRA considers the commitments of the entity towards other group entities, new ventures, and its investments in subsidiaries/SPVs. Accordingly, future cash flows are projected after considering the entity's milling capacity utilisation levels, capital expenditure programme, and the likely prices of input material (paddy) and rice prices, the growth it envisages, the debt repayment schedule, its funding requirements, and the funding options available to it. These cash flows are then used to determine the entity's future debt-servicing capability under various scenarios.

The various financial metrics assessed by ICRA could be divided into four categories—profitability, leverage, coverage, and liquidity. This document provides a summary of why ICRA considers these ratios to be important. For a more detailed description, readers may refer to the note titled - Approach for Financial Ratio Analysis, published on ICRA's website. In case of groups consisting of entities 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.

3.1 Profitability

Profitability metrics are a measure of an entity's efficiency and return on investments. It is imperative for most businesses to invest regularly in physical assets, integration, marketing, and to sustain or improve their competitive position. Entities that have superior profitability can do so through internally-generated resources with low dependence on external financing. Moreover, such entities can generate sufficient surplus not only to meet debt-servicing obligations but also to reward equity investors. Moreover, entities with higher profitability have better resilience to economic downturns.

Profitability of a rice producer is primarily a function of its cost structure, product mix, brand presence and position in the value chain. The cost structure of various players varies, depending upon the level of integration and automation, which help in improving the product yield. Strong brand recall, strong distribution network, access to geographies, allow for some premium pricing and provides relatively higher flexibility in protecting profitability. Key profitability metrics that ICRA looks into include the OPBITDA[1] margin, the PAT[2] margin, and the RoCE[3].

3.2 Leverage & debt coverage

Leverage ratios measure the indebtedness of an entity. The leverage level of a rice player is predominantly a function of its inventory-holding policy (as discussed above) and its receivable cycle. Many rice players can have sizeable receivable levels. This is especially analysed for export clients to assess their credit quality as well as the level of payment security involved.

Fundamentally, a low financial leverage is viewed as a credit positive. Besides protecting the cash flows of players by imposing a lower debt service burden, especially during periods of cyclical stress, lower leverage also imparts greater financial flexibility to raise incremental external capital (debt or equity) to tide over temporary funding shortfalls. ICRA also notes that the extent to which an entity leverages its balance sheet is, in addition to the business requirements, also a function of the philosophy of the management towards growth and funding mix.

Apart from the capital structure, ICRA also pays attention to the coverage indicators, including interest coverage, debt service coverage, operating profit and net cash accruals relative to total debt, while evaluating the financial health of entities in the rice industry. ICRA is particularly concerned about an entity's capability to honour its contractual obligations under stress conditions such as cyclical downturns, and delays in payments by customers.

3.3 Liquidity and financial flexibility

Liquidity ratios measure the buffer, which an entity has in the form of cash or cash equivalents with respect to its obligations that can be utilised in case of any temporary cash flow mismatch. The existence of adequate buffers of liquid assets/bank lines to meet short-term obligations is viewed positively. In addition, ICRA notes that an entity with strong liquidity can mitigate the impact of any short-term exigencies or events that might adversely impact cash flows in the interim. The entity's liquidity and financial flexibility is assessed by its unutilised bank / credit limits, liquid investments, and the nature of its relationship with banks, financial institutions and other intermediaries also the strategic importance of the entity to the group to which it belongs, along with the financial strength of group entities.

3.4 Foreign currency-related risks

The foreign currency risk can arise due to export-related revenues and receivables, which may be un-hedged. The inputs are predominantly purchased in the Indian currency and some part of the production, especially basmati rice, is exported. Thus, the exporters face the risk of the rupee appreciation with respect to their revenues and receivables. The various forex risk mitigating methods include (a) use of working capital funding denominated in foreign currency such as export packing credit and export bills discounting provides a natural hedge as these limits are squared off with the export receivables (b) use of forward covers to hedge foreign currency receivables.

[1] Operating profit before interest, tax, depreciation & amortisation
[2] Profit after tax
[3] Return on capital employed

3.5 Contingent liabilities/off-balance sheet exposures and accounting quality

In this case, the likelihood of devolvement of contingent liabilities/off-balance sheet exposures and the financial implications of the same are evaluated. ICRA also looks at the quality of accounting practices followed by an issuer based on interactions with the statutory auditors as well as studying the Auditors' Report and Notes to Accounts disclosed by an entity in its Annual Report. Some of the key factors looked at include auditor qualifications with respect to internal control systems and asset liability mismatch; contingent liabilities and other off-balance sheet items and the method of revenue recognition, inventory valuation, and depreciation policy of an issuer in comparison to its industry peers.

4.0 Management Quality and Corporate Governance

All debt ratings necessarily incorporate an assessment of the quality of the rated entity's management. An entity with an experienced management and independent directors on its board are considered positive factors. An entity should practice sound corporate governance policies to serve the interest of all stakeholders. The management risk analysis also factors in the historical track record of the entity or group in servicing its obligations within time. Any delay or default history in the repayment of principal or interest payments reduces the comfort level for the rated entity's future debt-servicing capability and willingness. Nevertheless, ICRA appropriately analyses the reason behind past defaults. Consistent operating performance, high transparency, and observance of conservative financial policies, which, however do not compromise the company's ability to grow, provide comfort in the rating process.

In addition, the rated entity's likely cash outflows arising from the possible need to support other group entities are important, in case the rated entity is among the stronger ones within the group. Usually, a detailed discussion is held with the management of the rated entity to understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the rated entity's industry.

Some of the other points assessed are:

- Experience and commitment of the promoter/management in the line of business concerned
- Policy on procurement and inventory holding of key raw material
- Policy of the promoter/management to risk taking and containment
- The entity's policies on leveraging, interest risks and currency risks
- The entity's plans on new projects, acquisitions, expansion, etc

5.0 Parentage

Apart from standalone credit considerations, the likelihood of extraordinary support coming in from the parent to an entity or the support that an entity is likely to extend to the other group companies is factored while assessing the credit profile of the entity. This process involves an assessment of the ability and willingness of the parent to extend support to the entity (and vice-versa), in addition to evaluating the entity's own fundamental credit strength. The overall corporate structure, extent of its complexity, movement of funds between various entities, and the relative importance of the entity being rated are also evaluated.

Summing Up

ICRA'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, based on 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 rice producers and traders, special attention is also paid to the scale of operation, positioning in the industry value chain, geographical diversity, cost competitiveness, management strategies for managing commodity price cycles and an overall approach towards managing liquidity and growth.

Contact us for any feedback or comments at: methodologies@icraindia.com

ANALYST CONTACTS

Sabyasachi Majumdar
+91 124 4545304
sabyasachi@icraindia.com

Harsh Jagnani
+91 124 4545394
harshj@icraindia.com

Deepak Jotwani
+91 124 4545870
deepak.jotwani@icraindia.com

ICRA Limited

CORPORATE OFFICE
Building No. 8, 2nd Floor, Tower A; DLF Cyber City, Phase II; Gurgaon 122 002
Tel: +91 124 4545300; Fax: +91 124 4050424
Email: info@icraindia.com, Website: www.icra.in

REGISTERED OFFICE
1105, Kailash Building, 11th Floor; 26 Kasturba Gandhi Marg; New Delhi 110001
Tel: +91 11 23357040-50; Fax: +91 11 23357945

Branches: **Mumbai**: Tel.: + (91 22) 24331046/53/62/74/86/87, Fax: + (91 22) 2433 1390 **Chennai**: Tel + (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294, Fax + (91 44) 2434 3663 **Kolkata**: Tel + (91 33) 2287 8839 /2287 6617/ 2283 1411/ 2280 0008, Fax + (91 33) 2287 0728 **Bangalore**: Tel + (91 80) 2559 7401/4049 Fax + (91 80) 559 4065 **Ahmedabad**: Tel + (91 79) 2658 4924/5049/2008, Fax + (91 79) 2658 4924 **Hyderabad**: Tel +(91 40) 2373 5061/7251, Fax + (91 40) 2373 5152 **Pune**: Tel + (91 20) 2552 0194/95/96, Fax + (91 20) 553 9231