

RATING METHODOLOGY – FAST MOVING CONSUMER GOODS (FMCG) FEBRUARY 2022



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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in February 2020. While this revised version incorporates a few modifications, ICRA's overall approach to rating companies in the Fast-Moving Consumer Goods (FMCG) industry remains materially similar.

Overview

The Indian FMCG industry is among the leading sectors of the Indian economy. Products in this industry are meant for frequent consumption and generally have inelastic demand dynamics, resulting in stable revenue and earnings profile for industry participants. Moreover, aided by generally stable regulatory environment as well as favourable demand prospects and low penetration levels in many consumer segments, India is also amongst the most attractive markets for Multinational FMCG players.

The Indian FMCG industry can be broadly classified into - Food and Beverages (F&B), Household Care, Personal Care, and Healthcare (over the counter or OTC) segments. Among these, the F&B sub-segment accounts for the bulk of the sector's revenues, followed by Personal Care and Household Care. The industry is characterised by a strong presence of multi-national corporations (MNCs), supported by their well-established brands across categories and widespread distribution networks. Despite the presence of large MNCs and large-scale players of Indian origin, the sector is relatively fragmented with the presence of numerous local/regional players. The FMCG companies market and sell their product through various trade channels. While traditional channels comprising stockists, wholesalers and retailers remain the mainstay, with the emergence of organised retail, companies now generate a sizeable part of their revenues from the modern trade (MT) segment. Further, the pandemic has led to a shift in consumer's shopping behaviour with increasing reliance on online shopping. Accordingly, the share of sales generated from e-commerce platforms is also increasing, albeit remaining marginal at present. In terms of growth, rural areas continue to be the key growth drivers, outpacing growth in relatively mature urban markets.

Rating Methodology

This rating methodology provides a reference tool for issuers, lenders and investors to understand ICRA's approach in assessing the business and financial risk profiles of companies in the FMCG sector. It aims to help various industry participants understand ICRA's approach in analysing quantitative and qualitative risk characteristics that are likely to affect rating outcomes. This methodology does not include an exhaustive treatment of all factors that are reflected in ratings but enables the reader to understand the rating considerations that are usually considered the most important. For analytical convenience, the key rating factors are grouped under four broad heads—industry risk assessment, business risk assessment, financial risk assessment and management, governance and financial reporting assessment. Some other considerations are also discussed in this document.

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- Competitive Intensity
- Government Policies

Business risk assessment

- Scale and Market Position
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 - Brand Strength & Product Innovation
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Financial risk assessment

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- Parentage
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Assessment of Environmental, Social and Governance (ESG) Risks

- Environmental (E) and Social (S) Risks
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Industry Risk Assessment

Industry Structure & Growth Prospects

Despite being one of the fastest growing markets globally for FMCG products, India's per capita consumption is still amongst the lowest, thereby providing long-term growth opportunities. Accordingly, the industry's growth prospects are relatively favourable aided by expectation of improving affordability, low penetration levels and improving consumer awareness and availability. Within the FMCG sector, certain product segments/ categories (such as processed foods, organic ingredient-based categories etc.) that currently have low penetration levels and are gaining consumer acceptance offer higher growth prospects.

Competitive Intensity

The FMCG sector is characterised by higher competitive intensity with presence of large number of national as well regional players. The competition in the FMCG industry has increased over the years as evident from the increasing pace of new product launches and variants, greater marketing push by companies, and their efforts to expand geographic presence as well as foray into new segments. Being a consumer-facing sector, branding plays an important role in consumer purchase decisions and a strong brand position generally allows premium pricing of products over that of weaker players. Consequently, to support or enhance brand visibility, industry players incur sizeable (12-15% of revenue) investments towards advertising, marketing, packaging and distribution costs. In addition, stronger brand equity helps to maintain market share and pricing position, where new entrants must make sizeable investments for customer acquisition, promotion, and branding to challenge incumbents.

In the FMCG industry, most companies have a combination of in-house manufacturing and outsourcing. Further, manufacturing facilities tend to be well spread out because of the need to provide timely delivery of products to trade channels, manage transportation cost, and access to raw materials. An issuer with manufacturing footprints or contract manufacturers across regions is better placed to mitigate event risks, including natural calamities or operational disruptions.

Government Policies

While analysing the exposure of an industry to regulatory risks, ICRA evaluates whether the government's role is restricted to that of a facilitator or does the government exercise control over many facets of the industry. ICRA further assesses the extent of susceptibility of an industry's competitiveness to the government's policies regarding subsidies, taxation and import-export restrictions and duties. In general, the role of Government policies in the FMCG industry is relatively limited and can largely be limited to changes in GST rates and import duties on certain products, especially tobacco and edible oils. Considering the fact that FMCG companies have relatively high margins and have an ability to pass along rising costs over time, the risk related to changes in duties etc. is low.

Business Risk Assessment

Scale and Market Position

The scale of operations, as measured by an entity's revenues, is one of the primary factors in evaluating the business position of FMCG companies. A large scale of operations enables economies of scale, drives cost and manufacturing process efficiencies, supports meaningful diversification across different product categories and geographies, leading to stronger bargaining power with various stakeholders in the value chain. Further scale allows entities to leverage on their cost structure, including advertising and promotion expenses towards enhancing consumer awareness of brands and products. It also lends entities more bargaining power with distribution channel partners and provides them with a cushion during any production disruptions with adequate inventory in distribution channels. Entry barriers can exist in the form of investments and efforts involved in building brands and expanding the distribution network, besides manufacturing infrastructure.

Sustained volume and revenue growth above the industry average is a strong positive. Such growth reflects an increase in market share and / or diversification across various products and geographies. On the other hand, a trend in declining revenues during a period when the industry is growing could be indicative of a weakening business fundamentals or depleting market primacy. ICRA attempts to analyse the drivers of growth in volumes and realisations separately on a best effort basis. Increase in realisations, attributable to price increase by a company, however, does not reflect real growth and is typically reflected in flat or declining profitability.

The market position of an FMCG company is a function of various factors such as brand strength, product characteristics, sales and service network and pricing strategy. Despite presence of large global FMCG companies in India, the Indian FMCG industry is fairly fragmented with the presence of numerous regional players. ICRA analyses the market share of FMCG companies in their addressable segments as companies generally tend to have presence in distinct product segments or categories. In addition, as industry-wise data is not commonly available, ICRA relies on issuers or industry sources to analyse market share on best effort basis.

A sustained revenue growth above the industry average is a strong positive and reflects increase in an issuer's market share on the back of successful product launches, entry into newer segments/ product lines or ability to command premium pricing. On other hand, stagnating or declining revenues, despite the backdrop of positive industry level growth, is indicative of an OEM's limited product portfolio or its inability to introduce products in line with customer requirements.

Competitive Position

Competitive position is one of the key parameters to evaluate the business risk profile of an entity. A strong competitive position of an entity is a key determinant of sustainable growth. A high market share in the addressable categories where the entity is present, is indicative of its strong competitive position and its track record of innovation. In the FMCG sector, ICRA evaluates competition position on three different parameters i) brand strength & product innovation, ii) distribution channel reach and iii) product category attributes.

- I. Brand Strength & Product Innovation
- II. Distribution reach, and
- III. Product category attributes

I. Brand Strength & Product Innovation

Given the Business-to-Consumer (B2C) nature of the FMCG sector, developing strong brands plays a key role in driving sustainable competitive advantage for an FMCG company. Strong brand strength or recall is supported by the ability to meet the customers' needs, offer unique features or differentiation, competitive pricing, and high quality. Thus, strong brands create customer loyalty while creating entry barriers against competition. If an entity has a strong brand, the customers are reluctant to switch, which offers pricing power and is an important measure of brand strength. In this regard, the entity's ability to spend on brand-building through advertising and marketing plays an important role.

A company's ability to maintain competitive advantage over its peers is also driven by its ability innovate and refresh its product portfolio at regular intervals. This allows brands to maintain their relevance with changing consumer demands and thus plays a crucial role in maintaining market share.

II. Distribution reach

A wide reach of the distribution channel lends competitive advantages to FMCG players. A wide distribution network supports quick ramp-up in production/sales in case of new product launches, as companies can leverage their existing distribution channel. To maintain their reach, FMCG entities also need to adapt to underlying trends in customer buying behaviour. For instance, FMCG companies have begun to focus on alternative distribution channels like e-commerce due to the steady increase in mobile internet penetration and smartphone usage. E-commerce platforms are location agnostic and can provide vast geographical access to new entrants that could have taken multiple years to establish for a traditional brick-and-mortar model. Following the spread of Covid-19 pandemic, there has been a considerable shift in consumer's shopping behaviour with increasing reliance on online shopping. Accordingly, the share of sales generated from e-commerce platforms is also increasing albeit it remains marginal at present. In addition, some FMCG companies have also started exploring avenues of reaching out to customers directly through the 'Direct-To-Customer' (DTC) route. While this remains in an early stage, its evolution and impact on traditional distribution channels and market position of companies remains to be seen.

III. Product category attributes

Based on end-usage of consumers, an FMCG product can be classified as (i) discretionary and non-discretionary, or (ii) economy and premium. For instance, toothpaste and soap are largely non-discretionary products but a packet of chips and a soft drink are discretionary items. Likewise, products that are positioned to cater to mass segment may be considered 'Economy' and others that priced higher and have niche market size are considered 'Premium'. Typically, an FMCG player has better pricing flexibility in premium product categories and non-discretionary items where brand equity plays a crucial role. Categories like infant food and personal care might be relatively less price sensitive and have higher brand loyalty than the laundry supplement (washing powders and detergent bars) segment.

Moreover, some product segments like deodorisers, processed dairy products (cheese, curd, dairy whitener) and instant-mix foods may have stronger growth prospects due to changing lifestyles, under penetration and preferences of customers. Entities with a presence in these segments may outperform the overall sector growth trend. Hence, the attributes of a product category could be a key differentiator for a company's growth prospects as well as its profitability vis-à-vis the overall sector trend. Entities having presence in products with relatively stable demand throughout the year are viewed positively vis-à-vis those having products associated with high seasonality (like soft beverages, ice creams etc) during certain periods/ festive seasons.

A regulated product category (such as tobacco products and alcoholic beverages) is considered relatively riskier from a credit perspective than other segments (such as soaps and toothpaste). Growth rate and profitability of regulated segments could be influenced by changes in regulations.

Diversification

Diversification and scale of operations are closely linked with an entity having large scale of operations being generally well-diversified. From the FMCG sector's perspective, diversification can be broadly classified as - i) geographical diversification, and ii) segmental and product diversification.

I. Geographical diversification

An entity that is well represented across multiple regions or geographies will be able to perform more consistently during various demand scenarios. Further, diversified revenue mix between rural and urban India can also mitigate the adverse impact of an uncertain monsoon in the rural market as well as an economic slowdown in the urban market. Geographic diversification is also favourable as it helps to mitigate any potential changes in customer preferences in a particular region. ICRA attempts to analyse geographic diversification in FMCG companies on best-effort basis (owing to constraints on data availability) and in general scale and pan-India distribution network is considered indicative of the level of geographic diversity. Likewise, companies with relatively higher regional concentration would tend to be assessed weaker on this parameter.

II. Segment/Product diversification

Segment or product diversification mitigates the impact of change in consumer preferences, product obsolescence, slowdown in a specific segment and weakening of an individual brand. Typically, the most diversified entities are present in several product segments, while smaller entities often depend on only a few segments. Over the long-term horizon, an entity with a diversified product portfolio is generally expected to have a relatively stable top-line growth and profitability against a company dependent on a specific product segment.

An entity may not have meaningful segment or product diversification but can still have large scale owing to its presence across various geographies and strong brand equity in its core segment. In some cases, an entity may have only one brand. While assessing the credit profile of such entities, a strong market position in their core operational area as well as long-term segmental growth prospects may mitigate some concerns related with lack of meaningful segment/ product diversification.

Financial Risk Assessment

The various financial metrics assessed by ICRA could be divided into four categories viz., 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. To form a view on how the various credit drivers could evolve in the future, ICRA also carries out sensitivity analysis under various scenarios.

Since the prime objective of the rating exercise is to assess the debt-servicing capability of a company, ICRA draws up projections on the likely financial position of an entity based on the expected movements in operating performance - factoring in the capex and investment requirements as well as the upcoming debt obligations. A sensitivity analysis is also carried out, considering various probable circumstances, and the adequacy of cash flows under each of these is assessed.

Profitability Metrics

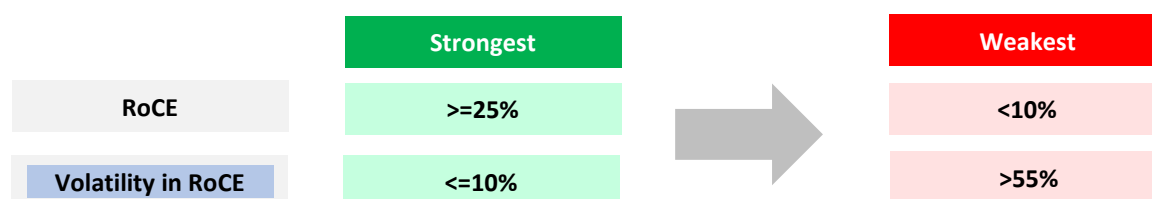
Profitability is a measure of the earnings generated by an entity in a given time period in relation to the resources deployed or alternatively a measure of how efficiently an entity sweats/ utilises its assets. From a ratings perspective, both the level as well as the stability in profitability metrics matter. A consistent track record of higher profitability shown by an entity compared with its peers reflects a superior competitive position arising from one or more factors, including greater brand strength, better distribution reach, attractive product profile and higher cost efficiency (operating or capital). Entities with higher profitability than its peers are likely to show stronger resilience against economic downturns and inflationary pressures and are more likely to generate relatively higher internal resources for re-investment and debt servicing, and also attract fresh capital. Furthermore, sustainable and adequate margins are essential for companies to enable the ongoing investments in promoting new product, which are needed to maintain market position.

The high competitive intensity in the sector mandates steady investments in new product launches, advertising, and marketing to maintain stable market position and profitability. In addition to revenue growth, sustainable profitability is one of the key factors that ICRA incorporates in its analysis to differentiate between entities. As the FMCG sector is generally characterised by relatively stable demand and well-established competitive dynamics, revenue growth and profitability are to a large part dictated by an entity's specific market position, its product portfolio, and its brand strength. As a result, there tends to be limited scope for significant margin expansion over time. In this context, a key differentiating factor among competing FMCG entities is the ability to maintain efficient operations, pass along price increases (pricing flexibility) and maintain market share. The two primary measures of profitability are—i) operating profit before interest, depreciation, and taxes margin (OPBDIT margin), and ii) return on capital employed (RoCE).

With raw material costs being the largest component of FMCG company's cost structure, any fluctuation in prices of key raw materials such as agricultural commodities, edible oils, crude oil derivatives, milk and milk products has a direct impact on the OEM's profitability. Thus, the ability of a company to undertake price hikes to offset the impact of hike in input costs remains an important rating criterion. While sector players generally maintain pricing discipline, discounting during periods of muted demand, impacting profit margins is also a phenomenon.

Validation of Business Risk through Profitability Metrics

[Indicative Metrics¹]



Working Capital Management

Generally, FMCG entities have a modest working capital cycle, as extended credit period from suppliers and advances from customers/distributors are sufficient to fund the working capital requirements. Select large FMCG players in India have also invested in IT systems to monitor inventory levels at the retail stage, enabling superior inventory and receivable management. A deviation from the general sector trend could reflect stress, as a company might be pushing inventory to its distributors or may have increased the credit period offered to its distribution partners to push sales, which could result in write-offs in future, thereby affecting profitability as well as the capital structure.

Leverage and Coverage Indicators

Financial leverage is a measure of an entity's dependence on borrowed funds. Lower the dependence on borrowings, the lower (better) the leverage. When an entity borrows, it is obliged to pay both interest as well as principal to the lenders as per a defined schedule. This increases the fixed cost burden on the borrowing entity and in the limiting case, increases the default risk. While high leverage may mean high risk from a credit perspective, it is an often-adopted course by shareholder-oriented managements, given that high leverage, in good times, leads to high returns on equity capital. An entity's financial leverage could thus be a function of its management's financial policy and risk tolerance, besides being a point-in-time reflection of an entity's business and financial choices. An entity with lower leverage is better equipped to withstand volatility in cash flow generation in situations of economic downturn, competitive challenges, unexpected costs, changing consumer preferences, or regulatory changes. Companies that generally pursue an aggressive financial policy, which involves significant reliance on debt financing, are likely to be more vulnerable to cyclical downturns than the OEMs which pursue a conservative financial policy.

Generally, FMCG entities have modest working capital cycle and primarily rely on long-term debt to fund their organic or inorganic growth plans. In general, such companies have relatively low capital intensity, which is also aided by considerable share of manufacturing being outsourced. Accordingly, companies tend to have low leverage. However, it may vary on a case-to-case basis. For instance, companies which pursue debt-funded acquisitions may have high leverage. Leverage is measured by ratios such as Total Debt Obligations by Tangible Networth and Operating profit and net cash accruals relative to total debt.

¹ The indicative financial metrics mentioned here and elsewhere in the document are intended to provide a broad overview to the readers regarding what ICRA generally considers as 'relatively strong' or 'relatively weak' metrics. It is, however, possible that an entity has relatively weaker metrics on one or more financial parameters, but its credit risk is assessed to be low because of other mitigating factors, including (but not limited to) stronger metrics on other financial parameters, a healthy business risk profile, strong financial flexibility or a strong promoter group that is willing to extend distress support to it.

Assessment of Leverage

[Indicative Metrics]

	Strongest	Weakest
Indebtedness Ratio	$\leq 0.9x$	$> 3.0x$
Debt to Profit Ratio	$\leq 0.5x$	$> 5.0x$

Apart from the capital structure, ICRA also pays attention to coverage indicators, including interest coverage, debt service coverage, while evaluating the financial health of an FMCG entity. Coverage is a measure of an entity's debt-servicing ability and is calculated as the ratio of profits to the debt servicing obligations in a given time period. Higher the ratio, higher the cushion available with an entity to withstand variability in profits for making good its financial obligations. Coverage is a function of an entity's profits, leverage and debt characteristics (in terms of cost of debt and repayment schedule). The interest coverage indicator reflects the entity's ability to fund the cost of external borrowings after meeting all operating expenditure requirements. The Debt Service Coverage Ratio (DSCR) is a measure of an entity's debt-servicing ability and is calculated as the ratio of profits to the debt servicing obligations in a given time period. Entities with higher profitability and lower leverage will generally have better coverage ratios and thereby healthier financial risk profiles.

Assessment of Coverage

[Indicative Metrics]

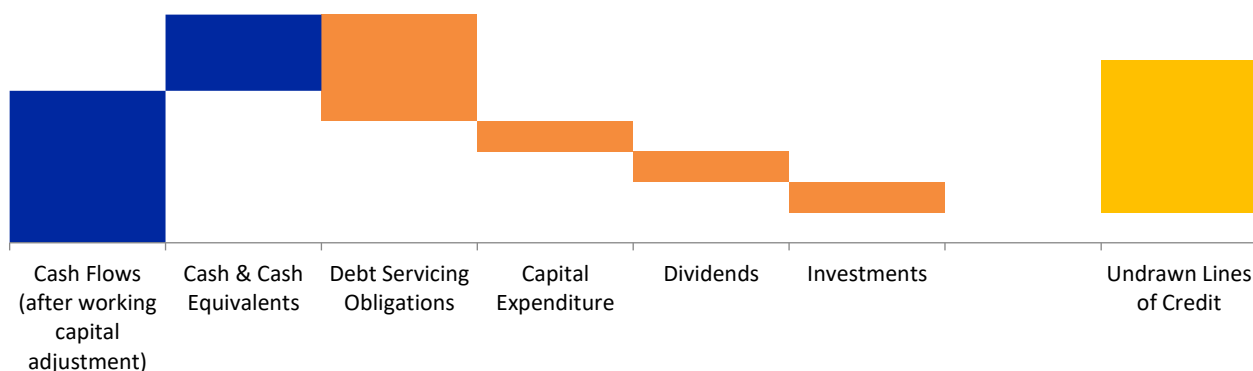
	Strongest	Weakest
Interest Coverage	$\geq 18.0x$	$< 2.0x$
DSCR	$\geq 4.0x$	$< 1.1x$

Liquidity

Liquidity is the measure of an entity's ability to meet its short-term cash obligations from various internal or external resources. Internal resources include cash flows from operations, unencumbered cash and cash equivalents on balance sheet and cash inflows expected from the monetisation of physical and financial assets. External ones include undrawn lines of credit or equity capital. The short-term obligations include both the committed as well as the contingent claims on an entity's cash, including the debt servicing obligations, working capital requirements, capital expenditure and other investment outlays, dividend and share buyback-related outflows, besides the sudden demand arising from crystallisation of discrete events such as unfavourable outcome of an ongoing litigation. The higher the cushion available between the resources available (especially internal resources) and the obligations, the better the liquidity profile of an entity. Liquidity is generally assessed in conjunction with the vulnerability of an entity to timely refinancing / renewal of short-term sources of funding. Depending upon the circumstances, an entity that has a relatively modest liquidity profile, but a strong refinancing ability may not be viewed too unfavourably. ICRA also notes that the liquidity available with an entity may be for a temporary period and hence an entity's overall policy towards maintaining adequate liquidity (given the trade-off between returns and liquidity) is accorded due importance in the analytical approach².

² For more details on how ICRA assesses liquidity, readers may refer to the document titled, "Liquidity Analysis of Entities in the Non-Financial Sector" published on ICRA's website

Liquidity snapshot over any defined period



It is cash that is required to service the obligations. A cash flow statement represents the sources from which cash is generated and its deployment. Analysed here are the trends in an entity's funds flow from operations, cash consumed to fund the working capital, the retained cash flows after paying out dividends or carrying out share buy-backs, and the free cash flows after meeting debt repayment obligations and capital expenditure needs. The cash flow analysis helps in understanding the external funding requirements that an entity has, to meet its maturing obligations.

Financial Flexibility

An entity's financial flexibility (or the lack thereof) is reflected in its ability to access the capital or the money markets at short notice, attract diverse and marquee investors and acquire the confidence of banks, financial institutions and intermediaries. A strong financial flexibility allows an entity to raise fresh borrowings or refinance existing ones in quick time and whenever required. Financial flexibility could arise from factors such as an entity's large scale of operations with strong financials, large unencumbered cash flows (such as rental income, annuity payments in road projects), unencumbered assets and the flexibility to borrow against such assets, or strong parentage or linkages with a strong group.

In contrast, among the various measures of an entity's depleting financial flexibility, one relates to a high share of pledged promoter shareholding. A sign such as this may imply that the entity might be persuaded to distribute high dividends or support the promoter group through other means to the detriment of its own credit profile. If the promoters fail to repay their loans (availed by pledging of shares) or top up the collateral when required, the lenders could sell the pledged shares. In some cases, this could trigger a change-of-control clause in the rated entity's bond indentures or loan documents and require it to redeem its debt ahead of schedule, creating a liquidity squeeze, besides affecting fresh capital-raising ability.

Foreign Currency Risks

Such risks arise if an entity's primary costs and revenues are denominated in different currencies. The FMCG sector's exposure to fluctuations in foreign currency with regards to imports generally remains low, as companies generally source much of their raw materials locally. Also, most of the FMCG companies focus on the domestic market thereby share of exports is limited. ICRA assesses the degree to which the companies may be able to pass on the currency risk by adjusting their product prices. This assessment is done by considering the materiality of the net foreign exchange earnings or expenditure in relation to the total revenues. Foreign currency risk for an entity is measured by considering its un-hedged net liabilities [= foreign currency receivables – foreign currency payables – foreign currency debt] and assessing the magnitude of such exposure, relative to the entity's profits.

Tenure Mismatches, and Risks Relating to Interest Rates and Refinancing

Large dependence on short-term borrowings to fund long-term investments or other long-term funding requirements can expose an entity to significant re-financing risks, especially during periods of tight systemic liquidity. ICRA evaluates the extent

of such mismatches and the mitigating factors therein. One source of mitigation could be the existence of adequate buffers of liquid assets/ committed bank lines to meet short-term obligations. Another could be the entity's strong financial flexibility to be able to garner fresh funds at a short notice or a potent ability to refinance. Further, ICRA evaluates the extent to which an entity might be impacted by movement in interest rates.

Contingent Liabilities/Off-Balance Sheet Exposures

The likelihood of devolvement of contingent liabilities/ off-balance sheet exposures and the financial implications of the same are evaluated for this.

Consolidated Financial Analysis

The FMCG sector in India comprises players operating across diverse business segments and geographies through various subsidiaries and associate companies. While evaluating the financial risk profiles of such companies, ICRA analyses consolidated/ group level financial indicators in terms of capital structure, debt coverage indicators and future funding requirements³.

Parentage

While the credit rating of an entity is a function of its standalone credit profile, in certain cases, the entity's credit quality can also be driven by the relationship with its parent or the promoter group (henceforth referred to as the parent). The FMCG sector is characterised by the presence of many global FMCG giants in India through their majority-owned subsidiaries, and well-established domestic players. In cases where an entity is owned by a foreign parent, the rating of the Indian entity is influenced by the parent's standing and the linkages between them.

If the parent's credit profile is relatively stronger than the rated entity, ICRA assesses the ability and the likelihood of the parent extending extraordinary support to the entity. Support here means financial support from the parent expected to be available to the entity in the form of loans, equity, extended credit period, advances etc. in times of credit or liquidity stress on the entity. It does not signify operational support in the form of new business opportunities, product sharing and so on as these aspects are factored in the standalone credit profile assessment itself. It may be noted that promoters in their individual capacity, or private equity firms/ other financial investors are generally not treated as parents for assessing the likelihood of extraordinary financial support coming in. If the parent's credit profile is relatively weaker than the rated entity, the entity's rating may be lower than what its standalone credit profile assessment would have merited. This is given the possibility that the entity may at some point of time be bound to extend financial support to its weaker parent, possibly to the detriment of its own credit profiles⁴.

³ For more details, please refer to ICRA's methodology titled 'Rating Approach—Consolidation' available at www.icra.in

⁴ For more details, readers may refer to the documents titled, "Rating Approach—Implicit Parent or Group Support" and "Rating Approach—Explicit third-party support", available on ICRA's website.

Debt-Servicing Track Record

Any history of past delays or defaults in meeting interest and principal repayment obligations reduces the comfort level with respect to an entity's future debt-servicing capability and willingness. Nevertheless, the reason behind past defaults are also analysed, which could also be due to adverse demand situations in the underlying sector.

Event Risk

ICRA recognises the possibility of events such as unrelated diversification, mergers and acquisitions, business restructuring, asset sales and spin-offs, litigations, equity infusion and refinancing, which could have a material impact on the credit profile of an entity. Incorporating the impact of such discrete events in the credit rating, from the beginning, is often difficult. Depending on whether and when such events occur, the rating opinion could be substantially different. To take rating decisions in such cases, ICRA applies its analytical judgment based on the rated entity's track record, the credibility of the management and the experience of having seen similar situations play out in other entities. However, given the nature of such events, it is possible that the rating may undergo a material change later, upon the occurrence of the event.

Asset Concentration Risk

In the FMCG sector, most companies have a combination of in-house manufacturing and outsourcing. Further, manufacturing facilities tend to be well spread out because of the need to provide timely delivery of products to trade channels, manage the transportation cost, and access to raw materials. In the past, companies had also set up manufacturing units in states that offered fiscal incentives. Accordingly, asset concentration has been fairly limited in the FMCG sector. Nonetheless, companies that have only a single manufacturing facility remain exposed to asset concentration risks, with force majeure incidents, or issues like labour unrest, political uncertainties etc. likely to disrupt the operations. On the other hand, companies which have a relatively diversified manufacturing presence, can offset this risk to some extent.

Management Quality Assessment

In addition to the sector, business and financial risk analysis, all credit ratings incorporate an assessment of the quality of the rated entity's management and its financial policies. An entity with an experienced management is considered a positive factor. The management risk analysis also factors in the historical track record of the entity or the group in timely servicing its obligations.

Quality of Management and Financial Policies

As a part of its process, ICRA undertakes discussions with the rated entity's management to understand its views on past performance as well as its future and strategies, besides the outlook on the sector. Some of the points assessed are:

- Experience of the promoter/ management in the sector
- Commitment of the promoter/ management to the rated entity
- Risk appetite of the promoter/ management and risk mitigation plans
- Policies on leveraging, managing interest rate and currency risks
- Management's past success in introducing new projects and managing changes in the external environment
- Management's plans on new projects, acquisitions and expansions
- Track record of balancing the interests of shareholders, creditors and other stakeholders

Periodic interactions with the management help ascertain the shifts, if any, in their financial policies.

Assessment of Environmental, Social and Governance (ESG) Risks

Environmental (E) and Social (S) Risks

As this methodology highlights, while undertaking credit assessment of entities, ICRA seeks to incorporate all relevant credit considerations into its rating decisions while taking a forward-looking view on the risks and the mitigants. The relevant credit considerations include (sometimes overtly, sometimes covertly) the E&S factors that could affect the rated entity/ transaction. While ICRA's analytical approach does not explicitly disaggregate these risks to assess their impact on the rating, these risks are often assessed broadly. Further, it is not always feasible to fully or precisely disaggregate the sub-components of E&S risks in credit analysis since these considerations often tend to overlap.

That said, the materiality of the E&S risks and the time horizon over which they are expected to crystallize differ widely across sectors and entities. In some cases, while the E&S risks could be material their effect on the credit profile may be muted because of other fundamental strengths of the entity. In other cases, the adverse impact of the E&S risks is expected to play out in the distant future, and hence these considerations do not necessarily weigh on the rating today—with the expectation that when these risks manifest in the distant future, the rated entity by then would possibly adapt itself by realigning its business model.

While evaluating E&S risks, ICRA's objective is only to assess the direct and indirect risks that an entity faces and how it already is or is intending to mitigate the impact of such risks on its credit profile. As an example, ICRA only assesses whether an entity is exposed to physical climate risks, or carbon transition risks such as those arising from changes in regulations or other environmental and social risks; and seeks to understand the various mitigation and adaptation approaches that the entity is implementing to mollify these risks.

FMCG companies remain exposed to the impact of changes in environmental norms with respect to treatment of manufacturing residual discharge/waste. Accordingly, companies could face operational disruptions if regulatory norms are not complied with. Further, with increasing awareness and restrictions on usage of different grades of plastics for packaging and finding environment-friendly solutions, the cost structure of the FMCG entities may be impacted. In addition, there is also a trend towards using organically grown input materials. Such developments can potentially increase costs for FMCG companies. Even as there is an increasing focus on carbon-neutrality, the likelihood of sudden impactful developments on this front for the FMCG industry remains low. Accordingly, entities in the FMCG industry have a low exposure to environmental risks, buttressed further by their better pricing power reflected in their ability to pass along the increase in costs over time.

On the social dimension, the FMCG sector has a prominent dependence on human capital, in terms of direct and indirect employees as well as contractual labour. Being an interplay of manufacturing and service business, maintaining healthy employee relations and retaining talent by an issuer as well as the supplier ecosystem is essential for disruption-free operations. This apart, there could be quality concerns that FMCG entities could face in certain product categories which could adversely impact their brand, or risks that an entire product category could face out of the social considerations that pertain to health consciousness (aerated drinks) or equity (fairness creams). While these risks are product category-specific, the overall exposure of the FMCG sector to social risks remains low to moderate.

Governance Practices

A sound corporate governance structure attempts to make clear the distinction of power and responsibilities between the Board of Directors and the management. The constitution of an entity's Board and the Board of Directors' participation in strategy formulation, besides the entity's adherence to legal and statutory compliance requirements are factored in during credit assessments. ICRA seeks to gain a qualitative understanding of an entity's commitment to following transparent and credible practices by the way its financial statements are reported, their level of disclosures, consistency in communication and the openness about sharing information during the credit rating exercise. Besides, the corporate group structure (whether

simple or complex), the rated entity's related party transactions and instances of supporting group entities at the expense of debt holders are assessed.

Summing Up

ICRA's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the instrument being rated. This opinion is arrived at following a detailed evaluation of the entity'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 and other funding requirements. ICRA's approach to rating FMCG incorporates a number of factors, which include an assessment of an entity's market position, product portfolio, diversification, distribution network as well as the management strategy for managing cyclical downturns and its overall approach towards investment and growth.

ANNEXURE

Summary of rating factors and an example to illustrate the key building blocks of a credit rating

		Strong				Comfortable				Adequate				Moderate				Weak	
Industry Risk	Industry Position																		
Business Risk	Scale and Market Position																		
	Geographic Diversification																		
	Product Portfolio																		
Financial Risk	Profitability and Earnings Stability																		
	Leverage																		
	Coverage																		
		Enhance						Support/ Neutral						Hinder					
Do these factors enhance or hinder the credit profile?	Diversification																		
	Refinancing Dependence, Liquidity and Financial Flexibility																		
	Currency Risk																		
	Financial Policy																		
	Management, Governance & Reporting																		
		Very High				High				Moderate				Low					
Parent Support	Likelihood of Parent Support																		
	Rating of Parent	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B/ C category				
	Final Rating	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B/ C category				

The above graphic is only for illustration purpose and does not represent a rating output from a formulaic model. The ratings assigned by ICRA are determined by Rating Committees based on both quantitative and qualitative considerations.

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