RATING METHODOLOGY – EDIBLE OIL

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Table of Contents:

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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 entities in the sector remains materially unchanged.

Overview

Edible oils constitute an important component of food expenditure in Indian households. The demand for edible oils in India has shown a steady growth, driven by increasing population, rising income levels and living standards. Moreover, edible oils have a favourable demand growth outlook over the medium-to-long term, which is further supported by positive macro and demographic fundamentals. At present, India plays an important role in the global edible oil market, accounting for ~10% share of consumption, ~10% share of oilseed production, ~5% share of edible oil production and ~20% share of world edible oil imports.

Edible oil processing consists of three operations – crushing and expelling (separating oil from the solids – generally done by *ghanis* and small-scale expellers/ oilseed crushers), solvent extraction (to crush and process hard oilseeds with low oil content such as soybean and cottonseed as well as chemically extract residual oil from the oilcake), and oil refining (which includes some or all of the following treatments — filtering, neutralisation, winterising, bleaching, deodorisation and degumming and filtering to make oil fit for human consumption).

In terms of volumes, palm, soybean, mustard and sunflower oil are the four largest consumed edible oils in India, with respective shares of ~38%, ~19%, ~12% and ~8% in total oil consumption in oil year (November-October) 2021. During the past decade, the domestic production of oilseeds and edible oil has remained stagnant but the demand has risen steadily, leading to a significant increase in import dependence. Almost ~60% of the total domestic consumption (with the main imported varieties being crude palm oil and soybean oil) is currently being fulfilled through imports. India's oilseed sector's ability to compete with imports is weakened by a fragmented processing industry afflicted by moderate capacity utilisation. Thus, the higher import duty gap between crude and refined oil remains critical for the domestic players to keep their refining operations competitive. Owing to high import dependence, edible oil prices in India are directly correlated to international oil price movements and currency movements that make profitability vulnerable to unexpected fluctuations.

The government has approved the launch of National Mission on Edible Oils – Oil Palm (NMEO-OP) in August 2021 to promote domestic production by a) ensuring price assurances to the farmers to absorb the volatility, and b) providing financial and technical assistance on inputs/ interventions for planting materials. Nevertheless, the challenges with respect to the agriculture ecosystem (water level and other environmental issues), gestation period and rising domestic demand will keep the import dependence high in the medium term.

In ICRA's opinion, the key determinants of the business risk profile of edible oil companies are their ability to mitigate the regulatory risk and the impact of adverse agro-climatic conditions. Other operational factors include operating efficiency, product diversity, market position and ability to secure raw material, besides the commodity price and forex-risk management systems. ICRA's assessment also factors in the entity's financial position and profitability metrics, its capital structure, ability to generate positive cash flows from operations and the adequacy of the same in relation to its contractual debt service obligations. ICRA also assesses the entity's management for its growth plans, risk appetite and financial policies.

Industry Risk Assessment

- Growth prospects
- Competitive intensity
- Agro-climatic risks
- Regulatory risks

Business Risk Assessment

- Scale and market position
- Geographic and product diversification
- Input related risks
- Exposure to speculation

Financial Risk Assessment

- Profitability
- Working capital management
- Liquidity and cash flows
- Leverage and debt coverage indicators

Other Elements of Credit Risk Assessment

- Parentage/Group support
- Exposure to currency risks
- Tenure mismatches, and risks relating to interest rates and refinancing
- Accounting quality
- Financial flexibility
- Debt servicing track record
- Contingent liabilities and off-balance sheet exposures
- Event risk
- Project risk

Management Quality

Assessment of Environmental, Social and Governance (ESG) Risks

- Environmental (E) and social (S) risks
- Governance risks

Industry Risk Assessment

Growth prospects

The demand for edible oils in India has shown a steady growth, driven by increasing population, rising income levels and living standards. Moreover, edible oils have a favourable demand growth outlook over the medium-to-long term, which is further supported by positive macro and demographic fundamentals. Within the edible oil sector, certain product segments/categories (such as cold pressed oils, organic ingredient-based categories etc.) that currently have low penetration levels and are gaining consumer acceptance offer higher growth prospects.

Competitive intensity

The edible oil sector is characterised by higher competitive intensity with the presence of a large number of national as well regional players. In the edible oil industry, companies have a combination of in-house crushing/refining and outsourcing. The competition in the edible oil industry has increased over the years, evident from the increasing pace of product launches and variants, greater marketing push by companies and their efforts to expand geographic presence. 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 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 the incumbents.

Agro-climatic risks

As the share of irrigated (by dams/canals/wells) area is relatively low in India, most regions are dependent on monsoon rainfall. Even the irrigated areas are indirectly dependent on monsoons. Thus, production of oilseeds is negatively impacted in the years of drought or deficient rainfall. However, the risk can be mitigated to some extent if the companies have a geographically diversified manufacturing/ procurement presence across several states as the likelihood of monsoons failing simultaneously across states remains low to moderate. Also, the risk is further mitigated for players who have access to imported feedstock (either crude palm oil for refining or soybean seeds for crushing, extraction and refining).

International agro-climatic risks can also impact the pricing of major imported oils like palm, soybean oil and sunflower oil. If there is a failure of crop or some natural calamity or any other cause of supply chain disruption in the major oil growing countries, it can significantly alter the pricing environment in India.

Regulatory risks

The profitability of edible oil companies is significantly influenced by regulatory changes and remains highly susceptible to the changes in the duty differential between import duties on crude and refined oil by the Government of India (GOI). Also, the profitability of these companies depends on the changes in the export tax levied by exporting countries, mainly Indonesia and Malaysia (that account for most of India's palm oil imports). Beginning 2007-08, the import duty on crude and refined edible oils had begun to be progressively reduced by the GoI. These policy changes were made to comply with foreign trade agreements entered into by India with other countries such as the Association of South East Asian Nations (ASEAN), apart from meeting shortfalls in domestic supplies to curtail inflation. However, in the past, the import duties were increased to support domestic oilseed cultivation and reduce import dependence. In October 2019, duty on crude and refined palm oil was as high as 40% and 45%, respectively. However, the effective duty on crude and refined palm oil was subsequently reduced to 5.5% and 13.50%, respectively, in February 2022 to curb inflation.

Overall, the profit margins of domestic refiners are influenced by changes in the import duty structure by the GOI or modifications in export duty by exporting countries because of limited value addition as well as limited ability of the players to fully pass on duty changes to end customers on account of the highly-fragmented industry structure. Therefore, ICRA's rating assessment takes into account the overall cost competitiveness of the entity and evaluates the consequences of duty changes and the viability of the players concerned. ICRA also notes that entities that crush seeds domestically and process oils are generally relatively less affected by the import duty structure than refiners of imported edible oil. However, they are subject to competition from imported oils, which is sensitive to duty changes.

Business Risk Assessment

Scale and market position

The edible oil industry in India is characterised by intense competition and fragmentation owing to the presence of a large number of units. This in turn is attributable to low entry barriers such as low capital and low technical requirements of the business. Though a number of inefficient units have been closed down after the reduction of high import tariffs on imported edible oil, the average capacity utilisation rates of Indian oilseed processors remain low (at 30%-50%), with many of the units operating only for a part of the year (during the local harvest season of raw materials). Thus, achieving economies of scale and having a competitive cost structure are of considerable importance. Due to the low value addition in comparison to the capital cost involved, there are many players in this industry who built scale by sourcing refined oil and marketing under their own brands. This has allowed them to grow their sales and profits without making significant capital investments in refining capacities. The ability of the players to grow sales volumes and maintain higher contribution margin without incurring major capital expenditure is a positive.

Further, large-scale integrated players are better placed than small- and mid-sized manufacturers to withstand the challenges in the business environment on the strength of the benefits related to economies of scale such as lower cost of production. Also, market participants with a high share of established branded products are better placed than participants operating in the commoditised bulk market. ICRA favourably views edible oil companies with benefits of large scale integrated operations, multi-product offerings and recognisable branded presence in retail markets as these have fared better than small/medium-scale domestic oilseed crushers.

Also, edible oil companies can strengthen their business profile through vertically-integrated operations. Some of the larger players in the edible oil business have also integrated their businesses by exploring the possibilities of both backward and forward integration. For instance, companies that refine edible oil may strengthen their sourcing by acquiring palm oil plantations in Indonesia or Malaysia, on the one hand, and creating brands on the other with the objective to draw greater value addition across the chain. Some companies also derive significant profits from the trading of de-oiled cakes (DOC) which have good export demand, thereby diversifying their revenue and profit generation sources. Besides improving profitability, such measures help companies to mitigate the impact of fluctuation in commodity prices to some extent. However, the benefits of backward integration could be neutralised in an adverse demand scenario because of high capital intensity as well as the associated long gestation period, which can result in higher fixed costs.

Assessment of scale
[Relative assessment from the perspective of the industry]

Strongly positioned	**Weakly positioned**
Entity is among the largest players in the industry *Entities having revenues > Rs. 10000 crore*	**The entity is a relatively smaller player in the industry in terms of scale of operations** *Entities having revenues < Rs. 200 crore*

Geographic and product diversification

In line with other industries, geographic diversity plays an important role for edible oil companies as it helps in mitigating the risks emanating from factors like weak monsoons, floods, pest outbreaks, etc inflicting a given geography. Also, companies that have greater geographic diversification are relatively less exposed to regional competitive dynamics or issues pertaining to buyer preferences in a given region. Some of the key business risks that can differ from one region to another are generally dependent on: A. Taste preference of a region and B. Level of competitive intensity.

A. Taste preference of a region: Being a consumable product, the demand for edible oils in India is largely a function of regional tastes and preferences and climatic conditions. For instance, mustard oil is consumed more in the northern and eastern parts of India and some parts of West India, while groundnut and cotton seed oil is largely consumed in the western parts of the country. Soyabean oil is preferred in central India, while palm oil is preferred in South and North India. Wider edible oil offerings help companies to be present across states having varying taste preferences which in turn helps the growth prospects of any edible oil company.
B. Level of Competitive Intensity: Competitive intensity is higher in states that have a large number of home grown edible oil players; for instance, Gujarat has several large branded edible oil players who compete across multiple edible oil offerings.

The flexibility to modify product portfolio as per the demand is a key strength in a market characterised by commodity price volatility. Players with presence across several states and having a wide product portfolio, strong brand presence, sizeable marketing field force and distribution network are better geared to handle competitive threats in comparison to smaller players with single product offerings (comprising players who refine and sell a single variety of edible oil that is grown/sourced from close vicinity/within the state and is generally either sold in bulk to larger refineries or sold under local brands).

Assessment of diversification

Strongly positioned	**Weakly positioned**
Highly diversified; no single region accounts for >50% of revenues	Key market accounts for > 90% of revenues; largely regional focused edible oil players
Single oil contribute < 40% to total oil revenues	Single oil contribute more than 90% to total oil revenues

Input-related risks

Edible oil companies are exposed to risks associated with raw material availability and sharp price fluctuations. The credit assessment factors in the extent of the scarcity of raw material used in the industry, volatility in prices and indigenisation levels (high import dependence reflects higher risks).

Compared to the demand growth for edible oils, domestic oil and oilseed (the key raw material) production has remained largely stagnant on account of low productivity in under-irrigated areas and shifting of acreage from oilseeds to other crops, leading to lower seed production. This has resulted in a significant demand-supply gap, which has been met through imports.

Domestic edible oil prices are directly linked to the prices of imported palm and soybean oil due to heavy reliance on imports and substitutability among oil varieties. Given the high volatility in international edible oil prices, domestic participants are exposed to the risk of an unexpected squeeze on margins due to pricing mismatches between raw materials (which are linked to domestic factors) and final product prices (affected by global factors). While mustard oil is almost entirely produced within the country, soybean oil is imported in significant quantities (about 60%-70%), while palm oil is imported both in the crude form (for refining in port-based refineries) and the refined form. With a significant portion of the consumed oil being imported, the foreign exchange movements also have an impact on the profit margins of the industry players. Thus, the overall profitability of market participants remains vulnerable to the risks emanating from commodity price volatility and forex movements.

Assessment of input-related risks

Strongly positioned	Weakly positioned
Companies with high degree of indigenisation; imported oils contribute to < 50% of total oil revenue	Imported oils contribute to more than 90% of total oil revenue market accounts for > 90% of revenues;

Exposure to speculations

One of the key risks that edible oil companies face is the risk arising out of the volatility in the prices of raw materials (oilseeds), crude and refined edible oil, which may be influenced by trends in international commodity prices, currency fluctuations, domestic demand-supply dynamics and macro-economic trends. The domestic edible oil prices are directly linked to the prices of imported palm and soybean oil due to heavy reliance on imports and their substitutability with other oil varieties. While mustard oil is almost entirely produced within the country, soybean oil is imported in significant quantities (about 60%-70%). Palm oil and sunflower oil is almost entirely imported in crude (for refining in port-based refineries) as well as in the refined form. Given the high volatility in international edible oil prices, domestic participants are exposed to the risk of unexpected squeeze on margins because of the mismatch between the prices of raw materials and final products (which are both linked to domestic factors as well as global ones). With a significant portion of the consumed oil being imported, the foreign currency movements also have an impact on the profit margins of industry players.

Exposure to commodity price risk may be hedged through back-to-back transactions with customers or through offsetting trade transactions on local/global commodity exchanges. In assessing the commodity and currency risks, ICRA evaluates the entity's hedging practices for commodity and forex, the management's track record in the business and commitment to the hedging policy, volatility in earnings in the past and longevity of the entity's operations in each of its market segments/presence across different oils. In addition, the extent of market risk in a business is influenced by the inventory-holding period. Companies with relatively higher inventory-holding periods owing to factors like processing, logistics etc. may face higher risk than the ones with a faster turnaround as the inventory value can change rapidly in either direction. Thus, the overall profitability of market participants remains vulnerable to risks associated with commodity price volatility, forex movements, as well as demand-supply dynamics. ICRA's credit assessment focuses on the entity's fundamental credit quality and seeks to evaluate its credit risk profile across commodity and currency cycles.

Assessment of risk management

Strongly positioned	Weakly positioned
No speculative transaction in the past and not expected in future as well; the entity holds lower inventory levels as compared to industry average reducing risk of inventory loss	Speculative transaction in the past and /or expected in coming years; the entity holds higher inventory compared to industry average exposing to high inventory loss

Financial Risk Assessment

While ICRA believes that a strong business profile drives a strong financial profile in the long term, the financial profile of an entity is also governed by the management's risk appetite and growth plans. ICRA analyses the long period past financial performance trends and estimates future financial performance to assess the financial risk exposure of an entity. The financial metrics provide a useful reference not only to evaluate the performance trends of an entity over a given time horizon, but also enable a comparison with its peers. As 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 an entity under various scenarios. This is done to assess the impact on contribution margins/profitability, cash flows and coverage metrics in the event of volatility in key variables such as sale volumes, raw material prices as well as product realisations.

Thus, the financial risk assessment is not done in isolation but in conjunction with the business and the industry risks that an entity is exposed to. An entity with low exposure to business and industry risks would generally have stable cash flows and thus would have a higher tolerance to operate with a relatively modest financial risk profile. In contrast, entities that are exposed to high business and industry risks need to maintain a stronger financial risk profile to have adequate cushion to manage cash flow volatility. The various financial metrics assessed by ICRA could be divided into five categories viz., Profitability, Working Capital Management, Leverage, Coverage, Liquidity and Cash Flows. This document provides a summary of these ratios. For a more detailed description, readers may refer to the document titled, Financial Ratio Analysis published on ICRA's website. Depending on the uncertainty around how the various credit drivers could evolve in the future, ICRA also carries out sensitivity analysis to assess the impact of the key variables on the various financial metrics.

Profitability

The analysis here focuses on determining the trend in the entity's operating profitability and how the same stands in comparison to its peers. An entity with higher profitability margins and returns on capital has greater ability to generate internal accruals, attract external capital, and withstand business adversity. The trends in operating margin and return on capital employed are analysed to establish the stability of cash flow generation and the sufficiency of the same vis-à-vis the entity's future debt-service obligations. While some players who have a strong brand and retail presence tend to retain relatively better profit margins, generally, the prevalent stiff competition, fragmentation and low value addition in the business cause the operating margins of edible oil manufacturers to be in the thin-to-moderate range. In addition, the risks of commodity price volatility and forex movements (as a significant portion of the consumed oil is being imported) impact operating margins. Thus, the overall profitability of market participants remains vulnerable to risks like weak harvests, commodity price volatility, forex movements (especially for refiners) and any inventory losses because of high working capital intensity in the business. The ability of an entity to procure raw material competitively, have well-defined policies to hedge commodity and currency risks, and efficiently convert raw material into end products can support profitability, because of the relatively high raw material intensity in the business.

Validation of business risk through profitability metrics

[Indicative Metrics[1]]

	Strongest	Weakest
RoCE	>=25%	<10%
Volatility in RoCE	<=10%	>=55%

[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 metrices 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 metrices 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.*

Working capital management

In the edible oil industry, the working capital intensity tends to be moderate. The analysis here evaluates the trends in the entity's key working capital indicators like inventory, receivables and creditors compared to industry peers. Players with high inventory and debtor levels are likely to have negative cash flows as their growth requires more capital to be blocked for working capital. For indigenous players who stock seeds, the inventory levels can remain high due to the seasonality of the raw material availability. ICRA also notes that the working capital intensity remains low for players that import crude edible oil by availing letter of credit facilities (for payment up to 180 days), which can lead to high creditor days.

Liquidity and cash flows

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 fund flow from operations, unencumbered cash and cash equivalents on balance sheet and cash inflows expected from the monetisation of physical and financial assets. External resources include undrawn lines of credit or equity capital. Short-term obligations include committed as well as 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 the crystallisation of discrete events such as litigation penalty. The higher the cushion between available resources (especially internal resources) and obligations, the better the liquidity profile of an entity.

Given the seasonality in working capital requirements, the peak working capital requirements are typically higher than the average working capital requirements. Accordingly, the sanction of sufficient working capital limits to fund the peak-level working capital requirements provides comfort. Also, for liquidity assessment, ICRA compares fund-based working capital limit utilisation with sanctioned fund-based working capital limits or drawing power, whichever is lower, and assesses the cushion available in the working capital limits. The drawing power can be a function of the inventory valuation and hence it is seen in relation to the realisable value, especially in a declining price scenario.

While an entity may have a DSCR >1 over the projected period, ICRA also assesses the sufficiency of the balance cash accruals (after meeting scheduled repayment) to fund the equity margin required for working capital and planned capital expenditure. If the projected levels of cash accruals (after repayments) are lower than the equity funding requirement for capital expenditure and enhanced working capital requirements, then despite a satisfactory projected DSCR, the entity may find itself stretched on liquidity. In such a situation, the financial flexibility of the entity to fund its growth requirements is seen as an important factor.

Leverage and debt coverage indicators

Given the generally high leveraging (working capital borrowings as well as terms loans for greenfield/brownfield expansion) of edible oil companies, the ramping up of operations with high capacity utilisation is essential to generate sufficient cash flows to service debt obligations. Accordingly, the objective here is to ascertain the level of debt in relation to the entity's own funds and is viewed in conjunction with the business risks that the entity is exposed to. ICRA, in its analysis of an edible oil entity's financial position, compares an entity's debt-to-equity ratio, operating profit to total debt and total outside liabilities to tangible net worth ratio (for players who import against letter of credit facilities) with that of its peers to determine its relative leverage position. Generally, conservative leverage ratios are viewed favourably as these reduce the committed outflows via interest and principal repayment. The long maturity profile (in case of term debt) and lower cost of loans can partially offset the risk associated with high financial leverage. Some of the key indicators considered by ICRA include –

- Leverage indicators: Total outside liabilities/Tangible net worth (TOL/ TNW), Total Debt/ OPBITDA

Assessment of leverage
[Indicative metrics]

	Strongest		Weakest
Indebtedness Ratio	<=0.9x	→	>3.0x
Debt to Profit Ratio	<=0.5x	→	>5.0x

- Debt coverage ratios: Interest coverage, debt service coverage ratio (DSCR)

Assessment of coverage
[Indicative metrics]

	Strongest		Weakest
Interest Coverage	>=18.0x	→	<2.0x
DSCR	>=4.0x	→	<1.1x

Other Elements of Credit Risk Assessment

Parentage/Group support

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).

All debt ratings necessarily incorporate an assessment of the quality of the entity's promoters as well as the strengths/weaknesses arising from the entity's being a part of a 'group'. Also of importance are the entity's likely cash outflows arising from the possible need to support other group entities, in case the entity is among the stronger entities within the group. Some key factors considered include:

- Strength of the other entities belonging to the same group as the entity
- Ability and willingness of the group to support the entity through measures such as capital infusion, if required

If the parent's credit profile is relatively strong than the rated entity, ICRA assesses the ability and the likelihood of the parent extending extraordinary support to the entity. Support here refers to financial support from the parent expected to be available to the entity in the form of loans, equity, extended credit period and advances in times of credit or liquidity stress on the entity. Support here does not mean operational support in the form of new business opportunities, distribution network sharing and so on, as these aspects are factored in the standalone credit profile assessment. If the parent's credit profile is weaker than the rated entity, the entity's rating may be lower than what its standalone credit profile assessment would have merited, 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 profile[2].

Exposure to currency risks

Such risks arise if an entity's major costs and revenues are denominated in different currencies. Such instances in the edible oil industry mainly include companies importing crude or refined palm/soybean oil (which is denominated in terms of US dollars) and selling in the domestic market. The foreign currency risk can also arise from unhedged liabilities, especially for companies that earn most of their revenues in local currency but have unhedged foreign currency borrowings (to part fund

[2] *For more details on this, readers may refer to the document titled, "Impact of Parent or Group Support on an entity's Credit rating", available on ICRA's website*

capital expenditure and/or working capital requirements like buyer's credit facility). The focus here is on assessing the natural hedge available as well as the hedging policy of the entity concerned to mitigate such risk for the net foreign currency exposure.

Tenure mismatches, and risks relating to interest rates and refinancing

Large dependence on short-term borrowings to fund long-term investments can expose an entity to significant re-financing risks, especially during periods of tight liquidity. The ratings factor in the existence of adequate buffers of liquid assets/bank lines to meet short-term obligations and the extent to which the entity could be impacted by interest rate movements on such borrowed funds.

Accounting quality

ICRA relies on a company's audited financial statements to analyse its financial performance during the rating process. It interacts with the statutory auditors as well as studies the Auditors' Report and other Notes to Accounts disclosed by a company in its Annual Report. Some of the key factors looked at include — auditor qualifications with respect to internal control systems, debt servicing and asset liability mismatch. Any deviation from the Generally Accepted Accounting Practices is noted and the financial statements of the entity are adjusted to reflect the impact of such deviations.

Financial flexibility

An entity's financial flexibility (or the lack thereof) is reflected in its ability to access capital or money markets at a short notice, attract diverse and marquee investors and enjoy 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, whenever required. Financial flexibility could emanate from factors such as an entity's large scale of operations with strong financials, large, unencumbered cash flows, 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 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.

Debt servicing track record

The company's debt servicing track record forms an important rating consideration. Any history of past delays or defaults in meeting interest and principal repayment obligations reduces the comfort level with respect to the company'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 industry. The company's ability to honour its debt obligations during a period of cyclical stress is also factored in.

Contingent liabilities and off-balance sheet exposures

ICRA reviews the contingent liabilities and off-balance sheet exposures disclosed by the entity in its Annual Report and evaluates the likelihood of their devolvement and the financial implications of the same.

Event risk

ICRA recognises the possibility of events, such as unrelated diversification, mergers and acquisitions, business restructuring, asset sales and spin offs, capital restructuring; and litigations, which could have a material impact on the credit profile of a company. 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.

Project risk

An entity undertaking a large-sized project capital expenditure (capex) is exposed to several risks, including cost and time overruns.

To ascertain project risks, ICRA endeavours to understand the entity's rationale for undertaking new investments. The risk profile could be different, depending on whether the new project is a case of related diversification or an unrelated diversification. The risk is heightened if the expansion is in a new/unrelated segment wherein promoters/management do not have a demonstrated track record or experience. Some of the other factors that are assessed include: (i) track record of the management in project implementation; (ii) experience and quality of the project implementation team; (iii) extent to which the capital cost is competitive; (iv) financing arrangements in place; (v) demand outlook; (vi) competitive environment; and (vii) marketing arrangement and plans. The impact of the project risk on the rating is influenced by the scale of projects being undertaken or planned to be undertaken in relation to the size of the assets and the cash flows of the entity's existing operations.

Management Quality

In addition to the business and financial risk analysis, all debt ratings incorporate an assessment of the quality of the entity's management and its financial policies. An experienced management is considered a positive factor.

Moreover, the likely cash flow impact on the rated entity from the possible need to support other group entities are of importance, in case the rated entity is among the stronger entities 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 points assessed are:

- Experience of the promoter/ management in the industry
- Commitment of the promoter/ management to the concerned line of business
- Risk appetite of the promoter/ management and risk mitigation plans
- The rated entity's plans regarding new projects, acquisitions, and investment in non-core business segments
- The rated entity's policies on leveraging, interest risk and currency risks

Periodic interactions with the management also help to estimate the possibility of the management's tendency to deviate from its core philosophy in times of stress.

Assessment of Environmental, Social and Governance (ESG) Risks

The assessment of ESG risks by ICRA involves a broad range of considerations that pertain to the sustainability of an entity with focus on aspects that can have a material impact on its credit quality. While the environmental and social (E&S) risks tend to be both sector-related as well as entity-specific and could be driven by external factors such as regulations or demographic changes, the governance risks are largely entity driven. The impact of the E&S risks on an entity's credit profile tends to be asymmetric. If the ESG risks are material but unmitigated, these generally pull down the ratings, but generally the ratings are not pushed up even when the ESG context is favourable.

Environmental (E) and Social (S) risks

As this methodology highlights, while undertaking the credit assessment of entities, ICRA seeks to incorporate all the 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, if not precisely. Further, it is not always feasible to fully or precisely disaggregate the sub-components of E&S risks in credit analysis as 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 crystallise differs widely across sectors and entities. In some cases, while the E&S risks could be material but 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.

Environmental and social considerations

Edible oil companies are exposed to agro-climatic risks given that the quality, prices and supply of the raw material (such as oil seeds) depend on various factors such as weather conditions/temperature, rainfall patterns, etc. Availability issues of quality raw materials due to the above-mentioned reasons could lead to a disruption in operations. Further, the industry is exposed to the risks arising from tightening regulations on environment, specifically pertaining to discharge/treatment of effluents and on the safety front. These have necessitated the industry to increase its investments towards meeting the evolving and tighter regulatory standards.

The social risk for the sector emanates from labour involvement, despite increasing mechanisation. The sector is exposed to labour-related risks and risks of protests/social issues with local communities, which might impact expansion/modernisation plans. Entities are also exposed to the risks of disruptions due to inability to properly manage human capital in terms of their safety and overall well-being. Further, entities are also subject to scrutiny related to food safety and sustainability, which may adversely affect the business.

Governance risks

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 follow transparent and credible practices by the way its financial statements are reported, its 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. As in other manufacturing sector ratings, the rating for edible oil companies involves an assessment of the business, management and financial risk profile. Market dynamics, scale & market position, risk management practice and the diversity of product/geographic mix ultimately determine the business risk profile, while the financial risk analysis focuses on profitability through price cycles, the extent of leverage, ability to service debt, hedging strategy and financial flexibility. The analysis is further complemented with financial projections over the maturity of the debt instrument that seeks to evaluate the adequacy of cash flows in comparison to the debt-servicing requirements.

ANNEXURE

Summary of rating factors and an example to illustrate the key building blocks of a credit rating for a edible oil company

		Strong			Comfortable			Adequate			Moderate			Weak		
Industry Risk	Industry Position															
Business Risk	Scale & market position															
	Geographic Diversification - Markets															
	Product diversity															
	Input related risks															
	Exposure to speculation/ Inventory risk															
Financial Risk	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 and 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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About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

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