Rating Criteria for Trading Companies

Introduction and Framework Overview

ACER Credit Rating Private Limited (ACER), a SEBI-registered credit rating agency, is committed to providing independent and transparent opinions on issuer and credit ratings. ACER's credit insights aim to empower investors, lenders, and businesses with opinions on ratings. It enables external stakeholders with informed decisions and fosters confidence in India's financial markets. With a clear vision to support India's economic growth story, ACER upholds the highest ethical and analytical standards, combining deep domain expertise, advanced analytics, and rigorous processes to ensure every rating is objective and insightful.

The Company reserves the right to amend this policy from time to time in accordance with the applicable regulations, circulars, and directives issued by the Securities and Exchange Board of India. This rating criteria will be reviewed annually.

The trading sector comprises entities engaged in the business of trading without significant processing or value addition. These entities act as intermediaries between manufacturers, suppliers, and end-users, operating across a wide range of products such as metals, agri-commodities, chemicals, fuels, textiles, consumer goods, and others. The sector is characterised by high turnover volumes and relatively low operating margins, resulting in strong dependence on scale, efficient cost management, and timely price pass-through. Operations are typically working capital-intensive, with funding requirements driven by inventory holding, receivables cycles, and credit terms extended to customers; consequently, trading companies rely significantly on bank borrowings and short-term financing facilities. Industry performance is influenced by demand–supply conditions, commodity price movements, competitive intensity, regulatory factors where applicable, and vulnerabilities in the supply chain, including dependence on limited suppliers, logistics disruptions, and geopolitical or climatic risks.

Credit risk in the sector is closely linked to the ability of entities to manage price volatility, counterparty credit risk, customer or supplier concentration, liquidity, and to generate sustainable cash flows and meet financial obligations across economic cycles and periods of price volatility. In addition, related-party transactions, which are common in group-driven trading structures, can materially influence business and financial risk profiles, particularly where pricing, credit terms, or fund flows are not conducted on an arm's-length basis. Accordingly, the presence, strength, and demonstrated track record of group or parent support through financial backing, operational integration, assured sourcing or offtake, and liquidity support remain important considerations in credit assessment, especially for entities with modest standalone financial strength.

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Rating Framework

ACER's credit rating framework for trading sector entities is anchored on four core pillars that collectively capture the key risk factors influencing credit quality. The framework is designed to reflect the operating characteristics of trading companies, including high volume–low margin business models, working capital intensity, commodity price surge and sensitivity to market conditions.

The four pillars are:

- **Business Risk** – Assessment of the industry environment, scale of operations, product and customer diversification, supplier profile, competitive positioning, demand–supply dynamics, and exposure to price volatility and concentration risks. The evaluation also considers management's performance and responsiveness under stress scenarios (such as sharp commodity price corrections), financial prudence including inventory and buffer stock management, and the entity's ability to mobilise resources, including sourcing from alternative suppliers.
- **Management Evaluation** – Evaluation of the management's experience, track record, strategic orientation, risk management practices, financial discipline, and corporate governance standards.
- **Financial & Liquidity Risk** – Analysis of quantitative financial performance, covering profitability, capital structure, leverage, debt coverage indicators, liquidity position, and working capital management efficiency.
- **ESG and Legal Risk** – Review of regulatory and statutory compliance, contractual and legal exposures, environmental and social practices relevant to trading activities, and governance and disclosure standards.

I. Business Risk

ACER Ratings evaluates the commercial durability of a trading entity by assessing its resilience against external market shocks and its indispensability within the global or domestic supply chain. As traders typically operate with thin margins and minimal value addition, any operational disruption can rapidly erode profitability.

1. Industry Risk

- **Demand-Supply Dynamics:** ACER analyses the fundamental drivers of the specific commodity industry, including production trends and consumption patterns that influence price stability.
- **Regulatory Sensitivity:** The sector is subject to government interventions in select industries like agriculture, including changes in import/export duties or trade restrictions on essential commodities, typically aimed at managing domestic prices and ensuring availability.
- **Barriers to Entry:** ACER assesses the competitive landscape, noting that while the sector is fragmented, certain commodities have entry barriers related to specialised market knowledge or capital intensity.

2. Size and Market Position

- **Scale and Market Position:** A larger scale of operations, as reflected by higher Total Operating Income (TOI), typically indicates a stronger market position and enhanced bargaining power with manufacturers and end-users, while a higher market share increases the entity's criticality within the value chain, providing a cushion to sustain operations during economic downturns.
- **Track Record:** We evaluate the entity's history and the promoter's experience, as a demonstrated ability to navigate multiple business cycles is a key indicator of sustainability.

3. Commodity Risk and Price Fluctuation

- **Margin Vulnerability:** Because traders operate on narrow spreads, even minor fluctuations in market prices can have a substantial impact on the credit profile.
- **Price Volatility Mitigation:** ACER favours entities that effectively mitigate exposure to price volatility through back-to-back trading arrangements or other prudent risk management practices. While confirmed sales orders reduce price risk during the holding period, entities engaged in spot or short-cycle trading without confirmed orders are also viewed favourably where they demonstrate strong price pass-through ability, rapid inventory turnover, disciplined inventory management, and a proven track record of generating stable margins despite market fluctuations.

4. Inventory and Turnover Risk

- **Holding Period Policies:** The risk of price volatility is directly proportional to the duration for which stock is held; thus, long inventory holding periods are viewed as higher risk.
- **Obsolescence Risk:** For sectors characterised by rapid changes in market preferences, such as electronics and garments, as well as sectors exposed to spoilage and quality deterioration, including agricultural commodities and perishable goods, we assess the risk of inventory value erosion arising from seasonality, demand variability, and time-sensitive market conditions.
- **Inventory Quality:** ACER reviews the ageing schedule of the inventory to ensure it remains liquid and capable of being converted into cash to meet maturing obligations.

5. Geographical Diversification

- **Market Spread:** Entities with a broad presence across multiple locations, regions or countries are better insulated from localised economic downturns or regional demand-supply imbalances.
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- **Regional Concentration:** High dependency on a single market is viewed as a risk factor, as it leaves the trader vulnerable to regional regulatory changes or logistical disruptions.

6. Suppliers and Customers

- **Concentration Risk:** Excessive reliance on a small number of suppliers or customers is a primary vulnerability; a diversified counterparty base prevents a single failure from causing a total business halt.
- **Counterparty Credit Profile:** ACER examines the creditworthiness of major customers, preferring those with high credit ratings or long-standing relationships that reduce the risk of order cancellations or payment defaults.
- **Bargaining Power:** Strong, long-term relationships with global producers can lead to more favourable credit terms and consistent supply streams, even during market shortages.
- **Brand Power:** Established brand strength and market reputation enhance customer stickiness, support pricing power, and improve negotiating leverage with both suppliers and customers, thereby contributing to stable volumes, predictable cash flows, and resilience during competitive or adverse market conditions.

7. Supply Chain and Value Chain

- **Criticality of Service:** ACER evaluates how vital the trader is to the movement of goods, such as their ability to break bulk consignments into smaller volumes for retailers.
- **Infrastructure Integration:** The ownership or control of logistical assets like silos, warehouses, and port facilities enhances operational efficiency and provides a competitive edge in "last-mile" connectivity.
- **Operational Efficiency:** ACER assesses the efficiency of operations based on inventory turnover, cost management, and return metrics, recognising both asset-light and asset-heavy business models. Asset-heavy structures are viewed favourably when supported by sufficient and sustainable cash flows to fund capital expenditure, strong asset utilisation levels, and demonstrable efficiency or cost advantages, while asset-light models are preferred where they enable scalability, flexibility, and superior returns without elevating financial risk.

8. Foreign Exchange (Forex) Risk

- **Exposure Analysis:** For entities engaged in international trade, ACER conducts an impact analysis of currency fluctuations on overall profitability.
- **Hedging Discipline:** A positive credit factor is the presence of a formal, documented hedging policy, such as the use of forward currency contracts or natural hedges (matching imports against exports).

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- **Speculative Intent:** ACER views unhedged or speculative foreign exchange positions negatively where they are not supported by natural hedging or underlying trade exposures, as such positions introduce avoidable volatility into the trader's typically thin operating margins.

II. Management Evaluation

In the trading sector, where success depends on rapid decision-making and navigating thin margins, ACER Ratings considers management evaluation to be a cornerstone of the credit profile.

1. Leadership Competence and Industry Experience

- **Track Record in Commodity Cycles:** ACER assesses the management's historical performance and their ability to navigate multiple, often volatile, commodity cycles. Deep industry experience is widely regarded as a key indicator of a firm's ability to weather economic downturns.
- **Strategic Vision:** ACER evaluates the leadership's growth strategies and their focus on maintaining a viable, sustainable business model rather than pursuing short-term speculative gains.

2. Composition of the Board and Governance Structure

- **Board Oversight:** ACER examines the composition of the Board of Directors to ensure a balance of expertise and independent oversight. A well-structured board provides essential checks and balances over the entity's risk-taking activities.
- **Compliance History:** ACER reviews the track record of legal and statutory compliance by the directors and the organisation. Any history of regulatory lapses or litigation is viewed as a potential threat to business continuity.
- **Accounting Quality:** The transparency and reliability of financial disclosures are scrutinised to gauge the overall quality of corporate governance practices.

3. Nature of Related Party Transactions (RPTs)

- **Transaction Integrity:** ACER evaluates the nature of related party transactions to ensure they are conducted at arm's length and do not drain the entity's liquidity or net worth.
- **Disclosure Standards:** High-quality disclosure regarding dealings with affiliates or associate entities is used as a measure of management's transparency with stakeholders.
- **Group Linkages:** If the trader is part of a larger conglomerate, ACER assesses the extent of operational and financial linkages, including any potential support from or obligations to the parent group.

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4. Risk Management Discipline

- **Risk Appetite and Speculative Intent:** A critical factor is the management's **history of speculative intent**. ACER views the absence of a well-defined, documented risk management policy negatively, as it leaves the thin-margin business vulnerable to market fluctuations.
- **Credit and Hedging Policies:** ACER reviews the management's discipline in enforcing credit limits on customers and their consistency in applying forex and commodity hedging policies.

III. Financial Analysis

In the trading sector, financial analysis shifts from asset-based lending to cash-flow and liquidity-driven assessments. Since traders often lack significant fixed assets, ACER Ratings prioritises the entity's ability to move current assets efficiently and maintain a robust capital base to absorb market shocks.

1. Capital Structure & Total Indebtedness

Trading companies rely heavily on **non-fund-based facilities** like Letters of Credit (LCs), which do not appear as traditional debt but represent significant liabilities.

- **TOL/TNW Focus:** ACER uses the Total Outside Liabilities (TOL) including non-fund-based exposure/ Tangible Net Worth (TNW) ratio to assess the overall capital structure. This provides a holistic view of the entity's leverage by including trade payables and acceptances alongside bank debt.
- **Net Worth Cushion:** A strong tangible net worth is vital as it acts as a permanent capital base that provides a "risk cover" against sudden inventory devaluations or counterparty defaults.
- **Liquidity Flexibility:** The availability of undrawn credit limits and structured channel financing arrangements is evaluated, as these enhance working capital flexibility, reduce reliance on spot borrowings, and provide support during periods of peak funding requirements or market stress.

2. Risk Coverage (The Shock Absorber)

Trading is a "low-margin, high-risk" business where a single price crash or a large bad debt can wipe out annual profits.

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- **Loss Absorption Analysis:** ACER evaluates the Risk Coverage Ratio, which measures the adequacy of the entity's net worth against potential losses in inventory, receivables, and unhedged foreign exchange positions.
- **Resilience Metric:** Entities with high risk coverage are viewed as more creditworthy because they can sustain unanticipated market shocks without compromising their solvency or needing emergency liquidity injections.

3. Liquidity & Solvency Ratios

Liquidity is the most critical metric for a trader's survival. ACER evaluates whether the entity has sufficient liquidity to meet its maturing obligations.

- **Current Ratio:** Indicates whether short-term assets can cover maturing liabilities. A ratio above 1.0x generally signals financial stability, but its interpretation depends on industry type and cyclicality, as some sectors operate efficiently with lower ratios due to fast inventory turnover or predictable cash flows.
- **Cash to Indebtedness:** ACER assesses the proportion of free cash and liquid equivalents relative to total liabilities. High cash balances provide a vital buffer during periods of restricted bank credit or market illiquidity.

4. Working Capital Management & Velocity

The efficiency of a trading business is defined by how fast it can turn a dollar of inventory back into a dollar of cash.

- **Gross Current Asset (GCA) Days:** ACER monitors GCA days to measure working capital intensity. A lengthening GCA trend suggests that capital is becoming trapped in slow-moving stock or overdue receivables, which increases the cost of borrowing and elevates credit risk.
- **Operating Cycle Discipline:** ACER analyses the debtor realization track record and inventory turnover. A **self-liquidating cycle**, where the sale of goods naturally provides the funds to pay off the bank LC, is the gold standard for trading credit profiles.

5. Interest & Debt Coverage

- **Interest Coverage Ratio:** This ratio measures the entity's "earnings cushion" to service its interest costs from operating profits. Since traders operate on thin spreads, even small increases in interest rates can significantly impact this ratio.
- **Cash Flow Adequacy:** ACER evaluates the Debt Service Coverage Ratio (DSCR) for entities with long-term loans, ensuring that operational cash flows—not just new borrowings—are sufficient to meet repayment schedules.

IV. ESG and Legal Risk

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- **Environmental:** While the environmental footprint of trading is typically lower than manufacturing, ACER assesses the impact based on the nature of products traded (e.g., chemicals vs. consumer goods).
- **Social:** ACER reviews compliance with safety norms and labour laws across the distribution and logistics network.
- **Governance and Legal:** ACER analyses the board composition, transparency in financial disclosures, and the track record of statutory and legal compliance by directors and the organisation. Any history of litigation or regulatory fines is critically reviewed for its impact on business continuity.

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