TRADING METHODOLOGY

In trading financial risks are high due to fluctuation of commodity price, devaluation of local currency, low margins earned and a competitive environment with low entry barriers. Therefore, NCR starts with credit risk assessment of trading concern based on nature of business, entity's market position and business strategy to deal with the above factors and hence, entities with established track record, scale of operations, relationship with the banks, past history of repayment & transaction record for last one year and security against loan. The broad areas of NCR's credit risk assessment for trading entities encompass evaluation of management quality, industry risk, business risk and financial risk profile and financial performance.

1. Management Risk

Management evaluation is one of the most important factors for supporting a trading entity's credit standing. Besides, experience of promoters in trading operations, succession of the owner, and experience in working and understanding of end-user industry is also very crucial. NCR examines the organization's structure, and relevant qualifications and experience of senior executives. Besides, extent of support of parent company or group in terms of financial and/or operations is also examined in detail.

The management's knowledge of local as well as global trade and regulations, understanding of various risks and approach/strategy for risk management and risk tolerance levels are of paramount importance. Capability and past track record of the management to perform under stress provides an added level of comfort.

2. Industry Risk Analysis

The analysis of industry risk focuses on the prospects and competitive factors affecting the industry. A trading entity faces plethora of risks relating to availability/seasonality and volatility in commodity price, foreign exchange fluctuations, counterparty risks as well as market risks relating to international/domestic competition, change in government policies, the economic environment and trade restrictions, low entry barriers, changes in technology etc. Therefore, the key ingredient of trading industry risk is determined by the degree of operating risk faced by the trading concern.

3. Business Risk Analysis

Analysis of business risk involves evaluation of trading entity's historical performances with emphasis on assessment of adequacy of cash flow to meet its operating expenses. NCR measures the trading entity's competitive position within the industry by analyzing the historical performances. Some of the key parameters used for assessing business risk are:

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3.1 Market share

The trading entity's current market share in its major activities and the historical protection of its position and projected ability for the future are important indicators of the competitive strengths of the trading entity. Market leader generally has financial resources to meet the competitive pricing challenges.

3.2 Product Diversification

The trading entity's operation with diversified products entail less risk as diversification results in better sustainability in cash flows. NCR analyses the view and focus of the proprietor on the issue of product diversification.

3.3 Size

Trading entities usually have a low fixed asset base. NCR examines the investments made by entities in warehouse/ shop (owned or rented) and distribution network, quality and quantity of inventory levels as well as investment in risk management systems.

3.4 Profitability Ratios

Trading entities usually operate on thin margins. NCR analyses the growth in profitability levels, volatility in margins and reasons thereof, geographic as well as commodity wise breakup of revenue and profitability in detail. Entities which have better risk management systems, laid down credit policies, control on overheads and which offer some value added service have generally stable earnings and profitability. Various ratios analyzed include gross margin, operating profit margin, net profit margin, ROA, ROE, etc. Moreover, trend in the growth rate of the trading entities reflect the entities' ability to sustain its market share, profitability and operating efficiency. The focus is drawn on growth in total income, EBIT and NPAT.

4. Financial Risk Analysis

NCR examines the past track record of capital structure, operating cycle, dependence on working capital borrowings for operations, capital expenditure plans, off balance sheet items as well as understanding the accounting policies followed by the entities. In addition, projected financials as well as cash flows are also analyses in detail.

4.1 Cash Flow and Coverage

The cash flow statement analysis reveals the ability of a trading entity to pay its obligations. Cash flow analysis is an important tool for the assessment of financial risk. The cash flow from operations provides a company with more secure credit protection than dependence on external sources. NCR uses most conservative approach to calculate the Debt Service Coverage whether the trading entities has capability

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to cover the financial expense, long term finances current portion and uncovered short term borrowings.

4.2 Liquidity Position

Liquidity ratios such as current ratio and adjusted quick ratio are broad indicators of the liquidity position of a trading concern. Moreover, entities with healthy cash position along with sufficient available bank lines are viewed favorably as they are better placed to meet any adverse market situation or sticky receivables. Further, if the trading entity requires higher working capital intensity, it should have also required adequate liquidity available for financial settlements.

4.3 Working Capital Management

The trading concern usually requires the higher working capital intensity that results in negative cash flow from operations consequence in higher debt. The working capital intensity of operations is analyzed by studying the inventory management and holding levels, credit period extended by suppliers as well as average receivable days keeping in focus the nature and availability of commodities traded as well as a general price direction. For entities with large inventory holdings, the working capital requirements are higher; and these entities carry higher risk of inventory losses in case of downward movement in prices. Also, in case of increase in prices, the working capital requirements for the entities also increase.

4.4 Capital Structure

NCR analyses capital structures to determine an entities' reliance on external financing and to use of funded debt & non fund based limits. The trading entities usually have low long-term loans but higher working capital borrowings, as there is a low investment requirement for fixed asset creation. Use of banking facilities (fund based as well as non fund based) as a key business differentiator significantly increases the risk profile of the concern. The growth in net worth base, dependency on working capital borrowings for funding the operations is seen in light with management strategy for growth. Adequacy of capital base to cater to specific operational, credit or market risks is seen in light with management strategy for growth. Entities with high gearing have low financial flexibility and more susceptible to any downturn or external shocks as compared to others. Various ratios analyzed include net debt/ net debt plus equity ratio, overall gearing ratio, interest coverage ratio, coverage ratio debt, payback period etc.

5. Security & Relationship Risk Analysis

NCR considers the factors related to relationship with bank and value of collateral against the loan which is important for the trading business. Considering factors are – whether the transaction with bank of entity and its sister companies are satisfactory? How long has the client been customer of one bank? Is there any past record of any force loan in last three years? Is there any default/ reschedule/ restructure in the history of banking relationship and the reason behind the same?

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These risk factors are from the perspective of Facility Ratings or Bank Loan Ratings (BLR) and are more relevant to banks for sanctioning credit facility than assigning entity ratings. We have covered these risk factors in our Bank Loan Rating Methodology.

In addition to the above factors, quality of accounts & disclosures are measured for assessing the overall creditworthiness of a trading entity. Moreover, NCR also emphasizes on whether the accounts reflecting the actual transactions with the bank or not. NCR also tries to verify the CIB status of the borrower.

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