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Rating Methodology by Sector

Foods

1. Business base

Given the matured market and low barriers to entry, a battle for sales in domestic food industry is very severe. In addition to the ability to develop new and high-value added products, Marketing and branding skills significantly affect the earnings of each company, and analyses of such qualitative aspects are important. Besides dealing food products in multiple categories, a great number of companies also deal with non-food businesses such as pharmaceuticals and distribution. Therefore, it is essential to grasp characteristics of the market and earning sources, roles, risks, and other factors pertaining to each business for assessing the creditworthiness of food industry.

(1) Characteristics of the industry

(i) Market overview

While domestic demand for food products is significantly correlated with the population, demographic change itself is small in Japan. With the exception of some categories such as beer and other beverages, for which demand is considerably affected by changes in weather, medium-term demand is generally more stable than in other industries. The food industry's credit rating reflects the stability of earnings based on stable demand.

In the long run, however, a fall in demand caused by the aging and decreasing population is inevitable. Demands in some categories are structurally reduced due to changes in dietary habits and preferences. Many food companies are expanding their business into new categories or overseas markets, seeking future growth and maintenance of earnings. There have also been an increasing number of cases of such alliances as mergers and integration to strengthen business bases in recent years. JCR focuses on the policies and the effects on financial affairs of such investment in a company's earnings growth.

(ii) Competitive situation

Low barriers to entry and the infrequent technological innovation required for food products make the competition intense. Companies are suffering from falling prices as a result of sales competition and the sluggish economy. JCR observes each company's response to the competition and falling prices, including improvement of brand power, development of high-value-added products, and effective use of marketing budgets. For those categories going through industrial reorganization due to market shrinkage, JCR monitors the progress of reorganization and changes in market shares of the companies among other factors.

Meanwhile, some categories are resistant to intense sales competition because of government regulations geared at protecting domestic agriculture, such as grain milling and sugar manufacturing. Along with the requirement to purchase domestic raw materials to protect domestic agriculture, additional restrictions apply to the quantities of imported raw materials, on which surcharges are imposed for the protection of agriculture. Raw material prices are, thus, set, which limits the room for cost reductions through a company's own initiatives while making price competition rather unlikely. Despite a large number of companies in the same business, the income of these categories is relatively stable. Because, however, removal of the regulations may create a risk, the possibility of changes made to each framework and the effects resulting from such changes must constantly be analyzed.

(iii) Cost structure

The more processed the food, the higher the gross margin tends to be. Yet, highly processed products tend to require a heavier burden of marketing expenses, often resulting in a significant loss on the operating balance. This applies to both business-use products, including those for food manufacturers, the restaurant industry, and private brand retailers, and commercial products. With business-use products, while the requirements of customers for products and prices are rigid, marketing expenses are unnecessary and, being custom-made products, stable sales volumes can be expected once the sale starts. Commercial products, on the other hand, are essential for improving the brand power of food companies while requiring a heavy burden of marketing expenses and frequent product modification and discontinuation. JCR scrutinizes how the income characteristics of each product and portfolio affect medium- and long-term earnings capacity.

(2) Important factors in market position and competitiveness

(i) Market position and brand power

Products with a large market share in each food category are well recognized by consumers and indispensable in retailing. The more such products, the more stable the sales volumes and the higher the production efficiency. These products can also increase the bargaining power in determining supply conditions, such as prices and shelf space. Confirming the market size and number of product lines of each company's products with a large market share is fundamental.

A large market share also increases the brand power of food companies. Powerful brands promote consumer trust and a sense of security, which contributes to the sales not only of a company's existing products but of new products. Products of powerful brands tend also to be invulnerable to low-price competition. JCR monitors each company's measures to strengthen its brands.

(ii) Ability to procure raw materials

The recent market prices of raw materials have been under strong upward pressure and highly volatile, owing to frequently occurring unseasonable and abnormal weather conditions, epidemics, increasing populations in emerging countries, changes in dietary habits associated with economic growth, the rise of biofuels, and inflows of speculative funds. Companies are diversifying their suppliers and procurement methods to control the risks associated with raw material procurement. Together with the trends in the prices of major raw materials, procurement methods must also be verified. Given the large amount of imported raw materials, the effect of foreign exchange and hedging methods also require attention.

(iii) Price pass-through

Income stability can be maintained if changes in raw material prices are flexibly applied to product prices, even if they are frequent. In particular, such industries as grain milling, sugar manufacturing, and oil manufacturing are easily affected by a single raw material, and changes in the spread of the raw material and products must be carefully monitored. Any structural change found in the spread must be applied to the credit rating, as it would affect the medium- and long-term earnings. Meanwhile, processed food products use a combination of multiple raw materials, rather than just one, and it is difficult to immediately hike up the price of a product, even if its raw material prices increase. The cost of these products is often controlled through weight changes or renewals, without changing the prices. Any effect of such measures on sale volumes and profit must be verified.

(iv) Cost-competitiveness

The food industry, under constant pressure to offer low prices, needs continuous rationalization to facilitate production and cost reductions. Improved cost-competitiveness allows lower product prices, resulting in increased sale volumes that lead to even better cost-competitiveness. JCR monitors each company’s measures aimed at rationalization and cost reductions during the entire process, from production to distribution.

(v) Marketing expenses

Marketing expenses for sales promotion and advertising are an absolute necessity to increase a company’s brand power and consumers’ willingness to buy its products. While effective use of marketing expenses increases profit, inadequate use conversely puts pressure on profit. Promotional expenses, in particular, often become funds for retail bargain sale offers, which tend to increase with a retailer’s buying power and at times of sluggish consumption. In addition to monitoring the effect of an increase or decrease in such marketing expenses on net sales, JCR examines each company’s investment policy, method of verification of the efficacy, management method, ability to control expenses, and other factors.

(vi) Responses to trade liberalization

In the future, the trading of agricultural product, including livestock, is likely to become more liberalized in Japan. The effect of the inflow of low-price raw materials and food products from other countries on the earnings of each company must be assumed in advance. The progress of the WTO, FTA, and TPP negotiations must be monitored, and each company's preparations for trade liberalization and responding capacity must also be investigated.

(vii) Business portfolio and overseas expansion

In addition to food manufacturing, food companies often engage in such businesses as wholesale, distribution, home meal replacements, restaurants, pharmaceuticals, and real estate. The profitability of each business and synergy between different businesses must be examined. In response to the shrinking domestic market, many companies are also entering overseas markets, seeking to increase their earnings. JCR monitors the market trends and growth potential of areas in which they enter.

Because building a business base from zero when entering a new category or overseas market would be extremely time-consuming, alliances or mergers and acquisitions are used in many cases. JCR investigates the size of investment and effect on financial affairs and monitors future contributions to earnings, synergic effect, and other outcomes of such activities.

(viii) Safety and reliability

The concept of "safety and reliability" is the basis of a food company, and, therefore, it is a crucial point in assigning a credit rating. JCR confirms the process of manufacturing and distribution, compliance with traceability requirements, and other activities for legal compliance. When a problem arises in this respect, specific details, measures taken, and effects on the business and earnings are investigated and applied to the credit rating.

2. Financial base

(1) Earnings strength

High profitability reflects a company's brand power, a product's high market position, and high cost-competitiveness. The gross margin is affected by production efficiency, a product's value-added level, and the ability to apply the cost of raw materials to the product price. Meanwhile, the operating margin is influenced by consumers' preference for low prices, brand power capable of competing against retailers' buying power, and the ability to control marketing expenses. Understanding the products and categories that increase the profitability and assessing the sustainability are also important.

Key financial indicators:

- Gross margin
- Operating margin

(2) Asset efficiency

Products from grain milling, sugar manufacturing, and oil manufacturing, which are close to being raw materials, require a reasonable capital expenditure and, yet, are difficult to differentiate from others in their same categories. For these products, constant cost reduction through efficient production to prepare for continuous capital investment is necessary. Investment in farms is made in some cases to cope with the traceability requirements and to ensure a more reliable supply of raw materials. Such upstream investment must be carefully monitored as it requires a heavy financial burden and tends to cause low profits. The asset efficiency is verified based on ROA, and the conditions of recovering the funds borrowed for the capital investment are examined using the ratio of interest-bearing debt to EBITDA.

Meanwhile, the inventory of raw materials and products must also be inspected. Particularly when a company is concurrently a food wholesaler, inventory assets and account receivables tend to increase, and an inventory loss and an allowance for bad debts are incurred due to changes in market conditions that may threaten the earnings stability. The status of inventory assets and working capital must be assessed and the percentage of working capital in interest-bearing debt must be monitored to understand the financial position.

Key financial indicators:

- Return on assets
- Ratio of interest-bearing debt to EBITDA
- Inventory turnover
- Working capital turnover

(3) Safety

Considering the long-term business environment, including a future decline in domestic demand and the effect of trade liberalization, companies are likely to make more active efforts to improve and maintain their profitability by advancing into global markets and new categories or by industrial reorganization. Mergers and acquisitions are also expected to increase, which will require investment capacity to obtain acquisition funds. The financial structure of food companies is generally favorable, representing a stable income structure, and, therefore, the companies are considered to have investment capacity to some extent. Those companies that are eager to make investments, however, must be monitored for their cash flow levels and financial resistance to an increase in interest-bearing debt.

Key financial indicators:

- EBITDA
- Free cash flow
- Equity ratio
- Debt equity ratio

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