Last updated: June 1, 2021

Rating Methodology by Sector

Foods

1. Business base

Given the matured market and low barriers to entry, sales competition in the 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 earning capacity of each company, and therefore, analyzing of such qualitative aspects is 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 the 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, the medium-term demand is generally more stable than in other industries. JCR's credit rating for the food industry reflects the stability of performance based on stable demand.

In the long run, however, a fall in demand caused by the decreasing and aging population is inevitable. Demands in some categories are structurally on a decline due to changes in dietary habits and preferences. Many food companies are expanding their business into new categories or overseas markets, seeking mid-to-long term growth and maintenance of earning capacity. There have also been an increasing number of cases of company acquisition, merger, integration and alliance for business base enhancement. For such investments for earnings growth, JCR focuses on each company' policy and effects on the financial structure, among others.

(ii) Competitive situation

Low barriers to entry and the infrequent technological innovation required for food products make sales competition intense. Companies also need to response to consumers' price sensitiveness. For these reasons, 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 needs to pay attention to the progress in 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 industry peers, the income of these categories is relatively stable. Because, however, changes to regulations, among others, 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 / earnings 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. Profitability is also different between business-use products and commercial products. For business-use products, including those for processed food manufacturers, home-meal replacement and restaurant industries, etc., while the requirements of customers for products and prices are rigid, marketing expenses are unnecessary and, as custom-made products, stable sales volumes can be expected once the sale starts. For private brands for nationwide retailing, there are often bidding for adoption. Because the scale of such business is large, once adoption ends, it would give a large impact on the company's earnings. 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 the mid-to-long-term earning 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 a company has, the more stable the sales volumes and the higher the production efficiency it enjoys. These products can also increase the bargaining power in determining supply conditions, such as prices and shelf space. It is fundamental to confirm the market size and the number of product lines of each company's products with a large market share.

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 are exposed to volatility that is higher than the past, 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

It is important to appropriately shift fluctuations in raw material prices to product prices. Recent years, costs for distribution and personnel have remarkably increased, which need to be shifted to product prices accordingly. In particular, grain milling, sugar manufacturing, oil manufacturing, etc. 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 changes found in the spread must be applied to credit ratings, as it would affect the mid-to-long term earning capacity. Meanwhile, processed food products use a combination of multiple raw materials, rather than just one, and it is difficult to immediately hike 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. JCR must verify whether such price pass-through and renewals have impacts on sale volumes and profits.

(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 sales volume, inadequate use conversely puts pressure on profits. Promotional expenses, in particular, often become funds for retail bargain offers, which tend to increase with sluggish consumption and retail buying power. 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

The trading of agricultural products including livestock, and food products have been gradually becoming more liberalized. Through trade negotiation these years, reduction of some custom rates has been implemented in a phased manner. JCR should examine each company's preparation and capacity to respond against trade liberalization as well as paying attention to each country's trade policy and progress of trade negations. The effects of the inflow of low-price raw materials and food products from other countries on the performance of each company must be assumed in advance.

(vii) Business portfolio and overseas expansion

In addition to food manufacturing, food companies often engage in such businesses as wholesale, distribution, home-meal replacement, restaurant, pharmaceutical 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 growth. JCR monitors the market trends and growth potential of areas in which companies enter.

Since building a business base from scratch when entering a new category or overseas markets would take very long time, 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 profits, synergic effect, and other outcomes of such activities.

(viii) Safety and security

The concept of "safety and security" is the basis of a food company, which is a crucial point in assigning credit ratings. JCR confirms the process of manufacturing and distribution, compliance with traceability requirements, and other activities for legal compliance. JCR incorporates the fact that basically there are no problems on safety and security into ratings. Accordingly, when a problem arises in this respect, specific details, measures taken, and effects on the business and performance need to be investigated and incorporated into credit ratings.

2. Financial base

(1) Earnings capacity

High profitability reflects a company's brand power, a product's high market position, and high cost competitiveness. The gross profit margin is affected by production efficiency, a product's value-added level, and the ability to shift the cost of raw materials to the product prices. Meanwhile, the operating profit margin is influenced by consumers' preference for low prices, brand power capable of competing against retail 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 profit margin
- Operating profit 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, it is necessary to reduce costs constantly through efficient production and prepare for continuous capital investment. Direct 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 be low in profitability. The asset efficiency is verified based on return on assets (ROA), and the conditions of recovering the funds borrowed for the capital investment are examined by using the ratio of interest-bearing debt to EBITDA.

Meanwhile, the inventory of raw materials and products must also be checked. In particular, when a company is concurrently engaged in food wholesale, an inventory loss in inventory assets and an allowance for sales credits can be incurred due to fluctuations in market conditions and economic cycle changes, which may threaten the income 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:

- ROA
- 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 performances by advancing into global markets and new categories or by industry reorganization. Mergers and acquisitions are also expected to increase, which will require investment capacity to obtain acquisition funds. In addition, capital investments are more required for personnel saving and automation for cutting personal costs and labor load. 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

Japan Credit Rating Agency, Ltd
Jiji Press Building, 5-15-8 Ginza, Chuo-ku, Tokyo 104-0061, Jap
Tel. +81 3 3544 7013, Fax. +81 3 3544 70