

## Rating Methodology by Sector **General Trading Companies**

General trading companies operate in a broad array of industries, including metals, energy, machinery, food, chemicals, and real estate. With respect to the form of business, in addition to conventional trading, they are also active in resource and business investment. JCR's rating method is geared toward large general trading companies that operate in an array of industries and forms of business.

### **1. Business base**

Large general trading companies operate in diverse businesses, and each of them has strengths in different areas. Understanding the business risk and competitiveness of each company requires an examination of its major businesses. The balance of each business in the consolidated earnings must also be considered. If earnings rely on a specific business, any changes in that business will significantly affect the overall consolidated results. The key factor is how stable the business portfolio is against changes in the external environment.

#### (1) Characteristics of the industry

##### (i) Market overview

Companies in this industry boast a wide range of business activities, and major earning sectors have changed over time. Due to the increased demand for crude oil, coal, iron ore, copper, and other such resources by emerging economies, the proportion of the resource and energy sector in the consolidated earnings of companies with interests in the sector has increased in recent years, and the market has been quite solid. Fluctuations in world economic trends, however, may significantly alter the market conditions; thus, this sector's volatility is considered to be slightly high.

General trading companies actively entering new businesses can expect future growth in this sector, but it calls for an assessment of how regional business will be developed. Nonetheless, the markets of areas that are expected to grow are often still being developed, and entry is often deemed as prior investment, from which a substantial short-term contribution to profit may not easily be expected. The market prospects may also be less clear than those for existing businesses, making the degree of risk associated with the businesses relatively higher. Maintaining medium- and long-term growth requires continuous development of growth areas, and such efforts should be identified. In view of regions, the percentage from overseas earnings has been increasing, indicating the escalating importance of overseas markets. Regions in which future growth can be expected include Asia, particularly China. Market entry by a company alone, however, is often difficult, and obtaining a superior local partner can be crucial.

## (ii) Competitive situation

The situation varies depending on the business area. Because sales prices in the resource and energy sector are often determined by the conditions of the international market, and some customers are fixed, competition does not create many issues. Acquiring interests, however, may be through bidding, and purchase price competition occurs. Every company attempts to avoid overbidding by postulating conservative future market prospects and benchmark investment yields. When the market price remains high, however, the price for establishing interests soars, and certain risks may be inevitable in the competition against other companies. The conditions of a company's acquired major interests should be observed.

While simple intermediation alone is decreasing in a conventional trading business, when supplemented by the various functions of a trading company, it remains the major operation of general trading companies. Key sectors in trading business include steel, natural resources, energy, chemicals, machinery, food, and many other products, and each sector boasts a different competitive situation. Long-established superior suppliers and customers are retained to an extent in many cases. Yet, structural changes in some sectors may reduce the market size and intensify the competition. Trends in each market, therefore, require attention.

## (iii) Cost structure

Although some trading companies own factories to operate direct production and pay fixed expenses, most trading businesses do not require large amounts of capital expenditure and pay only small amounts in fixed expenses. The primary costs lie in the prices of goods purchased, and trading companies often earn a certain margin depending on the sales amount or quantity. The cost structure, therefore, is relatively stable.

## (2) Key factors in market position and competitiveness

### (i) Market position

Investment in interests in the resource and energy sector is often limited to partial investment, with the position at the global level not necessarily high, on the other hand, looking at the domestic level, there are some cases maintaining a significant market share. Because the sales prices of some items are determined based on international market conditions, the effect of differences in market shares on profitability is not substantial. Nevertheless, there are some benefits, such as market positions that improve depending on the size of interests held and relevant information that becomes promptly available when acquiring a new project. JCR identifies the rated company's market position.

In some other business areas, trading companies maintain stable income by retaining a certain market share based on their past business experience. Maintenance of such business becomes a criterion for assessing their income stability.

(ii) Business portfolio

Understanding the overall business conditions is essential for general trading companies operating various businesses. While profit and loss information is maintained for each segment for accounting purposes, in reality, numerous businesses with varying characteristics exist in a single segment. Every company, therefore, is managing their businesses by further dividing them into smaller units that correspond to business characteristics. More specifically, each of the units is analyzed for its profitability and future potential (i.e., declining, mature, stable, and growth businesses), which are then categorized into a group that needs withdrawal or improvement, a group in which more management resources will be invested, or other groups, to develop a business strategy for each unit. In view of assessing credibility, the key criterion is how to improve the profitability and growth potential of the businesses by reducing low-income, declining units and increasing high-income, growing units. Concentration of earnings in a particular unit increases the possibility that any change in the unit will affect overall earnings. Consequently, the distribution of earnings among a larger number of diverse units is considered to help improve income stability. Confirming the condition of the overall businesses requires an understanding of the unit-based business portfolio, which is incorporated in credit rating assessment.

(iii) New investment

Continuous new investment is essential for obtaining new sources of income to maintain growth potential. New investment, however, does not necessarily meet company expectations, and the degree of risk is relatively higher than for existing businesses. There have been many cases of a company's failure to ensure a new investment's expected profits, resulting in losses. Conversely, appropriate new investment has contributed to a subsequent increase in earnings in many other cases. The progress of major investment projects in the past must be examined to assess the effect on future income. The viewpoint of diversified investment is also crucial in new investment, as investment of comparatively too large for a company's financial strength, i.e., in terms of equity capital, could create possible negative consequences too serious to ignore. In view of risk management, keeping the amount of each investment small and investing in more diverse businesses or regions is favored. JCR focuses on a company's investment policy as well as the diversification of investment.

(iv) Risk management

While somewhat predictable losses can be covered by impairment, provisions, etc. in accounting, unpredictable losses must also be controlled, considering the degrees of various business risks faced by general trading companies. Because of this, many companies estimate their risk assets (the largest amount of loss estimated under certain conditions) and tries to control the risk assets based on their risk buffer (equity capital). While estimation methods vary depending on the company, making an

intercompany comparison difficult, changes within the same company can be observed. Risk assets should basically be covered by a risk buffer, and many companies set the ratio of risk assets to risk buffer at 100% or less as the standard. Based on this balance between the risk assets and risk buffer, a company's risk management conditions are included in assessing a credit rating.

## 2. Financial base

### (1) Earnings strength

General trading companies operate not only simple trading, but also businesses combined with investment. Any analysis of their earnings conditions must therefore include returns on investment. While various indicators may be used, JCR focuses in particular on a company's basic earnings strength (operating income before provision of allowance for doubtful accounts + interest balance + dividends received + investment profit (loss) on equity method). This indicator deducts the cost of bad debts as a special factor while interest earned through investment/loans, dividends received, and investment profit (loss) on equity method are taken into consideration.

Also since, in general, the higher the risk, the higher the returns, whether returns are comparable to the degree of risk is an important consideration in addition to the amount of surface profit. Many companies manage unit-based risk and returns, and an assessment of the number of units below benchmark earnings and improvements that can be made going forward, along with potential risk factors, must be confirmed.

Key financial indicators:

- Operating income
- Investment profit (loss) on equity method
- Financial balance
- Basic earning power (operating income before provision of allowance for doubtful accounts + interest balance + dividends received + investment profit (loss) on equity method)
- Risk and return indicators of each company

### (2) Safety

Maintaining financial stability is important for general trading companies, which are exposed to relatively high degrees of business risk in their operation across a range of businesses and in which are continually making new investments. To confirm their financial details, various factors need to be assessed in addition to the amount of equity capital on the surface, including unrealized gains/losses on an affiliate's publicly traded stock that affect equity capital, deferred tax assets whose asset potential decreases depending on the situation, and retirement benefit obligations that potentially require payment of expenses. Further, potential profit and risk of loss should also be identified, and the effect on equity capital should be considered. While continuously making new investment, general trading companies sell businesses, and the resulting unrealized profit or loss is realized when a business is sold. An

unrealized loss may be considered as impairment following a decline in the profitability of the business. Particularly when the external environment has deteriorated, progress in investment projects may fail to meet expectations, resulting in an increased risk of a loss. There also many cases in which foreign currency assets associated with overseas investment are held, or a large amount of securities of business partners is retained, and the effects of fluctuations of foreign exchanges and stock prices on equity capital require attention.

Key financial indicators:

- Shareholders' equity
- Net debt equity ratio
- Equity ratio

### (3) Conditions of financing

General trading companies borrow a large amount of funds from external institutions, making them susceptible to changes in their financing environment. Maintaining some surplus for the necessary funds is important, and enhancing liquidity, such as the commitment line and current ratio, must be confirmed. The ratio of long-term and short-term borrowings in the funds financed, transactions with financial institutions, including main banks, issuance of corporate bonds, and changes in the cost of financing must also be monitored.

Key financial indicators:

- Current ratio
- Ratio of long-term and short-term borrowings

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**Japan Credit Rating Agency, Ltd.**

Jiji Press Building, 5-15-8 Ginza,  
Chuo-ku, Tokyo 104-0061, Japan  
Tel. +81 3 3544 7013, Fax. +81 3 3544 7026

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