Overview

Edible oils constitute an important component of food expenditure in Indian households. The demand for edible oils in India has shown a steady growth, driven by improvement in per capita consumption, which in turn is attributable to rising income levels and living standards. However, the Indian edible oils market continues to be underpenetrated as current per capita consumption levels of India (at 14.4 Kg/year for 2013-14) are lower than global averages (24 kg/year). Thus, edible oils have a favorable demand growth outlook over the medium-to-long term, which is further supported by positive macro and demographic fundamentals. India currently plays an important role in the global edible oil market, accounting for ~11% share of consumption; 7% share of oilseed production; 5% share of edible oil production and 14% share of world edible oil imports.

Edible oil processing consists of three operations: crushing and expelling (separating oil from the solids – generally done by Ghanis and small-scale expellers / oilseed crushers), solvent extraction (to crush and process hard oilseeds with low oil content such as soyabean and cottonseed as well as chemically extract residual oil from the oilcake), and oil refining (which includes some or all of the following treatments—filtering, neutralization, winterizing, bleaching, deodorization and degumming and filtering for making oil fit for human consumption).

Historically, India has been a major importer of edible oils with almost 30-40% of its requirements being imported till 1980s. In 1986, the Government of India established the Technology Mission on Oilseeds and Pulses (TMOP) in order to enhance the production of oilseeds in the country. The TMOP launched special initiatives on several critical fronts such as improvement of oilseed production and processing technology; additional support to oilseed farmers and processors besides enhanced customs duty on the import of edible oils. Consequently, there was a significant increase in oilseeds area, production, and yields until the late-1990s. However, in order to fulfill its obligations towards various international trade agreements and also meet the increasing demand-supply deficits, India began to reduce import restrictions on edible oils in the late 1990s; and it was gradually brought under Open General License. This led to a significant slump in the domestic oil seeds market, as edible oil prices fell sharply in line with the low international prices prevailing at that time.

In terms of volumes, palm oil, soybean oil and mustard oil are the three largest consumed edible oils in India, with respective shares of 43%, 17% and 13% in total oil consumption during the last two years. Although domestic production is on an increasing trend, imports meet ~55-65% of consumption, with the main imported varieties being crude palm oil and soybean oil. The ability of India’s oilseed sector to compete with imports is weakened by a fragmented processing industry afflicted by low capacity utilization. Owing to high import dependence, the edible oils prices in India are directly correlated to international oil price movements and the currency movements, which make the edible oils prices vulnerable to unexpected margin fluctuations.

In ICRA’s opinion, the key determinants of business risk profile of edible oil companies are their ability to overcome the regulatory risk and agro-climatic conditions. Other operational factors include operating efficiency, product diversity, market position, ability to secure raw material and commodity price & forex risk management systems. ICRA’s assessment also factors in the company’s financial position and returns metrics, its capital structure, ability to generate positive cash flows from operations and the adequacy of the same in relation to its contractual debt service obligations. ICRA also assesses the issuer company’s management for its growth plans, risk appetite and financial policies.

Business Risk Profile Assessment

Commodity and Currency Risks

One of the key risks that edible oil companies face is the risk arising out of volatility in prices of raw materials (oilseeds), crude edible oil and refined edible oil, which may be influenced by trends in...
international commodity prices, current fluctuations, demand-supply dynamics and macro-economic trends. The domestic edible oil prices are directly linked to the prices of imported palm and soyabean oil due to heavy reliance on imports and their substitutability with other oil varieties. While mustard oil is almost entirely produced within the country, soyabean oil is imported in significant quantities (about 45%-50%) while Palm oil is imported both in crude form (for refining in port-based refineries) as well as in the refined form. Given the high volatility in international edible oil prices, domestic participants are exposed to the risk of unexpected squeeze on margins due to pricing mismatches between raw materials and final product prices (which are both linked to domestic factors as well as global factors). With a significant portion of the consumed oil being imported, the foreign currency movements also have an impact on the profit margins of the industry players.

Exposure to a commodity is either taken through physical possession or through financial derivatives and the risk may be hedged through back-to-back transactions with customers or through offsetting trade transactions on local/global commodity exchanges. In assessing commodity and currency risk, ICRA evaluates the company’s trading and hedging strategies for commodity and forex, management’s track record in the business and commitment to the hedging policy, volatility in earnings in the past and longevity of the company’s operations in each of its market segments/presence across different oils. In addition, the extent of market risk in a business is also influenced by inventory holding period. Companies with relatively higher inventory holding periods owing to factors like processing, logistics etc may face higher risk compared to the ones where turnaround is faster as the inventory value can change rapidly in either direction. Thus, the overall profitability of market participants remains vulnerable to risks emanating from commodity price volatility, forex movements, besides demand-supply dynamics and ICRA’s rating framework focuses on the issuer’s fundamental credit quality and seeks to evaluate its credit risk profile across commodity and currency cycles.

Agro-Climatic Risks

As the share of irrigated (by dams/canals/wells) area is low in India, most of the regions are dependent on monsoon rainfall. Even the irrigated areas are indirectly dependent on monsoons. Thus production of oilseeds gets negatively impacted in years when there is a drought or deficient rainfall. Besides, the edible oil manufacturers are also impacted by the inventory levels and at times by larger credit period to push sales. However, the risk can be mitigated to some extent if the companies have a diversified geographic manufacturing presence spread across several states as the probability of monsoons failing simultaneously across states remains low to moderate. Also, the risk is further mitigated for players who have access to imported feedstock (either crude palm oil for refining or soyabean seeds for crushing, extraction and refining).

Regulatory Risks

The profitability of edible oil companies is significantly influenced by the regulatory changes and remains highly susceptible to the changes in the duty differential between import duties on crude and refined oil by the Government of India (GOI) as well as to the changes in the export tax by the exporting countries mainly Indonesia and Malaysia (as majority of palm oil imports are from these two countries). Beginning 2007-08, the import duty on crude and refined edible oils has been progressively reduced by the GOI. These policy changes have been made to comply with foreign trade agreements entered by India with other countries such as the Association of South East Asian Nations (ASEAN), apart from meeting shortfalls in domestic supplies so as to curtail inflation\(^1\). Overall, the profit margins of domestic refiners are influenced by any changes in the import duty structure by the GOI or changes in export duty by exporting countries because of limited value addition as well as limited ability of the players to pass on fully duty changes to the end customers on account of highly fragmented industry structure. ICRA’s rating assessment therefore, besides taking into account the overall cost competitiveness of the issuer, also evaluates the consequences of duty changes and viability of the players concerned. ICRA also notes that entities that crush domestic seeds and process into oils will be relatively less affected compared to refiners; nevertheless they will also be subject to competition from imported oils, which is sensitive to duty changes.

\(^1\) In December 2014, the duty on refined palm oil was increased to 15% from 10.0% while that on crude palm oil was increased to 7.5% from 2.5%, with the net duty differential being maintained at 7.5% (7.7% including education cess) to protect the domestic industry
Cost Competitiveness

The edible oil industry in India is characterized by intense competition and fragmentation, with the presence of a large number of units attributable to low entry barriers such as low capital and low technical requirements of the business. While a number of inefficient units closed down after reduction of high import tariffs on imported edible oils, the average capacity utilisation rates of Indian oilseed processors remain low (at ~30%-40%), with many of them operating only for a part of the year, that is, during the local harvest season of raw materials. Thus achieving economies of scale and having a competitive cost structure are of considerable importance. Although due to low value addition in the business, operating profit margins of edible oil manufacturers have inherently been thin; players having cost competitive structure or bulk purchases of raw materials as well as having established brand presence have achieved relatively better margins due to high brand penetration and better pricing power. The ability to maintain high capacity utilization levels is influenced by factors such as extent of cost competitiveness and location of the units as presence near a large consumer market confers competitive advantage in terms of logistics, local taste preferences, price of the end products as well as duty protection available from imports.

Market Position

During the past decade, the domestic production of oil seeds and correspondingly edible oil has remained stagnant, whereas the demand has risen steadily leading to a significant increase in import dependence. The flexibility to modify product portfolio as per the demand is a key strength in a market characterized by commodity price volatility. Accordingly, players with a diversified presence and exposure to the three major categories of oil, namely, palm oil, soya bean oil and mustard oil, are better positioned for growth as compared to players with single product concentration. Further, large-scale integrated players are better placed than small and mid-sized manufacturers to withstand the challenges in the business environment on the strength of benefits related to economies of scale such as lower cost of production and access to cheaper working capital credit. Also, market participants with a high share of established branded products are better placed than participants operating in the commoditized bulk market. ICRA favorably views edible oil companies with benefits of large-scale integrated operations, multi-product offerings and recognizable branded presence in retail markets as these have fared better as compared to small/medium-scale domestic oilseed crushers.

Level of business integration

Apart from enjoying strong market position and diversification, edible oil companies also strengthen their business profile by vertically integrated operations. Some of the larger players in the edible oil business have also integrated their businesses by exploring possibilities of both backward and forward integration. For instance, companies engaged in refining of edible oils may strengthen their sourcing by acquiring palm oil plantations in Indonesia or Malaysia on one hand and can create brands on the other with the objective to draw greater value addition across the chain. Besides improving profitability, such measures also help companies in mitigating the impact of fluctuation in commodity prices to some extent. However, benefits of backward integration could be neutralized in adverse demand scenario because of high capital intensity as well as long gestation period associated which can result in higher fixed costs.

Management Quality

All debt ratings necessarily incorporate an assessment of the quality of the issuer’s management as well as the strengths / weaknesses’ arising from the issuer’s being a part of an established group of companies. Also of importance are the issuer’s likely cash outflows arising from the possible need to support other group entities, in case the issuer is among the stronger entities within the group. Usually, a detailed discussion is held with the management of the issuer to understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the issuer’s industry. Some of the other points assessed are:

- Experience of the promoter / management in the line of business concerned
- Commitment of the promoter/management to the line of business concerned
- Attitude of the promoter / management to risk taking and containment
- The issuer's policies on leveraging , interest risks and currency risks
- The issuer's plans on new projects, acquisitions, expansion, etc.
- Strength of the other companies belonging to the same group as the issuer
ICRA Rating Feature

- The ability and willingness of the group to support the issuer through measures such as capital infusion, if required

ICRA notes that some entities in the past have resorted to opportunistic price-based trading in crude edible oils/seeds while some have taken long/short position using the various derivative instruments available anticipating favourable price movement; however as edible oil prices tend to be volatile, such practices expose the entities to the risk of high losses and/ or liquidity crunch to meet the margin requirements in case of unfavourable price movements. Hence, ICRA views such entities with adequate caution and analyses the impact of unfavourable price movement on the open position taken by the company either on exchanges or in the form of physical inventory as it could have significant impact on the financial profile of the company. ICRA also notes that since the edible oil industry is characterized by intense competition and fragmentation, the company’s approved hedging strategies for commodity and forex as well as the management’s track record and commitment towards adherence to the hedging policy is also assessed.

Financial Risk Profile Assessment

In order to assess the issuer’s current financial position, trends in profitability, gearing, coverage and liquidity are also analysed. These are discussed below:

**Profitability and Returns:** The analysis here focuses on determining the trend in the issuer’s operating profitability and how the same stands in comparison to peers. A company with higher profitability margins and returns on capital has a greater ability to generate internal accruals, attract external capital, and withstand business adversity. The trends in operating margin, working capital position and return on capital employed relative to the company’s cost of capital are analysed to establish the stability of cash flow generation and the sufficiency of the same vis-à-vis the company’s future debt service obligations. Overall because of high competition, fragmentation and low value addition in the business, operating margins for edible oil manufacturers tend to be in a thin to moderate range which are further exposed to risks of commodity price volatility and forex movements as a significant portion of the consumed oil is being imported. Thus the overall profitability of market participants remains vulnerable to risks emanating from weak harvests, commodity price volatility, forex movements especially for refiners and to any inventory losses because of high working capital intensity in the business. Thus the ability of a company to procure raw material cost competitively, have well-defined policies to hedge commodity & currency risk and efficiently convert raw material into end products can aid the profitability, because of relatively high raw material intensity in the business. For entities rated by ICRA, during the last five years, the average OPBDITA margins have averaged ~3% with net profit margins of ~0.5%. The RoCE has average at ~10% levels with fixed asset turnover (Operating income/Gross Block) of ~250%.

**Gearing and Debt service coverage ratios:** Given the low capital intensity of edible oil companies, and the high leveraging (working capital borrowings as well as terms loans for Greenfield/brownfield expansion), ramping up of operations with high capacity utilisation are essential to generate sufficient cash flows to service debt obligations. Accordingly the objective here is to ascertain the level of debt in relation to the issuer’s own funds and is viewed in conjunction with the business risks that the issuer is exposed to. ICRA, in its analysis of an edible oil company’s financial position, compares its debt-equity and Total Outside Liabilities/Total Net Worth (TOL/TNW) (for players who import against letter of credit facilities) with that of its peers to determine its relative leverage position. Generally, conservative leverage ratios are viewed favourably as the same reduce the committed outflows via interest and principal repayment. Long maturity profile (in case of term debt) and lower cost of the loans can partially offset the risk associated with high financial leverage. The other debt coverage indicators that are also examined include Interest Coverage Ratio, ratio of Net Cash Accruals to Total Debt, and Debt Service Coverage Ratio (DSCR). The high leverage for the sector is reflected in last 5 year average TD/TNW of ~2.5x, Interest coverage of ~1.5x, TOL/TNW of ~3.5x, Total Debt/OPBDITA of ~4.5x, current ratio of ~1.1x and Net cash accruals/Total debt of ~10% for the entities rated by ICRA.

**Working capital intensity:** Working capital intensity in the edible oil industry tends to be high because of high inventory holdings, given the seasonality in raw materials (that is, availability of oil seeds). The analysis here evaluates the trends in the issuer’s key working capital indicators like Receivables, Inventory and Creditors, again with respect to industry peers. ICRA also notes that working capital intensity remains low for players who import crude oil by availing letter of credit facilities (for payment upto 180 days) which can lead to high creditor days. However, in such cases ICRA analyses TOL/TNW with respect to industry peers.

Other areas which are analysed include the following:

- **Cash flow analysis:** Cash is required to service debt obligations. Cash flows reflect the sources from which cash is generated and its deployment. Analysed here are the trends in the issuer's
Funds Flow from Operations (FFO), the Retained Cash Flows, and the Free Cash Flows after meeting debt repayment obligations and capital expenditure needs. The cash flow analysis also helps in understanding the external funding requirement that an issuer has to meet its maturing debt obligations.

- **Foreign currency related risks**: Such risks arise if an issuer’s major costs and revenues are denominated in different currencies. Examples in the edible oil industry would majorly include companies importing crude or refined palm / soyabean oil (which are denominated in US dollar terms) and selling in the domestic market. The foreign currency risk can also arise from unhedged liabilities, especially for companies earning most of their revenues in local currency but having unhedged foreign currency borrowings which could pertain to part-funding of capital expenditure and/or working capital requirements like buyer’s credit facility. The focus here is on assessing the natural hedge available as well as hedging policy of the issuer concerned to mitigate such risk for net foreign currency exposure.

- **Tenure mismatches, risks relating to interest rates and refinancing and financial flexibility**: Large dependence on short-term borrowings to fund long-term investments can expose an issuer to significant re-financing risks, especially during periods of tight liquidity. The existence of adequate buffers of liquid assets / bank lines to meet short-term obligations is viewed positively. Similarly, the extent to which an issuer would be impacted by movements in interest rates is also evaluated. ICRA assesses the issuer’s liquidity by analysing the month-wise utilisation pattern of both fund based and non-fund based limits over the last 12-18 month period as well as the extent of drawing power available with the issuer. Moreover, ICRA also evaluates the strength of the entity’s relationship with banks, financial institutions and other intermediaries, which is a key factor for the timeliness in sanction of working capital funds to the entity. Also, the issuer’s financial flexibility—as reflected by its unutilised bank/credit limits, liquid investments, as well as financial strength of promoter group to infuse funds (either equity capital or unsecured debt ) to meet cash flow shortfall, is assessed.

- **Accounting quality**: Here, the Accounting Policies, Notes to Accounts, and Auditor's Comments are reviewed. Any deviation from the Generally Accepted Accounting Practices is noted and the financial statements of the issuer are adjusted to reflect the impact of such deviations.

- **Contingent liabilities / Off-balance sheet exposures**: In this case, the likelihood of devolvement of contingent liabilities / off-balance sheet exposures and the financial implications of the same are evaluated.

**Summing up**

As in other manufacturing sector ratings, rating of edible oil companies involves an assessment of business risk, management risk and financial risk profile. ICRA takes a case-by-case approach to evaluating the credit risk profile of edible oil companies, considering the diversity in their product lines and market dynamics. While the cost structure, capacity utilization, duty structure, diversity of product / consumer mix and hedging strategy would ultimately determine the business risk profile; the financial risk analysis would focus on profitability through price cycles, the extent of leverage, ability to service the debt and financial flexibility. The analysis is further complemented with financial projections over the maturity of the debt instrument that seeks to evaluate the adequacy of cash flows in comparison with the debt servicing requirements.
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