

JCR Solicits Public Comments on Revisions to Rating Methodology by Sector “General Trading Companies”

Japan Credit Rating Agency, Ltd. (JCR) is considering revisions to the rating methodology by sector “General Trading Companies” as described below, and solicits opinions on the proposed rating methodology.

1. Outline

JCR is considering reviewing its rating methodology by sector "General Trading Companies," as described in the attachment. The purpose of these revisions is to make the rating more transparent by measures such as adding new key indicators.

2. Future Plans

JCR solicits public comments on this matter. Comments will be accepted by e-mail to "Contact Us" on JCR website until June 21. JCR plans to finalize this rating methodology in about one or two months. There will be no existing individual ratings that need to be reviewed.

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Draft for Public Opinions

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. In addition to traditional trading, they are also active in investment. This rating methodology targets major general trading companies that are involved in a wide variety of business fields and business forms.

1. Business base

The major general trading companies are involved in a diverse range of businesses and have different areas of expertise. In order to understand the business risks and competitiveness of each company, it is necessary to check the status of their main businesses. In addition, attention should be paid to the balance of each business in terms of consolidated revenue. If earnings are dependent on a particular business, changes in that business will significantly affect the overall consolidated results. The key point is how stable the business portfolio is against changes in the external environment.

(1) Characteristics of the industry

(i) Market overview

The business areas of general trading companies are diverse and can be broadly divided into resource and non-resource sectors. Different companies have different percentages of revenues in the resource and non-resource sectors to the consolidated revenues. The resource sector covers crude oil, coal, iron ore and copper. Demand and market conditions in the resource sector significantly change due to global political and economic changes, thus profits in this sector should be regarded as highly volatile. On the other hand, profits in the non-resource sector are generally more stable than in the resource sector, although some businesses are affected by market fluctuations.

For general trading companies that are actively expanding into new businesses, it is important how they develop in sectors and regions where future growth can be expected. However, in some sectors with growth potential, the market may be still developing and due to the strong implication of upfront investment, there are cases where it may be difficult to expect a large contribution to profit in a short period of time. In addition, business risks are relatively high due to the uncertainty of the market outlook compared to existing businesses. However, in order to maintain medium- to long-term growth potential, it is necessary to continue developing growth areas, and the status of such efforts should be confirmed. By region, the importance of overseas markets is increasing, as the proportion of revenues generated overseas is rising. Asia is one of the regions where growth

can be expected in the future, but in many cases it is difficult to expand independently, so it is important to find good local partners.

(ii) Competitive situation

The situation varies depending on the business area. In the resource sector, since sales prices are often determined by the conditions of the international market and general trading companies have fixed customers, there are not many issues regarding competition. Acquiring interests, however, may be through bidding, and purchase price competition occurs in such cases. Every company attempts to avoid overbidding by postulating conservative future market prospects and benchmark investment yields. However, depending on the situation, certain risks may be inevitable in the competition against other companies, and the status of acquisition of major interests should be confirmed.

While simple business of intermediation alone is decreasing in a conventional trading business, businesses that add various trading company functions are still the main business of general trading companies. Key sectors in trading business include steel, natural resources, energy, chemicals, machinery, food, and many other products, and the competitive situation differs in each area, but in many cases they have secured a fixed number of good suppliers and customers for a long time. However, in some sectors, the market size may shrink and competition may intensify due to structural changes, so it is necessary to pay attention to trends in each market.

(iii) Cost structure

In some cases, fixed cost burdens are incurred by owning factories and conducting direct production activities, but most trading businesses do not require large capital investment and have light fixed cost burdens. In trading businesses, purchase is the main cost, but trading companies often earn a certain margin on the sales amount or quantity, so their cost structure is relatively stable.

(2) Key factors in market position and competitiveness

(i) Market position

Investment in interests in the resource sector is often limited to partial investment, with their position at the global level being not necessarily high. However, there are cases where they secure a reasonable share in domestic handling, including trade. For some commodity items, the effect of differences in market shares on profitability is not significant, as selling prices are determined based on international market conditions, but the size of the interests held improves the market position and some benefits such as relevant information becoming promptly available when acquiring a new project are recognised. Confirmation of market position is needed.

In some non-resource sectors, trading companies secure a certain market share and stable earnings due to their past trading history. The holding status of such fields is a key factor in assessing the stability of earnings.

(ii) Business portfolio

For general trading companies with a diverse business portfolio, it is essential to understand the overall business situation. For accounting purposes, profits and losses are managed by segment, but in reality there are many businesses with different characteristics within the same segment. For this reason, each company manages its businesses based on a more subdivided business unit in accordance with the characteristics of the business. Specifically, profitability and future potential of each business unit (e.g., declining, mature, stable, growth, and other areas), are analyzed, and strategies are formulated for each business unit after classifying it into business that needs to be withdrawn or reviewed, business where management resources should be invested more intensively, and other businesses. From the perspective of assessing creditworthiness, the key point is how to improve overall profitability and growth by reducing businesses in low-profit and declining fields and increasing businesses in high-profit and growing fields. In addition, if revenues are concentrated in certain businesses, it is more likely that changes in those businesses will affect overall revenues. Therefore, JCR considers that earnings stability can increase when earnings are spread across a greater number of diverse businesses. Confirming the condition of the overall businesses requires an understanding of the business unit-based business portfolio, which needs to be incorporated in credit rating assessment.

(iii) New investment

Continuous new investment is essential in order to secure new sources of revenue and maintain growth potential. New investment, however, does not always progress as planned, and the risk is relatively higher than for existing businesses. In many cases in the past, planned revenues were not secured and losses were recorded. On the other hand, there are many cases where appropriate new investments have contributed to subsequent earnings growth, and it is necessary to check the progress of major investment projects that have been implemented to date and consider the impact on future earnings. It is also essential to have a diversified investment perspective with regard to new investments. Investing excessive amounts relative to financial strength, such as the size of equity capital, will have non-negligible consequences in the event of an eventuality; it is preferable from a risk management perspective to keep the amount invested per investment low and invest in a more diverse range of sectors and regions. JCR places importance on the diversification of investments as well as the investment policy.

(iv) Risk management

Somewhat predictable loss risks can be covered by accounting impairments and provisions, but given the scale of the various business risks that general trading companies have, unexpected losses also need to be managed. For this reason, many companies calculate risk assets (maximum loss amounts that can be expected under certain conditions) and try to control risk assets based on risk buffers (equity capital). The calculation methods vary from company to company and it is difficult to compare risk-responsiveness among companies, but it is possible to read changes in this within the same company. It is desirable to basically cover risk assets with a risk buffer, and many companies set the ratio of risk assets to risk buffer at 100% or less as the standard. It is

necessary to understand their risk management status through the balance between risk assets and risk buffer and factor it into the rating.

2. Financial base

(1) Earnings strength

General trading companies operate not only simple trading, but also businesses combined with investment. Therefore, analysis of their earnings situation needs to take into account the returns from their investments. While various indicators can be considered, JCR calculates in particular basic earnings strength (gross profit - SG&A expenses (excluding provision of allowance for doubtful accounts) + net interest expenses + dividends received + investment profit (loss) on equity method). This indicator deducts the cost of bad debts as a special factor, while taking into account interests and dividends received and investment profit (loss) on equity method through investment and loans. In recent years, companies have published net income excluding one-off gains and losses in their IR materials, which can be helpful in determining recurring earnings strength. JCR also places emphasis on net income including one-off gains and losses.

Key financial indicators:

- Operating income (Gross profit - SG & A expenses)
- Investment profit (loss) on equity method
- Financial balance
- Basic earning strength (operating income before provision of allowance for doubtful accounts + net interest expenses + dividends received + investment profit (loss) on equity method)
- Net income

(2) Safety

Maintaining financial stability is important for general trading companies, which are exposed to relatively high degrees of business risk, as they operate a diverse range of businesses and continuously invest in new businesses. To confirm their financial structure, various factors need to be considered and assessed in addition to the superficial amount of equity capital. For example, unrealized gains/losses on shares in listed group companies, which can be a supplement to equity capital, and deferred tax assets whose asset potential decreases depending on the situation. Furthermore, potential profit and risk of loss should be also identified, and the effect on equity capital should be considered. While continuously making new investment, general trading companies sell businesses. When a business is sold, unrealized gains or losses are realized. Unrealized losses can be manifested as impairment losses as the profitability of the business declines. In particular, when the external environment deteriorates, investment projects do not progress as planned, resulting in an increased risk of losses. There are many cases where general trading companies hold a large amount of foreign currency denominated assets associated with overseas investments, as well as securities of business partners, and it is necessary to pay also attention to the impact of fluctuations in foreign exchange rates and stock prices on equity capital.

Key financial indicators:

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

(3) Conditions of financing

General trading companies externally finance a large amount of funds, making them susceptible to changes in their financing environment. It is important to have a certain amount of margin for the required funds, and it is necessary to check the status of supplemental liquidity such as commitment lines, as well as the current ratio. In addition, the ratio of long-term and short-term funds in the funds financed, status of borrowings and bond issue, and changes in financing costs should also be monitored.

Key financial indicators:

- Current ratio

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