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Rating Methodology by Sector

Foods

In this rating Methodology, a wide range of companies related to processed foods and beverages are targeted, centering on food processors, such as livestock and fishery businesses positioned upstream in the commercial flow, as well as downstream food-related distribution and wholesaling businesses.

1. Business base

With the matured market and low barriers to entry, sales competition in the domestic food industry is 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 such qualitative aspects is important. Besides dealing with food products in multiple categories, a great number of companies also enter non-food businesses such as pharmaceuticals and distribution. Therefore, it is essential to grasp the characteristics of the market and earning sources, roles, risks, and other factors.

(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 the stable demand.

In the long run, however, a decline in demand caused by the shrinking and aging population is inevitable. Demands in some categories are structurally decreasing 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's 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 sensitivity. For these reasons, JCR places emphasis on each company's efforts for competition and sales expansion, 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 pays attention to the progress in reorganization and changes in market shares of the companies, among other factors.

(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 at the operating profit level. Also, profitability and the difficulty of passing on costs through pricing are different between business-use products and commercial products. The business-use products include those for processed food manufacturers, home-meal replacement and restaurant industries, and private-labels for retailers. For such products, customers' requirements for products and prices are strict, but marketing expenses are unnecessary. As these products are custom-made, stable sales volumes can be expected once sales commence. It is relatively easy to pass on raw material cost price increases. Meanwhile, regarding private labels for nationwide retailing, there are often bidding for adoption. Because the scale of such business is large, if adoption ends, it has a large impact on the company's earnings. Additionally, major retailers have price negotiation power, resulting in strong downward pressure on prices. 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 evaluates how the income characteristics of each product and portfolio affect the mid-to-long-term earning capacity.

(iv) Risks related to policies

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, 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.

(2) Important factors in market position and competitiveness

(i) Market position

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 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 extreme weather conditions, epidemics, increasing populations in emerging countries, changes in dietary habits associated with economic growth, the rise of biofuels, inflows of speculative funds, and geopolitical risks. 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, JCR has a good grasp of the effect of foreign exchange and hedging methods.

(iii) Price pass-through

To maintain earning capacity, it is important to appropriately reflect fluctuations in raw material prices in product prices. In recent years, the increase in distribution and labor costs has also become significant, and it is necessary to pass these costs through according to the situation. Regarding food price increases, consumers react sensitively, greatly affecting demand, and retailers and wholesalers also have strong resistance. Since the sales competition is intense, there are many cases where price revisions are decided by considering the situation of competitors. Therefore, it takes a long time for price pass-through to permeate. In addition, evaluations are conducted with awareness that there are disparities in the difficulty of price pass-through depending on product groups due to competitive conditions. On the other hand, since there are many cases where sales volume declines because of price pass-through, JCR will verify whether there is any impact on medium-term sales volume.

(iv) Cost competitiveness

The food industry, under constant downward pressure on 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 consumers' willingness to buy its products and a company's brand power. 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 effectiveness verification, management method, ability to control expenses, and other factors.

(vi) 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 entering overseas markets, seeking growth. JCR monitors the market trends and growth potential of areas 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, synergies, and other outcomes of such activities.

(vii) 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) Earning capacity

Operating profit is an indicator of a company's earning capacity, influenced by its brand power and the competitive advantage of its products in the market. Therefore, JCR evaluates the company's business base by confirming the size and stability of operating profit. The gross profit margin is affected by a product's production efficiency, value-added level, and ability to shift the cost of raw materials to the product prices. Meanwhile, the operating profit margin is influenced by the brand power capable of countering consumers' preference for low prices and retail buying power, and the ability to control marketing expenses. Understanding the products and categories that increase profitability and assessing sustainability are also important.

Key financial indicators:

- ■ Operating profit
- ■ Gross profit margin
- ■ Operating profit margin

(2) Cash flow generation capacity

In the food business, there are many investments aimed at improving production streamlining and labor reduction to enhance price competitiveness, as well as investments for safety and security. Since these are investments that do not directly lead to an increase in sales, it is necessary to monitor both the securing of cash flow and the progress of investment recovery. Additionally, although an increasing number of companies are expanding investments in overseas markets with growth potential, it takes time for market penetration due to differences in food culture and dietary habits. To support these medium- to long-term investments, cash flow generation capacity is important, and JCR will check the level and trend of EBITDA. Also, to understand the balance between the planned investments and the cash flow generation capacity, the trend of the ratio of interest-bearing debt to EBITDA will be examined from a long-term perspective.

Key financial indicators:

- EBITDA
- Ratio of interest-bearing debt to EBITDA

(3) Safety

Considering the long-term business environment, including a future decline in domestic demand, companies are likely to make more active efforts to maintain and improve their performances by advancing into global markets and new categories or by industry reorganization. Mergers and acquisitions are also expected to be pursued aggressively, which will require investment capacity to obtain acquisition funds. In addition, capital investments are more required for labor reduction and automation to cut personnel costs and labor load. Therefore, JCR will confirm the current status and outlook of the financial structure by the size of equity, the equity ratio and the debt/equity ratio. The financial structure of food companies is basically favorable with a stable earning structure, and, therefore, the companies are considered to maintain some investment capacity. Those companies that are eager to make investments, however, must be monitored for their financial resistance to an increase in interest-bearing debt and goodwill.

On the other hand, it is also necessary to check the inventory status of raw materials and products. Especially in cases where companies also engage in food wholesale such as fisheries and livestock, fluctuations in market conditions and economic changes can lead to inventory losses in stock and loan loss allowances for sales receivables, posing potential instability factors for profits. JCR will assess the soundness of the financial position, paying attention to the proportion of working capital within interest-bearing debt, and examining the inventory turnover period and working capital turnover period to determine whether inventory is being properly managed

Key financial indicators:

- Equity capital
- Equity ratio
- Debt/equity ratio
- Inventory turnover period
- Working capital turnover period

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