Rating Criteria for Fast-Moving Consumer Goods Industry

Executive summary

The fast-moving consumer goods (FMCG) industry deals primarily with the production, distribution and marketing of a wide range of consumer products such as personal and household products, detergents, and food and beverages. Rising affordability, especially of the middle-income group, is a major contributor to the growth of India’s FMCG market. CRISIL’s rating analysis of FMCG entities factors in their business, financial, and management risk profiles. In analysing the business risk, CRISIL looks into factors such as brand equity, diversified product portfolio, and innovation and product differentiation capabilities. The efficiency of the players’ distribution networks, supply chain management, manufacturing facilities (both in-house and outsourced) and raw material sourcing are other key constituents of CRISIL’s assessment of FMCG companies. In assessing the financial and management risk profiles of FMCG players, CRISIL follows the standard criteria it employs for all manufacturing companies.

Scope

While the broader criteria of manufacturing companies apply to entities in the FMCG industry as well, this article details the industry-specific factors that impact the market positions and operating efficiencies of companies in the FMCG industry.

CRISIL’s rating criteria for the FMCG industry include the following key factors:

Business Risk Analysis

Market position

Product mix

CRISIL studies a company’s product mix to ascertain the categories in which it operates. The companies with a presence in segments such as toothpastes, soaps, and detergents that are essential items with a recurrent need, tend to have stable sales; the companies with a presence in discretionary segments such as perfumes and cosmetics, on the other hand, tend to have a dip in sales during times of recession. A player’s presence in niche categories, where competition is fairly low, strengthens its market position.

For each product category in which a company operates, CRISIL studies the expected drivers of volume growth and determines their sustainability over the long term. New products that are closely linked to the

1 For the detailed criteria, refer to our articles, ‘Rating Criteria for Manufacturing Companies’ and ‘CRISIL’s Approach to Financial Ratios’ under the ‘Criteria and Methodology’ section on the CRISIL website.
consumers' needs, values and lifestyle tend to exhibit strong volume growth. The Indian market is extremely price-sensitive. Segmentation in product portfolios, into popular and premium categories, therefore assumes importance: the popular segment products are targeted at the lower and middle-income groups and are typically, value-for-money products, whereas the premium segment products are targeted at the high-income customers. To cover the gap between the popular and premium segments, the players have begun to launch new products at price points between the two segments, thus adding to the threat on demand for products in the premium segment. The market's price sensitivity also necessitates good product management, especially during times of recession. A wide portfolio, with products at a variety of price points, helps companies mitigate risks associated with any particular segment.

A wide range of products enables FMCG companies to balance growth objectives and competitive pressures. CRISIL does not, however, view a small product portfolio as an absolute negative since companies may dominate their chosen segments or straddle a niche. For instance, soft drink majors such as The Coca Cola company and PepsiCo, and companies such as Colgate-Palmolive Company and Cadbury India Limited have relatively smaller product portfolios than those of companies such as Hindustan Unilever Ltd (HUL) and Nestle Company; the fact that companies with smaller portfolios have also been successful indicates that other factors also critically influence a company’s performance.

**Innovation track record**

To maintain customer interest and to stay ahead of the competition, companies need to constantly introduce new and better products. CRISIL evaluates a company's product innovation capabilities and track record in creating successful brands. One good indicator of innovation is the contribution to revenues, of brands that have been introduced in the last three to five years. In analysing innovation strength, CRISIL looks at the nature of innovation. New product introductions that permit a company to build an early lead in any category offer greater cash flow benefits than innovations that represent a minor variation of existing products.

**Competitive landscape**

**Differentiation**

The first and foremost factor that CRISIL analyses is a product's perceived benefit and differentiation vis-a-vis others in the market. A product can command a premium only if the consumers are convinced of its superiority.

**Market share**

CRISIL looks at the market share trends of a company's products. A consistently high market share has several advantages. It ensures a stable relationship with and better control over the distribution channel. Also, the company does not need to offer very high margins to the trade since this is compensated by higher volumes. Established products with high market share also entail lower marketing and advertising expenses since it is cheaper to maintain an established brand than to create a new one.

The rate of acquisitions in the FMCG industry is higher than that in other industries. CRISIL’s analysis of FMCG companies factors in the companies’ acquisitions. Acquisitions strengthen the acquirers’ business risk profiles by enhancing their product offerings and geographical reach. CRISIL also evaluates the acquirer’s ability to integrate its operations with those of the acquired firm.
Pricing Power

CRISIL goes beyond the published market shares, and examines market dynamics. This is because high market shares do not necessarily translate into price protection. Companies with small market shares can still pose strong price competition to the market leaders.

Brand equity

Brand equity is the degree of consumer loyalty that a company's products maintain. This is an important factor since established brands act as high entry barriers. If brand loyalty is strong, consumers tend to be willing to pay a high price for the product, and are reluctant to switch to competitive products.

CRISIL analyses an FMCG company's brand-building capabilities. Factors such as the management's willingness and ability to spend on advertising and other sustained brand-building efforts are examined. During periods of slow growth and economic recession, the companies are often tempted to show higher short-term profits by reducing their advertising expenditure. The companies with successful brands have an edge over their competitors, supported by greater association with customers and lower advertising expenses.

Operating efficiency

Wide and extensive distribution reach, continuous cost-cutting efforts, optimal manufacturing facilities and efficient raw material sourcing are critical elements that determine an FMCG company's operating efficiency.

Distribution network

The distribution network's reach is assessed to ascertain the geographical diversity of sales. Greater sales diversity reduces geographical risks, especially those arising from changes in customer preferences in some areas. In India, a good rural-urban sales mix helps even out the effect of an uncertain monsoon on the consumers' purchasing power. A wide dealer network enhances the reach of products. The companies can use the same network to distribute new products, and thus benefit from a headstart. The companies, whose products have strong export potential also have an advantage, especially during downtrends in the domestic market.

Supply chain management

Supply chain management is another critical factor that CRISIL considers while analysing FMCG companies. The ability to offer a product when the consumer wants to purchase it is the most important factor that drives sales and promotes consumer loyalty. It also motivates retailers and wholesalers to stock the company's products. In the recent past, many FMCG players in India have invested resources in supply chain-related information technology (IT) initiatives, which have translated into better inventory management and collection efficiencies.

Manufacturing facilities

The manufacturing process in the FMCG industry is not capital intensive. Most companies have a combination of in-house production and outsourcing. The decision to outsource or produce inhouse depends on issues such as transportation costs and access to raw materials. Typically, high-technology products are made in-house, while others are sourced from vendors. The product's shelf-life determines whether a company will opt to set up a production facility of its own or continue to outsource production.
Raw material sourcing

The management of raw material costs is an important aspect for FMCG companies, especially for products that are dependent on commodities such as sugar, cereals and oil. Efficient raw material sourcing is essential, especially in businesses, where the margins are thin. For items like edible oil, where there is high import dependence, effective risk management systems on the procurement side are critical, and are, therefore, analysed in detail. A wide sourcing base, which ensures the quality and quantity of purchase at the best possible price, is considered a positive factor in the rating analysis.

Financial and management risk analysis

For the analysis of the management and financial risk profiles of FMCG companies, CRISIL follows the standard criteria it employs for all manufacturing companies. These criteria are presented in detail in our criteria publications, 'Rating Criteria for Manufacturing Companies' and 'CRISIL's Approach to Financial Ratios' under the ‘Criteria and Methodology’ section on the CRISIL website.

Conclusion

In CRISIL’s opinion, the key success factors for the FMCG sector include the presence of:

- Wide and diversified portfolio of products
- Brand equity
- Successful innovation and product differentiation
- Distribution network, and
- Efficient supply chain management.
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