

Rating criteria for the fast-moving consumer goods industry

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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 goods, detergents, and food and beverages.

CRISIL's rating analysis of FMCG entities factors in their business, financial, and management risk profiles. Factors considered under business risk include brand equity, diversity in product portfolio, and innovation and product differentiation capabilities. Rising affordability is a major contributor to growth in India's FMCG market. Efficiency of distribution networks, supply chain management, manufacturing facilities (both in-house and outsourced) and raw material sourcing are other key criteria assessed under business risk. In assessing the financial and management risk profiles of FMCG players, CRISIL follows the standard criteria it employs for all manufacturing companies¹.

Scope

The broader criteria of manufacturing companies apply to entities in the FMCG industry as well. This article², however, outlines the industry-specific factors that impact the market positions and operating efficiencies of FMCG players.

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

Business Risk

Market position

Product mix

The product mix determines the categories in which a player operates. Players in segments such as toothpastes, soaps, and detergents that are essential items, and therefore, in frequent demand, tend to have stable sales; those present in discretionary segments such as perfumes and cosmetics, on the other hand, often report declining sales during times of recession. Presence in niche categories, where competition is fairly low, strengthens market position.

For each product category, the expected drivers of volume growth and their long-term sustainability are taken into account. New products that are closely linked to consumer needs, values and lifestyles tend to exhibit strong volume growth. The domestic market is extremely price-sensitive. Products in the popular segment are targeted at the low- and middle-income groups and typically, present a value-for-money proposition, whereas those in the premium segment are targeted at high-income customers. To cover the gap between these segments, players launch products at new price points, thus adding to the competitive pressure for products in the premium segment. The price sensitivity necessitates prudent product management, especially during a recession. A diversified portfolio, with products at a variety of price points, helps mitigate risks associated with any one segment.

¹ For the detailed criteria, refer to our articles, 'Rating Criteria for Manufacturing and Services Sector Companies' and 'CRISIL's Approach to Financial Ratios' under the 'Criteria and Methodology' section on the CRISIL website.

² For accessing the previous published document on "Rating criteria for Fast moving consumer goods", kindly follow below mentioned link: https://www.crisil.com/content/dam/crisil/criteria_methodology/consumer-staples/archive/CRISIL-Ratings-criteria-fmccg-industry_2007.pdf

A wide range of products enables balancing of growth objectives and competitive pressure. However, a small product portfolio is not necessarily viewed as an absolute negative since companies may dominate their chosen segments or straddle a niche. The success of players with smaller portfolios indicates that other factors also critically influence performance.

Innovation track record

To maintain customer interest and to stay ahead of the competition, companies need to periodically introduce new and better products. Product innovation capabilities and track record in creating successful brands are, therefore, taken into account. One good indicator of innovation is the contribution to revenue, of brands introduced in the last three to five years. Product launches that provide an early-mover advantage in any category offer greater cash flow benefits than those that are minor variations of existing products.

Competitive landscape

Differentiation

A product's perceived benefits and differentiation over competing products is a key consideration. A product may be said to command a premium only if consumers are convinced of its superiority.

Market share

CRISIL looks at the market share trends of each product. 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 for by higher volumes. Established products with a large market share also have lower marketing and advertising expenses since it is cheaper to maintain an established brand than to create a new one.

Acquisitions in the FMCG industry tend to outnumber those in other industries. Acquisitions strengthen the acquirer's business risk profile by enhancing product offerings and geographical reach. However, ability to integrate operations with those of the acquired firm is a critical factor considered.

Pricing power

Sizeable market shares do not necessarily translate into price protection. Players with small market shares can pose strong price competition to market leaders. CRISIL, therefore, evaluates not only the published market shares, but also the market dynamics, to determine pricing power.

Brand equity

Brand equity is the degree of consumer loyalty that a company's products maintain. The presence of established brands serves as a formidable entry barrier for new brands. If brand loyalty is strong, consumers tend to be willing to pay a high price for the product, and are reluctant to switch to competing products.

Brand-building capabilities are a key consideration. Factors such as the management's willingness and ability to spend on advertising and brand-building are examined. During periods of slow growth and economic recession, players tend to slash their advertising expenditure to boost short-term profits. Companies with successful brands have an edge over the competition, thanks to greater association with customers and lower advertising expenses.

Operating efficiency

Distribution reach, optimisation of cost-cutting initiatives and of use of manufacturing capacity, and efficiency in raw material sourcing are critical elements considered under 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. Companies that can use the same network to distribute new products benefit from a headstart. Those with products that have a strong export potential also have an advantage, especially during downtrends in the domestic market.

Supply chain management

Supply chain management is another critical factor. Ability to offer a product when the consumer wants to purchase it is the most important factor that drives sales and promotes consumer loyalty. This is even more essential for products that are in seasonal demand. It also motivates retailers and wholesalers to stock the product. Several FMCG players in India have invested in supply chain-related information technology (IT) initiatives in recent years, enhancing inventory management and collection efficiencies.

Manufacturing facilities

Manufacturing is not capital intensive in the FMCG industry. 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 on its own or to outsource production.

Raw material sourcing

Efficiency in management of raw material costs is an important consideration for FMCG companies, especially in the case of products that are dependent on commodities such as sugar, cereals and oil. Ability to source raw material is essential, especially for businesses where the margins are thin. For items such as edible oil that are largely imported, effective risk management systems in procurement are critical, and are, therefore, analysed in detail. A wide sourcing base optimises the quality, quantity and pricing of purchase, and is considered a positive factor in the rating analysis. It also facilitates inventory management and reduces the impact on profitability, of fluctuation in raw material price.

Financial Risk

In analysing the financial risk profiles of FMCG companies, CRISIL follows the standard criteria it employs for all manufacturing companies. The criteria are presented in detail in our criteria publications, 'Rating Criteria for Manufacturing and Services Sector Companies' and 'CRISIL's Approach to Financial Ratios' under the 'Criteria and Methodology' section on the CRISIL website.

Management Risk

In analysing the management risk of FMCG companies, CRISIL follows the standard criteria it employs for all manufacturing companies. The criteria is presented in detail in our criteria publications, 'Rating Criteria for Manufacturing and Services Sector Companies' under the 'Criteria and Methodology' section on the CRISIL website.

Conclusion

CRISIL evaluates the following key factors under business risk for players in the FMCG sector:

- Diversity in product portfolio
- Brand equity and market share
- Innovation and product differentiation capabilities
- The strength of the distribution network
- Efficiency in supply chain management.

About CRISIL Limited

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