Article Title: ARCHIVE | Criteria | Corporates | General: Agricultural Co-operatives Criteria-Australia And New Zealand Data: The credit rating analysis of agricultural co-operatives incorporates an assessment of operating environment, critical success factors, areas of vulnerability, and various financial measures. The rating assessment of an entity balances business risk and financial risk factors. At times, an entity's credit rating may be influenced more strongly by a change in its financial measures or by changes in its business risk profile. The definition used for an agricultural co-operative includes co-operatives as defined in corporate regulations, and entities with a predominantly supplier shareholder base where payments are made to the supplier shareholders in a manner that provides a high degree of financial flexibility. Standard & Poor's examines a range of key factors in evaluating the credit risks of agribusiness co-operatives. These include financial flexibility, operating efficiency, market position, regulatory environment, ownership structure, diversification, access to capital, cash flow protection, and risk mitigation strategies. Agribusiness entities inherently have a higher business risk relative to most other consumer products entities, with their commodity-based orientation and earnings volatility resulting from significant exposure to export markets. A company's ability to cope with potential volatility will be assisted by low-cost structures, conservative financial polices, diversification of products and markets, or by adding value along the production chain. Financial ratios typically should be stronger than for more stable consumer products entities; however, in the case of many co-operatives, the objective of maximizing returns to suppliers means that traditional ratio analysis is less meaningful. In these cases, the analytical focus centers on seasonal debt requirements and cash flow generation to service interest obligations and debt maturities. An understanding of the parameters of financial risk mitigation strategies, such as hedging and forward sales, also is critical to the analysis. Standard & Poor's regards the Australian and New Zealand agribusiness industries as being exposed to significant industry risks, reflecting supply volatility due principally to seasonal conditions and global commodity price cycles, as well as exchange rate risk arising from a heavy reliance on export markets. However, the traditionally sound credit quality of Australian and New Zealand co-operatives reflects their globally competitive cost position, strong market positions in global trade, and product quality. Also, in many cases, it reflects the financial flexibility afforded by the subordination of payments to supplier shareholders to those payments made to other creditors, and by conservative advance payment policies. Financial Flexibility Critical to the structure of higher rated supplier-owned entities is the subordination of payments to the supplier shareholders for products supplied to the co-operative, to those payments made to other creditors. A conservative advance payment policy and flexibility in the size and timing of subsequent payments to suppliers also is critical. Reported financial ratios are often modest for the rating category, but are less meaningful given the objective of maximizing returns to suppliers and the often "bundled" nature of the supplier payments, which include both a payment for product supplied and a profit component. The flexibility afforded by the ability to set the price paid for product supplied, combined with a conservative advance payment policy, can help offset the typically higher-risk profile arising from relatively small earnings and equity bases. Final payments to suppliers are usually not made until after the entire season's production is sold, often the following financial year. The more conservative the advance payment policy, the higher degree of protection provided should commodity prices fall below expectations. Flexibility in price setting can at times be constrained by the need to pay a competitive price to suppler shareholders for products delivered, where neighboring co-operatives or companies are prepared to accept new suppliers. In the event of this situation, the rating would typically be lowered to reflect the reduced financial flexibility for the co-operative. Operating Efficiency Compared with global competitors, Australian and New Zealand co-operatives generally are very cost efficient. This reflects low-cost, year-round, pasture-based production systems, underpinned by large-scale farming operations, and by farming systems that allow a high level of production per labor unit. An ongoing commitment to increased productivity also has contributed to cost competitiveness. In the New Zealand dairy industry, rationalization at the manufacturing level has produced fewer and larger factories using advanced state-of-the-art technology. This continuing trend of rationalization has increased the scope for economies of scale, as unit costs are linked closely to the scale of processing plants and the level of capacity utilization. New Zealand and Australian dairy products manufacturing costs are in the lowest global production cost quartile. Australian grain production costs also are generally low in global terms. Market Position Relatively small domestic markets, combined with a low-cost base and excess capacity, provide significant opportunities for agricultural co-operatives to export. International cost competitiveness, product quality, and the ability to supply significant volumes for export trade on a reliable basis are key reasons for Australia and New Zealand's strong market positions in global trade. These include Australian wool (market leader), New Zealand dairy products (number two), Australian dairy products (number three), Australian wheat (number four), and Australian sugar (number three). Both New Zealand and Australia's share of global trade is increasing at the expense of the European Union (EU) and the U.S., although trade barriers remain a key negative. Growth prospects for Australian and New Zealand agricultural commodities are favorable, reflecting internationally competitive cost positions, product quality, and a general trend to lower global trade barriers, production subsidies and quota arrangements. These trade restrictions traditionally have restricted marketing opportunities for agribusiness commodities. As these trade restrictions are reduced or removed, internationally cost competitive producers such as Australia and New Zealand are well placed to benefit from expanded growth opportunities. However, recent moves to increase agricultural protection in the U.S. will constrain growth prospects. Regulatory Environment The statutory roles of AWB Ltd., Queensland Sugar Ltd., and New Zealand Dairy Board (NZDB) (until October 2002) as single-desk sellers for export products provides strong market positions and a significant barrier to entry. Standard & Poor's would view the industry structure as marginally less stable if single-desk seller status is removed, which will take place for the New Zealand Dairy Board in October 2002. Trade barriers and subsidies in the EU, U.S., and other markets, are a negative credit factor for Australian and New Zealand co-operatives given their dependence on export markets for the majority of sales revenue. Between 50%-95% of New Zealand and Australia's agribusiness production of different commodities is exported. Ownership The high level of supplier ownership in co-operative entities results in the following: Significant barriers to entry, which protect market position and result in strong local ownership. This compares with Australian meat processing, for example, where the majority is foreign-owned; A cooperative structure means entities often have significant flexibility in price setting, while also aiming to maximize returns to growers; Subordination of supplier shareholder payments to other creditor payments is a key credit positive; Industry consolidation typically occurs via mergers with other co-operatives rather than acquisitions. Hence, the financial impact generally is limited, although integration risk remains a rating factor; Lack of access to equity capital is a negative factor, as entities are more reliant on debt funding; and The need to get 50%-75% shareholder approval for major decisions can delay decision-making, but also can protect companies from being acquired. Diversity Higher rated co-operatives typically have broader diversity, achieved through a flexible product mix, an increasing share of value-added products, a broad geographic spread for both production and customer bases, and strong positions in more stable domestic markets that partially offset the risks associated with volatility in global markets. Access to Capital In contrast to publicly owned entities, supplier-owned entities typically have limited access to capital, as supplier shareholders themselves are small businesses and have limited financial resources. As a result, co-operatives often are more reliant on debt markets for capital needs. Some supplier-owned entities retain funds from shareholders in profitable seasons to ensure additional funds are available for capital expenditure as required. Changes to share standards required for supplier shareholders also have been used in the New Zealand dairy industry, whereby new suppliers or existing suppliers who increase production volumes are required to pay a higher share price for new volume supplied. This is more equitable in that those suppliers contributing to the need for capacity expansion contribute a greater share of the cost of that expansion. It also is a more conservative approach to funding in contrast to fully debt-funded capital expenditure. Financial Ratio Analysis As a result of pricing flexibility and the aim of maximizing payments to supplier-shareholders, traditional ratio analysis is less meaningful and ratios generally are moderate for the ratings assigned. However, they are also less meaningful because of the significant protection provided by the priority ranking of creditor payments to supplier payments. Financial management is driven mainly by cash flow requirements to meet working capital, capital expenditure, and by overall balance sheet structure. Dairy products entities typically depend on short-term finance to fund seasonal inventories. Long-term funding is used for capital expenditure, but is typically a smaller proportion of the total. The liquid nature of the inventory and the staple nature of most agricultural products provide a predictable degree of creditor protection. The predominant use of seasonal funding requires the careful management of working capital to ensure that interest obligations and debt maturities can be comfortably met. Conservative advance payments and the timing of subsequent payments throughout the season are critical credit positives. Gearing ratios also are less meaningful as gearing will vary significantly throughout a season. Balance date gearing often is not indicative of the underlying capital structure of the entity. The degree of seasonality of both borrowings and cash flow generation is a key focus for the rating analysis. A strong reliance on commercial paper programs for funding requires careful analysis of liquidity backup policies for issuers to ensure that they are adequate to meet the effects of unforeseen market disruption. Risk Mitigation Strategies Agribusiness entities typically seek to stabilize price realization by using foreign currency hedging products to mitigate currency risk, as well as commodity price hedges, in the light of large exposures to export markets. These policies partially mitigate the risk that final prices received will not exceed the initial advance price. While grain futures markets are well developed, the absence of a developed futures market for dairy products limits opportunities for price hedging. Forward commodity sales programs also are used to mitigate risk. Strategies to add value to commodities and manufactured agricultural products also can reduce risk associated with exposure to undifferentiated commodity markets. Other Investments Co-operatives increasingly are diversifying their range of operations. While diversification generally is viewed as a positive factor, this may not be the case where the diversification involves business activities that do not benefit from the subordination of payments to supplier shareholders. As the ratings assigned to co-operatives usually are critically dependent on the financial flexibility afforded by subordination of supplier payments, increasing investment in operations, which do not benefit from this flexibility may result in a lowering of the credit rating. As a result of these investments, a decreasing proportion of creditor payments would benefit from the subordination of payments to suppliers; hence the credit quality is weaker. Table 1 Rated Co-operatives and Supplier-owned Entities ISSUER ISSUER CREDIT RATING AWB Ltd. AA-/Stable/A-1+ Bonlac Foods Ltd. BB/Developing/B Fonterra Co-operative Group Ltd. AA-/Stable/A-1+ Queensland Sugar Ltd. AA/Stable/A-1+