Article Title: ARCHIVE | Criteria | Corporates | General: Evolution Of Japan's Trading Companies Adds New Risk Dimensions Data: (EDITOR'S NOTE: —Additional contacts have been added to this article to show the current analysts that are covering this sector.) Over the past decade, the raison-d'être of Japan's general trading companies (GTCs) has changed profoundly, and with it so has their credit quality. What were once core trading activities have since become of secondary importance to far riskier long-term lending and capital investment activities. This gradual shift in activities—from trade intermediaries to providers of long-term capital—has not been accompanied by a commensurate rise in profitability and strengthening of the GTCs' capital base. In fact, it has already entailed a sharp deterioration in the credit standing of most GTCs, whose ratings have dropped by an average of two categories since the early 1990s. In addition to the continuing transformation of GTCs into providers of long-term capital, deflationary pressures, the slow unraveling of keiretsu groups and the resulting erosion of financial support from once closely related banks, together with the banks' own weakening credit standing, all point to the likelihood of a continued degradation of GTCs' credit quality. Standard & Poor's analytical approach to assessing the creditworthiness of GTCs has evolved with the GTCs' changing business profile. Originally, it was oriented toward assessing the profitability, diversity, and most critically, the reliability and sustainability of earnings derived through the GTCs' trading activities. The resulting analytical conclusion was that the low-risk nature of such trading activities—and the highly dependable cash flow that such activities generated—could comfortably sustain a very high degree of financial leverage. Now, in view of the preeminence of balance sheet-oriented activities, the analytical focus is foremost on assessing how much capital is being put at risk through the various long-term investment or lending activities. Ultimately, the adequacy of the capital base is placed in the broader context of the GTCs' corporate strategy, risk management procedures, asset quality, profitability, and liquidity position, in reaching an overall conclusion on the GTCs' credit standing. Historical perspective: For GTCs, the strategic shift in business activity has been more a matter of survival than of choice. Over the past ten years, Japanese corporations, which used to form the main client base of GTCs, have considerably enhanced their own trading and distribution capabilities. In particular, Japanese companies used to be highly dependent on GTCs for much of their international sales and purchasing activities. Now, however, Japanese companies are largely self-reliant in dealing with international buyers and suppliers, a radical transformation that paralleled the evolution of Japanese corporates from mere exporters to multinational entities with global production capabilities. As a result, the basic international intermediary function of GTCs has come under severe pricing pressure to the point of not generating adequate returns. Reflecting this trend is the case of Marubeni Corp., which in April 1999 decided to drop Nissan's export business to North America, which despite being large and high-profile had become incapable of generating sufficient profits. More recently, Japanese companies' efforts at cutting costs to stem deteriorating profitability have typically been targeted at eliminating the costly layers of "go-betweens" linking suppliers and end-buyers. This trend, which is a direct threat to the survival of the GTCs' traditional intermediation function, is expected to accelerate with the development of online electronic market platforms. It was thus quite revealing that the themes of the message to shareholders of GTCs last year, were all similar in addressing the need for reinvention, self-transformation, redefinition, and even revolution. Tellingly, GTCs have become frequent providers of seed capital to the electronic market platforms as part of an if-you-can't-beat-them-join-them defensive strategy. GTCs have always had a mix of both short-term trading activities and long-term lending or investing activities. However, whereas the long-term lending and investing activities were originally a secondary function that was pursued to support and generate the mainstay trading activities, they have now become, by default, GTCs' main strategic focus. Impact on Credit Risk The impact from this evolving strategic business model on the credit quality of GTCs is profound. Whereas back-to-back trading of miscellaneous commodities, for which GTCs are still best known, implies minimal risk, long-term investment activities are inherently highly risky. Asset Quality Asset quality, itself very much driven by asset composition, is a primary consideration when assessing the credit standing of GTCs. Given the extreme disparity in the nature of operations and the risk characteristics separating back-to-back trading activities from green-field venture capital investments, Standard & Poor's seeks to breakdown the GTCs' assets in as much detail as possible. Asset quality is thus reviewed with respect to type, mix, diversity, and geographic diversity or concentration. A qualitative analysis of management strategy—with regard to targeted investment areas, risk tolerance, growth, and profit parameters – together with an appraisal of risk management systems—supplements the more standard quantitative analysis of asset quality. This quantitative analysis essentially revolves around measuring asset quality with respect to delinquencies, charge-offs, and recoveries, both in absolute terms and by peer comparison. Related discussions are held to understand reserve policies, and the adequacy of reserves is assessed in regard to trends, peers, the business mix, and the economic environment. The stronger GTCs have put in place comprehensive risk management systems that, while not addressing the fundamental under-capitalization of the industry, are useful in shedding light on the companies' attitude towards reserving for risks on different types of assets, and more generally on managing their portfolio. Asset valuation, particularly of equity holdings, is another area of investigation. Capital Adequacy Directly tied to asset quality is an evaluation of capital adequacy. Indeed, asset quality cannot be properly assessed without considering the amount of capital needed or available to support the various asset types. As such, beyond allowing a rigorous tracking of the changing nature of the GTCs' business over time, the asset breakdown that is performed to measure asset quality also makes it possible to assess how much capital is being put at risk by each type of business activity, and thus to shed some light on the GTCs' overall capital adequacy. Essentially, the concern is that while certain trading activities can be supported with a very thin capital base (explaining the historically high leverage of GTCs), investment activities, in contrast, need strong capital backing to cover downside risk. While imperfect disclosure does not permit the rigorous use of a capital adequacy model, attaching standard risk-capital weights to assets classified into a number of broad asset categories (short-term receivables, investments in and advances to associates, other investments, long-term loans and receivables, and fixed assets) and to contingent liabilities, still yields enlightening results as a sort of stress-test of capital adequacy. For example, assigning weights of 3% to short-term receivables, 15% to each of "investments and advances to associates", "long-term loans and receivables", "other assets", and 30% to fixed assets, would suggest that essentially all of the nine largest GTCs are inadequately capitalized, some of them to a critical degree. Such an approach to evaluating the capital adequacy of GTCs, while basically sound, would require far greater quality disclosure—particularly with regard to problem assets and country exposure—to be more reliable. In particular, specific risk-weightings should be allocated to assets that are 30 days past due, 90 days past due, restructured, etc. Even for performing assets, increased disclosure would be needed to acknowledge that the need for capital backup is larger when, as is increasingly often the case, advances and investments are in capital-intensive or high-risk industries (such as cable or satellite telecommunications, power generation, or internet firms), or green-field ventures in emerging markets (such as petrochemical plants in Indonesia, cement plants in the Philippines, or liquefied natural gas projects in Algeria). Notwithstanding information limitations, however, the evidence strongly suggests that GTCs would need to sharply boost their capital base simply to maintain a stable credit standing. Profitability An evaluation of the GTCs' profit generation ability remains a core aspect of the analysis, and is usually straightforward. Profitability is weak and volatile, and is inadequate in regard to the GTCs' need to rebuild their capital base. Operating (sometimes referred to as "trading") income has seen a general downward trend over the past 10 years, reflecting both pricing pressures on low value-added intermediary functions and the shift toward longer-term investment and lending activities. Similarly, the mix of operating profit versus nontrading income (i.e. dividend and interest income, and gains on securities sales) reflects the increasing dependence of GTCs on nontrading income, which is less predictable. Efficiency is another important aspect of profitability, and most GTCs have targeted employee headcount as a means to improve efficiency. However, there has been no noticeable improvement in the ratio of selling, general and administration to gross trading profits, perhaps partly due to increases in IT-related expenses, but also because labor costs have remained high. Operating margins are reviewed both before and after reserve costs; the unadjusted operating margins are meant to be indicative of the GTCs' fundamental ability to generate profits, but are actually just as useful in pointing to the degree of risks that the GTCs are taking on their trading operations. Liquidity Besides their generally deteriorating asset quality and weak capitalization, GTCs also increasingly suffer from mediocre liquidity. Given their high degree of financial leverage and almost exclusive reliance on external borrowings (as opposed to internally generated funds and equity sourcing), the reliability and diversity of funding sources of GTCs is a crucial aspect of their overall creditworthiness. The deteriorating liquidity condition of GTCs is attributable to a combination of factors, chiefly the substantial sell-off over the years of what were once massive securities holdings to smooth down volatile earnings performances, or alternatively to generate gains during an otherwise unprofitable year, and the continued volatile performance of the stock market. Perhaps most critically, within the context of the gradual unraveling of the keiretsu (Japanese conglomerates originally set up with a trading company at their core), weakening links with (formerly) related banks signal a potentially significant deterioration in GTCs' access to liquid funds. The weaker GTCs in particular are highly dependent on short-term bank borrowings, as they are essentially unable to access the capital markets and their banks are unwilling to provide them with long-term financing. Indeed, this critical dependency on bank financing may precipitate the default of some of the weaker GTCs over the next two-three years, either in the form of debt forgiveness or filing for court protection. Stronger GTCs, on the other hand, often look to initial public offerings (IPO) of some of their subsidiaries as a way to generate both gains and liquidity. However, these subsidiaries and other investments are fundamentally illiquid, and their ability to raise equity is in any case highly unpredictable, being dependent on both strong profit prospects for the entity to be listed and favorable market conditions. A more realistic liquidity source for these GTCs may be the securitization of some of their better quality receivables. Accounting and Disclosure Disclosure, while improving, remains inadequate in view of the range and complexity of the operations of GTCs. Adding to the challenge is that three separate sources must be consulted to get the full range of information provided by these companies. The five largest GTCs file consolidated financial statements based on generally accepted U.S. accounting principles (GAAP), as well as Japanese-based GAAP financial statements (yukashoken houkokusho), and "Analyst Reports". With a combination of all three sources available in the public domain, it becomes possible to perform a useful, though still inexact, classification of assets by term and type, to track aggregate provisions for impaired assets and charge-offs, and thus draw some views on the GTCs capital adequacy. Country disclosure remains haphazard with improvements still needed with regard to asset valuation and quality, and provisions taken. For short-term assets, reporting standards are not exacting enough to enable a distinction to be made between virtually risk-less back-to-back trading activities or other receivables for which the GTC simply acts as an agent, and other trading activities where the GTC acts as principal, and which are in essence a form of short-term lending. Limited information on proprietary trading has become a less significant concern as the level of involvement of GTCs in what was once a major business activity has decreased significantly. This reflects their dismal track record with 'tokkin' funds in the mid-1990s and the increased cost of funds that no longer permit GTCs to engage in arbitrage activities. Disclosure on long-term assets is also limited, particularly with regard to asset quality and provisioning policy. Because GTCs are not regulated, disclosure of problem loans varies widely. SFAS (Statement of Financial Accounting Standards) No.114 is the standard adopted by the three strongest GTCs to report impaired loans. It resulted in Mitsubishi Corp., Sumitomo Corp., and Mitsui & Co. Ltd. posting allowances to long-term investments and loans of a fairly sizeable 7%-12% range at the end of fiscal 2000 (ended March 2001). Other GTCs reported higher provisioning rates, but the standard that they used is unclear. Trading companies have yet to publicly adopt a problem loan classification system similar to that used by banks, although this would clearly be in the interest of the strongest ones as it would reduce mounting doubts about their financial standing and differentiate them from weaker industry participants. Valuation of equity investments is also problematic, with no consistent approach to investments that have, or need to be, written down. So far, SFAS No.121 (accounting for the impairment of long-lived assets) has yet to be adopted by all GTCs. Information on the ratio of profitable-to-unprofitable-subsidiaries, which is readily available for all GTCs, is of limited value because it does not reveal the names and size of the largest unprofitable investments, nor how seriously impaired these assets are. To some extent, the ratio of profitable-to-unprofitable-subsidiaries, and how it changes over time, does give some insight into the investment record of GTCs and their efforts towards maintaining ownership of, or liquidating, unprofitable subsidiaries. Lack of meaningful segment disclosure is another analytical limitation. Interestingly, it stems not from a deliberate effort of GTCs to obscure their accounts, but simply from management's only recent and still incomplete recognition of the distinct risk characteristics of GTCs' various business activities. For example, all business activities related to metals—a common business segment among GTCs—are reported under one single accounting segment, thus lumping together the assets and operating profits of activities that may be as diverse as overnight trading on the London Metals Exchange, an equity investment in an iron core company in Brazil, or a partly developed mining operation in Indonesia. It is only in the past two to three years that GTCs have introduced comprehensive internal risk management systems that take a coordinated approach to all of the GTCs' business activities, and that make use of "value-at-risk" models. In turn, with the establishment of such internal risk control systems, accounting standards are also expected to evolve to better reflect the way GTCs manage themselves. Individual Profiles Vary While all GTCs face uniformly negative industry conditions, it is important to recognize the wide differences in credit quality that exist among them, as evidenced by the quantitative data, and thus to appreciate their varying ability to cope with future challenges. Among the nine largest GTCs, for example, net worth adjusted for unrealized holding gains as of the end of fiscal 2000 (March 2001) varied from an average of over ¥800 billion for the three highest rated companies, Mitsubishi, Mitsui, and Sumitomo, versus an average of below ¥40 billion for the two lowest-rated ones, Tomen Corp. and Kanematsu Corp. Non trading assets, as a multiple of net worth, averaged around 1 times (x) for Mitsui and Sumitomo, around 4x for midsized Itochu Corp. and Marubeni, and over 6x for Nissho Iwai Corp., Kanematsu, and Tomen. Furthermore, the financial flexibility derived from unrealized gains on marketable securities varied from over ¥258 billion for Mitsubishi to an unrealized loss of ¥19 billion for Marubeni. Another significant difference is in the composition of the GTCs' balance sheets. Weak GTCs such as Nissho Iwai, Kanematsu, and Tomen have almost twice as large a proportion of their assets tied-up in long-term receivables and investments as higher-rated Mitsui and Sumitomo (28% versus 17%). However, despite this greater exposure to higher-risk long-term investments, they finance themselves disproportionately through short-term debt (an average of around 70% of total debt for Nissho Iwai, Kanematsu, and Tomen versus 28% for Mitsui and Sumitomo). Rating Methodology: Major Analytical Factors A review of essentially subjective credit elements, namely the GTC's corporate and strategic goals, risk management systems and risk tolerance, and financial policies, provides another way of evaluating credit quality. Indeed, these more subjective credit risk factors provide the necessary framework to evaluate GTCs' profitability, asset quality, liquidity, and capitalization, which constitute the essential aspects of the GTCs' overall credit standing and direction. An outline of the rating methodology used for GTCs is detailed below. Corporate Strategy The mix between trading (by type, also including short-term lending) and investing (broadly defined to include loans, guarantees, and equity investments) activities, at present and in the future. A possible third category is financial investments (i.e. proprietary trading). Growth objectives, by sector. Trading strategy (by individual products), position taking, hedging, perceived market strengths and weaknesses. Investment strategy (product/sector and market expansion plans). The objectives of diversification plans and the content of exit strategies. Countries of operation and the degree of business involvement (passive or active investment). Track record and credibility (comparison of past performance with budgets/plans). Managerial vision (logic and risk of strategic direction). Financial/Management Policy Internal financial benchmarks for each type of business activity (i.e. trading versus investment): the return expectations and level of capitalization. Management philosophy with regard to liquidity and liquidity-planning. Management philosophy regarding risk asset leveraging. Stance towards financial investments. Appetite for risk taking (both in trading activities and investment). Overall financial goals (e.g. adjusted gross and net debt to equity ratio targets). Risk Management An assessment of internal quantitative risk management systems, market and credit risks, country risk, asset risk, and exit strategies for investment activities. Asset valuation (particularly for impaired assets). Monitoring of investment portfolio. Adequacy of computer systems support to quantitatively monitor various risks and capitalization Back office and operations; valuation of positions; audit function. Track record versus intended risk exposure; major errors over past five years in position-taking, hedging, and accounting, and remedial actions taken. Underwriting criteria, approval process for different types of activities, delegation of approval authorities. Monitoring of risk exposures, review functions, internal rating system, role of audit department. Collection and foreclosure policies for problem assets. Profitability Earnings quality; strength and sustainability of trading operations; return on, and volatility of, long-term investment activities. Operating income analysis (level/trend per product group). Net interest revenue (typically negative for the weaker GTCs). Investment income (dividend income versus gains on investments). Operating expenses: level and trends; comparison to peers. Asset Quality Detailed asset classification. Impaired asset classification; reserving policies. Structure of balance sheet: relative proportion in low-risk credit assets (back-to-back trading, short-term loans) versus higher-risk assets (loans, real estate investments, and equities. Large problem credit exposures. Concentration of credit risk; sector and geographic mix. Problem loans/investments: definition of categorization; levels of, and changes in, problem assets; and expected development. Provisions/reserves against on- and off-balance sheet exposures; reserving/provisioning policy and adequacy. Contingent liabilities, particularly as related to affiliates or nonconsolidated subsidiaries. Capitalization and Asset/Liability Management Capital adequacy assessment: comparison of capital level in relation to asset type. Absolute size of capital base and ability to absorb extraordinary, unexpected losses. Off-balance sheet liabilities. Interest rate sensitivity: assets versus liabilities. Maturity structure: assets versus liabilities. Funding and Liquidity/Financial Flexibility Short- and long-term financing requirements versus existing liquidity facilities. Mix and diversity of funding sources; availability and amount of commitment/overdraft lines; composition of lending banks (i.e. main banks, other banks, exposure levels); group support. Access to external financing (debt and equity financing). Monetizable assets (short-term marketable securities, long-term securities, ability to sell loans and investments). Debt maturity profile.