Liquidity Analysis of Non-Financial Sector Entities

CareEdge RATINGS AFRICA

A subsidiary of CARE Ratings Limited, India

Background:

Liquidity risk assessment is an integral part of the risk analysis of any entity. Liquidity measures an entity's ability to meet its obligations in the near-term (typically next one year) from its cash accruals and any external sources available with it. An entity's obligations may be in the form of debt servicing, working capital requirements, capital expenditure plans, investment plans, dividend payments, share-buybacks etc., apart from devolvement of any contingent liabilities. Analysing liquidity is crucial for arriving at the short-term rating.

Liquidity analysis:

While analyzing the liquidity of any entity, CareEdge Africa (CRAF) considers the following:

- **Cash Flows:** The entity's cash flows are examined to assess the liquid sources for repaying short term obligations (essentially the obligations which are payable in the next four quarters). The assumptions underlying the cash flow projections are analysed to make a realistic assessment of short-term liquidity of the entity.

- **Availability of unencumbered cash and cash equivalents:** Unencumbered cash and cash equivalents includes funds which can be accessed at a short notice by the entity to service obligations or bridge any temporary cash flow mismatches that occur, such as cash, bank balance in current account, funds invested in liquid mutual funds, listed equity shares, unencumbered fixed deposits (FDs) etc. Maintenance of unencumbered cash and cash equivalents, especially if maintained on a continuous basis, is seen favorably from the liquidity perspective.

  On the other hand, encumbered cash and cash equivalents like funds maintained in Debt Service Reserve Account (DSRA), margin money, FDs earmarked against any loan/facility etc. can be used only for the purposes they have been earmarked for. CRAF adequately factors the availability of such funds while assessing the available liquidity for meeting the obligations for which these are earmarked.

- **Investment in group entities/ Loans and Advances extended to group entities:** Investment in group entities/ loans and advances extended by the entity to its group entities are generally not considered liquid, as these may not be readily available to the entity when it requires the funds for its own purpose, as it's availability is dependent on factors beyond the control of the entity.

- **Unutilized lines of credit from lenders:** While assessing the liquidity position of an entity, CRAF also assesses the availability of any unutilized portion of the sanctioned limits which can help the entity meet any short-term mismatches.

  Quantum of unutilized lines of credit is calculated by comparing the entity's monthly maximum and average utilization with sanction limit of the working capital limit, typically for the preceding 12 months. Consistently high utilization may be a sign of weak liquidity.

Further, the entity may have undrawn term loans, either in the form of project-specific loans or general corporate loans. CRAF considers whether the undrawn term loans are sufficient in relation to the project(s) being implemented and for general corporate purposes, while assessing the entity's liquidity position.

However, CRAF does note that availability of undrawn lines of credit only reduces the chances of defaults but does not eliminate it completely as these lines may be withdrawn at any point in time by the lenders. This especially becomes relevant in cases of Commercial Paper (CP) which is carved out of the working capital limits of the entity, thus implicitly creating back-up liquidity facilities. In extreme situations, inability or unwillingness of the bank to restore the limits or shortfall in drawing power could lead to inadequacy of backup liquidity at the time of CP maturity. Extent of utilization of working capital facilities and likely variation in drawing power is hence studied in detail by CRAF to assess the nature of cushion available.

- **Liquidity support available from parent/ group:** While assessing the liquidity position, CRAF factors in the liquidity support from the parent/ group in light of their stated commitments to infuse funds in the entity, and the past track record of honoring such stated commitments.

  While assessing the explicit support extended by the parent/ group in the form of guarantees, letters of comfort, undertakings etc., CRAF follows its 'Criteria for Rating Credit Enhanced Debt' which is available on our website www.careratingsafrica.com

- **Financial Ratios:** Financial ratios are used to make a holistic assessment of financial performance of the entity, as also to see the entity's performance w.r.t. its peers within the industry. They are not an 'end' in itself but a 'means' to understanding the fundamentals of an entity. Primarily to analyze an entity's liquidity, CRAF uses the following ratios:
  - Turnover ratios
  - Liquidity ratios

    For more details on these Financial Ratios please refer to the Criteria on 'Financial ratios – Non-Financial Sector' on our website www.careratingsafrica.com

Using the above parameters to assess the entity's liquidity position, CRAF arrives at and discloses the liquidity indicators in the press releases using one of the following levels:

- Superior/ Strong
- Adequate
- Stretched
- Poor

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About:

CareEdge is a knowledge-based analytical group that aims to provide superior insights based on technology, data analytics and CRAF (Africa) Private Limited (CRAF) is the first credit rating agency to be licensed by the Financial Services Commission of Mauritius in May 2015. It is also recognized by Bank of Mauritius as External Credit Assessment Institution (ECAI) from May 2016. CRAF is also licensed by Capital Markets Authority of Kenya to operate as a Credit Rating Agency in Kenya. CRAF intends to expand across other geographies in Africa with Mauritius as its hub of operations. With an equitable position in the Mauritius capital market, CRAF (Africa) Private Limited provides a wide array of credit rating services that help corporates to raise capital and enable investors to make informed decisions backed by knowledge and assessment provided by the company.

CRAF's shareholders are CRAF Limited, African Development Bank, MCB Equity Fund and SBM (NFC) Holdings Limited.

CRAF gets its technical support in the areas such as rating systems and procedures, methodologies, etc. from CRAF Limited on an ongoing basis. CRAF Limited, with an established track record of rating companies over almost three decades, follows a robust and transparent rating process that leverages its domain and analytical expertise backed by the methodologies congruent with the international best practices.

CRAF's Rating Committee consist of full-time members comprising of Senior Rating officials from CRAF Limited and a panel of experienced professionals from Mauritius and African Development Bank.

CRAF has had a pivotal role to play in developing bank debt and capital market instruments including MMIs, corporate bonds and structured credit.