

RATING APPROACH – LIQUIDITY ANALYSIS (NON-FINANCIAL SECTOR)

March 2024



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This rating methodology describes ICRA's approach to assess the liquidity profile of entities in the non-financial sector. This document does not include an exhaustive discussion of all the factors that our analysis considers but provides an overall perspective of the considerations that are usually the most important.

This document updates and supersedes ICRA's earlier document on this subject, published in March 2022. While the revised version incorporates a few changes intended to provide more clarity on a few aspects, ICRA's overall approach to analysing the liquidity profile of entities in the non-financial sector remains materially similar.

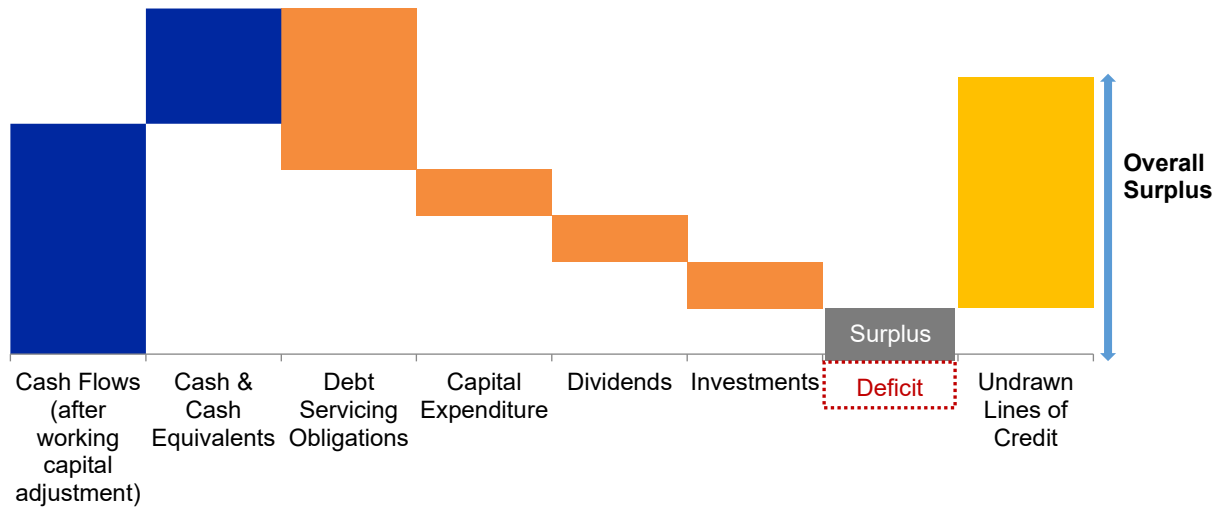
Defining liquidity

Liquidity measures an entity's ability to meet its cash obligations over the near term using the cash generated from internal resources and by tapping external sources of committed financing.

- **Internal sources** of cash include the cash generated from operations, cash and cash equivalents on hand, cash inflows expected from the monetisation of physical and financial assets, besides dividend or interest income among others.
- **External sources** of committed financing include various forms of external capital such as undrawn working capital limits, short-term loans, project loans and other loans from financial institutions, besides fresh capital committed to be brought in by an investor. Such capital could be in the form of equity, debt, or hybrid instruments.
- **Cash obligations** include both the committed as well as the contingent claims on an entity's cash, including the debt-servicing obligations, working capital requirements, capital expenditure and other investment outlays, dividend and share buyback-related outflows, besides the sudden demand arising from crystallisation of a contingent liability.
- **Near term** generally means the next 12 months, but it might also stand for a different time horizon depending on the seasonality, lumpiness or stress points associated with an entity's cash flows.

An entity that consistently meets its near-term obligations without relying on external sources could be said to have stronger liquidity compared to an entity that has to rely on external sources/ support even for meeting its debt servicing obligations under normal circumstances.

Liquidity snapshot over any defined period



Impact of the liquidity position on the credit rating

Liquidity analysis is integral to the evaluation of an entity’s credit risk profile. While most of the defaults are triggered by liquidity stress, the underlying reason for the stress is often a combination of the entity’s weak business and/ or financial profile which culminates into a weak liquidity position. While higher rated entities typically have a stronger liquidity profile, the extent of impact of liquidity on the credit rating varies.

- In some situations, liquidity attains such primacy that it alone constrains an entity’s credit rating, as other credit drivers, even if supportive, become secondary. This follows the premise that to succeed in the long term, an entity first needs to survive the short term. Thus, if an entity has a poor liquidity position, given the high probability of default, it would likely be rated in the non-investment grade, regardless of other credit positives.
- In other situations, while strong liquidity supports the credit profile, its utility beyond a point becomes less useful. This means that the rating of two entities might be the same, if the only point of difference between them is that the liquidity of one is strong and that of the other is exceptionally strong.
- In still others, while a strong liquidity position would lend some support, an entity’s final rating level would still be constrained if its fundamental business and financial risk profiles are weak.

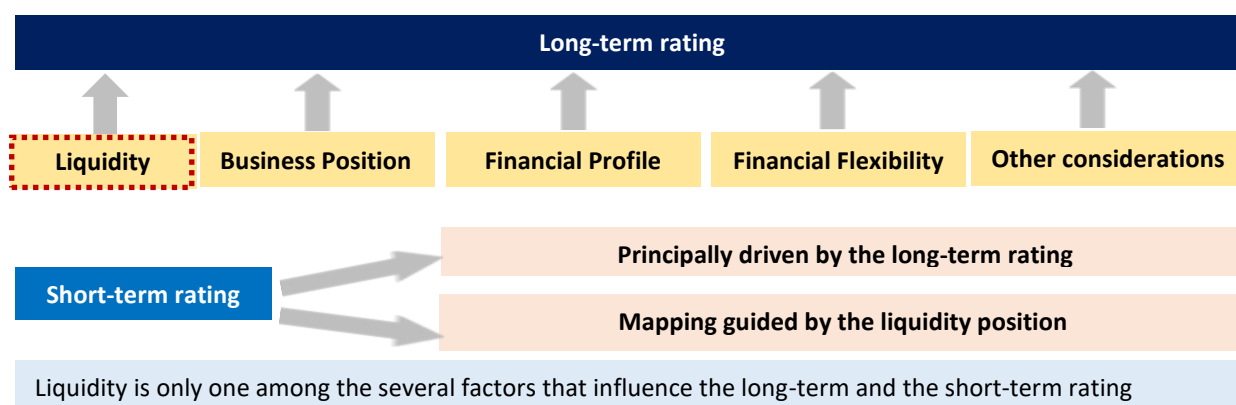
Impact of liquidity on an entity’s credit profile

Impact Scenario	Liquidity	Other Credit Factors
Profound impact; severely constrains the credit rating	Poor	Do not matter
Supports the credit profile; however, limited utility beyond a point	Strong	Strong to adequate
Credit profile only moderately benefits	Strong	Weak

Linkage between long-term and short-term ratings

ICRA's long-term rating for an entity takes into consideration both its liquidity profile as well as other credit factors, including its business position, management quality, financial flexibility, profitability, leverage, and debt coverage metrics. Durable credit strengths in combination with healthy liquidity typically allow an entity to have a higher long-term rating. The short-term rating, while being linked to an entity's long-term rating, is also influenced by the liquidity position, reflecting a higher or a lower short-term rating, for the same long-term rating¹. Also, given that the liquidity situation adjusts more frequently, the short-term ratings tend to be less stable than long-term ratings².

The Credit Rating Schema



Analytical Approach for Liquidity Assessment

ICRA's approach for liquidity assessment is centred on an entity's projected cash flows over the near term. For estimating the near-term cash flows, ICRA considers:

- The potential variability in an entity's fund flows from operations because of factors such as economic slowdown, industry cyclical, input cost pressures and changes in the entity's competitive position
- Availability of unencumbered cash and cash equivalents
- The sources of external financing, in terms of their quality and diversity, to access their ready availability in times when the entity needs these the most
- Both the certain and the contingent claims on cash—peak working capital demands, capital expenditure and investment needs, debt repayments etc— in relation to the various sources of cash

Sustainable Liquidity: The liquidity assessment is based on whether the liquidity available with the entity is expected to be sustained going forward or is it only a point-in-time reflection of the liquidity status. If an entity has exceptional liquidity at a given point in time but neither its historical track record nor ICRA's prognosis suggests that such comfortable liquidity could be maintained by the entity going forward, ICRA does not necessarily draw comfort from such temporarily high liquidity and the liquidity assessment takes into consideration this aspect appropriately. This is often applicable for entities operating in commodity sectors or cyclical industries, where the high point in a cycle may not sustain, and for entities with high upcoming investment requirements.

¹ For more details on how ICRA's short-term ratings map with its long-term ratings, refer to ICRA's website www.icra.in to view the note titled, "Mapping of ICRA's Long-Term and Short-Term Ratings".

² For comparing the stability metrics of ICRA's long-term and short-term ratings, refer to the rating transition studies published by ICRA on its website.

SOURCES OF CASH

I. FUND FLOWS

An entity's fund flows in a given year might draw from its core operations or from other non-operating sources such as dividends or interest earned on deposits or on loans and advances extended to third-parties³ or from asset disposals.

Fund flows from operations

Consistently high, stable and predictable levels of fund flows from operations⁴ support an entity's liquidity position. Fund flows are expected to show stability and predictability if an entity has a strong and durable competitive position and operates in a non-cyclical industry. Other things being equal, entities with such characteristics can bear relatively moderate levels of liquidity without straining their credit profile. This is in comparison with those that might have relatively superior liquidity in the base case but otherwise remain exposed to the risk of fund flows depleting sharply even in moderate stress situations. An understanding of an entity's business and industry risk profile is thus a critical element to assess the predictability and stability of its fund flows. ICRA performs a sensitivity analysis on key variables—volume growth, price realisations, cost drivers—to determine the peaks and troughs an entity's fund flows might experience in the near term against the backdrop of its cash obligations.

While the fund flow analysis is generally done over a one-year time horizon; in case of businesses that are seasonal, where working capital requirements might peak during a few months, or where large cash obligations might bunch up during few months—such as bullet principal repayments or Letter of Credit (LC) payments—the fund flow analysis is also undertaken on a monthly, quarterly or half-yearly basis, as the case may be. In case of seasonal businesses (as in beverages, sugar, cotton ginning, wind and solar power) or when there is lumpiness in cash collections (as in educational institutions), the alignment of fund flows with the debt repayment schedule is critical to avoid a situation of cash flow mismatch or liquidity strain.

Fund flows from non-operating sources

An entity might be reporting interest income on deposits, rental income from the leased real estate assets or dividend income from its investment portfolio. While these complement the fund flows of an entity from its core operations and thereby support liquidity, their sustainability, timing, and value are evaluated for their consideration as a source of regular fund flows.

- *Sustainability*: Investments in interest-bearing assets (or proceeds from sale of rent bearing real estate assets) might be used to fund an acquisition or be paid out to shareholders as dividends, halting the stream of the erstwhile recurring interest/ rental income. In addition, the regularity of the interest income depends on the credit profile of the investee entities as deterioration in their credit profile could result in delay/ suspension of interest payments or may even lead to a write-down of the principal amount (or vacancy related risks related to the rental income generated from real estate assets). ICRA engages with an entity's management to form an opinion on the likely uses of surplus liquidity to judge the availability of the non-operating sources of income in the near term. ICRA also endeavours to assess the credit quality of the investments to form a view on the continuity of interest income and risk of any write-downs.

³ While interest earned on loans and advances extended to third-parties has been termed as a source of non-operating income here, a corporate entity such as a holding company has a business profile where such sources of cash are core to the operations.

⁴ Fund flows from operations are measured post interest and tax pay-outs and pre-working capital changes. The measure also excludes the impact of non-cash items such as depreciation, write-offs and asset revaluation.

- *Timing and Value:* Dividend pay-outs are discretionary, implying that the timing of their declaration by the investee entity(ies) and their value is often uncertain.

Besides the above, an entity may have other physical (real estate) or financial assets (stake in subsidiaries), which can be monetised. However, ICRA considers these as sources of cash only when such assets have already been contracted to be sold to a third-party, not when the sale of such assets is merely in the realm of the management's intent. Yet, the availability of assets that could be liquidated within a reasonable time horizon, even if not immediately, is considered favourably for entities with longer-term liquidity needs, particularly for entities that have a track record of liquidating such assets well ahead of liquidity demand.

II. CASH AND CASH EQUIVALENTS

Unencumbered cash balances and liquid investments

Consistently high levels of unencumbered cash balances and liquid investments are seen favourably from a liquidity perspective. Unencumbered cash balances and liquid investments refer to the funds deposited by an entity in its current/ deposit accounts with banks⁵ or invested in overnight mutual funds, which could be accessed at short notice without restriction or loss in value. Unencumbered fixed deposits, although have a fixed maturity, are considered liquid as these may be redeemed anytime or an overdraft facility may be availed against them to take care of temporary cash flow mismatches.

Encumbered fixed deposits or cash balances maintained as part of the say, the Debt Service Reserve Account (DSRA)⁶ or as margin funding for non-fund based limits, are not available to be utilised for servicing obligations, other than those for which they are specifically earmarked. ICRA, however, adequately factors in such deposits while assessing the liquidity requirements corresponding to the obligations for which these are maintained, provided these are contractually utilised on or prior to the due date of the corresponding obligations. ICRA also considers investments in short tenor mutual funds, Government securities, the highest-rated listed corporate bonds and shares of large cap/ index companies as sources of liquidity after applying an appropriate hair cut on the value of these investments, which in turn depends on their inherent volatility.

While an entity may deposit its surpluses in other instruments such as closed-ended or locked-in securities, invest in lower-rated or unlisted corporate bonds, or in equity shares of mid-cap/ small-cap companies, or extend loans and advances to group/ unrelated entities, these investments are not considered as liquid as these might not be redeemable at short notice. Closed-ended or locked-in securities have a fixed maturity and are not redeemable before the maturity date, while the liquidity of lower-rated/ unlisted corporate bonds in the secondary market is generally limited. The investment in the equity shares of mid-cap/ small-cap companies is subject to market volatility, and it is difficult to determine an appropriate mark-down on the value of the investment to arrive at the realizable value. Moreover, redemption of loans and advances by the group/ unrelated companies is dependent on their own credit profiles and cannot be assumed to be redeemed to the rated entity in a timely manner or on demand. Further, while assessing the cash balances held by subsidiaries or group companies, ICRA tries to determine whether these funds are earmarked/ encumbered for a specific purpose or are they fungible/ available to meet requirements at the consolidated level.

Using the data related to cash and cash equivalents in liquidity analysis has limitations as such disclosures are often available as on the balance sheet dates. To alleviate this point-in-time data availability induced deficiency, ICRA

⁵ In some situations, ICRA may not provide the full liquidity benefit of cash and bank balances to entities that have their deposits (either DSRA or free cash) parked in weaker financial institutions.

⁶ DSRA is considered a source of liquidity only if it can be utilized on or before the due date as per the transaction documents.

engages with the rated entity's management to understand its broad liquidity management policies and the associated controls put in place.

III. EXTERNAL FINANCING

External financing refers to the undrawn lines of credit that an entity has access to from the financial institutions, which could be tapped into for meeting the gap between the cash generated from internal sources and the upcoming cash uses. It also includes funding committed by investors in the form of debt, equity or hybrid instruments. External financing acts as the second line of defence against cash flow mismatch when internal sources of cash get dwarfed by the aggregate claims on cash. ICRA notes that among two entities with equivalent aggregate sources of cash—internal and external—the one that has a higher proportion of internal sources could generally be said to have superior liquidity than the other, given the limited dependence on external sources that might be unreliable in nature, especially in situations of tight market or financial system liquidity.

Undrawn lines of credit

An undrawn line of credit refers to the unutilised portion of sanctioned facilities (such as working capital, overdraft, short term as well as long term loan), which could be utilised by an entity at any point of time to meet its obligations⁷. An entity may have undrawn fund-based working capital or overdraft limits because of healthy cash generation from operations, obviating the need to utilise the sanctioned limits fully. Undrawn term loans may be related to a pending capital expenditure or may pertain to an unutilised general-purpose corporate loan that may have been availed as a buffer in case of a cash shortfall. Apart from helping overcome cash flow variability because of subdued business or macro-economic environment, the external backup lines also enable an entity to tide over disruptions, if any, in the financial markets as an entity's refinancing ability generally gets restricted during such periods⁸.

The availability of undrawn working capital limits is determined by taking into account the expected utilisation of the working capital limits in relation to (a) the lower of the sanctioned working capital limits; and (b) the available drawing power. While the presence of adequate undrawn working capital limits is a positive from a liquidity perspective, an entity may choose to operate at lower-than-eligible limits because of which the utilisation of its working capital limits may appear high. In such a situation, to determine an entity's flexibility to get its working capital limits enhanced, ICRA assesses the sufficiency of its drawing power in relation to the total working capital borrowings (including short-term working capital loans and commercial paper borrowings) and its ability to furnish collateral/ charge to the lenders, as also its relationship with the lenders. The sufficiency of undrawn term loans is assessed in relation to the funding requirements for project capex and for general corporate purposes, while taking into account other committed sources of funds such as equity capital.

To get a perspective on an entity's track record in maintaining adequate undrawn working capital/ overdraft limits with respect to monthly obligations (such as statutory payments, debt servicing and LC payments), ICRA analyses the average and peak levels of monthly utilisation of working capital/ overdraft limits in relation to the sanctioned limits (such as cash credit, overdraft and export packing credit) or the drawing power, whichever is lower, over the preceding 12 to 24-month period.

⁷ Undrawn bank limits are considered as a liquidity back-up only if these are from healthy banks. The weaker banks may not be able to lend incrementally because of capital constraints or regulatory restrictions.

⁸ That said, even back-up lines from lenders are exposed to the risk of being withdrawn or cancelled when the financial markets are unstable.

The utilisation of working capital limits with respect to the sanctioned limits or drawing power may appear high because of the following reasons:

- Inadequate availability of long-term funds resulting in dependence on working capital borrowings
- Increase in working capital requirements without a timely tie-up of enhanced working capital limits because of its inability to furnish adequate collateral or the inability to provide the required margin, besides procedural reasons and aversion to maintain cushion on account of the associated costs

Consistently high utilisation of working capital limits with respect to the sanctioned limits or drawing power may reflect weak liquidity. Also, while a tie-up of adequate lines of credit is a positive, ICRA considers the likelihood of such lines being withdrawn or cancelled or becoming costly upon covenant breach or under other conditions. More diversified funding sources as opposed to reliance on a single financial institution mitigates the risk of the lines of credit being snapped suddenly.

Other forms of external funding committed by investors

The funding committed by a promoter group or that committed by other investors could be for augmenting the long-term funding position of an entity or to fund the equity portion of a committed capital expenditure programme or other purposes. In case an entity is undertaking a capital expenditure programme, such equity funding might be a pre-requisite for the entity to be able to draw down the sanctioned term loans from lenders. In such cases, external funding from one source (from promoters/ investors) supplements the other (from lenders). This also implies that if the externally (or internally)-funded equity margin is absent or deficient, the liquidity comfort attached with an already sanctioned and undrawn term loan may need to be reconsidered. While determining the liquidity support available to an entity from a promoter group or an unrelated third-party, ICRA only considers the funding amount already committed as well as the past track record of infusing such capital. Expectations from the promoter group to provide extraordinary support to the rated entity in times of distress, while being a rating factor, is not considered a liquidity measure.

CLAIMS ON CASH

Debt repayments

The amount and the timing of an entity's debt-servicing obligations depends on the nature of the loan and the way it is structured.

Term loans and corporate bonds: The repayments pertaining to a term loan, or a corporate bond might be structured such that the pay-outs are amortised equally at a defined frequency over the contracted tenor of the loan, with or without an initial moratorium. Or the repayments might have a ballooning structure to match the pay-outs with the expected cash inflows of the underlying assets which might be projected to ramp-up gradually. In either case, ICRA estimates the cushion between the available cash and the debt repayments at various points in time to measure an entity's liquidity. In case of loans with bullet repayments, while the interim period liquidity might appear comfortable, the entity might be exposed to the refinancing risk as the maturity date nears. For such loan structures, ICRA tries to assess the trade-off between liquidity risk and refinancing risk during the currency of the loan. ICRA also assesses the loan agreements for clauses that define the triggers for loan acceleration, like in case of a cross-default, which can trigger an acceleration on one loan, upon a default on another loan. The closer an entity might be to defaulting on another loan, the higher would be the risk of debt acceleration and hence liquidity strain. ICRA also recognises that an entity faces a prepayment risk, given the possibility of debt acceleration upon the breach of covenants, including financial covenants, operating covenants, rating-linked covenants and default by other entities in the Group having cross-default clause with the entity. On failing to meet the covenants, if the entity is unable to get waivers from the lenders/ investors, or the lenders/ investors do not provide it adequate time to arrange for alternative funding to pay off the accelerated loans, the ratings would typically face a downward

pressure. Likewise, put options on loans are evaluated to gauge the likelihood of these being exercised by the lenders/investors. Thus, for liquidity analysis, the loans/ bonds which are likely to be accelerated or where the put option is likely to be exercised, could be considered as due for repayment earlier than their scheduled date of repayment.

Commercial papers: Commercial papers (CPs) are generally issued by entities to meet their short-term funding requirements. Unlike the cash credit limits available from banks, which are revolving in nature, CPs are required to be repaid at a designated due date. The mode of repayment could be internal funding or refinancing through a new CP issuance. In case of the latter, an entity might be vulnerable to market risks as nearer to the due date of the existing CPs, when the entity might be preparing for a roll-over/ refinance, the possibility of the market being in a turmoil, marked by tight systemic liquidity and high yields, cannot be ruled out. This risk is largely mitigated if an entity maintains alternate liquidity say, in the form of an equivalent amount of cash balance or undrawn working capital lines or an overdraft facility as back-stop. Also, as regulations allow entities to issue CPs for purposes other than meeting the working capital requirements, ICRA evaluates the risk of the entities using the short-tenor CP proceeds for long-term purposes, which might have the effect of exerting pressure on the asset-liability position.

Letters of Credit: An entity may avail the LC (or Buyer's Credit) facilities from banks for purchase of raw material or capital goods. Someone purchasing raw materials, say with a 90-day LC, needs to have a cash conversion cycle of less than 90 days to ensure that before the LC becomes due for repayment, the raw material is converted into finished goods and debtors against such sales are also realised. In case the cash conversion cycle is longer than the LC tenor, then the risk of LC devolvement may increase. Moreover, bunched up LC repayments, tend to exert liquidity pressure compared to LC payments, which are spread out and are aligned with the expected sales realisation. If an LC is opened in foreign currency for import of raw material or capital goods, then on the due date of payment, the liability under the foreign LC may also increase because of currency depreciation. Such risk is more pronounced in longer tenor LCs used for import of capital goods, compared with shorter-tenor LCs, issued for importing raw materials. In case no term loan is sanctioned against a capital goods LC and there is no funding committed for the payment of the LCs, it becomes necessary that suitable build-up of cash balances happens such that the LCs could be retired through these within the due date. Accordingly, in such cases, ICRA assesses the availability of cash balances and adequacy of cash inflows as well as external sources of funds to meet such lumpy payment to estimate the impact of the maturing LCs on the entity's liquidity profile.

Contingent claims

Performance guarantees: In some businesses, an entity might be required to submit bank guarantees in bidding for orders (bid-bond guarantee) or as security for compensating the customers in case of deficiency or inability to execute orders (defect liability guarantee/ performance guarantee). These are disclosed as contingent liabilities in an entity's financial statements. While drawing projections, ICRA estimates the cash margin that an entity would require, to secure the issuance of performance guarantees, depending upon the value of the orders for which the entity is likely to bid and the actual value of the orders, which the entity is expected to be awarded. In case the projected internal cash flows aren't sufficient to fund the cash margin, it would reflect poorly on its liquidity and in such cases, the entity would have to depend on external funding support for funding the margin. Besides the above, ICRA also evaluates the likelihood that the performance guarantees would be invoked by the beneficiaries. This in turn would be a function of the risk associated with individual orders being executed in terms of their complexity and the degree to which such a risk is mitigated by the entity's track record of executing similar orders in the past. Depending on the materiality of the performance guarantees invoked, a contingent claim would crystallise into an actual claim and might potentially be a drag on liquidity.

Financial guarantees: It is common for entities to give corporate guarantees in favour of the loans taken by their subsidiaries or group companies, which facilitates the sanction of such loan facilities. While assessing the credit profile of such entities, the financial guarantees extended in favour of others are considered as the entity's

obligations (in case the other entities are not consolidated for evaluating the entity's credit profile) as these are legally enforceable in case the borrower entity is unable to pay these on its own.

Litigations: ICRA also assesses the contingent liabilities on account of various litigations which might be sub judice before the court of law. While it is difficult to pre-empt the outcome of such litigations, it attempts to assess the likely impact of these liabilities on the credit profile, especially if the amount of such liabilities is significant.

Working capital requirements

The working capital cycle⁹ is the time taken by an entity to convert its net current assets (receivables and inventory net of payables) into cash. The longer the working capital cycle, the greater the working capital funding requirement for an entity and vice-versa. Typically, with everything else being the same, the entities with a shorter working capital cycle will have a better liquidity profile because of faster cash turnaround and thereby lower incremental working capital requirements¹⁰.

However, one of the analytical issues while assessing the working capital cycle, which is not reflected directly in cash flows, relates to distinguishing between entities whose favourable working capital cycle is the result of an inherently efficient working capital management and those whose seemingly favourable working capital cycle is because of the stretching of payables. The latter would rather reflect liquidity stress rather than being an indication of high bargaining power with business partners. In such a situation, an entity may find itself in a deeper liquidity crisis whenever such liberal credit terms are snapped.

Apart from the length of the working capital cycle, liquidity assessment also involves analysing the stability of an entity's working capital cycle. A declining working capital cycle, combined with improving profit margins, is generally indicative of an efficient working capital management as well as an improvement in bargaining power with the business partners, and vice versa. Changes in working capital then become a source of cash rather than a claim. While assessing liquidity, ICRA also assumes that the entity would need to set aside a certain cash amount (as a percentage of revenues) to run its day-to-day operations. This is considered as not being available to fund other sundry requirements.

Capital expenditure and investment outlays

One of the biggest claims on an entity's cash is outlay towards capital expenditure, especially when it is towards a new project. If an entity is expected to internally fund, through cash flows and/ or existing cash balances, the entire capital expenditure (and the working capital requirements) could be considered to have a highly comfortable liquidity position. In most cases, however, entities depend on external borrowings to fund the bulk of the capital expenditure; in which case, ICRA assesses whether it has the wherewithal to arrange the margin funding (through internal or external means) for the planned capex. The phasing of the capex is also a factor. The overall liquidity might be easier to manage if a project is being executed in phases or modules vis-à-vis when the execution is planned in a concentrated leap. Moreover, ICRA also analyses the proportion of the expenditure, which is discretionary or can be deferred depending upon the market conditions. A capex programme that can be deferred once initiated offers a leeway in managing the cash flows, depending upon the entity's circumstance and market conditions. Other lumpy claims on cash include the investments committed towards subsidiaries/ group entities or towards funding acquisitions.

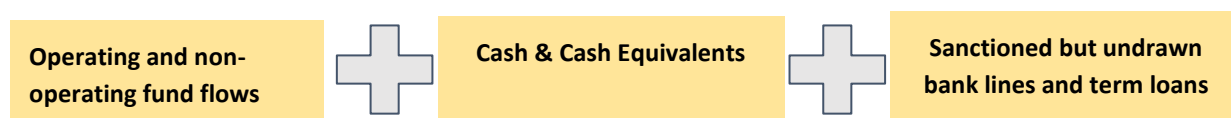
⁹ Working capital cycle is defined as $\text{Receivable Days} + \text{Inventory Days} - \text{Payable Days}$

¹⁰ In addition, such entities will have a lower proportion of long-dated receivables and inventory which will limit the risk of write-downs on such assets in future.

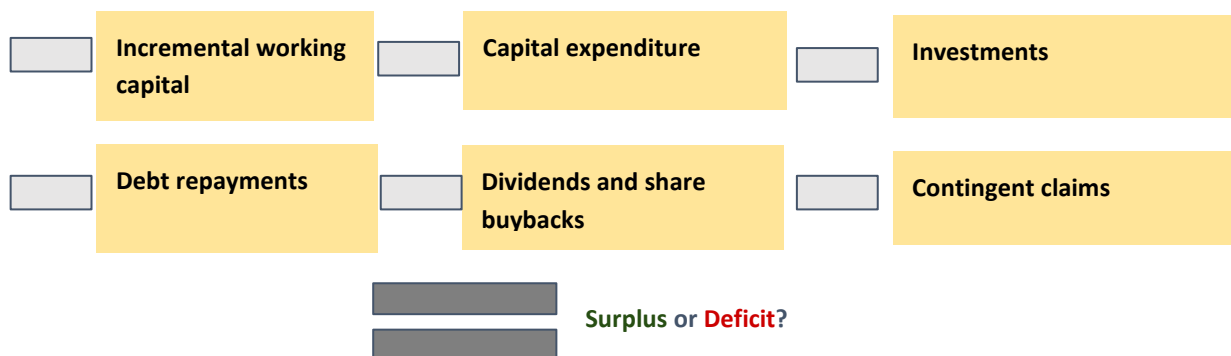
Dividend pay-outs

ICRA examines the dividend-paying track record of entities and engages with their managements to understand the dividend policies for building its own assumptions of possible future dividend pay-outs to the shareholders. While dividend pay-outs are supposed to be discretionary, when compared to debt servicing or maintenance capital expenditure obligations, in practice they are often sticky. Also, the dividends might be less discretionary in circumstances where the promoter entity might be critically dependent on dividend income to service its own debt obligations. In such situations, a liquidity analysis performed by ICRA considers dividend pay-outs as fixed claims on cash.

Sources of cash



Claims on cash



OTHER CONSIDERATIONS

In addition to cash flow analysis, ICRA also assesses the adequacy of an entity’s long-term sources of funds in relation to its long-term assets. An asset-liability mismatch exposes an entity to refinancing risks. This apart, ICRA evaluates the rated entity’s financial flexibility and the management’s policy and approach towards liquidity management, as these mitigate refinancing risks while supporting the liquidity profile.

Adequacy of long-term sources of funds

While cash flow analysis assesses the adequacy of an entity’s internal resources and committed external sources of financing in relation to its obligations, it does not distinguish between the nature of such cash flows. In other words, a cash flow analysis does not specifically capture whether it is the long-term sources of funds that are deployed towards creation of long-term assets - including fixed assets, long-term investments and long-term loans and advances - or the short-term funds. In cases where short-term sources of funds (such as working capital limits, short term loans and customer advances) are deployed for long-term purposes, the liquidity of an entity remains vulnerable to timely refinancing/ renewal of the short-term sources of financing. Thus, assessing the adequacy of an entity’s long-term sources of funding is an important aspect of liquidity analysis.

The long-term funding requirements may be towards assets such as:

- Fixed Assets
- Long-term investments, loans, advances
- Margin towards working capital and non-fund based limits

The long-term funding may be from sources such as:

- Net worth / Internal cash flows
- Preference shares
- Long-term loans, non-convertible debentures and such other instruments
- Long-term advances, deposits from customers and business partners

A quick assessment of an entity's long-term funding adequacy could be made by referring to the current ratio. Generally, the higher the current ratio, lower is the mismatch between long-term assets and long-term sources of funding. However, the current ratio is analysed after adjusting for the long-dated receivables and obsolete inventory as such assets may not be readily convertible to cash and are generally ineligible for short term bank funding. A related aspect is the evaluation of receivable and inventory ageing to appropriately estimate the long-term funding requirements (as long dated receivables and inventory are generally not funded by financial institutions) as well as to assess the possibility and extent of write-offs of these assets. In addition to the ageing analysis of current assets, the quality of receivables is also assessed to determine the likelihood of timely collection of such receivables. A significant proportion of unsecured receivables, concentrated among a few entities with weak or unascertainable credit profile, poses a bigger risk compared to a diversified distribution of receivables (among uncorrelated entities) or concentration among entities having a stronger credit profile.

Financial flexibility

Financial flexibility refers to the ability of an entity to raise fresh capital or refinance existing borrowings regularly at short notice. Typically, the degree of financial flexibility will be higher if the entity has large-scale operations with strong financials, unencumbered cash flows (such as rental income, annuity payments in road projects) or unencumbered assets/ flexibility to borrow against existing assets. Financial flexibility may be further reinforced by an entity's strong parentage or linkages with a strong group. While an entity may appear to have a certain degree of flexibility, the same is seen against its track record, especially at times of distress or market disruptions. It might also happen that a negative event pertaining to one or more entities in a given sector roils the lenders and investors, making them averse to lending to or investing in all the entities in the sector, harming the financial flexibility of most industry players. Financial flexibility could also be impacted in cases of weakening business profile, or management & governance concerns, which could translate into sharp decline in market capitalisation or spike in bond yields and consequently constrain an entity's ability to raise fresh capital or materially increase its cost of capital.

In general, other things being the same, strong financial status enhances an entity's credit profile which gives it flexibility to raise fresh capital or refinance an existing borrowing. As a result, while an entity may have weak cash flows, its strong financial flexibility might partially mitigate the liquidity risk.

Event risks

The impact on liquidity arising from event risks such as acquisitions, future litigations, product liabilities and so on are difficult to incorporate in ratings at the outset; implying that an adjustment to an entity's rating might be required when such discrete risks crystallise.

Summing up

This note discusses ICRA's approach to assessing the liquidity profile of entities in the non-financial sector. Since the liquidity profile is dependent on the adequacy of the entity's future cash flows in relation to its obligations, a detailed evaluation of the entity's business and financial risks, its competitive strengths, its business objectives and its plans and strategies is undertaken. These apart, ICRA also assesses the policies and the approach of the entity's management towards maintaining adequate liquidity buffers to tide over short-term cash flow pressures.

ANNEXURE - Select Liquidity Ratios and Cash Flow Measures

Ratio	Measure	Description
Gross Cash Conversion Cycle	Debtor Days + Inventory Days	<p>A long gross cash conversion cycle indicates that an entity has high requirement for working capital funding. In addition, such entities are likely to have higher risk of long-dated receivables turning bad and inventory turning obsolete.</p> <p>An entity may have a long gross cash conversion cycle owing to its unique business model or because of the nature of the industry. In such cases, the entity may be getting adequately compensated for a longer cash conversion cycle by way of realising better pricing for its products, manifested in the form of higher operating profit margins.</p>
Fund Flows from Operations (FFO)	Operating revenues less Operating costs (including taxes) less Interest paid	<p>Several cash flow measures (as mentioned alongside) are applied in financial risk analysis, each of which carries specific information content. Additional adjustments may be carried out on these to clean up for the impact of one-time, exceptional or non-recurring items. Finally, adequacy of adjusted cash flows and other internal / external resources is measured against cash obligations to assess the liquidity position of an entity.</p>
Cash Flows from Operations (CFO)	FFO less Operating working capital changes	
Retained Cash Flows (RCF)	CFO less Dividends paid plus Non-operating income less Non-operating working capital changes	
Free Cash Flows (FCF)	RCF less Capital expenditure	
Current Ratio	Ratio of current assets to current liabilities	

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