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Don't panic at rating downgrade

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Don't panic at rating downgrade

It could be a short-term blip. Though, a consistently bad rating should worry you

TANIA KISHORE JALEEL

YESTERDAY, Moody's downgrade of the country's largest bank, the State Bank of India, took the market by surprise. The stock, as a result, has lost a little over eight per cent in two days.

A number of other companies have also been downgraded in the recent past. These include Tata Motors, Tata Steel, Sterlite Industries, Hindalco, Reliance Industries, Indian Oil Corporation and Tata Chemicals.

From a retail investor's perspective, for those holding shares of these companies, any downgrade in rating may not impact them directly. Of course, the stock price could fall for a few days but if the company is a blue-chip, things may not be so bad in the short run. In fact, if the share price falls sharply, one could add to the holding.

Rating downgrades happen for many reasons. Sometimes, it is reflection of a rough business cycle or economy that can hurt the company in the short run. Only, if the company keeps getting bad ratings over a longer period of time, there is cause for worry.

It is important to understand the implication of these ratings. When credit rating agencies (CRAs) such as Moody's, Fitch or Standard & Poor's downgrade a company, the idea is to caution investors on creditworthiness. The lower the rating, the more the chance that investments may get stuck.

D R Dogra, MD and CEO of CARE Ratings, says, "When a company is rated, CRAs look at its ability to repay debt. It is downgraded when there are doubts regarding its future cash flow." Typically, a company's credit cycle, fi-nancials, industrial and business risks, servicing and repayment ability and debt-equity ratio are considered at the time of rating it. "Foreign currency conversion is also important, as it could push up the liabilities further," he adds.

The first direct impact for the downgraded company is rise in the cost of funds. "This is especially true for foreign borrowing.

A DOWNGRADE IS DONE TO CAUTION investors, while its effects depend on the factors involved

Reason: The company becomes a risky proposition for the lender, because of which a higher rate of interest is levied on the amount lent," explains Prashanth Prabhakaran, president, retail broking, at India Infoline. An increased cost of borrowing affects companies' bottomline, which impacts the earnings per share (EPS). "If the EPS falls, the stock ends up looking expensive," he adds.

It is up to the company management to fire-fight and control such a situation. Downgrade by a leading agency could further pressure the stock temporarily.

In some cases, it could even have a long-term impact, unless the company takes necessary steps to rectify the downgrade. Dogra says, "If the company raises funds through a qualified institutional placement or undertakes capacity expansion, improving its credit profile, the rating agency could revisit its decision." CRAs regularly review companies' creditworthiness.

Soon after a downgrade, the share price can fall, as in the case of SBI, where the shares fell around eight per cent in two days. Analysts say SBI's long-term prospects are stable, but the near term (three to six months) could be jittery.

Investors can use a rating downgrade or upgrade to ascertain the prospects of a company.

Vaibhav Agrawal, vice president, research, at Angel Broking says in case of capital-intensive sectors such as power, a high cost of funding could negatively impact the internal rate of return.