Liquidity Analysis of Non-Financial Sector Entities

[Issued in May 2022]

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 the next one year) from its cash accruals and any external sources available to 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 analysing the liquidity of any entity, CARE Ratings 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 the short-term liquidity of the entity.

- **Availability of unencumbered cash and cash equivalents:** Unencumbered cash and cash equivalents include funds which can be accessed at a short notice by the entity to service obligations or bridge any temporary cash flow mismatches which occur, such as cash, bank balance in the 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 continuously, is seen favourably 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. CARE Ratings 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 purpose, as its 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, CARE Ratings also assesses the availability of any unutilized portion of the sanctioned limits which can help the entity meet any short-term mismatches.

  The Quantum of unutilised lines of credit is calculated by comparing the entity's monthly maximum and average utilisation with lower of (a) sanction limit of the working capital limit and (b) available drawing power, typically for the preceding 12 months. Consistently high utilization may be a sign of weak liquidity. However, at times, the entity with higher drawing power may choose to have lower sanctioned limits and use its internal accruals for funding its operations.

Further, the entity may have undrawn term loans, either in the form of project-specific loans or general corporate loans. CARE Ratings 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, CARE Ratings does note that the 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 backup liquidity facilities. In extreme situations, the inability or unwillingness of the bank to restore the limits or shortfall in drawing power could lead to the inadequacy of backup liquidity at the time of CP maturity. The extent of utilisation of working capital facilities and likely variation in drawing power is hence studied in detail by CARE Ratings to assess the nature of cushion available.

- **Liquidity support available from parent/group:** While assessing the liquidity position, CARE Ratings 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 honouring such stated commitments.

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

- **Financial ratios:** Financial ratios are used to make a holistic assessment of the 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, CARE Ratings 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.careedge.in

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

- Superior/Strong
- Adequate
- Stretched
- Poor

[For the previous version please refer criteria on 'Liquidity Analysis of Non-financial sector entities' issued in **May 2020]**

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