

[Issued in October 2024]

## Background:

Liquidity risk analysis is an integral part of the credit risk assessment of an entity. It measures an entity's ability to meet its obligations in the near-term (typically the next one year) from its internal cash accruals, available cash and cash equivalents, and 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 buy-backs, and others, apart from cash outflow towards devolvement of contingent liabilities. Analysing liquidity of an entity is also crucial for arriving at its short-term rating.

## Liquidity analysis:

While analysing the liquidity of an entity, CARE Ratings Limited (CARE Ratings) considers the following:

- **Cash flows:** An entity's cash flow projections are analysed to assess the liquidity sources for repaying short-term obligations (generally the obligations which are payable in the next four quarters). However, the nature of the industry, seasonality associated with it, and lumpiness / ballooning of the debt obligations among others might warrant review on a longer time horizon as well. The assumptions underlying the cash flow projections are analysed to make a realistic assessment of the short-term liquidity of an entity.
- **Availability of unencumbered cash and cash equivalents:** Unencumbered cash and cash equivalents include funds which can be accessed at a short notice without restriction by an entity to meet its obligations or overcome temporary cash flow mismatches which may occur. It includes cash balance, bank balance in the current account, funds invested in liquid mutual funds, listed equity shares of large cap / index entities (non-strategic investments), listed corporate bonds of highly rated entities, government securities, and unencumbered fixed deposits (FDs) among others. Maintenance of unencumbered cash and cash equivalents, if maintained on a sustained basis, is seen favourably from the liquidity perspective.

On the other hand, encumbered cash and cash equivalents such as funds maintained in debt service reserve account (DSRA), margin money, and FDs earmarked against loan / facility among others can be used only for the purposes for which they have been earmarked for. CARE Ratings generally does not factor the availability of such funds while assessing the available liquidity for meeting the obligations.

- **Investment in group entities / loans and advances extended to group entities:** Investment in group entities / loans and advances extended by an entity to its group entities are generally not considered liquid even if classified as short-term as their availability depends on the credit profile of group entities which is beyond the control of the entity. Thus, these may not be readily available to the entity when it requires the funds for its own purposes.
- **Unutilised lines of credit from the lenders:** While assessing the liquidity position of an entity, CARE Ratings also assesses the availability of unutilised portion of the sanctioned limits (subject to drawing power being available, if applicable), which can help the entity meet short-term cash flow mismatches.

The quantum of unutilised working capital limits is calculated by comparing the entity's monthly maximum and average utilisation with lower of (a) sanctioned working capital limits and (b) available drawing power,

typically for the preceding 12 months. Consistently high utilisation may be a sign of weak liquidity.

Moreover, an 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 notes that the availability of undrawn lines of credit only reduces the chances of defaults, however, does not eliminate it completely as these lines may be withdrawn at 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 an entity, thus implicitly creating back-up liquidity facilities. In extreme situations, the inability or unwillingness of a lender to allow utilisation of the limits or shortfall in drawing power could lead to the inadequacy of back-up liquidity at the time of CP maturity. Hence, CARE Ratings conducts a detailed analysis of the extent of utilisation of working capital facilities and the likely variation in drawing power to assess the nature of cushion available.

- **Liquidity support available from parent / group:** While assessing the liquidity position of an entity, CARE Ratings factors in the financial flexibility and liquidity support from the parent / group in light of their stated commitments to infuse funds into the entity and past track record of honouring such stated commitments. CARE Ratings also interacts with the management of the rated entity to understand its posture with respect to liquidity management and contingency / back-up plans to mitigate liquidity risk.

While assessing the explicit support extended by the parent / group in the form of guarantees, letters of comfort, and undertakings among others, CARE Ratings follows its criteria for 'Rating Credit Enhanced Debt', which is available on [www.careedge.in](http://www.careedge.in).

- **Financial ratios:** Financial ratios are used to make a holistic assessment of the financial performance of an entity and to compare the entity's performance against its industry peers. These are not an 'end' in itself but a 'means' to understanding the fundamentals of an entity. To analyse an entity's liquidity, CARE Ratings primarily 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 [www.careedge.in](http://www.careedge.in).

Using the above parameters to assess the rated entity's liquidity position, CARE Ratings arrives at and discloses the liquidity indicators in the press releases at 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 2022](#)]

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