

Tracing back its losses

Hemindra Hazari

CRISIL is India's first and premier credit rating agency. Since its inception, it has improved the awareness of company analysis by introducing debt rating in India. Holders of corporate debt, investors and analysts are grateful to credit rating agencies such as CRISIL for introducing methodologies for gauging the financial and industrial performance of companies.

CRISIL's success, has made it the favourite poaching ground for foreign institutional investors (FIIs) seeking research analysts.

However, there are a few exceptions in evaluating a company's performance such as Bata, which needs an independent evaluation to investigate what went wrong.

In end March 1996, Bata declared its results for the year ended December 31, 1995, which showed a net loss of Rs 42.2 crore compared with a net profit of Rs 0.98 crore in the previous year.

In January 1995, CRISIL's ratingscan had rated Bata's Rs 10 crore commercial paper P1+, an AA rating for Bata's Rs 6 crore non-convertible debentures and a FAA rating was awarded for Bata's fixed deposit programme.

By July 1995, well after Bata had declared its results for the year ended December 31, 1994 in which net profit plummeted to Rs 0.98 crore from Rs 19.9 crore in 1993, CRISIL placed Bata on a rating watch with a negative implication.

The rapid deterioration in Bata's financials surprised the rating agency as its ratingscan report in January 1995 was optimistic on the company's future.

After analysing Bata's 1991, 1992 and 1993 results, the ratingscan states, "the extensive distribution network of over 1,100 Bata shops spread throughout India will ensure the continuity of its dominant market share in the future... The profitability of the company's products has improved over the last 3 years on account of value engineering in the shoes produced, as well as a cost consciousness drive throughout the organisation."

By July 1995 (a mere six months later), after the entire financial community were aware of the problems in Bata, CRISIL produced a different picture of Bata and put in on rating watch for "failure to maintain its position in industry... and for incurring advertising and marketing expenses to support its marketing strategy."

The press release from CRISIL also stated that the company's "financial position deteriorated further due to build-up of inventories, constraining working funds and hence lowering of profitability."

The irony of the statement is that the company's poor working capital management was evident in its 1993 results which the credit rating agency had analysed and subsequently awarded Bata the highest commercial paper rating at P1+.

A critical shortfall in CRISIL's commentary in its January 1995 Bata report was the lack of cash flow analysis.

Although the disclosure of the cash flow is a recent phenomenon in American and European accounts, many analysts are unaware of interpreting the cash flow statements.

In India, Marwari business houses' fabled parta system resorted to cash flow accounting

Cash flow analysis of Bata

Rs. in crores

	31/12/93	31/12/94
Profit after tax	19.9	1.0
Depreciation	3.4	7.0
Cash profit	23.3	8.0
Working capital	-27.0	-6.02
Net cash flow	-3.7	1.8
Increase in equity	48.0	0
Capital expenditure	-17.1	-30.8
Dividend	-3.7	0
Increase in long term borrowings	-3.6	12.5
Change in NLF*	19.9	-16.5
NLF b/f	-50.0	-30.1
NLF c/f	-30.1	-46.6

* NLF (net liquid funds) : cash plus liquid investments minus short term debt

on a daily basis to gauge the profitability of their enterprises.

It is a tragedy that credit rating agencies in India are not commenting upon cash flow analysis and instead prefer to incorporate measures such as debt to equity, current ratio, interest cover and profit margins to gauge the all important liquidity status of a company.

Credit rating agencies like the layman appear to give excessive importance to profits although profits are based on accrual accounting and therefore indicators based on profits such as margins, cash profit and interest cover may not give an accurate estimation of the liquidity.

Standard & Poor's Debt Rating Criteria states, "Earnings power may be the best long term determinant of credit-worthiness, but when an interest or principal payment date arrives, earnings are not what matters.

The obligation cannot

be serviced out of earning, which is just an accounting concept; payment has to be made with cash."

The January 1995 rating scan on Bata said, "the profitability at the OPBDIT level correspondingly improved from 7.1 per cent during 1991 to 9.9 per cent in 1993... The interest coverage at the OPBDIT level improved to 3.33 during 1993 on account of the increased profitability as well as the reduced interest charges of the company" — it ignored the important role played by the company's rights issue in compensating for the poor working capital management of the company.

In 1993 of the cash profit of the company of Rs 23.3 crore, there was a working capital cash outflow of Rs 27 crore, resulting in a negative net cash flow of Rs 3.7 crore which meant that in 1993, the company did not generate any cash from selling footwear.

The profits of the company in

1993 were therefore 'paper profits' as it was not supported by cash flow.

The rights issue which raised Rs 48 crore plugged the hole in the operating cash flow, reduced debt, financed the capital expenditure and paid the dividend for the company.

The reduced interest charges therefore was brought about not by reducing debt from cash generated from operations but from the equity issue.

Moreover, even after the induction of external funds, Bata's NLF (net liquid funds cash plus liquid investments minus short term debt) was negative which is an apparent indicator that the company's cash flow from operations was blocked.

The Net liquid funds cash plus liquid investments minus short term debt was reduced from a negative Rs 50 crore in 1992 to a negative Rs 30.1 crore in 1993 on account of the equity issue but the fact that it continued to be negative as the company was not generating cash from its operations should not have qualified Bata from having the highest commercial paper rating.

Cril managing director R Ravimohan disagrees, "CRISIL was satisfied with Bata's ability to raise local resources, the willingness of the parent company to support its Indian subsidiary and Bata's long standing image in the Indian market. In any case Bata's negative cash flow was financed through access to domestic funds."

In the January 1995 ratingscan, CRISIL was able to identify Bata's business being working capital intensive" but it was unable to analyse Bata's poor working capital management. The credit rating agency's claim of improved profitability in 1993

reveals its inability in distinguishing between profits and cash flow, which is a matter of concern for subscribers of corporate debt.

The NLF of Bata further deteriorated in 1994 to a negative Rs 46.6 crore as the net cash flow was only Rs 1.8 crore as compared to the cash profit of Rs 8 crore. The company's working capital management did not improve significantly. Instead its short term borrowings increased to finance its capital expenditure which caused further strain on the company's financials.

The combination of poor working capital management and deploying short term funds for acquiring long term assets caused the further deterioration in Bata's NLF.

Therefore there exists a clear pattern and cause of the company's worsening liquidity position which is detectable through the easily available annual reports.

The purpose of rating is also to provide an early warning signal of improvement or deterioration in a company's financials. The cash flow analysis is one of the most important analytical tools available to see through profits and losses.

The problem in Bata's cash flow can be traced back to 1993.

Although Bata till date has not defaulted on its interest payments, its poor cash flows from operations in the past finally resulted in huge losses in 1995.

In future, CRISIL should disclose and comment on a company's cash flow in its ratingscan so as to provide prospective debt holders with comprehensive information.