Business and Political Observer 16 November 1992

Escorts: A+ rating, but cheques bounce

COMPANY ANALYSIS

Hemindra Hazari

CAN a company have its cheques bounce and yet enjoy a A+ rating for its debentures? Let us take a look at Escorts Ltd. The company rolled over its debentures and got a rating of A+ which is the third highest rating given for debentures by the credit rating agency. 'A' is an investment grade criteria for debentures and is "judged to offer adequate safety of timely payment of interest and principle; however, changes in circumstances can adversely affect such issues more than those in the higher rated categories." A+ for Escorts is higher rated than this definition.

In the letter of option dated October 10, 1992 Escorts offered to extend the redempton period of its 30,000 — 15 per cent secured redeemable non-convertible debentures of Rs 100 each aggregating to Rs 30 crores. For the rolled over debentures, Escorts offered 18 per cent per annum. The very fact that Escorts was rolling over its debentues and offerring an increase of 3 per cent per annum in interest rates highlighted the company's need for liquidity. The rolled over debenture issue closed on 2nd November, 1992. Major holders of such debentures usually include financial institutions.

In 22nd October, 1992 a new story, "Escorts cheques bounce" in The Economic Times stated that "several cheques issued by the company on its Punjab National Bank account in the capital were not honoured by the bank," as Esocrts was facing a severe cash crunch. The managing director, Mr Rajan Nanda maintained that "the cash crisis was not crippling," thereby admitting that Escorts was facing a liquidity problem.

A liquidity crisis of such a magnitude is not an over night phenomena, yet the credit rating agency after analysing the company's balance sheets and having access to confidential financial information certified Escorts as an investment grade company, thereby misinforming bond holders and bankers. An independent financial analysis of Escorts and a change in the criteria for credit rating is warranted.

The word credit is derived from the latin *creditum* and is defined as the "confidence in the ability and the intention of a person or institution to pay, based on its solvency and probity, thereby entitling it to be trusted in borrowing or buying." From a financial perspective, a company to be creditworthy must have solvency, liquidity and management capability. This is not the same as profits. Most financial analysts regard profit after tax plus deprecition as cash generation in real terms. However, profits and depreciation are partly based on transactions but more importantly, are based on managerial discretion with regard to the annual presentation of accounts to shareholders.

Standard & Poor's Debt Rating Criteria states, "Earnings power may be the best long-term determinant of creditworthiness, 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."

Therefore, profit ratios and its derivatives such as interest coverage may not give an accurate estimation of liquidity. Moreover, loss of liquidity can and does lead to loss of solvency.

To estimate liquidity, short term borrowing power (net current assets less 25 per cent of gross current assets plus UTI and intercorporate investments) minus short term borrowing should be studied. This is the procedure generally recommended by various committees to determine borrowing limits. The figure should normally be positive. For a company to have adequate liquidity for the next year, the positive liquidity figure should be greater than interest accrued but not due on the balance sheet date, plus provision for dividend, plus provision for taxation less advance tax paid, plus capital expenditure commitments and any other appropriations relating to previous periods to be paid out in the next year. Liquidity analysis is important because it shows whether the company has adequate liquidity to pay for its cash commitments made during the accounting year and during next financial year relating to the previous accounting year.

Liquidity Status of Escorts

	31/3/92	31/3/91	31/3/90
Short term borrowing power (STBP)	35.25	45.10	23.26
Short term borrowing (STB)	75.55	56.86	46.69
Liquidity (STBP-STB)	-40.30	-11.77	-23.43
Interest accrued but not due	-10.78	-8.74	-6.49
Provision for tax less advance tax paid	-20.40	-11.47	-10.22
Dividend payable	-10.18	-11.87	-10.17
Commitments for capital expenditure	-16.20	-22.65	-13.36
Liquidity less cash commitments	-97.86	-66.50	63.67

If the company has a liquidity shortfall, then it has to increase its short term borrowing and or use its current cash flows to fulfill its past cash commitments.

Unfortunately, many perceived blue-chip companies overdraw on their bank limits and deploy the funds in short term securities and earn on the interest differential. Banks permit this risky practice as it is renumerative and the companies being perceived blue-chips are unlikely to default on the overdrawn limits. A liquidity analysis of Escorts reveals that in 1989-90, 1990-91 and 1991-92, the company has been having a liquidity shortfall. In all three years Escorts overdrew on its bank limits and had a negative liquidity and its liquidity less cash commitments worsened from a negative Rs 63.67 crores in 1989-90 to a negative Rs 97.86 crores in 1991-92.

Liquidity shortfall is caused by four factors: company acquires long term assets through short term funds, company discharges long term obligations from short term funds, company has operating cash losses and finally management diverts the cash flow outside the company including for tax and dividend not resulting in current assets. Corporate management tries to mitigate a liquidity crunch by increasing short term borrowing, relying on future cash inflows, or raising long term finance through debt and or equity. Relying on future cash inflows and short term borrowing is unhealthy because the company is depending on projected cash inflows to fulfill cash commitments.

Therefore, raising long term finance through debt or equity is a prudent financial practice as long as it is servicable.

Escorts resorted to increasing its short term borrowing hoping that future cash inflows would overcome the liquidity shortfall. Short term borrowing in 1989-90 was Rs 46.69 crore which increased to Rs 56.86 crore in 1990-91 and further increased to Rs 71.68 crore in 1991-92. Apparently, the Rs 35 crore of non-convertible debentures issued for working capital requirements and privately placed in 1990-91 was insufficient to overcome the liquidity problem.

Any company regardless of its blue chip nature which has overdrawn on its bank limits without resorting to raising adequate long term finance is following a risky financial strategy. A company which has overborrowed on its short term permissable bank fiance is bound to have a negative liqudity because management has made numerous cash commitments for the next year which has to be deducted from the previous year's liquidity.

Escorts in the last three years has experienced a liquidity shortfall and this is a sufficient indicator of poor working capital management and lack of financial planning which has led to the present liqudity crisis.

By having its cheques dishonoured, Escorts has violated all norms of probity and solvency and has jeopardised its creditworthiness.

Therefore, the A rating and the methodology for credit appraisal may need to be reviewed in the light of the Escorts debacle. □

LETTERS

CRISIL chief clarifies

WE refer to Mr Hemindra Hazari's article in *The Observer* dated November 16, 1992 titled "Escorts: A rating, but cheques bounce".

The article refers to some cheques that Escorts issued which were not honoured by a branch of the Punjab National Bank. The company has explained that it had made adequate arrangements to honour all its obligations in the aggregate in the numerous bank accounts it operates; however, as a result of some obligations being met out of Punjab National Bank instead of another bank the balance in the Punjab National Bank had got depleted and therefore the branch was not in a position to honour the cheques.

CRISIL rates debt instruments of companies; the rating applies to the specific instrument rated and not to other obligations of the company. In rating a long-term instrument such as a debenture, CRISIL takes into account the long-term business fundamentals of the company including the goals and philosophies of top management, strategies and policies, company's strengths and weaknesses, cash flow adequacy and systems for timely payment of interest and principal on the debt instrument.

The author has based his analysis presumably on published past annual reports and has suggested the need for Escorts' to raise long-term funds to reduce its dependence on short-term borrowings. The CRISIL has assigned an "A" rating to Escorts Rs 30 crore non-convertible long term debentures being rolled over in November 1992 after consideration of all factors. CRISIL stands by its rating.

R Jayakumar, Manager
CRISIL, Bombay