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Hindustan Lever — P1 + ?

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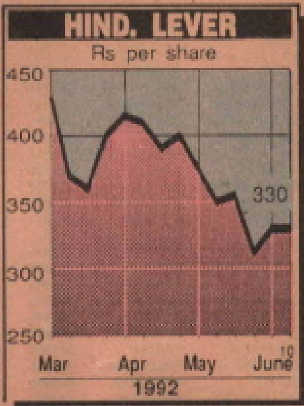
CAN a company suffer from lack of liquidity and yet maintain the highest rating of P1+ for commercial paper and FAAA for fixed deposits? The answer is yes. Let us look at Hindustan Lever Ltd, having 94 per cent of its equity issued in the form of bonus shares and widely perceived to be the bluest of the blue-chip companies in the Indian stock market.

While most financial analysts concentrate on profit margins, liquidity analysis is totally ignored. The financial community, shareholders and creditors are content with analysing profits and rarely analyse a company's liquidity management beyond calculating current ratio and acid test ratio. Contrary to the existing understanding of financial literature, profit after tax plus depreciation is not cash generation in real terms. Many reputable profit-making companies are constrained by liquidity. According profit and depreciation are partly based on transactions and more importantly based on managerial discretion with regard to the annual presentation of accounts to shareholders. Liquidity analysis is important because it shows whether the company has adequate liquidity to pay for its cash committments made during the accounting year and during the next financial year. 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 committments.

Lack of liquidity is naturally never mentioned in the Director's Report which usually suggests that despite all adversities the company has done well without usually mentioning what went well to achieve the position. However, the balance sheet contains a wealth of information for the financial analyst.

Management decision making is an endless and continuous process. During this process numerous commitments are made which would become a part of the accounting reporting system only after the transaction has taken place. Obscure but vital items like committed capital expenditure, bills discounted, gratuity etc. are reported as notes to accounts and are not incorporated in the accounting set. These items are extremely important in analysing liquidity management.

To analyse liquidity, short term borrowing power (net current assets less 25 per cent of gross current assets) minus short term borrowing (including bills discounted) should be studied. This is the procedure followed under RBI guidelines to determine borrowing limits. The figure should normally be positive.



In 1990, Hindustan lever had a negative figure of Rs 34.03 crores which marginally declined in 1991 to a negative Rs 32.02 crores mainly because of the increase in cash balances from Rs 5.29 crores in 1990 to Rs 31.58 crores in 1991. None of Hindustan Lever's loans and advances qualify for current account status.

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 to be paid out in the next year. In 1990 the company had a shortfall in liquidity of Rs 67.24 crores. To finance the shortfall, short term borrowing increased from Rs 111.37 crores in 1990 to Rs. 123.36 crores in 1991. As the company enjoys P1 rating for commercial paper it can raise short term finance at a cheaper cost. In 1991 the company raised Rs 25 crores of commercial paper compared to Rs. 20 crores in 1990. In 1991 the shortfall in liquidity worssened to Rs 85.39 crores from Rs 67.24 crores in 1990. Therefore the company will have to finance part of the shortfall with 1992 cash flows.

LIQUIDITY STATUS OF H L L

(Rs in Crores)

	31-12-1991	31-12-1990
Short Term Borrowing Power	112.28	95.05
Short Term Borrowing	144.30	129.08
Liquidity	-32.02	-34.03
Interest Accrued But Not Due	-1.87	-1.81
Dividend Payable	-28.55	-23.51
Provision for Tax Less Advance Tax Paid	-11.83	0.00
Commitments for Capital Expenditure	-11.12	-7.89
Liquidity Less Cash Commitments	-85.39	-67.24

Another source for short term finance is investments in UTI units and inter corporate deposits. In 1991 and 1990 the company had outstanding UTI investments of Rs. 0.87 crores and Rs 1.6 crores respectively.

The UTI investments being negligible will have a marginal effect on the company's negative liquidity.

A company's quoted investments is another source of liquidity. However, most companies treat it as a long term investment which is to be sold during times of financial crisis. Although Hindustan Lever's market value of its quoted investments as on 31st December was Rs 27.15 crores in 1991 and Rs 9.53 crores in 1990, the majority of the investments are not intended to be sold. The 14.74 lakh shares of Stephan Chemicals cannot be sold because it is a Hindustan Lever subsidiary. As on 24th December 1991 which was the last trading day in 1991, the HDFC portfolio accounted for Rs 1 crore and the Stephan Chemicals portfolio Rs.25 crores. Therefore while the market value of quoted investments reflects the financial strength of Hindustan Lever it need not be used to augment the company's liquidity under normal operating conditions.

The company's negative liquidity implies that it has overdrawn on its bank limits and it reflects poorly on the management. Negative liquidity means that the cash generation of the succeeding period will have to be used to finance cash payment committments of the previous year. This is unhealthy because the company is relying on future period inflows against certain past period payments due. Secondly, if the practice continues, the liquidity gained is at the cost of additional borrowing which implies additional cost and thirdly such constant additional borrowing will have the compounding effect of any debt burden and impede the growth in fixed assets.

Hindustan Lever is not the only perceived blue chip company to face liquidity problems. While it is likely given the management's track record that the company will over come its liqudity problems in the future, it may not deserve the highest credit rating as it has overdrawn on its bank limits for two years in succession. □

LETTERS

Different methodology

WE refer to the article on Hindustan Lever by Mr Hemindra Hazari in the supplement of *The Observer* dated June 22, 1992.

We appreciate the scholarly analysis carried out by the author of the article with reference to liquidity management of the captioned company. May we suggest that in evaluating liquidity management, the author should also take into account the financial flexibility of a company, ie. the ability of the company to raise funds from various sources based on its inherent financial strengths. Further, in liquidity management, the author may also like to examine average daily collections and average daily payables. Hindustan Lever, given its market standing and its total gearing (Total debt/Tangible networth) of not more than 0.66 during the last four years, has such ability to raise funds to meet its obligations. The company also had interest coverage (OPBDIT/Interest and finance charges) of more than six times during the last two accounting periods, which reflects the high cover provided by its internal funds generation for meeting its debt obligations.

CRISIL's evaluation for rating commercial paper not only takes into account the year-end figures but also the monthly movement of the cash flows during the past as well as those estimated for the immediate future periods. CRISIL's rating methodology takes into account not only the company's liquidity, but also an overall evaluation of the industry in which the company operates, the market position of the company within the industry, its operating efficiency, cash flow adequacy (past and future), variability of cash flows, financial flexibility, an evaluation of the management, etc. Taking these into account, we stand by our rating of "FAAA" and "P1+" assigned to the Fixed Deposit Programme and Commercial Paper Programme of Hindustan Lever Limited.

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