

Mutual Funds Demystified

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We will continue our discussions on 'quality' aspect which influences the rating that a Credit Rating agency such as CRISIL, ICRA and FITCH, to name a few, allot to the specific debt instrument. This rating, in turn, influences the rate at which the company can borrow from the market.

Why are we concerned with this rate? To refresh our memory, the cost of capital is nothing but the rate at which the company can raise capital (either debt or equity). In the case of debt, this is nothing but the current borrowing cost.

As we discussed in the last issue, rating agencies evaluate the company's ability to repay the interest and principal on the due dates. Better the company's ability to repay, higher is the rating allotted. As part of this process, they adopt an **E-I-C framework** to the analysis. We went through this in some detail last time.

To summarize, they look firstly at **macro economic factors** (world economy growth projections,

domestic GDP growth, government fiscal deficit, expected Inflation rate, to name a few), **micro economic factors** (such as demand and supply, capital availability, overall consumption pattern, surplus likely to be available in the hands of consumers, availability of labour) to arrive at the landscape in which the Industry is operating.

Next they delve into the **dynamics of the industry** (who are the larger players, what are their strengths and weaknesses, is the industry in a growth phase or a declining phase, what are the regulatory factors that might affect the fortunes of the industry etc). having done this, they are in a position to rate the industry from an attractiveness point of view to arrive at the opportunities or threats as the case may be from the company's standpoint.

Finally they look at the **specific company's features** such as competitive position, strengths and weaknesses and financial situation. The analysis may be carried forward one step further if the borrowing is specifically for a project as then they will need to examine the project's techno-economic feasibility and financing pattern (to determine how the rest of the capital cost of the project is going to be raised).

Having done this, they prepare a sales forecast and projection of the profit & loss account for the proposed period of the borrowing. They then prepare a forecast of the cash flows and of the repayment schedule for loans taken and likely to be taken by the company.

Cash flows are very critical to any analysis as very often the profits of a company may not correctly reflect the ability of the company to repay the interest and principal. Why? This is because there are expenses such as depreciation, which are only book entries and not real, cash expenses. Hence such monies will be available for use by the company to repay loans. Earnings can also get

locked up in working capital and capex spend. So what is important is the cash flows available.

Based on the forecasted cash flows and repayment schedule, they then arrive at what is known as the Debt Service Coverage Ratio. This is a very simple concept. Let me illustrate with an example

No	Parameter	Year # 1	Year # 2	Year # 3
1	Cash Flows	100	125	150
2	Repayment Obligations	50	100	200
3	Debt Service Coverage Ratio			
	(ROW 2/ROW 4)	2.0	1.25	0.75

The table shows the projected cash flows, repayment obligations and the calculation of the ratio, which is nothing but the first item divided by the second item. The purpose of the computation is to arrive at the cushion (or comfort zone) of the company in generating the cash from its business operations in order to repay the loan. As seen, in year 1 the company has a DSCR of 2, which means that he is expected to have double the cash required to meet his repayment obligation in that year. However, the same drops sharply to 1.25 - only a 25% cushion and in the third year the cash generated will be sufficient only to service three-fourths of the repayment obligation. Cash flows are higher, but payment obligations have risen even faster.

Credit ratings agencies generally insist on a Debt Service Coverage Ratio of at least 1.5 (50% cushion) in each year of the tenure of the borrowing, to justify giving a good rating to borrowing program of the company.

The purpose of the above discussion was to show the depths to which the rating agencies go to ensure that they do a proper assessment of the 'company's ability to repay interest and principal'.

We will delve into further aspects of 'quality' in future discussions.

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