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Effect of Credit Rating on Cash Holding and Earning Momentum of Indian Companies

KEYWORDS: Credit Rating, Cash Holding, Earning Momentum, India.

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ABSTRACT *The paper examines the influence of credit rating given to a firm on their cash holding and earning momentum. The study was done using a random sample of 30 Indian companies from a group of top 200 listed companies on BSE. Using the regression model it was found that credit rating do had a positive and significant impact on both cash holding and earning momentum of a firm. It was observed that companies were pretty much concerned about maintaining their ratings so as to maintain a good financial brand in the market.*

INTRODUCTION

Credit Rating is an assessment of the credit worthiness of individuals and corporations. It is based upon the history of borrowing and repayment, as well as the availability of assets and extent of liabilities. According to CRISIL (a credit rating agency), a credit rating represents the rating agency's opinion on the likelihood of a rated debt obligation being repaid in full and on time.

A credit rating is not a recommendation to buy, hold, or sell a debt instrument. A credit rating is one of the inputs used by investors to make an investment decision. Importantly, Credit ratings are assigned to debt instruments, focused on the risk of non-payment, the primary variable in debt instruments.

Fair credit ratings depend on the level of disclosure provided by the firms to the credit rating agencies. Thus, if the agencies are not provided with the relevant confidential insights to the business strategy, they does not assign credit ratings without issuer interaction, except when a previously rated instrument is outstanding or when a specific investor asks for a private exercise. Also, for rated clients, if subsequent information is not adequate, the agency may suspend the rating and inform the investors. Generally, it is assumed that credit rating is an assurance of the repayment of the rated instrument. But rather, it is an opinion on the relative degree of risk associated with such repayment. This opinion represents a probabilistic estimate of the likelihood of default.

Cash Holdings/Cash in Hand is one such important liquid asset which is to be maintained by the firm in order to settle any uncertain obligation. Firms hold a significant portion of their assets in the form of cash as a buffer against future uncertainty. It is a way to hedge against undesired states of nature. As per the literature, firms with strong growth hold more cash and ones that invest and research more, hold more cash. It has also been observed that companies with huge profit and turnovers keep about 10%-20% of total assets as cash in hand. This proves that liquid asset in terms of cash is essentially required by every firm be it large or small.

Another important and the most relevant ratio which firms need to maintain necessarily is the Earnings per Share (EPS). EPS is nothing but the portion of a company's profit allocated to each outstanding share of common stock. Earnings per share serve as an indicator of a company's profitability. And evidently profitability is the first factor which affects an investor's decision to invest in a firm's securities. This makes it important to calculate the change in the EPS occurring yearly so that a momentum of the profitability of the firm can be measured. This is nothing but what is called as Earnings Momentum. The definition of Earnings momentum says "When corporate earnings per share (EPS) growth is accelerating or decelerating from the prior fiscal quarter or fiscal year, it is termed as Earnings Momentum."

With its significance in a firm's financial stability, it gives a scope for the researchers to analyze that what can affect the earnings momentum of a firm. Credit ratings being another variable to judge the financial position of a firm can have a significant impact on the earnings momentum of a firm. Thus, this research also brings forth the interpretation of the effect that credit ratings can have on the earnings momentum of a firm.

LITERATURE REVIEW

In the financial system around the world, the earnings fluctuate widely according to the variations in the economy. These variations apart from affecting the earnings, affects a lot of financial decisions taken by a firm in order to assure their investors. As during an economic boom, a firm's profitability increases, it also affects various other areas which need an equal attention to be paid on.

Firms with strong growth rate opportunities and riskier cash flows hold relatively high ratios of cash to total assets and especially the large firms with credit ratings tend to hold low ratios of cash to total assets (Opler *et.al* 1997). According to Teruel *et.al* (2008), a cash level target is set by the firms which depend on the quantum of cash flows, leverage level and the type of debts they have taken. It has also been stated in a research that, longer cash conversion cycles and lower financing deficits are some other factors affecting holding of cash by the firms (Bigelli and Sanchez-Vidal, 2011).

A substantial number of studies have focused on the differing influences' cash holdings have on financially constrained versus unconstrained firms. Liquidity is particularly valuable for firms that have high costs of obtaining exter-

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nal equity or that are in a potential distress position. Kim, Mauer, and Sherman (1998), Faulkender and Wang (2006), and Denis and Sibilkov (2010), among others, found that more financially constrained firms hold more cash. Opler *et.al* (1997) found that the presence of a bond rating and, by extension, an investment grade rating, results in a firm holding less cash, as they are less financially constrained.

In a study of debt rating changes from 1985 to 2005, Khieu and Pyles (2012) found that an upgraded firm increases its long-term debt level; while a downgraded firm does not use shorter term debt relative to total debt than a no-change firm does one year after the credit ratings shift. This evidence is in contrast to findings by Goyal and Wang (2010), which examine a sample of 4,089 debt issues for the period 1983-2003 and find that credit default risk increases after firms issue a short-term debt and the opposite is true for long-term debt issuances. Their finding suggests that borrowers' private information plays a role in corporate decisions of debt maturity structure.

Though there have been a lot of researches done determining factors affecting cash holdings of a firm, not much has been researched on credit rating affecting the cash holding and earning momentum. Thus, this research is an attempt made to fill this gap and try to determine what effect credit rating has on the earnings momentum as well as on the cash holdings of a firm.

OBJECTIVES OF THE STUDY

In the light of the above discussion, following are the objectives of the study:-

To determine the effect of credit rating on Cash Holdings of a firm

To determine the effect of credit rating on Earning Momentum of a firm

RESEARCH METHODOLOGY AND DATA

The research is undertaken by taking a random sample of 30 listed Indian companies in BSE 200 index. This sample provided enough variations in the financials and credit ratings of the companies which is the core of the study. The quarterly data from year 2006 to 2014 for these companies was collected from their respective annual reports and BSE. The data for credit rating was taken from CRISIL. Since CRISIL rates the companies from rating "AAA to D" which are alphabetical, they were converted into numbers by ranking AAA (the highest one) as 20 and D (the lowest one) as 1. Every notch downgrade is ranked 1 less than the previous one. The impact of credit rating on cash holding and Earning Momentum was found using the classical linear regression model mentioned as:-

$$Y_t = \beta_0 + \beta_1 X_t + \mu_t \quad \text{------------ eq. (1)}$$

Where-

β_0 is intercept of the model,

β_1 is the marginal impact of credit rating

X_t is the credit rating of the respective company

μ_t is the error term

However Y_t for the first model represents Cash holdings in Cr. Rs. as the dependent variable and for the second model it represents Earning Momentum (taken as growth of EPS) as the dependent variable.

RESULTS

Credit ratings directly affect capital structure decisions by managers. The results apply both to the potential for an upgrade as well as a downgrade and to both large and small firms. Managers appear to be most concerned with ratings changes around the AA and B credit rating levels, as well as the change from investment grade to junk.

Table – 1
Credit Ratings and Cash Holdings

Dependent Variable	β_0	β_1	R^2
Cash Holdings	16.04300047* (4.64019E-74)	0.002308197* (0.013)	0.408

- * **Significant @ 5% level of significance**
- * **P values are shown in bracket**

It could be observed from table -1 that credit rating had a positive and significant impact on the cash holdings of top 200 listed Indian companies taken randomly. This is evident since a higher rating attracts a lot of investors deepening the capital base of the company.

Table – 2
Credit Ratings and Earning Momentum

Dependent Variable	β_0	β_1	R^2
Earning Momentum	16.4795416* (2.25044E-79)	0.004493197* (0.047)	0.344

- * **Significant @ 5% level of significance**
- * **P values are shown in bracket**

The results in table -2 are in line with what is reflected in above table. A higher rating is showing a strong effect on the earning's growth of Indian companies. This is very much in line with the theory stating a reduction in financial cost due to higher notch of ratings.

Most executives would agree that, ceteris paribus, it is better to have a good credit rating. Yet very few firms have either an "AAA" or "AA" rating. The reason is that achieving a high rating requires a firm to include a substantial amount of equity in its capital structure, and this can be very costly. Hence, we expect only those firms that benefit the most from having low bankruptcy risk to target capital structures that allow them to have high credit ratings.

CONCLUSION

The research was undertaken to fill a vital gap in the literature on finding the impact of credit rating on the core financials of top listed Indian companies. It was found that higher credit rating do improves the financial performance of the companies along with strengthening the balance sheet. The companies are very much concerned about their credit rating, since not only it directly affects the investment into the company, but also create a financial brand in financial markets for these companies.

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