Effects of Credit Rating on Equity Returns

Gorakanti Vinya
Dept of MBA(FINANCE)
JNTU, Anurag Group Of Institution

Abstract- *As capital has shifted from traditional bank lending to capital markets, the main target on Credit Rating Agencies (CRAs) and their assessments of credit risk has increased.*

Aside from growing number of rated issues the CRAs have also expanded the width of their coverage, In addition to the traditional long term debt issues the CRAs now a days are providing the rating to variety of debt instruments. Bond and equity markets has increasingly attracted the attention of market participants as they have link between them. This is all about how credit rating effects the equity returns. For identifying the features that has potential relevance that can links between indicators of credit risks and return patterns on equity markets, various aspects of the credit rating process are analyzed and interpreted with focus on the impact on equity investor. The study the abnormal share reaction associated with credit rating changes.

Keywords*:* Rating , Returns, Downgrades, Upgrades

I. INTRODUCTION

The markets are increasingly showing interest on the link between the credit rating and equity return. It shows credit rating as the indicator of credit risk on abnormal equity returns. Through investigation the announcement credit rating associated with changes in equity market return. Can be understand and observe that who announcement effects by relating them to various components of the rating process. The study announces that credit rating has impact on firms' share prices. The downgrades announcement of rating shows more impact on return than upgrades.

CREDIT RATING:

Credit ratings are predictions of potential credit losses due to failures of credit making payments, delay. The aim of a credit rating is to measure the long term default risk rather than short term fluctuations, payments or partial payments. A credit loss is defined because the difference between what the issuer has promised to pay and what's is actually received. Credit ratings measure total credit loss, including both the probability that an issuer will default also because expected severity of the loss.

EQUITY RETURNS*:*

Returns on equity is the ratio of net income that the business has earned during that particular year. It is used to measure the profitability of shareholders. It views net income as a percentage of shareholder equity. Equity return is calculated by dividing net income with shareholders equity.

ROLE OF CREDIT RATING ON EQUITY MARKET:

- The most common issue faced by the investors who publicly traded on bonds is the information asymmetric between the investors and issuer.
- CRAs may play a important role for the existence of public debt markets. CRAs are specialized in information gathering and access to non-public. CRAs facilitate the borrowers to get accessed to debt markets.
- Signaling is that function, which involves interpretation and provision of new information.
- Since it would not be efficient for individual investors to invest the required amount in reducing information asymmetric.
- CRAs have a certification role, which involves the formalization of a professional credit risk opinion. credit rating coverage is required by investors and regulators in order for issuers to achieve their confidence or approval.
- The participants on equity markets are concerned with the information associated with credit ratings.

TOP FIVE CREDIT RATING AGENCIES:

- Credit Rating Information Services Of India Limited-(CRISIL)
- Credit Analysis And Research System-(CARE)
- Investment Information And Credit Rating Agencies-(ICRA)
- Brick Work Risk-(BWR)
- Small And Medium Enterprise Rating Agencies-(SMERA)

OBJECTIVES:

- To analyze the effects of upgrades and down grades in mid capital companies.
- To analyze their performance of the stock of both mid capital and small capital.

NEED FOR THE STUDY:

To analyze the best companies among the selected companies and to know the future growth and returns of those companies in the market.

SCOPE OF STUDY:

The study deals with the effects on stock returns due to the credit rating. Our study is restricted to four companies with two different capital bearing companies. The companies are selected on random basis.

RESEARCH METHODOLOGY:

Data used in in research paper is secondary data collected from websites, books and fact sheets.

II. REVIEW OF LITERATURE

Pinches and Mingo (1975) made an attempt to analyze the impact of ratings on debt market and investors in US. The authors evaluated that the bond ratings had a direct impact on the debt market

Pogue and Soldofsky (1969)The authors found that the probability of getting higher rating was directly related to firm‟s size and profitability and it was inversely related to leverage and earning instability of the issuing firm.

EFFECTS OF CREDIT RATING ON THE MID CAPITAL COMPANIES:

UPGRADS OF MID CAPITAL COMPANIES

S NO	COMPANIES	EFFECTS			
		BEFORE THE EVENT		AFTER THE EVENT	
		RETURN	NUMBER OF DAYS	RETURN	NUMBER OF DAYS
1	STRELITE TECH	NEGATIVE	2	NEGATIVE	9
2	TRENT LTD.	NIL	0	NEGATIVE	16
3	TUBE INVESTMENTS	POSITIVE	11	POSITIVE	2
4	TVS MOTORS .LTD.	POSITIVE	9	POSITIVE	4

DOWNGRADES OF MID CAPITAL COMPANIES:

SNO	COMPANY	EFFECTS			
		BEFORE		AFTER	
		RETURNS	DAYS	RETURNS	DAYS
1	STRELITE TECHNO	NILL	0	POSITIVE	8
2	TRENT LTD	NEGATIVE	3	NEGATIVE	9
3	TUBE INVESTMENT INDIA	NEGATIVE	2	NEGATIVE	10
4	TVS MOTORS CO LTD	POSITIVE	10	POSITIVE	19

EFFECTS OF CREDIT RATING ON THE SMALL CAPITAL COMPANIES:

UPGRADES OF SMALL CAPITAL COMPANIES:

S NO		EFFECTS			
		BEFORE THE EVENT		AFTER THE	
	COMPANY NAME	RETURNS	NUMBER OF DAYS	RETURNS	NO OF DAYS
1	AEGIS LOGISTICS LTD	NILL	0	NEGATIVE	21
2	ALOK INDUSTRIES LTD.	POSITIVE	9	POSITIVE	20
3	DYNAMATIC TECHNOLOGIES LTD	NEGATIVE	1	NEGATIVE	20
4	INDO COUNT	NEGATIVE	2	NEGATIVE	10

DOWN GRADES OF SMALL CAPITAL COMPANIES :

SNO	COMPANY	EFFECTS			
		BEFORE THE EVENT		AFTER THE EVENT	
		RETURNS	NO OF DAYS	RETURNS	NO OF DAYS
1	AEGIS LOGISTICS LT	NEGATIVE	13	NEGATIVE	6
2	ALOK INDUSTRIES LTD	NIL	0	NEGATIVE	12
3	DYNAMATIC TECHNOLOGIES	NILL	0	POSITIVE	16
4	INDO COUNT	POSITIVE	5	POSITIVE	15

III. FINDINGS

- In case of the downgrades, most of the small cap companies are giving significant positive returns; this suggests that the stock is performing very well irrespective of the downgrade announcements and is giving higher returns than the expected returns.
- But this is not true in case of mid-cap companies. In mid-cap companies, downgrades are having an adverse negative impact on the stock returns.
- The stock returns are positive over the post-announcement period. This indicates that the shareholders

are very much sensitive to the rating changes and react in accordance to the rating changes thereby the actual returns fetched are lower due to decrease in the prices of the stock.

- In case of upgrades, the mid-cap companies' stocks are outperforming the market and are able to fetch higher returns after the upgrade than before.
- Whereas, the small capital companies are not able to give significant positive returns to the investors.

IV. CONCLUSION

Credit rating is an opinion about the credit standing of an issuer company and is helpful for all the investors (market participants), especially for the investors in decision making process. The study examined the impact of credit rating upgrades and downgrades and also studied the behavior of the investors, downgrade announcements are associated with negative abnormal share price reactions, whereas no systematic reaction is associated with upgrades. Rating updates driven by changes in profitability and companies market position are much pricing relevant than motivated by changes in capital structure. Official opinions on the rating update have less pricing impact. Based on these we identify several additional aspects of the credit rating process with implications for the impact on equity returns. These factors provide the foundation for a comprehensive analysis of the asymmetric reactions between upgrades and downgrades and also for the cross-sectional variations for both rating events.

REFERENCES

[1] https://shodhganga.inflibnet.ac.in/bitstream/10603/4466/11/11_chapter%202.pdf
[2] http://arc.hhs.se/download.aspx?MediumId=132
[3] https://www.researchgate.net/publication/331437065_IMPACT_OF_CREDIT_RATINGS_ON_STOCK_RETURNS
[4] https://economictimes.indiatimes.com/wealth/invest/why-credit-rating-downgrade-should-concern-you/articleshow/58974383.cms