Rating of loans by holding companies backed by pledge of shares

(Issued in June 2019)

Background

Investment holding companies (holdcos) investing in operating companies, monetise their holdings by availing loans against these investments. Loans against shares (LAS) are structure based transactions where shares held by the holdco are pledged in favour of the lender/trustee and entails a structure that places reliance on the security of the shares to ensure timely repayment as per the pre-defined terms. CARE Ratings suffixes "SO" (Structured Obligation) symbol to the rating of LAS to indicate that the rating is based on the pre-defined structure and is not based on the standalone credit profile of the issuer.

Peculiarities of LAS Transactions

The facility is granted/proposed on the principal basis of pledge of listed shares to the lender/trustee. This methodology will not be applied if the shares of an unlisted entity are pledged. The entities that avail LAS are mainly investment holding companies whose revenue streams are restricted to investment income in the form of dividend or profit on sale of shares. As such, these entities may not be in a position to repay their debt from operational cash flows and their repayment capacity and financial flexibility is assessed on the basis of the strength of the shares held by the holdcos. The value and effectiveness of the security can be judged from the performance of the pledged stock of the underlying company through its average daily volume traded, volatility and liquidity, security cover and the soundness of the legal structure together with the effectiveness of the structure of the LAS transaction as enumerated below :

<u>Trustee administered mechanism</u>

A LAS transaction is generally trustee administered to ensure adherence to the defined structure and monitoring of share price, to ensure top-up when required within the stipulated timelines or sale of pledged shares as defined in the structure.

<u>'T minus' mechanism</u>

The structure stipulates a particular number of days before the due date when the borrower has to arrange for cash to the extent of the total repayment obligation (including interest) and maintain the same in an account operated by the trustee. If the borrower fails to arrange for the required amount, the trustee will have the right to sell the shares pledged to meet the short-fall.

Share top-up or cash collateral

During the tenure of the loan, if the share price of the underlying company falls such that the stipulated security cover is breached, the trustee instructs the holdco to provide a cash collateral or pledge additional shares to maintain the stipulated security cover within a pre-defined time period, failing which, the trustee has the right to sell the shares pledged to arrive at the stipulated security cover. As such, CARE factors the sufficiency of unencumbered shares required for top-up, over and above the pledged shares, in its analysis. Also, if the issuer consistently maintains high level of liquid investments or cash, it is considered positively.

Further, the debt to be rated should be secured by first and exclusive pledge on the underlying shares. CARE would assign the rating based on the term sheet, information and clarification related to the transaction, as provided by the Issuer.

CARE's criteria on rating loans backed by shares of listed entities factors in assessment of the credit/liquidity enhancement provided to ensure credit/liquidity protection offered to investors*. *Some of the important features that help assess share performance include the following:

Collateral risk analysis

The collateral in these transactions are shares of one or more listed companies. The factors which influence the rating are security cover, tenure of instrument, promoter holding, beta of the stock, liquidation avenues and credit rating of the underlying company.

Security cover

Security cover is the market value of the pledged shares to the amount of debt to be rated. A high security cover is considered positively as it entails better cushion for repayment.

Liquidity risk

Liquidation horizon

Liquidation horizon is the number of days that would be required to liquidate the pledged shares to arrive at the total repayment obligation (including interest repayment) assuming average traded volume of the pledged shares. Though it is known that the share price of the investee company may witness a fall if the promoter share-holding reduces, this parameter gives a fair indication of the time that would be needed to sell the shares, if required. CARE generally considers only Group 1 shares (as defined by the National Stock Exchange) or Group A shares (as defined by the Bombay Stock Exchange) as security. Also, the underlying security in the form of shares should have been traded on all trading days (unless it is not traded on any of the days for technical reasons) for the past twelve months. If the shares of the underlying company are heavily traded, the entity will score well on the liquidity parameter.

Extent of unencumbered shares held by the promoter group

CARE Ratings evaluates the value of unencumbered shares held by the holdco apart from the pledged shares to be able to top-up in case of a fall in the share price of the underling company.

Market risk

Tenure

Share price movement over a long period may be very steep and hence longer the tenure of the debt to be rated, the more risky it is considered to be.

Beta

The movement in the share price of the underlying stock vis-à-vis the movement in the SENSEX over a period of time is evaluated to assess the volatility in value of the underlying security. A high beta to SENSEX will be considered to be more risky.

Price Earning (PE) multiple

The PE multiple of the underlying company based on the consolidated financial results for last four trailing quarters is compared with the PE multiple of the industry to which the company belongs to assess how the underlying company fares against the other players in the same industry with respect to the price of shares and earnings potential. A lower variation as compared to the industry PE is viewed positively.

Credit Rating of the underlying entity

The analysis for rating a LAS transaction *inter alia* factors in standalone rating of the debt of the company whose shares are pledged to incorporate the fundamental credit quality of the underlying company in the analysis. CARE generally considers only shares of entities whose debt is rated CARE A- (or equivalent rating from any other rating agency) or higher, as 'eligible' underlying securities.

The standalone rating of underlying company is critical as :

- Standalone rating of an entity takes into account a host of factors like the company's track record, resourcefulness, group strength, operational performance, financial risk profile and future outlook.
- If the underlying entity is a fundamentally strong operating company as determined by its credit rating, it is more likely to generate stable operating cash flows. A company with a sound business profile and good growth potential is expected to have a more resilient stock performance.
- Financial flexibility will be higher if the operating entity is strong from the credit perspective and has resourceful promoters

Further CARE believes that the performance of the underlying company will have a bearing on the price of equity shares affecting the value of shares under asset cover. Also, the rating of loans by holding companies by pledging shares of operating companies held by them, will generally be capped at the rating of the operating company whose shares are pledged or the lowest rating in the operating companies in case shares of multiple companies are pledged.

Additional factors to be considered

Legal risk analysis

CARE Ratings reviews the transaction documentation to determine whether the structure features are accurately captured in the document and takes a legal opinion on the enforceability of pledge, or any other matter as deemed necessary.

Trustee – The trustee monitoring the structure, should be of repute and acceptable to CARE.

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