

# Rating Methodology: Factoring Linkages in Ratings

(Parent-Subsidiary Link, Group Support, Government Support)

[In supersession of “CARE’s Rating Methodology: Factoring Linkages in Ratings (Parent-Subsidiary Link, Group Support, Government Support)” issued in [August 2018](#)]

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## Background

The credit risk assessment of a corporate entity begins by analysing the various risks (management, industry, business, financial, project risk) at a standalone level. While this would be adequate in many cases, there are situations where entities do not operate in complete isolation and exhibit “linkages” with other companies and corporate entities. These “linkages” often influence the credit profiles of individual entities and hence need to be analyzed while assigning ratings to individual entities. Such analysis is applied as a building block on top of the individual risk assessment and may result in a rating which is either notched up or down vis-à-vis the entity’s standalone rating. Further, there are situations which require taking a view on a group of related entities while arriving at individual entity ratings or joint ventures (JV) driven by JV partners. Apart from this, ratings of entities which are supported directly or indirectly by the state or central government need to address the linkage with the government. This paper aims to highlight the situations under which such linkages are analysed and the approach followed by CARE Ratings in each situation.

Broadly, CARE Ratings looks at these situations:

- where the companies are linked through a parent-subsidiary relationship
- linkages between JV partners and the JV while rating joint ventures
- a group of entities which collectively have management, business and financial linkages
- entities with direct or indirect support from the government

The analytical approach followed in these situations is highlighted below.

## 1. Addressing Parent-Subsidiary Link in Ratings

While assigning ratings to a corporate parent company or its individual subsidiaries, a standalone view may not give the complete picture due to the presence of linkages between the parent and its subsidiaries. The ratings of parent as well as subsidiaries are influenced by the individual credit profile as well as the nature and strength of these linkages. CARE Ratings examines these linkages and factors them while assigning ratings to the parent company as well as to the individual subsidiaries. The approach followed for rating a parent is highlighted below, followed by approach for rating of subsidiaries.

### 1.1. Rating of a Corporate Parent Company

A corporate parent company can be categorized as :

- i. Corporate parent company having substantial business operations  
[Often the flagship company of the group or the main company of a business vertical of the group]
- ii. Investment holding companies with no major business operations

#### ***i. Corporate parent company with substantial business operations***

Such companies are often the flagship companies of the group or the core company of a group in a specific industry segment. The corporate parent company is characterized by having a substantial portion of the group's business operations and often contributing to a large share of overall group's revenue, assets and profits. Over time, a company would expand its operations through organic or inorganic routes and would operate through various subsidiaries. The subsidiaries could be set up with various motives as highlighted below:

- Operating as a backward/forward integration to the parent
- An extension of the parent in different regions and geographies
- A trading/marketing arm for parent's products and services
- Related diversification
- Setup with legal or tax motivations

In such cases, a standalone view of the parent may not be sufficient to capture the risk presented by the subsidiaries. Hence, CARE Ratings takes a consolidated view of the parent and its subsidiaries while assigning rating to the parent company in such cases. An exception to this is when a subsidiary operates in a completely different business segment

than the parent or if a subsidiary is of the nature of a Special Purpose Vehicle which is ring-fenced from the parent. In such cases, CARE Ratings factors in the cash flow impact of likely support or investment to such subsidiaries by the parent.

In cases where the parent has explicitly spelt out / committed the extent of support (either through written communication or as indicated in the discussions with the management) it will be providing to its subsidiary, CARE Ratings will adopt a limited consolidation approach and the committed support in the form of forecasted equity investments or debt/advances to be provided to the subsidiary will be incorporated in analysis of the parent company.

**ii. Investment holding companies**

An investment holding company is a company whose majority of the assets are in the form of investments in equity, debt and loans & advances to group companies. Such holding companies typically do not have any operations of their own and their income is primarily in the form of dividends, interest and capital gains on their investment portfolio. The investments made by holding companies are generally of long-term nature. Such holding companies may raise debt for onward investment into group companies. The debt would be primarily raised on the back of the security of the value of investments held by the company. In such cases, a consolidated approach may not be suitable as the business profile of group companies may vary significantly. CARE Ratings thus evaluates holding companies on a standalone basis. CARE Ratings however factors the financial support expected to be provided to the subsidiaries in the form of further investments to fund growth/expansion plans of the subsidiaries or financial support in case the subsidiary is not in a position to meet its operational/capital requirements through its own cash flows. In the analysis of the investment holding companies, the expected sources of funding these investments and the possible impact on the capital structure of the holding company is assessed. CARE Ratings also looks at the quality of the investment portfolio held by the company and checks for impairment in value of these investments.

Apart from this, CARE Ratings also looks at the standalone leverage, debt to market value of investments, liquidity, financial flexibility, resource raising capacity and cash flow adequacy while assessing the credit risk of holding companies. Further the cushion of market value over book value vis-à-vis aggregate debt level is also looked into. To assess the resource raising capacity, CARE Ratings inter alia considers the share-holding pattern of the holding company. Resourceful promoters with a majority stake will be in a position to

support the holding company in a timely manner. However, if the shareholding of the holding company is fragmented without a clear majority, it would entail further analysis on commitment of the individual shareholders to support the holding company.

In the Financial Sector, holding companies may be in nature of a CIC (Core Investment Company) as defined by Reserve Bank of India (RBI), which may have various subsidiaries engaged in financial services business such as asset financing, mortgage financing, infra financing etc. CARE Ratings takes a consolidated view in such cases if the level of integration among them is very high. However, if the subsidiaries belong to diverse businesses, a consolidated approach will not be appropriate as it will not capture the nuances of each individual business. This is true for financial sector holding companies holding investments in infrastructure assets in the form of Special Purpose Vehicles (SPVs) which have ring-fenced cash flows. In such cases, CARE Ratings follows a standalone approach in the rating of the financial sector holding companies and also assesses the operational, managerial and financial support that the financial sector holding company/CIC provides to its group companies or subsidiaries. While the CIC can continue to fund group companies, any other company of the group resorting to group funding makes the group funding structure complex and would be viewed negatively.

### 1.2. Rating of a Subsidiary Company

While rating subsidiary companies, CARE Ratings assesses the standalone credit profile of the company and then adjusts the rating for the nature and strength of the linkages of the subsidiary with its parent company. The standalone rating of the subsidiary may be notched up or down depending on the credit strength of the parent. The extent of notching would depend upon the nature and strength of linkages between the parent and the subsidiary. Such linkages may take the form of:

- **Economic and strategic importance of the subsidiary to its parent**
  - Level of business integration and interdependence
  - Sharing of common name or a brand
  - Extent of shareholding of the parent
- **Parent's demonstrated track record of support provided to the subsidiary**
- **Cash-flow fungibility between parent and subsidiary**
  - Significant flow of funds between parent and subsidiary companies

- Foreign parent/subsidiary
- Regulatory restrictions on transfer of funds
- **Legal or moral obligation of the parent to support the subsidiary**
  - Guarantees, Letters of Comfort, undertakings, etc. given by the parent
  - Assessment of the parent’s ability to access capital markets in an event of default by the subsidiary
  - Apart from enforceability, willingness and intent of timely support is important
- **Subsidiary of a weak parent**

The above factors are elaborated below.

**a) Economic and strategic importance of the subsidiary to its parent**

The economic and strategic importance of a subsidiary to its parent is assessed by looking at the criticality of operations of the subsidiary for the parent and overall contribution to parent’s consolidated income and profits. A core subsidiary is defined as a company whose operations are **very critical** for the parent’s current and future business objectives. A core subsidiary in distress could severely impact the parent’s consolidated operations and hence, the parent would have a strong incentive to support such subsidiaries in times of distress.

At times, a subsidiary could use a common name or brand of its parent, or publicly highlight its parentage on its website and other corporate communications. Such a linkage provides strong incentive for the parent to support the subsidiary in distress in order to maintain the sanctity of its own brand or corporate identity. Presence of this linkage is considered favourable for notching up the standalone credit profile of the subsidiary.

The extent of shareholding of the parent in the subsidiary emphasizes the level of commitment of the parent in the business and the extent of control over the entity. The higher the shareholding, greater the parent’s commitment level and control over the operations of the subsidiary.

**b) Parent’s demonstrated track record of support provided to the subsidiary**

While the strategic importance of a subsidiary to its parent can be gauged by looking at the parameters highlighted above, the actual demonstrated track record of the parent extending support to the subsidiary in the past underlines the parent’s willingness to

extend support. Explicit financial support by way of infusion of equity, extending debt or loans & advances or operational support by way of relaxed credit period clearly highlights the parent's stance towards supporting its subsidiary.

### **c) Cash flow fungibility between parent and subsidiary**

When there are substantial transactions in the form of loans, advances, investments, sub-debt or flow of funds between parent and subsidiary companies for operations, the cash flows between them are considered to be fungible and it is assumed that the cash-flows of the parent and subsidiaries will be available to meet their financial obligations. Cash flow fungibility with a financially strong parent will be considered positively while rating the subsidiary and the standalone rating of the subsidiary will be appropriately notched up. On the other hand, cash flow fungibility may at times be difficult even with a wholly-owned subsidiary if the cash-flows of the subsidiary are ring-fenced in any manner. Cash flows of SPVs are generally seen to be ring-fenced by way of covenants in the loan documentation to safeguard the interest of the lenders and avoid flow of funds to parent. In these cases, the subsidiary will be assessed on a standalone basis.

Cash flow fungibility may also be restricted by regulations like in case of foreign subsidiaries/parent. Regulatory restrictions in any of the countries to which the group companies belong will render difficulties in a free flow of funds.

### **d) Legal or moral obligations of the parent to support the subsidiary**

The parent's commitment to the subsidiary is further strengthened if there is explicit support extended in the form of legally enforceable arrangements like corporate guarantees, put options etc. An unconditional and irrevocable corporate guarantee given by parent to the lenders of the subsidiary is treated as a strong credit enhancement and the rating of the subsidiary is equated to the rating of the parent. Further, the support can also be demonstrated through arrangements like put options, letters of comfort or cash-flow shortfall undertaking provided by the parent which entail a moral obligation on the parent. Presence of such arrangements further emphasizes the strength of parent-subsidiary linkage and the rating of the subsidiary is notched up appropriately depending on the extent of enforceability of the credit enhancement in the form of a put option or letter of comfort or other credit enhancement measures. The ratings in these cases are

suffixed with the symbol “SO” (Structured Obligation) which denotes comfort derived from an external credit enhancement to notch up the rating.

In case of a default by a subsidiary which was consolidated for the purposes of assessing the parent, the parent’s ability to raise capital and access the capital markets may get affected. In such cases the parent’s rating may be lowered to factor in the reduced financial flexibility.

**In all these cases, CARE Ratings notches up the rating of the subsidiary depending on the extent of linkage as explained above. If the linkages are assessed to be very strong due to strategic importance of the subsidiary to the parent, parent’s demonstrated track record to support the subsidiary, cash flow fungibility or legal or moral obligation of parent to support the subsidiary, the standalone rating of the subsidiary can be notched up by multiple notches, even upto the rating of the parent. It may also be noted that in case where the parent has explicitly spelt out (through written communication or as indicated in the discussion with the management of the parent), the extent of support it will be providing to its subsidiary, the notch up in the rating of the subsidiary will be restricted to the extent of the committed support.**

**e) Subsidiary of a weak parent**

In cases where the subsidiary has a stronger credit profile than the parent, there is a likelihood of drain of surplus cash flows from the subsidiary to the parent. Further, the parent may burden the subsidiary with more debt as its own ability to raise debt may be reduced. The weakness of the parent may eventually curtail the financial flexibility of the subsidiary itself. Such instances may require notching down the rating of the subsidiary from its standalone rating.

**f) Parent Subsidiary Linkages in Financial Sector**

In Financial Sector, especially in case of large groups, it has been observed that there is high level of integration between parent and various subsidiaries which are formed as per different regulations of RBI, NHB, and IRDAI etc. They also tend to share the common brand name and often have common treasury operations. Further, the implication of default by one subsidiary is assessed to be high on other group entities as well, hence in

such cases rating of parent & various subsidiaries may be same or tend to be close to each other.

## 2. Joint ventures (JV)

The base rating of a JV is conducted on a standalone basis and the extent of holding of each JV partner in the JV determines the extent of notch up in case of higher rated JV partners. CARE Ratings also applies the above factors viz. strategic importance of JV to a particular JV partner, JV partners' demonstrated track record of support, etc. and extent of control on the operations of the JV by individual JV partners, to determine the extent of notch up in the rating. However, CARE Ratings also takes into account the inherent limitations in the holding structure of the JV and possibility of conflicts between JV partners and restricts the extent of notch up in the rating.

## 3. Group Assessment in Ratings

Corporate structures can take various forms with cross holding of shareholding between entities of the same group, entities with significant business transactions with group concerns, entities in the same area of business and belonging to the same group but having different legal structures etc. Often, organized business groups carry out various businesses by floating separate companies with varied ownership structures. Such entities may derive benefit of the group's established brand name, management bandwidth and financial flexibility. While analyzing such companies belonging to an organized group, CARE Ratings begins with the standalone analysis of the entity and then applies notching based on the nature and strength of the linkages with the group. The linkages are similar to those highlighted in the parent-subsidary section and as given below.

- Economic and strategic importance of the entity to the business group
  - Level of business integration and interdependence among group entities
  - Sharing of common name or a brand
- Demonstrated track record of support provided to the entity by stronger entities in the group
- Cash flow fungibility between group entities
  - Significant flow of funds between the group entities
  - Foreign group companies
  - Regulatory restrictions on transfer of funds between the group entities
- Legal or moral obligations of the group to support the entity

- Extent of support provided by the entity to relatively weaker group entities

### **'Combined Approach' in assessing group entities**

Many small and mid-sized businesses are promoted by individuals or are family-owned. In such cases, the promoters could have floated a number of entities in similar lines of business driven by various motives. Such entities are often controlled by a single promoter group and the decision making is highly centralized. Such entities also exhibit high degree of cash flow fungibility. This necessitates the need to look at these entities on a combined basis.

In a 'Combined Approach', CARE evaluates the group of entities as if it were a single entity and combines the financials and business risk profiles of these entities to take a view on the ratings. For taking a combined approach, the entities should meet the following criteria.

- Closely held entities with significant ownership & control by a common promoter/promoter family
- Entities exhibit cash flow fungibility
- Entities operate in similar lines of business

In case of parent-subsidiary relationship, holding companies and entities not meeting the above criteria, the notching approach is employed where economic importance of the entity to the group, extent of support, sharing of brand name and other factors are considered for notching the standalone rating of the entity. The combined approach largely applies to promoter driven, family-owned, closely-held businesses where promoters float and control several entities in similar business lines. In a combined approach, CARE would typically assign the same rating to all the entities in the group. However, CARE may differentiate (within the same rating category) between individual entities based on their constitution, relative size, group contribution and financial profile relative to the overall group.

## **4. Factoring government support in ratings**

Public Sector Entities (PSEs) are owned by central or state governments and may receive support from the government depending upon their status, role and strategic importance. Rating of such entities begins with the standalone assessment and then notched up based on the nature of support expected to be received from the central or state government. The form of support could be explicit such as a guarantee or a budgetary support or implicit whereby the government provides

support in times of stress. The extent of support provided by the government to such entities would primarily depend on the following factors.

- Policy function served through the entity
- Strategic importance of the entity to the Centre/State
- Extent of ownership and control of the government
- A commercial entity, owned majorly by the government, would tend to operate largely independently and may face competition from private players in the segment. Such entities can be found in the manufacturing sector, and are assessed on the basis of other approaches like parent-subsidiary link or group assessment as the case may be. Such entities would exhibit lower integration with the government framework. For other PSEs, the rating approach would consider notching up of the standalone rating based on the nature and extent of the government support. Rating of entities which are of significant strategic importance to the state/centre is normally equated with the state rating or central government ('CARE AAA') rating.

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**HEAD OFFICE**

CARE Ratings Limited

(Formerly known as Credit Analysis & Research Ltd.)

4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022.

Tel: +91-22-6754 3456, Fax: +91-22- 6754 3457, E-mail: care@careratings.com

**REGIONAL OFFICE**

<p><b>AHMEDABAD</b> 32, Titanium, Prahaladnagar Corporate Road, Satellite, Ahmedabad - 380 015 Tel: +91-79-40265656 Fax: +91-79-40265657</p>	<p><b>KOLKATA</b> 3rd Floor, Prasad Chambers, (Shagun Mall Bldg.) 10A, Shakespeare Sarani, Kolkata - 700 071. Tel: +91-33- 40181600 / 02 Fax: +91-33-40181603</p>
<p><b>BENGALURU</b> Unit No. 1101-1102, 11th Floor, Prestige Meridian II, No. 30, M.G. Road, Bangalore - 560 001. Tel: +91-80-46625555 / 46625544 Fax: +91-80-41514599</p>	<p><b>JAIPUR</b> 304, Pashupati Akshat Heights, Plot No. D-91, Madho Singh Road, Near Collectorate Circle, Bani Park, Jaipur - 302 016. Tel: +91-141-402 0213 / 14</p>
<p><b>CHANDIGARH</b> SCF No. 54-55, First Floor, Phase 11, Sector 65, Mohali 160062. Tel No. +91-172 4904000</p>	<p><b>HYDERABAD</b> 401, Ashoka Scintilla, 3-6-502, Himayat Nagar, Hyderabad - 500 029. Tel: +91-40-69000500 - 522 Fax: +91-40-40020131</p>
<p><b>CHENNAI</b> Unit No. O-509/C, Spencer Plaza, 5th Floor, No. 769, Anna Salai, Chennai - 600 002. Tel: +91-44-2849 7812 / 2849 0811 Fax: +91-44-28490876</p>	<p><b>NEW DELHI</b> 13th Floor, E-1 Block, Videocon Tower, Jhandewalan Extension, New Delhi - 110 055. Tel: +91-11-4533 3200 Fax: +91-11-45333238</p>
<p><b>COIMBATORE</b> T-3, 3rd Floor, Manchester Square Puliakulam Road, Coimbatore - 641 037. Tel: +91-422-4332399 / 4502399</p>	<p><b>PUNE</b> 9th Floor, Pride Kumar Senate, Bhamburda, Senapati Bapat Road, Shivaji Nagar, Pune - 411 015. Tel: +91-20- 4000 9000</p>