# CARE Ratings' criteria on consolidation & combined approach

[Issued in February 2023]

**Background**

A company may undertake its business activities under a single entity or separate entities established as subsidiaries, associates or joint ventures (JV) or group entities on account of operational, legal, taxation or regulatory considerations. Such entities may be in a similar line of business having financial linkages with the parent or amongst each other; or may be involved in diverse businesses with limited or no business overlap or financial linkages. Furthermore, the strategic importance and the reputational significance of each entity within the group may also be different. The standalone business and financial profile provide useful insights of the various risks which an entity is exposed to; however, analysing standalone profile alone may not always be sufficient in cases where there are financial inter-linkages among group entities or when the businesses are closely inter-linked. This makes analysis of consolidated business and financial risks imperative for assessment of the credit risk profile of an entity. While the consolidated business profile provides an overview of the business strength of the overall group, which in turn drives the sustainability of the market position and thereby the stability in earnings and cash flows; the consolidated financials provide a holistic representation of the financial position of the parent and its subsidiaries as a single economic unit and considers both the financial resources available and the obligations of the group in totality.

This criteria paper outlines CARE Ratings Limited's (CARE Ratings') approach to assess an entity's credit risk profile on a consolidated basis while considering its linkages with its subsidiaries. This document also discusses situations wherein CARE Ratings takes a combined view of the entities without any *inter-se* shareholding linkages, but controlled by common promoters, depending on the extent of similarity in their businesses, and strength of financial linkages.

**Consolidation and aspects considered while rating the parent entity**

A corporate parent company can be categorised as:

1. 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].
2. Parent established as the holding company of subsidiaries operating in a similar line of business.
3. Investment holding companies with no major business operations.

**1. Corporate parent company with substantial business operations**

Such companies are often the flagship or the core company of a group in a specific industry segment. The corporate parent company generally has a substantial portion of the group's business operations and often contributes to a large share of overall group's revenue, profits and asset base. 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's business in different regions/ geographies
- A trading/marketing arm for the parent's products and services
- Diversification
- Legal or tax saving motives

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.

CARE Ratings takes a consolidated view of the parent and its subsidiaries in the following situations:

- the business of the subsidiary is strategically important to the business of the parent, eg, subsidiary is the marketing arm of the parent
- parent has control over the management and operations of the subsidiaries
- parent and subsidiaries have legal obligations with respect to each other's financial dues, eg, guarantee given by the parent to lenders of subsidiaries or cross guarantees between parent and subsidiaries
- parent has demonstrated financial support to the subsidiaries in the past
- parent has moral obligation towards the subsidiaries by having a shared name or same brand or common board
- current or expected movement of funds across entities through inter-corporate deposits, advances and loans, equity infusions, etc.

As such the extent and strength of linkages between the parent and subsidiaries determine whether there is a need for adopting a consolidated approach. CARE Ratings also examines restrictions if any, on the flow of funds between the parent and subsidiary due to reasons like foreign exchange regulations if the subsidiary or the parent is based outside India, restrictive covenants in loan documents, etc.
An exception to taking a consolidated approach would be 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.

**Consolidation of entities with non-controlling stake and strategic JVs**
There can be certain entities which are not linked to the parent by control or majority ownership and hence not consolidated as per the reported financials, but there could be an explicit credit support such as a guarantee or a shortfall undertaking, etc., extended for majority of the debt of such entities by parent or any of the other entities which have been consolidated as per reported financials. Besides, there could be entities which are not linked by ownership but there exist cross-default clauses in the loan terms of such entities with other entities which are consolidated. Furthermore, a parent may have certain associates or JVs, which are not consolidated line by line but only share of profit or loss and investments are considered in reported consolidated financials, but to whom the parent is expected to extend unhindered support for meeting their obligations. In all such situations, CARE Ratings makes suitable adjustments in the reported consolidated financials to duly factor in the impact of debt of such supported entities and likely financial support for debt servicing, capex, and loss funding if any.

**Limited consolidation or exceptions from full consolidation**
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) that it will provide to its group entities, 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 group entities will be incorporated in analysis of the parent company. Furthermore, CARE Ratings does not consolidate the group entities if it is not of strategic importance to the parent, or if it provides minimal economic incentive for the parent to provide support, or if the parent is insulated due to its stated posture of non-support and track record of non-support to such group entities, provided there are no legal obligations, such as guarantees extended by the parent. In such scenarios, the parent's credit risk profile is assessed independently without factoring in debt and losses of any of such related entity. However, the value of investments is assessed in a manner like any other equity investment, including testing the investment for any impairment in value.

**2. Parent established as holding company of subsidiaries operating in similar line of business**

Such companies typically do not have substantial business in their standalone operations but operate as a holding company of various subsidiaries operating in similar line of business. For example, a corporate house or promoter group may have different holding companies for its different business verticals with various subsidiaries operating separately under each such holding company. In such cases, CARE Ratings takes a consolidated approach after assessing the below aspects: -

- the business of the subsidiaries is strategically important to the parent, eg, different subsidiaries set up to execute parent's growth strategy in an industry or business.
- parent has control over the management and operations of the subsidiaries.
- parent has moral obligation towards the subsidiaries by having a shared name or same brand or common board.
- parent and subsidiaries have legal obligations with respect to each other's financial dues, eg, guarantee given by the parent to lenders of subsidiaries or cross guarantees between parent and subsidiaries.
- parent or individual subsidiaries have demonstrated financial support amongst them in the past.
- current or expected movement of funds across entities through inter-corporate deposits, advances and loans, equity infusions, etc.

**3. 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 operating in diverse/unrelated business activities or generally have non-controlling shareholding in such group companies. Such holding companies typically do not have any major operations of their own and their income is primarily in the form of dividends, interest and capital gains on their investment portfolio. These entities typically raise debt on the strength of their investments in operating companies to mobilise funds for further investments or extend loans and advances to other operating group companies and usually refinance the debts on maturity. For details on the rating of investment holding companies, please refer to the methodology on 'Rating of loans by investment holding companies' on CARE Ratings' website (www.careratings.com).

In the Financial Sector, holding companies may be in the nature of a Core Investment Company (CIC) as defined by Reserve Bank of India (RBI), which may have various subsidiaries engaged in the 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 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 providing additional support to the group entities makes the group funding structure complex and would be viewed negatively.

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

In many family-owned businesses or corporate groups, several entities are floated 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 centralised. 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 Ratings evaluates the group of entities as if it were a single entity and combines the financial and business risk profiles of these entities to take a view on the ratings.

CARE Ratings adopts a combined approach if the entities meet the following criteria:

- Closely-held entities with significant ownership and control and management by a common promoter/promoter family.
- Entities exhibit cash flow fungibility.
- Entities operate in similar or related (eg, forward or backward integration) lines of business.

A common management must exert control over the treasury operations of individual entities, thus ensuring a seamless flow of funds amongst them. In this regard, CARE Ratings shall rely on management articulations that entities would support each other in distress and will not operate in isolation.

CARE Ratings also takes a combined view in the entities where there exists cross guarantee clauses in loan documents, or the cash flows are comingled due to presence of structures in financing documents of entities operating in similar lines of businesses including infrastructure SPVs.

CARE Ratings does not adopt a combined approach if any of the entities in the group is a company whose shares are listed on any of the stock exchanges, however, combined approach shall be taken if there are cross guarantees extended by such listed entities, to the lenders. Furthermore, if the entities have restrictions imposed by financing documents on *inter-se* movement of funds or if the entities have otherwise not exhibited cash flow fungibility in the past (instances of one entity getting into financial stress while the other entity having surplus funds not supporting the former), then CARE Ratings does not take a combined approach and instead assess them on a standalone basis.

In a combined approach, CARE Ratings would typically assign the same rating to all the entities in the group. However, CARE Ratings may differentiate between the ratings of individual entities by upto two notches, based on their constitution, relative size, contribution to the group cash flow, strategic importance to the group, project risk and standalone financial profile relative to the overall group.

**[**For previous version please refer 'Rating Methodology - Consolidation & Combined Approach' issued in February - 2022**]**

**CARE Ratings Limited**

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

Phone : +91 - 22 - 6754 3456 | CIN: L67190MH1993PLC071691

Connect :

Locations: Ahmedabad | Andheri-Mumbai | Bengaluru | Chennai | Coimbatore | Hyderabad | Kolkata | New Delhi | Pune


**About:**

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