Rating Methodology: Consolidation and Factoring Linkages in Ratings

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

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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. Also, in cases where the corporate entity has invested in other businesses and the credit risk profiles of these entities are so intertwined that a standalone assessment of the entities does not reflect the true picture of the consolidated businesses, CARE Ratings applies a consolidated approach in ratings. We have in this paper covered the situations when CARE Ratings applies the consolidated approach. 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 the following aspects:

1. Consolidation and aspects considered while rating the parent entity
2. Notching up and extent of notch-up or notch-down while rating the subsidiary entity where the companies are linked through a parent-subsidiary relationship
3. Linkages between JV partners and the JV while rating joint ventures
4. A group of entities which collectively have management, business and financial linkages

5. Entities with direct or indirect support from the government

The analytical approach followed in these situations is highlighted below:

1. Consolidation and aspects considered while rating the parent entity

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.

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's business in different regions and geographies
- A trading/marketing arm for 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 following situations :

- the business of the subsidiary is strategically important to the business of the parent eg: subsidiary is marketing arm of 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 parent to lenders of subsidiaries or cross guarantees between parent and subsidiaries
- parent has demonstrated financial support to subsidiaries in the past
- parent has moral obligation towards the subsidiaries by having a shared name or same brand or common board

As such the extent of linkages between the parent and subsidiaries determine whether there is a need for adopting consolidated approach. 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 subsidiaries will be incorporated in analysis of the parent company.

However, in cases where a corporate parent has **subsidiaries in foreign countries**, CARE Ratings generally excludes the foreign subsidiaries from the consolidation and factors the amount of support to be provided to the subsidiaries separately in case the financial position of the subsidiaries is weak, as cash flow fungibility between the parent and subsidiaries may be restricted in these cases.

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. 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 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 providing additional support to the group entities makes the group funding structure complex and would be viewed negatively.

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 by 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. CARE Ratings takes a view on the strength of linkages by assessing the following factors:

- **Economic and strategic importance of the subsidiary to its parent**
  - Level of business integration and interdependence
  - Common business relationships or common lenders
  - Shared resources like marketing teams or finance functions
  - Extent of shareholding of the parent
  - Size of investment in subsidiary vis-à-vis overall size of operations of 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. Please refer to CARE Ratings' website (www.careratings.com) for the methodology on 'Rating Credit Enhanced Debt' for more details on this aspect.
  - Sharing of common name or brand
  - Common management or common board of directors
  - Reputation of listed parent linked with the subsidiary's market performance
  - Apart from enforceability, willingness and intent of timely support is important

The above factors are elaborated below :

a) <u>Economic and strategic importance of the subsidiary to its parent</u>

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. Business relationships with common set of suppliers, customers, contractors, lenders, etc. would also hint at strong business linkages between parent and subsidiaries. At times parent and subsidiaries share certain business functions like finance or marketing demonstrating strong linkages. Also, the investments made by a parent in the subsidiary are substantially high vis-à-vis its overall size of operations, the parent entity is expected to assign high strategic importance to the subsidiary and its operations. 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.

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. 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.

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 "CE" (Credit Enhancement) which denotes comfort derived from an external credit enhancement to notch up the rating. Further details about the approach on external credit enhancements can be accessed in CARE Ratings' methodology on 'Rating credit enhanced debt' on our website: www.careratings.com

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 or have a common board or management. It may also be possible that a subsidiary's performance in the financial markets may have an impact on the parent's market reputation, especially if the parent is a listed entity. 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.

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 up to the rating of the parent. In case the extent of linkage is assessed to be moderate, the rating of the subsidiary after notching up will be somewhere between the standalone rating of the subsidiary and 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.

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.

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.

3. 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, legal constitution of the joint venture, extent of control on the operations of the JV by individual JV partners, etc. 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.

4. 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-subsidiary 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
  - Common business relationships or common lenders
  - Shared resources like marketing teams or finance functions
  - Common share-holding
- 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
  - Cross guarantees between group entities
  - Sharing of common name or brand
  - Common management or common board of directors
- Extent of support provided by the entity to relatively weaker group entities

Group entities in Banking and Financial services sector

In case of Banking and financial services sector, different business verticals are operated through separate entities mainly due to regulatory reasons. However, the level of integration between these entities is usually quite high with them showing the attributes mentioned above Also, due to the high reputation risk involved, such entities are expected to support each other in times of need. As such, CARE Ratings aligns the ratings of these entities close to each other.

'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. CARE 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. CARE adopts a combined approach if the entities 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 between individual entities ratings by upto two notches, based on their constitution, relative size, contribution to the group cash flow, strategic importance to the group and financial profile relative to the overall group.

5. 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 centre may be equated with the central government ('CARE AAA') rating.

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