CARE Ratings' Criteria on Consolidation & Combined Approach

CareEdge RATINGS

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Background

A company may undertake its business activities under a single entity or under 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. Further, the strategic importance and the reputational significance of each entity within the group may also be different. The standalone business and financial risk profile provides useful insights on the various risks which an entity is exposed to. However, analysing the standalone profile alone may not always be sufficient in cases where there are financial interlinkages among the group entities or when the businesses are closely interlinked. This makes the analysis of consolidated business and financial risks imperative for assessment of the credit risk profile of an entity. The consolidated business risk 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 for assessing an entity's credit risk profile on a consolidated basis while considering its linkages with its subsidiaries / JVs / associates. 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 upon the extent of similarity in their businesses, and the strength of financial linkages.

Consolidation and aspects considered while rating the parent entity

A corporate parent entity can be categorised as:

1. Corporate parent entity having substantial business operations [often the flagship entity of the group or the main entity of a business vertical of the group].
2. Parent established as a holding company of the subsidiaries operating in a similar line of business.
3. Investment holding companies with no major business operations.

1. Corporate parent entity with substantial business operations

Such entities are often the flagship or the core entity of a group in a specific industry segment. The corporate parent entity generally has a substantial portion of the group's business operations and often contributes to a large share of the overall group's revenue, profits and asset base. Over time, an entity 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 / expansion
- Legal or tax saving motives

- Regulatory requirement

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 the rating to the parent entity 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, e.g., the subsidiary is the marketing arm of the parent,
- the parent has control over the management and operations of the subsidiaries,
- the parent and the subsidiaries have legal obligations with respect to each other's financial dues, e.g., corporate guarantee given by the parent to the lenders of the subsidiaries or cross guarantees between the parent and the subsidiaries,
- the parent has demonstrated financial support to the subsidiaries in the past,
- the 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 the entities through inter-corporate deposits, advances and loans, equity infusions, etc.

As such the extent and the strength of the linkages between the parent and the 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 the foreign exchange regulations, if the subsidiary or the parent is based outside India, restrictive covenants in the 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 (SPV), which is ring-fenced from the parent. In such cases, CARE Ratings assesses the parent based on standalone profile and factors in the cash flow impact of the likely support or investment to such subsidiaries by the parent.

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

Consolidation in case of other group entities

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 adopts a limited consolidation approach, and the committed support in the form of equity investments or debt / advances to be provided to the group entities are incorporated in the analysis of the parent entity. Further, CARE Ratings does not consolidate a group entity if its cash flows are ring-fenced or if it

operates in a different sector (e.g., a financial sector subsidiary of a parent who is into manufacturing business) or 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/or track record of non-support to such group entity, provided that there are no legal obligations, such as corporate guarantees extended by the parent. In such scenarios, the parent's credit risk profile is assessed independently without factoring in the debt and the 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 the value. Also, the cash flow impact of the likely support or investment to such subsidiaries by the parent is considered while rating the parent.

2. **Parent established as a holding company of the subsidiaries operating in a similar line of business**
Such entities typically do not have substantial business in their standalone operations but operate as a holding company of various subsidiaries operating in a 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, e.g., different subsidiaries set-up to execute the parent's growth strategy in an industry or business,
- the parent has control over the management and operations of the subsidiaries,
- the parent has moral obligation towards the subsidiaries by having a shared name or same brand or common board,
- the parent and the subsidiaries have legal obligations with respect to each other's financial dues, e.g., corporate guarantee given by the parent to the lenders of the subsidiaries or cross guarantees between the parent and the subsidiaries,
- the parent or the individual subsidiaries have demonstrated financial support amongst them in the past,
- current or expected movement of funds across the entities through inter-corporate deposits, advances and loans, equity infusions, etc.

3. **Investment holding companies**
An investment holding company is an entity whose majority of the assets are in the form of investments in equity, debt and loans & advances to the group entities operating in diverse / unrelated business activities or generally have non-controlling shareholding in such group entities. 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 entities to mobilise funds for further investments or extend loans & advances to other operating group entities and usually refinance the debt on maturity. For details on the rating of investment holding companies, please refer to the 'CARE Ratings' Criteria on Rating of Investment Holding Companies' Debt' 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 the 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, then 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 entities or subsidiaries.

While the CIC can continue to fund the group entities, any other entity 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 a 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 rating.

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 (e.g., forward or backward integration) lines of business.

A common management must exert control over the treasury operations of the individual entities, thus ensuring a seamless flow of funds amongst them. In this regard, CARE Ratings shall rely on the 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 exist cross guarantees in the loan documents, or the cash flows are comingled due to presence of structures in financing documents of the 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 may be taken if there are cross guarantees extended by such listed entities to the lenders. Further, if the entities have restrictions imposed by the financing documents on the 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 rating of individual entities by up to two notches, based on their constitution, relative size, contribution to the group's present and future cash flow, strategic importance to the group, project risk and the standalone financial risk profile relative to the overall group.

Disclosure of extent of consolidation and rationale for consolidation

In cases where the credit risk assessment is done based on consolidated / combined approach, CARE Ratings discloses the extent of consolidation (full, proportionate or moderate) and rationale for consolidation in line with the extant regulations of the Securities and Exchange Board of India (SEBI). The extent of consolidation is generally 'full' / 'proportionate' in case of line-by-line consolidation of the entities, depending upon the control / ownership structure. However, the extent of consolidation is generally 'moderate' in case of consolidation by 'equity method' of accounting and in cases where the debt and support to other group entities is factored in the analysis of the parent.

[For the previous version, please refer to 'CARE Ratings' Criteria on Consolidation & Combined Approach' issued in February 2023]

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