

Background

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, CareEdge Africa (CRAF) applies a consolidated approach in the ratings. In this paper, we have covered situations when CRAF applies the consolidated approach or combined approach in the ratings.

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. CRAF 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 in this methodology.

A corporate parent company can be categorized 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. Investment holding companies with no major business operations

i. Corporate parent company with substantial business operations

Such companies are often the flagship of the group 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, 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 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, CRAF takes a consolidated view of the parent and its subsidiaries while assigning rating to the parent company in such cases.

CRAF 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 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

As such the extent of linkages between the parent and subsidiaries determine whether there is a need for adopting consolidated approach. CRAF 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 is based outside Mauritius, 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, CRAF 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) that it will provide to its subsidiary, CRAF 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.

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 CRAF website (www.careratingsafrica.com).

The holding companies may have various subsidiaries engaged in the financial services business such as asset financing, mortgage financing, infra financing, etc. CRAF 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, CRAF 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 provides to its group companies or subsidiaries. While the holding company 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, the promoters float 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', CRAF 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. CRAF 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.

CRAF 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 or related (eg, forward or backward integration) lines of business

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, CRAF would typically assign the same rating to all the entities in the group. However, CRAF 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 and financial profile relative to the overall group.

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CRAF (AFRICA) PRIVATE LIMITED

Corporate Office: 5th FLOOR, MTML SQUARE, 63, CYBER CITY, EBENE MAURITIUS

CIN: 127054 | BRN: C14127054 | FSC License No.: CR14000001

Connect:



Locations: Ebene

Saurav Chatterjee

Director & Chief Executive Officer



+ 230 5862 6551

+ 230 5955 3060

Vidhyasagar Lingesan, CFA, FRM

Chief Rating Officer



+ 230 5273 1406

+ 230 5955 3060

Naveen Kumar Dhondy

Rating Head



+ 230 5955 3060

About:

CareEdge is a knowledge-based analytical group that aims to provide superior insights based on technology, data analytics and CRAF (Africa) Private Limited (CRAF) is the first credit rating agency to be licensed by the Financial Services Commission of Mauritius in May 2015. It is also recognized by Bank of Mauritius as External Credit Assessment Institution (ECAI) from May 2016. CRAF is also licensed by Capital Markets Authority of Kenya to operate as a Credit Rating Agency in Kenya. CRAF intends to expand across other geographies in Africa with Mauritius as its hub of operations. With an equitable position in the Mauritius capital market, CRAF (Africa) Private Limited provides a wide array of credit rating services that help corporates to raise capital and enable investors to make informed decisions backed by knowledge and assessment provided by the company.

CRAF's shareholders are CRAF Limited, African Development Bank, MCB Equity Fund and SBM (NFC) Holdings Limited.

CRAF gets its technical support in the areas such as rating systems and procedures, methodologies, etc. from CRAF Limited on an ongoing basis. CRAF Limited, with an established track record of rating companies over almost three decades, follows a robust and transparent rating process that leverages its domain and analytical expertise backed by the methodologies congruent with the international best practices.

CRAF's Rating Committee consist of full-time members comprising of Senior Rating officials from CRAF Limited and a panel of experienced professionals from Mauritius and African Development Bank.

CRAF has had a pivotal role to play in developing bank debt and capital market instruments including MMIs, corporate bonds and structured credit.

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