

Ratings Methodology – Notching by factoring linkages in Ratings

(Parent Subsidiary linkages, Group linkages and Joint ventures)



Background

The credit risk assessment of a corporate entity begins by analysing the various risks (management, industry, business, financial and 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 group companies and corporate entities. These “linkages” often influence the credit profiles of individual entities and hence need to be analysed while assigning ratings to individual entities. This 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.

Furthermore, 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. This paper aims to highlight the situations under which such linkages are analysed, and the approach followed by CareEdge Africa (CRAF) in each situation.

Broadly, the following aspects are covered in this methodology:

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

1. Rating of a subsidiary

While rating subsidiaries, CRAF 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. CRAF takes a view on the strength of linkages by assessing the following factors:

- **Economic and strategic importance of the subsidiary to its parent**
 - Extent of shareholding of the parent
 - Level of business integration and interdependence
 - Common business relationships or common lenders
 - Shared resources like marketing teams or finance functions
 - 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
 - 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 CRAF' website (www.careratingsafrica.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) 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 the 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. Subsidiaries may also be formed as backward or forward linkages as raw material suppliers or marketing arms. At times, parent and subsidiaries share certain business functions like finance or marketing demonstrating strong linkages. Also, if 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.

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 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 works on the principle of credit substitution and the rating of the subsidiary is equated to the rating of the parent. Furthermore, 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 CRAF' methodology on 'Rating credit enhanced debt' on our website: www.careratingsafrica.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. The linkage would act as deterrence to the parent to let the subsidiary falter on its obligations. Presence of this linkage is considered favourable for notching up the standalone credit profile of the subsidiary.

Extent of notch-up

In all these cases, CRAF 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, the parent's demonstrated track record to support the subsidiary, cash flow fungibility or legal or moral obligation of the 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 belongs to a weak parent, there is a likelihood of drain of surplus cash flows from the subsidiary to the parent. This could be in the form of operational support like elongated credit period or differentiated pricing. Furthermore, the parent may burden the subsidiary with more debt as its own ability to raise debt may be lower. The subsidiary may also upstream funds to parent by way of high dividend. The weakness of the parent may eventually curtail the financial flexibility of the subsidiary. Such instances may require notching down the rating of the subsidiary from its standalone rating. The extent of notch-down will also be based upon the extent of linkages between the parent and subsidiary. The following factors will determine the extent of notch down:

- Extent of the control the parent has on the subsidiary – If the weak parent has significant control over the subsidiary, it will be easier for the parent to influence the operations of the subsidiary, and it may be in a position to extract higher benefits from the subsidiary, and the extent of notch down may be higher in such cases.
- Track record of support provided to weak parent – If there has been persistent support provided by the subsidiary to the weak parent in the past, the rating of the subsidiary will be notched down appropriately.
- Legal or moral obligation – If the subsidiary has provided any explicit support to the weak parent by way of guarantee/letter of comfort/undertakings, etc., the subsidiary will have a legal/moral obligation to meet the parent's obligations, and this will be factored negatively in the subsidiary's 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 the Central banks, Capital market Regulators, Insurance Regulatory bodies, etc,. They also tend to share the common brand name and often have common treasury operations. Furthermore, 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. CRAF 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, CRAF 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, CRAF 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
 - 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
 - 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 companies operating in the Banking and Financial services sector, typically, 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, CRAF aligns the ratings of these entities close to each other.

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