

Background

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 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. This paper highlights the approach used by CARE Ratings South Africa (Pty) Limited to assess the debt raised by such type of holding companies with and without pledging of their investments.

1. Debt raised by holding companies (without pledge of investments)

The investments made by holding companies in the group/operating companies are generally of long-term nature. The debt raised by investment holding companies would be primarily backed by the value of investments held by the company. In such cases, a consolidated approach may not be suitable as the business profile of investee/operating companies of the group may vary significantly. CARE SA thus evaluates investment holding companies on a standalone basis. CARE SA, however, factors the financial support provided/expected to be provided to the group entities in the form of investments or loans to be extended to fund growth/expansion plans of such group entities or financial support in case the group entities is not in a position to meet its operational/capex/debt servicing requirements through its own cash flows. In the analysis of the investment holding companies, the expected sources of funding these investments and the possible impact on the financial profile of the holding company are assessed. CARE SA also looks at the quality of the investment portfolio held by the company with respect to the credit risk profiles of the investee entities and also checks for impairment in value of these investments.

Apart from this, CARE SA also looks at the standalone leverage, debt-to-market value of investments, unencumbered investments, liquidity, financial flexibility, resource raising capacity and cash flow adequacy while assessing the credit risk of holding companies. For this purpose, CARE SA also considers the off-balance sheet exposures such corporate guarantees extended by the holding company while assessing its leverage and debt-related aspects. Furthermore, the cushion of market value over book value vis-à-vis aggregate debt level is also looked into. While assessing the cushion available to raise debt against unencumbered investments, CARE SA duly considers that a holding company may not be inclined to encumber all the shares it holds in operating companies, even if those shares might be eligible to be encumbered technically. In this regard, holding company's management articulation about future borrowing plans and its investment and financial policy are assessed by CARE SA. Also, to safeguard from inconsistencies in maintaining liquidity, given the trade-off between returns and liquidity, the overall liquidity assessment is done in the context of the company and management's policy towards maintaining adequate liquidity. To assess the resource raising capacity, CARE SA inter alia considers the share-holding pattern of the holding company. Resourceful promoters with a majority stake will be in a better position to support the holding company in a timely manner. 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.

2. Debt raised by holding companies backed by pledge of shares

Investment holding companies monetise their holdings in operating companies by availing debt against these investments. Loans against shares (LAS) are structure-based transactions wherein shares held by the holding company are pledged in favour of the lender/trustee with a structure that places reliance on the security of the underlying shares to ensure timely repayment as per the pre-defined terms. For debt securities such as non-convertible debentures, bonds and other capital market instruments, CARE SA suffixes "SO" (Structured Obligation) symbol to the rating of LAS to indicate that the rating is based on such pre-defined support structure and is not based on the standalone credit profile of the issuer. However, CARE SA does not assign "SO ratings" for bank facilities/commercial papers/fixed deposits backed by such support structures. Please refer CARE SAs' website (www.careedgesouthafrica.com) for the methodology on 'Rating Credit Enhanced Debt' for more details on this aspect.

Peculiarities of LAS Transactions

The facility is granted/proposed on the principal basis of pledge of listed shares to the lender/trustee. This methodology will not be applied if the shares of an unlisted entity are pledged. The entities that avail LAS are mainly investment holding companies whose revenue streams are restricted to investment income in the form of dividend or profit on sale of shares. As such, these entities may not be in a position to repay their debt from operational cash flows and their repayment capacity and financial flexibility is assessed on the basis of the strength of the shares held by the holdcos. The value and effectiveness of the security can be judged from the performance of the pledged stock of the underlying company through its average daily volume traded, volatility and liquidity, security cover and the soundness of the legal structure together with the effectiveness of the structure of the LAS transaction as enumerated below:

- Lender/Trustee-administered mechanism
An LAS transaction is generally administered by trustee or lender to ensure adherence to the defined structure and monitoring of share price, to ensure top-up when required within the stipulated timelines or sale of pledged shares as defined in the structure.
- 'T minus' payment mechanism
The structure stipulates a particular number of days before the due date when the borrower has to arrange for cash to the extent of the total repayment obligation (including interest) and maintain the same in an account operated by the lender/trustee. If the borrower fails to arrange for the required amount, the lender/trustee will have the right to sell the shares pledged to meet the shortfall.
- Share top-up or cash collateral
During the tenure of the loan, if the share price of the underlying company falls such that the stipulated security cover is breached, the trustee instructs the borrower to provide a cash collateral or pledge additional shares to maintain the stipulated security cover within a pre-defined time period, failing which, the trustee has the right to sell the shares pledged to arrive at the stipulated security cover. As such, CARE SA factors the sufficiency of unencumbered shares required for top-up, over and above the pledged shares, in its analysis.

Furthermore, the debt to be rated should be secured by first and exclusive pledge on the underlying shares. CARE SA would assign the rating based on the term sheet, information and clarification related to the transaction, as provided by the Issuer.

CARE SA's criteria on rating loans backed by shares of listed entities factors in assessment of the credit/liquidity enhancement provided, to ensure credit/liquidity protection offered to the investors. Some of the important features that enable the assessment of share performance include the following:

- **Collateral risk analysis**

The collateral in these transactions are shares of one or more listed companies. The factors which influence the rating are security cover, tenure of instrument, promoter holding, beta of the stock, liquidation avenues and credit rating of the underlying company.

- **Security cover**

Security cover is the market value of the pledged shares to the amount of debt to be rated. A high security cover is considered positively as it entails better cushion for repayment. Besides this, pledge of a diversified set of stocks is seen positively as it reduces unsystematic risks unique to a specific company or industry.

- **Liquidity risk**

Liquidation horizon is the number of days that would be required to liquidate the pledged shares to arrive at the total repayment obligation (including interest repayment) assuming average traded volume of the pledged shares. Though it is known that the share price of the investee company may witness a fall if the promoter share-holding reduces, this parameter gives a fair indication of the time that would be needed to sell the shares, if required. CARE SA generally considers Main Board Prime Segment (as defined by FTSE/JSE) as security. Also, the underlying security in the form of shares should have been traded on all trading days (unless it is not traded on any of the days for technical reasons) for the past 12 months. If the shares of the underlying company are heavily traded, the entity will score well on the liquidity parameter. CARE SA evaluates the value of unencumbered shares held by the holdco apart from the pledged shares to be able to top-up in case of a fall in the share price of the underlying company.

- **Valuation and market risk**

Share price movement over a long period may be very steep; and hence, longer the tenure of the debt to be rated, the riskier it is considered to be. The movement in the share price of the underlying stock vis-à-vis the movement in the FTSE/JSE over a period of time is evaluated to assess the volatility in value of the underlying security. A high beta to FTSE/JSE will be considered to be riskier. The PE multiple of the underlying company based on the consolidated financial results for last four trailing quarters is compared with the PE multiple of the industry to which the company belongs to assess how the underlying company fares against the other players in the same industry with respect to the price of shares and earnings potential. A lower variation as compared to the industry PE is viewed positively.

- **Credit rating of the underlying entity**

The analysis for rating an LAS transaction inter alia factors in standalone rating of the debt of the company whose shares are pledged to incorporate the fundamental credit quality of the underlying company in the analysis.

The standalone rating of underlying company is critical as:

- Standalone rating of an entity takes into account a host of factors like the company's track record, resourcefulness, group strength, operational performance, financial risk profile and future outlook
- If the underlying entity is a fundamentally strong operating company as determined by its credit rating, it is more likely to generate stable operating cash flows. A company with a sound business profile and good growth potential is expected to have a more resilient stock price performance.
- Financial flexibility will be higher if the operating entity is strong from the credit perspective and has resourceful promoters.

Furthermore, CARE SA believes that the performance of the underlying company will have a bearing on the price of equity shares affecting the value of shares under asset cover. Also, the rating of loans by holding companies by pledging shares of operating companies held by them will generally be capped at the rating of the operating company whose shares are pledged or the lowest rating in the operating companies in case shares of multiple companies are pledged.

- **Legal risk analysis**

CARE SA reviews the transaction documentation to determine whether the structure features are accurately captured in the document and takes a legal opinion on the enforceability of pledge, right to sell shares or any other matter as deemed necessary.

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