CARE SA's Criteria on Notching by Factoring Linkages in Ratings

(Parent-Subsidiary Linkages, Group Linkages, Joint Ventures and Private Equity)

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Background

The credit risk assessment of an entity begins with analysing the various risks (management, industry, business, financial and project risk) at the standalone level. While this would be adequate in many cases, there are situations wherein entities do not operate in complete isolation and exhibit 'linkages' with other group 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 the top of the standalone risk assessment and may result in a rating which is either notched-up or down vis-à-vis the entity's rating based on its standalone risk assessment.

Moreover, there are situations which require taking a view on a group of related entities while arriving at an individual entity's rating or joint ventures (JV) driven by JV partners or entities which are held by private equity (PE) funds. This paper aims to highlight the situations under which such linkages are analysed, and the approach followed by CARE Ratings South Africa (Pty) Limited (CARE SA) in each situation for non-government entities. For entities controlled by central or state governments, please refer to CARE SA criteria on Notching by Factoring Linkages with Government on www.careedgesouthafrica.com.

It may be noted that a parent entity is generally rated on a consolidated basis depending upon the extent and strength of linkages between the parent and subsidiaries, unless 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 SA factors in the cash flow impact of the likely support or investment to such subsidiary by the parent, while rating the parent entity.

This methodology covers below aspects on notching the rating(s) by factoring linkages:

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

1. Rating of a subsidiary

CARE SA while rating subsidiaries / step-down subsidiaries, assesses the standalone credit profile of the subsidiary and then adjusts the rating for the nature and strength of the linkages of the subsidiary with its parent entity / ultimate parent entity, as the case may be. The standalone rating of the subsidiary may be notched-up depending upon the credit profile of the parent. The extent of notching-up would depend upon the nature and strength of the linkages between the parent and the subsidiary. CARE SA takes a view on the strength of the 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
    - Shared resources like marketing teams or finance / treasury functions or common lenders
    - Size of the current and future capacities, revenues, and profits of the subsidiary vis-à-vis that of the parent
    - Size of the investment in the subsidiary vis-à-vis overall size of the parent's net-worth

- **Parent's demonstrated track record of support provided to the subsidiary**

- **Cash flow fungibility between the parent and the subsidiary**
    - Significant flow of funds between the parent and the 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 to the subsidiary or cross guarantees between the entities.
    - Sharing of common name or brand
    - Common management or common Board of Directors
    - Reputation of a listed parent linked with the subsidiary's performance
    - Apart from enforceability and ability, 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 of the subsidiary's income and profit to the parent's consolidated income and profits. Business relationships with common set of suppliers, customers, contractors, etc., would also hint at strong business linkages between the parent and the subsidiaries. The subsidiaries may also be formed for backward or forward integration as raw material suppliers or marketing arms. At times, the parent and the subsidiaries also share certain business functions like finance / treasury or marketing or there are common lenders, which demonstrate strong linkages. Also, if the investments made by a parent in the subsidiary are substantially high vis- à-vis its net-worth, the parent entity is expected to assign high strategic importance to the subsidiary and its operations. A core subsidiary is defined as an entity whose operations are very critical for the parent's current and future business objectives. A core subsidiary could severely impact the parent's consolidated operations in times of distress, and hence, the parent would have a strong incentive to support such subsidiaries in times of distress. Similarly, a parent will be more likely to provide support to a profitable subsidiary which would be in temporary distress rather than supporting a loss-making or structurally unviable subsidiary, due to absence of economic incentive.

The extent of shareholding of the parent in the subsidiary emphasises the level of commitment and the extent of control of the parent over the subsidiary. The higher the shareholding, greater would be 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 signifies the parent's willingness to extend support. Track record of extending financial support by way of infusion of equity, extending debt or loans and 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 the parent and the subsidiary

When there are substantial transactions in the form of loans, advances, investments, sub-debt or flow of funds between the parent and the subsidiary entities , the cash flows between them are considered to be fungible and it is assumed that the cash flows of the parent and the 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 thus, the standalone rating of the subsidiary will be appropriately notched up.

Cash flow fungibility may, however, be restricted by the regulations in case of foreign subsidiaries / parent. Regulatory restrictions in any of the countries to which the entities belong will render difficulties for free flow of funds.

d) Legal or moral obligation of the parent to support the subsidiary

An unconditional and irrevocable guarantee with a structured payment mechanism given by the parent to the lenders of the entity works on the principle of credit substitution and the rating of the PSE is equated to the rating of the parent. The ratings in these cases are suffixed with the symbol 'CE' (Credit Enhancement) which denotes comfort derived from an explicit external credit enhancement. Further details about the approach on external credit enhancements can be accessed from CARE SA methodology on 'Rating Credit Enhanced Debt' on www.careedgesouthafrica.com.

The parent's commitment to the subsidiary is further strengthened if there is an explicit support extended in the form of legally enforceable arrangements like corporate guarantees, put options, letters of comfort or cash flow shortfall undertaking etc. provided by the parent. Also, there could be presence of cross-default clauses in the loan agreements of the parent, which entails a moral obligation on the parent. Presence of such arrangements further emphasize the strength of the parent-subsidiary linkage, and the rating of the subsidiary is notched-up appropriately depending upon the extent of enforceability of such credit enhancements. Nevertheless, presence of an explicit support as stated above is not a pre-requisite for notching-up the ratings of subsidiaries, if there is an intent on the part of the parent to provide timely need-based distress support to the subsidiary.

At times, a subsidiary could use a common name, logo, brand or email domain of its parent, or publicly highlights its parentage on its website and other corporate communications or has a common board or management as that of the parent. It may also be possible that a subsidiary's performance may have an impact on the parent's market reputation, especially if the parent is a listed entity or is an unlisted public limited company or a private limited company regularly raising funds from the capital markets.

Such a linkage puts a strong moral obligation on 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 a deterrent for the parent to let the subsidiary falter on its debt obligations. Presence of this linkage is considered favourable for notching-up the standalone credit profile of the subsidiary.

Extent of notch-up

CARE SA notches-up the rating of the subsidiary depending upon the extent and strength of the linkages 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 of support to 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, and may also be equated with the the rating of the parent. In case the extent of the linkages are 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 extent of notch- up in the rating of the subsidiary will be restricted to the extent of the committed support. When the rating of the subsidiary is notched-up for parent support, the parent rating is arrived at after factoring-in the extent of such support on the cash flows of the parent.

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 or loans and advances Moreover, 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 the parent by way of high dividend. Thus, 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 such notch-down will also be based upon the extent of linkages between the parent and the subsidiary. The following factors will determine the extent of notch-down:

- Extent of 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 thus, the extent of notch-down may be higher in such cases.

- Track record of support provided to the weak parent – If there has been a 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.

In such scenarios, the rating of the subsidiary would generally be capped to that of the parent. However, if the cash flows of the subsidiary are ring-fenced in any manner by way of covenants in the loan documentation to safeguard the interest of the lenders and avoid flow of funds to the parent, the subsidiary will be assessed on a standalone basis. The rating of such subsidiary may even be higher than that of the parent and may not be capped to the rating of the parent. Also, in such situations, the rating of the parent will not draw any comfort from the rating of the subsidiary.

Parent Subsidiary Linkages in the Banking and Financial Services Sector

In the Banking and Financial Services Sector, especially in case of large groups, it has been observed that there is a high level of integration between the 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 a common brand name and often have common treasury operations. Moreover, the implication of default by one subsidiary is assessed to be high on other group entities as well. Hence in such cases, due to presence of high moral obligation, the rating of the parent and various subsidiaries may be the same or tend to be close to each other.

2. Entities held by PE funds

The base rating of an entity held by a PE fund is generally arrived at on a standalone basis. However, CARE SA may notch-up the rating of such entity due to presence of a PE fund if the PE fund directly / indirectly holds majority stake in the entity and if the PE fund has a long-term investment horizon in the rated entity. Such notch-up is applied only if there has been a demonstrated track record of the PE fund supporting the investee entities and there is a clear articulation (either through written communication or as indicated in the discussion) to provide distress support to the rated entity.

3. Group assessment in ratings

Corporate structures can take various forms with cross holding of shareholding between the entities of the same group, entities with significant business transactions with the group concerns, and entities belonging to the same group but having different legal structures, etc. Organised business groups often carry out various businesses by floating separate entities with varied ownership structures. Such entities may derive benefit of the group's established brand name, management bandwidth and financial flexibility. While analysing such entities belonging to an organised group, CARE SA 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.

Group entities in the Banking and Financial Services Sector

In the entities operating in the Banking and Financial Services Sector, generally 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 above-mentioned attributes. Also, due to the high reputation risk involved leading to high moral obligation, such entities are expected to support each other in times of need. As such, CARE SA aligns the ratings of these entities close to each other.

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