Rating Criteria for Consolidation of Companies

Executive Summary

Corporate entities, as a part of their diversification process, may invest in new businesses or conduct their existing business operations through separate legal entities such as subsidiaries, associates, Joint Ventures (JVs) or Special Purpose Vehicles (SPVs) for the purpose of tax, legal or regulatory requirements. These entities may either conduct operations similar to those of the parent company, having close business and financial linkages with the parent/flagship entity or be associated with diversified businesses. In such cases, a standalone assessment does not depict the actual picture of the consolidated business. For such entities, the strategic importance for the group, and the financial and operational linkages and obligations between the parent and its subsidiaries need to be factored in the ratings.

The overall consolidation of entities provides a holistic view of the group, and its business and financial strength, which in turn is reflective of the overall credit profile of the group, economic linkages within the group entities and cash flow generation as against debt obligations at an aggregate level for the group. In general, the standalone financial and business risk profile is reflective of the rated entity's position only; however, when businesses have close interlinkages, and cash flow fungibility exists between parent and subsidiaries the generation of cash flow at the consolidated level is used to understand the group's overall business and financial risk profile. These important aspects are, in essence, captured in the audited consolidated financials of the said entities and are one of the critical inputs in the ratings of consolidated entities.

Scope of the Criteria:

The document provides a comprehensive analysis of the attributes considered by Brickwork Ratings (BWR) while arriving at the rating of an entity based on the consolidation approach. The scope of this document is to capture the important aspects of various risks associated with the entity's creditworthiness, while arriving at BWR's consolidation approach to determine the rating of entities wherein support is extended by the parent/group company to its subsidiaries, associates or related entities, and the level of business and financial integration among them. A key factor for consolidation is the compulsion and ability of one entity to support the other during distress situations. Basis the effect of these attributes on the standalone credit rating of an entity, the rating is either notched up or down based on extended support, or financial and business linkage among consolidated entities. This, in turn, helps ascertain the debt servicing capability as against cash flow generation and the ability to fund its operations in distress situations.

BWR also examines the parent's willingness and/or ability to support (both explicit and implicit) the subsidiary in case of exigencies. The extent of integration between the rated entity and related entity is analysed based on the equity stake held, commonality of management/promoter, common board members, stated or documented support, the economic/strategic importance of the related entity to the parent entity, common logo/name and the fungibility of cash flows.

Risk Assessment and Rating Methodology: BWR analyses an entity's credit quality based on the qualitative and quantitative risks that could impact the overall credit profile of the entity, such as the sustainability of its operations and its efficiencies, financial position, debt servicing ability, cash flow generation and profitability. In general, these risks are broadly classified in BWR's rating criteria as business risks, industry risks, regulatory risks, financial risks, liquidity position, financial flexibility and management risks. Generally, the rating is arrived at on a standalone basis, and subsequently, it will be notched up based on the group's business risk profile, including all the businesses present in the group or it is expected to have a presence in, interlinkages with the parent or the group entities, parent control and reported consolidated financials as per IND AS. However, the notch-up criteria is applicable only for certain situations wherein entities do not operate individually and are instead, controlled by parent, having the majority equity stake and have business and financial linkages by some of the other group companies. These linkages often help the entity in various ways, such as strategic importance to the parent, economic and financial linkage and shared name, but not limited to loans extended from the parent, equity contribution, extended credit period and advances. Here, group support does not relate to committed financial support alone; it should be available during distress situations and unforeseen events or whenever the need arises. Strong legal linkages in the form of unconditional and irrevocable pre-default guarantees from the stronger entity in the group indicate strong and legally enforceable tangible support and warrant a closer linkage of the ratings between that of the guarantor and the rated guaranteed instrument. The assumption behind the aforesaid consolidation of the group is based on the overall representation of the scale of operations, asset base, debt levels and profitability. However, group's consolidated credit quality will be analysed on a case-to-case basis and the rating may be capped at the consolidated level rating.

In analysing the credit risk profile of a company that has a direct or indirect controlling interest in another entity, BWR considers the financials of the company and its related entity on a consolidated basis, wherever available. The audited consolidated accounts give a better picture of the group's financial health, capital structure, liquidity, net worth and leverage levels. The consolidated assessment of financials helps assess the liabilities that the rated company needs to honour in the case of exigencies in a related entity.

BWR's Approach to Consolidation:

Business Risk and Management Risk of the Group

A corporate group often contains entities having varied business operations and different legal and corporate structures. While assessing a group's business and management risk, BWR analyses the extent of linkages between the entities operating within the group. These linkages are as follows:

- **Economic importance of the entity to the group:** BWR assesses the importance of the subsidiary to the parent. The same is assessed by analysing the subsidiary's overall contribution to the parent's consolidated income and profits. Strong business linkages are further reflected by common suppliers, customers, contractors, lenders, dependence on the marketing network of the subsidiary and so on. A subsidiary whose operations are critical for the parent company has a strong incentive to receive support during times of distress. BWR analyses the parent support received by a subsidiary in the past and the parent's willingness to support the subsidiary.
- **Cash flow fungibility between parent and subsidiaries:** The smooth flow of transactions

between the parent and subsidiary companies in the form of loans, advances and investments implies that there is fungibility of cash flows between the parent and subsidiaries and that the parent will come to their rescue in the case of any financial difficulty to any of the subsidiaries. BWR views cash flow fungibility between a parent company and its subsidiary positively, unless the same is explicitly restricted by a relevant agreement, and the subsidiary rating gets notched up in such cases.

Assessment of Group's Key Financial Parameters and Financial Risk

BWR analyses the group's audited consolidated financial position by doing a detailed assessment of the group liabilities, net sales, profitability, net worth, interest cover and debt servicing ability, which further gives an insight into the group's financial position. The strength of the parent, and its ability and willingness to extend support to the subsidiary, if and when the need arises, is evaluated. Stronger consolidated financials of the parent company could help in the notching up of the respective subsidiary's standalone rating. Similarly, a parent with a relatively higher rated subsidiary(ies) is likely to receive a greater rating uplift over its base rating in the consolidation approach. BWR also assesses the parent company on its ability to extend support to its subsidiary and the timing of support. BWR applies the following steps while consolidating:

- Cancelling all off-setting reciprocal pairs, such as assets and liabilities, revenues, costs, investment and equity accounts to nullify all intra-group transactions
- In addition, BWR also adjusts and nets-off all the sales made within the group entities. Such a method is referred to as the line-by-line addition method used for subsidiaries, proportionate consolidation method for JVs and equity methods for associates.
- An investment holding company is one whose major portion of assets are in the form of equity, debts, loans and advances to group companies. Such entities rely mainly on dividends, interests and capital gains on their portfolio. All investments in related entities and borrowings within the group are netted-off from the group's net worth.

Consolidation Approach for Subsidiaries that do not Operate in the Same Sector as the Parent

Since the parameters and ratios used in cases where the subsidiaries and the parent operate in different sectors may be significantly different, a capital allocation approach is followed by BWR. Under this approach, some capital is allocated by the parent to the unconsolidated subsidiary, to be deducted from the parent's net worth. Such capital support uplifts the subsidiary, and its impact on the parent is factored into the rating.

Others

In cases of moderate linkages between the group companies, BWR relies on the companies to provide their consolidated accounts. This is specific to cases wherein commonalities are observed in the management and when the entity is undertaking specific operations of the related group entity (raw material sourcing, branding, same name used, production, customer sourcing and marketing activities). Such transactions can have cash flow implications for both the entities.

In cases where the group companies hold substantial equity in the company but have no management control over other entities, the extent of cash flow transactions between the two entities may be assessed.

Conclusion

BWR ascertains the cash flow implications, and resultant business and financial risk profile of an entity by examining the various scenarios of linkages between the parent and subsidiary company. Generally, the entity's rating is arrived at, on a standalone basis and subsequently, it will be notched up based on the consolidation of the pooling of interests of various group entities through the analysis of the overall representation of financial position of the group and interlinkages with the parent or the group. The stronger the linkages in terms of the economic importance of the entity to the group, the stronger is the potential support provided by the parent to the entity. Hence, the final rating involves an assessment of the ability, incentive and group/parent's willingness to support the subsidiary or group companies and vice versa.

The previous version of this document can be found in
www.brickworkratings.com/download/Criteria-Consolidation_of_Companies.pdf

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