



## Rating Criteria for Consolidation of Companies

### Executive Summary

Corporate entities, as a part of their diversification process and/or to explore new business opportunities, 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 group/parent/flagship company, have close business and financial linkages with the group/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 and the financial and operational linkages and obligations between the parent and its subsidiaries need to be factored in the ratings. Brickwork Ratings (BWR) ascertain the level of integration and linkage to adopt the appropriate treatment for consolidation.

The overall consolidation of entities provides a holistic credit profile of the group, at an aggregate level. In general, the standalone financial and business risk profile is reflective of the rated entity's position; however, when businesses have close interlinkages, and cash flow fungibility exists between parent and subsidiaries that may further strengthen the credit profile of the subsidiary/related entity.

### Scope of the Criteria:

A key factor for consolidation is the compulsion and ability of one entity to support the other during distress situations. The document provides a comprehensive analysis of the attributes considered by BWR while arriving at the rating of an entity based on the consolidation approach. Refer to the section below that outlines different approaches towards the consolidation before arriving at the credit rating of any entity.

BWR also examines the Group/Parent's willingness and/or ability to support 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. Once the integration level and linkages are looked into, then the consolidation approach is adopted accordingly.

**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 risk profile. However, the notch-up criteria is applicable only for certain situations wherein entities do have business and financial linkages by some of the other group companies. The 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 (implicit support).

The assumption behind the aforesaid consolidation of the subsidiaries is based on the overall representation of the scale of operations, asset base, debt levels and profitability. However, consolidated credit quality will be analyzed 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/parents'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 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 Group/parent/flagship company on its ability to extend support to its subsidiary and the timing of support.

### **In case of strong linkages, BWR applies the following steps while consolidating (considering the entities as one economic unit)**

- Cancelling all off-setting reciprocal pairs, such as assets and liabilities, revenues, costs, investment and equity accounts to nullify all intra-group transactions
- 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. It is also to be noted, where an entity is involved in specific operations of a related group/parent/flagship company (such as raw material sourcing, production, customer sourcing, and marketing activities), even though there is no shareholding in the group company. Such transactions can have cash flow implications for both entities, and the assessment of support can be based on these cash flow impacts. BWR may also decide not to pursue consolidation, even if the company legally holds a minority stake, however has limited financial recourse or if the linkages between the companies are weak.

### **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.

The previous version of this document can be found in [https://www.brickworkratings.com/download/Criteria-Consolidation\\_of\\_Companies-Sep2021.pdf](https://www.brickworkratings.com/download/Criteria-Consolidation_of_Companies-Sep2021.pdf)

**About Brickwork Ratings:** Brickwork Ratings (BWR), a Securities and Exchange Board of India [SEBI] registered Credit Rating Agency and accredited by Reserve Bank of India [RBI], offers credit ratings of Bank Loan, Non- convertible / convertible / partially convertible debentures and other capital market instruments and bonds, Commercial Paper, perpetual bonds, asset-backed and mortgage-backed securities, partial guarantees and other structured / credit enhanced debt instruments, Security Receipts, Securitisation Products, Municipal Bonds, etc. BWR has rated over 11,400 medium and large corporates and financial institutions' instruments. BWR has also rated NGOs, Educational Institutions, Hospitals, Real Estate Developers, Urban Local Bodies and Municipal Corporations. BWR has Canara Bank, a leading public sector bank, as one of the promoters and strategic partner. BWR has its corporate office in Bengaluru and a country-wide presence with its offices in Ahmedabad, Chandigarh, Chennai, Hyderabad, Kolkata, Mumbai and New Delhi along with representatives in 150+ locations.

**Disclaimer:** It must be clearly understood that a Rating opinion is based on various factors/aspects which includes application of certain Rating criteria. The particular criteria applied depends on a number of factors, inter alia, sector/Industry, historical performance, cyclical trends, prevailing economic condition, group support etc. Rating opinions factor many assumptions and the application of any particular criteria or a set of criteria may be full or partial depending upon peculiarity of each case. Application of any Rating criteria should not therefore be considered as rendering finality or completeness to a Rating assessment. A reference to criteria needs to be perceived in broad terms, only as an aid to a rating decision.

Brickwork Ratings India Pvt. Ltd. (BWR), a Securities and Exchange Board of India [SEBI] registered Credit Rating Agency and accredited by the Reserve Bank of India [RBI], offers credit ratings of Bank Loan facilities, Non- convertible / convertible / partially convertible debentures and other capital market instruments and bonds, Commercial Paper, perpetual bonds, asset-backed and mortgage- backed securities, partial guarantees and other structured / credit enhanced debt instruments, Security Receipts, Securitisation Products, Municipal Bonds, etc. [hereafter referred to as "Instruments"]. BWR also rates NGOs, Educational Institutions, Hospitals, Real Estate Developers, Urban Local Bodies and Municipal Corporations.

BWR wishes to inform all persons who may come across Rating Rationales and Rating Reports provided by BWR that the ratings assigned by BWR are based on information obtained from the issuer of the instrument and other reliable sources, which in BWR's best judgement are considered reliable. The Rating Rationale / Rating Report & other rating communications are intended for the jurisdiction of India only. The reports should not be the sole or primary basis for any investment decision within the meaning of any law or regulation (including the laws and regulations applicable in Europe and also the USA).

BWR also wishes to inform that access or use of the said documents does not create a client relationship between the user and BWR.

The ratings assigned by BWR are only an expression of BWR's opinion on the entity / instrument and should not in any manner be construed as being a recommendation to either, purchase, hold or sell the instrument.

BWR also wishes to abundantly clarify that these ratings are not to be considered as an investment advice in any jurisdiction nor are they to be used as a basis for or as an alternative to independent financial advice and judgement obtained from the user's financial advisors. BWR shall not be liable to any losses incurred by the users of these Rating Rationales, Rating Reports or its contents. BWR reserves the right to vary, modify, suspend or withdraw the ratings at any time without assigning reasons for the same.

WR's ratings reflect BWR's opinion on the day the ratings are published and are not reflective of factual circumstances that may have arisen on a later date. BWR is not obliged to update its opinion based on any public notification, in any form or format although BWR may disseminate its opinion and analysis when deemed fit.

Neither BWR nor its affiliates, third party providers, as well as the directors, officers, shareholders, employees or agents (collectively, "**BWR Party**") guarantee the accuracy, completeness or adequacy of the Ratings, and no BWR Party shall have any liability for any errors, omissions, or interruptions therein, regardless of the cause, or for the results obtained from the use of any part of the Rating Rationales or Rating Reports. Each BWR Party disclaims all express or implied warranties, including, but not limited to, any warranties of merchantability, suitability or fitness for a particular purpose or use. In no event shall any BWR Party be liable to any one for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of any part of the Rating Rationales and/or Rating Reports even if advised of the possibility of such damages. However, BWR or its associates may have other commercial transactions with the company/entity. BWR and its affiliates do not act as a fiduciary.

BWR keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of the respective activity. As a result, certain business units of BWR may have information that is not available to other BWR business units. BWR has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

BWR clarifies that it may have been paid a fee by the issuers or underwriters of the instruments, facilities, securities etc., or from obligors. BWR's public ratings and analysis are made available on its web site, [www.brickworkratings.com](http://www.brickworkratings.com). More detailed information may be provided for a fee. BWR's rating criteria are also generally made available without charge on BWR's website.

This disclaimer forms an integral part of the Ratings Rationales / Rating Reports or other press releases, advisories, communications issued by BWR and circulation of the ratings without this disclaimer is prohibited.

BWR is bound by the Code of Conduct for Credit Rating Agencies issued by the Securities and Exchange Board of India and is governed by the applicable regulations issued by the Securities and Exchange Board of India as amended from time to time.