



## BWR's Approach to Rating Entities based on Group Support

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### **Executive Summary:**

A group of companies normally comprises common promoters, significant cross-holdings, a high level of operational and financial linkages, and sometimes, a shared name or logo. These entities may have common procurement, marketing, name sharing and branding strategies at the centralised level, from an operational perspective. The overall credit strength of a group depends on the collective financial stability and integrated operations of the entities it comprises, as cash can flow seamlessly among these entities and there can be a high possibility of cross collateral agreements with banks/lenders or corporate guarantees. Therefore, while assessing an entity/entities forming a part of a larger group, Brickwork Ratings (BWR), based on several such factors, expects the group to provide support to its entities in times of financial distress.

A group may offer support to an entity as implicit support, which is normally assessed based on empirical evidence and financial muscle, or the said support can be explicit. Both these kinds of support reflect the expectation that a parent company of the group will step in to support a subsidiary or group entity in the event of a financial difficulty and meet its debt obligations. Implicit support from a group company is an economic factor that can influence an entity's credit rating. The extent of parent or group support depends on the entity's relation with the group or parent, ranging from the entity being a non-core, non-strategic investment to a fully integrated part of the group.

### **Scope of the Criteria:**

The criteria in this document are mainly applicable to large groups that have multiple/same sector operations with a relatively complex holding structure and have the ability to raise/mobilise funds from capital markets / other sources. The methodology adopted by BWR usually involves determining the standalone rating of the entity initially and then the extent of notching up or down based on the implicit support or linkage with the group, and the group's overall credit quality. The said criteria may not be applicable to homogenous groups with a common promoter and family-owned business, and those that may be operating one or two entities within the same group. The said criteria would not be applicable to entities wherein the audited financial statements of the consolidated financial position are not historically prepared / have not been provided by the company.

### **Risk assessment and Rating Criteria:**

The assessment of the credit risk is done after evaluating an issuer's business and financial risks, its competitive strengths, likely cash flows over the life of the instrument being rated and the adequacy of such cash flows vis-à-vis its debt servicing obligations. BWR then assesses factors such as the degree of integration between the entity and group, extent and likelihood of support from the group or parent,

promoter control over decision making and operations, flow of cash within group companies and moral obligation on the group to support the entity.

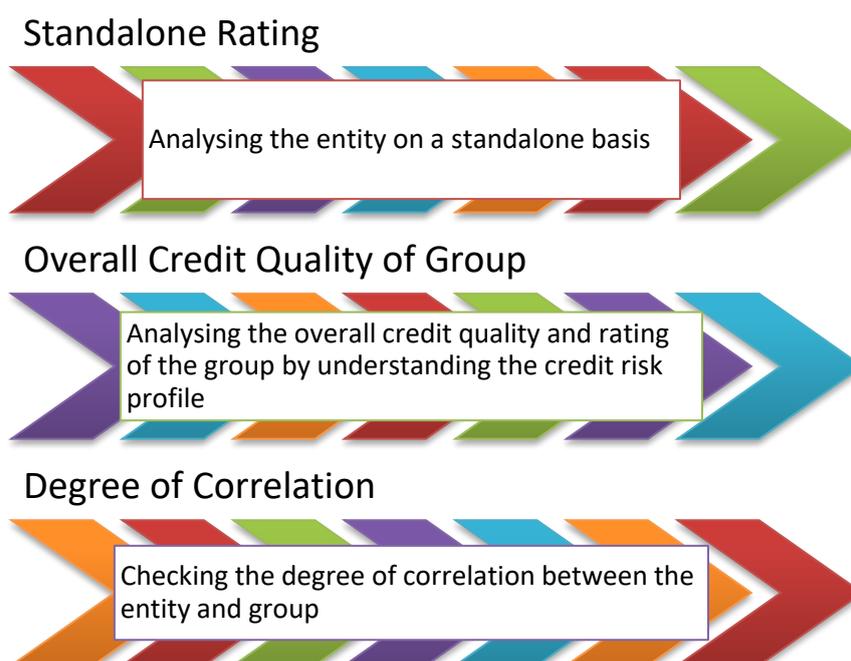
Additionally, BWR analyses whether the bifurcation of business is mainly due to geographic operations or tax and legal reasons, or backward or forward integration, is creating a significant dependence over its group entity. The group's ability and willingness to extend support to the entity (and vice versa) is also assessed, besides evaluating the issuer's own fundamental economic viability. The support may be financial in the form of loans, equity, an extended credit period, the subordination of unsecured loan provided or advances. The support may also be in the form of letter of comfort or undertakings by the stronger group company to support the rated entity in the case of a cash flow shortfall.

The group's overall credit profile is analysed by factoring in the business, financial and management risks of its major constituent entities. Taking a group view necessitates the evaluation of the overall group credit profile, by using consolidated group financials, even though a parent subsidiary relationship may not exist, and consolidated financials may not be required under the prevailing accounting standards.

Implicit support reflects the expectation that a parent company/flagship company of the group will step-in to support a subsidiary or group entity in the event of a financial difficulty and meet the shortfall in its debt obligations. Implicit support from a parent/group company, which is mainly assessed based on past track record, is an important factor that can impact an entity's credit rating of an entity.

BWR first determines a stand-alone credit rating for the entity. Subsequently, the relationship of the entity with the group and its significance to the group is taken into account. A judgment is made based on a number of factors, on the extent of support the parent/group would provide in the event of financial stress. In general, these factors reflect the importance of the subsidiary to the group and the nature of the financial and business linkages between them. Once the overall balance of the factors has been assessed, the number of notches by which the standalone rating should be improved is determined.

The rating approach involves a sequence of processes such as the following:



Based on the above processes, the standalone rating of the entity is arrived at and notched either up or down based on degree of correlation with group. The following parameters are generally adopted to determine the extent of notching of a group entity's rating:

**1. Business linkages, strategic importance and economic significance:**

The relevance of the entity to the group, extent of shareholding by promoters/group and economic incentives to the group are examined. The relative contribution of the entity towards the consolidated turnover and profits of the group, commonality in business activities, ownership/extent of shareholding, geographical presence, and criticality and economic relevance of the entity to the group are considered. BWR considers business linkages between the entity and group in addition to the extent to which the group is critically dependent on the rated entity for operations and business stability. If the group's business is significantly impacted by disruptions in the operation of the rated entity, then the group would likely extend support in a distress situation. Overall, higher criticality of the rated company to the group's operations or closer business linkages between the group and the entity, such as similar lines of business with a different geographical presence, generally results in a higher notch-up from the entity's standalone rating. The notch-up in these instances would be capped to the consolidated group view, even though a particular entity's standalone profile may be better than the group's consolidated profile. This is to effectively reflect the ultimate group risk emanating from exposure towards multiple entities at each individual entity rating level.

An entity that holds a high strategic importance to a group may draw financial support from the group company as and when required. The group, which may have earlier pronounced the strategic importance of an entity to its own business plans, may find itself constrained to alter its stance at a later point in time if incremental investments in the entity become uneconomic or the parent's strategic objectives change. In such a scenario, any notching-up that may have been factored into the entity's previous rating would be re-looked at and appropriately reflected in the entity's revised rating.

**2. Extent of common management control:**

The extent of management control on the rated entity can be understood based on the group's active involvement in managerial decisions and the entity's day-to-day operations. The extent of management control, commonality of resources, presence of common board members and track record of the group in extending financial support to group companies in times of distress are some of the key differentiating factors while arriving at ratings of multiple entities in a group. Similarly, a shared brand name also creates a moral obligation to support group entities in view of the reputation risk involved.

**3. Credit quality of groups:**

Groups with a satisfactory credit quality usually have an established brand name and reputation in the industry, are generally listed, have a professional management and a strong, independent board, and good financial flexibility. The promoters' stake in the various group companies could be significant, and they exercise management control over the group. Some groups may, however, operate as family groups, in one or two businesses, with common promoters, segregation of the business among different family members, geographical divisions, or being created for legal/taxation purposes. Companies in this group are characterised by the commonality of promoters/management, fungibility of cash flows, intergroup transactions including the cross guarantee of debt. In cases where the instrument being rated is unconditionally and irrevocably

guaranteed by another group company with a higher rating, backed by a suitable structured payment mechanism, the rating of the instrument is equated to the rating of the guarantor. The rating is suffixed with the CE (Credit Enhancement) tag, which highlights the credit enhancement in the form of the parent/group guarantee and payment mechanism.

## Conclusion:

While assessing an entity, BWR analyses in depth the entity's standalone financial and business risks, in addition to the group's consolidated financial and business strength, degree of correlation between the entity and group, economic relevance to the group and support extended to it financially or through other factors associated with the group company. Hence, the final rating involves an assessment of the ability and willingness of providing group support to various group entities and vice versa.

*The previous version of this document can be found in [www.brickworkratings.com/download/Criteria-GroupSupport.pdf](http://www.brickworkratings.com/download/Criteria-GroupSupport.pdf)*

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