Ratings of Entities based on Parent Support

Executive Summary:

Brickwork Ratings (BWR) analyses an entity's credit profile based on qualitative and quantitative risks that are likely to affect the sustainability of its operations, financial position, debt servicing ability to meet its debt obligations on its own, cash flow generation, profitability and its scale of operation. 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 entity is assessed on a standalone basis and subsequently Rating is notched up based on implicit or expected support from the parent or group entities. However, the notch-up criteria is applicable only for certain situations, where entities do not operate individually and are instead, backed by the parent or other group companies. These linkages can be broadly classified as legal linkages, operational and financial linkages, and strategic linkages, and often help the entity in various ways such as through a shared name and common management, loans from the parent, equity contribution, an extended credit period and advances. Here, parent support does not factor in the committed financial support in the form of, say, corporate guarantees (which will be rated under the credit enhancement methodology), but implicit support that would (expectedly) come in during a distressed situation or whenever the need arises. The assumption for the aforesaid support from parent is based on the higher or superior credit profile of the parent than that of the entity.

Notch-up Approach:

While arriving at final rating of the subsidiary, BWR will assess the following:

- Standalone rating of the subsidiary without any support
- Consolidated rating of the parent considering all present and expected obligations towards entities to be supported
- Strength of legal, operating, financial and strategic linkages to decide the extent of notch-up to be provided; broadly, the linkages may be categorised as strong, moderate or weak.

The assumption for the aforesaid support from the parent is based on the higher or superior credit profile of the parent than that of the subsidiary. However, in the case of the parent's lower or weaker credit quality than its subsidiary, the rating may be capped at the consolidated rating level. However, if the stronger subsidiary's cash flow is ringfenced and the linkages between the parent and subsidiary are weak, the subsidiary may be rated on its standalone credit profile and higher-than-the-parent/consolidated rating.

Scope of the Criteria:

The document provides a brief analysis of the attributes considered by BWR while arriving at the rating of an entity based on parent support. Here, the parent would also include joint venture partners in a Joint Venture (JV) and the ultimate holding company in corporate group structures, where support is expected to flow in from the ultimate parent and not the holding company, which in turn is the step-down subsidiary of the ultimate parent. The scope of this document is to capture risks associated with the creditworthiness of the entity while arriving at the rating of entities where its parent company has extended implicit support to the entity. The impact of these risks on the standalone credit profile of an entity is assessed, and based on the evaluated parent support, the rating is notched up or down based on the extended support or linkage with the parent that is highlighted, which helps ascertain the debt servicing capability as against cash flow generation and ability of the parent to support the entity in a distress situation.

Risk Assessment and Rating Methodology:

BWR factors in the financial and managerial support a subsidiary may get from a parent company in times of financial difficulty. The extent of notching up or down the rating will depend on the economic importance of the entity to the parent, moral obligation of the parent to support the subsidiary and past record of the parent in extending support to its subsidiaries in events of exigencies. Risk evaluation is based on identifying the level of support that flows to a company from its parent/group. Initially, the entity's business and financial risks, liquidity position, competitive strengths, likely cash flow generation over the life of the instrument being rated and the adequacy of such cash flows vis-à-vis its debt servicing obligations are understood.

Implicit support from a parent company is an economic and financial linkage that can impact and most likely notch up/down 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 being a non-core, non-strategic investment to a fully integrated part of the group. This, in turn, determines the range of implicit support by the parent or group, from an expectation of very little or no help at one end to ratings equalisation at the other.

BWR follows a ‘bottom-up’ approach that first determines a stand-alone credit rating for the entity. Subsequently, the relationship and linkage with the parent or group is considered. A judgment is made based on a number of factors as to what extent the parent/group would provide support in the event of financial stress. In general, these factors reflect the importance of the subsidiary to the parent and nature of linkages between them. Once these factors have been assessed, the number of notches up or down by which the standalone rating should be improved is determined.

The notch-up criteria is majorly based on the quantitative/qualitative parameters, and gap between parents’ and entities rating. Besides other criteria, the following should necessarily be factored in for notching up:

- Parent companies’ image, background, rating history and activities/performance/ operational synergy/common activities, and track record of past ratings
- Promoters' background, image, track record and reputation
- Parent company being considered for providing support should have capacity to support without material dilution in its strength post supporting.
- Parent company’s guarantee, if any, under the sanction terms, even though it may not be a CE rating case
- Established brand value, reputation and overall performance for the last three years, of the parent

company. This implies that the notching up will be restricted for outright new companies/groups.

- Parental support should be visible from the entity's past track record and financials. One such parameter for visibility is the entity's satisfactory rating, which should be close to the parent's rating, thereby validating that there is already a support ongoing basis, and the entity is being kept in good shape.
- The way notching up is done for assigning a rating, notching down should also be done on lower parental rating and on its subsequent downgrades.

Broad parameters for assessing linkages can be summarised as below:

- Legal Linkages: Corporate guarantee from the parent company or a letter of comfort/undertaking to support the rated entity's debt and cross default provisions
- Operating Linkages: Common brand name/logo, common management, treasury, inter-company transactions, common supply chain, backward/forward integration and interdependence for key business transactions
- Financial Linkages: loans and advances from parent or extended suppliers period to fund the subsidiary's operations, or any other form of tangible support
- Strategic Linkages: the criticality of subsidiary's operations/market for the parent in terms of long-term growth, notwithstanding the subsidiary's standalone scale or vintage

However, the assessment of some of the key factors is inherently subjective, for example, the strategic relation importance of a subsidiary, and is likely to vary over time with the economic cycle and as the general view of the reliability of implicit support changes.

The criteria defined in this document are applicable to subsidiaries that have significant shareholding from a clearly identifiable parent. In the case of JVs of two or more partners holding equal stake, the support is attributed to the partner that explicitly backs most of the JV's debt. BWR assesses the JV agreement, overall control and strength of the JV partners, before considering the support from either of the JV partners.

The final rating of a subsidiary is a function of three key parameters:

a. Determination of standalone rating of the subsidiary
b. Determination of the parent's rating, considering its overall credit profile
c. Notch up or down for parent support, based on the linkage (business and financial) with parent, name sharing and strategic importance to the parent

Generally, the subsidiary's rating is capped at the parents' rating, with the exception of when the subsidiary has arms' length operations from the parent and if the subsidiary's cash flows/ overall credit profile can be demonstrated to be better than that of the parent.

a. Subsidiary's Standalone Rating

This involves an assessment of the subsidiary's ability to sustain its operations and meet its debt obligations from its own cash accruals without depending on support from the parent. It is possible that the subsidiary's standalone rating could be higher than that of the parent in some cases. However, the subsidiary rating can be notched up or down depending on the parent company's nature and strength. While analysing the parent company, BWR considers the following:

- Economic and strategic importance of a subsidiary to its parent
- A subsidiary's economic and strategic importance to its parent is analysed by checking the criticality of its operations for the parent and the overall contribution of the consolidated income and profits towards the parent company. Another strong link between a subsidiary and the parent company is the relation between suppliers, customers, contractors and lenders, among others. The impact of any disruption in the subsidiary's operations on the group is a key element in assessing the strategic importance to the parent.
- Parent's demonstrated track record of support provided to the subsidiary:
- BWR analyses the parent support received by a subsidiary in the past and its willingness to support the subsidiary in the case of exigencies or distress situations in future.
- Cash-flow fungibility between the parent and subsidiary:
- Cash flow fungibility from the parent company is seen positively, unless explicitly restricted under relevant agreements, and the subsidiary rating gets notched up accordingly.
- Legal or moral obligation of the parent to support the subsidiary:
- A scenario where the subsidiary company enjoys an irrevocable corporate guarantee from the parent company and the presence of a cross default clause in the underlying debt is seen as an important factor in assessing the notch up for parent support by BWR. Similarly, sharing a common brand/logo implies a significant reputation risk for the parent and therefore, a higher propensity to support the subsidiary's debt servicing.

b. Parent's Rating

The strength of the parent and its ability and willingness to extend support to the subsidiary, if and when the need arises, is evaluated. A parent company's strong credit profile could result in notching up the rating of its subsidiary. Similarly, a parent with a relatively higher rated subsidiary(ies) is likely to receive a greater rating uplift over its base rating. BWR also assesses the parent company on its ability to extend support to its subsidiary and the timing of support.

c. Extent of Notch-up

In cases where the subsidiary's debt instrument is unconditionally and irrevocably guaranteed by the parent, and backed by an escrow mechanism, the rating of the guaranteed instrument may be appropriately notched up and is suffixed by the Credit Enhancement (CE) tag, to highlight the credit enhancement in the form of a guarantee and payment mechanism. Even in the absence of such documentation, BWR may notch up, depending on the assessment of implicit support available from the parent.

In the case of SPVs that have been set-up by holding companies for executing infrastructure projects and the debt of SPVs is structured with a limited recourse to the parent due to the inherent risk involved, BWR may or may not notch up the SPV's rating depending on the kind of support available to the said SPV.

Conclusion

While assessing an entity, BWR analyses the entity's standalone financial and business risks, in addition to the parent support extended to it financially or through other factors associated with the parent company. Hence, the final rating involves an assessment of the ability, willingness and timeliness of parent support available with the subsidiary companies and vice versa.

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

BWR'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. 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.