

Rating of subsidiary based on support extended to parent

Background

Brickwork Ratings (BWR) evaluates the level of support flowing from a stronger subsidiary (in terms of credit profile) to a weaker parent by assessing the likelihood, ability, willingness and extent of such support, factoring it into the subsidiary's overall credit profile. The evaluation framework encompasses financial, operational or strategic assistance that may be extended to the parent entity during periods of stress. This approach is the reverse of the conventional assessments, which typically focus on parent's support to its subsidiary. If a subsidiary is expected to materially support a weaker parent in ways that could strain its own financial or operational stability, its rating may be subject to downward adjustment.

Scope

The scope of this criteria document is to outline the methodology for assessing support extended by a subsidiary to its parent entity. This framework is based on the premise that such support is considered when the subsidiary possesses a stronger credit profile (evaluated on a standalone financial basis) relative to the parent. The assessment also factors in the nature and strength of the linkage between the parent and subsidiary.

Methodology for subsidiary support to parent

Support from a subsidiary to the parent company depends on economic and financial linkage that can influence and likely degrade the subsidiary company's standalone credit rating. A financially robust subsidiary may support a struggling parent if the fallout threatens broader group stability, borrowing costs, and/or regulatory frameworks—especially when internal financial flexibility and strategic interdependencies exist.

Key considerations in analyzing subsidiary support to the parent are as follows:

1. Shared management and governance:

The nature of parent-subsidiary relationship in terms of common shareholding is important. When subsidiaries are fully owned and controlled by the parent, the parent has access to a more stable flow of resources from the subsidiary. However, if the subsidiaries are partially owned or operate as Joint Ventures (JV), the level of support may be less consistent and harder to access.

2. Level of operational integration:

The degree of integration between a subsidiary and its parent in terms of operations is crucial. If the subsidiaries are closely tied to the parent's operations in backward or forward integration processes, or in

terms of long-term growth, any impact on the parent's operational efficiency can directly affect the subsidiary's operating performance and revenue generation, making their support vital.

3. Risk mitigation and structural defense

A strong subsidiary might act to shield the parent from reputational or operational fallout if the parent is in distress within the corporate group, especially when the parent is integral to the subsidiary's market credibility or regulatory positioning.

4. Track record of support to parent:

If a subsidiary has a track record of extending support to a financially weaker parent, its credit rating may be notched down if such support materially weakens the subsidiary's own credit profile.

A financially weaker parent may draw on its subsidiary's cash flow through related-party transactions, or seek other support as follows:

1. Financial support from subsidiaries:

- **Debt repayments:** In some cases, subsidiaries may assume repayment responsibilities for loans or other financial obligations on behalf of the parent company, particularly when the parent's debt-servicing capacity is constrained. While this can enhance the parent's liquidity position, it may also place additional financial strain on the subsidiary, if the support leads to increased leverage.
- **Profit distributions:** One of the primary ways a subsidiary supports the parent is through the payment of dividends. If a subsidiary generates significant cash flows, it may contribute a substantial portion of its profits to the parent in the form of dividends, thereby strengthening the parent's liquidity position. This is particularly common in holding companies or conglomerates where subsidiaries may be the primary source of income.
- **Equity investments:** Subsidiaries may inject capital into the parent company under certain circumstances, either in the form of equity investment or through asset transfers. If subsidiaries hold significant appreciating assets, such as real estate or intellectual property, these may be transferred to the parent. However, transfers can negatively affect the financial stability of the subsidiary.

2. Operational support from subsidiaries:

- **Combined expertise and innovation:** Subsidiaries can provide the parent company with access to vital technology, intellectual property or management expertise. For instance, a subsidiary's advanced technology may be critical to the parent's products or services, boosting its market competitiveness. Such operational support can enhance the parent's performance and reduce risks.
- **Cost sharing:** In some cases, subsidiaries and parents share operational costs to achieve economies of scale. A subsidiary might be more efficient in specific functions (such as supply chain management or R&D) and can offer its expertise and/or resources to optimize the parent company's operational costs. However, such cost-sharing arrangements may weaken the subsidiary's profitability and financial stability by lowering operational efficiency, imposing an excessive cost burden and depleting its resources.

3. Strategic support from subsidiaries:

- **Market and product diversification:** Subsidiaries with diversified operations across multiple markets or product segments can help mitigate the parent company's exposure to volatility in any single market, thereby enhancing overall risk resilience. By providing diversification through different products or services, subsidiaries can reduce the volatility of the parent company's earnings and revenues. However, this may limit the subsidiary's own growth potential due to diluted strategic focus, the risk of brand dilution and a higher chance of underperformance.
- **Synergies and strategic alignment:** When subsidiaries and parents are strategically aligned, such as when they complement each other's business models or operations, the parent can benefit from synergies. These may include shared branding, joint product development or co-marketing activities that can strengthen the parent company's market position. However, such alignment may also reduce the subsidiary's agility, adaptability and market responsiveness thereby constraining its operational flexibility.

Notch down approach for subsidiary

This criteria document outlines the methodology for a notch-down approach when the parent's credit quality is lower than that of the subsidiary. BWR may keep the standalone rating of a subsidiary unchanged if a weaker parent has low ability and willingness to tap into the subsidiary's cash flow. However, BWR may adjust the subsidiary's rating downwards by few notches if a subsidiary is stronger but stands to be drained by its parent or group firm.

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

- Determination of standalone rating of the subsidiary company
- Determination of the parent's rating (on the consolidated financials), considering its overall credit profile with all current and future obligations
- Extent of notch down based on the linkage (strategic, business and financial) with the parent company

Broad parameters for assessing linkages can be summarized as below:

- **Legal linkages:** Legal linkages in terms of cross default provisions, cross guarantees, enforceable put option.
- **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 subsidiaries, extended suppliers' period to fund the parent's operations, or any other form of tangible support.
- **Strategic linkages:** The criticality of parent's operations/market for the subsidiary in terms of long-term growth, notwithstanding the parent's standalone scale or vintage

BWR may notch down subsidiary's rating, depending on the assessment of support that can be provided to the parent. The level of support is determined based on the linkage between the subsidiary and the parent.

- **Weak linkage:** If only one of the four linkage parameters (as outlined above) is met, the rating could either remain unchanged or be slightly lower than the subsidiary's standalone rating, depending on the parent's ownership stake in the company.
- **Medium linkage:** If two out of the four parameters of linkage are met, the rating might be moderately lower than the subsidiary's standalone rating but will be between the standalone rating of the subsidiary and the parent rating.
- **Strong linkage:** If the company has strong linkages with the parent, BWR may adjust the rating one notch upper than the parent rating or up to the parent rating itself. This applies if three or more of the four linkage parameters are met.

Conclusion

Rating criteria based on the support from subsidiaries to the parent are integral to understanding financial interdependence within a corporate group. Rating agencies assess how the level of support from strong subsidiaries to weak parents may impact the financial strength, operational flexibility and strategic goals of the subsidiary company during the times of stress of the parent firm. The extent of support extended to the parent and linkages with the parent firm can materially influence the subsidiary's overall credit profile and reduce its operational and financial flexibility.

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