Acuite
RATINGS & RESEARCH

Criteria for Consolidation of Companies

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Preamble

Promoters often establish separate legal entities for varied considerations such as difference in markets/ customers/ products or regulatory/ tax/ legal considerations or other factors such as lenders/ investor preferences. It is not uncommon for a promoter to have a presence across the value chain but through different legal entities. For instance, a steel manufacturer may have one unit manufacturing TMT Bars in one entity, and another unit manufacturing billets (raw material for TMT bars) in another entity. Similarly, a hospitality player may decide to have separate entities for each hotel property geography wise which will facilitate financial flexibility in case of a decision to monetize any or some of the assets. A gems and jewellery manufacturer may have its manufacturing operations in India but decide to have marketing subsidiaries geography wise in overseas markets.

In view of the structuring of the activities across various entities and significant operational and financial linkages between these entities, it becomes imperative that a consolidated approach is adopted. A consolidated approach will result in a more appropriate assessment of the overall profitability, cashflows, capital structure and debt protection indicators of the business as a whole. In cases where the entities are significantly aligned to each other, the consolidated approach will result in a more accurate assessment of the overall risk and credit profile.

Generally, Acuité relies on consolidated financials prepared by the issuer/ borrower entity or group. These consolidated financials typically provide a holistic view of a parent company along with its subsidiaries/ associates. These financials provide an overall view of the profitability, capital structure, borrowings, etc. In certain cases, Acuité may consolidate the business and the financial risk profiles of the issuer entity with other group entities including associates if such a consolidation is necessary for an adequate assessment of the business position and performance of the issuer/ borrower.

Objectives of the Document

This document is fundamentally aimed at understanding Acuité's own approach towards consolidation, the need for consolidation of financial statements and the ensuing analysis of the same. It also sheds significant light on the larger study of the degree of support that a parent/ holding/ group company extends to its Subsidiaries/ SPVs/ Group Company and Acuité's view on the same.

Method of Consolidation

Acuité follows the following 3 stage method for consolidation:

- **Reciprocal pairs of assets & liabilities are identified and offset against each other:** Here, investments/ intercorporate borrowings or lending in related entities are negated against each other and only the net value is considered.
- **Adjusting the Net-worth with that of the Subsidiary/group Company:** Here, the net worth of the subsidiary is added to that of the parent and any investment by the parent in the subsidiary is deducted from the net worth of the consolidated balance sheet.

- **Offsetting Revenues and Costs:** Here, the inter-group transactions are offset, by limiting transfer pricing related issues in inter-group transactions. By taking a net value, the financial ratios are re-calculated and analysed.

Cases Relevant for Consolidation

While the degree of impact of consolidation on the risk-return metrics varies significantly across firms and business models, the need for consolidation as an exercise is well warranted in a large pool of cases. In order to adopt a consolidated approach, it becomes necessary to ensure presence of significant operational/ financial linkages between the entities being consolidated, besides common management. The operational linkages could be through significant sale/ purchase transactions, common clientele base etc. The financial linkages could be due to reasons like corporate guarantees for borrowings, significant loan/ investment transactions etc. The stance of the management is one of the key factors influencing the decision to adopt a consolidated approach or otherwise.

Acuité analyses the following six factors to the extent they are applicable:

- Identify the Business & Strategic Significance of the Entity being rated for the Parent/group company.
- Degree of linkages and injections of funds along with ease of support to and from the parent/group company to the entity being rated.
- Presence of statutory, legal or documentary assistance to establish track record and likelihood of support from the parent/group entity to the entity being rated. Acuité also factors in the management's stated posture while analysing this factor.
- Analyse the percentage shareholding/crossholding by the parent/group companies in the related entity- higher the shareholding, greater is the probability of the parent/group extending support to the latter.
- Understand the Management's opinion of the role of the rated Entity in the Parent/Group. Acuité also analyses the degree of management control that the related or parent entity wields over the rated entity.
- Study the presence or absence of shared names, brands, business channels and other synergies.

Once the related entity and the firm have been evaluated on these parameters, Acuité establishes the degree of integration of both the entities, and this understanding drives the foundation for further analysis. Only in cases where strong levels of inter-linkages are established, Acuité follows the complete integration method, wherein the business, financial and management risk profiles of the related entity and the entity being rated are combined.

In cases of consolidation generally, all the entities are rated at similar levels given the expectation of high cash fungibility. However, in certain cases, Acuité may adopt a differential approach when some of the entities diverge significantly from other entities in terms of size, scale of operations or contribution to overall profits etc.

In cases where semi-strong or moderate levels of linkages are established, Acuité may apply a group/ parent notch-up to the ratings of the entity being rated instead of a consolidation approach.

Please click here to access the criteria on "Group and Parent Support"

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