



Criteria for Group and Parent Support

Executive Summary

The rating of the credit facilities/debt instruments issued by any issuer (i.e. obligor) primarily revolves around a holistic assessment of its industry, business, financial and management profile. The rating is based on the obligor's standalone credit profile as evaluated under the aforementioned parameters, i.e. wherever the obligor entity is not associated with any larger group or company, i.e. the standalone credit profile is the driver of the rating.

There are certain cases where the obligor is a subsidiary of another company with a strong credit profile or an associate of an established corporate group with a demonstrated track record of performance and established credibility. In such cases, the final rating factors in not only the standalone credit profile of the obligor entity but also the benefits it derives from being associated with a larger group or parent. The benefits are in the form of a notch up over the standalone rating, which reflects the expectation of support from the group both on a going basis and also in distress. The rating exercise in such cases will broadly entail the following three steps:

- Assessing the standalone credit Rating of the obligor
- Assessing the credit quality (i.e. Rating) of the parent or group (if not already rated by Acuité)
- Arriving at the extent of notch up over the standalone credit profile

The credit quality of the parent company is arrived at after considering the assessment under business, financial and management parameters. In case of a direct parent-subsidary relationship or a stepdown relationship (i.e. parent holds the majority stake in one company, which in turn holds majority stake in our obligor company), it is the ultimate parent company which will be considered for the rating notch up. The key aspects to be examined are the ability and management's willingness to extend timely support to the obligor, i.e. firstly, the parent or group itself has to be rated higher than the standalone obligor and in the investment-grade category. Secondly, a majority holding does not necessarily qualify for parent notch up unless there is an implicit or explicit understanding based on management discussions, past track record, documentation through guarantee or letter of comfort, etc. that the parent will continue to extend necessary support (financial and non-financial) to the obligor in future.

In case of a Group Notch up (i.e. cases wherein the majority shareholding in the obligor is held by multiple entities controlled by the same promoter), the flagship operating entity of the group may be considered as a surrogate for the Group. Acuité observes that in certain situations, the support could also flow from other group entities besides the flagship entity, based on their free cash flow generation. Hence, under group assessment, Acuité also examines the various entities in the group to understand their financial strength and their debt burden. This is important since some of the entities may not be consolidated in the flagship entity but still may be pivotal to the group in terms of their cash flow generation and overall debt position.

The extent of notch up is essentially based on broadly two parameters: (a) Economic importance of the obligor to the parent or group & (b) Moral obligation to support the entity. Under each of these parameters, there are sub-parameters for which objective scores are assigned. Based on the scores arrived at under these two factors, an aggregate notch-up score is computed. The gap between the parent and standalone rating is compared with the percentage notch-up score to decide the extent of notch-up. Acuite will mention in its analytical approach section of the Rating Rationale that the rating factors in support from the parent or group. It may be noted that the mere presence of a Corporate Guarantee or Letter of Comfort (particularly in case of non-sovereign corporate entities) does not necessarily qualify for the equation of the rating with the guarantor's credit rating unless there is an associated payment structure which can ensure timeliness of the support.

The following section dwells on the specific sub-parameters which are considered for determining the notch up:

I. Business Rationale

Strategic importance to Parent / Group

The criticality of the rated entity to the parent/ group is one of the most important factors in the parent notch-up framework. The importance of any entity will emanate from factors like significant operational and/ or financial linkages with the parent/ group. An entity supplying a significant proportion of the raw material requirements of its parent company or providing critical job work services to its parent is an example of such operational linkage. Similarly, if the major part of distribution of the products/ allied services of the parent is handled in a separate entity, such an entity will be critical to the parent/group. A related example is a captive BPO unit of a large bank handling its back-office functions. Such a unit will be critical to the bank's operations, and ongoing managerial and financial support to the entity can be expected from the bank. A typical example is of an Indian subsidiary of a multinational group. The scale of operations of the subsidiary could be modest relative to the group. However, if the management has significant expansion growth plans for India, the lenders/ investors can expect significant ongoing support from the overseas parent.

In a nutshell, the scoring under this parameter will be based on the extent of operational and/or financial linkages, both present and expected, with the parent /group and the way the business of the entity is correlated with the growth strategies of the group.

Magnitude of parent's investment in company

The investment of the parent in the subsidiary/ associate entity also has a bearing on the likelihood of support which can be expected by the investee entity. A significant investment by the parent in its subsidiary indicates a high level of commitment to the subsidiary and its operations. The significance of the investment has to be evaluated both in terms of the absolute amount of fund infusion and in relation to the net worth of the investing entity. A subsidiary/ associate entity which contributes significantly to the overall consolidated performance will continue to get ongoing as well as distress support from its parent. It has to be understood in this context that besides equity

investment, a parent/ group can support the subsidiary/ group entity through other measures such as extending unsecured loans, guarantees for raising debt or lenient terms of trade credit. The overall exposure has to be reckoned by considering the magnitude of investment.

Extent of shareholding

The shareholding pattern is an important factor influencing the decision to extend support to an entity. A wholly owned subsidiary can be expected to receive higher support from its parent vis-à-vis a subsidiary with a high proportion of minority interest. The likelihood of timely support is also influenced by factors like the nature of the non-controlling shareholder. A shareholding pattern with 2-3 dominant/ institutional shareholders besides the parent may require the concurrence of these shareholders for any major decisions such as equity infusion, etc. Certain decisions may entail a special resolution, in which case the shareholder holding a 75% stake becomes important. However, a parent or group entity with less than a majority (51%) stake may also support the rated entity (associate company) if there are strong business linkages. If the parent or a group entity is the largest shareholder (less than 51%) and the other shareholders have significantly smaller stakes, the group may have management control and therefore, support may need to be built in.

Ease of support

The ease of support is also a key parameter in the parent/ group notch-up framework of Acuité. In certain cases, the parent company or group may be willing to extend support to the borrowing entity. However, the ability to provide timely support could be impeded due to factors like regulatory restrictions or some other factors. This may be particularly relevant for multinational companies bringing in funds from offshore, where necessary approvals need to be taken. In the case of 100% ownership by a domestic parent entity, the ease of support is relatively established. However, in case of a shareholding structure involving 2-3 dominant shareholders besides the parent (which can also be the Government), the ability of the parent to take a decision and provide support to the entity can sometimes be relatively challenging. In case of entities governed by special acts of Parliament/ Legislature, certain regulatory compliances may be required prior to infusion of funds. In such cases, timely support can be impeded.

II. Moral Obligation

Level of management involvement and control

An entity in which there is a high degree of involvement of the parent company in the day-to-day operations and the management is more likely to receive support than an entity in which the parent is just a passive investor. The parent company's association in the day-to-day management can be by way of appointment of senior management officials of the parent on the Board of the subsidiary company, involvement in decisions regarding appointment of senior managerial personnel and particularly the MD/ CEO. The parent company's ability to influence the subsidiary's key metrics, such as profitability, capital structure, etc. is evaluated under this parameter. In certain cases, the management of the parent company may influence the pricing of the transactions between the parent and subsidiary or

decisions like payment of royalty to the parent or group. In certain cases, the lenders of the parent company may have stipulated covenants regarding consolidated gearing and debt protection indicators. The adherence to these covenants may require the parent to ensure that the financing decisions of the subsidiaries do not cause any breach of covenants at the group level. The management's involvement in the operations of such subsidiaries becomes critical since the subsidiaries have to be ensured adequate funding support without reneging on the commitments to the parent/ subsidiary's lenders.

Shared name/ brands

The sharing of common names or common brands among various group entities indicates a common corporate umbrella which effectively indicates to the external stakeholder, i.e. lender or investor, that the entity shares an association with a larger group. These common brands enjoy a high degree of credibility in the investor and lender fraternity and reflect a high degree of integration among the group companies. Any lender or investor initiating exposure to a relatively weak entity from the group assumes a certain degree of support from the parent or group. Any credit event relating to even one such a group entity may have implications for the brand's perception and the future borrowing programme for the group as a whole and therefore, the expectation is the group will make an effort to ensure financial stability in these companies with shared brand names.

Written Commitments and Pronouncements, Management's Stated Posture

In certain situations, the parent company explicitly supports the fundraising initiatives of the subsidiary by extending Corporate Guarantees or Letters of Comfort/ Letters of Undertaking/ Letters of Awareness in favour of its lenders. While certain documents like Letters of Comfort/ Letters of Awareness are not legally enforceable documents like Guarantees, however, lenders or bankers rely on these written commitments while considering the credit decisions. A 'Letter of Comfort' casts a moral responsibility on the issuer i.e. parent company, to ensure that the debt obligations are met in a timely manner. While most of the guarantees are post-default in nature, the expectation is that the corporate guarantor will arrange for timely funding support to avoid a credit event. The parent company may also provide additional documents like equity commitments and Non-Disposal Undertakings to lenders which provide an additional source of comfort. The existence of cross-default clauses in the parent company's borrowing programmes also acts as an additional comfort since any serious default on the subsidiary debt, if not cured, can trigger an acceleration of the parent's debt. The management's stated posture also becomes important in this case. The articulated stance to support the borrowing entity and ensure timely debt servicing will result in a higher score under this parameter.

Track record of support

Acuité will assess the future support also based on the parent's approach in the past. The demonstration of timely support to the borrowing subsidiary or other group entities will result in a high score under this parameter. The timeliness and magnitude of support are critical aspects to be examined in this regard. An equity infusion or

issuance of a corporate guarantee over the past 2-3 years qualifies for a higher score than an equity infusion in the distant past.

Scenario of a Rating Notch Down

In specific cases of parent-subsidary relationship, where the subsidiary's standalone credit profile is significantly stronger than the parent's credit profile, Acuite may also notch down the rating of the subsidiary (entity being rated). The rationale behind the notch down approach is that the subsidiary's cash flows could be regularly upstreamed to the parent by way of ICDs, dividends etc., thereby impacting the subsidiary credit metrics.

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