CRISIL
An S&P Global Company

Criteria for notching up standalone ratings of companies based on parent support

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Executive summary

While assessing the credit quality of subsidiaries, CRISIL Ratings factors in the likely support from a higher rated parent in the event of distress. The extent of the support is based on a comprehensive framework that evaluates the economic benefits that will accrue to the parent due to its association with the subsidiary, and the moral obligation, corporate status, and demonstrated track record of the parent in extending such support.

Scope

This criteria article[1] pertains to subsidiaries with significant shareholding by a clearly identifiable parent, and also JVs where two or more partners hold equal stake in the JV. The criteria may also be applied in case of step-down subsidiaries of an ultimate parent if CRISIL Ratings believes that distress support to the step-down subsidiary will emanate from the ultimate parent, rather than the intermediate holding company.

CRISIL Ratings notches up a subsidiary only when the credit rating of the parent is stronger than the standalone rating of the subsidiary. While the rating on the subsidiary is notched up for parent support, the likely impact of such support on the credit quality of the parent is also factored in.

The notch-up framework is typically applied when there is no explicit unconditional, irrevocable and continuing guarantee from the parent, but there is still intent on part of the parent to ensure timely support to its subsidiary, in the event of distress. In case notched-up rating is lower than the parent rating and if the debt instrument being rated is unconditionally and irrevocably guaranteed by the parent, backed by a robust payment mechanism, the rating on the guaranteed instrument of the subsidiary is equated with that of the parent, and suffixed by 'CE' (credit enhancement). This is done to highlight the credit enhancement in the form of guarantee and payment mechanism. For more details on guaranteed instruments, please refer to *'CRISIL's criteria for rating instruments backed by guarantees'*, available on www.crisil.com.

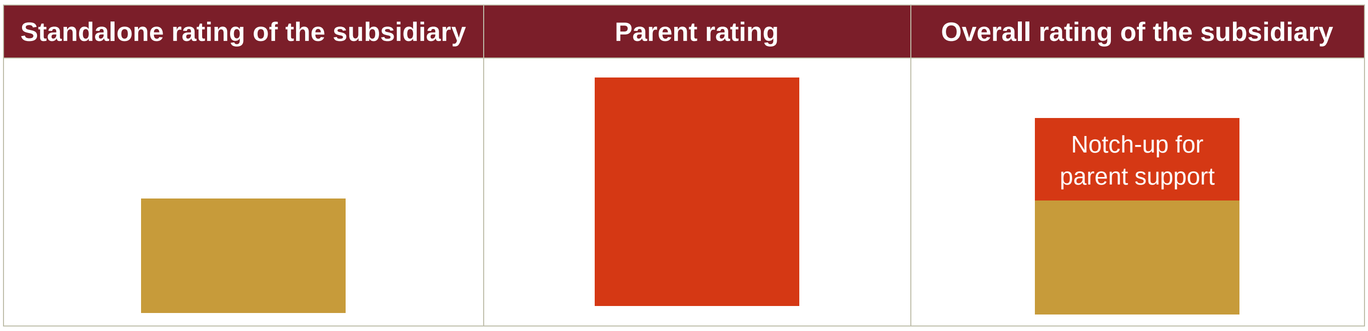
As for entities belonging to a strong group with common promoters and intra-group investments, CRISIL Ratings adopts the methodology described in *'Criteria for notching up standalone ratings of companies based on group support'* available on www.crisil.com. When factoring in support from the government for government-related entities, CRISIL Ratings employs its 'Criteria for notching up standalone ratings of entities based on government support', also available on www.crisil.com.

Framework for notch-up based on parent support

The final rating of a subsidiary revolves around three critical aspects: the standalone rating of the subsidiary, the rating of the parent, and the extent of notch-up (*see Chart 1*).

[1] For the previous version of this article, which was published in Aug 2021, please refer to the link below: https://www.crisil.com/content/dam/crisil/criteria_methodology/criteria-research/archive/criteria-for-notching-up-stand-alone-ratings-of-companies-based-on-parent-support.pdf

Chart 1: Overall rating of the subsidiary



Standalone rating of the subsidiary

This rating indicates credit quality without factoring in parent support. The rating is an assessment of the ability of the subsidiary to meet debt obligation on its own without relying on support from the parent, including for sustaining operations.

Parent rating

This rating indicates credit quality of the parent. CRISIL Ratings factors the credit support extended to a subsidiary in the parent rating.

CRISIL Ratings notches up ratings only when the parent rating is higher than the standalone rating of the subsidiary. The subsidiary's rating is notched up only in case the parent rating adequately captures the impact of the subsidiary's liabilities. For instance, in the case of ring-fenced special purpose vehicles (SPVs) set up by holding companies for executing projects (such as roads or power plants), the debt in such SPVs, due to their inherent riskiness, is usually structured with no or limited recourse to the parent. Support from the parent may be limited to meeting project cost overruns or shortfall in cash accrual to meet debt obligation only in the initial years. However, if CRISIL Ratings believes that the linkage between the SPV and parent is exceptionally strong, the SPV may be fully integrated[2] with the parent, and in such cases, extent of notch up will be based on the framework described in the next section.

Extent of notch-up

CRISIL Ratings employs its criteria framework to estimate the extent of notch-up to be provided to the standalone rating of the subsidiary. The framework assesses the willingness of the parent to provide distress support and distinguishes between 'ongoing' support, when the subsidiary is doing well, and 'distress support', when the subsidiary is under financial stress. The framework is based on parameters that characterise the level of strategic and financial linkages between subsidiary and parent. These are broadly classified into factors that constitute the economic rationale of a parent for supporting the subsidiary, moral obligation on the parent to extend support, and the corporate status of the parent (*see Chart 2*). CRISIL Ratings endeavours to hold periodic discussions with the management of the parent to ascertain their stance of supporting the subsidiary being rated and the parent's support philosophy is considered as an input while applying the framework.

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[2] To understand how CRISIL Ratings factors the impact of a subsidiary on its parent's rating, please refer to "CRISIL's Criteria for Consolidation" available on www.crisil.com

Chart 2: Parameters for assessing the extent of notch-up

A. Economic rationale	B. Moral obligation	C. Corporate status of the parent
A.1. Strategic importance of the subsidiary to the parent A.2. Extent of parent holding A.3. Economic incentive to the parent	B.1. Extent of management control B.2. Shared name B.3. Domiciliary status B.4. Stated posture of the management	Listing status / Propensity to raise funds from capital markets

Economic rationale

The following parameters are evaluated in assessing the economic rationale for a parent to support its subsidiary:

A.1. Strategic importance to the parent: This is based on the relative size of the operations of the subsidiary with respect to that of its parent; the criticality of the subsidiary in terms of expansion plans, product launches, and market focus; and commonality in lines of business. Investments of the parent in other related subsidiaries having synergies with the subsidiary being rated are also considered. For captive finance companies, the extent of the parent's sales that are financed by these companies is taken as a measure of strategic importance.

A.2. Extent of parent holding (current and prospective): A higher shareholding of the parent in a subsidiary reflects greater commitment. CRISIL Ratings notches up the rating depending on whether the parent is able to exert control over the subsidiary. For instance, the rating may be notched up even if the parent holds a stake of less than 50% provided the parent is the dominant shareholder and is able to wield control. In case of JVs where two or more partners hold equal stake, CRISIL Ratings follows a different approach as described later in the section on JVs.

A.3. Economic incentive to the parent (current and prospective): A parent will be more likely to support a profitable subsidiary in temporary distress so as to prevent erosion of economic value of its investment. If a loss-making subsidiary gets into distress, the parent may be reluctant to extend support beyond a point. Hence, economic incentive is a powerful reason for providing support, and is measured in terms of return on capital/assets employed, both in absolute terms and with respect to industry standards.

CRISIL Ratings follows a forward-looking approach and takes a medium-term view on the economic prospects of the subsidiary, while also evaluating past trends and track record of performance. As for greenfield ventures, the timeframe set by the parent for the subsidiary to break even and the performance of the subsidiary in meeting specific targets set by the parent are also factored in while evaluating economic incentive.

Moral obligation

The following parameters constitute moral obligation on a parent to support the subsidiary:

B.1. Extent of management control: A subsidiary is considered to be under the control of its parent if:

- The parent exerts control over the board
- Daily operations are managed by the parent, or the parent conducts periodic reviews of operations
- Regular technical inputs are provided by the parent
- The subsidiary and parent have a common treasury

B.2. Shared name: This creates public awareness of the parentage of a subsidiary and displays the intent of the parent to associate itself with the subsidiary. As a result, moral obligation will be high on the parent to provide support. Even in the absence of a shared name, public perception of parentage – due to the sharing of brands, usage of the same logo, or acknowledgement of parentage on the website of the subsidiary – exerts pressure on the parent to provide support in case of distress.

B.3. Domiciliary status: This parameter assesses the relative ease with which a parent can transfer funds to its subsidiary, and the pressure exerted by common lenders and labour unions on the parent to support the subsidiary. Ease of transfer of funds and market pressure will be higher for a domestic parent vis-à-vis a foreign parent. In case of subsidiaries of foreign parents, the presence of common bankers, the role played by the subsidiary in the global supply chain and carved out bank lines of credit are factored in while evaluating the domiciliary status.

B.4. Stated posture of the management: The level of commitment of support is assessed on the basis of:

- Legally enforceable provisions, such as guarantees, put options, and cross-default provisions provided to the subsidiary’s debt instruments
- Assurances from the parent, such as letters of comfort, keep fit letter, maintenance of a debt service reserve account, and shortfall undertakings
- Demonstrated track record of support in the form of regular equity infusion, extension of unsecured loans

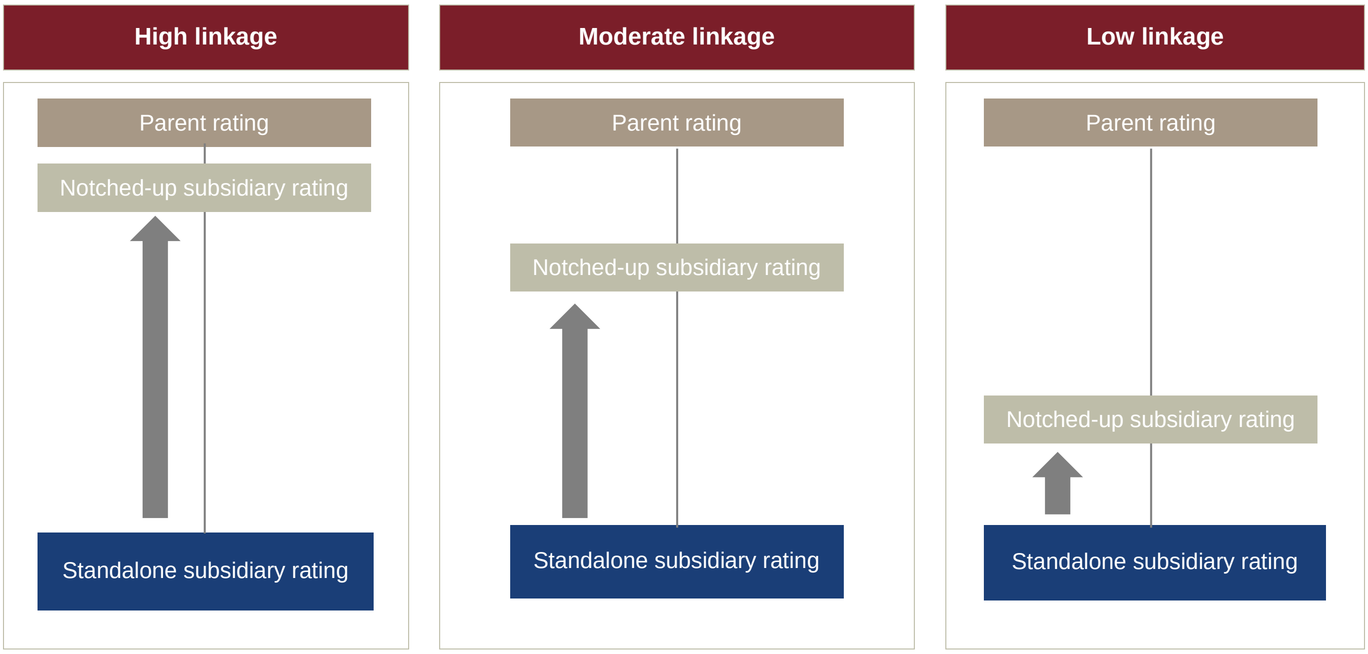
Corporate status of the parent

If the parent is a public limited company listed on a stock exchange, the propensity to support its subsidiary will be high as a default on debt obligation by the subsidiary may adversely affect any plans of the parent to raise funds from the capital market. For the same reason, unlisted public limited or private limited companies regularly raising funds from capital markets also have a high obligation to support their subsidiaries. An unlisted public limited company has a larger number of stakeholders than a private limited company, and hence, has a higher obligation to support its subsidiary.

Final rating of the subsidiary

CRISIL Ratings does not notch up the standalone rating of a subsidiary if the linkages between the subsidiary and parent are weak as per the evaluation of the parameters listed in Chart 2. If the linkages are assessed to be very strong, the final rating of the subsidiary is equated with the rating of the parent. If the linkages are assessed as moderate, the final rating of the subsidiary would be somewhere between its standalone rating and the rating of the parent. (See Chart 3).

Chart 3: Determining the extent of notch-up



Usually, infrastructure SPVs are not notched-up / notched- up only to a limited extent of 1-2 notches for parent support. This is because, these entities are generally structured as ring fenced entities that raise debt without explicit recourse to the parent.

Moral obligation on financial sector parent

The implications of letting a subsidiary default are higher for a financial sector parent as money is the raw material for these entities. If such a default materialises, it will negatively impact the reputation of the parent and dent investor confidence, create trust deficit and adversely affect its business prospects. Hence, CRISIL Ratings places higher weightage on moral obligation for subsidiaries of financial sector parents.

Joint ventures

CRISIL Ratings exercises caution while notching up ratings on JVs where two or more sponsors hold equal stakes, considering potential conflicts that may arise between sponsors. CRISIL Ratings may attribute support to a sponsor that articulates distress support to the entire debt of the JV. The attribution of support to one sponsor more than the others depends on the extent of criticality of the JV to that sponsor, business and operational linkages, perception of the bankers, infrastructure sharing, and managerial control. The extent of notch-up for the JV is as per the notch-up framework for parent support.

In exceptional cases, CRISIL Ratings may attribute support to two sponsors with strong credit profiles, if CRISIL Ratings believes that the JV is equally critical to both the sponsors holding equal stakes, the sponsors articulate distress support to the JV and CRISIL Ratings believes that the sponsor interests are aligned.

PE/Sovereign/Pension/ Insurance Funds

Typically, funds (floated by PE/Sovereign/Pension/ Insurance) invest in companies for limited duration before exiting for a profit. In these cases, the funds may not provide any distress support to the investee company. However, in the recent times, few large funds floated by PE players, sovereign funds, pension and insurance funds, have grown in size and have changed their orientation from a mere short-term investment to a medium-to-long term strategic support.

The change in orientation could be in one or more than one characteristic mentioned below:

1) Longer duration of investment
2) Majority controlling stake with an active treasury and management control
3) Commitment to provide distress support to the company in case of any shortfall to meet debt repayment

In the above cases, the parent-notch up framework may be used to arrive at a moderate level of credit support, if any, from the funds to the investee company.

Conclusion

CRISIL Ratings criteria for notching up ratings of entities based on parent support factor in three critical aspects:

- Performance of the subsidiary as represented by its standalone rating
- Ability of the parent to extend distress support as indicated by its rating
- Willingness of the parent to support the subsidiary, as determined by the notch-up framework

The extent of notch-up is based on parameters, such as the economic rationale and moral obligation of the parent to support the subsidiary, and the corporate status of the parent. Moral obligation is accorded greater weightage in case of subsidiaries of financial sector parents. The ratings of JVs with two or more partners holding equal stakes may be notched up for one sponsor depending on the criticality of the JV to the identified sponsor. In exceptional cases, support may be attributed to two sponsors holding equal stakes, if the JV is critical to both the sponsors.

About CRISIL Ratings Limited (A subsidiary of CRISIL Limited)

CRISIL Ratings pioneered the concept of credit rating in India in 1987. With a tradition of independence, analytical rigour and innovation, we set the standards in the credit rating business. We rate the entire range of debt instruments, such as, bank loans, certificates of deposit, commercial paper, non-convertible / convertible / partially convertible bonds and debentures, perpetual bonds, bank hybrid capital instruments, asset-backed and mortgage-backed securities, partial guarantees and other structured debt instruments. We have rated over 33,000 large and mid-scale corporates and financial institutions. We have also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and infrastructure investment trusts (InvITs).

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