

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

Executive summary

Indian business houses have a history of operating several companies in diverse lines of businesses. A group of companies may be identified by the presence of common promoters, significant cross-holdings and sometimes, a shared name or logo. While assessing the credit quality of companies belonging to a group, CRISIL factors in the likely support that the companies may receive from the group. The benefit of a notch-up is, however, provided only to companies belonging to a group with a reasonably strong credit quality. CRISIL considers the presence of a clearly identifiable parent as more favourable than membership in a group. Therefore, while the extent of notch-up for group support is restricted to four notches, there is no restriction on notch-up for parent support. CRISIL employs a comprehensive framework to decide if a company belonging to a group is to be notched up, and the extent of it, for group support. The framework captures the degree of integration between the company and the group, and is based on a set of economic parameters, and factors that create a moral obligation on the group to support the company.

CRISIL has now further refined its notch-up criteria, which was previously updated in May 2013, for group support based on a study of its portfolio of notched-up ratings and on interactions with market players. The major changes incorporated are the following:

- Group support may now be factored in for entities in groups in the 'BBB' category as well, unlike in the past when the application was restricted to groups in the 'A' and higher categories. This change takes into account the significant improvement in default rates of CRISIL ratings in the 'BBB' category over the last decade (see Table 1). Companies with standalone rating of 'B' or higher may also be notched up for group support unlike earlier when CRISIL did not consider doing so when the standalone rating was lower than 'BBB'. This change is in light of the significant improvement in default rates of rating in categories 'B' and higher (see Table 1).
- The extent of notch-up is now restricted to four notches (up from three notches earlier) for companies with standalone rating of 'B' or higher, and strong linkages with a group in the 'AA' or higher category.

Table 1: 3-year cumulative default rates of CRISIL ratings (based on monthly static pools)

Period	AAA	AA	A	BBB	BB	B	C
1990-2000	0.00%	2.13%	11.61%	20.66%	40.91%	71.53%	63.16%
2004-2014	0.00%	0.17%	2.44%	5.21%	13.47%	23.08%	36.11%

A. Scope of criteria

This criteria article pertains to companies belonging to a group, held by common promoters or other companies in the group. In case of subsidiaries with a clearly identifiable parent, CRISIL adopts the methodology described in 'Criteria for notching up standalone ratings of companies based on parent support', which is available on the CRISIL website.

The criteria apply to large groups with operations in multiple sectors with a relatively complex holding structure. These have ability to raise resources based on their brand or reputation in the financial markets. Most companies in the group may be listed, and each will have a professional management and a strong, independent board. However, the promoters will retain a sizeable stake (could be as low as 30 per cent), and exercise control over companies in the group and over the board.



The criteria may not be applicable to family groups of the ‘smoke-and mirrors’ kind, operating as one single entity, under a common promoter or promoter family. Many promoters/families run medium-to-small groups in one or two business segments, but with several companies. The reasons for operating several companies may include the following:

- Each company in the group may take care of a particular geography, market or one part of the value chain
- Opportunistic buying and selling of operations, with little or no strategic justification
- Segregation of roles of different family members
- Legal or tax reasons

Such companies will, however, have some common characteristics:

- High fungibility of cash flows between the companies and inter-company transactions
- Promoter control over operations and decisions, including what business to undertake, or which entity should execute a specific contract
- Companies in the group that are typically not listed in the equity markets
- Cross-guarantee of debt from one company to another

Group support is factored into the ratings when the group company’s debt is not explicitly guaranteed by another company in the group. If the instrument being rated is unconditionally and irrevocably guaranteed by another group company, backed by a payment mechanism, the rating of the instrument is equated to the rating of the guarantor, suffixed with the tag, SO (Structured Obligation), to highlight the credit enhancement in the form of the guarantee and payment mechanism.

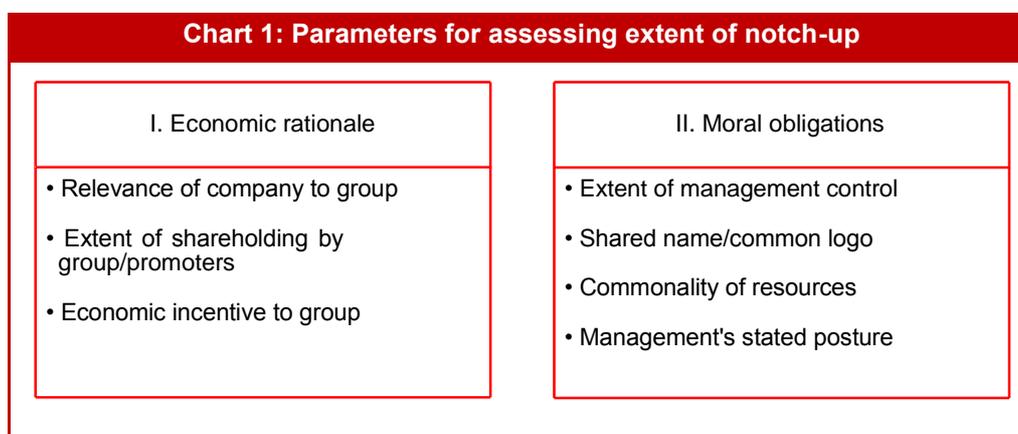
B. Assessing credit quality of group

The overall credit quality of a group is assessed to gauge its ability to support its members. It is of paramount importance to first identify the companies that constitute the group. A company may be part of a group based on holdings by common promoters, investments by other companies in the group, or a shared name or logo. CRISIL also evaluates the promoter’s and management’s willingness to identify a company as a member of the group.

The group’s overall credit profile is analysed by factoring in the financial, business and management risks of its major constituent entities. The ability of stronger entities in the group to support other companies and the impact of such support on the overall credit quality of the group are evaluated. If the group’s credit quality comes under pressure on account of honouring the liabilities of weaker entities, it will impact the rating of the major constituents of the group.

C. Extent of notch-up

CRISIL employs its group notch-up framework to estimate the extent of notch-up to be provided to the standalone rating of a company. The framework assesses the level of strategic and financial linkages between the company and group, and is based on the following parameters: the economic rationale for the group to support the company; and, factors that create a moral obligation on the group to support the company (*Chart 1*).



I. Economic rationale

The following parameters are part of the economic rationale for a group to support a group entity:

- i. Relevance of company to group: The relevance of a company to its group may be evaluated based on the relative contribution of the company towards the consolidated turnover and profits, commonality in lines of business, and criticality of the company to the group (whether the company is a critical supplier to other group companies or operates in a major growth market). The promoters' outlook on the company's business is also factored in during the evaluation.
- ii. Extent of shareholding by group/promoters (current and prospective): CRISIL notches up the rating of a firm for group support when there is significant shareholding by the promoters or other group companies, because this reflects a greater commitment towards the company. CRISIL also takes into account holdings by other stakeholders, including dealers and employees, if their interests are aligned with those of the promoters.
- iii. Economic incentive to group (current and prospective): If a firm is not profitable, its group may be reluctant to extend support beyond a point. But if a profitable firm falls into temporary distress, timely support by the group will prevent erosion of the economic value of the investment held by the group. CRISIL follows a forward-looking approach on the profitability of the firm, taking a medium-term view on 'return on capital/assets employed', but balanced by its past performance. In case of companies in the project stage, the timeframe set for the company to break even and contribute positively to investments made by the group is also factored in when evaluating economic incentive.

II. Moral obligations

The following parameters constitute moral obligations on a group to support an entity:

- i. Extent of management control: This is determined by the extent of control exerted by the group on the company's board, the group's active involvement in managerial decisions and day-to-day operations, sharing of systems and expertise between group and company, and the presence of a common treasury.



- ii. Shared name/common logo: A shared name between the group and company creates a moral obligation on the group to bail out the company in times of distress. Even in the absence of a shared name, integration of the company with the group may be manifested in the form of a common logo, or acknowledgement of group membership on the company's website/letter pads/visiting cards.
- iii. Commonality of resources: Market pressure in terms of common bankers, common location of operating units would increase the group's moral obligation to support the rated company. The pressure to bail out the rated company would also be high from the market, government and common lenders.
- iv. Management's stated posture: The track record of the group in extending financial support to group companies is considered an indicator of the management's stated posture. CRISIL will not notch up companies in a group if the track record of supporting group companies is unsatisfactory. Guarantees and assurances such as letters of comfort, or shortfall undertakings from one or more group companies also reflect the group's commitment to the rated company.

D. Final rating of group company

CRISIL does not notch up the standalone rating of a group company if the strategic and financial linkages between the company and group are weak on evaluation of parameters listed in *Chart 1*. CRISIL notches up the standalone rating of a group company only if the credit profile of the group is 'BBB' or above.

In case of subsidiaries, it is possible to identify a single-parent entity that will provide distress support. However, if support is expected from a group of companies, it may not be possible to identify a single entity as the source of distress support, resulting in uncertainty regarding the extent and timeliness of support. CRISIL, therefore, restricts the extent of notch-up for group support to four notches. Furthermore, the final notched-up rating is in most cases maintained at least one notch lower than that of the group rating. This is in contrast to the notch-up of subsidiaries for support from a clearly identifiable parent, where no such restrictions apply.

E. Conclusion

CRISIL's group notch-up criteria factor in the ability and willingness of a group to support its group company in times of distress, depending on the strategic and financial linkages between the company and group. These linkages are captured in a comprehensive framework, which is based on a set of parameters characterising the economic rationale for the group to support the company, the moral obligations on the group, and demonstrated track record of the group in supporting its companies. This framework is used to determine if, and the extent to which, the rating of a company is to be notched up for group support.

About CRISIL Limited

CRISIL is a global analytical company providing ratings, research, and risk and policy advisory services. We are India's leading ratings agency. We are also the foremost provider of high-end research to the world's largest banks and leading corporations.

About CRISIL Ratings

CRISIL Ratings is India's leading rating agency. We pioneered the concept of credit rating in India in 1987. With a tradition of independence, analytical rigour and innovation, we have a leadership position. We have rated over 95,000 entities, by far the largest number in India. We are a full-service rating agency. We rate the entire range of debt instruments: bank loans, certificates of deposit, commercial paper, non-convertible debentures, bank hybrid capital instruments, asset-backed securities, mortgage-backed securities, perpetual bonds, and partial guarantees. CRISIL sets the standards in every aspect of the credit rating business. We have instituted several innovations in India including rating municipal bonds, partially guaranteed instruments and microfinance institutions. We pioneered a globally unique and affordable rating service for Small and Medium Enterprises (SMEs). This has significantly expanded the market for ratings and is improving SMEs' access to affordable finance. We have an active outreach programme with issuers, investors and regulators to maintain a high level of transparency regarding our rating criteria and to disseminate our analytical insights and knowledge.

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