CRISIL
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CRISIL's criteria for rating entities belonging to homogenous corporate groups

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Executive summary

In India, there are several family-owned groups that operate in a particular sector (such as textiles, jewellery, trading, and real estate) through different entities. Though these may not have apparent shareholding linkages, they often have common ownership and strong business, financial and managerial relationships. For instance, a promoter family may operate a jewellery business through different, fully owned entities with common procurement and branding strategies, and a centralized treasury. CRISIL defines such groups as 'homogenous' where several entities represent the promoter family's interest in a particular sector.

Entities in such groups are not listed and unlikely to have a sizeable minority shareholding. They can have seamless cash flow, and there is a high likelihood of corporate guarantees or cross-collateral agreements between them. The promoters of such entities and their families are actively involved in managing operations and capital allocation decisions. Therefore, the credit risk profile of a homogenous group is driven by the collective strength and integrated operations of its constituent entities.

CRISIL combines the business and financial risk profiles of all entities to arrive at the group rating, after considering the significant business, financial and managerial linkages. The ratings of individual entities are either equated to the combined group rating, or may be differentiated by up to three notches. The differentiation will be based on the contribution of an entity to the group's cash flow, it's exhibited and forecasted growth, its criticality to the group and its financial risk profile relative to the group.

Scope

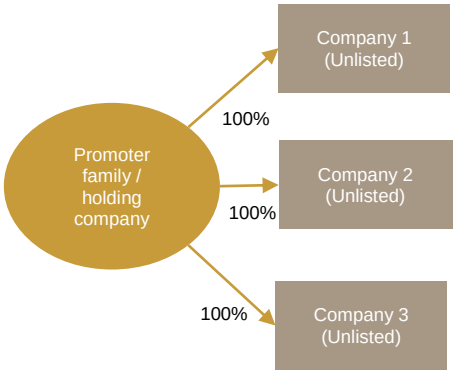
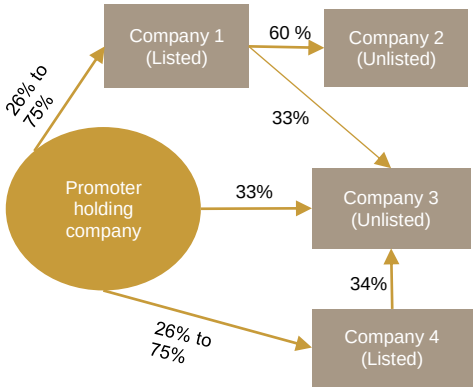
This criteria[1] is applied to homogenous family groups in the non-financial sector under common promoters with no clearly identifiable shareholding linkages between entities. When there is a clearly identifiable parent-subsidiary relationship, CRISIL applies its '*Criteria for notching up standalone ratings of companies, based on parent support*'[2]. In case of a group of companies under common promoters, with no clearly identifiable parent, CRISIL may apply either its '*Criteria for homogenous groups*', or its '*Criteria for notching up standalone ratings of companies based on group support*'[3]. This will be based on the characteristics of the group, as outlined in Table 1.

[1] *For accessing previous version of the document , kindly follow link: https://www.crisil.com/content/dam/crisil/criteria_methodology/criteria-research/archive/Criteria%20for%20rating%20entities%20belonging%20to%20homogenous%20corporate%20groups.pdf*

[2] *Please refer to the CRISIL website, www.crisil.com*

[3] *Please refer to the CRISIL website, www.crisil.com*

Table 1: Characteristics of groups to decide applicable criteria

Parameter	Characteristics for application of criteria	
	Homogenous groups criteria	**Notch-up based on group support**
Shareholding pattern		
	• All entities held 100% by the promoter family • Unlisted entities, with minimal external shareholding	• Promoter shareholding varies from 26-100% in different entities • Presence of listed entities/external shareholding in unlisted entities
Board composition	• Promoters and their families will have high levels of representation and commonality across all boards	• While the promoters will be present on each board, there will be outside members with differences in the overall composition
Management	• Active involvement of promoters, in managing operations of individual entities • Capital allocation, funding decisions taken centrally by the promoters	• Professional management for each entity • Capital allocation, funding decisions taken by the individual managements, with guidance from the promoters
Business lines	• Entities in similar or related business lines; however, there may be instances where promoters may diversify into new sectors • Separate entities to avail tax benefits, handle stakeholder demands, or segregate roles and responsibilities within promoter family	• Entities in unrelated business lines, where each business is insulated from the rest
Operational linkages	• Significant operational synergies, in the form of common manufacturing locations, procurement/ marketing, intercompany sales, and other functions	• Limited or no operational linkages • Inter-company transactions, if any, happen at arm's length
Financial linkages	• All entities typically share a common treasury • Cash flow easily fungible among entities, as they are all held by the same promoter family • Corporate guarantees and collateral sharing are common between entities	• Finances of entities are managed independently • Presence of external/minority shareholders restricts flow of funds between entities • Collateral sharing is unlikely; however, in some cases, there can be guarantees extended between entities depending on management philosophy

Parameter	Characteristics for application of criteria	
	Homogenous groups criteria	Notch-up based on group support
Group credit risk profile	• Although there could be differences in the level of cash flow contribution, business risk profile and credit strength are derived from the collective strength of all the entities	• Few strong listed entities contribute significantly to the group's cash flow and credit risk profile
Promoters' stance	• With high level of business linkages and fungibility of cash flow between entities, credit support between them is ongoing and continuous	• Need-based distress support between the entities, based on business viability
Lenders' perspective	• Banks are typically common across entities • Banks view all entities as part of the same group, with minimal interest rate differentials • Banks draw comfort from overall support provided to the entities by the group	• Entities raise resources from multiple sources • Lenders view each entity separately, but draw comfort from the group

A. Credit quality of a homogenous group

All entities operate in similar businesses and perform specific functions, including:

- Geographic diversification by entering into new markets
- Extending product portfolio to related business lines
- Backward integration by supplying critical raw material
- Forward integration by entering into retailing or distribution

All entities are typically unlisted and fully owned by the same promoters, who exert a high degree of operational control. Cash flow are fungible between entities, and decisions pertaining to capital allocation and debt funding are taken centrally by the promoters. Considering the significant business, financial, and managerial linkages between entities, CRISIL assesses the credit quality of a homogenous group, as if all the entities were part of a single company. The group rating is arrived at, by combining the business and financial risk profiles of all entities, as highlighted in Table 2.

Table 2: Consider a homogenous group with three entities: A, B, and C. The group manufactures its products through entity A and sells them to customers in two regions, via entities B and C..

Business risk	• The group's market position is driven by combined sales through B and C • Operating efficiency is based on vertically integrated operations of A, B, and C
Financial risk	• Based on consolidated financials of all entities, after adjusting for inter-company sales, equity holdings, and loans and advances • Projections based on aggregate capital expenditure, debt-raising plans
Management risk	• Based on assessment of the promoter's risk appetite, competence, and integrity

B. Identifying homogenous group companies

CRISIL combines only those entities within a homogenous group, where significant business and financial synergies can be established. The entities have to meet the following preconditions for being included in the group:

- **Fully held by common promoters:** The entities must be unlisted, and held by the same promoters with marginal shareholding of external investors. This allows the promoters to exercise a high degree of control over operations, and provides them flexibility to allocate surplus cash flow of one entity to fund or support the operations of another, thereby lending financial stability to overall operations of the group.
- **Business linkages between entities:** The entities must be engaged in similar or related business lines, with operational linkages such as common manufacturing facilities and procurement/marketing functions, and vertically integrated operations. The entities must contribute to the group's business risk profile, either by strengthening its market position through geographic expansion, new product lines or diversification of customer base, or via improved operational efficiency, through supply of components and job-work for other group entities, among others. If the promoters control other entities, operating in an unrelated business segment, these entities may not be combined under the homogenous group.
- **Financial linkages between entities:** A common management team must exert control over the treasury operations of individual entities, thus ensuring a seamless flow of funds between them. CRISIL usually obtains an undertaking from the promoters to this effect. The entities may also provide financial assistance to each other, through corporate guarantees, loans and advances, and cross-company equity holdings.

CRISIL's approach if the preconditions are not met:

Even within a homogenous group, certain entities may not satisfy all the preconditions for being included in the group. Such entities would be assigned ratings, based on the group notch-up framework[4] to factor in group support, if applicable. Typical examples of entities not combined into a homogenous group and the reasons for this, are given in Table 3.

Table 3: Entities not combined into a homogenous group

Characteristic	Reasons for not combining
Substantial external shareholding	• Restrictions on accessing cash flow • Potential conflicts over extent of fund support
Limited business linkages with other entities	• Not contributing to the group's business risk profile • Typically low scale and limited debt • Shell companies, with no operations (for example, entity formed to hold assets such as land)
Independent management	• Limited fungible cash flow with other entities • Intent of insulating cash flow
Entities operating in a different business line*	• Not contributing to the business risk profile of other entities • Extent of support will depend on business viability

** In case a group operates in two or more business lines, entities in one business line may be combined under a sub-group, if they satisfy all preconditions. The benefits of being associated with a common promoter group will be factored into the rating of the sub-group, through the group notch-up framework.*

In addition to the preconditions stated, CRISIL performs the following checks to ensure that the business and financial linkages will continue in the medium-to-long term:

- **Presence of family factions:** Second- or third-generation homogenous family groups may be subject to family splits. These are typically followed by severing of linkages, between different entities. This will impact the collective business strength of the group, and thus, weaken the credit risk profiles of individual entities. Hence, CRISIL, in its assessment of homogenous family groups, factors in the risks of family separation in the future.

  For instance, CRISIL considers risks of family separation to be high, in the following scenario:

  - Shareholding and board composition of one set of entities is concentrated with one family faction, and
  - Roles and responsibilities of family members are segregated, not based on functions (such as procurement, marketing, and finance), but based on companies.

[4] *As per CRISIL's "Criteria for notching up standalone ratings of companies based on group support"*

CRISIL exercises caution if it believes that there is high probability of a family split. Entities belonging to different factions will be combined if only the promoters have strongly articulated against any such split in the medium term, and there are significant business and financial linkages that necessitate consensus between factions.

- **Common bankers:** Homogenous group entities typically transact with common bankers, who draw comfort from established relationships with the group, and maintain minimal interest-rate differentials between entities. There may even be instances where the bankers could be different, but CRISIL may still choose to combine, based on business and financial linkages between the entities. However, the entities will be included in the group, only if there are no explicit restrictions in the loan sanction terms on movement of funds between entities.

C. Ratings of individual group entities

The credit risk profile of a homogenous group is driven by the integrated operations of its entities, enabling the group to achieve market competencies though economies of scale, pricing power of an established brand, and sharing of common promoter/managerial expertise. Hence, the credit risk profile of each entity is centrally linked to the credit risk profile of the group. However, the ratings of all the entities may not be equated to that of the group credit rating. CRISIL may choose to differentiate between ratings of individual entities by up to three notches lower than that of the group. This will depend on their contribution to the group's cash flow, criticality of operations, growth prospects, and relative financial risk profile and project risk, if any.

Entities with significant contribution to the group: If an entity contributes substantially to the group, its business risk profile has a material effect on the group's credit risk profile. Hence, credit risk profiles of such entities are equated to that of the group.

Entities with low contribution to the group: In case an entity's contribution is low, CRISIL may lower the rating of that particular entity by up to two notches, to indicate its weaker business risk profile relative to that of the group. The entity's contribution is considered low if its earnings before interest, tax, depreciation, and amortization (EBITDA) is less than 10% of the group's EBITDA, and it significantly deviates from other group entities. The extent of notch-down is restricted to two notches as CRISIL believes the group has high moral obligations to extend business, financial, and managerial support.

For entities with a low contribution to the group, CRISIL looks at following conditions to decide the extent of notch-down from the group rating:

If the entity's EBITDA is not growing in line with that of the group, and if it has a weak financial risk profile compared with that of the group's benchmarks, then the rating will be lowered by up to two notches.

However, if the entity displays either a healthy financial risk profile or its EBITDA continues to grow in line or better than that of the group, the notch-down may be restricted to one notch. If both these conditions are met, CRISIL may choose to equate its rating to that of the group.

Furthermore, there may be instances where a smaller entity may perform crucial functions such as supply of critical components to the group's operations. CRISIL may choose to equate the ratings of these entities to that of the group based on its assessment of criticality.

Project entities yet to commence operations: A project entity is combined into the group only if business linkages are expected to be established with the group, once operations commence. The rating of a project entity may be lowered from the group rating by up to three notches, based on the assessment of project risks relative to the group's credit risk profile. Presence of financial linkages with the group, in the form of fund infusions and corporate guarantees, are also considered while deciding the extent of notch-down.

D. Conclusion

CRISIL terms groups of entities operating in similar business lines, fully held by common promoters with centralized decision-making, as homogenous groups. Entities in such groups operate as if they were divisions of a single company. While assessing the credit quality of these entities, CRISIL first arrives at the group rating by combining the business and financial risk profiles of all constituent entities. The ratings of individual entities included in the group are either equated to or notched down from the group rating, depending on the entity's contribution to the group's business and other linkages with the group.

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It is India's foremost provider of ratings, data, research, analytics and solutions, with a strong track record of growth, culture of innovation and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

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