Ratings

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 factors in the likely support from a higher rated parent in the event of distress. The extent of the notch-up 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.

CRISIL has now further refined its notch-up criteria, which was previously updated in May 2013, for parent support based on a study of its portfolio of notched-up ratings and on interactions with market players. The major changes are summarised in Box 1.

Box 1: Summary of revisions to the previous framework for notch-up for parent support

CRISIL has extensive experience in applying its notch-up criteria to multiple cases covering diverse sectors, groups, and rating categories since 2001. This has provided strong empirical evidence to validate the robustness of the criteria.

As part of a recent criteria review, CRISIL studied three-year cumulative default rates and average one-year transition rates of outstanding notched-up ratings in its portfolio over the past ten years. Perspectives of debt and capital market participants have also been factored in.

The study shows only one instance of default among CRISIL's portfolio of notched-up ratings. This implies that the notch-up criteria have been successful in identifying entities that are likely to receive timely financial support from a strong parent. Notched-up ratings also displayed stability on par with their respective category averages, indicating that the extent of notch-up, as judged by the criteria, successfully captures the level of support that flows to an entity from its parent or group, or from the government. As a result, the credit risk profile of the entity is insulated from minor fluctuations in standalone performance, lending higher stability to the notched-up rating.

CRISIL has now refined its parent notch-up criteria based on the study, with an aim to enhance the scope and efficacy of the notch-up criteria. The previous framework has been fine-tuned to incorporate the following:

- Higher weightage to moral obligation on financial-sector parents to lend support, given the wider implications of a default by the subsidiary on the parent
- Notching-up of joint ventures (JVs) where two or more sponsors hold equal stakes

A. Scope

This criteria article pertains to subsidiaries with significant shareholding by a clearly identifiable parent. For JVs where two or more partners hold equal stake, CRISIL may attribute support to a partner which explicitly backs the entire debt of the JV. As for entities belonging to a strong group with common promoters and intra-group investments, CRISIL adopts the methodology described in *'Criteria for notching up standalone ratings of companies based on group support'* available on www.crisil.com.

CRISIL adopts a different approach when factoring in support from the government for government-related entities (*'Criteria for notching up standalone ratings of entities based on government support'* is also available on www.crisil.com)

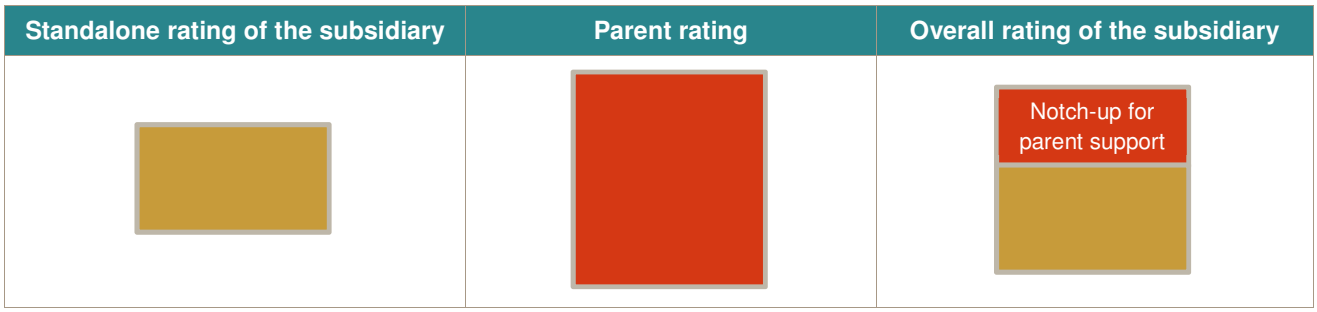
CRISIL notches up a subsidiary only when the credit rating of the parent is stronger than the standalone rating of the subsidiary. While the rating on the subsidiary is notched up for parent support, the likely impact of such support on the credit quality of the parent is also factored in. In the case 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. CRISIL may not notch up the ratings of such SPVs, or will limit it to one or two notches depending on the track record of support from the parent. However, if CRISIL believes that the linkage between the SPV and parent is exceptionally strong, the SPV may be fully integrated[1] with the parent and in such cases, extent of notch up will be based on the framework described in the next section.

The notch-up framework is applied when there is no explicit guarantee from the parent. If the debt instrument being rated is unconditionally and irrevocably guaranteed by the parent, and backed by a trustee-monitored payment mechanism, the rating on the guaranteed instrument of the subsidiary is equated with that of the parent, and suffixed by 'SO' (structured obligation) to highlight the credit enhancement in the form of guarantee and payment mechanism.

B. 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*).

Chart 1: Overall rating of the subsidiary



1. Standalone rating of the subsidiary

This rating indicates credit quality without factoring in parental 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.

[1] To understand how CRISIL consolidates the financials of a company and its related entities, please refer "CRISIL's Criteria for Consolidation" available on www.crisil.com

Refer the following link for accessing the previous published rating criteria

https://www.crisil.com/content/dam/crisil/criteria_methodology/criteria-research/CRISIL%20Ratings%20research%20notching%20up%20stand%20alone%20parent%20sup%202013.pdf

2. Parent rating

The rating indicates the ability to support a subsidiary when necessary. This credit support is factored into the rating of the parent. CRISIL notches up ratings only when the parent rating is higher than the standalone rating of the subsidiary.

3. Extent of notch-up

CRISIL 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*).

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

I. Economic rationale	II. Moral obligation	III. Corporate status of the parent
• Strategic importance of the subsidiary to the parent • Extent of parent holding • Economic incentive to the parent	• Extent of management control • Shared name • Domiciliary status • Stated posture of the management	• Listing status • Propensity to raise funds from capital markets

I. Economic rationale

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

i. 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 funding provided by these companies to the parent is taken as a measure of strategic importance.

ii. Extent of parent holding (current and prospective): A higher shareholding of the parent in a subsidiary reflects greater commitment. CRISIL 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 follows a different approach as described in Section E, on JVs.

iii. 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 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.

II. Moral obligation

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

i. 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

ii. 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/letter pads/visiting cards of the subsidiary -- exerts pressure on the parent to provide support in case of distress.

iii. 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.

iv. 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
- Assurances from the parent such as letters of comfort, maintenance of a debt service reserve account, and shortfall undertakings
- Demonstrated track record of support in the form of regular equity infusion and extension of unsecured loans

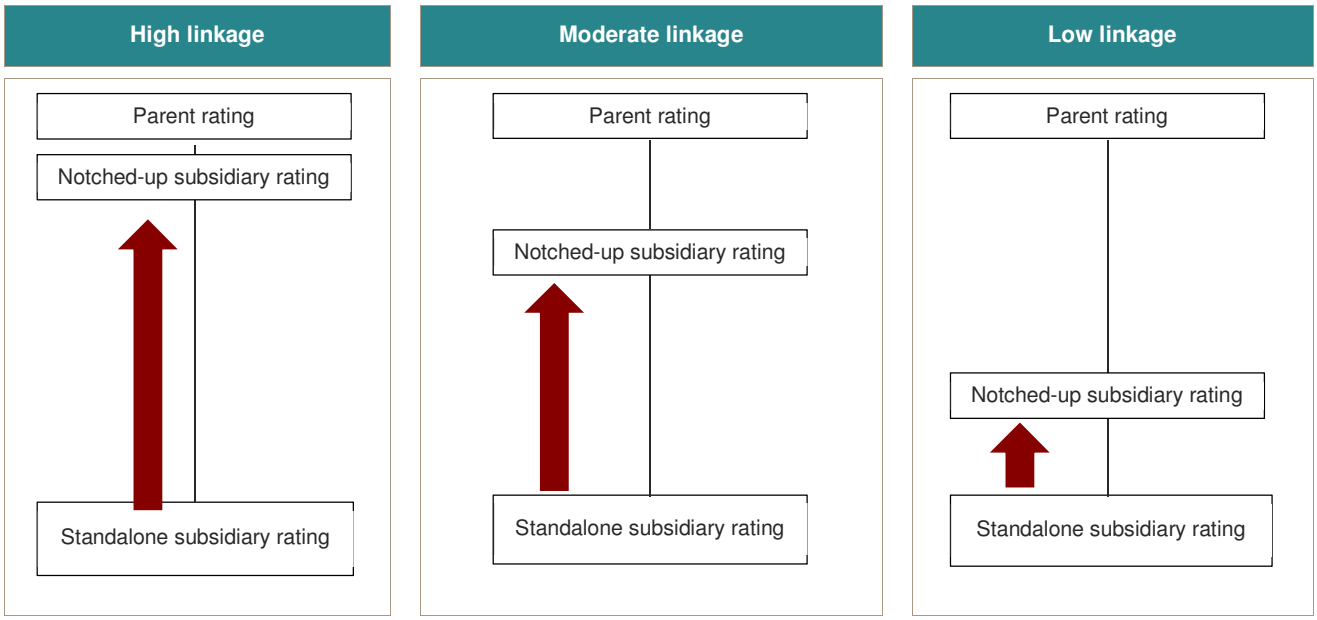
III. Corporate status of the parent

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.

C. Final rating of the subsidiary

CRISIL 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. For instance, after evaluation of various parameters, if CRISIL assesses the score on the linkages between the subsidiary and the parent to be 60 out of 100, the rating is notched up to 60% of the difference between the rating of the parent and the standalone rating of the subsidiary (*see Chart 3*).

Chart 3: Determining the extent of notch-up



D. Moral obligation on financial sector parent

The implications of letting a subsidiary default are higher for a financial sector parent than for a corporate sector parent. If such a default materialises, it will negatively impact the reputation of the parent and dent customer confidence, adversely affecting its business prospects. Hence, CRISIL places higher weightage on moral obligation for subsidiaries of financial sector parents, while maintaining almost equal weightage on economic rationale and moral obligation in the case of corporate sector parents.

E. JVs

CRISIL 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 may attribute support to a partner that comes forth with a verbal or written commitment that it will provide distress support to the entire debt of the JV, regardless of the actions of the other JV sponsor(s). The attribution of support to one parent more than the others depends on the extent of criticality of the JV to that parent, 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, with adequate differentiation factored in for the kind of support manifested.

F. Conclusion

CRISIL's notch-up criteria factors in three critical aspects:

i. Performance of the subsidiary as represented by its standalone rating

ii. Ability of the parent to extend distress support as indicated by its rating

iii. Willingness of the parent to support the subsidiary

CRISIL has a comprehensive framework to determine if the rating of a subsidiary is to be notched up and its extent. The framework 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 are notched up only if a sponsor provides a written/verbal commitment to provide distress support to the JV.

About CRISIL Limited

CRISIL is an agile and innovative, global analytics company driven by its mission of making markets function better. We are India's foremost provider of ratings, data, research, analytics and solutions. A strong track record of growth, culture of innovation and global footprint sets us apart. We have delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

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