VIS

Credit Rating Company Limited

# LINKAGES BETWEEN PARENT AND SUBSIDIARY COMPANIES

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# SCOPE OF CRITERIA

With the passage of time, Pakistan has witnessed the emergence of large corporations and groups, which have altered the competitive landscape in the country. These entities often have diversified interests, which are manifested through their investment in subsidiaries and associate companies. Parent entities can often have a significant degree of influence, over the credit risk profile of their subsidiaries and associate companies which may be manifested in the form of support or negative intervention. This criteria framework assesses the linkages between parent and subsidiary entities and their impact on ratings. It applies to entities whose risk profiles are significantly influenced by their relationship with their parent and/or subsidiary company.

# SUMMARY OF CRITERIA CHANGES

The fundamental criteria outlined in the Linkages Between Parent and Subsidiary Companies methodology remains unchanged, however, this criteria document further elaborates on possible scenarios specific to holding company structures.

# RATINGS FRAMEWORK

VIS Credit Rating Company Limited (VIS)'s approach to rating subsidiaries is a bottom-up approach. This starts with assigning a stand-alone rating to the parent and subsidiary in line with their respective methodologies. The standalone rating takes into account factors such as the existence of a commercial relationship between the parent and subsidiary, at an arm's length. The consolidated credit profile and the standalone credit strength of the parent and its subsidiary are used to determine the final ratings.

The next step is to determine the likelihood of support that is expected from the parent. The likelihood of support has two components — willingness and ability to support. Willingness to support incorporates considerations of reputation and confidence sensitivity, strategy, operational integration as well as marginal return on required prospective investment and the role of financial regulators.

Factors such as shared name pertain more to a moral obligation rather than a legally binding requirement. The strategic importance and relative size of a subsidiary to that of the parent entity may be an important indicator of the degree of support that might be forthcoming in times of distress because an institution might not be willing to bear a dent on its own franchise when it has the ability to prevent this from happening.

Ability to support depends on the parent's own risk profile and the correlation between the parent and subsidiary's respective financial condition. In highly correlated businesses, parent and subsidiary may undergo a trough in their business cycle at the same time; thus the parent's ability to provide support may be impaired in times of contingencies. As per the above mentioned process, the ratings of subsidiaries are based on their own standalone creditworthiness, with a potential notching to reflect parental support.

A weak entity sponsored by a strong parent usually enjoys a stronger rating than it may have on a stand-alone basis. Given that the parent has the ability to support the subsidiary in times of financial distress, there could be various outcomes ranging from ratings equalization to negligible or no support from the parent. Wider the gap, better evidence of support is required.

The degree of notching reflects an assessment of the support that might be forthcoming when needed, which in turn depends on a number of factors, including strategic importance, percentage ownership, management control, shared name, relative size and nature of parent's operations, and history of support to the subsidiary.

Rating of a strong subsidiary owned by a weak parent may be capped at the parent's level. Exceptions to this rule can occur when the subsidiary is legally ring fenced and a parent's bankruptcy may not be able to cause the bankruptcy of its subsidiary. In such a scenario, the subsidiary will be able to pay off its obligations as per its own capability before winding up and creditors will be protected to the extent of the entity's stand-alone strength, which implies that the subsidiary may be rated higher than the parent. The aforesaid is subject to the legal and regulatory stipulations in definition of a subsidiary which may impact the status of a subsidiary. In Pakistan a subsidiary/associate in regulatory regime (companies act 2017) is not ring fenced in the sense that while liquidators of the parent company may not opt for liquidation of subsidiary company they may resort to force sale of subsidiary to meet the claims of the main company.

In a purely holding company structure, it is common for the holding company to be rated lower than its subsidiaries, and there are valid reasons for this. Holding companies typically depend on dividends, distributions, or other cash flows from their operating subsidiaries to meet their own financial obligations. As a result, their financial stability is directly tied to the performance and willingness of those subsidiaries to upstream cash. If these cash flows are restricted or if subsidiaries prioritize their own debt obligations, the holding company may face increased financial risk. Additionally, holding companies often experience greater structural subordination, meaning their creditors rank behind the subsidiary's direct creditors in claims on the subsidiary's assets. In a distress scenario, lenders to the concerned subsidiary company are generally paid first. However, exceptions exist—if a holding company has strong liquidity, independent cash flows, or a well-diversified portfolio of profitable subsidiaries, its rating could be on par with or even higher than some of its subsidiaries.

While the norm for "ratings lift" may be restricted for subsidiaries of NBFCs since they have a cap on their leverage, it could be elevated for commercial banks because of their access to a larger pool of funds. In case of industrial corporates, which are further constrained in the amount of debt that they can take on their books, the rating lift provided to their subsidiaries may be considerably limited. Further analysis of intra-group debt may be warranted to determine the level of support that can be realistically built into the ratings. It is also important in credit default ratings where immediate support is required to avert default that wherever regulatory stipulations do not permit unhindered investment into subsidiaries and associates, the presence of an arrangement to support exists.

The ownership of an entity by more than one parent would result in a dilution of impact of a strong parent, in case one parent defaults or is under distress. This, however, would depend on the relationship between each parent and the subsidiary. In case of a foreign parent, the linkage between parent and subsidiary could be different from locally established entities. As foreign parent may not be subject to the same rules for bankruptcy; thus the bankruptcy of the parent would not in itself instigate bankruptcy of the subsidiary. In an entity which is a subsidiary of more than one large distinct shareholders, the support from the shareholder which holds the highest stake or has the management control may carry more weightage in support determination.

The creditworthiness of the foreign parent is an important factor in the subsidiary's rating to the extent of its ability and willingness to expand or squeeze the subsidiary's cash reserves. In the absence of rating assigned to the parent by an international rating agency, a shadow rating is assigned to the same in order to facilitate the analysis.

The sovereign rating of Pakistan itself also comes into play when applying notching guidelines to the rating of a company based in Pakistan, having a foreign parent. The extent of notching would also take into account the rating of the foreign parent versus the rating of Pakistan itself, which is deep non-investment grade currently. This implies that the rating uplift from a financially strong foreign parent could be significant.

However, given the risks in the local environment and Rupee depreciation over time, at times even financially strong foreign parents have exhibited reluctance to extend support to their local subsidiaries. This brings us to our earlier highlighted criterion whereby the marginal return on additional investment may not be justified, given the risk exposure. Sovereign boundaries impede integration and make it easier for a foreign parent to distance itself in the event of problems at the subsidiary level. In such scenarios, the rating of a subsidiary may largely reflect its stand-alone financial risk profile.

# INSTRUMENTS WITH UNDERLYING GUARANTEES BY PARENT ENTITY

If a highly rated parent guarantees the debt being issued by a subsidiary, VIS will review whether the guarantee mechanism is triggered before or after the payment due date. Moreover, coverage of the guarantee is also reviewed to see if the same covers principal or interest or both. Presence of structured mechanism whereby the guarantee may be invoked before due date so that all debt obligations (both principal and interest) are repaid in a timely manner may even result in equation of debt ratings with that of the parent. However, in the absence of a structured mechanism where payment before due date does not have certainty, the notching is based on VIS's standard notching criteria and strength of the guarantee. In cases where the entire debt of the subsidiary is guaranteed by the parent, key indicators of the parent entity are analyzed based on consolidated debt levels. The guarantees of parent entities other than Scheduled Banks would be assigned weight in relation to difference between parent ratings and the subsidiary ratings as such that parents generally cannot issue a full faith payment guarantee, unless they arrange that to be issued on their behalf from a scheduled bank.

# CROSS-DEFAULTS

Cross-default clauses here mean that a default in subsidiary's debt instrument triggers an event of default in other debt instruments issued by the parent or the subsidiary. Given the strong intent and legal linkages, inclusion of such clause may result in support to subsidiary ratings. However, this is the case if all debt of subsidiary are covered under such clauses. VIS will also closely monitor legal documents as any changes in the same with regards to cross default clauses will result in an immediate impact on ratings.

**Faheem Ahmad**
President & CEO, VIS Credit Rating Company Limited
Founder, VIS Group Chairman,
Vice-Chairman, Association of Credit Rating Agencies in Asia

Mr. Ahmad possesses 30+ years experience in financial risk assessment with focus on Islamic finance, venture capital and general management. He has top level management experience at international level in the fields of credit ratings, Islamic and conventional financial risk assessment modeling, industrial management and construction engineering. Mr. Ahmad is an active participant at international forums on Credit Ratings. He obtained his B.S in Civil Engineering from NED University of Engineering and Technology, Karachi. He also has Masters Degrees in Engineering and Business Administration from USA.

**Talha Iqbal Choangalia**
Senior Manager

Mr. Talha having completed his undergraduate studies from the Institute of Business Administration (IBA) in 2010, Talha joined VIS Credit Rating Company Limited as a financial analyst. In almost five years spent at VIS and Islamic International Rating Agency (Technical collaboration with VIS), Talha has been involved in the entity, corporate governance and fiduciary ratings of numerous institutions in Pakistan and abroad. His overall experience in ratings includes commercial banks, insurance and manufacturing sectors. He has also been involved in rating a number of Sukuk issued by IFIs and Corporates. Recently, Talha has been involved in drafting a revised takaful methodology for IIRA. He has spoken at international forum hosted by VIS and IIRA and has facilitated training courses on the subjects of ratings and credit analysis.

NATIONAL EXCELLENCE

INTERNATIONAL REACH

Jahangir Kothari Parade (Lady LLoyd Pier) Inspired by Her Excellency, The Honorable Lady Lloyd, this promenade pier and pavillion was constructed at a cost of 3 Lakhs and donated to the public of Karachi by Jahangir Kothari to whose genrosity and public spirit the gift is due. Foundation stone laid on January 5, 1920. Opened by Her Excellency, The Honorable Lady Lloyd on March 21, 1921.

**Dome:** A roof or vault, usually hemispherical in form. Until the 19th century, domes were constructed of masonry, of wood, or of combinations of the two, frequently reinforced with iron chains around the base to counteract the outward thrust of the structure.

**Origins**: The dome seems to have developed as roofing for circular mud-brick huts in ancient Mesopotamia about 6000 years ago. In the 14th century B.C. the Mycenaean Greeks built tombs roofed with steep corbeled domes in the shape of pointed beehives (tholos tombs). Otherwise, the dome was not important in ancient Greek architecture. The Romans developed the masonry dome in its purest form, culminating in a temple built by the emperor Hadrian. Set on a massive circular drum the coffered dome forms a perfect hemisphere on the interior, with a large oculus (eye) in its center to admit light.

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**VIS Credit Rating Company Limited** is committed to the protection of investors and offers a blend of local expertise and international experience to serve the domestic financial markets. With its international reach, VIS is positioned to aim for an international mark. In this regard, the global experience of our international affiliates and partners have been invaluable towards adding depth to our ongoing research endeavors, enriching us in ways, that enable us to deliver our responsibilities to the satisfaction of all investors. The edifice of the Jahangir Kothari Parade has stood proudly through the years and is a symbol of our heritage. Its 'Dome' as the most stable of building structures, exemplifies architectural perfection. Committed to excellence, VIS continues its endeavour to remain an emblem of trust.

## INTERNATIONAL

### Affiliates

Islamic International Rating Agency – **Bahrain –** iira.com

Credit Rating Information & Services Ltd. – **Bangladesh –** crislbd.com

### Collaborations

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