

Parent and Subsidiary Rating Linkage

Approach to Rating Entities within a Corporate Group Structure

Sector-Specific Criteria

This criteria report updates the one published in 2019 under the same title.

The criteria set out in this report supplement and are applied in conjunction with Master criteria for corporates. These criteria do not apply to subsidiaries of non-financial corporates with substantial financial style operations (These are covered by FI master Criteria).

Scope

This report outlines the methodology India Ratings and Research Private Limited (Ind-Ra) uses when assigning or reviewing Issuer Ratings (IRs) to non-financial companies linked together by a parent and subsidiary relationship. Included within this report are the considerations that Ind-Ra uses when assessing the legal, operational and strategic ties that can link the IRs of two or more issuers. These considerations are outlined in five steps later below, and assist the agency in determining when it is appropriate to:

- assign a rating to a parent company and/or its subsidiary according to their respective standalone credit profiles;
- equalise the ratings of a parent company and its subsidiary at a level consistent with the consolidated profile due to a high degree of financial, legal and/or business integration;
- notch the IR of a subsidiary (or a parent) higher than its standalone credit profile would indicate, due to its relationship with its parent company (or its subsidiary) that has a stronger credit profile; or
- notch the IR of a subsidiary (parent) lower than its standalone credit profile would indicate, due to its close relationship with a parent (subsidiary) company that has a weaker credit profile
- Factor the impact of a rating transition for the subsidiary (parent) on the parent (subsidiary)

Highlights

Three pillars determining the strength of any linkage – The Criteria covers in details the various aspects governing the three essential pillars of any support construct – the ability to support, the propensity to support (including assessment of historical evidence), and the timeliness of support.

Factors Determining Relationship: Understanding the multi-faceted relationship between a parent company and its subsidiaries is crucial for determining each company's relative vulnerability to default. Many factors make this process challenging: legal jurisdiction, corporate structures, company bylaws, loan documentation, the degree of integration between the entities, and the strategic importance of each subsidiary.

Non-Financial Corporates' IRs: This Criteria Report outlines the methodology used by Ind-Ra in respect of non-financial corporate credits.

Notching Qualification: References to "notching" within this paper refer only to the relationships between IRs, and not to specific debt issuances. It is also important to point out that any notching guidance described in this report applies both to investment-grade and speculative-grade IRs.

Exceptions: These criteria do not apply to either Finance Companies (FinCos) or pass-through funding vehicles (PFVs). The former – subsidiaries which have substantive financial services-style operations – often for capital goods companies or retailers, may be assigned IRs on a case-by-case basis, but typically not exceeding the rating of the non-financial corporate parent.

Analysts

Rohit Sadaka
+91 33 4030 2503
rohit.sadaka@indiaratings.co.in

Abhishek Bhattacharya
+91 22 4000 1786
abhishek.bhattacharya@indiaratings.co.in

Guaranteed Debt: If a stronger entity guarantees all the debt obligations of weaker entity on an irrevocable and unconditional basis, Ind-Ra will first analyse the guarantee documents to ascertain whether the guarantee is pre-default or post-default. Pre-default guarantee will have a structured payment mechanism including scope for invocation of the guarantee on or before the due date of the guaranteed debt obligation, in case the borrower is unable to service the debt. In case of a pre-default guarantee, the rating of the guaranteed debt will mostly be same as that of the guarantor's IR. In arriving at the IR of the guarantor, Ind-Ra will add the guaranteed debt to the debt of the guarantor. However, in case the guarantee is post default in nature, Ind-Ra will assess the strength of the guarantee and other linkages to arrive at the final notching, if any of the guaranteed IR as per the methodology detailed later in this criteria report.

The following sections outline the steps taken by Ind-Ra when determining whether or not to link the IRs of a parent and its subsidiary (collectively the steps form a Linkage Considerations Framework, (LCF)). The five steps followed are:

1. determine if a parent/subsidiary relationship exists;
2. determine whether or not the parent and/or subsidiary operates under special restrictions that would dictate the use of other existing Ind-Ra's criteria;
3. determine the relative standalone credit strength of the parent and its subsidiary as well as the consolidated credit profile;
4. determine the strength of any parent and subsidiary relationship by assessing any legal, operational and strategic ties; and
5. formulate a conclusion including final notching and/or impact on parent's (subsidiary's) rating from a rating transition event for the subsidiary (parent).

An abridged flow chart (at left) summarising these steps (please see Appendix I for a more detailed chart).

Step 1: Determine if Parent/Subsidiary Relationship Exists

Before determining whether the IRs of a parent and subsidiary should be linked, Ind-Ra examines the relationship between the two companies to see if it is more than a joint venture or associate. In doing so, the agency determines if ownership by the parent constitutes sufficient control and/or recourse that linkage should be considered. While there are varying levels of strength and weakness to this relationship, the first step is a binary decision — either no significant relationship is present, or some form of relationship is present.

Associate or Joint Venture Relationship

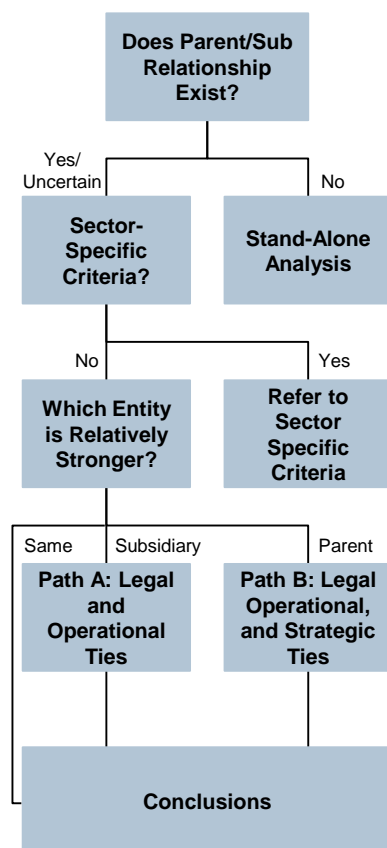
An example of this type of a relationship is when a 'parent' company (or investor) holds an equity stake in another company (vehicle or investee) with some influence but not control over strategic decisions made by the investee, which would perhaps not be fully consolidated in the financial statements of the investor. In addition, the investee's existence would not be considered to be particularly important to the parent.

Under this assessment, there is no potential linkage of the ratings between the entities, and their ratings should be based on their individual standalone credit profiles. Consequently, there would be no need to proceed any further under the guidance in this report.

However, equity accounting, does not automatically lead to an assessment of no linkage between investor and investee. For example, irrespective of the non-recourse legal status of the debt investee, if Ind-Ra determines that the investor is likely to support the investee in financial distress, then we may assume linkage.

Figure 1

LCF Summary Flow Chart



LCF: Linkage considerations framework
Source: Ind-Ra

Parent and Subsidiary Relationship

A parent that has majority ownership and/or an influential control of the entity should be considered to have a parent/subsidiary relationship for the purpose of this analysis. As a result, steps 2–5 of the LCF would be followed to determine the degree of linkage that is appropriate. This would also include entities whose existence is of strategic importance to the parent, even though the company’s financials may not be formally consolidated. For example, this could include a subsidiary that may not be financially material to its parent but whose solvency is important (i.e. default by the subsidiary poses “reputational risk” to the parent) or represents an entry point into an important foreign territory or product market for the parent.

Step 2: Determine if Sector-Specific Criteria Exists

The next step is for the agency to determine whether any legal or regulatory hurdles exist that would require the use of other specific Ind-Ra’s criteria. Companies that operate within the Insurance, Financial Institutions or Public Utility sectors abide by specific industry regulations that would affect Ind-Ra’s assessment of credit linkage, as would ratings related to public sector entities.

Step 3: Determine the Standalone Credit Strengths

Once the parent-subsubsidiary linkage has been established and the possibility of applying sector-specific criteria has been excluded, the next step of the analysis would be to determine the standalone credit profiles of the parent and subsidiary consistent with Ind-Ra’s [Corporate Rating Methodology](#).

Sometimes the standalone credit profiles of the parent and its subsidiary will be the same. In this situation, the two companies’ IRs will be the same, although technically not ‘linked’ — in other words neither of the company relies on the other to meet its obligations. Our assessment of the standalone credit quality of the parent in this step is not restricted to its unconsolidated financials but will also include cash flow and diversification benefits from other relevant group activities. For non-linked identically assigned IRs in a group, there will be no need to proceed to Path A or Path B of the LCF.

The consolidated credit profile, where treating parent and subsidiary as strongly or moderately linked entities serves as a reference point for their ratings. Ind-Ra uses the following approach to arrive at the credit profile of the parent. This approach summarises the various principles enshrined in the criteria.

1. The standalone credit profiles of the parent and the subsidiaries shall be assessed
2. Any subsidiary, whereby the entire debt has been guaranteed by the parent, shall be consolidated
3. Any subsidiary, whose credit profile is stronger than the parent, shall be consolidated with the exception of entities covered by Point 6 below
4. Any subsidiary, whose credit profile is weaker than the parent and the legal, operational and strategic linkages are assessed to be ‘strong’, shall be consolidated with the exception of entities covered by Point 6 below
5. Any subsidiary, whose credit profile is weaker than the parent and the legal, operational and strategic linkages are assessed to be ‘weak’ shall not be consolidated and shall be dealt in the following manner:
 - a. Any cash outflow to the entity which has been contractually committed shall be considered as outflows in the cash flow projections. Non-contractual support to such entities shall be considered only if it is temporary, makes economic sense for the parent and also if the parent has sufficient resources for the support
 - b. Any potential dividends, interest receipts or return of capital from the subsidiary shall be considered as inflows in the cash flow projections

6. Any subsidiary or associate company which is a special purpose vehicle (SPV) with non-recourse debt (NRD) shall be treated as follows:
 - a. A debt is considered non-recourse if no entity other than its borrower has any legal obligation to make up for any deficiencies in debt-servicing. Typically, non-recourse debt-holders have access only to the borrower's cash flow and in case of default, have only the borrower's assets as collateral. A non-recourse debt is not backed by a corporate guarantee or cross-collateral of the parent, and the borrower's cash flow is ring-fenced using various covenants
 - b. Such entities are not consolidated
 - c. The following are considered as outflow for the parent in the cash flow projections: (a) equity, (b) cost overruns, (c) temporary support for debt service
 - d. Any potential dividend or other inflows from the entity permissible under its debt covenants shall be considered as cash inflows
 - e. More information on Ind-Ra's approach to the treatment of NRD is contained in the report '[Treatment of Non-Recourse Debt](#)'

The consolidated profile of the parent as arrived at using steps above would be assessed and compared with the subsidiary's credit profile.

When the parent's credit profile is weaker than that of its subsidiary, Path A of the LCF is used to determine the legal and operational relationship that exists. In contrast, when the parent is stronger than the subsidiary, Path B of the LCF is used.

Please see Appendix II for a discussion on instances where a lack of financial information of the subsidiary exists.

Step 4: Analyse Legal, Operational and Strategic Ties

In order to assess the degree of linkage between the parent company and its subsidiary, and therefore the extent to which the IRs are correlated, Ind-Ra undertakes an analysis of various aspects of the relationships. These are broadly described under the captions (i) Legal Ties, (ii) Operational Ties and (iii) Strategic Ties.

Legal Ties

Of these three major sub-components of the LCF, legal ties would generally be the most important since they may constitute specific, tangible linkage between the parent and subsidiary. As a result, the presence of a legal tie could outweigh the lack of operational and strategic ties, and result in a close linking of ratings (conversely, the absence of formal agreements would not necessarily supersede the presence of strong operational and strategic ties). Below is an analysis of the main legal ties examined by Ind-Ra.

Guarantees

If a stronger entity guarantees all the debt obligations of its weaker related entity and guarantee is pre-default with strong legal clauses (including unconditional and irrevocable obligation), the rating of the guaranteed debt would mostly be same as that of the guarantor's IR. In these cases 'CE' rating is assigned to the IR of issuer and both its and guarantor's rating may generally move in tandem. If a subsidiary guarantees payment of a substantial portion of its parent's debt obligations and guarantee is pre-default with strong legal clauses as above, the rating of the parent's guaranteed debt will be based on the consolidated credit profile.

In case of a post default guarantee given by the guarantor, Ind-Ra will assess the strength of the guarantee by comparing the guarantee documents provided with a set of exhaustive clauses typical for an ideal guarantee template and then opine whether the strength of guarantee is strong or weak. For a guarantee to be construed as strong it should have clauses including and not limited to:

- Legal ties would generally be the most important form of tangible support, and result in an equalisation of ratings

- Irrevocable, absolute and unconditional obligation to pay.
- payment on demand
- Guarantee is not effected by variation of any right of obligor, termination of any agreement or insolvency of obligor
- It is a continuing/ongoing security
- Amount is paid without set-off
- Principal and interest included in the liability covered

Analyst will assign a level of strength to the guarantee based on the above exercise and then proceed to assess the operational and strategic linkages as well.

- If the strength of guarantee is strong and other linkages are strong as well the rating may be equated or notched down minimally from the assessed standalone rating of the guarantor.
- If the strength of the guarantee is weak leading to overall weak legal linkage while the other linkages are strong, the rating would be arrived at using the criteria without credit enhancement from guarantee.
- If the strength of guarantee is strong while other linkages are weak, up to two-notch benefit may be provided.

In case of post default guarantee, if the guaranteed issuer defaults, the rating of the issuer will be downgraded to default category and that of the guarantor would be placed on a negative rating watch, to be followed by assessment of the expected rating implication of the probable guarantee invocation. If the guarantor defaults the rating of guaranteed issuer should also be adjusted to the extent of notching benefit provided for the guarantee.

There could be exceptions to the above criteria in case of a legal opinion differing on the guarantee's validity and enforceability.

Where only certain subsidiaries guarantee the parent's debt, Ind-Ra assesses the independent credit profiles of the subsidiaries and their contributions to the relevant rating. This analysis would also consider whether guarantees are granted on a joint and several bases. Ind-Ra considers that a level of significant joint obligation must exist. As an example, the agency would strongly consider equalising the parent IR to the group's consolidated risk profile where group subsidiaries representing at least 80% of group EBITDA or assets guarantee the parent debt. In such group structures, however, in order to be prudent, investors should assume that subsidiaries which are not guarantors would not contribute to this support, although they may have some ability to provide upstream support through dividends.

A weaker entity that has only some portion of its debt guaranteed by a stronger entity may have a lower IR than that of the stronger entity - despite specific guaranteed debt instruments having ratings based on framework discussed above.

Public or private letters of support, comfort letters and "keep well" agreements do not constitute legal guarantees and may be construed as willingness to support while assessing strategic linkage. Ind-Ra notes that some capital call agreements do create an obligation of funding, and would therefore be taken into consideration when applicable.

Dividend and/or Inter-Company Loan Restrictions

Where there are forms of restricted access of cash flows (one component of ring-fencing) between a holding company and its subsidiaries, Ind-Ra will generally undertake separate analyses of the respective vulnerabilities to default, and will usually expect to assign different IRs if the two entities have different standalone credit profiles. Such ring-fencing mechanisms can take the form of restricted dividend covenants, or minimum financial ratios, before paying subordinated inter-company loan obligations.

Ring-Fence

Various provisions ring-fence an entity, thereby protecting it from contamination from other (group) entities. Provisions may include:

- separate financing, including no cross-default or cross-acceleration conditions, and no external guarantees;
- separate liquidity (cash management, availability under credit facilities, cash pooling, treasury management);
- covenanted dividend restrictions;
- covenanted, or company policy, mitigating related-party transactions, and other potential conflicts of interest (eg, feedstock, shared services);
- non-common ownership;
- separate management, and active independent board representation consistent with a separate company

The presence of one or more of these factors could result in an operating company being rated higher than its parent company. This covenanted insulation could benefit the IR of the operating company by hampering the flow of cash from the stronger to the weaker party at a time of stress. Any ring-fencing which improves the credit profile of a stronger subsidiary is likely to weaken the credit strength of the parent company, as the access to subsidiary cash flows is restricted to a permitted dividend stream or loan. These cash flows are usually junior in payment priority to subsidiary debt and therefore potentially significantly more volatile than subsidiary operating cash flows. The tighter the ring-fence – i.e. the more likely it is that cash flows leaving a subsidiary are restricted - the greater the potential for notching differential between the parent the subsidiary.

In the absence of tight ring fencing of the subsidiary, in assessing the standalone profile of a stronger subsidiary, we would take into account the parent's requirement for cash flows from the subsidiary to meet its own financing requirements. For example, if a parent has few other sources of cash to meet its own interest and principal obligations, our assessment of the standalone IR of the subsidiary will reflect that dividends (or other inter-company payments) are quasi-debt service and reflect a burden or additional fixed-charge obligation.

Ind-Ra also considers the positioning of covenants. Any such restricted access covenants in public bond documentation typically support long-lasting adherence to such mechanisms. Ind-Ra would not place much reliance on these types of covenants in private bank financings, as they can be easily refinanced – or the covenants waived if breached. Ind-Ra recognises, however, that issuers can take steps to remove constraints imposed on them by such ring-fencing covenants even in public debt obligations, by refinancing the relevant bonds. Ind-Ra would take into account the likelihood of such a refinancing (including total size of debt needed to be refinanced), as well as the track record and announced intentions of the relationship of a parent and its subsidiary – as they relate to cash flow movement between the entities.

Cross-Defaults

Cross-default clauses generally provide that a meaningful default within an entity's capital structure or a related party's debt instrument triggers an event of default in its other debt instruments. At this point, while they wait for the grace period to expire, debtholders can consider whether the relevant quorum should waive the uncured event of default, or enforce it by accelerating the loan. The cross-default enables all debtholders to simultaneously prepare to take action, whereas progressing to enforcement enables each one (or under cross-acceleration clauses, all relevant debt holders) to take more definitive action.

When viewed as a form of legal linkage and as a statement of intent by both debtor parties, cross-defaults may lead to equalising or near-equalising of ratings on an ex-ante basis. We take into account materiality, including any basket of carve-outs for cross-defaults and/or the relative size of the debt instrument with the cross-default. At the very least, at a point of stress, they may provide the opportunity for creditor classes (who may have stakes in both entities) to link the fates of two entities as, say, lenders at the parent level could exert pressure on management to either support or not support the subsidiary with parent cash flows – depending on whether those lenders are also lending at the subsidiary level.

Ind-Ra's assessment of linkage due to the presence of cross-default linkages will remain dynamic as documentation changes can affect the ratings. For example, as a subsidiary approaches financial distress, the parent company may take an action to remove the subsidiary out of a 'restricted' or 'principal' subsidiary definition to prevent it from triggering the cross-default clause.

Different Jurisdictions

Even if contractual guarantees or cross-defaults exist, subsidiaries in some jurisdictions – despite their financial strength – may not be a benefit to a consolidated group profile or as a guarantor, because of impediments (legal or otherwise) which prevent enforceability of contractual terms.

Ind-Ra may choose to limit the benefit derived from a financial guarantee if the subsidiary is domiciled in a country where concern about the stability, timeliness and/or enforceability of law exists. This consideration would also extend to Ind-Ra's assessment of support in situations other than those where there is a full financial guarantee or cross-default clause and where the potential for support could be affected negatively by any restriction on the cross-border transfer of funds.

Operational Ties

These may constitute tangible ties between the parent and subsidiary including management integration and control, centralization of core operations like treasury and logistics, integration in terms of human resources or technological platforms etc.

The criteria for linkage determined by operational ties differ depending on whether the parent is stronger or weaker than its subsidiary. For example, common management and decision-making is important in establishing linkage when the parent is weaker because it would likely draw on the stronger subsidiary's resources, assuming that no ring-fencing exists. This is a less important consideration when the parent is stronger. Similarly, operational integration is not relevant when the subsidiary is stronger, as the weaker parent would likely be less interested in synergies with the subsidiary than it would be in obtaining its cash flows — again, assuming no ring-fencing is in operation, as previously detailed in the Legal Ties section above.

Management Control and Commonality

The level of control and commonality that exists between the management of a parent company and its subsidiary is an important factor in determining linkage when the parent is weaker than the subsidiary. Degrees of control in this context indicate varying levels of linkage. An example of strong linkage would be effective control of the board of directors (BoD) of the subsidiary by the parent company. Weak linkage would typically entail a low level of senior management overlap, with the parent company and the subsidiary having separate CEOs, CFOs, board of directors, and/or marketing functions. In case of a strong parent, management control and commonality is expected and hence this might not be a driving factor to establish strong operational linkage.

Centralised Treasury

The level of financial integration between parent and subsidiary is another indication of the degree of linkage between the two entities and, consequently, between their IRs. Ind-Ra examines the level of integration between the financing operations of the two entities to determine the degree of linkage between them. Specifically, Ind-Ra would deem that strong linkage exists when all external funding and application of fund is managed or overseen by parents finance team.

Conversely, Ind-Ra would deem financial integration linkage to be weak when the funding is entirely decentralised, with all significant group companies operating their own treasury functions and raising funds (including liquidity facilities) on their own with no involvement of the parent company.

Operational Overlap and/or Integration

While the first two operational ties outlined above address the weaker parent/stronger subsidiary analysis under Path A of the LCF, operational overlap and integration is generally only relevant under the stronger parent Path B scenario. Strong linkage under these criteria would reflect subsidiary operations that are operationally integral to the core business of the parent company. For example, an oil and gas company which owns subsidiaries operating in the downstream petrochemicals sector: long-term off-take agreements between the two parties, and an absence of alternative off-takers/suppliers, would provide evidence of strong interdependence. More moderate levels of integration, with considerable avoidance costs arising for one year after the parent's decision to replace its subsidiary, would represent weak-to-moderate linkage.

- Operational Ties encompass management control, centralised treasury, and being operationally integral to the group

- Strategic Ties are only considered when the parent is stronger. All things equal, a weaker parent will use cash flow from its stronger subsidiary regardless of strategic relationships

Strategic Ties

Strategic ties are a key consideration when determining the correlation of the relative vulnerability to default between a financially strong parent company and a weaker subsidiary, due to the ability of the parent to financially support its subsidiary if it makes strategic sense. This section of the analysis is broken into two distinct areas: Strategic Importance and Tangible Support.

Strategic Importance

A financially weak subsidiary is deemed to be highly important to its financially stronger parent if the latter's performance is contingent upon the success of the subsidiary. Where the strategic importance is so high that it potentially affects the survival of the financially stronger entity, ratings may be equalised. The strategic importance could come from a reputational standpoint in case of brand or name sharing, it could come from a return on investment perspective if the subsidiary is expected to drive a significant share of incremental returns or it could even be from the perspective of establishing presence in a new geography or product/service offering in line with the medium/long term business plan for the parent. In case of a large conglomerate, Ind-Ra would try to establish a strategic hierarchy among the group companies to arrive at the strength of strategic linkage for the subsidiary under question.

At the other end of the spectrum is the situation where a subsidiary whose operations and/or business strategy are distinctly different from the core operations of its financially stronger parent company, and of little financial or commercial value to the future direction of the parent. Under this latter situation, the two entities' ratings would be based upon their own credit fundamentals, reflecting Ind-Ra's view that the parent would not hesitate to sell the subsidiary or allow it to fail if doing so made economic sense. In between the two edges of the spectrum are situations in which a subsidiary has some strategic importance to its parent company, but not to the degree that it is a foregone conclusion that the parent would step in to help the subsidiary meet its debt obligations on a timely basis.

Public or private letters of support, comfort letters and "keep well" agreements do not constitute legal guarantees and may be construed as willingness to support while assessing strategic linkages.

Tangible Support

The higher the degree of demonstrated tangible support between a financially stronger parent company and its subsidiary, the more likely the ratings will be closely linked. Examples of tangible support include frequent cash-based equity injections and/or occasional (preferably subordinated) intercompany loans, and/or regular provision of low (or zero) cost land from the parent to the subsidiary. Weak strategic ties tend to be reflected in an absence of tangible support or the presence of only soft support letters to banks. In the situation of a newly formed subsidiary where an historical record of support is not available, Ind-Ra would take into account the event risk related to the subsidiary, the degree of isolation of such entity from the rest of the organisational structure, and management's intention toward such a structure.

Ind-Ra notes that it is common for operations with riskier business profiles to be placed in a subsidiary isolated from the rest of the organisation, which could sometimes imply a lower intention of support from management if the entity is not successful.

Step 5: Conclusion and Notching

The ultimate conclusion on whether to link IRs and guidelines related to any notching depends on whether Path A or Path B of the LCF is followed. Identical IRs are a possibility under four of the five decision trees. Any such case of equal IRs would be based on the consolidated credit profile of the two entities. Conversely, different IRs would be based on both the standalone credit profiles of each entity and the consolidated credit profile.

Path A (Weaker Parent)

Based on the presence of linkage from the legal and operational considerations outlined above, and any appropriate weighting that may be necessary, the following general criteria in respect of the IR levels of the two entities is applied at Ind-Ra.

If the balance of considerations indicates:

- **Strong Linkage** – the stronger the degree of linkage between the two entities, the more likely the IRs will be assigned at the same level. Under this scenario, Ind-Ra would analyse the parent and subsidiary as a consolidated group – and set the rating accordingly. For example, if the parent's standalone financial condition suggests a 'BB' rating, and the subsidiary's standalone profile suggests 'BBB', the parent and subsidiary IRs will be based on the consolidated credit profile – which would likely come out somewhere between the two standalone ratings, depending on the relative size of the subsidiary.

In case of a parent default under this path, the rating of the subsidiary would be put at least under a negative watch which is to be resolved upon the assessment of the implication of the default.

- **Weak Linkage** – in certain situations, where Ind-Ra deems linkage to be weak, the IR of the subsidiary could be rated higher than the consolidated profile (similarly, the parent can be notched down from the consolidated profile). Within that consolidated profile, where the parent may be the weaker entity, in general, the rating guideline is a maximum of two notches higher for the subsidiary if weak linkage is established (contractual ring-fencing, no guarantees, zero or little common management), but wider notching may be warranted in some cases based on specific circumstances (eg if a parent is in bankruptcy while the subsidiary continues to operate with no risk of consolidated bankruptcy filing)

The relative importance of the factors that determine any potential notching will be assessed by Ind-Ra on a case-by-case basis, as in certain situations individual factors will tend to carry more weight in the analysis. Generally, however, the presence of documentary or legal protection for the cash flows of the subsidiary company will be the most important factor in assessing the ability to notch the subsidiary IR above that of the parent.

Path B (Stronger Parent)

Based on legal, operational and strategic considerations, the following general criteria in respect of the IR levels of the two entities will apply. If the balance of answers indicates:

- **Strong Linkage** – the stronger the degree of linkage between the two entities, the more likely the IRs will be closely *correlated* with each other; however, that is not to say that they will be identical. While there is potential for the IRs of the parent and subsidiary entities in this situation to be the same (assuming that strong linkage can be established), there is also greater likelihood of the IR of the subsidiary to be lower than the IR of the parent, typically within a range of three notches. In order to rate the subsidiary's IR at the same level as its parent in this scenario, Ind-Ra would expect a large majority of the following sub-set of criteria to be met:
 - comprehensive cross-default provisions affecting parent and subsidiary across all major lending groups and public debt obligations;
 - subsidiary is operationally integral to the core business of the parent;
 - subsidiary is strategically important to the future direction of the group's operations, potentially providing long-term fiscal benefits or access to markets that the parent could not otherwise access;
 - tangible financial support is provided by the parent to the subsidiary in the form of ongoing unsecured loans/ICDs, regular equity infusions or guarantee;
 - level of parent's investment in the subsidiary is deemed significant relative to the scale of the group and its financial resources or its future investment outlay; and
 - publicly declared or agency-notified group strategy regarding the parent's treatment of its subsidiary

To the extent that most, but not all of the above criteria are met in this scenario, Ind-Ra's analytical judgment will determine the level of downward notching, if any, that should be applied to the subsidiary's ratings. In case of a subsidiary default under this path, the rating of the parent would be put under a negative watch, to be resolved upon the assessment of the implication of default. In case, just a few or none of the above criteria are met, the assessment would be done as per the weak linkage under path B outlined (the following section).

- **Weak Linkage** – in situations where Ind-Ra deems there to be a weak linkage relationship under Path B of the LCF outline, the IRs of the parent and the subsidiary should not be linked – and should therefore be based on the respective standalone credit profiles of the two entities. Ind-Ra realises there are instances when a parent (such as a conglomerate or a country) holds a minority equity stake in an operating company (“subsidiary”) where it would be a larger burden for the parent to allow the subsidiary to declare bankruptcy than it would be to maintain capital calls. This is typically the case when the parent's reputation would be harmed by allowing the subsidiary to go bankrupt (often called “reputational risk”). Since these investments usually comprise minority stakes, their ratings may or may not be determined by the LCF (step 1: Determine if Parent/Subsidiary Relationship Exists). If Ind-Ra believes support by the parent will be available in time of crisis, then the agency will consider notching up the standalone rating of the subsidiary. In general, the rating guideline would be a maximum of three notches benefit. But a notching up of the subsidiary would be predicated on the credit profile of the parent and subsidiary being minimally correlated, to ensure that the parent will not be itself in financial trouble when the subsidiary is likely to need support.

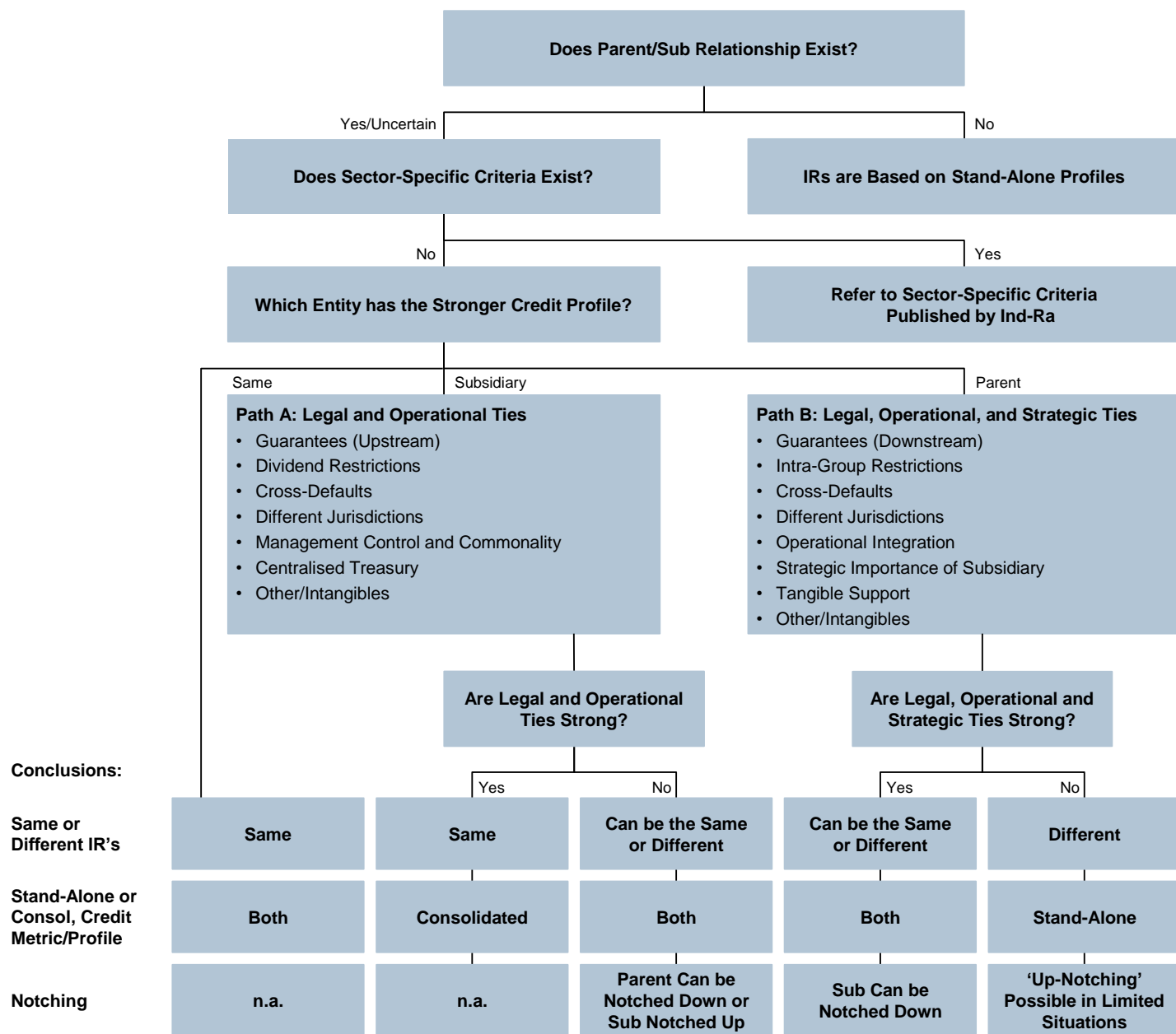
Limitations

Please see the Limitations in the master criteria [Corporate Rating Methodology](#).

Appendix I

Figure 2

LCF Outline



IR – Issuer rating; n.a. – Not applicable
Source: Ind-Ra

Appendix II

Guidelines for Rating a Subsidiary's Debt without Standalone Financial Information or a Parent Guarantee

There are occurrences when a subsidiary has issued debt instruments but does not issue standalone financial statements, nor does it benefit from a downstream parent guarantee. This situation most typically occurs after an acquisition where the debt issuer (subsidiary) is acquired and the acquiring company (parent) is not obligated to guarantee the bonds or provide ongoing financial statements of the acquired subsidiary.

There could be various reasons for the parent to not refinance the subsidiary debt at the parent level including a short maturity, attractive coupon, or an expensive make-whole provision, among others. The decision for the parent to not guarantee the debt could include additional administrative and filing costs, as well as flexibility related to an evolving business structure.

In such instances, Ind-Ra uses the following factors as a guideline for maintaining and determining the subsidiary's debt rating. This methodology does not apply to debt at a subsidiary where that subsidiary generates the vast majority of group cash flows since the analyst can reasonably determine the financial status of the subsidiary even if separate financial statements are not filed.

Importantly, the below guidelines are not meant as an alternative to the Parent-Subsidiary Linkage methodology used in the main body of these criteria, nor are these guidelines meant for new debt issuances.

Considerations for Maintaining the Subsidiary's Debt Rating

Management Rationale/Intention

Ind-Ra would be unlikely to maintain ratings if management's rationale for not guaranteeing subsidiary debt revolved around wanting flexibility for an evolving business model. This would signify to Ind-Ra that the parent and acquired company may not be a long-term strategic fit and that the financial status of the subsidiary could be materially different in the future. Alternatively, if the decision came down to additional administrative costs/ burdens then Ind-Ra would move on to the remaining factors below.

Ability to Support the Subsidiary

Ind-Ra would then consider the financial stability of the parent company (on a fully consolidated pro forma basis). The subsidiary ratings are more likely to be maintained when the parent is rated investment grade. A parent rating in the 'IND BB' category or lower would result in Ind-Ra withdrawing the subsidiary rating.

Track Record of Management's Treatment of Bondholders

In many cases Ind-Ra would not rate the subsidiary debt if parent management (with the current company or in previous roles) had in the past allowed a subsidiary to default on debt or spun off a debt-issuing subsidiary that resulted in that subsidiary having a materially weaker credit profile. The remaining factors outlined below will still have to be taken into account as a management past action on one subsidiary may not be relevant or likely for other subsidiaries.

Operational/Strategic Integration

Ind-Ra would be more likely to maintain a subsidiary rating in the situation where a parent executes a vertical or horizontal acquisition with the intention of fully integrating manufacturing, distribution, purchasing, treasury, billing, customer service and product brands, among other functions. This would also signify to Ind-Ra that the consolidated financial statements are a good representative of the company's future financial profile indicating a lower risk of subsidiary spin-offs. Complementary acquisitions that provide revenue synergy potential provide similar evidence. Ind-Ra would be less likely to rate the acquired subsidiary if it remained a separable asset, be it from a product, brand, supply chain or geographical standpoint, unless there are strong complementary ties.

Other Considerations

Expectation for Future Bond Market Access

A parent's need for future bond market access due to expected refinancing and/or a history of debt-financed acquisitions would support the maintenance of a subsidiary debt rating. A parent maturity schedule that spans the entire maturity schedule of the subsidiary would be viewed as a strong incentive for the parent to maintain access to the bond markets and therefore support the subsidiary debt.

Legal; Cross-Default or Material Subsidiary Cross-Default Language

Situations where the acquired subsidiary qualifies as a "subsidiary", "material subsidiary" or "principal subsidiary" (or any similar language) described in the events of default section of the parent's public debt covenant packages would support maintenance of a subsidiary's debt rating. Such language often declares a parent default in the instance of a default by such subsidiary. The maturity date of the applicable parent bonds would have to extend beyond the subsidiary debt maturities in order to maintain the ratings. Since this language is most common in bank credit agreements and bonds, historical usage and current outstanding borrowings would have to be taken into account. This language in and of itself, however, may not be enough to justify maintaining the subsidiary ratings since long-term strategic importance and operational integration should also still be considered.

Reputation Risk

In situations where the subsidiary has been rebranded to mirror the parent, reputation risk would be a potential incentive for the parent to support the subsidiary. This could also be an issue when a parent is using the subsidiary as an access point for a new country/ market.

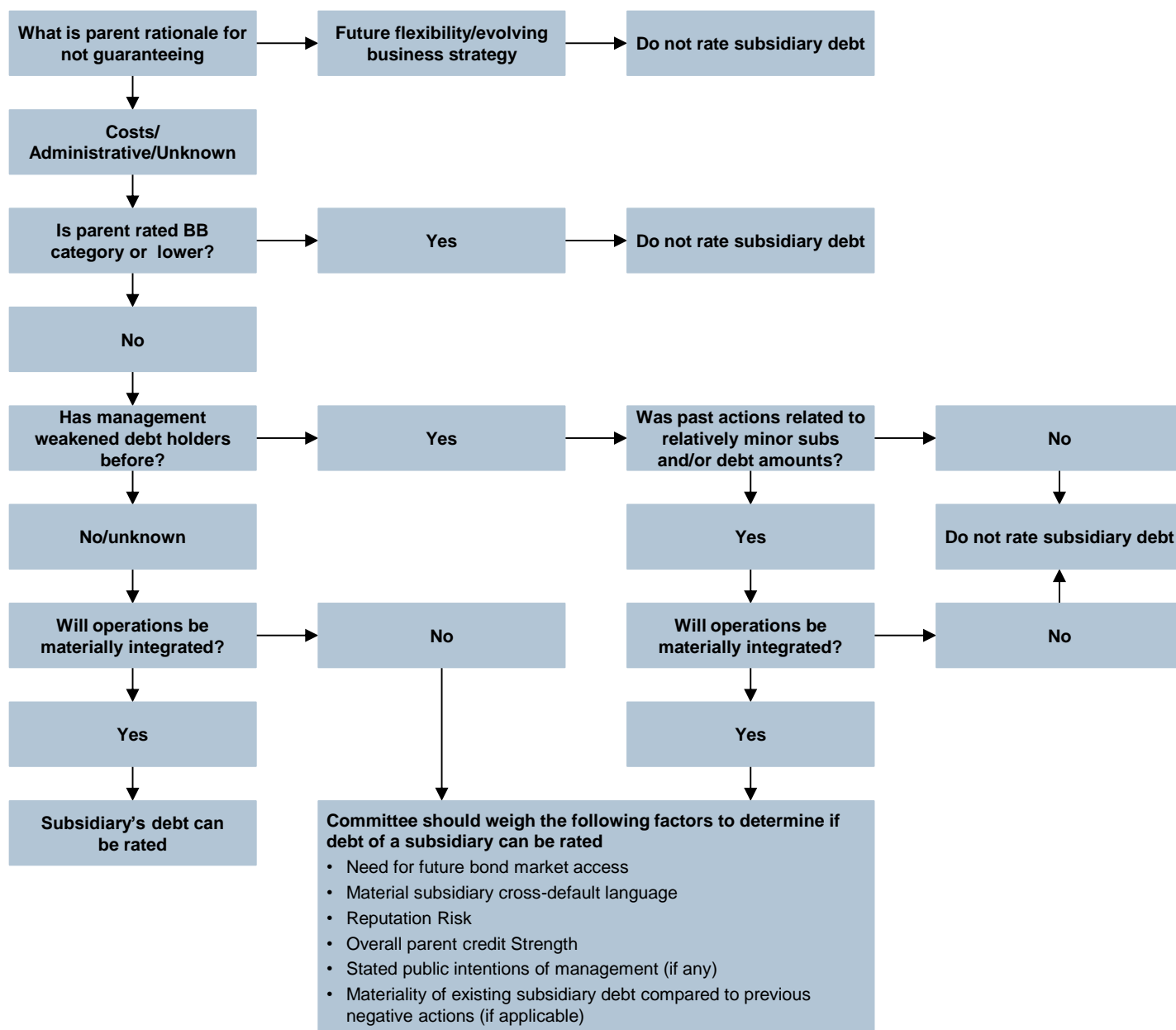
Step 2: Methodology for Determining Such Ratings

The following outlines (Appendix II) the methodology Ind-Ra uses when rating a subsidiary without standalone financial information or a parent guarantee. The methodology is based on the credit profile of the parent company on a fully consolidated basis and pro forma for the applicable acquisition (if it has not yet occurred). This step is only applicable if the analyst determines that a subsidiary debt rating can be maintained based on the considerations outlined in Step 1 above.

Appendix II Flow Chart

Figure 3

Rating Subsidiary Debt Without Standalone Financial Information or a Parent Guarantee



Source: Ind-Ra

Appendix III

Rating Linkages with the State

The above criteria are also applied when considering the rating of a state-owned entity (SOE) or state-supported entity (SSE).

The three headings of Legal, Strategic and Operational are equally applicable to Ind-Ra's assessment of the linkage between the sovereign and privately or publicly-owned entities linked with it.

Based on the level of linkage between state and SOE/SSE, the rating can be notched up to three levels from the standalone rating depending upon the past or expected tangible or policy support from the parent. However, in cases where legal linkages are deemed to be strong due to the presence of pre-default guarantee or are strategically important to further GoI's policy objective and exercises significant control in determining outcome of the key decisions for the company, the ratings can be equated.

Turning to strategic considerations, some industries can be fundamentally strategic to the country, and state ownership can support the case for enhanced credit ratings. This, in itself, is not enough to build a case for an equalisation of the ratings – forms of government involvement typical for such entities can both enhance or be detrimental to support linkage. Conversely, industries which have strategic value to a country but whose companies have been privatised or operate in a competitive environment – such as telecoms and utilities with truly independently assessed tariff-setting regimes – are unlikely to benefit from the same degree of rating linkage, on the grounds of their strategic significance.

Operationally, some companies embody state development objectives such as developing national infrastructure. Assessing the degree of support is always potentially dynamic.

Exceptions

These criteria do not apply in cases where the corporate entity is classified by Ind-Ra as a public sector entity, defined as follows:

“An entity directly or indirectly majority-owned or tightly controlled by the state/sub-national (the sponsor), or with equivalent special public status, whose activities fulfil a public sector mandate in a non-competitive sector, where forms of state subsidy or grant from the sponsor comprise the majority of revenues for the entity, or it receives ongoing capital injections, and are material to the existing and prospective financial profile of the entity. Generally such entities do not have a profit maximisation function, with profitability often being determined by the aforementioned grants or subsidies.”

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