



Parent and Subsidiary Rating Linkage Criteria Methodology

Table of Contents

1. Introduction	2
2. Standalone Credit Profiles of Parent and Subsidiary	2
3. Linkages between Parent and Subsidiary	2
4. Notching	3
5. Rating Linkage in case of Financial Institutions	4
6. Rating Linkage in case of Government-owned Entities	4

Summary

This criterion explains PACRA’s approach to rating subsidiaries of financial and non-financial parent entities, as well as entities owned partially or fully by the central or state governments. The purpose of this analysis is to incorporate the impact of linkages, (legal, financial, operational etc.) which exists between parents and subsidiaries, on the credit profile of the subsidiary being rated. PACRA uses the standalone credit profile of the subsidiary as the starting point of its analysis and subsequently notches the same higher or lower, based on its linkages with its stronger or weaker parent.

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1. Introduction

1.1 Scope: This criteria is applicable when rating entities, which exhibit certain linkages with their parent entities, as a result of which their own credit profile is altered significantly. In such situations, standalone assessment of the entities, as suggested by their respective methodologies, may not present the complete picture and hence the impact of the linkages needs to be factored in to arrive at the final rating opinion.

1.2 A parent that has the majority shareholding and/or control of the entity being rated is considered to have a parent-subsidiary relationship in this criteria. Other related parties, such as associated companies or joint ventures, where no majority stake exists and/or there is influence, but not control, lie outside the scope of this criteria.

1.3 Rating Approach: PACRA's approach to parent and subsidiary rating linkage is divided into three broad stages:

1. Examining standalone credit profiles of both parent and subsidiary.
2. Analyzing the strength of linkages, which exists between parent and subsidiary.
3. Notching the credit rating of the subsidiary (higher or lower than its standalone credit profile) relative to its stronger/weaker parent.

2. Standalone Credit Profiles of Parent and Subsidiary

2.1 The standalone credit profiles of the parent and subsidiary are evaluated in consistency with the respective applicable methodology(s). For instance, in case of corporate entities, PACRA's Corporate Rating Methodology would apply, while, in case of financial institutions, PACRA's Financial Institutions Rating Methodology would apply).

3. Linkages between Parent and Subsidiary

3.1 PACRA's rationale behind examining the linkages between a parent and its subsidiary is to determine the likelihood of support which can be expected to be available to the subsidiary, in times of need. Support, in this context, refers strictly to extraordinary financial support, rather than ongoing financial support or operational support. When assessing linkages between a parent and subsidiary, PACRA looks at legal ties, business linkages, and track record of providing support.

3.2 Legal Ties: Legally enforceable arrangements can have an overbearing impact on subsidiary ratings, compared to other linkages. Examples of such legal ties include guarantees and cross-default covenants.

3.2.1 Guarantees: Guarantees are a form of credit enhancement, which can lead to equalization of ratings between a parent and its subsidiary. If the stronger parent guarantees all debt obligations of its weaker subsidiary (downstream guarantee), with strong enforceability and legal clauses such as irrevocability and un-conditionality, this can lead to equalization of subsidiary rating with the parent. It is important that the guarantee mechanism is enforced pre-default, rather than post-default. In such cases, the guarantee obligation will be incorporated into the debt burden of the guarantor (parent) in its standalone credit profile assessment.

3.2.2 Cross-default Covenants: Cross-default clauses between a parent and subsidiary may lead to near-equalization of ratings. However, in its assessment, PACRA takes into consideration that when a subsidiary is under financial strain, the parent may make documentation changes to prevent triggering cross-default.

3.3 Business Linkages: Business linkages are considered strong where a subsidiary holds sufficient operational and/or strategic importance for the parent. In this scenario, the likelihood of the parent extending

support, when needed, would be high. Here, PACRA looks at whether the subsidiary's operations are critical to the parent's operations and overall profitability. This is likely in cases where the subsidiary is part of the parent's value chain and/or there is sharing of core functions (for example, finance, marketing, procurement) or their respective brands are linked. Likewise, if a subsidiary has an important standing in the parent's strategic objectives (long-term growth, diversification, brand building etc.), this would also create incentive to support. While assessing the potential impact of business linkages on subsidiary rating, PACRA takes a conservative approach since the perception of strategic importance remains vulnerable to changes in the parent's stance based on its own business plans. Therefore, even when business linkages are deemed to be extremely strong, this is unlikely to result in equalization of ratings between parent and subsidiary.

3.4 Track Record of Support: PACRA looks at the track record of support exhibited by the parent to the subsidiary in the form of guarantees, loans, injection of equity, offering credit period relaxation, etc. Where a track record is not available, PACRA may engage with the parent to assess their views on potentially supporting the subsidiary.

4. Notching

4.1 The ultimate notching of the subsidiary's rating is determined by viewing the strength of linkages (as examined above) in relation with the relative credit profile of the parent.

4.2 Stronger Parent/Weaker Subsidiary: If the parent's credit profile is stronger relative to the subsidiary and linkages are considered strong, this could result in the subsidiary being notched up by multiple notches closer to the parent's rating, and possibly equal to it. It should be noted that, of all linkage factors, PACRA views guarantees to be the strongest form of linkage with the highest impact on the rating of the subsidiary. On the other hand, if linkages are deemed weak, the extent of notching would be limited, with the final rating of the subsidiary remaining closer to its standalone credit profile.

4.3 Weaker Parent/Stronger Subsidiary: When the parent's credit profile is weak relative to the subsidiary, this may have adverse rating implications for the subsidiary, given the possibility that the subsidiary may be bound to extend financial support to the parent at some point. In such cases, the subsidiary's rating may need to be capped at the parent's rating. However, when support to the parent can be restricted/ruled out (for example, due to certain ring-fencing mechanisms or in the absence of cross-default covenants), the final rating of the subsidiary would reflect its standalone credit profile and could be higher than the parent's rating.

Inter-company Cash Flow Restrictions: Where the parent has a weaker credit profile relative to the subsidiary, there is the possibility of the weaker parent drawing on the subsidiary's resources to meet its own funding needs. Inter-company cash flow restrictions in the form of dividend covenants or loan restrictions can prevent this. Existence of such ring-fencing mechanisms is considered to secure the credit profile of the subsidiary against potential cash outflows. The more restrictions on a subsidiary's cash flows going to its parent, the greater the difference between the rating of the parent and subsidiary.

5. Rating Linkage in case of Financial Institutions

5.1 PACRA opines that the likelihood of parent support to the subsidiary is generally higher in the financial sector, due to the typically high level of integration between financial institutions and their financial subsidiaries, and existence of substantial reputational risk. This means that the implication of a subsidiary's default is likely to be high on the parent, and possibly on other group companies as well. Thus, when rating such subsidiaries, PACRA forms a view on the level of integration and reputational incentive for the parent to support. Where this is deemed to be high, the rating of the subsidiary is likely to be close to that of the parent, or, in certain cases, may be equalized.

6. Rating Linkage in case of Government-owned Entities

6.1 The criteria defined above may not be entirely applicable for entities which are owned, or partially owned, by central or state governments. When rating such an entity, PACRA begins by examining its standalone credit profile. Subsequently, PACRA examines the following factors, inter alia, to determine the importance the entity holds for the government. This allows factoring in the likelihood of extraordinary financial support that can be expected from the central or state governments, according to which the rating of the entity is notched up.

- Extent of government ownership and/or control in the entity.
- Operational/strategic importance of the entity to the government's policy objectives. As in the case of non-government-owned entities, PACRA recognizes that this is subject to changes in the government's stance, policies or possible a change in the government itself.
- Whether the entity is a dominant provider of the products/services it is involved in.
- Role of private sector in the entity's area of operations.
- Track record of government support to the entity.

6.2 The likelihood of government support is considered high if an entity is majorly owned and directly controlled by the government and is deemed to be highly integrated into operations/strategy and operating in a non-competitive sector (for examples, public utilities sector),. Thus, the rating of the entity is likely to be higher than its standalone credit profile, and can be notched up equivalent to the rating of the government. The extent of notching depends upon the relative degree of importance of the entity and likelihood of support from the government.

6.3 There are entities in which the government holds ownership stake (majority or minority) but control is more subtle/indirect. These entities hold strategic significance for the government, but operate largely independently whilst competing against private players (for example, certain OMCs). In such cases, PACRA would consider the linkage to the sponsor as a credit enhancement. However, the final rating of the entity would remain closer to its standalone credit profile.