

The Pakistan Credit Rating Agency



# Parent and Subsidiary Rating Linkage Criteria

Methodology

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## Summary

This criterion explains PACRA's approach to rating subsidiaries and parents of financial and non-financial 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.) that exist between parents and subsidiaries on the credit profile of the subsidiary or parent 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. Similarly, if the parent is being rated, the potential impact of a strong or weak profile of subsidiary/subsidiaries is also considered.

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## Introduction

### Scope

This criteria framework is applicable when rating entities that exhibit certain linkages with their parent or subsidiary entities, as a result of which their credit profile is significantly altered. In such situations, the standalone assessment of the entities, as suggested by their respective methodologies, may not represent the complete picture. Hence, the impact of the linkages needs to be factored in to arrive at the final rating opinion.

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 framework. 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 methodology.

### 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 that exist 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 or vice versa.

## Standalone Credit Profiles of Parent and Subsidiary

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

## Linkages between Parent and Subsidiary

PACRA's rationale behind examining the linkages between a parent and its subsidiary is to determine the likelihood of support that 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 or operational support. When assessing linkages between a parent and subsidiary, PACRA examines legal ties or obligations, business linkages (such as shared names or brands), and the track record of providing support.

### 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. Similarly, in the case of a strong subsidiary, the impact of the guarantee provided to the parent is factored into the rating opinion.

### 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 unconditionality, 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. The same is applicable to the scenario where the subsidiary has provided a guarantee to the parent.

## **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 the mechanism for triggering cross-default covenants and whether either can make changes to prevent triggering cross-default. Similarly, the fallout of default of the parent on the subsidiary is considered in case debtors go for liquidation, and the rating is adjusted accordingly. In case the subsidiary has legal or regulatory protection, the impact of the parent's default is limited on the rating.

## **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 an incentive to provide support. PACRA also takes into account if there is a shared name, brand, or common logo. This shows a strong association of the parent with the subsidiary, hence a higher propensity of the parent to provide support to its subsidiary. If the parent is a foreign company, PACRA takes into account the creditworthiness of the foreign company, the significance and contribution of the subsidiary to the parent's business and financial profile, legal framework, and other relevant aspects to assess the commitment of the parent to provide support to the subsidiary. 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.

## **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. In case the track record is not available, PACRA may engage with the parent to assess their views on potentially supporting the subsidiary.

## **Notching**

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

### 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, among linkage factors, PACRA views pre-default guarantees as the strongest form of linkage, with the highest impact on the subsidiary’s rating. 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.

### Weaker Parent/Stronger Subsidiary

If the parent’s credit profile is weaker than the subsidiary’s, this may have adverse rating implications for the subsidiary, given the possibility that it may be required 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. Moreover, PACRA also takes into account the creditworthiness of the subsidiary as a stand-alone entity. This is to analyze the impact of the bankruptcy of the parent company. If the creditworthiness of the subsidiary is strong and it is able to pay off its obligations on its own with a limited impact of the parent’s default, then the subsidiary will have a higher rating than its parent. The parent’s rating may be capped at the subsidiary’s rating or lower than the subsidiary rating where the parent is dependent on the subsidiary’s support.

**Inter-company Cash Flow Restrictions:** *If 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. The 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.*

		Strong	Moderate	Weak
Profile of Parent	Strong	Notched-up Rating Up to Parent Rating		
	Moderate		Notched-up Rating	
	Weak			No Notching/Standalone
	Standalone Rating of Subsidiary			

## Rating Linkage in the case of Financial Institutions

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 the 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. If 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. Moreover, financial institutions generally have a greater ability to provide support compared to corporates due to their ability to mobilize funds.

## Rating Linkage in the case of Government-owned Entities

The criteria defined above may not be entirely applicable to entities that are owned, or partially owned, by central or state governments. While 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.
- Any guarantees provided to 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 possibly, a change in the government itself.
- Whether or not the entity is a dominant provider of the products/services it is involved in.
- Reliance of the general public on products/services and associated systemic risk
- Role of the private sector in the entity's area of operations.
- Track record of government support to the entity.

The likelihood of government support is considered highest if the entity's collapse could result in significant systemic risk or social impact. Similarly, government support is considered to have a high likelihood 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 example, the 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 the likelihood of support from the government.

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.