

METHODOLOGY GOVERNING LINKAGES BETWEEN PARENT AND SUBSIDIARY COMPANIES

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 form support, or negative intervention.

This methodology elaborates on how this relationship is factored into the Issuer Credit Ratings (ICR) of the members of the group.

Rating Methodology

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, for [corporate](#), [commercial banks](#), and [Non Bank Financial Companies](#) (NBFC). The stand-alone rating takes into account factors such as the existence of a commercial relationship between the parent and subsidiary, at an arm's length basis since it may be of significant value for the subsidiary.

In certain circumstances, stand-alone ratings for parents and subsidiaries may converge. This occurs when both work with similar business and financial risks, making their vulnerability to default akin. This does not imply inter-dependence in ratings; rather it suggests that the parent company has sufficient income from its other activities to service its obligations.

The next step involves identifying the "group status" of an entity, which determines the degree of uplift in its stand-alone rating. Holding companies often have a diversified portfolio of investments, which reduces their overall business risk and makes their financial standing more robust. While one parent may house many different companies, and institutions, the degree of importance of each may vary. This determines how "strong" or "weak" the linkage between the parent and subsidiary is and hence in turn whether or not the parent entity may provide support in times of distress.

Relationship between parent and subsidiary

Strong linkage is visible in the case of subsidiaries, whose operations are closely aligned with the core business of the parent company. These subsidiaries often share the identity of the parent, through the same name or brand, and constitute a significant proportion of the consolidated group. Hence, such subsidiaries will be closely linked to the parent's reputation and will most likely be protected by them under any circumstances. Some subsidiaries will be highly strategically important however the extent of support they warrant may be questionable based on how closely integrated they are to the parent group.

Weak linkage exists for those subsidiaries that are less integral to the group's current identity and future strategy, hence not important enough to guarantee support from the group. This includes subsidiaries involved in businesses distinct from the core operations of the group, making them less valuable from a commercial or future strategic perspective. However, some subsidiaries may not be very important strategically but may share the name of the group, which would result in pressure on the parent to provide assistance.

In addition to the above, willingness and ability of the parent company to support a distressed subsidiary hinges on a number of important considerations. These include commercial relationships, marginal return on the investment required, common management and decision making, degree of financial integration, history of support to the subsidiary, and financial regulation.

Parent companies that are financial institutions are more likely to support their weaker subsidiaries. The business of these institutions is highly sensitive to factors such as reputation, trust and confidence. Additionally, financial institutions are under strict regulation. In these circumstances abandoning a weak subsidiary will be more damaging to the parent.

On the other hand, it is possible to have a parent with a weaker standalone risk profile, than the subsidiary. In this case, the subsidiary may provide support to the parent through guarantee. While the standalone rating of the subsidiary may be higher than the parent, its ICR will not be higher than the group's rating. This is because in times of distress, the subsidiary will divert funding towards the parent, which will have an impact on its own rating. However, if the subsidiary is separated or insulated from the parent, it may have an ICR higher than the group's credit profile. This is because its cash flows may be protected through covenants which limit upstream support.

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Government Related Entities

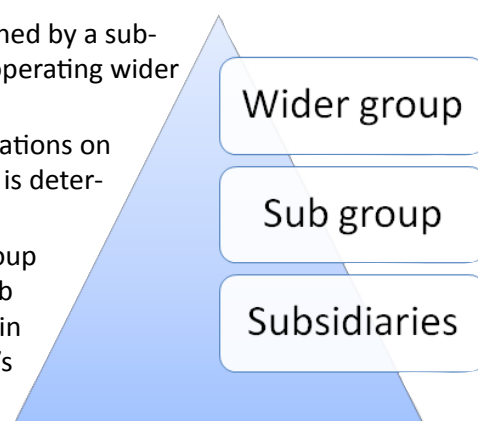
The potential for extraordinary Government support may exist for certain groups and subsidiaries (Methodology: [Government supported Entities](#)), which may warrant a rating uplift. These include industries which may be of strategic importance to the country, in terms of development, infrastructure, etc. However, the degree of support extended hinges on the currency of the debt obligations. Local currency obligations are distinguished from foreign currency obligations, since the sovereign has the ability to exercise control over the local currency only, while foreign currency is determined through the market. Hence, their guarantee covers local currency obligations with limited support, if any, being provided for foreign currency obligations.

Group Status and Sub Groups

In certain cases, a three-fold relationship exists with subsidiaries being owned by a sub-group, which is in turn owned by a non operating holding company or an operating wider group.

In this case, the association of the sub group to the wider group has implications on its rating, as well as the ICR of its subsidiaries. Notching of the subsidiaries is determined by the relationship between the wider group and the sub group.

In a rare case, the “non-strategic” or “weak linkage” subsidiary of a sub group may be of high importance to the wider group, who may supersede the sub group in providing assistance to the subsidiary in times of distress. Hence, in this case, the ICR rating of the subsidiary will be based on the wider group’s credit profile.



Non-operating holding companies, financial sponsors and cross default

A non-operating holding company is highly dependent on its operating subsidiaries for financing. This results in a structural subordination, with the creditworthiness of the parent being notched below the core operating entities.

In case the group is owned by a financial sponsor, it will be assessed without factoring in the sponsor’s support. This is because financial sponsors usually have diverse interests, and may not have any long term or strategic interest in the group entity. This diversity results in a reduction in the ability and motivation to support an individual entity in distress. The assessment of the group may factor in one or more intermediate holding companies, while exclude other holdings by the financial sponsor. However, the rating must factor in any impact of the financial sponsor’s exit strategy on the entity, incase such a situation arises.

The ownership of an entity by more than one holding company would result in a dilution of impact, in case one holding company defaults or is under distress. This would depend on the relationship between each parent and the subsidiary. In case of a non-operating interest, the parent is treated as an equity affiliate, and the operating entity is not factored into the assessment of the group’s credit profile. However, any material impact of the magnitude or variation in the parent’s investment may be accounted for. In case of partial control, the group’s credit profile will reflect a partial consolidation of the operating entity and group’s credit profile. Similarly, in case of significant control, the investment will be treated as an integrated subsidiary, and the group’s credit profile will fully account for it.

Cross-default provisions in a parent subsidiary relationship can result in an important rating consideration. Such a clause would strengthen the weaker party, and result in a convergence of ratings. Cross-default clauses suggest than default in one party can trigger a default in the other. This creates motive to support the weaker entity during distress, depending on overlap of lenders and materiality. Cross-default provisions are subject to the legal jurisdiction and its impact on the enforceability of contracts.