RATING APPROACH – CONSOLIDATION

November 2022

Click to Provide Feedback

This rating methodology describes ICRA's approach to consolidation while analysing the credit profile of an entity, which has linkages with other related entities such as subsidiaries and group entities. This document does not include an exhaustive discussion of all the factors that our analysis considers but provides an overall perspective of the considerations that are usually the most important. This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in August 2021. The revised version incorporates a description of how ICRA factors-in the existence of cross-default linkages among loans on different balance sheets.

Overview

An entity may undertake its business operations under a single legal entity (parent[1]), or under separate legal entities such as subsidiaries[2], associates, joint ventures (JVs) or group entities—formed out of operational, legal, tax or regulatory considerations. Such entities may all be in a similar line of business, having close business and financial linkages with the parent or among each other; or may be involved in diverse businesses with limited or no business overlap or financial linkages. Furthermore, the strategic and the reputational significance of each entity within the group may also vary.

This methodology document articulates ICRA's approach to analyse an entity's credit risk profile while taking into account its linkages with other group entities. While an entity's standalone business and financial profile provides a useful and a revealing glimpse of the various risks which it is exposed to, however, analysing these alone may not always be sufficient in cases where there is a possibility of funding interchange among group entities or when the businesses are closely interlinked. As a result, analysis of consolidated business and financial risks is imperative for a fair assessment of the credit risk profile of an entity. While the consolidated business profile provides an overview of the business strength of the overall group, which in turn drives the sustainability of the market position and thereby the stability in cash flows; the consolidated financials provide a holistic representation of the financial position of the parent and its subsidiaries as a single economic unit and reveal both the economic resources available and the obligations of the group as a whole.

It may, however, be noted that ICRA's approach extends beyond an analysis that is based solely on the reported consolidated financials; and lays greater emphasis on substance over form. For entities reporting financials as per IndAS, the consolidation is already done on the principle of 'control' rather than 'ownership', nevertheless, in some cases, ICRA still makes some adjustments while conducting consolidated analysis. For instance, if a parent holds 60% equity stake in a weak subsidiary, this

Table of Contents:

ANALYST CONTACTS

Mr. K. Ravichandran
Executive Vice President and Chief Rating Officer
+91 22 6114 3408
ravichandran@icraindia.com

Mr. Jitin Makkar
Senior Vice President
+91 124 4545 368
jitinm@icraindia.com

Mr. Pratik Singhania
Vice President
+91 124 4545 801
pratik.singhania@icraindia.com

[1] Henceforth in this methodology document, reference made to 'parent' may be construed as reference made to the parent of a subsidiary(ies), or the principal entity within a group, unless mentioned otherwise.
[2] Henceforth in this methodology document, reference made to 'subsidiaries' may be construed as reference made to 'subsidiaries', 'associates', 'joint ventures' and 'group entities' of the parent entity, unless mentioned otherwise.

subsidiary would have been consolidated while preparing the consolidated financials. However, if as per ICRA's assessment, the parent is unlikely to extend any funding support to this weak subsidiary, this subsidiary is excluded from the consolidated analysis. Similarly, if a parent holds 100% equity stake in a special purpose vehicle (SPV), this SPV would have been consolidated while reporting the consolidated financials. However, if such an SPV's cash flows are insulated from the parent such that even the surplus funds after making pay-outs to various stakeholders cannot be up-streamed to the parent, ICRA would exclude such an SPV while undertaking consolidated analysis. However, in such cases, any funding support from the parent to the SPV would be factored-in while analysing the parent. For entities that do not report their financials as per the IndAS, adjustments are also made in cases such as when a subsidiary is consolidated with the parent in the reported financials because of the parent holding a majority equity stake in the subsidiary, despite the parent not having control over the subsidiary, because of the presence of a significant minority shareholder at the subsidiary level. The said adjustments involve the exclusion of such subsidiaries from consolidated analysis[3]. Effectively, while rating decisions in many cases are taken based on an assessment of the reported consolidated financials and the corresponding consolidated business profile; in many others, analysis based on the reported consolidated financials only provides a broad perspective of the group, without being the primary driver of ratings.

This note discusses the following key aspects:

» **Reporting of the consolidated financials as per the accounting standards**

» **Limitations of relying only upon the reported consolidated financials**

» **Approach for adjusting the reported consolidated financials**

» **Assessment of the adjusted consolidated financial and business profile**

Reporting of the consolidated financials as per the accounting standards

Consolidated financials provide a useful representation of the overall scale of operations, profitability, debt levels and asset base of the group being evaluated. For reporting consolidated financials or representing interest in joint ventures or associates, entities in India follow the three methods as prescribed under the Indian Accounting Standards—IGAAP or IndAS (Indian Accounting Standards substantially converged with the IFRS)—depending on their ownership share in the equity capital or the degree of control on the subsidiaries:

Subsidiary	Joint Venture	Associate
Line-by-line addition of the financial statement items of the parent and its subsidiaries while netting-off reciprocal items (such as sales by one and purchases by the other; or the parent's equity investment in the subsidiary and the parent's portion of equity in the subsidiary). This approach is termed as the **Full Consolidation** approach.	**Proportionate Consolidation Method** or **Equity Method** (*depending on the accounting standard followed i.e. IGAAP or Ind AS*)	**Equity Method**

[3] While excluding the subsidiary from consolidated analysis, any funding support from the parent to the subsidiary or vice-versa is still factored-in while analysing the parent.

ICRA considers an entity's reported consolidated financials, prepared and presented in line with the accounting principles, as the preliminary input for credit risk assessment. If required, suitable adjustments are made to these, as per ICRA's standard adjustments, as discussed in the sections below, such that these provide a fair assessment of the entity's credit risks.

Limitations of relying only upon the reported consolidated financials

While the importance of analysing an entity's financial position, based on its reported consolidated financials, is undeniable, relying on these alone for credit assessment has its limitations. The reported consolidated financial statements present information about the group as a single economic unit without considering the distinctiveness of the separate legal entities and do not take into account the possibility of funds being non-fungible among the various entities consolidated. This implies that in case there are regulation-driven or structural constraints or economic disincentives in the free flow of funds among the constituent entities, an analysis based on reported consolidated financials may tend to provide a false impression of funding fungibility. Given below are a few examples of such constraints:

Examples of constraints to the free flow of funds among the consolidated entities:

- For entities with foreign parent or subsidiaries, the regulations of the respective foreign country may carry restrictions on the repatriation of funds outside the native country.
- Fund outflows from a stronger subsidiary may be curtailed in case there is the presence of significant minority shareholders or institutional investors. Such shareholders or their representatives on the board may block any proposal of extending funding support to the parent.
- There may be covenants imposed by lenders in the loan documents pertaining to the parent (or the subsidiary) according to which fund outflows to subsidiaries (or the parent) may be restricted.
- A subsidiary may be controlled by its parent; however, the parent may have indicated its lack of willingness to extend further support to the subsidiary, as the subsidiary may either be unviable or no longer important to the parent.

As a result, the assumption of fungibility of funds among the entities that may have been considered for consolidation in the reported financials may not always hold. This necessitates following an approach that appropriately adjusts for the regulatory stipulations, the structural limitations and economic considerations, while assessing the feasibility of funding interchange among the related entities[4].

Approach for adjusting the reported consolidated financials

In case the reported consolidated financials constitute entities that have a strong business linkage among them or there are reputational or strategic considerations such that the funds could flow among the consolidated entities unhindered, ICRA generally relies on the reported consolidated financials for credit risk assessment without making any specific adjustments.

In cases where the entities that are included in the reported consolidated financials do not satisfy the above criteria; or in cases where there are entities that satisfy the above criteria but are not consolidated as per the accounting standards (because such entities may not be linked by ownership), an analysis of consolidated business and financial risk profile of the entities that may have been consolidated for reporting purposes may not provide a fair representation of the credit risks. Thus, the reported consolidated financials are appropriately adjusted to exclude the entities whose funds are not

[4] The Companies Act, 2013 imposes restrictions on extension of loans & advances among group entities under certain conditions. However, this does not preclude the possibility of support from one group entity to another in other forms including an extended credit period, asset purchase or equity infusion.

fungible with the other consolidated entities and even those entities to whom extension of any group support is unlikely. At the same time, the entities that are not consolidated, as per the accounting standards but have linkages among each other - like being a part of the same promoter group and having a close business relationship or mutual inter-dependence, are considered for consolidation as per ICRA's adjustments.

The following adjustments may be required in the reported consolidated financials for a fair assessment of the credit risk of the group:

Inclusions	Exclusions
» Entities not linked by ownership and hence not consolidated as per the reported financials but otherwise having strong business and financial linkages among each other by virtue of being part of the same promoter group. » Entities not linked by ownership and hence not consolidated as per the reported financials, but an explicit credit support such as a guarantee or a shortfall undertaking is extended for most of the loan facilities of such entities by any of the other entities which have been consolidated. Also, the entities which are not linked by ownership but there exist cross-default clauses in the loan terms of such entities with respect to the other entities which are consolidated. » Associates or JVs which are reported using the equity method but to whom the entity is expected to extend unhindered support for meeting their liabilities. In the above cases, the adjusted consolidated financials are assessed by ICRA (by including the above entities) as these would more appropriately reflect the liabilities that the entity may be required to support.	» Entities that are consolidated by ownership or control, as per the accounting standards, however: ○ Funding interchange among the stronger and the weaker entities may be hindered because of legal, structural[5] or regulatory constraints. ○ The entities may be in dissimilar lines of business such that the approach to analysing their financial and business risk is different as in the case of consolidation of a financial sector entity and a non-financial sector entity. ○ The entities are unlikely to receive support from or extend support to the other consolidated entities because of lack of willingness. In the above cases, the adjusted consolidated financials are assessed by ICRA (by excluding the above entities) as these more appropriately reflect the credit risk of the constituent entities.

Even as there may be constraints in terms of funding interchange among the subsidiaries, that may warrant excluding such entities from consolidation, the analytical approach for assessing the overall credit profile of the group does take into consideration the ongoing and future outflows from the parent towards the 'excluded' subsidiaries (and vice versa). This approach of factoring in only the funding interchange between the parent and its subsidiaries is also referred to as the **Limited Consolidation** approach. Also, the business risk analysis involves considering only the entities which are fully consolidated. For understanding the rating approach applicable in a case where the parent is a holding company, which does not have significant operations of its own and depends on investment income and/or divestment of its investments to service its debt and incur other sundry expenses, please refer to the rating methodology on 'Holding Companies' available at www.icra.in.

[5] Structural constrains could include among others, presence of a significant minority shareholder in the stronger subsidiaries or presence of cash trap mechanism such that even the surplus after meeting the pay-outs as defined in the cash flow waterfall cannot be up-streamed to the parent.

Assessment of the adjusted consolidated financial and business profile

ICRA's approach to assess the adjusted consolidated financials to evaluate the overall credit risk profile of the group is presented below:

Scenario	ICRA's Approach for Credit Risk Assessment
Funding interchange among the consolidated entities is for reasons such as business linkages, reputation sensitivity or strategic considerations or on account of presence of cross-default clauses	Assess the adjusted consolidated financials as well as the business profile to evaluate the overall credit profile of the group. (a) The parent will generally be assigned the rating corresponding to the overall credit profile of the group, as assessed above. (b) The entities whose credit profile, on a standalone basis, is assessed to be at par or better as compared to the group credit profile, are also assigned the rating corresponding to the group credit profile[6]. (c) The ratings of the entities, whose standalone credit profile is weaker as compared to the group credit profile, may be uplifted with respect to their standalone base rating depending on the extent of willingness of the group to extend support to them. This in turn would depend on the nature of the business linkages of the entity with the group, its relative strategic importance and the reputation sensitivity of the group[7]. The greater the willingness of the group to extend support to the weaker entities, the closer will be the latter's ratings to that of the group credit profile.
Funding interchange among the consolidated entities is due to some form of explicit support from the stronger entities to the other consolidated entities which covers most of the latter's debt servicing obligations	Assess the adjusted consolidated financials as well as the business profile to evaluate the overall credit profile of the group. (a) The support provider will generally be assigned the rating as per the approach discussed in the previous scenario. (b) The specific instruments of the entities for which a strong form of explicit credit support is available may be assigned the same rating as that of the support provider. A strong form of explicit credit support is one that has attributes such as legal enforceability, coverage of the entire amount of debt obligation at all times, unconditionality and irrevocability, besides the presence of a pre-default invocation and payment mechanism. The rating symbol for such instruments would typically have the (CE) suffix indicating that such rating is credit enhanced by way of an explicit support from a third-party and does not reflect the standalone credit quality of the entity. (c) In case the form of explicit support is strong in all respects except that the invocation and payment mechanism is post-default in nature, the rating of the

[6] Please refer to the approach for rating SPVs described in the section below.

[7] The parameters that ICRA considers for assessing the ability and willingness of a parent to extend support to its subsidiaries is discussed in the rating methodology, 'Rating Approach - Implicit parent or group support' available on ICRA's website www.icra.in.

Scenario	ICRA's Approach for Credit Risk Assessment
	specific instruments of the entities, to which an explicit support is available, would be typically lower than that of the support provider. The extent of difference between the ratings would depend upon the weaker entity's standalone creditworthiness, the support provider's creditworthiness, besides the strength of inter-linkages between the support provider and the entity. The rating symbol for such instruments would typically have the (CE) suffix indicating that such rating is credit enhanced by way of an explicit support from a third-party and does not reflect the standalone credit quality of the entity. For more details, please refer to ICRA's methodology, 'Rating Approach - Explicit third-party support' available at www.icra.in.

The subsidiaries which are not consolidated with the parent are evaluated on a standalone basis wherein the standalone financial and business profile of such entities are analysed while factoring-in the ongoing and future inflows from the parent (and vice versa).

Rating approach for SPVs

The infrastructure projects in roads and power sector are typically executed through Special Purpose Vehicles (SPVs) whereby their cash flows are escrowed. There exists a cash flow waterfall mechanism which defines the seniority of pay-outs by the SPV to the various stakeholders. Moreover, typically there also exists a Debt Service Reserve Account (DSRA) which provides liquidity support in case of temporary cash flow mismatches.

While the approach for rating the SPVs is largely similar as that described in the sections above, there are a few nuances as described below that are considered while evaluating the consolidated and the standalone credit profiles of the SPVs and the parent.

1. *Timing of up-streaming of surplus cash flows*: In cases where the surplus cash flows from the SPV, after making the required payouts as per the water-fall mechanism, can be up-streamed/ distributed to the parent, these are often subject to the satisfaction of certain covenants. As a result, the pay-outs may not be aligned with the year for which the financials are prepared. Thus, though the surplus cash flows of the SPVs may be generated in a particular year, these may not be available for distribution to the parent in the same year. The timing of the release of the surplus funds from the SPVs to the parent is factored-in during the consolidated liquidity assessment of the parent.

2. *Availability of DSRA for only SPV-specific debt*: The DSRA which is created at the SPV level can be utilised only in case there is a shortfall in servicing of the specific debt at the SPV level. Thus, the DSRA in one SPV cannot be used to meet the shortfall in the parent or in another SPV. Accordingly, the liquidity available in the form of DSRA at the SPV level is appropriately adjusted while assessing the consolidated liquidity profile of the parent.

3. *Evaluating the credit profile of the SPV (when there are no cross-default linkages with the parent)*: As the cash flows at the SPV level are typically escrowed and there exists a defined priority of pay-outs, such cash flows are first available to service the SPV's own obligations and only the surplus funds are distributable to the parent. As a result, the credit profile of a stronger SPV is not constrained by the credit profile of a relatively weaker parent/ group and thus the rating of the SPV can be higher than that of its parent/ group.

4. *Evaluating the credit profile of the SPV (when there are cross-default linkages with the parent)*: Because of the presence of cross-default clauses, a consolidated analysis of the parent and the SPV is carried out. The rating view formed based on the consolidated analysis would be the rating of the parent. If the SPV is weaker than the parent, it would typically be rated lower than the parent, despite the presence of cross-default linkages between the parent and the SPV. This is because a cross-default linkage does not imply a legal obligation on the parent to service the debt of its subsidiary SPV—unlike a guarantee. Nevertheless, the rating of the weaker SPV may be uplifted from its standalone base rating depending on the extent of willingness of the parent to extend support to it. Also, even if the SPV is assessed to be stronger than the parent, its rating will be capped at the rating of the parent because of cross-default linkages between the loans on the balance sheets of the two entities. However, exceptions could be made to this approach and the ratings for the loans on different balance sheets could be de-linked from each other despite the presence of cross-default linkages if the SPV does not have a funding dependence on the parent and it is assessed that it would be in the economic interest of the lenders/ investors not to invoke the cross-default clause and accelerate the payment from a well-performing SPV, upon a default by the parent.

Rating approach when the detailed financials of several group entities are not available

There may be cases when a parent only reports standalone financials and/ or the detailed financials of several other subsidiaries that ought to be considered for inclusion (exclusion) in (from) the reported consolidated financials are not available. In such cases, ICRA endeavours to consider the funding support that the unconsolidated subsidiaries may require from the parent (or vice versa) while undertaking the financial risk assessment of the parent. For this, both the past track record of the funding support as well as inputs received via discussions with the parent's/ subsidiary's management in terms of future funding requirements are considered and the reported financials of the parent are suitably adjusted to factor in the expected funding interchange with the relevant unconsolidated entities.

Approach for consolidated analysis when a parent and its subsidiary are in dissimilar businesses which are assessed using different analytical approaches

In case the parent is a non-financial sector entity with a subsidiary in the financial sector (such as the captive finance arm of an automobile manufacturer); or the parent and its subsidiary both operate in the financial sector but in dissimilar businesses (such as banking and insurance), an analysis based on the reported consolidated financials may not allow for a meaningful credit risk assessment. In such cases, the parent and its subsidiary are assessed separately on a standalone basis by applying the rating methodology of their respective sectors. The standalone analysis, however, does consider the ongoing and future funding interchange (including the likely extraordinary support) among them.

The ongoing funding support from the parent to its subsidiary is assessed based on the funding requirement in the subsidiary which would depend on factors such as expected growth in the latter's business, expected delinquency levels, capital adequacy and solvency ratio requirements, and the intent of the parent to maintain a certain ownership level. The extraordinary funding support from the parent to its subsidiary is determined based on the estimated funding requirement of the subsidiary that shores up its capital and/ or liquidity, to the extent that it uplifts the subsidiary's standalone rating to the rating level commensurate with what would have been assigned to a subsidiary if it were to be assessed based on the same rating approach as the parent.

The funding support from the subsidiary to its parent is assessed based on factors such as the estimated surplus available for distribution and the dividend distribution policy.

Consolidation versus Consolidated View

Consolidation

Consolidated analysis involves an assessment of the credit profile of the parent/ group by combining the financial and business risk profile of the various entities (such as subsidiaries) in the group to represent these as a single economic unit. The consolidation can be either Full Consolidation or Limited Consolidation. The parent is typically assigned the rating as that assessed for the group based on consolidated analysis and the ratings of the other relatively weaker group entities/ subsidiaries may be uplifted from their standalone credit rating depending upon the strength of the business and the financial linkages with the parent. The rating of the parent and the other group entities considered for consolidation may or may not be the same.

Consolidated View

The parent along with the various subsidiaries which are consolidated for assessing the group credit profile are considered to share a common credit profile because of reasons such as the various subsidiaries being an extended arm of the parent with separate legal existence only because of regulatory or operational reasons. Further, there exists a high degree of business, financial, and management linkage between the various entities. As a result, all the entities in the group operate as a single enterprise in substance, even as they may have distinct legal identities. As a result, all the entities that are considered for consolidation are assigned the same credit rating.

Summing Up

ICRA's credit rating is a symbolic representation of its opinion on the relative credit risk associated with the debt instrument being rated. This opinion is arrived at after evaluating an entity's industry, business and financial risks, its liquidity and financial flexibility, the management's financial policy and its corporate governance practices. As this note has highlighted, apart from the standalone credit considerations, the likelihood and quantum of funding that could be forthcoming from the group (and vice-versa) are also important factors in assessing an entity's credit profile. The possibility of support coming from a stronger group entity, during periods of stress, reduces the risk of default and can thus lift an entity's rating (from the unsupported level) depending on the financial strength of the group and linkages of the entity with the group. Conversely, the burden of supporting weaker group entities during periods of stress can pull down the rating of an entity (from its unsupported level). While in some cases, an analysis based on the reported consolidated financials provides a good measure of an entity's exposure to the various credit risks; in several others, making appropriate adjustments to the same may be necessary for adequately analysing an entity's credit risk profile.

Contact us for any feedback or comments at: methodologies@icraindia.com

RELATIONSHIP CONTACT

L Shivakumar
+91 22 6114 3406
shivakumar@icraindia.com

MEDIA AND PUBLIC RELATIONS CONTACT

Ms. Naznin Prodhani
+91 124 4545 860
communications@icraindia.com

Helpline for business queries

+91-9354738909 (open Monday to Friday, from 9:30 am to 6 pm)

info@icraindia.com

About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

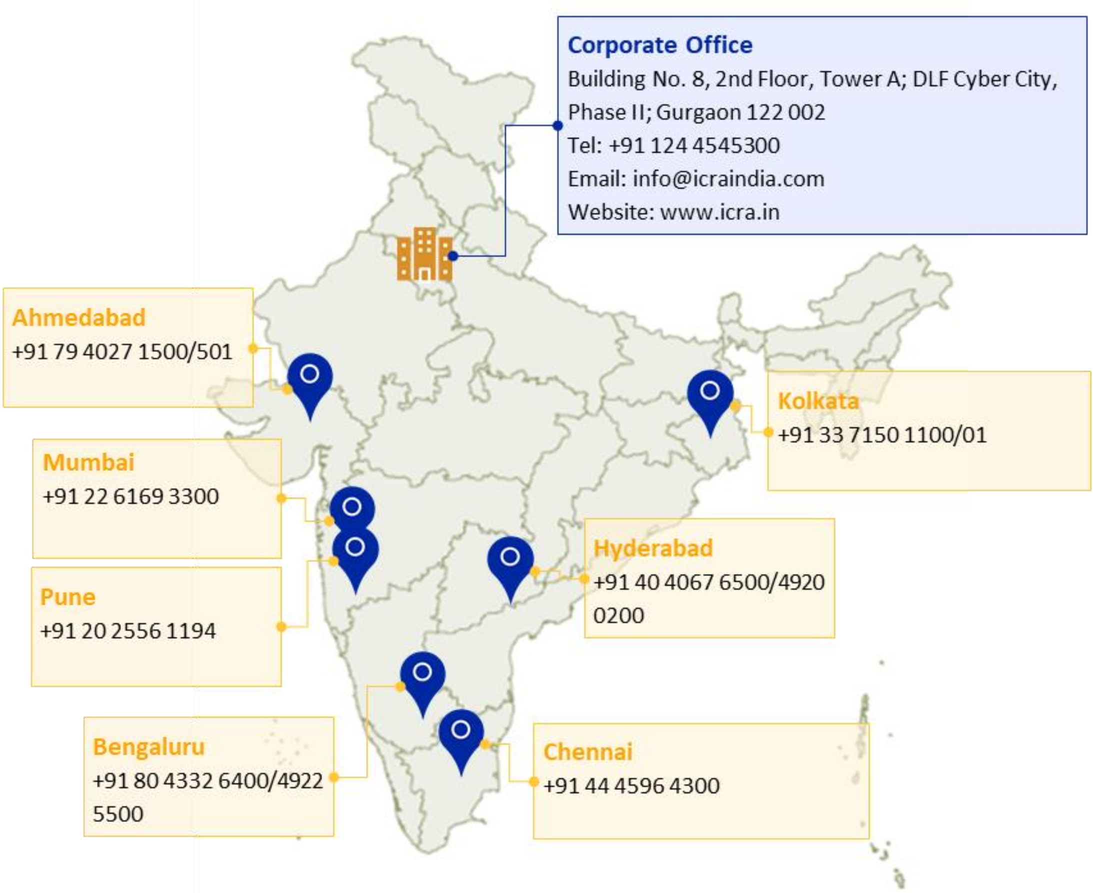
For more information, visit www.icra.in and www.icraresearch.in

ICRA Limited

Registered Office

B-710, Statesman House 148, Barakhamba Road New Delhi-110001
Tel: +91 11 23357940-45

Branches



ICRA ratings should not be treated as recommendation to buy, sell or hold the rated debt instruments. ICRA ratings are subject to a process of surveillance, which may lead to revision in ratings. An ICRA rating is a symbolic indicator of ICRA's current opinion on the relative capability of the issuer concerned to timely service debts and obligations, with reference to the instrument rated. Please visit our website www.icra.in or contact any ICRA office for the latest information on ICRA ratings outstanding. All information contained herein has been obtained by ICRA from sources believed by it to be accurate and reliable, including the rated issuer. ICRA however has not conducted any audit of the rated issuer or of the information provided by it. While reasonable care has been taken to ensure that the information herein is true, such information is provided 'as is' without any warranty of any kind, and ICRA in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness or completeness of any such information. Also, ICRA or any of its group companies may have provided services other than rating to the issuer rated. All information contained herein must be construed solely as statements of opinion, and ICRA shall not be liable for any losses incurred by users from any use of this publication or its contents.