

## RATING METHODOLOGY – HOLDING COMPANIES

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This rating methodology explains ICRA's approach to rating holding companies and supersedes ICRA's earlier methodology document on this subject, published in January 2021. While this revised version incorporates a few changes intended to provide more clarity on a few aspects, ICRA's overall approach to assessing holding companies remains materially similar. Also, a section has been added to provide a broad perspective on how environmental, social and governance (ESG) risks are incorporated by ICRA in its credit assessments.

### Overview

Holding companies are constituted by promoters or sponsor groups<sup>1</sup> to channel their investments into various investee companies that might individually be engaged in related or unrelated businesses. For the scope of this methodology, the holding companies are those that do not have significant operations of their own and depend on investment income and/or divestment of their investments to service their debt and incur other sundry expenses. Since the holding companies are designed mainly to hold investments in investee companies, most of their assets are typically deployed in the form of investments (or loans and advances) in the investee companies. A holding company's ability to raise new debt or refinance existing borrowings hinges strongly on the market value of its investments in investee companies. The objective of forming a holding company could be multifarious, including capital allocation flexibility, tax planning, achieving better cost efficiencies at the enterprise level, and so on, often with the aim of achieving a large scale and a business diversification, besides portfolio value maximisation.

Holding companies and their associated corporate structures might assume diverse ownership forms, ranging from exercising control on the investee companies (henceforth investee companies and operating companies are used interchangeably), either individually or in concert with the sponsors, to not exercising control and merely being financial investors. The list of rating drivers covered in this methodology document is not exhaustive but provides an overall perspective to the lenders, investors, and other market participants on the rating considerations that ICRA usually considers to be the most important. This document describes the attributes of the three forms of holding company structures which are generally prevalent, and the approach adopted by ICRA to analyse each of these.

<sup>1</sup> Henceforth referred to as "sponsors".

## Holding Company Structures

The analytical approach to assessing holding companies depends on their structure, which in turn is governed by the sponsors' objectives. Given below are the salient attributes of some general holding company structures and ICRA's approach to evaluating them.

### Structure 1

The holding company either has the full ownership or holds the majority equity stake with no significant institutional shareholding in most of the material operating companies in the Group. There may be financing, management or operational linkages among the holding and the operating companies. The holding company may have extended or may be willing to extend financial support to the operating entities when they face credit or liquidity stress.

**ICRA's approach:** Analysing the consolidated business profile and financial statements of the holding company and the operating companies, along with other factors such as sectoral diversification of cash flows and refinancing ability, to determine the holding company's credit rating.

### Structure 2

The holding company, along with other sponsor companies, either holds a substantial equity stake in most of the material operating companies in the Group, or in case the holding company on its own holds a majority equity stake in the operating companies, there exists a substantial institutional shareholding in the operating companies. The holding company, along with other sponsor companies, drives/significantly influences the business strategy of these operating companies but does not have unfettered control over their cash flows. There may be financing, management or operational linkages among the holding and the operating companies. The holding company may have extended or may be willing to extend financial support to the weaker operating entities when those face credit or liquidity stress.

**ICRA's approach:** The holding company's credit rating would principally be tied to the credit quality of the operating companies, while factoring in the diversity of its investments and other standalone factors, most notably its refinancing ability based on the market value of its investments.

### Structure 3

The holding company, along with other sponsor companies, holds non-controlling equity stake in the various operating companies. The operating companies' financing and management are separate. The holding company may influence the business strategy of some operating companies via board representation but does not have unfettered control over their cash flows. The holding company is unlikely to extend financial support to the operating entities when they face credit or liquidity stress.

**ICRA's approach:** The holding company's credit rating need not be constrained by the credit risk of the operating companies. To a great degree, the holding company's rating would be governed by standalone considerations, including the market value of its investments and its ability to achieve profitable divestitures.

## Key Rating Considerations

### Structure 1

**Rating Approach:** Since in the first type of structure, the holding company and its operating subsidiaries are characterised as being closely integrated, with the holding company exercising a high degree of control on the operating companies, ICRA's approach to analysing such holding companies is typically no different than that adopted for rating any "parent" having multiple subsidiaries. The fact that the holding company does not have any (or material) operations of its own, unlike a general "parent", is inconsequential to the analysis. Thus, ICRA would consolidate the business as well as the financials of the holding company with that of the operating companies to arrive at a Group rating view. In most situations, the consolidated financials, as reported by the holding company are used directly, unless some specific adjustments are required to be made to better reflect the consolidated economic reality. The adjustments could relate to consolidation of certain Group entities to which the holding company might have extended corporate guarantees; or exclusion of select entities that may have been consolidated out of accounting requirements but may otherwise be insulated from Group dynamics because of inter alia regulatory reasons, or presence of restrictive debt covenants, or the holding company's (parent's) track record and commitment to extend only limited support to such entities<sup>2</sup>.

The rationale for adopting the consolidation approach is the premise that there is a track record of, or an expectation of, unhindered funding interchanges between the holding company and the operating companies. The holding company and the operating companies might also be tied through cross-guarantees or cross-defaults, implying a more explicit transmission of credit risk among these. As a result, undertaking a consolidated financial statement analysis is more meaningful as this allows looking beyond the legal boundaries among the various entities and treating these as representing a single consolidated enterprise, in substance.

**Potential Rating:** The Group rating view, formed upon analysing the consolidated financial statements of the holding company and upon analysing the business risks of the Group, becomes the reference point for assigning final ratings to each individual entity.

- » The holding company's credit rating could be the same as the Group rating view.
- » The rating of the individual operating companies may differ depending on their individual credit profiles and their importance to the overall Group strategy but would generally be capped at the Group rating<sup>3</sup>.

### Structure 2

**Rating Approach:** In the second type of structure, while the holding company (along with other sponsor companies) may drive/significantly influence the business strategy of the operating companies and there may also be financing, management or operational linkages between these, the extent of integration among the various companies is limited compared with Structure 1. This may either be because of the presence of substantial institutional shareholding or lack of a majority equity shareholding in the material operating companies. As a result, the holding company does not have unconstrained access to the operating companies' cash flows.

Because of the above reasons, consolidating the financials of the operating companies with the holding company may not be analytically appropriate. Thus, a different analytical approach becomes necessary to evaluate such holding company structures. The credit risk of such holding companies, nevertheless, continues to be influenced by the credit quality of their investments and their distinctive ability to leverage based on the market value of their investments, besides their standalone financial risk profile. The building blocks of the credit risk assessment framework applied to rate such holding companies is presented below.

<sup>2</sup> For more details, refer to ICRA's methodology titled, "Consolidation", available on ICRA's website [www.icra.in](http://www.icra.in)

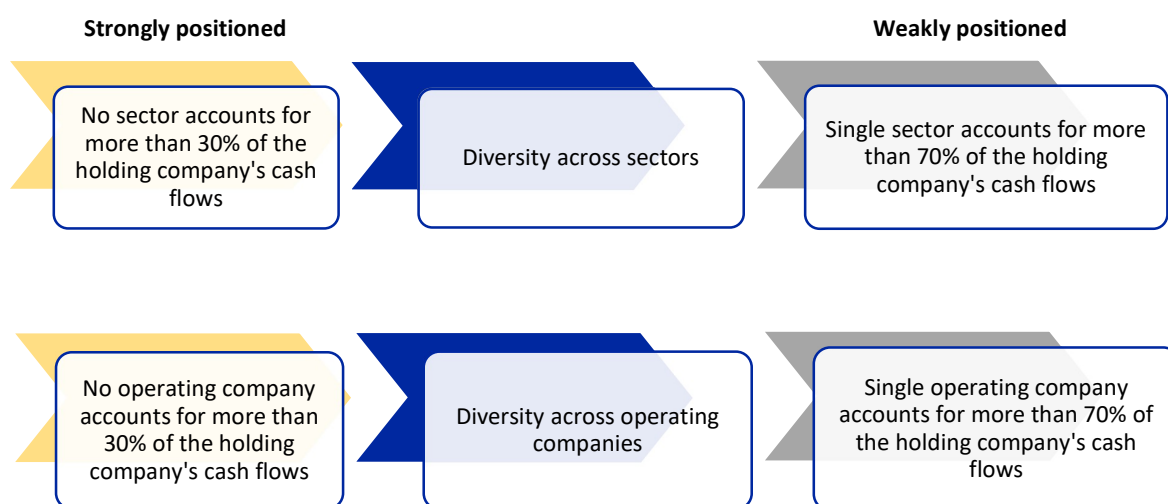
<sup>3</sup> For more details on this, refer to ICRA's methodology titled, "Implicit parent or group support", available on ICRA's website [www.icra.in](http://www.icra.in)

Business Risk	Blended credit quality of investees Diversity of investments across sectors and companies
Financial Risk	Debt coverage Leverage
Other Parameters	Financial flexibility and liquidity Investment and financial policies Governance, financial reporting, and disclosures
Parent or Group Support	Parent's ability and willingness to extend financial support to the holding company out of business, strategic and reputational considerations

### Determination of Business Risk

**Blended credit quality of investees:** The assessment of Structure 2-type holding companies starts with determining the blended credit quality of the operating companies. As the holding companies depend on the income earned from investees (such as dividends, rents, or royalty) to be able to service their debt and incur sundry expenses, the blended credit quality indicates the sustainability of the income and thereby, is the key driver of the holding companies' rating. ICRA determines the average credit quality of the investees by taking into consideration the unsupported rating of the individual operating companies (i.e. the rating that does not factor in the impact of any implicit or explicit external support on the investees' credit profile) and weighting these appropriately.

**Diversity of investments:** Since a holding company depends on cash flow streams that are often discretionary (from the investees' perspective), specifically when these relate to dividends, having a diversified investment portfolio across multiple operating companies is viewed favourably from a credit perspective as it mitigates the impact of weakness in any particular operating company. ICRA measures an investment portfolio's diversity in terms of its spread across operating companies and also the spread across sectors. In case there are multiple operating companies in the same sector, the benefit of diversity in investments is considered only if such individual companies are uncorrelated (for example, the companies cater to different customers, geographies, or products). This factor tends to have either a positive or a neutral impact on the overall business risk of the holding company, depending on the extent of diversity.




### Determination of Financial Risk

ICRA's assessment of a holding company's financial metrics is based both on the past numbers as well as the projections drawn. The following are the two key ratios that ICRA evaluates:

**Debt coverage:** A holding company that consistently reports higher income in relation to its debt servicing obligations, by implication, does not need to rely on other sources (asset sales, refinancing) to pay off its debt. This is considered a favourable attribute from a credit perspective. ICRA measures the (standalone) debt coverage of a holding company through two indicators viz., interest coverage ratio and debt service coverage ratio<sup>4</sup>. Non-recurring cash flows, such as profit from asset sales, are excluded from these measures, although these are factored into the overall rating assessment.

**Leverage:** Other things being equal, a high leverage invariably implies a high credit risk and vice versa. ICRA measures a holding company's (standalone) leverage through the Total Debt/OPBITDA<sup>5</sup> multiple (where OPBITDA is operating profit before interest, tax, depreciation, and amortisation; and Total Debt is borrowings plus commitments such as guarantees)<sup>6</sup>.

It could be argued that the Total Debt/OPBITDA multiple and debt service coverage ratio are not the best measures of a holding company's leverage and debt servicing capacity as the debt is typically expected to be refinanced on maturity and hence, repayment of the principal amount does not critically depend on OPBITDA or cash accruals. However, this ratio allows making a distinction among holding companies that might be critically dependent on refinancing (because of inadequate OPBITDA or cash accruals) versus holding companies that might be reasonably self-sufficient (because of high OPBITDA or cash accruals) to service their debt obligations. The aspect of risk arising from high leverage in relation to OPBITDA or inadequate coverage being mitigated because of high financial flexibility arising from the market value of investments is taken into consideration separately, as outlined in the next section.

	Strongest		Weakest
Interest Coverage	$\geq 18.0x$		$< 2.0x$
DSCR	$\geq 4.0x$		$< 1.1x$
Total Debt / OPBITDA	$\leq 0.5x$		$> 5.0x$

### Other Parameters

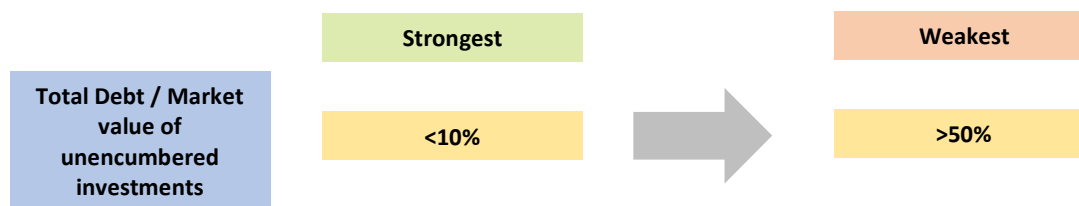
**Financial Flexibility:** One of the key distinguishing features of a holding company is the financial flexibility available to it to take on additional borrowings or refinance existing debt on the back of the market value of its unencumbered investments. ICRA measures the financial flexibility of a holding company by estimating the ratio of its Total Debt to the market value of unencumbered investments. The lower the ratio, higher is the financial flexibility to refinance or raise new debt.

- » While calculating Total Debt, ICRA includes the off-balance sheet obligations like corporate guarantees.
- » While estimating the market value of investments, ICRA does not simply go by the prevailing market values but makes suitable adjustments to factor in the equity market's volatile nature.
- » While assessing the financial flexibility, ICRA duly considers that a holding company may not be inclined to encumber the shares it holds in operating companies beyond a threshold, even if those shares might be eligible to be encumbered technically. For example, a holding company having a 60% equity stake in an operating company, might not be keen to encumber its holdings beyond 10%, lest it should lose majority control in a worst-case scenario.

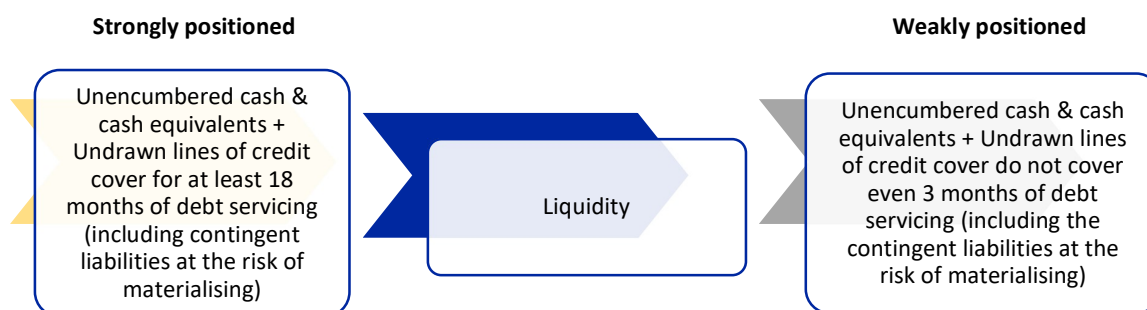
<sup>4</sup> For more details, refer to ICRA's methodology titled, "Financial Ratio Analysis", available on ICRA's website [www.icra.in](http://www.icra.in)

<sup>5</sup> For a holding company, OPBITDA includes dividend, rent or royalty income.

A holding company may have other sources of financial flexibility too, like unencumbered assets, physical or financial (other than the equity shares in operating companies) that could be collateralised, linkages with a strong sponsor group, or strong relationship with banks, financial institutions, and other intermediaries, that may allow it to borrow at short notice. ICRA considers these factors as well in financial flexibility assessment on a qualitative basis.



**Liquidity:** Maintaining a comfortable liquidity position through on-balance sheet or off-balance sheet resources is essential for any entity, and more so for a holding company whose operating cash flow, by their very nature, could be fickle. For assessing the liquidity position of a holding company, ICRA estimates the period for which the unencumbered cash and cash equivalents and undrawn lines of credit cover the upcoming debt servicing obligations. This apart, ICRA evaluates the degree of diversity in funding sources that a holding company has at its disposal. ICRA notes that it may maintain good liquidity, but rather inconsistently, given the trade-off between returns and liquidity; hence, the overall liquidity assessment is done in the context of the company's policy towards maintaining adequate liquidity<sup>6</sup>.



**Investment and Financial Policies:** An established track record of making fundamentally sound investments, a generally conservative approach adopted towards growth and investments, and a consistent track record of maintaining low financial leverage are some of the attributes that ICRA assesses to form a view on the sustainability of a holding company's credit profile.

**Governance, Financial Reporting and Disclosures:** ICRA seeks to gain a qualitative understanding of the holding company's commitment to following transparent and credible practices by the way its financial statements are reported, their level of disclosures, consistency in communication and the openness shown in sharing information during the credit rating exercise, and with other stakeholders in general. Inconsistency in the various forms of information shared, which could be a reflection of weak management information systems, and a general tendency to being opaque in communications are viewed unfavourably.

**Potential Rating:** A holding company's rating (before factoring parent/Group support) would be anchored around the blended credit quality of the operating companies with the extent of notch down from the blended credit quality being dependent on the holding company's standalone considerations as elaborated in the sections above.

<sup>6</sup> For more details, refer to ICRA's methodology titled, "Liquidity Analysis of Entities in the Non-Financial Sector", available on ICRA's website [www.icra.in](http://www.icra.in)

### Parent or Group Support

If the holding company being rated is the ultimate holding company of the sponsor group, the aspect of its rating being supported or negatively influenced by a parent would not be applicable. However, if the holding company being rated is an intermediate holding company of the sponsor group, ICRA analyses the positive or negative impact that the parent may have on the rated company's credit profile. Such an analysis involves:

- » Assessing the credit quality of the parent, which would be a determinant of its ability to extend financial support to the rated company if it faces credit or liquidity stress, and
- » Assessing the importance that the rated company holds for the parent out of business, strategic or reputational considerations, which would be a determinant of the parent's willingness to extend financial support to the rated company<sup>7</sup>.

### Structure 3

**Rating Approach:** In the third type of structure, the holding company (along with other sponsor companies) is characterised as one that generally holds non-controlling equity stakes in the various operating companies. These structures are limited in the Indian context. This section outlines ICRA's approach to rating Structure 3-type holding companies, where neither the (parent) holding company (along with other sponsor companies) exercises control over the cash flows of the operating companies (because of lack of control) nor is it likely to extend distress support to the operating companies, should there be a need. Such holding companies have a greater resemblance to financial investors as opposed to strategic investors—with their business model focused sharply on portfolio value maximisation through monetisation of assets (whenever pertinent) and reinvestment.

Given the distance maintained, the risk of credit contagion between such holding companies and their operating companies is low. It is for this reason that such holding companies' ratings need not be constrained by the credit risk of the operating companies. To a great degree, such holding companies' ratings are governed by standalone considerations.

From a rating methodology perspective, ICRA's approach to analysing Structure 3-type holding companies remains broadly similar to that for analysing Structure 2-type holding companies as attributes such as the quality and the diversity of investments/ cash flows are the common considerations in both the structures. However, there is one key point of difference. While for the rating of Structure 2-type holding companies, the blended credit quality of the investees is an important rating driver, it is not so for Structure 3-type holding companies. The latter are not as exposed to the credit risk of the investees as they are to the equity risk. The building blocks of the credit risk assessment framework applied to rate such holding companies is presented below.

Business Risk	Diversity of investments
Financial Risk	Debt coverage Leverage
Other Parameters	Financial flexibility and liquidity Investment and financial policies Governance, financial reporting and disclosures
Parent or Group Support	Parent's ability and willingness to extend financial support to the holding company out of business, strategic and reputational considerations

<sup>7</sup> For more details, refer to ICRA's methodology titled, "Implicit parent or group support", available on ICRA's website [www.icra.in](http://www.icra.in)



The explanation on why the above factors matters and what their rating implication is, remains similar to that provided in the previous section of this document.

**Potential Rating:** Given that the rating of a Structure 3-type holding company would be governed essentially by standalone considerations, it is possible that its credit quality is superior to that of the operating companies on the back of high quality of investments, diversification of investment portfolio, strong financial flexibility by virtue of low debt in relation to the market value of unencumbered investments and approach of maintaining arm's length distance from the operating companies with the general lack of commitment to financially support the operating companies at times of stress. These attributes could allow the holding company to maintain significant financial capacity to service its own debt obligations and qualify to be rated higher than the investees, with these strengths more than offsetting the dependence on potentially lower rated operating companies for most of the income.

At the other extreme, if the holding company does not have adequate investment diversification and the fundamentals of the operating companies are also weak, then the quality of the investments also has a bearing on the holding company's rating. This is because of the dependence of the holding company on discretionary dividend pay-outs from the investees, or divestment of stake in the investees, both of which could get impacted due to weakening of the credit profile of the investees.

## Assessment of Environmental, Social and Governance (ESG) Risks

The assessment of ESG risks by ICRA involves a broad range of considerations that pertain to the sustainability of an entity with focus on aspects that can have a material impact on its credit quality. While the E&S risks tend to be both sector-related as well as entity-specific and could be driven by external factors such as regulations or demographic changes, the G risks are largely entity-driven. The impact of the E&S risks on an entity's credit profile tends to be asymmetric. If the ESG risks are material but unmitigated, these generally translate into pulling down the rating, but generally the ratings are not pushed up even when the ESG context is favourable.

### Environmental (E) and Social (S) Risks

As this methodology highlights, while undertaking credit assessment of entities, ICRA seeks to incorporate all relevant credit considerations into its rating decisions, while taking a forward-looking view on the risks and the mitigating elements. The relevant credit considerations include (sometimes overtly, sometimes covertly) the E&S factors that could affect the rated entity/ transaction. While ICRA's analytical approach does not explicitly disaggregate these risks to assess their impact on the rating, these are often assessed broadly, if not precisely. Further, it is not always feasible to fully or precisely disaggregate the sub-components of E&S risks in credit analysis since these considerations often tend to overlap<sup>8</sup>.

That said, the materiality of the E&S risks and the time horizon over which they are expected to crystallise differs widely across sectors and entities. In some cases, while the E&S risks could be material, their effect on the credit profile may be muted because of other fundamental strengths of the entity. In other cases, the adverse impact of the E&S risks is expected to play out in the distant future, and hence these considerations do not necessarily weigh on the rating today—with the expectation that when these risks manifest in the distant future, the rated entity by then would possibly adapt itself by realigning its business model.

While evaluating the E&S risks, ICRA's objective is only to assess the direct and indirect risks that an entity faces and how it already is or is intending to mitigate the impact of such risks on its credit profile. As an example, ICRA only assesses whether an entity is exposed to physical climate risks, or carbon transition risks or other environmental and social risks; and seeks to understand the various mitigation and adaptation approaches that the entity is implementing to mollify these risks. Notwithstanding the above, as an example, it is possible that even if an entity A has a higher carbon footprint than entity B, it

<sup>8</sup> For example, carbon-reduction measures by an entity would have positive implications for the health and well-being of the community (an S factor) as well as for reducing greenhouse gas emissions (an E factor).



does not materially affect ICRA's credit opinion on entity A because ICRA's credit opinion considers a wide gamut of credit-relevant factors, and the E&S factors are only one among those.

The holding companies are exposed to environmental risks through their operating companies. If the operating companies face business disruption because of physical climate adversities, or if such businesses face climate transition risks because of technological, regulatory, or customer behaviour changes, it could translate into credit risks for the holding companies. However, the risk can be mitigated via adequate sectoral diversification of the operating companies. Likewise, the exposure of holding companies to social risks depends on the nature of the sectors in which the operating companies are present and the relative concentration of investments.

### Governance Risks

A sound corporate governance structure attempts to make clear the distinction of power and responsibilities between the Board of Directors and the management. The constitution of an entity's Board and the Board of Directors' participation in strategy formulation, besides the entity's adherence to legal and statutory compliance requirements are factored in during credit assessments. ICRA seeks to gain a qualitative understanding of an entity's commitment to following transparent and credible practices by the way its financial statements are reported, their level of disclosures, consistency in communication and the openness about sharing information during the credit rating exercise. Besides, the corporate group structure (whether simple or complex), the rated entity's related party transactions, and instances of supporting group entities at the expense of debt holders are assessed.

### Summing Up

This document discusses the various factors that are generally evaluated by ICRA to determine a holding company's credit rating. The rating approach may differ depending on the type of the holding company structure being evaluated. While the document describes the attributes of three broad holding company structures and the approach adopted by ICRA to analyse these, the eventual approach adopted to arrive at rating decisions may not always fit neatly in one single approach. The holding company structures could be disparate and often the analytical approach might require improvisation on a case-by-case basis. Nevertheless, this document should serve as a reference for lenders, investors, and other market participants to understand the general principles that ICRA follows for rating holding companies.

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## 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](http://www.icra.in) and [www.icraresearch.in](http://www.icraresearch.in)

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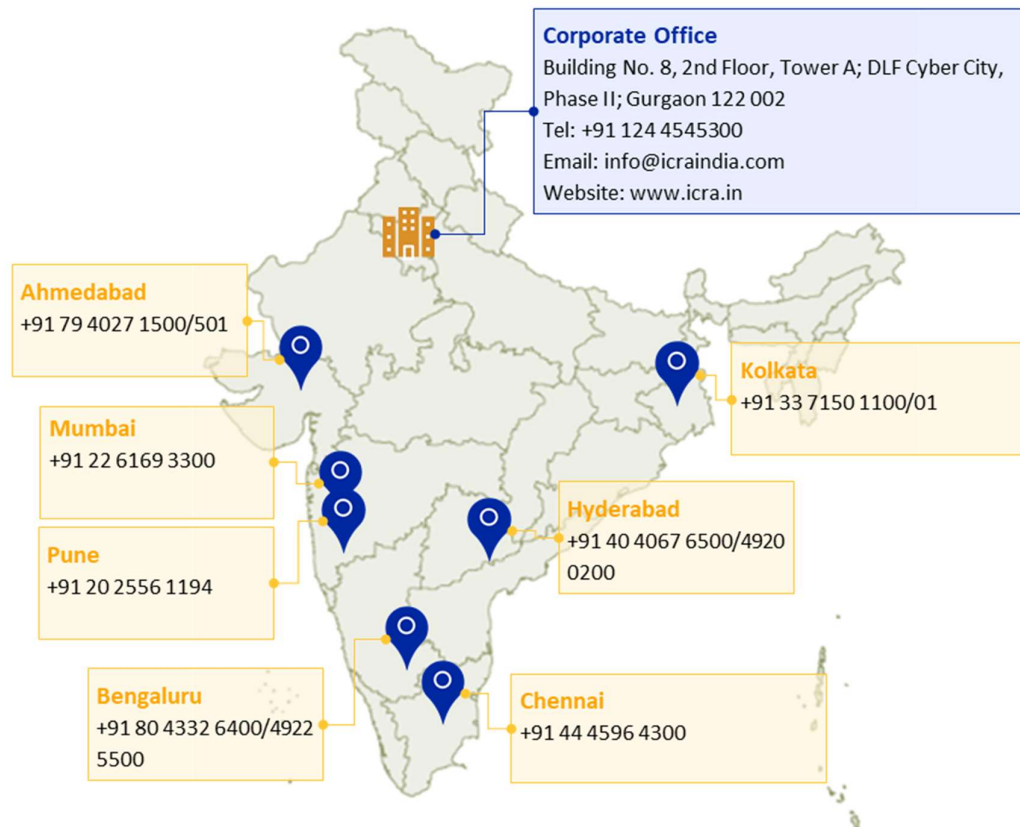
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### Branches



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