ICRA

Rating Approach – Implicit Support from Parent or Group

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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in July 2021. While a few additional clarifications on the analytical approach have been provided in this updated version, ICRA's overall approach to rating entities while factoring-in implicit support from parents or groups remains materially similar. The document provides additional commentary on how ICRA assesses the credit profile of entities that are owned by multiple sponsors (like in the case of joint ventures) or are a part of larger groups where the flow of extraordinary support cannot be attributed to a single identifiable entity.

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
Vice President
+91 124 4545 368
jitinm@icraindia.com

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

Mr. Balaji Murali
Vice President
+91 44 4596 4300
balaji.murali@icraindia.com

Overview

The credit rating of an entity is a generally a function of its standalone credit profile; however, in certain cases, the entity's credit quality can also be driven by the relationship with its parent or the group entities. For the latter, ICRA's methodology for rating entities involves the determination of an entity's notional standalone rating as the first step and subsequently notching the rating up, based on the likelihood of support coming in from the parent or group entities[1], at a time of distress.

'Support' means financial support from the parent expected to be available to the rated entity in the form of loans, equity, extended credit period or advances. Such support from the parent is expected when the rated entity faces stress, including cash flow mismatches or a fund shortfall to meet its debt obligations. 'Support' does not mean the ongoing or committed financial support from the parent but the extraordinary support which cannot be foreseen and thus cannot be factored-in while assessing the notional standalone rating of the entity. It also does not mean operational support in the form of new business opportunities, technology-sharing, or distribution network-sharing. The latter are the factors that are considered while determining the notional standalone rating and not for assessing the degree of uplift based on parent support. As the expectation of implicit support is not based on any contractual commitment, a holistic assessment of the likelihood of such support from the parent, based on qualitative considerations, is critical.

It may be noted that promoters in their individual capacity, or private equity firms or other financial investors are generally not treated as parents for assessing the likelihood of extraordinary financial support coming in. While there are constraints in assessing the creditworthiness of an individual, private equity firms or other financial investors have interests across a portfolio of entities and may not have the incentive to extend financial support to the investee entities in times of distress, beyond their planned / committed investment.

[1] Henceforth in this methodology note, reference made to the 'parent' may be construed as reference made to the 'parent and/ or group entities' of the rated entity, unless mentioned otherwise.

The first step of determining the notional standalone rating is based on an evaluation of the entity's exposure to industry and regulatory risk, its business position, its financing choices, liquidity, financial flexibility and management quality. The notional standalone rating is subsequently notched up, based on an assessment of the parent's ability and willingness to extent extraordinary support to the entity. Based on the support considerations, while the credit profile of the entity (subsidiary) improves, that of the parent weakens although the impact on the ratings of the parent and the subsidiary is not necessarily proportionate and depends on their relative sizes and credit profiles.

The above description assumes that the parent's credit quality is superior to that of the entity. In case it is otherwise, the entity's rating may likely be capped at the parent's rating on evaluation of the possibility that the entity may, at some point, be bound to extend financial support to its weaker parent, unless the entity is insulated from the parent or its cash flows are ring-fenced.

The focus of this document is to articulate ICRA's approach to assigning ratings in cases where the relative credit strength of an entity's parent may have the effect of either notching-up or notching-down an entity's notional standalone rating. This approach does not apply to cases where the parent has extended some form of strong explicit credit support[2] to the rated entity such as a guarantee, which results in credit substitution of the entity's rating with that of the parent.

The document discusses the following key aspects:

- Approach towards rating entities based on parent support;
- The factors considered to gauge the parent's incentives to extend support to the entity;
- The extent to which the entity's notional standalone rating could be notched up or notched down based on linkages with the parent

Approach towards rating entities based on parent support

While the credit rating of an entity is typically a function of its standalone business and financial risk profile, in certain cases, the entity's credit quality could also be driven by the relationship with its parent. A parent's support to an entity and vice-versa could be driven by multiple reasons, including those arising out of business linkages or considerations that are strategic or reputational. The rating approach followed by ICRA to factor-in the parent support involves the sequence of steps, as given below:

- Determining the notional standalone rating of the entity, without assuming any extraordinary form of funding support coming from the parent
- Determining the rating of the parent, which corresponds to the overall credit profile of the group and is generally based on the consolidated[3] analysis of the parent and all its subsidiaries[4] and other related entities—to determine the ability of the parent to extend support
- Evaluating the nature of linkages between the entity and the parent—to determine the willingness of the parent extending support
- Notching up the rating of the entity with respect to its notional standalone rating based on the entity's linkages with the parent and the parent's wherewithal to extend support

An entity may be financially weak on a standalone basis, but if it has strong business linkages with the parent and is strategically important to it, and the parent has high reputation sensitivity to default by any group entity, and the parent has either acknowledged the intent (or has a track record) of extending support to the entity, the entity may be assigned a rating closer to that of the parent. ICRA seeks validation of the above by way of engaging with the parent to understand its views on

[2] Refer to ICRA's methodology "Rating Approach- Third-party support" available at www.icra.in
[3] Refer to ICRA's methodology "Rating Approach -Consolidation" available at www.icra.in
[4] Henceforth in this methodology note, reference made to the 'subsidiary' may be construed as reference made to the 'subsidiary and/ or group entities' of the rated entity, unless mentioned otherwise.

extending support to the rated entity, besides examining the track record of the parent extending timely support to the entity, when required. At the other extreme, if the rated entity is not core or strategically important to the parent and neither are there any business linkages or any reputation sensitivity associate with a group entity default, nor is there any acknowledgement from nor track record of the parent extending support to the entity, the entity's notional standalone rating is not uplifted based on parent support.

If the entity's credit profile is stronger on a standalone basis (compared with its parent), its rating would still be capped at the parent's rating. This is because the entity may inevitably be compelled to extend financial support to its weaker parent, given the latter's control over it. However, if the entity is sufficiently insulated from its weaker parent or its cash flows are ring-fenced, it may be rated higher than the parent. However, in such a case, the parent's rating would not derive much benefit from the presence of a relatively stronger subsidiary. In effect, the affiliation between a stronger and a weaker entity, whether having a parent-subsidiary relationship or being part of the same group, generally affects the credit quality of both. The analytical challenge is to determine how close the two ratings could be pulled based on the affiliation.

The factors considered to assess the extent of notching-up from the notional standalone rating of the entity to arrive at its final rating are discussed next.

Factors considered to gauge the parent's incentives to extend support to the rated entity

This section delves into the aspects related to the ability of and motives behind a parent's willingness to extend support to its relatively weaker subsidiary.

Factors considered while assessing a parent's ability to support	Factors considered while assessing a parent's willingness to support
• Parent's rating • Structural aspects	• Business linkages of the parent with the entity • Strategic importance of the entity to the parent • Parent's reputation sensitivity

Ability to Support

- **Parent's credit profile:** It is natural to expect a parent with a strong credit profile, to possess greater wherewithal to extend support to a weaker subsidiary on the back of a superior balance sheet and higher financial flexibility, compared to a parent whose credit profile is relatively weaker. Thus, an entity, say rated [ICRA]BBB on an unsupported basis, having a higher rated parent, is likely to receive a greater rating uplift over its base rating than a similar entity, whose parent may have a relatively lower rating.

- **Structural aspects:** While a parent generally has access to the subsidiaries' resources, its ability to extend extraordinary support to the subsidiaries may sometimes be limited. Such limitation might be because of loan covenants, regulatory hurdles, or legal constraints. Limitation might also be because of constraints on cash flow fungibility in the case of a foreign parent or the presence of different significant minority shareholders at the parent and subsidiary level[5]. The notching up of a subsidiary's standalone rating based on parent support thus takes cognizance of such limitations.

[5] It might also be the case that the parent has expressly stated that its support for the subsidiaries would not be available beyond a specified threshold.

Willingness to Support

- **Business linkages:** To form an opinion on the willingness of the parent to extend extraordinary financial support to an entity, ICRA considers whether the parent and the rated entity have business linkages, including an assessment of the extent to which the parent is critically dependent on the rated entity for its own business stability. The assessment of this factor is conducted from the parent's standpoint—to assess the importance the rated entity holds to the parent's operating value chain. If the parent's business could face disruption in case there is a disruption in the operations of the rated entity, the likelihood of the parent extending distress support to the entity would be high. The entity too might be critically dependent on the parent for its own business volumes such that if the parent were to switch to some other supplier or service provider, the rated entity might experience severe distress; however, this aspect is considered relevant to determine the rated entity's notional standalone rating and not to determine the rating uplift possible based on extraordinary support from the parent.

  Related product lines or common core customers of the entity and its parent are also indicative of stronger levels of business integration between them. In such cases, the entity may be operating more like a division of the parent and its separate legal form may only be for regulatory, taxation-related, or operational reasons. Overall, higher criticality of the rated entity to the parent's operations or closer business linkages between the parent and the entity generally results in a higher notch-up from the entity's standalone rating. However, ICRA notes that there may be a high correlation between the business performance of the parent as well as the rated entity, such that they suffer from the same adverse economic conditions, making it difficult for the parent to extend support to the entity when the latter needs it the most.

- **Strategic importance of the entity to the parent:** An entity that holds a high strategic importance for the parent is more likely to draw extraordinary financial support from the parent, when required. Strategic importance may stem from the entity being in a line of business that the parent considers high on priority and critical to the parent's own long-term growth, profitability, or diversification objectives, which creates an incentive for the parent to extend support.

  In the past, there have been instances when entities that had strong sponsors ended up defaulting on their dues to lenders, which illustrates the difficulty in judging the strategic importance an entity may have for its parent. Given that the perception of strategic importance doesn't hinge on any legally binding premise, any rating uplift considered for an entity, based on an evaluation of its strategic importance to the parent, remains vulnerable to changes in the parent's stance. A parent, who may have earlier pronounced about the strategic importance of an entity to its own business plans, may find itself compelled to alter its stance at a later point in time if incremental investments in the entity become uneconomic or the parent's strategic objectives change. While assessing the necessity of a rating uplift, ICRA, therefore, doesn't assess an entity's strategic importance to its parent in isolation, but in conjunction with its fundamental economic viability.

- **Parent's reputation sensitivity:** In ICRA's assessment, if a default in debt servicing by an entity could potentially damage the reputation of its parent, the latter would be incentivised to extend regular and timely support to the entity to preserve its franchise. A dent to the reputation of the parent could possibly make it difficult for it to raise capital on its own balance sheet or in its other ventures. For example, if an entity shares its name or logo with the parent or there are commonalities in the name used in the various publication materials, it could be considered a proxy for a higher reputational sensitivity of the parent towards a potential default by a group entity. More the reputation sensitivity of the parent, the greater will be its inclination to extend financial support to its subsidiaries in their times of need. ICRA examines the track record of the parent to have financially supported even the weakest entities in the group for ensuring timely debt servicing by them. In ICRA's experience, reputation sensitivity is observed to wield relatively greater influence in financial sector ratings.

A parent's commitment to support an entity is also assessed based on the presence of contractual features such as cross-default linkages between the parent's debt and the rated entity's debt and the presence of a contractual surplus sharing arrangement between the parent and the rated entity. In addition, there may be situations where the parent might have guaranteed some of the debt instruments/ facilities of an entity (a subsidiary or a group entity). All these could be an indirect indication of a relatively stronger commitment of the parent towards the entity, which could contribute to a higher notch-up in the rating of the entity. This apart, the intent to support is gauged based on the parent's demonstrated past track record of extending financial support in a timely manner like need-based equity infusions or extension of unsecured loans or advances and commitment to extend timely extraordinary support in the future. ICRA seeks validation of the above by way of engaging with the parent to understand its views on extending support to the rated entity.

Broad framework to assess the willingness of parent support *(applicable for entities that are not Government-owned)*

Parameter	Factors considered
Intent of Support	Has the parent expressed its intent to extend support to the rated entity, if a need arises? Is there a past track record of support ensuing from the parent to the rated entity?
Business Linkages	Are the operations of the parent and the rated entity highly integrated, such that if there is a disruption in the operations of the rated entity, it would in turn lead to a disruption in the operations of the parent?
Strategic Importance	Is the rated entity in a line of business that the parent considers to be a priority as it offers strong long-term strategic benefits in the form of business, product or geographical diversification?
Reputation Sensitivity	Does the parent have high reputation sensitivity and would be willing to extend extraordinary support to the rated entity when the latter faces stress?

While the above factors are applicable for assessing the likelihood of a parent extending extraordinary support to a group entity in general, these may not be entirely applicable to evaluate the likelihood of financial support ensuing to entities that are Government-owned. The factors that ICRA considers for assessing the likelihood of the Central or the state government (as applicable), to extend extraordinary financial support to the rated Government-owned entity, are outlined below.

Broad framework to assess the willingness of parent support *(applicable for entities that are Government-owned)*

Factors considered
Is the entity of high strategic importance to the Government and acts as a central vehicle to further its policy objectives in areas such as national security, energy security, food security etc.?
Will a default by the entity have severe adverse systemic consequences such as loss of investor/ public confidence in the Government's credibility?
Is the Government expected to maintain majority ownership in the entity to control all the key decisions on strategy and operations? What is the entity's board composition?
Is the entity a dominant provider of products or services in its area of operations and such public services hold a high public importance?
Is private sector role in the given areas of operation likely to be limited?

The above factors only indicate the broad elements that ICRA looks at for assessing the importance that a Government-owned entity holds for the Central or the state Government. The analysis also includes observing the track record of the Government in extending ongoing and extraordinary support to the rated entities in a timely manner. Further, ICRA notes that the 'importance' that an entity holds for the Government is prone to change with time and sometimes with a change in the Government at office.

Rating approach when the entity is fully owned by the Government and works like its extended arm

The extent of integration of some Government-owned entities with the sponsor Government is so high that such entities could effectively be considered as an extended arm of the Government. This could be stated for entities that perform a regulatory function, or for state or central urban/ industrial/ any other authority, or for a nodal agency (such as a Trust) formed for meeting specific purposes like on-lending to various development projects etc. For such entities, carrying out standalone analysis either does not hold meaning or is not possible. Thus, for such entities, the general approach of uplifting the standalone rating of the entity based on an evaluation of the likelihood of parent support (Government support in such cases) cannot be applied.

For such entities, instead of following the typical bottom-up approach (i.e. uplifting the notional standalone rating based on the likelihood of the parent support), ICRA follows the top-down approach of analysis (i.e. notching-down from the parent's rating depending on the importance of the entity for the parent and the likelihood of timely support from the parent). The rating of such entities is generally either at par or close to the Government's rating. However, it is worth qualifying that in some cases, a wider notching (vis-à-vis the rating of the Government concerned) may apply typically when there is a high non-rule based financial linkage of the rated entity with the (state or central) Government and there are concerns around the lack of timeliness of transfer of funds from it. Also, a wider notch gap could apply in cases where despite the presence of rule-based fund transfer linkages between the rated entity and the state or Central Government, there is a track record of delays in the receipt of rule-based transfers. A wider notching could also apply in cases where even the regular payables are stretched by the Government, leading to a weak financial profile of the entity.

Extent to which the entity's notional standalone rating could be notched up or notched down based on linkages with the parent

The approach that ICRA follows is described below:

- **When the parent is stronger than the entity:** When an entity has a strong business, strategic or reputational significance for the parent and there is also an acknowledgement/ demonstration of intent by the parent to extend support including presence of contractual features, if need arises, or there is a track record of receiving timely support, the entity could be rated close to the parent's rating. Conversely, when an entity's operations do not hold much business, strategic or reputational importance to the parent, and there is no acknowledgement/ demonstration of intent by the parent to extend support (nor there is a track record), the final rating of the entity would generally be closer to its own standalone rating. The sub-scenarios indicated above are the two extremes of the spectrum. For situations where the entity's importance to the parent lies somewhere in between the above two extremes, the extent of notch up from the entity's standalone rating is done based on the factors described in the previous section.

- **When the parent is weaker than the entity:** When the extension of support from the stronger entity to its weaker parent cannot be ruled out, the final rating of the subsidiary would generally be restricted to the parent's rating. When the extension of support from the stronger entity to its weaker parent can be ruled out because of regulatory stipulations, ring fencing of its cash flows or structural limitations (*such as presence of other institutional shareholders, presence of substantial minority shareholding, existence of restrictive debt covenants*), the final rating of the entity would reflect its standalone credit quality and could be higher than the parent's rating. In such cases, the parent's rating too will not draw support from the presence of such stronger entity in the corporate family and only the inflows from such stronger entities, such as dividends are considered for the assessment of the parent's credit profile.

RATING APPROACH IN SOME SPECIFIC SCENARIOS

Rating approach in the case of group support: An entity's notional standalone rating could also be uplifted based on the likelihood of support from group entities. The entity might be a part of a large corporate group having common promoters or crossholdings, even as each entity would have an independent board and management team. In such cases, ICRA first assesses the group credit profile based on its methodology on consolidation. Subsequently, the extent of notch uplift from the notional standalone rating of the entity is based on the linkages with the group based on the factors discussed earlier. It needs to be noted that unlike a parent-subsidiary relationship wherein the flow of support could be attributed to a single identifiable entity, the flow of support from a 'group' could be relatively more fluid and may come from different group entities at different points in time. Given the lack of specificity around the support provider, the extent of notch-up based on group support may be relatively limited[6].

Rating approach in the case of joint ventures (JVs): While rating JVs, it is important to determine which JV partner is expected to extend extraordinary support and that specific partner's credit profile would form the basis of deciding the notch uplift from the JVs notional standalone rating. In such cases, ICRA endeavours to gain an understanding from the rated JV and the JV partners regarding the support philosophy.

- In case a specific JV partner is expected to take the full onus of extending support, the notch uplift considerations are applied while assuming support to be forthcoming from that specific JV partner.
- In case the JV partners are expected to extend extraordinary support to the JV in proportion to their respective shareholdings, the notch uplift considerations are applied based on the weakest link approach. This implies that the relatively weaker JV partner's credit profile becomes the basis of deciding the extent of notch uplift.
- In case it is unclear as to which JV partner would extend support or whether the aspect of joint ownership might lead to indecision in extending the required support in a timely manner, ICRA may not factor-in such purported 'support' in its assessment.

Approach while rating a step-down subsidiary: In the case of a step-down subsidiary, the extent of notching-up is generally based on ICRA's view on the credit profile of its immediate parent, rather than the ultimate parent. However, when the entity's immediate parent only acts as an intermediary/conduit through which the support flows from the step-up or the ultimate parent, that is, where the ultimate parent drives the flow of support to the rated entity, then the notch-up is based on the credit profile of the ultimate parent. Such scenarios may arise where the step-down subsidiary holds strong importance for the ultimate parent because of strategic/ business reasons and reputational sensitivity. The rated entity in such cases might be directly held by the immediate parent (rather than directly by the ultimate parent) only out of certain operational considerations.

[6] In cases where the parent and its various subsidiaries are considered to share a common credit profile because of high degree of business, financial, and management linkages, such that the various subsidiaries operate as an extended arm of the parent with separate legal existence only because of regulatory or operational reasons, ICRA takes a consolidated view of these entities and assigns them the same rating.

Summing Up

ICRA's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the entity being rated. This opinion is arrived at after evaluating an entity's business and financial risks, its competitive strengths, the likely cash flows and the adequacy of such cash flows vis-à-vis its debt servicing obligations. As the note has highlighted, apart from standalone credit considerations, the likelihood of extraordinary support coming in from the parent to an entity or the support that an entity is likely to extend to the parent is also assessed to notch the entity's notional standalone rating (either upwards or downwards) to arrive at the final rating. This process involves an assessment of the ability and willingness of the parent to extend support to the entity (and vice-versa), in addition to evaluating the entity's own fundamental credit strength.

ANNEXURE

Ascertaining the notching gap between the rating of the support provider and the supported entity

Illustration

Support Provider's Rating
AA+

Rating Uplift
A-
Based on the willingness of the support provider to extend support; and the degree of correlation between the support provider and the rated entity

Notional standalone rating of the entity
BB+

In case the likelihood of support is 'Low', the final rating of the entity would be close to its notional standalone rating.

In case the likelihood of support is 'Very High', the final rating of the entity would be close to that of the support provider.

In case the likelihood of support is 'Moderate' or 'High', the final rating of the entity would be somewhere between the above two extremes.

LOW	MODERATE	HIGH	VERY HIGH

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