



Parent and Subsidiary Rating Linkage Criteria Methodology

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Summary

This criterion explains LRA's approach to rating subsidiaries of financial and non-financial parent entities, as well as entities owned partially or fully by the central or state governments. The purpose of this analysis is to incorporate the impact of linkages, (legal, financial, operational etc.) which exist between parents and subsidiaries, on the credit profile of the subsidiary being rated. LRA uses the standalone credit profile of the subsidiary as the starting point of its analysis and subsequently notches the same higher or lower, based on its linkages with its stronger or weaker parent.

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1. Introduction

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

1.2 A parent that has the majority shareholding and/or control of the entity being rated is considered to have a parent-subsidiary relationship in this criteria framework. Other related parties, such as associated companies or joint ventures, where no majority stake exists and/or there is influence, but not control, lie outside the scope of this criteria.

1.3 Rating Approach: LRA's approach to parent and subsidiary rating linkage is divided into three broad stages:

1. Examining standalone credit profiles of both parent and subsidiary.
2. Analyzing the strength of linkages, which exists between parent and subsidiary.
3. Notching the credit rating of the subsidiary (higher or lower than its standalone credit profile) relative to its stronger/weaker parent.

2. Standalone Credit Profiles of Parent and Subsidiary

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

3. Linkages between Parent and Subsidiary

3.1 LRA's rationale behind examining the linkages between a parent and its subsidiary is to determine the likelihood of support which can be expected to be available to the subsidiary, in times of need. Support, in this context, refers strictly to extraordinary financial support, rather than ongoing financial support or operational support. When assessing linkages between parent and subsidiary, LRA looks at legal ties, business linkages, and track record of providing support.

3.2 Legal Ties: Legally enforceable arrangements can have an overbearing impact on subsidiary ratings, compared to other linkages. Examples of such legal ties include guarantees and cross-default covenants.

3.2.1 Guarantees: Guarantees are a form of credit enhancement, which can lead to equalization of ratings between a parent and its subsidiary. If the stronger parent guarantees all debt obligations of its weaker subsidiary (downstream guarantee), with strong enforceability and legal clauses such as irrevocability and un-conditionality, this can lead to equalization of subsidiary ratings with the parent. It is important that the guaranteed mechanism is enforced pre-default, rather than post-default. In such cases, the guaranteed obligation will be incorporated into the debt burden of the guarantor (parent) in its standalone credit profile assessment.

3.2.2 Cross-default Covenants: Cross-default clauses between a parent and subsidiary may lead to near-equalization of ratings. However, in its assessment, LRA takes into consideration that when a subsidiary is under financial strain, the parent may make documentation changes to prevent triggering cross-default.

3.3 Business Linkages: Business linkages are considered strong where a subsidiary holds sufficient operational and/or strategic importance for the parent. In this scenario, the likelihood of the parent extending support, when needed, would be high. Here, LRA looks at whether the subsidiary's operations are critical to the parent's operations and overall profitability. This is likely in cases where the subsidiary is part of the parent's value chain and/or there is sharing of core functions (for example, finance, marketing, procurement) or their respective brands are linked. Likewise, if a subsidiary has an important standing in the parent's strategic objectives (long-term growth, diversification, brand building etc.), this would also create incentive to support. While assessing the potential impact of business linkages on subsidiary rating, LRA takes a conservative approach since the perception of strategic importance remains vulnerable to changes in the parent's stance based on its own business plans. Therefore, even when business linkages are deemed to be extremely strong, this is unlikely to result in equalization of ratings between parent and subsidiary.

3.4 Track Record of Support: LRA looks at the track record of support exhibited by the parent to the subsidiary in the form of guarantees, loans, injection of equity, offering credit period relaxation, etc. Where a track record is not available, LRA may engage with the parent to assess their views on potentially supporting the subsidiary.

4. Notching

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

4.2 Stronger Parent/Weaker Subsidiary: If the parent's credit profile is stronger relative to the subsidiary and linkages are considered strong, this could result in the subsidiary being notched up by multiple notches closer to the parent's rating, and possibly equal to it. It should be noted that, of all linkage factors, LRA views guarantees to be the strongest form of linkage with the highest impact on the rating of the subsidiary. On the other hand, if linkages are deemed weak, the extent of notching would be limited, with the final rating of the subsidiary remaining closer to its standalone credit profile.

4.3 Weaker Parent/Stronger Subsidiary: When the parent's credit profile is weak relative to the subsidiary, this may have adverse rating implications for the subsidiary, given the possibility that the subsidiary may be bound to extend financial support to the parent at some point. In such cases, the subsidiary's rating may need to be capped at the parent's rating. However, when support to the parent can be restricted/ruled out (for example, due to certain ring-fencing mechanisms or in the absence of cross-default covenants), the final rating of the subsidiary would reflect its standalone credit profile and could be higher than the parent's rating.

Inter-company Cash Flow Restrictions: Where the parent has a weaker credit profile relative to the subsidiary, there is the possibility of the weaker parent drawing on the subsidiary's resources to meet its own funding needs. Inter-company cash flow restrictions in the form of dividend covenants or loan restrictions can prevent this. Existence of such ring-fencing mechanisms is considered to secure the credit profile of the subsidiary against potential cash outflows. The more restrictions on a subsidiary's cash flows going to its parent, the greater the difference between the rating of the parent and subsidiary.

5. Rating Linkage in case of Financial Institutions

5.1 LRA opines that the likelihood of parent support to the subsidiary is generally higher in the financial sector, due to the typically high level of integration between financial institutions and their financial subsidiaries, and existence of substantial reputational risk. This means that the implication of a subsidiary's default is likely to be high on the parent, and possibly on other group companies as well. Thus, when rating such subsidiaries, LRA forms a view on the level of integration and reputational incentive for the parent to support. Where this is deemed to be high, the rating of the subsidiary is likely to be close to that of the parent, or, in certain cases, may be equalized.

6. Rating Linkage in case of Government-owned Entities

6.1 The criteria defined above may not be entirely applicable for entities which are owned, or partially owned, state governments. When rating such an entity, LRA begins by examining its standalone credit profile. Subsequently, LRA examines the following factors, inter alia, to determine the importance the entity holds for the government. This allows factoring in the likelihood of extraordinary financial support that can be expected from the state governments, according to which the rating of the entity is notched up.

- The extent of government ownership and/or control in the entity.
- Operational/strategic importance of the entity to the government's policy objectives. As in the case of non-government-owned entities, LRA recognizes that this is subject to changes in the government's stance, policies or possibly, a change in the government itself.
- Whether or not the entity is a dominant provider of the products/services it is involved in.
- Role of private sector in the entity's area of operations.
- Track record of government support to the entity.

6.2 The likelihood of government support is considered high if an entity is majorly owned and directly controlled by the government and is deemed to be highly integrated into operations/strategy and operating in a non-competitive sector (for examples, public utilities sector). Thus, the rating of the entity is likely to be higher than its standalone credit profile, and can be notched up equivalent to the rating of the government. The extent of notching depends upon the relative degree of importance of the entity and the likelihood of support from the government.

6.3 In Sri Lanka, several state-owned enterprises in sectors like aviation, energy, banking, and transportation, where the government holds a stake, operate largely independently while competing with private firms. Though commercially driven, the government subtly influences their strategies through regulatory oversight, policy, and financial support. These entities are strategically important for safeguarding national priorities such as energy security, financial stability, and infrastructure. In such cases, LRA would consider the linkage to the sponsor as a credit enhancement. However, the final rating of the entity would remain closer to its standalone credit profile.