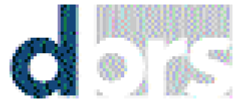


Dominion
Bond
Rating
Service

Rating Parent - Holding Companies

DBRS Rating Approaches

Rating Parent – Holding Companies

Overview

While most large companies are in fact parent or holding companies (note that this case study uses the phrase "parent"), this is not typically a ratings issue as the operating companies are wholly owned and there are no impediments that restrict access to cash. In these cases, analysis for the DBRS rating would focus on the overall consolidated entity.

However, there are many real life examples of less simple combinations where parent companies are used, and outside of those situations where guarantees are in place (the pattern used in over 90% of borrowings in Canada involving foreign companies), there is a long list of considerations that can influence the credit quality of these more complicated situations, both for parent companies and the operating entities they invest in.

The purpose of this document is to document some of the many cases available, and suggest the rating principles followed. The rating emphasis may differ between situations because the "intent" of the parent company is important e.g. will the parent company support a failing operating company (where there is no legal guarantee, a parent often can simply walk away from its equity investment, but may not do so for business reasons or to protect its good name.)

Structural subordination of the parent company (parent company debt effectively ranks after operating company debt) is a basic principle used. Other situations examined by the cases that follow include those where the parent company owns less than 100% (minority interest), "ring fencing" of the operating company, and unique situations that exist with captive finance companies and income trust structures in Canada.

Background: Parent Companies versus Operating Companies

Parent companies can have several advantages over operating companies. They sometimes have better liquidity, superior diversification, and often have less debt than operating companies.

However, debt in the parent company is often effectively subordinate to debt in the operating company. Double leverage is possible in a parent company, and often the parent company does not have full control over the operating company's cash flow.

Considerations

Strengths:

- Parent companies often have better liquidity than operating companies due to other liquid holdings or in many cases, the ability to sell shares of its investments
- Parent companies can be better diversified
- Parent companies usually have less debt, since interest is not tax deductible, so debt levels are limited

Challenges:

- Debt in the parent company is effectively subordinate to debt in the operating company
- The parent company does not necessarily have full control over the operating company's cash flow, especially if minority interest exists
- Interest expense in the parent company is not efficiently tax deducted against dividends
- Tax and other issues can add complexity in transferring income into a parent company from the operating company (a major issue in Canada)
- Double leverage is possible if the parent company issues debt and advances it down in the form of equity to the operating company

Summary of Cases

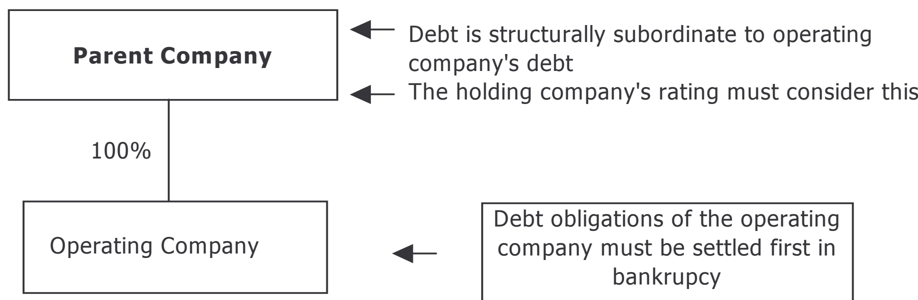
The general policies followed by DBRS for parent companies/operating companies are summarized by the following 11 cases:

Case	**Policy Followed**
Case 1: Parent company debt effectively ranks after debt of the operating company	This is the standard base case where there is one or several 100% owned operating companies. Because of structural subordination, parent company debt in this case is often rated lower than the debt of the operating company, often by one rating grade for investment-grade debt, and potentially more as credit ratings fall to lower levels. High debt at the parent company can also lead to a larger ratings differential.
Case 2: This example summarizes the blend in ratings principal	Where various operating companies exist, the starting point for the parent company rating is a weighted average rating for all operating companies, with possibility for further ratings reduction at the parent company for structural subordination or high debt level issues.
Case 3: Small/no debt at the parent company, with the operating companies doing the borrowing	The rating of the parent company and operating company debt in this case could be the same. parent company debt is effectively serviced from the operating companies.
Case 4: Parent company borrows and advances funds to operating companies	The parent company and the operating companies could carry the same ratings, assuming the operating companies are restricted from borrowing on their own, except for small amounts. High debt levels in the operating company could lead to a lower parent company rating due to structural subordination of the parent company debt.
Case 5: Debt of parent company guaranteed by operating company	The parent company and operating companies providing the guarantee would typically be rated the same.
Case 6: Operating company is ring fenced from the parent company	Ring fencing can occur through covenants, or in some cases (e.g. utilities and financial companies) the presence of a strong regulator can be a factor. Because covenants can be broken and regulators provide different degrees of protection, cases vary. Ring fence protection can allow for a different rating for the operating company, but must be examined case by case to see how tight the ring fencing protection is.
Case 7: Where the intent of the parent company is to support the operating companies	Cases exist where the intent and support of the parent company is to support the operating companies, but without any formal guarantees. In such cases, the parent company's rating is considered when rating the operating company (e.g. some Canadian subsidiaries have their foreign parent's support but not a direct guarantee). While a consideration, the rating on the operating company without a guarantee may be below that of the parent.
Case 8: Where minority interest exists with an operating company	Minority interest acts as a form of ring fencing of the operating company, since the parent company no longer controls the cash flow of the operating company. In some cases, this can allow the operating company to carry a different credit rating, since it may partially shield the operating company from the parent company's access to cash.

Case	Policy Followed
Case 9: Very close links exist between parent company and the operating company (e.g. captive finance companies)	The most common example here is captive finance companies that are highly dependent on the parent company for their existence. With consideration for close interflows of cash flow and payables between the companies and other factors, DBRS typically rates the captive finance company the same as the parent, despite the reality that the liquidity and credit risk for the finance company may appear superior from stand alone statements.
Case 10: Rating treatment of an income fund versus the operating company of the fund	With income fund structures, debt may be issued by the fund itself or by an operating company owned by the fund (which is often a corporation). At the operating company level, the debt rating would consider both the financial profile of the operating company and consolidated debt of the fund overall, since the operating company services the parent company's is debt. Similarly, debt ratings at the fund level would also consider consolidated financial statements. The degree of stress placed on the operating company or fund statements in any given rating will vary with the individual circumstances of each situation.
Case 11: Parent company guarantees the debt of operating company	Where an unconditional guarantee exists, the operating company carries the same rating as the consolidated parent.

The Standard View of Parent Company Debt Ratings

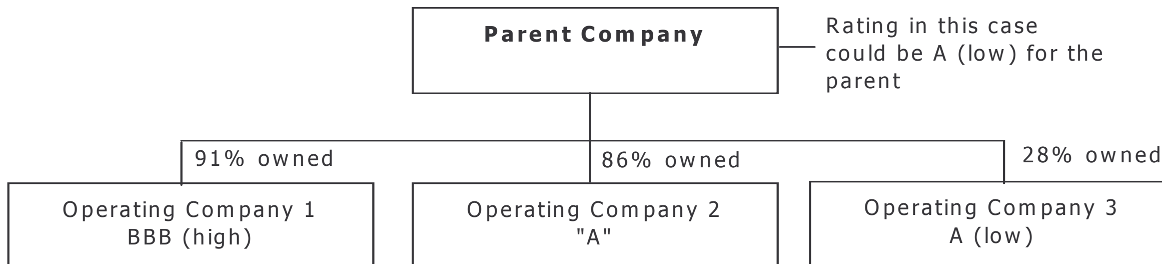
Case 1



- The above view represents the general prevailing view of the treatment of the most simple case of a parent company setup.
- In many such cases, parent company debt would be rated one rating category below the operating company debt due to structural subordination of the parent company, as creditors at the parent company level are one-step removed from the assets and cash flow at the operating level.
- At rating categories below BBB, the rating category differential between the two entities could be more than one rating category.
- Debt levels at the parent company are another key consideration in the difference between the ratings.
- Debt at the parent company typically represents "double leverage" as proceeds are used to make equity investments in the subsidiaries.
- Generally speaking, it is unusual (and negative for the rating) for parent companies to have unconsolidated debt levels that exceed 30%.
- If the ownership here was less than 100%, minority interest issues would have to be considered.
- The above view is the standard view analysts have of parent company debt, but there are many exceptions to this view, and many different circumstances.

The Blend in Rating Approach

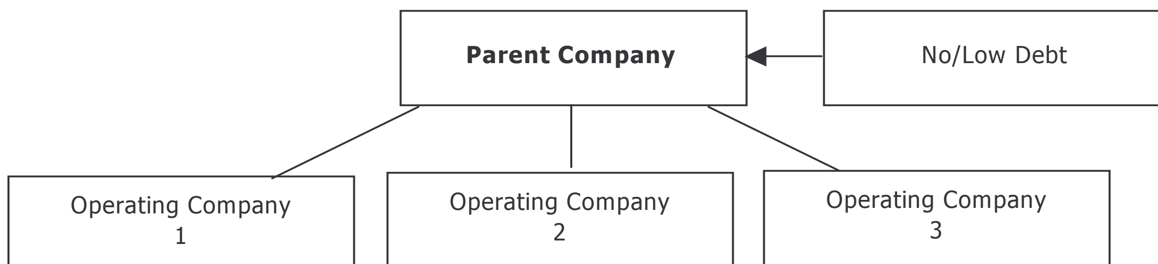
Case 2



- All operating companies are under 100% owned, so minority interest exists.
- Ratings for the operating companies allow for borrowing and future expectations at that level.
- While many other considerations would be included, the ratings in this category show how the starting point for the parent company rating is a simple blend-in of the weightings of the three operating company investments.
- In addition to the relative sizes of the investments in the three entities, the magnitude of their ability to pay dividends (and many other factors) would also be considered.
- The A (low) in this case assumes an average of the three ratings. A lower rating may be required, depending on the reality of structural subordination and possibly the existence of debt at the parent company.
- In some cases, the diversity of the operating companies allows the structural subordination effect to be offset, as this diversity can enhance the stability of cash flow at the parent company level.

Parent Company Has Little or No Debt

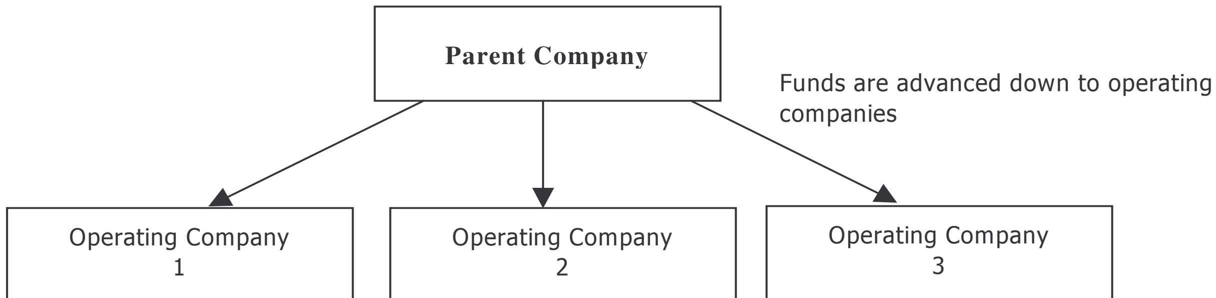
Case 3



- In this case, the parent company exists to “hold” the operating companies in one legal entity and the operating companies borrow on their own.
- The parent company in this case could have the same implied rating as the overall strength of the operating companies.
- However, this is typically only possible when there are very small amounts of debt at the parent company level.
- In some cases, a parent company may be able to have debt/capital levels in the 10% range and still not have any structural subordination issues taken into account in the rating as the level of debt is deemed “insignificant”.
- Future debt expectations are as important a consideration as the level of debt presently outstanding.

Parent company Borrows and Advances Funds to the Operating Companies

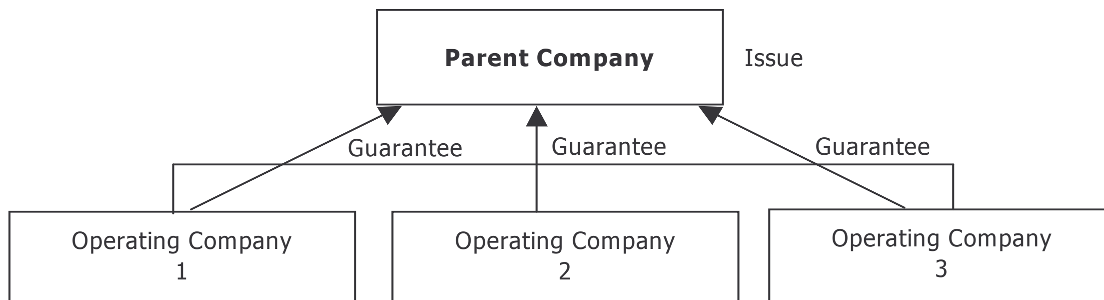
Case 4



- This structure is often used when an organization wishes to centralize and control overall borrowing.
- The operating companies may be restricted from doing any substantial borrowing themselves by covenants.
- The parent company borrows and advances funds down to the operating companies.
- While some borrowing may be permitted by operating companies, such as bank debt for working capital purposes, this is usually for small limited amounts for short time periods.
- Since there are no significant creditors at the operating level, creditors at the parent company level have full recourse to the operations in the event of default.
- In a case such as this, the parent company could carry the same credit rating as the overall strength of the operating companies, with no deduction in the rating for structural subordination of debt.
- This case principle typically breaks down if debt becomes “significant” at the operating entities.

Operating Companies Guarantee Debt of Parent company

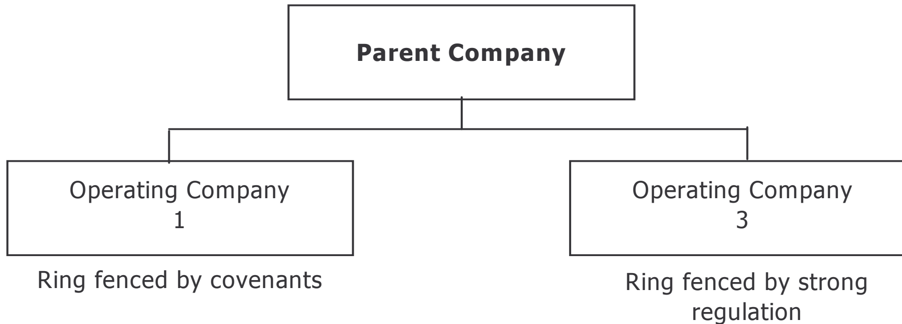
Case 5



- The operating companies in this case guarantee the debt issued at the parent company.
- In this case, there is no structural subordination, and the parent company is rated the same as the overall strength of the operating companies.
- As the parent debt is guaranteed, the full consolidated financial statements of the parent company are examined in the analysis.

Operating Company is Ring Fenced from the Parent company

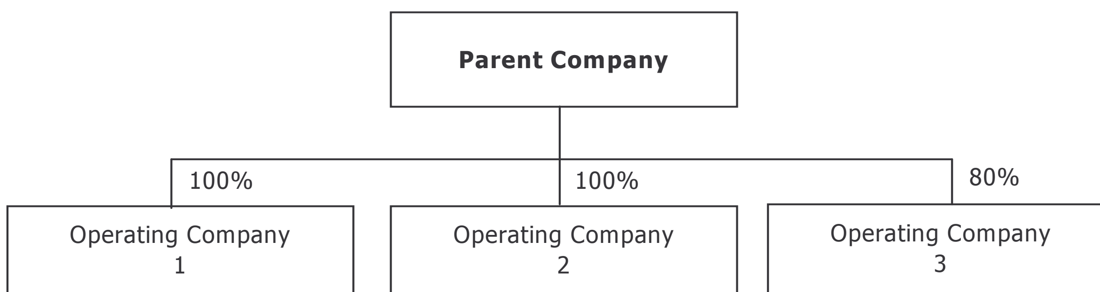
Case 6



- The operating companies can be ring fenced by such things as covenants or the presence of a regulator, who oversees the operating entity (i.e. some utilities and financial institutions).
- Covenants may limit dividends, inter-company cash transfers, and set other restrictions between the operating companies and the parent company.
- Regulators who oversee an entity act as a possible source of ring fencing for that company. For example, DBRS used this principal in applying a rating of A (low) for Westcoast Energy, which is higher than the BBB (high) rating for Duke Energy (there were also other considerations for this rating differential).
- By their nature, covenants must be considered on a case by case basis.
- Regulators also exhibit varying degrees of control, and each case must be examined to understand how much support a regulator can provide.
- Because many of these considerations include subjective aspects, it is often the case that even with tight ring fencing actions, there is a typically a limit between the difference that can exist between the ratings assigned to a parent company and the related ring fenced operating entities.

Where the Intent of the Parent company is to Support the Operating Companies

Case 7

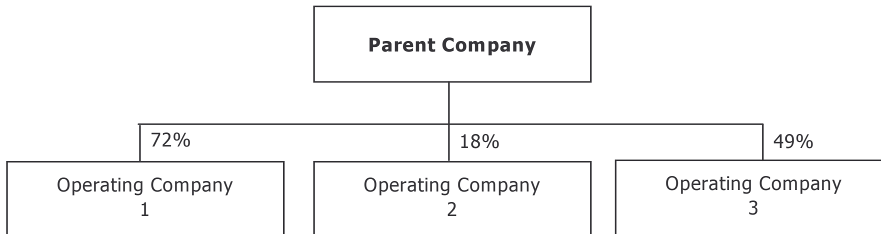


- The parent company may show and indicate its intent to support a wholly owned operating company, without having the legal obligation.
- The parent company usually does this to preserve its equity investment and will add additional equity to the operating company and add other general support.
- However, if there is a major problem at the operating company, particularly if support could severely impact the strength of the parent company, this support would likely be withdrawn. As such, future intent has limitations.
- Nevertheless, there is often a rational whereby the support from the parent company can be given some consideration in ratings for the operating companies.

- In those cases where DBRS believes that the parent company support is not strong, ratings for the operating companies would de-emphasize the strength of the parent company in the operating company ratings.
- In the case of Operating Company 3 in this example and as discussed in the next case, the minority interest could be a problem even when there is a high level of control.

Parent Companies where Minority Interest Exists

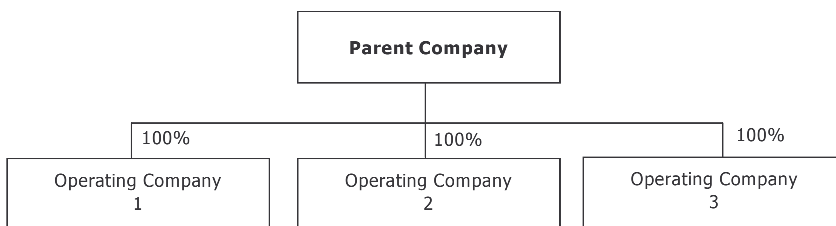
Case 8



- Minority interest exists where the parent owns under 100% of the operating company.
- Minority interest acts as protection for the operating company from the parent company, often creating a ring fencing situation without the existence of any covenants or regulator.
- This is because the minority interest presence restricts the ability of the parent company to have direct and full control of cash at the operating companies.
- The parent company must legally be aware of the operating company's minority shareholders, applying good governance and recognizing the interests of minority shareholders.
- Where minority interest exists, the rating of the parent and the operating company often will vary based on the individual details of the case in question, recognizing the ring fencing protection provided by the minority interest.

Close Operating Links Between the Parent Company and Operating Companies (The Captive Finance Companies Case)

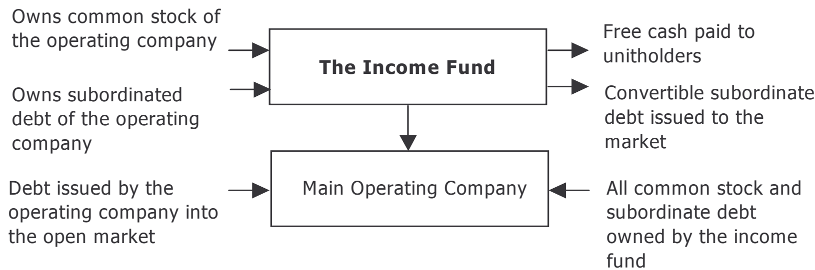
Case 9



- The best example is the close operating and strategic links between captive finance companies and their operating manufacturing parent.
- Note that in this case, the parent company is also an operating company.
- There is free cash flow between them, and high levels of inter-company payables exist at any point in time.
- The captive finance company is heavily dependent on the parent as it's receivables are generated by the sale of manufactured product.
- The captive finance company serves as a means of assisting the parent make the sale. In most cases, profitability is a secondary priority consideration, as the emphasis is for the parent company to make the sale.
- On this basis, the captive finance company's rating is based on the performance of the consolidated company, and DBRS typically flows the parent rating through to the captive finance company.
- This is the typical DBRS policy, notwithstanding the superior liquidity and collateral of the captive finance company on a stand-alone basis.

Rating Treatment of Income Trusts

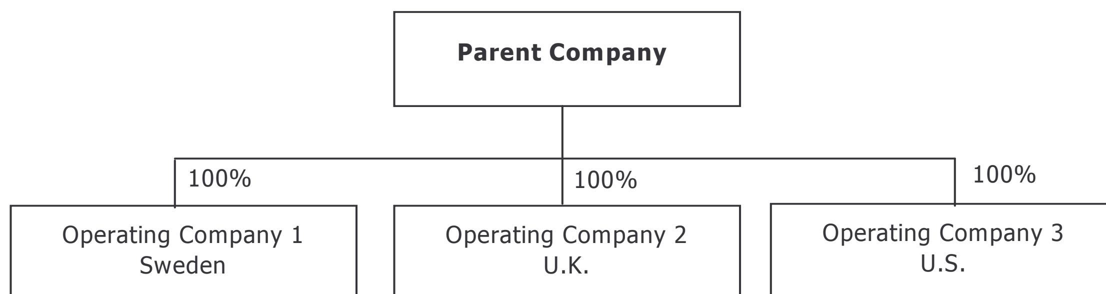
Case 10



- The above represents a typical simplified structure of an income fund.
- The income fund either: (1) holds subordinate (or senior) debt; and/or (2) owns equity in the operating company.
  - Interest payments are made to the fund by the operating company, which reduces the amount of tax paid by the operating company.
  - The remaining free cash earned by the operating company is paid in the form of dividends up to the fund.
- The fund is a form of an open-end mutual fund, and pays out all its income to unitholders on a tax-free basis.
- The "corporate" structure of the main operating company often assures limited liability status.
- With most income fund structures, debt is issued at the operating company level, but since the operating company services the parent company debt, the debt rating considers both the financial profile of the operating company and consolidated debt of the fund.
- Similarly, debt ratings at the fund level would also consider consolidated financial statements.
- The degree of stress placed on the operating company or fund statements in any given rating will vary with the individual circumstances of each situation.
- Inter-company debt lent from the fund down to the operating company is often ignored in the rating, since this serves as a means of transferring cash flow from the operating company up to the parent.

The Parent Company Guarantees the Debt of its Operating Companies

Case 11



- Parent companies often guarantee the debt of many of their operating companies throughout the world.
- In this case, the debt of the consolidated parent company is rated, and the same rating applies to all the operating companies in the world.
- This is typically the borrowing pattern used by large multinational companies that borrow in Canada, where an unconditional guarantee exists from the parent to the operating company.
- Without the guarantee, the operating company's rating would give some weighting to the parent company, but the debt would likely be rated lower than the consolidated parent company.
- Between a full guarantee and subjective support, other alternatives include keepwell arrangements, the strength of which depends on the details of the agreement.

Other Considerations

The aforementioned cases cover many of the basic principles used by DBRS in assessing parent company situations. However, because the cases were constructed to provide insight into particular basic principles, these cases used do not by any means cover all the factors that need to be considered in evaluating parent company situations. Other issues that may be relevant, and in fact critical in some circumstances, follow. Note that this list is not presented in any order of importance and is not meant to be exhaustive.

(1) One of the basic tools in evaluating parent companies is to analyze the cash flow on a "cash in/cash out" basis. Knowing exactly from where the cash is coming provides a more accurate assessment of how stable incoming cash is. Knowing how the cash is used by the parent company allows for a better understanding of how deficiencies could be addressed in a worst-case scenario (such as cutting common dividends). Finally, it is important to know if the parent company has an ongoing surplus or deficiency on a net cash basis, and if there is a deficiency, how large and manageable the situation is.

(2) When analyzing cash in, one tool in assessing the stability of the incoming dividends is to understand the dividend payout ratio at the operating entities. All other things being equal, higher dividend payout ratios obviously carry more risk of being maintained in times of stress.

(3) When analysing dividend payouts and the ability of transfers to occur between operating companies and the parent company, it is important to understand that the existence of regulation at an operating company could meaningfully restrict the ability to pay out dividends. In some circumstances, this could also be the case when entities are in different countries.

(4) While consolidated statements can have value, DBRS typically finds that an analysis of the non-consolidated parent company statements is important to the evaluation, as it is important to understand the levels of debt, cash, and goodwill that exist at the parent company itself. These are often non-public documents.

(5) As is the case with ratings in general, historical statements and ratios provide an understanding of what has occurred in the past, but expectations for the future are of primary importance. For example, a DBRS rating may seem low for the balance sheet strength of a parent company due to the fact that this strength may note be maintained in the longer term.

(6) In some situations, the parent company may own preferred shares or even some debt of the operating companies, which must be considered in the evaluation. These securities are often issued for tax and other inter-company reasons.

(7) Parent companies with meaningful debt could add pressure to operating companies to maintain dividends by actions such as restricting expenses and capital expenditures in the operating company, which could be problematic, particularly in the longer term.

(8) In addition to investments in subsidiaries, some parent companies have meaningful holdings of cash and liquid securities that are positive from a liquidity perspective.

(9) While it is often the case that as a last resort, parent companies can sell shares in their investments to provide additional liquidity, one must always consider issues such as the following: (a) How amiable would the company be to doing such? (b) What is the market reality that it could do such and in what time frame? (c) Are there control issues that would limit the pricing value of doing such? (d) Could issues such as control blocs delay a sale?

(10) Within situations where minority interest exists, the ability of the parent company to influence areas such as asset transfers and strategic decisions may still exist, but can vary dramatically by the reality of issues such as the degree of voting control and need for proper governance.

(11) In assessing the degree to which a parent company would support an operating company (which can have an impact on both ratings), it is important to understand how critical the operating company is to the parent company. Even if the parent company could legally abandon the subsidiary, it may be practically impossible to do so due to the integration/interdependence of the businesses. In some cases, there may also be brand name or other negative market/customer consequences that could prevent a parent company from not supporting an operating entity even when it can legally choose to do so by walking away from the investment.

(12) The base starting point of assessing the ratings of the operating companies to arrive at a rating for the parent company as discussed in Case 1 is fairly simplistic. In real life, there may be cases where the highest rating of an operating company may not be the best starting point. The parent company rating in question may be the result of additional security support that has no bearing on the ultimate common dividend stability. There may also be significant subordinate debt and or preferred instruments that support the top rating.

(13) As noted briefly in the case illustrations, the existence of inter-company agreements and the potential to commingle funds are normally critical factors in the evaluation of related ratings. When such factors are extensive, it typically reduces the distance between ratings at the different entities, with the key focus tending to be the strength of the overall consolidated entity.

(14) There are cases where parent companies and or operating companies may not be reporting issuers, which can have liquidity restrictions and could also increase the potential for commingling and inter-company type issues.

(15) As a non-rating issue, note that in some cases, DBRS may apply a corporate rating to an entity for clarity of rating opinion, even if that entity has no debt outstanding. In most cases, the Corporate Rating definition used by DBRS is the most senior level of unsecured debt. Ratings on specific securities issued by the Company could be higher or lower than this Corporate Rating, depending on the collateral available and other circumstances.