DBRS Criteria: Rating Parent/Holding Companies and Their Subsidiaries

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Insight beyond the rating.

CONTACT INFORMATION

Peter Schroeder
Manager Director – Rating Committee
+1 212 806 3284
ps@dbrs.com

Kent Wideman, CFA
Chief Credit Officer
+1 416 597 7535
kwideman@dbrs.com

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Overview

The following document outlines the DBRS approach to rating parent/holding companies, which will, in some cases, have implications for the ratings of the subsidiaries that are held by the parent organization. The majority of companies rated by DBRS are, in fact, holding companies and, in most instances, the operating companies are wholly owned and all debt is issued at the parent level. In such cases, there are no holding company issues and the DBRS rating focuses on the overall consolidated entity. However, there are many examples of more-complex combinations where differences between holding companies and their operating subsidiaries must be taken into consideration. It is also critical to understand the relationship between the parent company and its subsidiaries. In many cases, a holding company could simply walk away from its equity investment in the subsidiary, but for business reasons or to protect its name, it does not do so. Such a situation would narrow the rating differential between the entities. Another key consideration for DBRS is structural subordination, whereby parent company debt can be seen as ranking junior to debt held at the operating company level (although this is not exactly an accurate legal representation of the situation) since the operating entity is closer to the cash flow it generates.

Note that, in all cases, any discussion on ratings refers to the issuer rating. The ultimate rating on a specific security can and does vary for a variety of security and ranking considerations.

While parent companies can have advantages over their operating companies, there are often disadvantages present as well. The following reviews some of the more important factors in both areas.

Holding Company Rating Considerations

ADVANTAGES

- **Better Access to Liquidity:** In some instances, parent companies have better liquidity than their operating companies because of other liquid holdings or, in many cases, having the ability to sell shares in their investments.
- **Superior Diversification:** Parent companies can be better diversified, holding multiple operating subsidiaries that may or may not be equally supported.
- **Less Debt Than Operating Companies:** Parent companies usually have less debt, since interest is often not tax deductible, so debt levels are typically set at reasonable levels.
- **Tax Advantages:** For multinational operations, there are often tax advantages of funding via operating subsidiaries in multiple countries.

DISADVANTAGES

- **Structural Subordination:** In simple structures, debt in the parent company is effectively subordinate to debt in the operating company.
- **Double Leverage:** When the parent company issues debt and advances it to the operating company in the form of equity, the result is double leverage.
- **Only Indirect Access to Cash Flow:** The parent company does not necessarily have full control over the operating company's cash flow, especially if it has a minority interest (i.e., the parent company owns less than 100% of the subsidiary).
- **Tax Deductibility of Interest Expense:** Interest expense at the parent company is not usually tax deductible and therefore not tax efficient.
- **Structural, Tax and Other Issues:** These can add complexity when transferring income to the parent company from an operating company.

DBRS Steps in Assessing Holding Companies

(1) IDENTIFY THE TYPE OF STRUCTURE

- Determine which structure best represents the specific holding company, based on the examples described in the Sample of Cases section.

(2) RATIONALE OR INTENT OF STRUCTURE

- Why has this structure been completed in this manner?
- What are the main issuers within the structure?
- What are the corporate and legal structures?

(3) CREDIT IMPLICATIONS OF THE STRUCTURE

- Does structural subordination exist within the structure?
- Identify the relationship between the holding company and the operating company.
- Are there any cross-guarantees in place?
- Are there any intercompany restrictions on cash flow?
- Is the entity within a regulated industry?

(4) QUALITATIVE FACTORS THAT SUPPORT THE RATING

- Determine the strength of an entity on a consolidated basis.
- Identify the amount of leverage at the parent level.
- What is the market position of the subsidiaries and how diversified are operations?
- Determine the quality and value of the assets and the entity's financial strength.
- Determine what support characteristics exist between the subsidiary and the parent.
- Review intercompany cash flow on a deconsolidated basis.

(5) RELATIONSHIP BETWEEN THE PARENT AND MAJOR SUBSIDIARIES

- How close is the relationship?
- Is there any support provided by the parent to the subsidiary?
- How dependent is the operating company on the support of the parent?

General Considerations

These general considerations will be relevant in many cases and in some circumstances will be critical. Note that this list is not presented in any order of importance and is not meant to be exhaustive.

RELATED TO FINANCIAL STATEMENTS

Deconsolidated Analysis

One of the basic tools in evaluating parent companies is to analyze the cash flow on a cash-in/cash-out basis. Knowing exactly where the cash is coming from 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. In general, it is important to know the levels of debt, cash and goodwill that exist at the parent company, which may require the analysis of non-public documents. Some parent companies have meaningful holdings of cash and liquid securities that are positive from a liquidity perspective. However, DBRS takes a conservative view toward giving a holding company a high level of additional credit for cash and securities in the absence of strong tangible evidence that these resources will not be redeployed for acquisitions or dividends or invested in owned and operated companies.

Dividend Policy

When analyzing cash in, one way to assess 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.

Dividend Restrictions

When analyzing dividend payouts and the ability to transfer between operating companies and the parent company, it is important to understand that operating company regulation could meaningfully restrict the ability to pay out dividends. This could also be the case when entities are in different countries.

Future Prospects

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; however, the parent company may not be able to maintain this strength in the longer term.

Liquidity of Asset Sales

Although 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: (1) How amenable would the company be to doing this? (2) What is the market reality that it could do this and in what time frame? (3) Are there control issues that would limit the pricing value of doing this? (4) Could issues such as control delay a sale?

RELATED TO STRUCTURE

Intercompany Interaction

As noted in the examples in the Sample of Cases section, the existence of intercompany 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. 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 intercompany purposes.

Minority Interest

In situations where minority interest exists, the parent company may still be able to influence areas such as asset transfers and strategic decisions, but the extent of its ability to do so can vary dramatically by the reality of issues such as the degree of voting control and the need for proper governance.

Structural Complexities

As shown in Case 1 (see the Sample of Cases section), which is fairly simplistic, the rating for the parent company is determined by assessing the ratings of the operating companies. 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.

RELATED TO INTENT

Management Approach

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.

Parent Intent

In assessing the degree to which a parent company would support an operating company (which can have an impact on the ratings of both entities), 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 because of the integration and/or interdependence of the businesses. In some cases, there may also be brand-name or other negative market and/or customer consequences that could lead to a parent company supporting an operating entity even when it could legally walk away from the investment. Often subjective, the following is a list of key factors DBRS looks for in assessing the relationship and intent that exist between a parent and its operating companies:

- Cross-default provisions.
- Economic incentives for the parent to support the subsidiary.
- Statements made by the parent company in support of the subsidiary, publicly or privately.
- The extent of parent company management control of the subsidiary.
- The effect on investor confidence if the parent company supported or didn't support the subsidiary.
- Whether the strategic importance of the subsidiary to the parent is critical.
- Shared name and reputation risk between the parent and subsidiary.
- The parent and subsidiary located in the same country.
- Past and/or ongoing tangible support provided by the parent.
- The size of the subsidiary in terms of total investment.
- The size of debt at the subsidiary that the parent would support.
- The parent's financial capacity to provide support.

OTHER

Reporting Issues

There are cases where parent and/or operating companies may not be reporting issuers, which can have liquidity restrictions and could also increase the potential for commingling and intercompany issues.

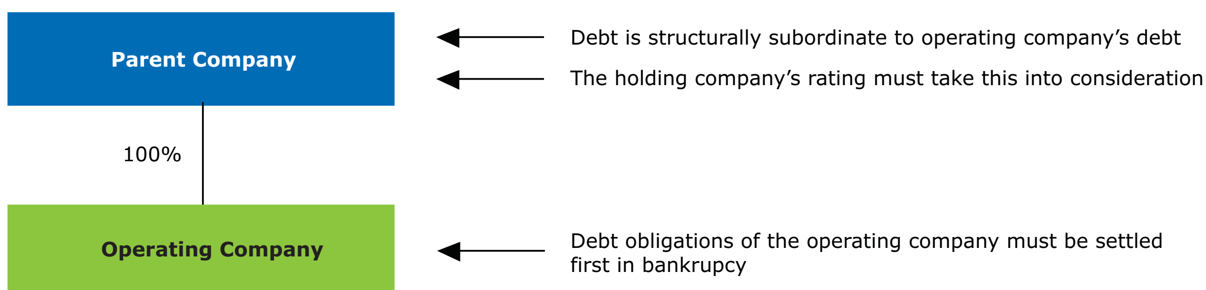
Issuer Rating

As a non-rating issue, note that in some cases, DBRS may apply an issuer rating to an entity for clarity of rating opinion, even if that entity has no debt outstanding. Ratings on specific securities could be higher or lower than the issuer rating, depending on the collateral available and other circumstances.

Summary of Cases

The general policies followed by DBRS for parent companies and operating companies are summarized by the following 11 cases. Note that these case examples by no means represent every situation, but they do cover the more common scenarios and, in tandem with the comments in the General Considerations section above, provide a fairly comprehensive framework as to the approach that DBRS would take in dealing with holding company rating situations.

Case 1: Traditional Structure



DESCRIPTION

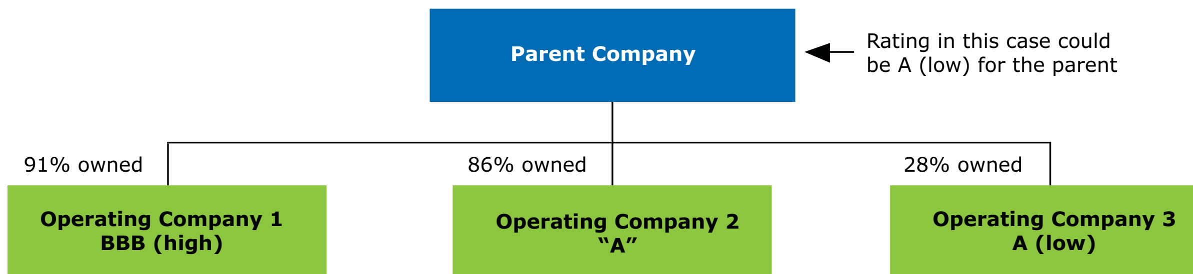
This is the most simple parent company setup, where there is one or several 100%-owned operating companies.

ANALYTICAL APPROACH

Because of structural subordination, parent company debt in this case is often rated lower than the debt of the operating company, usually by one notch for investment-grade debt and potentially more for entities that are below investment grade. In this scenario, creditors at the parent company level are one step removed from the assets and cash flow at the operating level. High debt at the parent company can also lead to a larger rating differential. Debt at the parent company typically represents "double leverage" as proceeds are used to make equity investments in the subsidiaries.

If the parent company's unconsolidated debt levels are less than 20% of the capital structure, one rating notch differential would be appropriate. It is unusual (and negative for the rating) for the parent company to have unconsolidated debt levels that exceed 30%. If the ownership here is less than 100%, minority interest issues would have to be considered.

Case 2: Portfolio Structure



DESCRIPTION

In the portfolio approach, the parent company's rating is based on the consideration of the size, importance and credit strength of all operating companies and possible interrelationships among them. The ultimate A (low) rating in this example would assume that the cash flows from Operating Company 2 and Operating Company 3 were significant in relation to Operating Company 1 and that the three operating companies do not exhibit a high degree of correlation. These factors would be necessary to provide a diversification element that is key to supporting the ultimate A (low) rating. Companies with this type of structure are typically considered conglomerates. In most cases, key operating companies are less than 100% owned, so minority interest exists.

ANALYTICAL APPROACH

Depending on the outcome of the four factors below, ratings on the parent have the potential to be higher or lower than the blended average of subsidiary ratings.

Deconsolidated Cash Flow Analysis

- **Cash In:** Review of cash flow from each subsidiary.
- **Cash Out:** Review of dividend policy, operating expenses and interest expenses at the parent level.

Degree of Leverage

- The analysis of the degree of leverage at the parent level is on a deconsolidated basis. Typically, debt levels of less than 20% on a deconsolidated basis are acceptable.
- In certain circumstances, ratings could be affected if leverage is in excess of 20% on a deconsolidated basis.

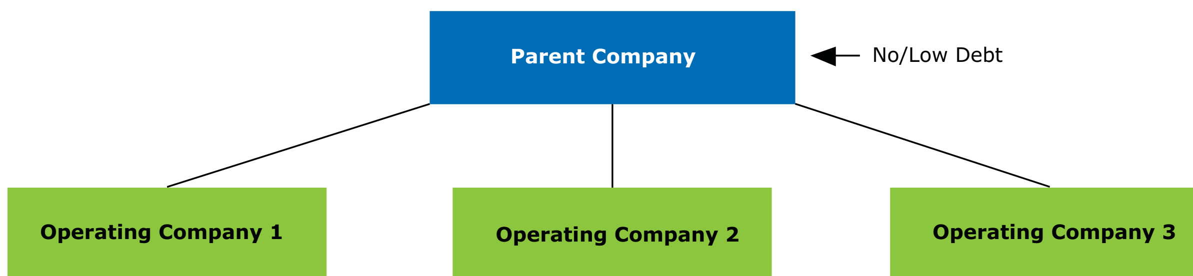
Relative Size of Each Investment

- DBRS would also factor in the relative size of each investment and the ability of the subsidiaries to maintain dividends.

Diversification of Assets

- Depending on the diversification of assets, the ratings could be supported and, in some instances, ratings at the parent level could be higher than the strongest operating subsidiary, although this would be unusual.

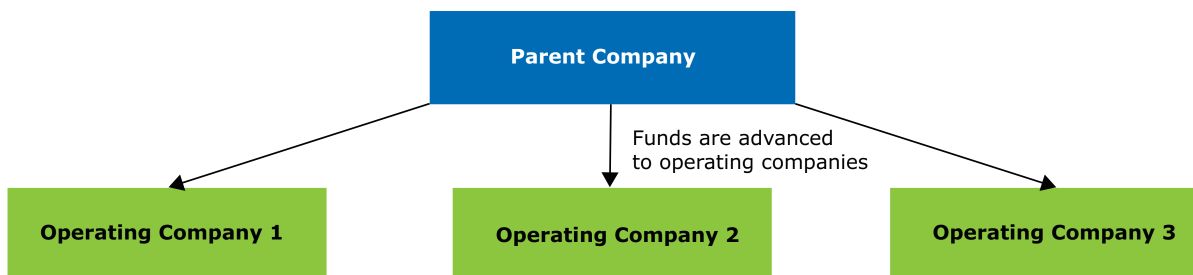
Case 3: Operating Company as Main Issuer



DESCRIPTION
In this case, the parent company exists to "hold" the operating companies in one legal entity and the operating companies borrow on their own. Parent company debt is effectively serviced from the operating companies.

ANALYTICAL APPROACH
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 and/or capital levels in the 10% range and still not have 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 outstanding.

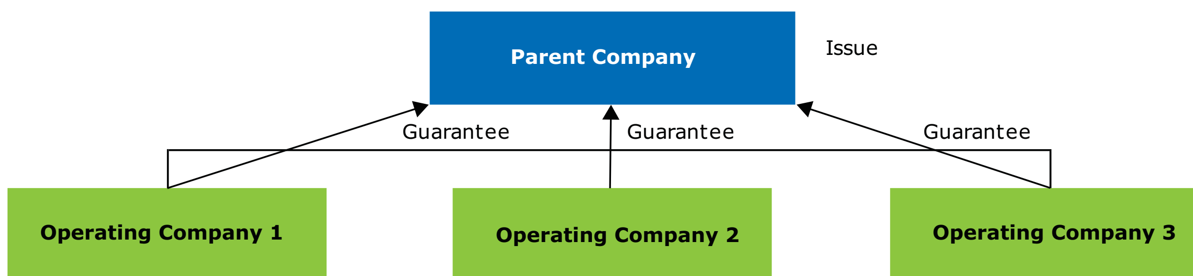
Case 4: Parent Company Advances to Subsidiary



DESCRIPTION
The parent company borrows funds and advances them to the operating companies. This structure is often used when an organization wants to centralize and control overall borrowing. The operating companies may be restricted from doing any substantial borrowing themselves by covenants. While some borrowing may be permitted by operating companies, such as bank debt for working capital purposes, this is usually for small limited amounts over 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.

ANALYTICAL APPROACH
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. 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 principle typically breaks down if debt becomes "significant" at the operating entities.

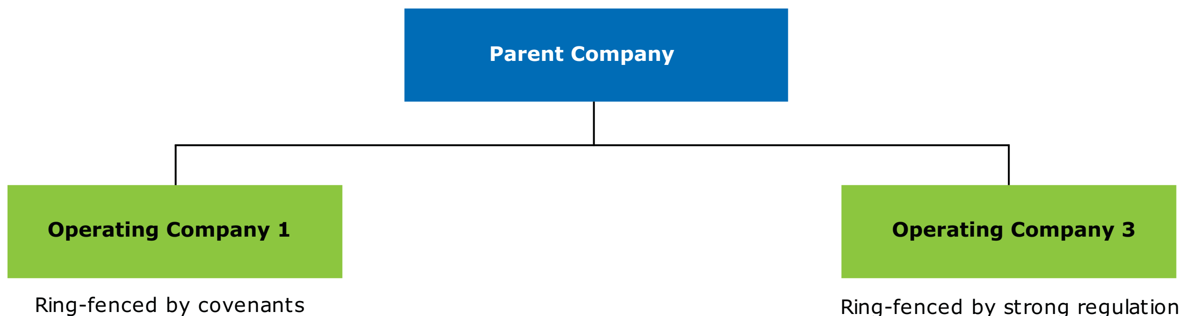
Case 5: Guarantee from the Subsidiary



DESCRIPTION
The main issuer is the parent company. The operating companies in this case guarantee the debt issued by the parent company.

ANALYTICAL APPROACH
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.

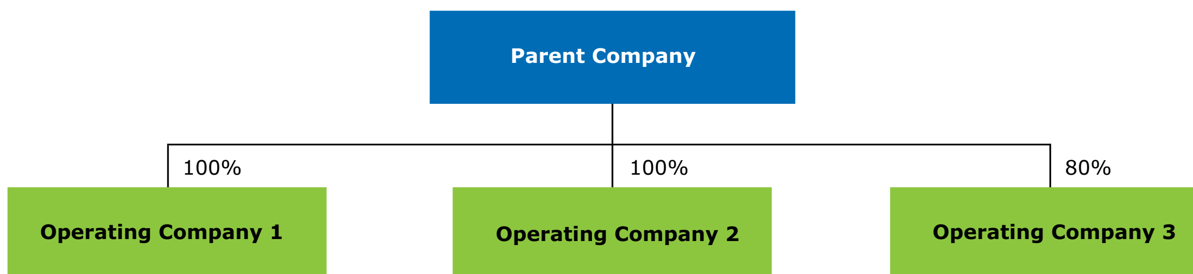
Case 6: Ring-Fencing Protection



DESCRIPTION
Operating companies are ring-fenced from the parent company. Ring-fencing can occur through covenants or, in some cases (e.g., utilities and financial companies), through the presence of a strong regulator. Covenants may limit dividends and intercompany cash transfers and set other restrictions on the operating companies and the parent company. Regulators that oversee an entity act as a possible source of ring-fencing for that company.

ANALYTICAL APPROACH
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 it must be examined case by case to see how tight the ring-fencing protection is. 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 credit is due to the existence of a regulator. Because many of these considerations include subjective aspects, it is often the case that even with tight ring-fencing actions, there is typically a limit between the difference that can exist between the ratings assigned to a parent company and the related ring-fenced operating entities.

Case 7: Parent Company Strong Intent

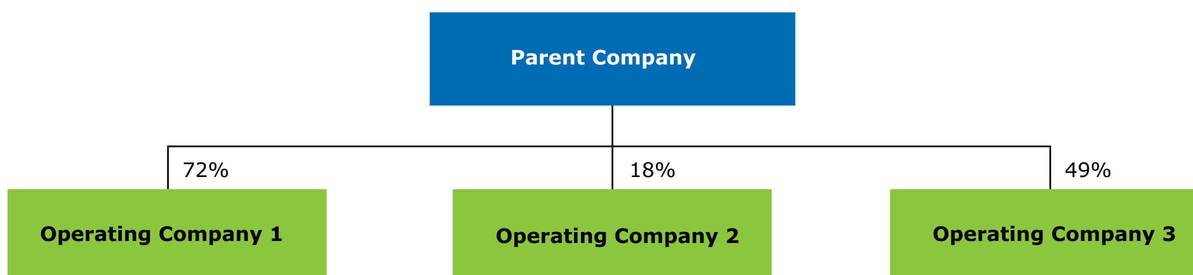


DESCRIPTION
Cases exist where the intent of the parent company is to support the operating companies, but without any formal guarantees. The parent company may show and indicate its intent to support a wholly owned operating company, without having the legal obligation to do so. The parent company usually does this to preserve its equity investment and will add additional equity to the operating company and add other general support.

ANALYTICAL APPROACH
In such cases, the parent company's rating is considered when rating the operating company (e.g., some subsidiaries have their foreign parent's support but not a direct guarantee). While the rating on the operating company is a consideration, without a guarantee it may be below that of the parent. A close examination of the relationship between the parent company and operating subsidiary is required. A full review of maximum liability to the parent and reputational risk is required for each entity within the organization.

If there is a major problem at the operating company, however, particularly if support could severely affect the strength of the parent company, this support would likely be withdrawn. As such, future intent has limitations. Nevertheless, there is often a rationale 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 case of Operating Company 3 in the illustration above, the minority interest could pose challenges to the holding company rating even when there is a high level of control (see Case 8 below).

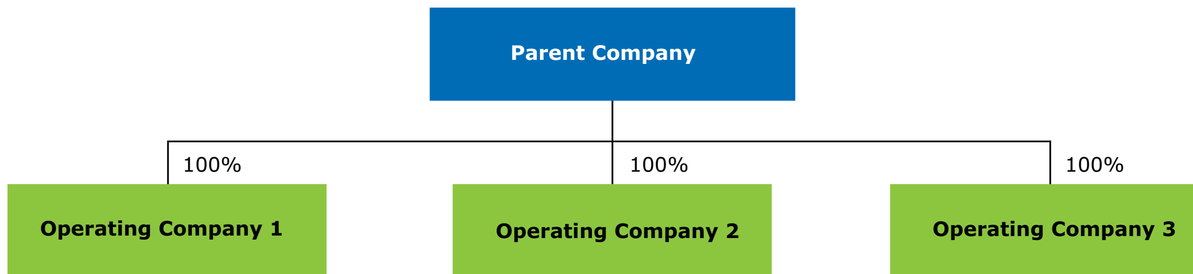
Case 8: Minority Interest Structure



DESCRIPTION
Minority interest exists where the parent owns less than 100% of the operating company.

ANALYTICAL APPROACH
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. The minority interest restricts the ability of the parent company to have direct and full control of cash at the operating companies. 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. The parent company must legally be aware of the operating company's minority shareholders, applying good governance and recognizing the interests of minority shareholders.

Case 9: Captive Finance Companies



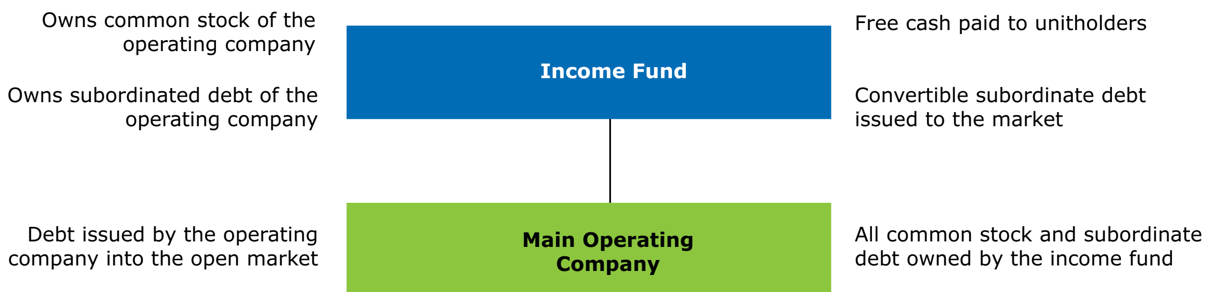
DESCRIPTION
Very close links exist between captive finance companies and their operating manufacturing parent.

ANALYTICAL APPROACH
There are four key considerations that would imply a higher rating for captive finance company:
- The value and first-claim ability of the captive assets.
- The relationship between the captive and the parent.
- The stand-alone strength of the captive.
- The level of ratings in the credit spectrum.

Typically the subsidiary rating is limited by the credit strength of the parent for four key reasons:
- The subsidiary is dependent on receivables of parent.
- The operating subsidiary can issue dividends and create intercompany transactions.
- The parent and operating subsidiary share management capabilities.
- Default of the parent could also cause captive finance company to default.

For more detailed information on this issue, please refer to the DBRS methodology *Rating Captive Finance Companies*.

Case 10: Income Funds*



DESCRIPTION

The income fund is a form of 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 takes into consideration both the financial profile of the operating company and the consolidated debt of the income 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).

ANALYTICAL APPROACH

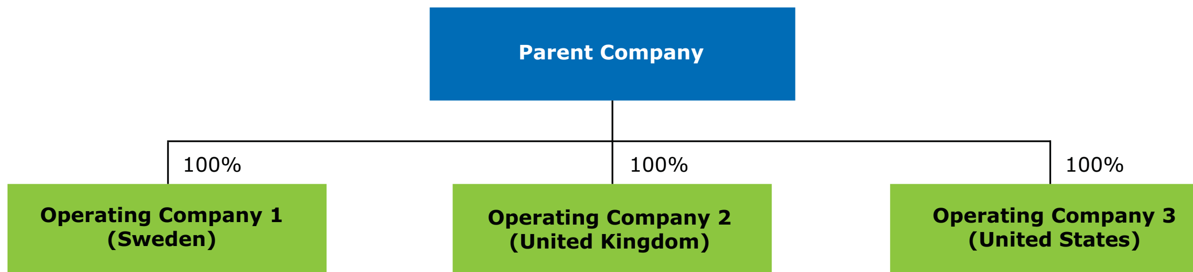
At the operating company level, the debt rating would consider both the financial profile of the operating company and the consolidated debt of the fund overall, since the operating company services the parent company's debt. Similarly, debt ratings at the fund level would also take into consideration the consolidated financial statements. The degree of stress placed on the operating company or fund statements for any given rating are examined on a case-by-case basis.

The income fund (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 to 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. Intercompany debt lent from the fund to the operating company is often ignored in the rating, since this serves as a means of transferring cash flow from the operating company to the parent.

* Also relates to real estate investment trusts (REITs).

Case 11: Multinational Parent Guarantee



DESCRIPTION
Parent companies often guarantee the debt of many of their operating companies throughout the world. The most common example of this scenario is a company with multinational operations that independently issue debt.

ANALYTICAL APPROACH
Where an unconditional guarantee exists, the operating company carries the same rating as the consolidated parent. 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 individual markets, 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.

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Corporate Headquarters

DBRS Tower
181 University Avenue
Suite 700
Toronto, ON M5H 3M7
TEL +1 416 593 5577