



Insight beyond the rating.

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Rating Captive Finance Companies

RATINGS FOR CAPTIVE FINANCE COMPANIES ARE TYPICALLY VERY CLOSE TO THE PARENT

The strength of the parent is typically a key consideration (and often a limiting factor) for establishing the credit strength of a captive finance company (CFP). DBRS defines a CFP as an entity whose main purpose relates to providing client financing for the products of the operating parent, with the finance entity typically being wholly owned by the parent.

By their nature, CFPs have at least three risks that are normally not present at their parent operating entities: high leverage, interest rate sensitivity and credit. However, if these are well managed, the “stand-alone” credit strength of the CFP may be stronger than its parent due to several advantages:

- CFP earnings may be less sensitive to economic and industry conditions as the spread business has at least some annuity-like characteristics. The parent may also have issues related to areas such as production and staff benefits.
- The underlying assets being financed are typically well diversified, liquid, easily identifiable and mobile. The parent typically has a high mix of fixed assets that are non liquid and single use.
- With an average term below three years, the liquidity of the financial assets held by a CFP is superior to that of the parent.

However, DBRS heavily weighs the strength of the parent in assessing the ratings of the CFP due to the following considerations:

(1) The CFP is heavily dependent on the parent as its receivables are generated by the sale of manufactured products. Given that the primary business of the CFP relates to the products of the parent, it would typically be affected by problems at the parent. Any major challenges at the parent could threaten the operations and asset values of the CFP and under worst-case scenarios (defaulting or a bankruptcy filing), it is difficult to envision a situation where the CFP would be able to continue as an ongoing operating entity. Defaulting action by the parent could result in the same action by the CFP.

(2) Given that the CFP is not regulated and is wholly owned, the operating company has some power in terms of areas such as dividends and intercompany transactions. As such, difficulties at the operating entity could easily translate into balance sheet and other pressures for the CFP.

(3) The parent and its CFP typically have a high degree of sharing in areas such as strategy, management, marketing, and in some instances, financing incentives/subsidies. In general, the parent provides a high level of support to the CFP and the level of interdependence and business ties between the two entities means that their long-term prospects are closely linked.

These factors meaningfully limit the degree to which even strong CFPs can be rated above their respective parent companies.



WHEN CFPs COULD BE RATED HIGHER THAN THE PARENT

Despite the aforementioned factors, there are cases in which a CFP's rating could be higher than that of its parent. In most cases, the difference would be limited to one notch. To exceed this limit, the CFP would have to be less than 50% controlled by the parent and there would have to be some comfort that the CFP had a franchise that would not be meaningfully damaged by major challenges at the parent. To achieve this, the CFP would likely need meaningful product lines beyond those related to the parent. These situations are expected to be infrequent and would be considered on a case-by-case basis.

In most cases, the CFP would not be eligible for a rating more than one notch above its parent. To determine when the one notch benefit is applicable, DBRS uses the following considerations (assuming that the one-notch benefit would be warranted by the relative strength of the CFP on a stand-alone basis.) The following factors are not meant to be exhaustive. Other relevant factors would also be examined on a case-by-case basis.

(1) The value and first claim ability of the CFP assets

DBRS considers the value of the CFP assets under various negative scenarios and the likelihood that creditors of the CFP would have first claim on its assets. Strength in both areas increases the possibility that the CFP debt rating could be higher than that of its parent. Relevant factors to consider would typically include:

- Would creditors of the CFP have first claim on its assets? (Are there criteria used by a bankruptcy court to determine if the CFP is an extension of the parent and not a separate company for the court proceedings, i.e., legal ring fencing?)
- Are there any present or potential abilities for the parent to infringe on this first claim ability through intercompany transactions, dividend policies or other means?
- Is there an expectation that under a worst-case scenario, the parent would be restructured rather than liquidated? (This has an impact in the value of the CFP's assets. Both wholesale and retail asset values would be much higher in a restructuring versus a liquidation.)
- How well would the financed assets (with recognition for both retail and wholesale) retain value under bankruptcy/restructuring or liquidation type scenarios?
- How liquid, mobile and diversified are the CFP's finance receivables?

(2) The relationship between the CFP and the parent

The greater the extent to which the CFP and its parent operate in unison, the less support there is for considering the CFP as "separate" and assigning it a higher rating than the parent. Relevant factors to consider would typically include:

- Do any support agreements or cross-default covenants exist between the CFP and the parent? (with support including keep well type agreements)?
- Does the CFP have financing incentives, intercompany obligations or transfer pricing arrangements with the parent?
- With respect to transfer pricing arrangements, are they established: i) on market terms? ii) on a subordinate basis relative to other debt? iii) with any demand or acceleration provisions?
- Is the CFP 100% owned by its parent? Could this change?
- Is there a stated dividend policy and how would it be described in terms of flexibility, level of control at the CFP and the level of the payout ratio itself?
- How separate is the CFP with respect to functions such as strategy, systems and marketing?
- Does the CFP have a separate board? Does this board include independent directors?
- What is the CFP's mix of third party versus wholesale receivables?
- Is the relative size of the CFP a factor, both absolutely and in relationship to the size of the parent?



(3) *The stand-alone strength of the CFP*

If the CFP has no ability to maintain its operations should the parent encounter default, bankruptcy or liquidation-type scenarios, there is less rationale for rating the debt of the CFP higher than that of its parent. Relevant factors to consider would typically include:

- Allowing for the relationship with the parent, is the CFP profitable? Specifically, does the parent make up the differential needed to ensure the commercial terms for the CFP's portfolio reflect market terms and values (i.e., any implicit subsidy is financed by the parent not the subsidiary)?
- To what extent does the CFP have profitable operations not related to the parent's products?
- If the parent were to cease manufacturing products, what is the likelihood that the CFP would be able to remain a going concern through other third parties filling the gap with either new products, parts or both?
- Does the CFP have appropriate bank lines and securitization ability separate from the parent?
- How strong are the capital and asset quality metrics and future expectations of such at the CFP? (with appropriate adjustments for off-balance sheet aspects)?

(4) *The level of ratings in the credit spectrum*

Lastly, DBRS considers the rating level of the operating entity, as it is typically more difficult for a CFP to be rated above the parent when the parent itself is highly rated.

WHEN CFPs COULD BE RATED LOWER THAN THE PARENT

Due to its importance to the parent in terms of sales and profit, a CFP is typically in a good position to be able to achieve at least the rating of its parent. As noted in this criteria, it is often the case where the stand-alone strength of the CFP is stronger than the parent, but its rating is limited by the credit strength of the parent.

Nevertheless, it is possible that a CFP could be rated lower than its parent. This would typically occur when the following considerations were met:

- (1) No guarantee from the parent for the CFP's debt was in existence and other support agreements (such as keep wells) were considered inadequate in some respect.
- (2) The CFP's key metrics (led by leverage and credit) were not considered strong, such that the stand-alone strength of the CFP would be considered as below the rating of the parent.
- (3) In terms of areas such as volume, profit and strategy, the financing provided to products at the parent would not be considered as "core" to the parent. Under DBRS's definition, a "core" product line would be one which a parent would have major difficulty continuing without, and would make every effort to support so that the finance operation could be maintained.
- (4) Where such exist, product lines outside of those with the parent have meaningful challenges/weaknesses.

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