Criteria
Rating Holding Companies and Their Subsidiaries

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Scope and Limitations

This criteria outlines the current DBRS approach for ratings of holding companies and their subsidiaries. The methods described herein may not be applicable in all cases; the considerations outlined in DBRS methodologies are not exhaustive and the relative importance of any specific consideration can vary by issuer. Further, this criteria is meant to provide general guidance regarding the DBRS methods and should not be interpreted with formulaic inflexibility, but understood in the context of the dynamic environment in which it is intended to be applied.

Overview

This document outlines the DBRS approach to rating holding companies and their subsidiaries. The terms “holding company” (holdco) and “parent company” are similar, with one exception: a holdco typically has no operations and is designed to simply hold investments in subsidiaries, while a parent company may have operations, as well as hold investments in subsidiaries. The use of the related term “corporate level” refers to either the parent or holding company, as the case may be, on a deconsolidated basis. Occasionally (such as in the title of this criteria), “holdco” also has this more generic sense of either a holding company (i.e., no operations) or a parent company (i.e., with operations). The context should make it clear which meaning applies.

This criteria outlines how DBRS determines a holdco’s issuer rating, not the ratings of individual securities of the holdco. Generally, an issuer rating reflects the probability of a company defaulting, given its total indebtedness, without regard to the ranking of the individual debt securities. The holdco probability of default is based directly or indirectly on a number of items, including: (1) holdco financial/liquidity risk, (2) credit strength of the subsidiaries, (3) contractual and legal relationships between members of the group and (4) any other factors that may reduce/increase the holdco’s risk profile (see Appendix).

As the foregoing factors vary greatly between holdcos, DBRS has grouped the examples into four broad categories. Group I includes examples (except for case I c.) where each company within the group (to the extent they are rated) would have the same issuer rating. Groups II and III include examples where the holdco is rated lower or higher than its subsidiaries, depending on the circumstances. Group IV includes examples of special legal or contractual arrangements, such as ring-fencing of a regulated subsidiary.

The appendix includes a number of general considerations that should be taken into account when evaluating holdcos. These include the holdco rationale, the structures, qualitative issues and the financial statements. These considerations underpin the analytical approach outlined in the examples shown below.

To establish ratings for holdcos and their subsidiaries, DBRS typically considers the following. First, the corporate group needs to be reviewed to determine if it functions as a single entity (with a central treasury function) or if the members operate somewhat independently (with more than one treasury function, or multiple borrowing points). The former would typically fall into Group I below and the latter would fall into either Group II or III.

For a corporate group to fall into Group II or III, its companies will have notional ranking differences that creditors need to take into account. For Group II and Group III issuers, the holdco rating reflects the various business units, as well as the nature of the legal and functional separation. Here the first task is to determine the stand-alone issuer rating for each subsidiary in the normal manner, using the relevant DBRS methodologies. From this, a “composite issuer rating” (i.e., a rating reflecting the credit quality of
the subsidiaries together without the holding company) is determined. It is this composite rating that is adjusted as necessary and assigned to the group’s holdco. The adjustment can reflect many factors, but “structural subordination” is normally the key factor (i.e., subsidiary creditors normally rank ahead of holdco creditors) with respect to assets of the subsidiary. This usually results in the holdco rating moving down one notch from the composite rating.

In addition, the adjustment to the final rating can reflect a number of other factors, including: (1) the amount of cash the holdco can receive from the subsidiaries and the control the holdco can exert over the dividend policies, (2) the presence of subsidiaries that are not wholly owned, (3) the number and diversity of subsidiaries, (4) the fact that a holdco has substantial operating assets or other assets apart from shares of operating subsidiaries, (5) holdco leverage over 20% of deconsolidated capital and (6) cross-default, guarantees (or bankruptcy remoteness provisions), etc. (Refer to the Appendix for more information.)

**Group I – Consolidated Credit**
- For corporate groups that are operationally and/or financially integrated or tied using cross-guarantees (i.e., one entity’s default causes a collective default), each rated entity within the group would generally be expected to have the same issuer rating.
- The issuer rating shared by each member of the group would be a rating reflecting the likelihood of default of the group as a whole.
- Typically, these corporate families are included in a DBRS report that primarily analyzes the consolidated financial statements. The resulting issuer rating would become the reference point for the ratings of the individual securities.

**Group II – Holdco – with Structural Subordination**
- Corporate groups that are not considered a single consolidated credit, where the holdco and its subsidiaries would have separate issuer ratings (i.e., there could be two or more default probabilities).
- The issuer rating for each subsidiary would be derived using the respective DBRS industry methodology.
- The holdco’s issuer rating could be notched down from the blended credit strength of the underlying subsidiaries, based on (1) the degree of support from its subsidiaries/investments, (2) structural/legal subordination, (3) double leverage and (4) other factors as discussed below.
- Typically, these corporate families are divided and covered in separate DBRS reports, based on their respective financial statements.

**Group III – Holdco – without Structural Subordination**
- Corporate groups that are not considered a single consolidated credit, where the holdco and its subsidiaries would have separate issuer ratings.
- The holdco’s issuer rating would not be notched down and could be notched up from the blended credit strength of the underlying subsidiaries, based on the presence of a number of positive factors discussed below.

**Group IV – Special Cases**
- A subsidiary’s rating can take into consideration special legal or contractual relationships (such as ring-fencing) or other positive or negative factors (including financial risks) at the corporate level. Note that these situations are not necessarily mutually exclusive from Groups I, II or III.
Case Examples

The examples below illustrate how DBRS would assign a rating to various types of holdcos in each of the four categories. The cases cover the more common situations and, in tandem with the comments above and the Appendix, provide a fairly comprehensive framework. More complex situations may require looking to the rationale used in two or more cases.

GROUP I – CONSOLIDATED CREDIT
These groups are considered a single consolidated credit and are operationally/financially integrated or tied using cross-guarantees. Case I c. is slightly different, as the focus is on the parent rating (the parent and subsidiary ratings are not tied). The rating takes into account the strength of all the individual companies in the group, which are not typically assigned individual ratings. Any companies that are subsequently acquired and remain as separate legal entities (for tax, jurisdictional or other reasons), but are operationally integrated and/or guaranteed, normally receive the same issuer rating as the other members of the group.

Case I a. Holdco Advances to Subsidiary
The holdco borrows funds and advances them to the opcos. This structure is often used when an organization wants to centralize and control overall borrowing. The opcos themselves may be restricted by covenants from any substantial borrowing. While some borrowing by opcos may be permitted, 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 holdco level have access to the value contained in assets of the opcos by way of the common equity in the event of default of holdco debt.

Analytical Approach – The holdco’s credit rating reflects the overall strength of the opcos, assuming the opcos are restricted from borrowing on their own, except for small amounts. There is no reduction in the rating of the holdco for structural subordination. This principle typically breaks down if debt becomes meaningful at the opcos, thereby creating structural subordination of the holdco debt to opco debt.

Case I b. Opcos Guarantee Holdco
The holdco and opcos borrow funds. To prevent structural subordination, the opcos guarantee the debt issued by the holdco.
Analytical Approach – When the holdco debt is guaranteed, the holdco issuer rating would be the same as the composite rating of the opcos, without structural subordination.

Case I c. Holdco/Opco Combination
Unlike most other examples in these criteria, the corporate level company here is a parent company (i.e., it has operations of its own, as well as owning shares of one or more opcos) and owns a majority of the subsidiary (or subsidiaries). The parent company and opco may be in similar businesses, but this is not necessarily the case.

Analytical Approach – DBRS will initially consider the credit strength of each of the parent company and the opco subsidiary, generally on an independent basis, using the appropriate industry methodology. DBRS will analyze the financial strength of the parent company with unconsolidated financial statements, where available, which show the actual cash dividends paid from the opco to the parent company. In certain situations, these actual cash dividends paid from the opco to the parent company may not reflect the true cash flow contribution potential of the opco company, or indeed may imply more cash flow contribution potential than is reasonably justified in the short to medium term. DBRS may therefore adjust, either up or down, the EBITDA of the parent company to reflect the additional potential financial support or additional potential risk to that support (i.e., possible reduction of dividends in the future) that the opco contributes. Factors such as the growth potential of the opco, its financial leverage, the nature of any covenants controlling its borrowings or the presence of any regulatory constraints, among others, will be reviewed by DBRS before making this potential adjustment. In the end, each entity would get its own issuer rating after taking into account such EBITDA or other adjustments.

Case I d. Income Funds and REITs
Income funds can issue debt at the fund level (normally a trust) and/or at the opco (including a limited partnership and/or a taxable corporation). The opco services the debt at all levels.

Analytical Approach – Income funds/REITs can have unique legal structures involving trusts, limited partnerships and opcos. When there is borrowing at different entity levels, the relationship of debt within the group structure needs to be reviewed to determine if all debt is pari passu, due to the presence of cross-guarantees, borrowing limitations or other structural features. Hence, the opco-level and fund-level debt ratings, assuming all debt is notionally pari passu, would reflect the overall business risk and the consolidated financial profile. Intercompany debt would not be a factor in the rating, as long as it is structured to serve only as a means of transferring cash flow from the operating company to the fund.
GROUP II – HOLDCO – STRUCTURAL SUBORDINATION
These are groups that are not consolidated credits – specifically, the holdco and the subsidiaries have separate default probabilities and separate ratings. Here the entities must be assessed individually, although still within the group dynamic.

As always, it is important to understand the holdco’s relationship with its subsidiaries. Here the holdco debt effectively ranks behind the debt at the opco (and is, therefore, “structurally subordinated”), since holdco debtholders have recourse to the assets and cash flow of the opco behind the first recourse to the assets and cash flow of opco that creditors enjoy. Also, it is important to confirm that the creditors of the subsidiaries do not have recourse to the holdco, e.g., through guarantees.

Case II. Traditional Structure
The holdco has one or more primary opcos. Both the holdco and opcos borrow material amounts from outside the group. The holdco’s funds are passed down by way of equity investments in the opcos possibly permitting additional indebtedness at the opco level (i.e., double leverage). The parent may also hold debt and preferred shares of the subsidiary.

Analytical Approach – The holdco’s debt is normally rated lower than the composite rating of the subsidiaries by at least one notch (due to structural subordination). In this case, creditors at the holdco level are behind the creditors at the subsidiary and their direct access to the assets and cash flow at the operating level (assuming there are no intercompany guarantees).

If the holdco’s deconsolidated debt levels are less than 20% of the capital structure, a one-rating-notch differential would be appropriate. As the ratio increases above 20%, the one-rating-notch differential may be inadequate. Holdcos with debt levels that are greater than 30% of the capital structure are likely to have more than a one-rating-notch differential. In addition to the effect of debt at the holdco on the holdco rating, when debt at the holdco starts to exceed 30% of the capital structure, the leverage of the consolidated group may start to increase to the point where the rating of the subsidiary is affected as well. DBRS will consider this metric (i.e., holdco debt as a percentage of the consolidated capital structure) in relation to other factors on a case-by-case basis.

In cases where one subsidiary has no debt and DBRS believes it has no plans to borrow, it may be appropriate not to have any rating differential (assuming the subsidiary requires an issuer rating), since there would be no structural subordination of holdco debt with respect to that subsidiary. For DBRS to permit no rating differential, the unleveraged subsidiary(ies) would have to be relatively large and wholly owned.

GROUP III – HOLDCO – WITHOUT STRUCTURAL SUBORDINATION
These are corporate groups that are not consolidated credits. Here, the holdco’s issuer rating would likely be notched higher than normally would be the case, given the credit quality of its subsidiaries/ investments. The higher notching is based on the presence of a number of additional positive factors. The weighting of these factors is determined solely by DBRS to ensure the enhancements are clearly beneficial and can differentiate from those holdcos which fall under Case II above.
Case III a. Conglomerate Structure
The holdco has a number of large and small opcos/investments. Both the holdco and opcos borrow outside the group, as in Case II above. Even so, the holdco’s rating equals, or is a notch above, the ratings of its subsidiaries, due to a number of credit-enhancing factors.

Analytical Approach – DBRS will initially determine the individual rating for each opco on an independent basis. From these, a composite rating is established. Depending on the outcome of the factors below, the rating of the holdco has the potential to be the same or above the composite rating of the subsidiaries, based on a review of the following:

• The degree of leverage at the holdco level on a deconsolidated basis. Debt levels of more than 20% of capital on a deconsolidated basis would cause additional rating pressure. Leverage in excess of 30% on a deconsolidated basis may cause a constraint to the holdco rating, relative to the composite rating of the subsidiary(ies).

• The amount of liquidity (i.e., committed credit lines, near-liquid assets) available as credit support.

• The size of cash inflows from all the subsidiaries, and whether they meet the cash needs of the holdco, including dividends, operating expense and interest expense. Specifically, a review is conducted on the relative size of each subsidiary and its ability to maintain its dividends.

• The diversification of the cash flow from the subsidiaries and investments (by geography, industry, product, etc.). The greater the variety and independence of the individual cash flow streams, the stronger the case for the holdco’s credit rating to equal or exceed the underlying investments.

Case III b. Enhancement
The holdco’s rating is above the rating of a major subsidiary, due to other enhancements that benefit its creditors.

Analytical Approach – The holdco may possess a number of enhancements that allow its rating to be higher than that of its major subsidiary. While there may be exceptions on a case-by-case basis, achieving a higher rating would typically require that the following condition is met:

(1) Assets are pledged as collateral (i.e., cash, or shares if the subsidiary is publicly traded).

As well, the presence of the following items bolsters the enhancement and strengthens the case for a higher rating of the parent company in relation to the opco:

(2) Significant, reliable cash inflow that exceeds borrowings and operating costs (i.e., dividend income from the major subsidiary);
(3) Additional assets that can be added and pledged should the assets in (2) decline;

(4) Significant amounts of unused but committed credit facilities;

(5) Other near-liquid investments;

(6) Limitations on third-party indebtedness and/or new issuance tests;

(7) Voting control of the major subsidiary, but with a structure that limits involvement in the day-to-day management of the subsidiary; and

(8) A history of a conservative use of leverage, etc.

GROUP IV – SPECIAL CASES
A subsidiary’s rating can take into consideration special legal or contractual relationships or other positive or negative factors (including financial risks) at the corporate level. Some of these cases are discussed further below. Note that these situations are not necessarily mutually exclusive from Groups I, II or III.

Case IV a. Multinational Support
• A strong holdco with substantial opcos in multiple countries can support the debt of its subsidiaries operating in different parts of the world. In these cases, the subsidiaries may issue debt locally where they operate (e.g., commercial paper). The rating of the guarantor may flow through to the subsidiary, provided the guarantee meets DBRS’s criteria for guarantees. In addition to guarantees, other forms of documented or undocumented support (such as a keepwell agreement, strong intent of the parent or strong business interrelationships), may permit a flow-through of the rating of the parent. These matters are discussed further in the criteria entitled DBRS Criteria: Guarantees and Other Forms of Explicit Support.

Case IV b. Ring-Fencing Protection
• Opcos can be ring-fenced (i.e., protected from the potential financial distress of a holdco) through covenants (that might limit the actions of a holdco) or, in some cases (e.g., utilities and financial companies), through the presence of a strong regulator. Covenants and subsidiary regulatory capital requirements may limit dividends and intercompany cash transfers and set other restrictions on the opcos and the parent company, usually to the detriment of the rating of the parent, all else being equal.
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 opco, but it must be examined case by case to see how tight the ring-fencing protection is. Because many of these considerations include subjective aspects, it is often the case that, even with tight ring-fencing provisions, there is typically a limit in the difference that can exist between the ratings assigned to a parent company and the related ring-fenced opcos.

Case IV c. Captive Finance Companies
• In cases where a company with substantial manufacturing or other operations owns a captive finance company (CFP), the rating of the CFP takes into account the relationship with and the creditworthiness of the parent. For a more complete discussion, refer to DBRS’s methodology Global Methodology for Rating Finance Companies, in particular its Appendix A – Captive Finance Companies.
Appendix – Other General Considerations

The case examples above should be considered in light of the four sections below. Each section provides a number of considerations that help with the assessment of the, at times, complex nature of holding companies. In turn, this helps with the identification of risk and assessment of its degree. As there is no one-size-fits-all approach, the weighting of these considerations is dependent on the specific facts of the group being evaluated.

(1) RATIONALE
Understanding the reasons for the use of a holdco can help with the overall credit assessment. There can be a number of potential benefits to a corporate family when operating under a holdco, as well as disadvantages. Some of the more important factors include the following:

Advantages:
(1) Better access to liquidity – In some instances, corporate families operating under a holdco may have better liquidity than their opcos, because of (a) multiple income streams, (b) other liquid holdings or, in many cases, (c) having the ability to sell shares in their investments.

(2) Superior diversification – Corporate families operating under a holdco can be better diversified, with a few or many opcos in: (a) regulated or non-regulated sectors, (b) different geographies and/or (c) different industries, etc.

(3) Tax advantages – Corporate families operating under a holdco may have more opportunities for group tax planning.

Disadvantages:
(1) Structural subordination – The holdco’s third-party debt is normally subordinate to the opco’s third-party debt.

(2) Double leverage – This occurs when the holdco issues third-party debt and advances it to the opco in the form of equity, which allows the opco to borrow against it.

(3) Tax deductibility – Total interest at the holdco may not be fully tax deductible if its income is modest.

(2) STRUCTURE
It is important to review a group’s functional and legal structure using a simplified organizational chart. The existence of intercompany agreements and the potential to commingle funds are normally important factors in the evaluation. When such factors are extensive, it typically reduces the distance between ratings at the different entities.

(1) Members of the group – All key subsidiaries should be identified to ensure all material assets, investments and operations are included. Determine the quality and value of the assets and the entity’s financial strength. Determine the subsidiaries’ diversity and market position.

(2) Minority interest – Identify any ownership by third parties in the subsidiaries. Review whether this affects voting control and governance, limiting the holdco’s role in operating, distribution and strategic decisions. When third-party ownership is material, the holdco should limit the deemed credit support from that subsidiary.
3) Funding – External funds may be raised at either the holdco or subsidiary level, or both. Internal cash flows may circulate freely within the group or be restricted. The holdco may have a bank facility that restricts the subsidiaries from borrowing, which may create a consolidated credit. If the subsidiaries are also able to borrow, the credit may need to be reviewed on a deconsolidated basis, including intercompany cash flow (dividends, interest, management fees, etc.).

4) Special intercompany funding – Some groups use a combination of reciprocal debt and preferred shares between a holdco and subsidiary in their tax planning. They are normally excluded from capital or cash flow calculations.

5) Cross-guarantees – Guarantees up to and down from the holdco can be used to bolster the credit strength of a smaller subsidiary or to consolidate the entire group from a credit perspective.

6) Integration – The group is integrated operationally (with support between the holdco and subsidiaries), as opposed to a pool of independent investments (with little support from the holdco).

7) Holdco liquidity – The holdco may have assets such as cash, marketable securities, etc., that may result in additional credit support in addition to credit support received from the subsidiaries. A holdco can also sell shares in the investments, depending on (i) the amount of time involved and (ii) any additional issues if selling from a control position.

8) Reporting issuer – If the parent and/or opcos are not reporting issuers, there may be limitations in raising new funds if only the private markets are available. This could increase the potential for the group to commingle funds.

(3) QUALITATIVE
In assessing the degree to which a holdco would provide credit support to an opco, or vice versa, it is important to understand how critical the opco is to the holdco and to the group overall. Also note that, while it may be possible for the parent company to abandon a subsidiary, it may not be practical to do so because of the integration and/or interdependence of the businesses. Bankruptcy courts are less likely to view a holdco and subsidiary as separate entities if their operations are integrated.

(a) Holdco leverage – Holdcos with meaningful debt could put pressure on opcos to maintain dividends by restricting subsidiary expenses and capital expenditures, which could be problematic over the longer term.

(b) Inferred support – There may be brand-name or other negative market and/or customer consequences that could lead to a holdco supporting an opco, even when it could walk away from the investment.

(c) Intent – The following factors are used to assess the relationship between a holdco and its opcos:
• Cross-default provisions.
• Economic incentives for the holdco to support the opco.
• Statements made by the holdco company in support of the opco, publicly or privately.
• The extent of holdco management control of the opco.
• The effect on investor confidence if the holdco did or did not support the opco.
• Whether the strategic importance of the subsidiary to the holdco is critical.
• Shared name and reputation risk between the holdco and opco.
• Whether the holdco and opco are located in the same country.
• Past and/or ongoing tangible support provided by the parent.
• The size of the opco in terms of total investment.
• The size of debt at the opco that the parent would support.
• The holdco’s financial capacity to provide support.
(4) FINANCIAL STATEMENTS

(1) Deconsolidated analysis – DBRS reviews the holdco’s cash flow on a cash-in/cash-out basis. This is best done using the holdco’s deconsolidated financial statements. The statements provide information on cash flow, assets, capitalization and the amount of indebtedness. Unconsolidated debt levels should normally be less than 20% of the deconsolidated capital structure. Normally, it is unusual (and negative for the rating) for the parent company to have unconsolidated debt levels that exceed 30% of the deconsolidated capital. In cases where the holdco’s deconsolidated financial statements are not available, DBRS may estimate the financial data, where possible.

(2) Cash inflow – DBRS reviews the source of the holdco’s cash inflow to assess its stability. One way to assess the stability of incoming dividends is to understand the dividend payout ratio at the opcos. Normally, a higher dividend payout ratio carries more risk in times of stress.

(3) Dividend restrictions – If there is regulation at the operating level, there could be meaningful restrictions on its ability to pay dividends. This could also be the case when entities are in different countries.

(4) Cash outflow – DBRS reviews how the holdco uses its cash to support liquidity and any deficiencies. This may include internal funding to support the group, strategic investing and ways potential shortfalls could be addressed, such as cutting common dividends, dividend reinvestment plan programs, etc.

(5) Additional assets – Some holdcos have meaningful amounts of cash and marketable securities on hand that could bolster the liquidity provided by cash inflows. DBRS will normally take a conservative view in assigning additional credit for cash and securities, unless there is strong tangible evidence that these resources will not be used for acquisitions, dividends or share buybacks, or be transferred to subsidiaries.

(6) Future prospects – An understanding of the holdco’s future intentions can be relevant to help determine if the holdco intends to maintain its current credit profile over the longer term.