The Pakistan Credit Rating Agency Limited

Methodology
Holding Company Rating

Table of Contents

Summary

This methodology describes PACRA's approach towards rating holding companies. Holding companies are entities whose primary activity is holding controlling and non-controlling stakes in private or publicly traded companies, for the purpose of generating capital gains and/or dividend income. The need for a separate framework for rating of holding companies arises to account for the unique risks emanating from their investment portfolios and its impact on their credit quality. While some holding companies' activities are restricted to holding stakes in investees, others have their own operations as well. This methodology applies to both, while, in case of the latter, the relevant sector methodology or PACRA's Corporate Rating Methodology supports.

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0. Introduction

- Scope
- Rating Framework

Introduction

A sound financial ecosystem is critical for functioning of any economy. It is defined by interaction of providers of funds - savers, users of funds - borrowers, financial institutions, and regulators. This system ensures smooth flow of funds between savers and borrowers; wherein, financial institutions provide platform for their interaction. Regulatory oversight safeguards the sanctity of this system. Like all systems, financial system has its own set of challenges. The most prominent being "Risk"; the risk that some participant may not be able to meet its commitments. All participants do their best to manage this risk to maximize their return. This is not possible unless we have independent information on this risk. Here comes expertise of rating agencies, providing independent opinion on credit risk. Flow of funds is only possible when the provider of funds has confidence that user of funds will be able to return these in a timely manner and as committed. Ratings help build this confidence. A higher rating means higher likelihood of timely repayment compared to a low rating. Our ratings are forward-looking and reflect our expectations for future financial and operating performance. However, historical results are helpful in understanding patterns and trends of a company's performance as well as for peer comparisons.

0.1 **Scope**: This methodology outlines PACRA's approach to rating holding companies (hereon referred to as "HoldCos"). While HoldCos are categorized as corporates, the need for a separate framework for rating HoldCos arises to account for the unique risks emanating from their investment portfolios and the resulting impact on their credit quality.

0.1.1 PACRA defines HoldCos as entities which are primarily involved in holding controlling and/or non-controlling stakes (equity participation) in other companies (hereon referred to as "investees") for the purpose of generating capital gains and/or dividend income. These stakes may be in group companies or outside the group.

0.1.2 It should be noted that PACRA's definition of HoldCos encompasses a greater range of entities, as compared to the definition of HoldCos laid out in the Companies Act'17. Furthermore, PACRA's definition of group, for the purpose of this methodology, may also be broader than that laid out in the SECP's Group Companies Registration Regulations'08 and SBP's Prudential Regulations for Corporate/ Commercial Banking. For the purpose of its analysis, PACRA may consider entities which do not fulfill the criteria under these definitions, as part of the HoldCo's group.

- ***Companies Act'17***: *Companies Act'17 defines HoldCo as "a company which is another company's holding company if, but only if, that other company is its subsidiary" while a subsidiary is defined a company in which the HoldCo "controls the composition of the Board" or "exercises or controls more than one-half of its voting securities either by itself or together with one or more of its subsidiary companies".*

- ***[SECP] Group Companies Registration Regulations'08:*** *"Group" means a holding company and its subsidiaries registered with the Commission" (i.e. Securities and Exchange Commission of Pakistan.*

- ***[SBP] Prudential Regulations for Corporate/ Commercial Banking (Revised till Jan'15):*** *"Group means persons, whether natural or juridical, if one of them or his dependent family members or its subsidiary, have control or hold substantial ownership interest (as defined in these regulations) over the other. For the purpose of this definition:*
  a) Subsidiary will have the same meaning as defined in section 3 of the Companies Ordinance, 1984 i.e. a company or a body corporate shall deemed to be a subsidiary of another company if that other company or body corporate directly or indirectly controls,

beneficially owns or holds more than 50% of its voting securities or otherwise has power to elect and appoint more than 50% of its directors.

b) Control refers to an ownership directly or indirectly through subsidiaries, of more than one half of voting power of an enterprise.

c) Substantial ownership/affiliation means beneficial shareholding of more than 25% by a person and/or by his dependent family members, which will include his/her spouse, dependent lineal ascendants and descendants and dependent brothers and sisters. However, shareholding in or by the Government owned entities and financial institutions will not constitute substantial ownership/affiliation, for the purpose of these regulations."

0.2 **Rating Framework**: PACRA's framework for rating HoldCos makes use of both qualitative and quantitative analyses. Overall factors are categorized under seven key areas: Profile, Ownership, Governance, Management, Investment Strategy, Business Risk and Financial Risk.

0.2.1 The quantitative factors help in achieving objectivity in the rating process while the qualitative side helps in establishing the sustainability of the relevant factors in the foreseeable future. Neither all factors can be quantified nor do quantitative values portray the whole story. PACRA, therefore, seeks to employ a best combination of both and would stick to it to ensure comparability on historical as well as synchronic basis. Meanwhile, PACRA achieves a clearer perspective on relative positioning of a HoldCo compared to that of others.

0.2.2 This methodology helps in identifying the factors that may create vulnerability in capacity and willingness of HoldCos to service their own financial obligations in a timely manner. Key rating drivers are pivotal for assessing the financial flexibility of an entity, which, in the case of HoldCos, depends largely on their ability to generate cash from their investments.

1. Profile

- Background
- Structural Analysis

Profile

1.1 **Background**: Until recently, in Pakistan, most companies were operating on a standalone basis and very few had subsidiaries or associates. Even where the term "group company" was used, it was usually used to refer to other company(s) with common shareholding or common management but not necessarily having legal beneficial interest. The HoldCo structure gained momentum when business houses realized that they could manage their investment portfolio in a more efficient manner by focusing on performance monitoring of investee companies, efficient capital allocation, talent management within group companies and control structures.

1.1.1 PACRA looks at the progress of the HoldCo since its inception in order to understand its evolution i.e. by acquiring stakes in other companies over a span of time or through internal restructuring process. Understanding the HoldCo's background helps PACRA in assessing how and through what means the HoldCo has achieved the desired expansion. Meanwhile, the group/sponsors' thought process behind establishment of the HoldCo helps PACRA to understand its strategy.

1.2 **Structural Analysis**: For structural analysis, it is crucial for PACRA to develop a clear understanding of the linkages between a HoldCo and its investees. This depends on the degree of operational involvement, and economic and financial significance of the investees to the HoldCo. Based on this analysis, PACRA classifies investees into four main categories:

Category	Description
Core	The entities where the HoldCo has operational control and are essentially a part of the HoldCo or treated as a wholly owned subsidiary. Financial stress for core entities will have a significant effect on the HoldCo's credit profile. It is very unlikely that the HoldCo would decide to divest.

Strategic	These entities may not act as flagship companies. They can be subsidiaries, associates, joint venture or the HoldCo may have partnerships in them. Core investments can translate into strategic investments upon divesture of holdings.
Trading	These comprise listed equity stakes held in other companies classified as Available for Sale and/or Held for Trading. These investments are least integrated and are held primarily with the intention of deriving trading income. The key risks involved here are liquidity and market risks.
Operations	Operational segment(s) which are treated as core business. These are embedded in the legal structure of the entity, offering full ownership with complete operational control. Major resource allocation is involved in operations and the management of those operations. Financial stress on operations can create a significant drag on the overall credit profile. When rating a holdco with operations, the sector methodology relevant to the entity's area of operations, or PACRA's Corporate Rating Methodology, is used alongside this methodology.

1.2.1 Following the structural analysis, PACRA maps the HoldCo's investment chart in detail to identify all direct and indirect stakes, including minority stakes. This is where structural complexity is examined. This can be determined on the basis of cross holdings, inter-company or related party transactions and/or availability of multiple debt funding sources. A complex structure, where it is difficult to separate the HoldCo from its investees, is viewed negatively.

2. Ownership

- Structure
- Ownership
- Business Acumen
- Financial Strength

Ownership

2.1 Ownership Structure: The assessment of ownership begins by looking at the legal status of the HoldCo. This is followed by an in-depth study of the shareholding mix in order to disentangle structure of ownership. Key factors that are considered for this purpose, inter-alia, include: i) shareholding structure which includes whether the individual(s) own the HoldCo directly or indirectly, ii) foreign or local shareholders, iii) whether the HoldCo is owned by a single group or through a combination of entities and individuals, and iv) whether it is part of a group or a standalone entity. All these deliberations are done to identify the man of the last mile. PACRA further considers how the HoldCo is actually run, as, at times, entities are run as family concerns despite being legally structured as a company.

2.2 Stability: In order to analyze the stability of ownership, a particularly important factor to be taken into account is succession planning. A very important part of our background analytical work is an attempt to assess whether, and under right of succession, the HoldCo's prospects would be supported and by whom. This is particularly relevant in case of family owned businesses and joint ventures, whose failures could have a contagious effect on the sustainability of the HoldCo. A stable ownership with clarity in succession, perhaps major stakes residing with one family or group, is considered positive for ratings. On the contrary, high free float (in case of listed concerns) leads to risk of take over and may anchor lower ratings.

2.3 Business Acumen: PACRA gauges the sponsors' business acumen. Having a strong business acumen set has been critical for sustainable success. As HoldCo's manage a diverse pool of investments (long-term and short-term), sponsors' ability to make key decisions foreseeing industry specific dynamics of each investee company along with strategic thinking capability are considered pivotal. Meanwhile, a deep and applicable understanding of the system is critical in order to determine how a business achieves its goals and objectives. The scope includes the assessment and understanding of how the sponsors of the HoldCo deliberate over and successfully make the right business decisions.

2.4 Financial Strength: PACRA analyzes the ability and willingness of the major shareholders to support the HoldCo both on a continuing basis, and support in times of crisis. Here, PACRA gives due importance to: i) behavior of the major shareholders to provide timely and comprehensive support in times of need in the past, ii) prospective view of key shareholders, incase such need arises, iii) other businesses of sponsors, and iv) the level of commitment of the major shareholder with the HoldCo in providing capital support. In case of no explicit commitment, PACRA attempts to form a view on availability of likely support. Support, in this context, refers strictly to financial support, rather than operational support. The scope for looking at other business of sponsors includes overall profiling of the key sponsors in the context of identifying the resources they have, outside the HoldCo. If, in a group structure, the financial strength of the sponsor is deemed to be weaker than that of the HoldCo, this may bode negatively for the HoldCo's standalone rating given the possibility that the HoldCo may at some point of time be bound to extend financial support to its weaker parent. PACRA also looks at the consolidated financial position of the HoldCo/group for consolidated liquid assets/investments, inter-company loans and/or asset transfers. It is not uncommon for a subsidiaries and/or other group companies to provide support to the HoldCo in times of need.

Table 1. Information Required on Ownership
- Shareholding pattern
- Details of sponsors' other businesses
- Sponsors' financial information
- Past pattern of sponsor support

3. Governance

- Board Structure
- Members' Profile
- Board Effectiveness
- Transparency

Governance

3.0 PACRA's assessment of governance involves both systematic analyses of governance data and information, and the more contextual reviews of the HoldCo's governance practices. PACRA considers four main factors while assessing the board structure of the HoldCo: (i) board structure, (ii) members profile, (iii) board effectiveness, and (iv) transparency.

3.1 Board Structure: This comprises assessment of board on various criteria including overall size, presence of independent members, duration of board members' association with the HoldCo, overall skill mix and structure of board committees. Size of the board may vary as per the scope and complexity of the operations of the HoldCo. While a very small board is not considered good, similarly, reaching a decision in an effective and efficient manner may not be possible in case of a large board. A healthy composition of board includes the presence of independent/non-executive members having limited relationship with the sponsoring group of the HoldCo. Meanwhile, same individual holding chairman and CEO positions is considered weak governance practice. The chairman is expected to have a non-executive role. Compliance with the code of corporate governance is also examined. PACRA also examines the independence of governance from major shareholders. Lastly, PACRA evaluates number of board committees, their structure, and how these committees provide support to the board. A board with higher number of members should have higher number of committees in place to assist in performing its role.

3.2 Members' Profile: PACRA collects information regarding profile and experience of each board member. This helps in forming an opinion about overall quality of the board. Moreover, diversification in terms of knowledge background and experience is considered positive. However, a fair number of board members should have related experience.

3.3 Board Effectiveness: In PACRA's view, the role of the board is to work with management in steering the HoldCo to its performance objectives and to provide critical and impartial oversight of management performance. PACRA analyzes the type and extent of information shared with board members, and quality of discussions taking place at board and committee levels. Here, the key concern is the in depth review of the quality and frequency of information about the investees' performance shared with the Board. Representation of HoldCo's Board members on investees' boards signals greater control. Meanwhile, PACRA also reviews the number of board meetings held during the year as these should be justified with the number of issues/matters arising. Board members' attendance and participation in meetings is important, and is gauged by viewing board meeting minutes. It is also important for PACRA to develop a view on the long-term direction of the HoldCo's financial decisions. Here, PACRA uses the HoldCo's financial policy as a guidepost.

Financial Policy*: Given that frequent asset rotation with high exposure to equity risk is a typical feature of HoldCo activity, capital structure metrics are relatively more challenging to forecast compared to other corporates. A HoldCo's financial policy indicates the level of risk tolerance of a HoldCo's Board and helps predict the direction of future investment and financing decisions. Clearly defined leverage targets are an important component of this. PACRA assesses the targets themselves and the HoldCo's ability to achieve them. The HoldCo's track record of sticking to its targets through different economic and industry cycles, along with managing to balance the interests of shareholders and creditors is also reviewed.*

3.4 Transparency: Quality of governance framework is also assessed by the procedures designed by the board to ensure transparent disclosures of financial and other information. This can be achieved through: i) ensuring independence of the audit committee, ii) strengthening the quality of internal audit function, which may be in-house or outsourced, and iii) improving quality of external audit by engaging auditors which are included in the State Bank of Pakistan's panel of auditors and/or have a satisfactory QCR rating. PACRA expects the HoldCo's audit committee function and internal audit function to report independently of the corresponding function placed at each subsidiary.

Accounting Quality*: PACRA reviews the quality of an entity's accounting policies as reflected in its notes to accounts, auditors' comments and other disclosures which are part of its financial statements. Adherence to accounting standards is assessed, particularly for unlisted concerns.*

Table 2. Information Required on Governance

- Details of board committees including ToRs
- Profile of BoD members
- Information packs used by the board
- Minutes of board meetings
- Financial policy
- Internal auditor detail (if outsourced)
- External auditor detail

4. Management

- Organizational Structure
- Management Team
- Management Effectiveness
- Control Environment

Management

4.0 Quality management, effective systems and controls, and well-defined strategy are essential ingredients for a successful HoldCo.

4.1 Organizational Structure: The assessment of management starts with PACRA conducting an in-depth analysis of organizational structure of the HoldCo. On a standalone basis, PACRA looks into the hierarchal structure, reporting line and coherence of the team. Number of management committees are established to monitor performance and assure adherence to the policies and procedures. Segregation of duties and occupancy of all positions would provide comfort as to the minimization of operational risk. PACRA also forms an opinion on the quality of management committees.

4.1.1 PACRA looks at investees' reporting lines, management teams and respective organizational structures. Delegation of authority assigned to investees is viewed positively. For the purpose of performance oversight, defined and established reporting lines from investee to HoldCo, creates synergy. PACRA also highlights the functions centralized at group or HoldCo level for a holistic picture of guidance and operating platform provided to corresponding division at investee level.

4.2 **Management Team**: Analysis of management includes evaluating experience profile of key individuals, management's track record to date, in terms of building up sound business mix, maintaining operating efficiency and strengthening the HoldCo's market position. Although judgment about management team is subjective, performance of the HoldCo over time provides a more objective measure. PACRA analyses the quality and credibility of management's strategy, examining plans for internal or external growth. Loss of key personnel, particularly members of senior management, can have potentially adverse effects on overall standing of the HoldCo relative to peers. Hence, HR turnover is reviewed to determine the stability of critical staff, with particular focus on key departments. Similarly, dependence of the management team on one or more persons is considered risky. In addition, the HoldCo's human resource policies are also reviewed to gauge its emphasis on retaining and recruiting vital staff.

Key-man Risk*: Key-man risk occurs when an entity is heavily reliant on an individual, or a limited number of individuals, who are accepted as the key holder(s) of important intellectual capital, knowledge or relationships. While this type of risk is more common in small to medium-sized entities, it can also exist in larger entities and is relatively challenging to benchmark and, hence, mitigate. PACRA attempts to identify the extent to which an entity is dependent on the expertise of such individual(s) and to ensure policies exist for succession/redundancy to limit the adverse impact of such a person unexpectedly leaving, on the HoldCo.*

4.3 **Management Effectiveness**: PACRA conducts a qualitative review of management systems and technology infrastructure to assess management effectiveness. One of the key tools available to management to effectively run an organization is the information provided to it. An important part of this analysis is looking at the HoldCo's MIS. Herein, integration of information regarding performance and financial position of investees into the HoldCo's MIS would be beneficial as it would ensure that critical information is available to management to inform decision making. PACRA also looks at the whether the management has laid out a pre-defined criteria to evaluate investees' performance. Management committees' meeting minutes are also reviewed, wherever available, to assess the quality of discussion.

MIS*: System generated – real-time based – MIS reports add more efficiency in decision making whether related to operational, financial or strategic issues. PACRA evaluates the quality and frequency of the MIS reports used by the management team to ascertain that decision-making within the entity is information-based.*

4.4 **Control Environment**: A robust control environment ensures that the HoldCo is driven by processes instead of being dependent upon individuals. Therefore, evaluation of the quality of policies and procedures, and invariable adherence to these, remains pivotal in the assessment of control environment. Built-in controls should demonstrate that conflict of interest is avoided.

Table 3. Information Required on Management

- Latest organogram
- Details of management committees
- Profile of senior management
- MIS reports
- Performance evaluation criteria for investees
- Minutes of management committees' meetings

5. Investment Strategy

- Investment Decision-making
- Investment Policy
- Investment Committee Effectiveness

Investment Strategy

5.0 PACRA carries out a qualitative assessment of the HoldCo's investment policy for a long-term view on its business profile and how it is likely to behave, going forward. PACRA also looks at how investment decisions are made in a HoldCo, and on which forum. Since investment decision-making is not a legal function, the structure of the forum can vary between HoldCos. Investment decision-making may be done at Board level, management level, a mixture of both, or at group level. Whichever forum is being used, PACRA considers this to be the HoldCo's Investment Committee (hereon referred to as "IC") and evaluates its composition, quality and effectiveness.

5.1 **Investment Decision-making**: Being the primary point of reference for any investment decision made and implemented, the IC is an integral part of the decision-making process. PACRA reviews the composition of the IC by looking at the profile of individual members, including their skills and experience, in order to gauge the investment acumen. Meanwhile, dominance of any particular member is carefully scrutinized through review of investment committee meeting minutes.

5.2 **Investment Policy**: When viewing the investment policy, PACRA analyzes how the management plans on managing its investment portfolio to strike a favorable balanced between conservative and riskier investments. Here, exposure limit for each investment type – core, strategic and non-strategic – in relation to sectors, groups and individual securities is considered important. PACRA also reviews relevant guidelines i.e. how well they are documented and their level of clarity and transparency. Clearly defined investment guidelines which offer long-term visibility of business profile are viewed positively. Transparent strategies revealing management intent and commitment towards maintaining a conservative and/or stable risk profile through exposure to mature companies, safer asset classes and liquid investments can be viewed more positively, as opposed to more speculative and opportunistic strategies.

5.3 **Investment Committee Effectiveness**: The investment decision making process is the pivotal stone of portfolio management. The effectiveness of the IC needs to be evaluated to ensure that it is discharging its responsibilities in the best possible manner and in the best interests of all stakeholders. Herein, the regularity and frequency of IC meetings is considered. Meanwhile, management's track record of adherence to stated investment guidelines and policies, wherever available, is considered an important and reliable indicator of management's commitment to goals.

Table 4. Information Required on Investment Strategy

- Profile of investment committee members
- Investment policy
- Investment committee meeting minutes

6. Business Risk

- Diversification
- Portfolio Assessment
- Income Assessment

Business Risk

6.0 PACRA has identified three main factors as drivers of HoldCo performance: level of diversification, portfolio assessment and income assessment. Level of concentration in a portfolio is an important risk indicator and HoldCos should seek to minimize it. Meanwhile, portfolio assessment and income assessment are considered important indicators of performance over the long term.

6.1 **Diversification**: PACRA considers the diversity of the HoldCo's exposure, both, in terms of business sectors (including own operations, if any) and individual investments. The key concern here is that investments and income should be well-spread over various sources to minimize the impact on the HoldCo in case a particular sector/investment is impacted. This could be in the form of a simultaneous cut in inflows through dividends and/or sale of investments. Therefore, the larger the number of sectors invested in, and the lower the degree of correlation between them, the more favorably it is viewed. Further depth is added to this analysis by examining the nature of the sources themselves, for example, inherent volatility/cyclicality of business sectors.

6.2 **Portfolio Assessment**: Since the overall quality of a HoldCo's portfolio is the product of the quality of its underlying investments, portfolio assessment is an essential part of business risk assessment. PACRA forms an opinion on each investee regarding the risk of becoming impaired and potentially worthless in case of default. Formation of a radical opinion for a listed and/or rated investee is relatively easier since detailed and timely disclosures are available. Where investees are unlisted and/or unrated, the opinion is conservative and primarily relies on information provided in the consolidated financials of the HoldCo. PACRA recognizes that holding controlling stakes – core and strategic – in unlisted concerns has its own benefits. HoldCos tend to keep a balance between listed and unlisted investments with a view of increasing their cash inflows and target growing sectors on a long term horizon, since unlisted companies are not subject to stringent regulations and public scrutiny, and can be developed at a slower pace.

Cash Consumers vs. Cash Producers: *All investments on a HoldCo's books may not be at similar developmental stages at a given point in time. Rather, some investments, particularly those in growing phase, i.e. emerging investments, may be cash consumers which means they need capital/financial support from the HoldCo. The HoldCo may divest its trading investments or rely on external financing to support their capital needs. However, their capacity to support the HoldCo in repaying the debt would likely be limited. On the other hand, mature investments and cash-cows, which generate dividend income and unrealized capital gains for the HoldCo without create a drag on its capital structure, would be cash producers. Maintaining a good balance between cash consumers and cash producers is critical for a HoldCo to ensure it has sufficient cash inflow to support emerging/non-performing investments without incurring significant debt burden.*

6.2.1 When looking at a HoldCo's investment portfolio, PACRA gives prime consideration to the ability of the HoldCo to liquidate its stake in its investees as this remains the ultimate source of debt repayment if the HoldCo is unable to refinance maturing obligations. Herein, there are two key concerns: investment mix and liquidity.

6.2.2 **Investment Mix:** PACRA looks at the mix of core, strategic and non-strategic investments in a HoldCo's portfolio. PACRA recognizes that a HoldCo may be unwilling and/or unable to liquidate core and strategic investments. This can be due to various reasons; these investments may hold strategic importance and/or carry reputational risk for the HoldCo. Further, other limitations such as cross default provisions or guarantees may also restrict abandonment of strategic investments. On the other hand, portfolios dominated by non-strategic investments can carry significant price risk. Thus, PACRA looks for a well-balanced portfolio.

6.2.3 Marketability: Marketability of asset portfolio is considered an important factor as highly marketable investments ensure a cushion for urgent cash in stressed times. While listings are a typical indicator of asset marketability, even listed majority stakes can be difficult to liquidate timely. Thus, these are excluded from the assessment. Similarly, even listed minority stakes may not offer a high degree of comfort. Investments in emerging markets or inherently volatile sectors can actually create additional risk as a sudden shock can erode equity price and make it difficult to dispose. While HoldCos typically take long-term positions in equity participations, ancillary investments in non-equity securities, such as fixed income investments, are also common. These usually do not represent a significant portion of the overall portfolio but can boost liquidity, especially in case of government securities.

6.3 Income Assessment: After portfolio assessment, PACRA examines the quality of its derivative income stream. PACRA looks at the standalone income performance, including yield on investments. The HoldCo's income is also analyzed relative to a suitable benchmark index for a holistic view on performance. Taking the limitations of standalone analyses into account, these figures are compared to other HoldCos. Historic volatility in the income stream is also factored in. Within this framework, PACRA also looks at how much control the HoldCo exhibits over its income. Internationally, HoldCos do not generally hold majority or large minority stakes in the entities in their investments. However, this is a norm in the local context. PACRA looks at controlling stakes to determine the level of influence and/or control the HoldCo can exhibit over an investee's dividend policy and distribution and/or major strategic decisions which can impact income, going forward. An important aspect of income assessment is its sustainability. PACRA looks at financial projections of the HoldCo to develop a view on future performance. Herein, the management's track record in providing reliable projections with minimal deviation reflected in actual performance, is also taken into account.

Table 5. Information Required on Business Risk

- Annual and quarterly financial statements of the HoldCo for the past three years
- Details of individual investees, including HoldCo's stake and total group stake in each investee, book value and market value
- Annual and quarterly financial statements of each investee (separately) for the past three years
- Break-up of dividend income from each investee
- Financial projections, along with detailed underlying assumptions

7. Financial Risk

- Coverages
- Capital Structure
- Consolidated Position

Financial Risk

7.0 In its financial risk analysis, PACRA emphasizes the coverages and capital structure of the HoldCo on a standalone and consolidated basis. A HoldCo's asset base mainly comprises investments, the fair/market value of which can deviate significantly from book value. Thus, PACRA incorporates market valuation in its analysis, where relevant. When rating HoldCos with operations, additional indicators of financial risk relevant to corporates, including working capital management, are factored in.

7.1 Coverages: PACRA emphasizes coverages as the key element in evaluating the liquidity and solvency of a HoldCo. Since a HoldCo's recurring cash income emanates mainly from its investment portfolio instead of internal generation, it is important to determine whether this, along with the cash balances maintained, is sufficient to service debt and withstand downturns in the economic environment. Apart from quantum, the timing of cash flows vs debt repayments is also critical. A cluster of debt repayments falling in a short time frame can create a liquidity shortfall. Generally, longer debt maturity profiles allow for greater flexibility in repayment. Insufficient liquidity can necessitate selling off assets, or require refinancing, which may be difficult during times of economic stress/disruption. PACRA also evaluates whether the HoldCo has adequate cushion available to cater to the financial needs of its investees by analyzing its cash flows vis-à-vis commitments to investees.

7.1.1 It is important to establish whether the HoldCo's asset base (i.e. investments) provides sufficient cover to its debt obligations. For this, PACRA incorporates market value of investments into its analysis, wherever possible, since this gives a more accurate picture of the ability of the asset base to cover debt. This approach ensures that asset values are not overstated or understated relative to liabilities, which remain close to market value. In case of unavailability of market value of assets, as in the case of unlisted equity stakes, PACRA refers to the investment's book value, which, in certain cases, may be applied with a haircut.

7.2 **Capital Structure**: PACRA analyzes the HoldCo's capital structure to determine its reliance on external funding. This is evaluated relative to its peers. Off-balance sheet exposure i.e. contingencies and commitments, is a critical concern when analyzing HoldCo capital structure, particularly guarantees which a HoldCo may have extended to its investees. Where the same does exist, PACRA incorporates this in its leverage metrics to reflect the burden of the respective obligations as well as the HoldCo's own debt liabilities.

***Downstream Guarantees**: It is highly desirable that funding arrangements between a HoldCo and its investees be strictly separate, with no recurring or extraordinary financial support flowing between them. However, in case of investments in subsidiaries and/or associates, a HoldCo may provide guarantees or collateral. These can potentially become a financial burden if the related entity defaults. PACRA views the quantum of the obligation but and the credit quality of the obligee to more accurately assess the likelihood of the contingency to materialize.*

***Financial Flexibility**: Financial flexibility allows an entity the latitude to meet its debt service obligations and manage stress without eroding credit quality. In terms of debt, the more conservatively capitalized an entity, the greater its flexibility. Other factors that contribute to financial flexibility include the ability to redeploy assets and revise plans for capital spending, strong banking relationships and equity markets access. Committed, multiyear bank lines along with provide additional strength. The inherent choice of dividend expense and capex investments may warrant an examination of reduction / suspension of one or both for stress cases.*

7.3 **Consolidated Position**: PACRA incorporates the consolidated credit profile of the group in its analysis by looking at the HoldCo's consolidated financial statements. For the purpose of its analysis, PACRA may also consider entities which are not consolidated in the HoldCo's financial statements, as part of the group, if considered relevant to the analysis. The overall objective is to evaluate financial flexibility at group level. PACRA looks at the group's coverages, leverage metrics and borrowing cushion in the form of unutilized credit lines from financial institutions. This allows PACRA to assess financial strength at group level and the possibility of the HoldCo deriving support from the group in case needed.

Table 6. Information Required on Financial Risk

- Complete schedule of all long term borrowings
- Bank wise detail of available credit lines and the extent of their utilization
- Spread calculations for investments acquired through external (commercial & bank) borrowing
- Details of future financing needs, and how the HoldCo aims to arrange the same (i.e. internal generation vs. external financing)
- Nature and status of intergroup lending and borrowing positions
- Group level dividends/revenues, profits, debt, equity of each company in the Group

Credit Rating

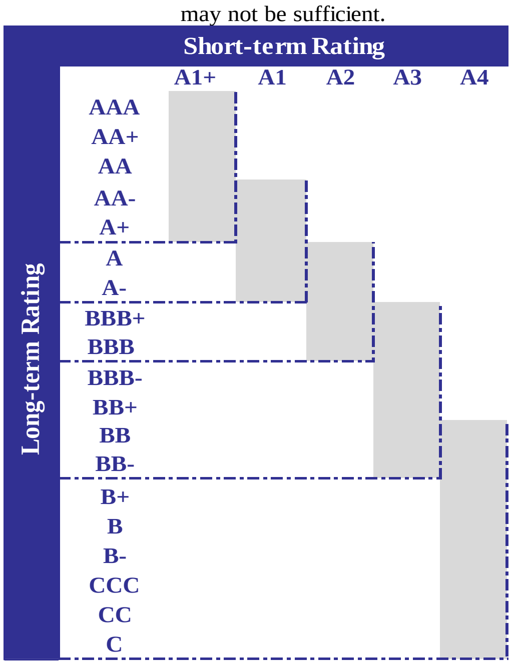
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long-term Rating

Scale	Definition
AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Short-term Rating

Scale	Definition
A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.



**The correlation shown is indicative and, in certain cases, may not hold.*

Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch Alerts to the possibility of a rating change subsequent to, or, in anticipation of some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating watch may accompany rating outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note. This scale is applicable to the following methodology(s):

Entities

a) Broker Entity Rating
b) Corporate Rating
c) Financial Institution Rating
d) Holding Company Rating
e) Independent Power Producer Rating
f) Microfinance Institution Rating
g) Non-Banking Finance Companies (NBFCs) Rating

Instruments

a) Basel III Compliant Debt Instrument Rating
b) Debt Instrument Rating
c) Sukuk Rating