



HOLDING COMPANY (HoldCo)

RATING METHODOLOGY

Forward looking opinion on the creditworthiness of HoldCo

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UPDATED: JUN 2017

Issued by: The Pakistan Credit Rating Agency Limited

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PAKISTAN CREDIT RATING AGENCY



1. Introduction

- **HoldCo – a way to manage investments**
- **Core, strategic and trading investments**

1.1 The need for a separate framework for assessing credit quality of Holding Companies (Holdco) arises as a substantial amount of risk and rewards of a holdco emanates from its “investments” in subsidiaries & associated companies. These “investments” have been built in order to capitalize on opportunities and/or to diversify risk. Resultantly there has been a drive towards formation of holdco structures, which give managers the leverage to manage their investments more effectively. This shift in stance has made such holdcos relying heavily upon performance of their holdings. As a consequence, ratings of holdcos are dependent on the stand-alone rating of their investments.

1.2 HOLDING COMPANY (HOLDCO) is defined as a corporate having investments in one or more companies. The holdco can be classified in two broad categories on the basis of the underlying structure. These investments may be strategic in nature, where the holdco intends to maintain its stake in order to reap benefits over a longer term horizon, or mere short-term investments classified as held for trading (HFT) in its books. In addition to the investment portfolio, a holdco may also have its own operations. However, the underlying rating approach will remain largely same in both cases. The holdco’s operations would be treated as a wholly owned subsidiary (Core investment).

1.3 The performance analysis of HoldCo requires to study each key investment in detail. This process begins with comprehensive critical analysis of the group structure. The objective is to account for all relevant direct and indirect stakes of the holdco and its investments. Once the complete group structure is clearly understood, it is easier to assess the importance of each entity to the holdco. Level of importance is established through analysis of operational and financial linkages between holdco and the investment.

1.4 The investments are classified as either;

- **Core:** The entities where the group has operational control and are essentially a part of the holdco. Financial stress for core entities will have a significant effect on the holdco’s credit profile. It is very unlikely that the group may decide to divest.
- **Strategic:** These entities may not act as flagship companies. Group can have partnerships in these companies. Core investments can translate into strategic investments upon divestiture of holdings.
- **Trading:** Least integrated entities. Holdco has intentions to sell. Primarily held to make gains in short-term. The key risk involved here is market risk.

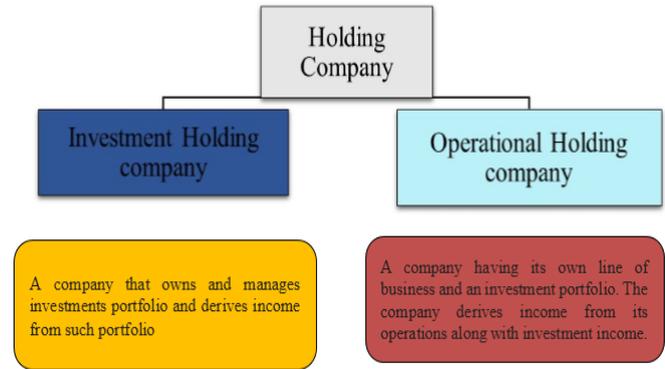
1.5 This classification determines the rating criteria for the investments and is hence one of the most crucial steps in the process. Investments classified as core and strategic play an integral role towards performance of a holdco, hence it is critical to assess their stand-alone ratings (SAR). All other investments (trading) only affect the holdco due to their liquidity and market risk and hence they are assessed for limited risks only. The penultimate step is assessment of group-related factors such as governance and management quality.

1.6 Rating approach of Holding companies (holdco) has evolved over time. Until recently, in Pakistan most companies were stand alone and very few had subsidiaries or associates. Even where the term “**Group Company**” was used, this in most cases referred to other company(s) with common shareholding or common management. However, such companies may not have a legal beneficial interest. Hence determination of these ratings accounted for factors such as governance, management quality, systems & controls, economic and business risks, and financial risks of the entity alone. Through the establishment of the holdco structure, the business houses felt that they could manage their investment portfolio in a more efficient manner by focusing on: Performance monitoring of investee companies, efficient allocation of Capital, Management of Talent within Group Companies and Control Structures. In recent times corporates have tend to diversify in order to minimize risks and/or capitalize on attractive opportunities, by augmenting their investment books. So much so that the risks arising from these investments become a major part of such companies’ overall risk profile. Hence, while doing a credit assessment of such an entity, it is also critical to assess risks of its investee companies. This concept forms basis of rating methodology for holdcos.

2. RATING APPROACH

THE APPROACH – ASSESS RISKS OF INVESTMENT PORTFOLIO COMPANIES

2.1 Holdcos are broadly classified in three categories, entities having (i) majority stake (>50%) in most of its investee companies but no operations of its own, (ii) majority stake in most of its investee companies along with own operations, and (iii) a non-strategic investment portfolio. Rating treatment for the first two follows largely the same principle with slight adjustment in the second case being because of the holdcos own operations, while the third type is assessed under a different methodology. The scope of this document covers theoretical and practical aspects of rating the first two types only.



2.2 RATING APPROACH:

Step 1	Analyze the group structure in detail establishing all direct and indirect stakes
Step 2	Determine level of importance of each investment to the Holdco
Step 3	Determine SAR of all core and strategic entities
Step 4	Determine importance of each investment and deduce notional rating of HoldCo from investments
Step 5	Assess market risk and dividend stream stability of non-strategic investments
Step 6	Incorporate group-related factors (governance, portfolio risk etc.)
Step 7	Combine results from steps 3, 4 & 5 to arrive at rating of Holdco

2.2.1 GROUP STRUCTURE ANALYSIS: The rating approach begins with an in-depth study of the group in order to disentangle complexity of the group structure. This process includes analyzing the detailed group chart identifying all direct and indirect stakes, including minority stakes.

2.2.2 It is also important to look at the corporate, legal and financial status of each company within the group. Classification of each investment can be made based on percentage ownership, PAT, EBIDTA and borrowings. These factors assist in determining the extent of criticality of each investment for the holdco.

2.2.3 DETERMINE IMPORTANCE OF INVESTMENTS TO HOLDCO: Once the group-level picture is clear, it is important to establish the relationship between the holdco and its investments. In an operational holding company major resource allocation is involved in operations and management of core operations, limited time is allocated towards monitoring of investment book. These investments are categorized as **core, strategic or non-strategic** depending on their degree of economic and financial significance to the holdco. This assessment of importance level is based on the severity of the effect that a default of the entity would have for the holdco. Some of the key factors that highlight this

criticality level include:

- **Legal Implications**
 - Guarantees/cross-default provisions
- **Limitations on abandoning the subsidiary**
 - Percentage ownership (current and prospective);
 - Strategic importance – integrated lines of business , critical common supplier/customers;
 - Cash producing as against cash consumptive;
 - Reputational risk to the holdco should the entity default (Shared name)
 - Significance of amount of investment (Size of entity relative to the whole group);
- **Strategy and Investment Philosophy**
 - Management control;
 - Management's stated posture to continue;
 - History to support.

This information is gathered and analyzed to sort out entities into the following three categories from the holdco's viewpoint:

- 2.3.4 NOTIONAL RATING:** HoldCo's notional rating is deduced from the ball park ratings of the core investment book. In this respect, due weightage is also given to the strategic investment book.
- 2.3.5 NON-STRATEGIC/TRADING INVESTMENTS:** Formation of a view on stability of cash flows (dividend stream) and/or market and liquidity risks arising from all non-strategic investments is the next step. These investments, normally classified as Held-for-Trading (HFT), are susceptible to market price fluctuations hence it is critical to form a view on their market risk, while assessment of sustainability of dividend stream will remain crucial for all investments, regardless of their classification. Liquidity of such investments is also a key consideration as it provides the holdcos with buffer to counter any cash flow constraints in a timely manner. As a base rule, holdcos with stable dividend incomes and more liquid portfolio with lower market risk will score better in this analysis.
- 2.3.6 QUALITATIVE FACTORS:** Qualitative factors such as asset quality and governance structure are also considered critical to assessment of a holdco's rating. These address risks on a group-wide level, taking a birds-eye view, rather than being entity-specific like those discussed above. Quality of asset base includes assessment of concentration of the investments, their geographic diversity and also diversity of the businesses themselves. Higher diversity reduces risks hence enhancing holdco's rating. Meanwhile, governance is a key element of this analysis as it looks at the quality of HR and oversight on the group companies. A holdco with formal procedures, HR and mandates to manage its investment book is bound to be better than one in which no such formal control exists.

Factors	Sub-Factors	Assessment
INVESTMENT	Concentration	Assets of large entities as a percentage of total group's assets
	Geographic Diversification	Market value of assets residing in a particular region as a percentage of total group's assets
	Business Diversity	Number of various businesses being operated under the holdco.

Factors	Sub-Factors	Assessment
Governance	Management	<p>Role of Group CEO:</p> <ul style="list-style-type: none"> Ideally should be focused towards strategic tasks/decision-making <p>Level of autonomy to CEOs of subsidiaries:</p> <ul style="list-style-type: none"> In an effective environment, this role should be more operational in nature <p>Coordination Platform:</p> <ul style="list-style-type: none"> Executive committee comprising all group company CEOs Standardized MIS <p>Management</p> <ul style="list-style-type: none"> Effectiveness of control framework Appetite for risk Business acumen Succession Planning
	Board of Directors	<p>Mandate of BoD:</p> <ul style="list-style-type: none"> Extent of focus on group strategy BoD's representation on subsidiaries Group level BoD committees <p>Board Quality</p> <ul style="list-style-type: none"> Profiles of BoD

2.3.7 Corporate governance structure of HoldCo's is important to qualitative analysis. While analyzing governance framework, among others, four main factors are looked into, i) board structure, ii) members' profile, iii) board effectiveness, and iv) financial transparency.

i) Board Structure: This comprises assessment of board on various criteria including overall size, presence of independent members, overall skill mix and structure of committees of the board. Size of the board may vary as per the scope and complexity of the business operations of the entity. Diversification in terms of knowledge background and experience of board is considered positive. However, a fair number of board members should have financial sector experience. Compliance of code of corporate governance is also examined.

ii) Members' Profile: PACRA collects information regarding profile and experience of each board member. This helps in forming an opinion about the quality of overall board.

iii) **Board Effectiveness:** PACRA considers the role of the board is to work with management in steering the entity to its performance objectives and to provide critical and impartial oversight of management performance. Board members' attendance and participation in meetings is considered a measure to assess the effectiveness. Moreover, PACRA analyses the type and extent of information shared with the board members, and quality of discussions taking place at board and committee level. Effective oversight requires frequent sharing and detailed information than required by statute.

iv) **Financial Transparency:** Quality of governance framework is also assessed by the procedures designed by the board to ensure transparent disclosures of financial information. The board may establish controls to ensure transparency through strengthening the role of audit committee, the quality of internal audit function, and effectiveness of external audit.

2.3.8 HOLDCO'S FINANCIAL LEVERAGE: Analysis of holdco's own leveraging even where it does not have any operations of its own is critical while assessing its creditworthiness. Borrowing patterns are not clearly established between the holdco and operational entities. A typical case arises where the holdco augments its investment book based on borrowed funds. This is known as 'Double Leveraging'. The double leverage ratio indicates the extent to which the equity of the parent is fully invested in its subsidiaries. Aside from equity investments in various subsidiaries, holding companies may also have advances or loans to any or all of these entities. Funds advanced to subsidiaries in the form of loans through prima facie have different connotations as against equity investment, these are usually sub ordinate to senior lenders and therefore are treated as equity exposure.

2.3.9 HOLDCO'S RATING – THE FINAL REFINEMENT: PACRA arrives at the final rating of holdco by incorporating its opinion of holdco's non-strategic investments and qualitative factors in the notional rating calculated earlier. In simple words, weighted sum of SARs of all key investments, assessment of market and liquidity risks on non-strategic investments and view on qualitative factors leads to a holdcos final rating.

Disclaimer:

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STANDARD RATING SCALES & DEFINITIONS

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 RATINGS		SHORT TERM RATINGS
AAA	<p>Highest credit quality. Lowest expectation of credit risk.</p> <p>Indicate exceptionally strong capacity for timely payment of financial commitments.</p>	<p>A1+: The highest capacity for timely repayment.</p> <p>A1: A strong capacity for timely repayment.</p> <p>A2: A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.</p> <p>A3: An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.</p> <p>B: The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.</p> <p>C: An inadequate capacity to ensure timely repayment.</p>
AA+ AA AA-	<p>Very high credit quality. Very low expectation of credit risk.</p> <p>Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.</p>	
A+ A A-	<p>High credit quality. Low expectation of credit risk.</p> <p>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.</p>	
BBB+ BBB BBB-	<p>Good credit quality. Currently a low expectation of credit risk.</p> <p>The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances or economic conditions are more likely to impair this capacity.</p>	
BB+ BB BB-	<p>Moderate risk. Possibility of credit risk developing.</p> <p>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.</p>	
B+ B B-	<p>High credit risk.</p> <p>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.</p>	
CCC CC C	<p>Very high credit risk.</p> <p>“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.</p>	
D	<p>Obligations are currently in default.</p>	

Rating Watch

Alerts to the possibility of a rating change subsequent to, or in anticipation of, a) some material identifiable event and/or b) deviation from expected trend. But it does not mean that a rating change is inevitable. Rating Watch may carry designation – Positive (rating may be raised, negative (lowered), or developing (direction is unclear). A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled.

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’.

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, a suspended rating should be considered withdrawn.

Withdrawn

A rating is withdrawn on a) termination of rating mandate, b) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, or e) the entity/issuer defaults.

Disclaimer: PACRA's rating is an assessment of the credit standing of an entity/issue in Pakistan. They do not take into account the potential transfer / convertibility risk that may exist for foreign currency creditors. PACRA's opinion is not a recommendation to purchase, sell or hold a security, in as much as it does not comment on the security's market price or suitability for a particular investor.