Parent-Subsidiary Linkage and Notching Criteria

Request for Comments

Scope of the Criteria

Lianhe Ratings Global Limited ("Lianhe Global") applies the parent-subsidiary linkage and notching criteria to corporate entities where we consider that the linkage between the rated entities and their respective parents may influence the rated companies' credit profiles. The parent can be a private company or a government/state-owned entity which may factor in direct/indirect support from the government owner.

Lianhe Global invites market participants to provide comments and feedback on this proposed criteria by 31 March, 2021 by submitting their comments and feedback to info@lhratingsglobal.com.

The criteria does not represent a comprehensive coverage but only addresses key rating factors to form our credit opinions and will be reviewed periodically.

Overview

The criteria explains our key considerations to assess the strength of linkage between a parent company and its subsidiary and the likely impact of the linkage on the credit profile of the subsidiary. Economic incentive, operational integration, and legal status/commitments are the key factors for our assessment which include sub-factors summarised in the table below. We generally apply the criteria on top of the individual credit assessment of the rated subsidiary (based on applicable criteria primarily according to its business profile) to derive the subsidiary's global scale Long-term Issuer Credit Rating ("LTICR"). We incorporate the strength of linkage into the rated entity's LTICR by using either a top-down or bottom-up notching approach.

Key Considerations for Parent-Subsidiary Linkage Assessment

Primary Factor	Sub Factor	Weight
Economic Incentive	Strategic Importance to the Parent	20%
	Parent Ownership	15%
	Potential Impact of Default	15%
Operational Integration	Management Control	15%
	Same Brand	10%
	Track Record of Support	10%
Legal Status/Commitments	Various Forms of Commitments	5%
	Funding Fungibility	10%

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Parent-Subsidiary Linkage Considerations

Lianhe Global assesses the linkage between a parent company and its subsidiary primarily based on the analysis of the following key factors: economic incentive, operational integration, and legal status/commitments. Each of these factors is assessed and defined as “Very Strong”, “Strong” or “Moderate to Weak” based on our assessments and then we decide the overall strength of linkage which are also defined as “Very Strong”, “Strong” or “Moderate to Weak”.

We generally consider that “Economic Incentive” has the highest influence on the overall strength of the parent-subsidiary linkage, while “Legal Status/Commitments” having the lowest influence. Analysts use a weighted-average approach to decide the overall strength of the parent-subsidiary linkage. The weight shown for each factor in the table represents an approximation of its relative importance for the overall linkage strength assessment, but the actual importance may vary and is subject to analytical judgements.

The likelihood of parental support usually depends on the strength of parent-subsidiary linkage. The parent can be a private company or a government/state-owned entity which may factor in direct/indirect support from the government owner. We consider that the economic incentive from a government owner may be different from a private company, which will be discussed in the following session.

Economic Incentive

Strategic Importance to the Parent

We assess a subsidiary’s strategic importance to its parent primarily by comparing its asset size, earnings contribution and business coverage relatively to its parent and the parent’s other subsidiaries. Whether the subsidiary provides any synergies in terms of product/service offering and geographic advantage are also considered, particularly with strong strategic alignment and common goals and objectives in business development. In addition, we believe that a parent is more likely to support a subsidiary which has been profitable but only in temporary distress compared with a constantly loss-making subsidiary. When we consider that the support will be come from a government entity, we generally focus on the rated entity’s policy function and strategic position to the overall economy to assess its strategic importance.

Parent Ownership

We consider that a meaningful and long-term ownership usually indicates the parent’s high tendency to support its subsidiary’s continuing operation. We also access whether the parent is able to exert control over the subsidiary to ensure ongoing strategic alignment and timely monitoring of the subsidiary. A controlling interest is usually with voting shares of more than 50% although other circumstances can be considered to determine whether a party still holds a controlling ownership despite owning less than the majority of the voting shares.

Potential Impact of Default

We consider that a parent’s propensity to support a subsidiary would be high if a default of its subsidiary could cause serious repercussions or even a collapse of creditor/investor confidence in the whole group. For example, a default on debt obligation by a subsidiary may adversely affect its parent’s fundraising from the capital market, which is usually more prominent for a public listed company.

Operational Integration

Management Control

A parent generally exerts control of its subsidiary over the board including the appointment/removal of the board of directors and senior managers and periodic reviews of the subsidiary's business and financial operations. We believe that a parent playing an active role in managing its subsidiary, such as the involvement in the subsidiary's budgetary decisions, business strategy, financial planning and internal control, usually indicates its high propensity of providing continuous support.

Same Brand

The likelihood of a parent providing support to its subsidiary tends to be high should the subsidiary carries the same brand name as the failure of the subsidiary may bring reputational risk to the whole group and damage the overall group's franchise. The moral obligation may also exist due to the public awareness of the parentage of the subsidiary even in the absence of a same brand name.

Track Record of Support

We also review whether a parent has constantly allocated resources and dedicated operational and financial support to its subsidiary, such as cross-selling products, experience sharing, regular equity infusion, and backup credit facilities.

Legal Status/Commitments

Various Forms of Commitments

There are various forms of commitments a parent may provide to show its willingness to provide support to its subsidiary in case of need. We generally favour legally enforceable provisions, such as guarantees, put options, and cross-default provisions embedded in the subsidiary's debt instrument, compared with those commitments which do not contain any legally enforceable promises, e.g. comfort letters and liquidity shortfall undertakings.

Funding Fungibility

Funding fungibility may affect a parent's ability to provide timely support to its subsidiary. We usually look at the domiciliary status, relevant regulations governing the fungibility of capital and liquidity, and potential pressure from other interested parties (such as lenders and labour unions of the parent) to assess the funding fungibility. In general, we consider that the transfer of funds is relatively easy for a parent and its subsidiary domiciled in the same jurisdiction.

Strength of Linkage and Notching

We usually adopt a bottom-up approach using the rated entity's standalone credit rating as an anchor rating and notching up from the rating to derive its LTICR to factor in the strength of the parent-subsidiary linkage. A top-down approach using the parent's LTICR as an anchor rating may be applied when the rated entity is highly integrated with the parent while the linkage assessment falling in the "Very Strong" or "Strong" category.

The table below indicates the cap on the LTICR can be assigned to the rated entity based on the strength of the parent-subsidiary linkage. The cap may become a rating constraint should the parent has weaker credit profile than that of the rated subsidiary. However, the cap may be lifted if the subsidiary has operated independently with the linkage assessment falling in the “Moderate to Weak” category or if there are specific ring-fencing arrangements limiting the parent’s ability to access/mobilise the assets or cash of the subsidiary.

Strength of Linkage and Notching

	Strength of Parent-Subsidiary Linkage		
	Very Strong	**Strong**	**Moderate to Weak**
Cap on the rated entity’s LTICR	Equalised to the parent’s LTICR	1 notch below the parent’s LTICR	2 notches below the parent’s LTICR

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