Article Title: ARCHIVE | Criteria | Corporates | General: Corporate Criteria--Parent/Subsidiary Links; General Principles; Subsidiaries/Joint Ventures/Nonrecourse Projects; Finance Subsidiaries; Rating Link to Parent Data: (EDITOR'S NOTE: — This criteria article has been fully superseded. Please refer to the "Table Of Contents: S&P; Global Ratings Corporate Criteria.") Parent/Subsidiary Links Affiliation between a stronger and a weaker entity will almost always affect the credit quality of both, unless the relative size of one is insignificant. The question is rather how close together the two ratings should be pulled on the basis of affiliation. General Principles In general, economic incentive is the most important factor on which to base judgments about the degree of linkage that exists between a parent and subsidiary. This matters more than covenants, support agreements, management assertions, or legal opinions. Business managers have a primary obligation to serve the interest of their shareholders, and it should generally be assumed they will act to satisfy this responsibility. If this means infusing cash into a unit previously termed a stand-alone subsidiary, or finding a way around covenants to get cash out of a protected subsidiary, then management can be expected to follow these courses of action to the extent possible. It is important to think ahead to various stress scenarios and consider how management would likely act under those circumstances. If a parent supports a subsidiary only as long as the subsidiary does not need it, such support is meaningless. A weak entity owned by a strong parent usually--although not always--will enjoy a stronger rating than it would on a stand-alone basis. Assuming the parent has the ability to support its subsidiary during a period of financial stress, the spectrum of possibilities still ranges from ratings equalization at one extreme to very little or no help from the parent's credit strength at the other. The greater the gap to be bridged, the more evidence of support is necessary. The parent's rating is, of course, assigned when it guarantees or assumes subsidiary debt. Guarantees and assumption of debt are different legal mechanisms that are equivalent from a rating perspective. Cross-default and cross-acceleration provisions in bond indentures also can be important rating considerations. They can provide a powerful incentive for a stronger entity to support debt of a weaker affiliate, because they trigger default of the stronger unit in the event of a default by the weaker affiliate. Bear in mind, however, that cross-default provisions can disappear if the debt that contains the provisions is retired or renegotiated. A strong subsidiary owned by a weak parent generally is rated no higher than the parent. The key reasons: The ability of and incentive for a weak parent to take assets from the subsidiary or burden it with liabilities during financial stress; and The likelihood that a parent's bankruptcy would cause the subsidiary's bankruptcy, regardless of its stand-alone strength. Both factors argue that, in most cases, a "strong" subsidiary is no further from bankruptcy than its parent, and thus cannot have a higher rating. Experience has shown that bankrupt industrial companies file with their subsidiaries more often than not. For rating purposes, the risk of "substantive consolidation" is a side issue. Consolidation in bankruptcy, sometimes referred to as substantive consolidation, occurs when assets of a parent and its subsidiaries are thrown together by the bankruptcy court into a single pool and their value allocated to all creditors without regard for any distinction between the two legal entities. In such cases, creditors of a subsidiary may lose all claim to the value associated with that particular subsidiary. Much more often, a parent and its subsidiaries will all file, but each legal entity will be kept separate in the bankruptcy proceeding. Creditors keep their claim to the assets of the specific legal entity to which they extended credit. Because corporate ratings address default risk, the key issue is not consolidation, but rather whether a bankruptcy filing will occur. Nonconsolidation opinions are, therefore, of more value with respect to recovery ratings and issue ratings of subsidiary debt, because those opinions address the likelihood of substantive consolidation, rather than the likelihood of simultaneous bankruptcies for parent and subsidiary. Perhaps the willingness to obtain such an opinion might also serve as some evidence of management intent regarding a subsidiary's independence. Protective covenants apparently protect a subsidiary from its parent by restricting dividends or asset transfers. In general, this type of covenant is given very limited weight in a rating determination. Reasons for limited value of protective covenants: They do not affect the parent's ability to file the subsidiary into bankruptcy; It is very difficult to structure provisions that cannot be evaded; and Ultimately, courts usually cannot force a company to obey the covenant. During severe financial stress, especially prior to a bankruptcy, a weak parent may have a powerful incentive to strip a stronger subsidiary. The court can, at best, only award monetary damages after the fact to a creditor who has incurred a loss (when the issue defaults) and chooses to sue. Subsidiaries/Joint

Ventures/Nonrecourse Projects With respect to the parent's credit rating, affiliated businesses' operations and their debt may be treated analytically in several different ways, depending on the perceived relationship between the parent and the operating unit. These alternatives are illustrated by the spectrum below. The same alternatives may apply when companies invest in joint ventures that issue debt in their own name, and when companies choose to finance various projects with nonrecourse debt. These analytical issues also may apply when companies take pains to finance some of their wholly owned subsidiaries on a stand-alone, nonrecourse basis, especially in the case of noncore or foreign operations. Sometimes, the relationship may be characterized as an investment. In that case, the operational results are carved out; the parent gets credit for dividends received; the parent is not burdened with the operation's debt obligations; and the value, volatility, and liquidity of the investment are analyzed on a case-specific basis. The quality of the investment dictates how much leverage at the parent company it can support. At the other end of the spectrum, operations may be characterized as an integrated business. Then, the analysis would fully consolidate the operation's income sheet and balance sheet; and the risk profile of the operations is integrated with the overall business risk analysis. Or, the business may not fall neatly into either category; it may lie somewhere in the middle of the spectrum. In such cases, the analytical technique calls for partial or pro rata consolidation and usually the presumption of additional investment, that is, the money the company likely would spend to bail out the unit in which it has invested. This characterization of the relationship also governs the approach to rating the debt of the subsidiary or the project. The size of the gap between the stand-alone credit quality of the project or unit and that of the group, sponsor, or parent is a function of the perceived relationship: the greater the integration, the greater the potential for parent or sponsor support. The reciprocal of burdening the parent with the nonrecourse debt is the attribution of support to that debt. The notion of support extends beyond formal or legal aspects—and can narrow, and sometimes even close, the gap between the rating level of the parent and that of the issuing unit. If the credit quality of a subsidiary is higher than that of the parent, the ability of the parent to control the unit typically caps the rating at the parent level. Exceptions are made in the case of bankruptcy-remote special purpose vehicles for securitization, regulated entities, independent finance subsidiaries, and the rare instances that have extremely tight covenant protection. The measure of control the parent can exercise is very much a function of ownership, so the percent of ownership of a joint venture or project and the nature of the other owner are critical rating criteria in such situations. Where two owners can prevent each other from harming the credit quality of a joint venture, the debt of the venture can be rated higher than either's rating, if justified on a stand-alone basis. Formal support--such as a guarantee (not merely a comfort letter)--by one parent or sponsor ensures that the debt will be rated at the level of the support provider. Support from more than one party, such as a joint and several guarantee, can lead to a rating higher than that of either support provider. (See Public Finance Criteria--Jointly Supported Debt.) Determining factors. No single factor determines the analytical view of the relationship with the business venture in question. Rather, these are several factors that, taken together, will lead to one characterization or another. These factors include: Strategic importance--integrated lines of business or critical supplier; Percentage ownership (current and prospective); Management control; Shared name; Domicile in same country; Common sources of capital; Financial capacity for providing support; Significance of amount of investment; Investment relative to amount of debt at the venture or project; Nature of other owners (strategic or financial; financial capacity); Management's stated posture; Track record of parent company in similar circumstances; and The nature of potential risks. Some factors indicate an economic rationale for a close relationship or debt support. Others, such as management control or shared name, pertain also to a moral obligation, with respect to the venture and its liabilities. Accordingly, it can be crucial to distinguish between cases where the risk of default is related to commercial or economic factors, and where it arises from litigation or political factors. (No parent company or sponsor can be expected to feel a moral obligation if its unit is expropriated.) Percentage ownership is an important indication of control, but it is not viewed in the same absolute fashion that dictates the accounting treatment of the relationship. Standard & Poor's also tries to be pragmatic in its analysis. For example, awareness of a handshake agreement to support an ostensibly nonrecourse loan would overshadow other indicative factors. Clearly, there is an element of subjectivity in assessing most of these factors, as well as the overall conclusion regarding the relationship. There is no magic formula for the combination of these factors that would lead to one analytical approach or another. Regulated companies. Normal criteria against rating a subsidiary higher than a parent do not necessarily apply to a regulated subsidiary. A regulated subsidiary is indeed rated higher than the parent if its stand-alone strength so warrants and regulatory protection is sufficiently strong. However, the nature of regulation has been changing--and creditors can rely on regulators to a much smaller extent that in the past. For one thing, deregulation is spreading. As competition enters markets, the providers are no longer monopolies--and the basis of regulation is completely different. Most of all, regulators are more concerned with service quality than credit quality. For example, some regulated utilities are strong credits on a stand-alone basis, but often are owned by companies that finance their holding in the utility with debt at the parent company (known as double leveraging), or that own other, weaker business units. To achieve a rating differential from that of the consolidated group requires evidence--based on the specific regulatory circumstances--that regulators will act to protect the utility's credit profile. The analyst makes this determination on a case-by-case basis, because regulatory jurisdictions vary. Implications of regulation are different for companies in Wisconsin and those in Florida or those subject to the scrutiny of the Securities and Exchange Commission under the 1935 Public Utilities Act. Also, regulators might react differently depending on whether funds that would be withdrawn from the utility were destined to support an out-of-state affiliate or another in-state entity. Finally, while regulators may be inclined to support investment-grade credit quality, there is little basis to believe regulators would insist that a utility maintain an 'A' profile. Their mandate is to protect provision of services--which is not a direct function of the provider's financial health. In fact, if a utility has little debt, the overall cost of capital, and therefore the cost of service, can be higher. There is a corollary that negatively affects the parent and weaker units whenever a utility subsidiary is rated on its stand-alone strength. If the regulated utility is indeed insulated from the other units in its group, its cash flow is less available to support them. To the extent, then, that a utility is rated higher than the consolidated group's credit quality, the parent and weaker units are correspondingly rated lower than the group rating level. Foreign ownership. Parent/subsidiary considerations are somewhat different when a company is owned by a foreign parent or group. The foreign parent is not subject to the same bankruptcy code, so a bankruptcy of the parent would not, in and of itself, prompt a bankruptcy of the subsidiary. In most jurisdictions, insolvency is treated differently from the way it is treated in the U.S., and various legal and regulatory constraints and incentives need to be considered. Still, in all circumstances, it is important to evaluate the parent's credit quality. The foreign parent's creditworthiness is a crucial factor in the subsidiary's rating to the extent the parent might be willing and able either to infuse the subsidiary with cash or draw cash from it. A separate parent or group rating will be assigned (on a confidential basis) to facilitate this analysis. Even when subsidiaries are rated higher than foreign parents, the gap usually does not exceed one full rating category. It is difficult to justify a larger gap, because it would entail a clear-cut demonstration that, even under a stress scenario, the parent's interest would be best served by keeping the subsidiary financially strong, rather than using it as a source of cash. In the opposite case of weak subsidiaries and strong foreign parents, the ratings gap tends to be larger than if both were domestic entities. Sovereign boundaries impede integration and make it easier for a foreign parent to distance itself in the event of problems at the subsidiary. "Smoke-and-mirrors" subsidiaries. Some multibusiness enterprises controlled by a single investor or family are characterized by: Unusually complex organizational structures; Opportunistic buying and selling of operations, with little or no strategic justification; Cash or assets moved between units to achieve some advantage for the controlling party; and Aggressive use of financial leverage. By their nature, these types of companies tend to be highly speculative credits, and it is inadvisable to base credit judgments on the profile of any specific unit at any particular point in time. The approach to rating a unit of such an organization still begins with some assessment of the entire group. Some of the affiliated units may be private companies; nonetheless, at least some rough assessment must be developed. In general, no unit in the group is rated higher than the consolidated group would be rated. Neither indenture covenants nor nonconsolidation opinions can be relied on to support a higher rating for a particular subsidiary. At the same time, there is no reason for all entities in a "smoke-and-mirrors" family to receive the identical rating. Any individual unit can be notched down as far as needed from the consolidated rating to reflect stand-alone weakness. This reflects the probability that a weak unit will be allowed to fail if the controlling party determines no value can be salvaged from it. Complex structures are developed in order to maximize such flexibility for the controlling party. Finance Subsidiaries' Rating Link to Parent Finance units are unlike other subsidiaries from a criteria perspective. In turn, there are two types of finance subsidiaries--independent and captive--that are very distinct in terms of the analytical approach employed by Standard & Poor's Ratings Services. Independent finance subsidiaries. Independent finance subsidiaries can receive ratings higher than those of the parent, because of the high degree of separation between these subsidiaries and the parent. A finance company's continuous need for capital at a competitive cost creates a powerful incentive to maintain its creditworthiness. Therefore, it can be argued that the parent would be better served, in a stress scenario, by divesting the still-healthy subsidiary than by weakening it or risking drawing it into bankruptcy. In addition, there must be evidence of the parent company's willingness to leave the subsidiary alone, including a history of reasonable dividend and management fee payouts to the parent. Nonetheless, a finance company subsidiary rating still is linked to the credit quality of the company to which it belongs. If the finance company's credit fundamentals are stronger than those of the consolidated entity, one cannot rule out the risk that this strength could be siphoned off to support weaker affiliates or service the debt burden of the parent. Whatever the rating would be on a stand-alone assessment, it is unlikely an independent finance subsidiary would ever be rated more than one full rating category above the parent rating level. To the extent that part of the receivables portfolio were related to parent company sales, there would be an additional tie to the parent risk profile. Conversely, if the consolidated entity's rating is higher than the subsidiary's, because of the stronger creditworthiness of the other affiliates, the analysis would attribute some of that strength to the finance company, making possible a higher rating than it could receive on its own. Assessing the degree of credit support includes the usual subjective factors, such as management intentions and shared names of the parent and subsidiary. In the case of a subsidiary that has been formed or acquired only recently, a demonstrable record of support is lacking and questions might remain concerning the long-term strategy for the subsidiary. Some formal support likely will be required. The most frequently used support agreement commits the parent to maintain some minimum level of net worth at its subsidiary. Frequently, the parent also will agree to assume problem assets and to maintain minimum fixed-charge coverage. Captive finance companies. A captive finance company--i.e., a finance subsidiary with over 70% of its portfolio consisting of receivables generated by sales of the parent's or group's goods or services--is always assigned the same rating as the parent. Captive finance companies and their operating company parents are viewed as a single business enterprise. The finance company is a marketing tool of the parent, facilitating the sale of goods or services by providing financing to the dealer organization (wholesale financing) and/or the final customer (retail financing). The business link between an operating-company parent and captive is the key consideration supporting the subsidiary's rating at the parent company level, apart from any support arrangements between the two. The parent's investment in the captive (in the form of equity and advances) may also provide economic incentive to maintain the captive's financial health. Conversely, a captive that appears strong on a stand-alone basis is not rated higher than its operating company. Because of the operational tie-in, the parent does not have the same options for divesting a healthy captive as in the case of an independent finance subsidiary. Eventually, then, the captive's bankruptcy risk is closely linked to that of its parent. This viewpoint is based in part on case history. A parent-company bankruptcy filing usually will result in a filing by its captive, either simultaneously or soon thereafter. Captive finance company debtholders may be better off than the parent debtholders with respect to ultimate recovery in a liquidation or reorganization, but bankruptcy would impair the timeliness of payments. Methodology. While the captive and parent ratings are equalized, the two are not analyzed on a consolidated basis. Rather, the analysis segregates financing activities from manufacturing activities and analyzes each separately, reflecting the different type of assets they possess. No matter how a company accounts for its financing activity in its financial statements, the analysis creates a pro forma captive unit to apply finance-company analytical techniques to the captive-finance activity, and correspondingly appropriate analytical techniques to the operating company. Finance assets and related debt liabilities are included in the pro forma finance company; all other assets and liabilities are included with the parent company. Similarly, only finance-related revenues and expenses are included in the pro forma finance company. The debt and equity of parents and captives are apportioned and reapportioned so that both entities will reflect similar credit quality. A tentative rating for the two companies is assumed as a starting point. Next, a leverage factor is determined that is appropriate for the captive at the tentative rating level, based on the quality of the captive's wholesale and retail receivables. With the appropriate leverage determined, the analyst calculates the amount of equity required to support credit quality at the assumed level, and the proper amounts of debt or equity can be transferred either to the parent from the captive or to the captive from the parent. No new debt or equity is created. Next, the analyst determines levels of revenues and expenses reflective of the captive's receivables and debt. The higher the tentative rating, the greater the level of imputed fixed-charge coverage and return on assets. For purposes of this analysis, any earnings support payments are transferred back to the parent. The analyst eliminates the parent's investment in the captive to avoid double leveraging. The captive is an integral part of the enterprise, not an investment to be sold. While its assets can be more highly leveraged than those of the parent, the methodology takes that into account when determining an amount of equity that is apportioned to support its debt. Following the segregation of the finance activity, the operating company profile may not be consistent with the tentative rating. The methodology is repeated, using parameters of a higher or lower rating level. Several iterations may be needed to determine a rating level that reflects the credit quality of both operating and financing aspects of the company. Leverage guidelines. The receivables portfolio of the pro forma captive entity is analyzed, as for any finance company. Both quantitative and qualitative assessments are made. Portfolios deemed to be of average quality include consumer credit card, commercial working capital, and agricultural wholesale. Auto retail paper is of higher quality, all other things being equal, while portfolios of commercial real estate and oil credit-card assets are generally less leverageable. Adjustments are made to reflect the performance of a given subportfolio. In addition, factors such as underwriting, charge-off policy, and portfolio concentration or diversity are considered. Securitization of finance receivables. An increasingly common funding mechanism for finance companies is the sale or securitization of finance receivables through structured transactions. Where companies sell finance receivables that are regenerative in nature (such as the operating assets financed by a captive for its parent), Our analytical approach in assessing leverage is to uniformly add back the sold receivables outstanding and a like amount of debt (the same treatment as the sale of regenerating trade receivables of operating companies, as explained in Rating Methodology: Industrials and Utilities). When the level of assets being financed is truly at the discretion of the finance company, there may be no need to add back receivables sold. The question then is one of permanence of the level of financial activity. No adjustment is made to add back the sold receivables, if the analyst has concluded the unit will continue to operate at a lower asset level. In those cases, the analysis focuses on the actual economic risks remaining with the company relative to the sold receivables. Depending on the type of transaction, the residual risks take the form of capitalized excess servicing, spread accounts, deposits due from trusts, and retained subordinated interests. If a company retains the subordinated piece of a securitization, or retains a level of recourse close to the expected level of loss, essentially all of the economic risk remains with the seller. There is no rating benefit deserved because there is no significant transfer of risk--and there is no point in analyzing such a company differently from the way it would be analyzed had it kept the receivables on its balance sheet. Another serious concern is moral recourse, i.e., the reality that companies believe they must bail out a troubled securitization, although there is no legal requirement for them to do so. Companies that depend on securitization as a funding source may be especially prone to taking such actions. In many situations, this expectation undermines the notion of securitization as a risk-transfer mechanism. (Also see "2008 Corporate Criteria: Ratios And Adjustments," published April 15, 2008.)