

Article Title: ARCHIVE | Criteria | Corporates | General: Issuing Equity Hybrids Via A Corporate Issuer's Operating Subsidiaries Data: (EDITOR'S NOTE: —This article, originally published on July 26, 2007, is no longer current. It has been superseded by "Hybrid Capital Handbook: September 2008 Edition," published Sept. 15, 2008.) Operating Subsidiaries Issuing Equity Hybrids Many companies structure their operating units as distinct legal entities, owned, controlled, and consolidated by the parent company. (This is especially the case in the utility business, where the operating subsidiaries are regulated entities. It is also the case for financial institutions, but this article relates only to corporate issuers.) If such operating subsidiaries issue equity hybrids, the rating benefit extends to the parent company and the larger consolidated entity--inasmuch as Standard & Poor's Ratings Services' analysis focuses on the consolidated economic entity. Issuance at the subsidiary level does pose some questions regarding how the equity aspects help parent company creditors. In particular, the lack of subordination and the potential for trapping funds at the subsidiary are two concerns that differentiate subsidiary issuance from parent issuance. However, we believe the equity credit for the parent is generally deserved, as explained below. Structural subordination A critical element of equity is subordination--and equity hybrids feature deep subordination (with the exception of trade payables). The significance of subordination is two-fold. It creates a cushion to absorb losses in bankruptcy, which leads to higher recovery (loss given default) on senior issues. In turn, the better recovery prospects for senior issues allows the company greater access to (senior) capital, enabling it to stave off a default in the first place. It is precisely this latter consideration which is important for the corporate credit rating (see "Equity Credit: What It Is, And How You Get It--Attributes of Equity", Corporate Ratings Criteria--2006, p. 74, on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis). In the case of subsidiary issuance, the subordination pertains to other claims against that subsidiary--but the hybrid's claim actually is senior to claims of parent company creditors. This priority of claims is referred to as structural subordination (of parent company creditor claims—even senior debt claims). Nonetheless, equity issued by a subsidiary enhances capital access, by reassuring potential debt providers to the subsidiary itself. As long as the subsidiary is positioned to raise additional funds--and it can direct those funds to its parent or affiliates--the default risk for the entire consolidated entity, including the parent, is lower. (As far as recovery prospects, parent company debt issues would indeed be disadvantaged by adding to operating company claims. Our recovery ratings and notching of parent issue ratings would reflect such priority claims.) Dividend stoppers As noted, we normally assume that parents and subsidiaries are free to direct cash at will throughout the consolidated group. (Indeed, in cases where this is effectively restricted--for example, by regulators or covenants--we do not apply the consolidated rating methodology.) Thus, the ability to defer payments on the equity hybrid is beneficial, not just for the immediate subsidiary that issued the hybrid, but also for the group as a whole, since the cash conserved can be directed to affiliates as needed. There is a concern, however, that cash conserved by the subsidiary from dividend deferral may not be available to its affiliates by virtue of the typical dividend-stopper provisions in the hybrid security. These provisions force the cessation of common dividends as long as the hybrid periodic payments are being deferred. If the dividend stopper pertains to dividend payments by the subsidiary to its parent, the cash conserved may be trapped at the subsidiary, limiting the equity benefit associated with the hybrid. There are, however, mitigating considerations regarding the dividend stopper: There is no requirement that a dividend stopper should apply to inter-company dividends. Some utilities have issued subsidiary securities that restrict payment of dividends by the parent on parent common stock; the subsidiary is free to pay dividends to the parent. (The linkage to parent company dividends adds a disincentive to defer. However, this consideration applies broadly to equity hybrids issued by the parent company. Accordingly, the issuance via a subsidiary is no more problematic than if the parent were the issuer.) There usually are ways other than common dividends to transfer cash inter-company, including, for example, loans and advances. Moreover, the dividend-stopper clauses of some utility hybrids have actually spelled out and permitted the up-streaming of cash payments to the parent for specific operating needs. (Of course, if there are constraints in individual situations—such as tax-related issues—our analysis will take the specific fact pattern into account.) The scenarios under which hybrid payments are deferred could well involve stress at the issuing subsidiary itself. (Indeed, the more significant the role of a particular operating subsidiary relative to its group, the more likely that

the group's distress emanates from that operating subsidiary.) In that case, the cash conserved directly assists the subsidiary meet its various obligations. And, indirectly, the parent benefits by avoiding the need to down-stream cash to help its subsidiary.