Article Title: ARCHIVE | Criteria | Corporates | General: Analytical Approach To Rating Financial-Industrial Groups Data: (EDITOR'S NOTE: — This criteria has been retired and is no longer current.) The complex web of relationships behind FIGs and their poor level of transparency create significant problems from the perspective of credit analysis and credit rating. Credit assessment of a FIG group company obviously must include a stand-alone assessment of the rated company, involving standard tools such as industry analysis, competitive assessment, and financial analysis. However, in many, cases it is not possible, or realistic, to assess the credit standing of FIG companies simply from a stand-alone perspective. Membership in a FIG can have positive, negative, or neutral impacts on the credit quality of individual FIG companies. These issues must be explored on a case-by-case basis in management meetings with the rated issuer—and, if necessary, with their owners or other relevant FIG group companies. An understanding of formal ownership structures is important, as is a general appreciation of the competitive and financial profiles of other group companies. To the extent that analytical credit is given to a FIG member for group membership that results in a higher rating than would be the case on a stand-alone basis, a law of "credit physics" must apply: to the extent that FIG membership raises the credit quality of one FIG member, this must be offset by a deterioration in the credit quality of the entity or entities providing the credit enhancement, at least in a contingent liability context. To the extent that a FIG company's own credit standing may be affected directly by the credit quality of another group company, this necessitates a rigorous credit analysis not only of the rated company, but also of the key group company or companies that exert an important influence on the FIG as a whole. This may be particularly true with regard to properly understanding interdependencies between FIG banks and industrial enterprises. To date, Standard & Poor's has published relatively few ratings on banks or industrial enterprises that are members of FIGs. Of the 25 ratings of Russian issuers that Standard & Poor's has published as of June 1998, only seven are members of official or unofficial FIGs, with six of the ratings being for financial institutions. In all these cases, ratings of the Russian banks are in the 'B' range, below Russia's foreign currency rating. This reflects Standard & Poor's general concerns regarding the Russian financial sector. The one industrial FIG that has been rated to date is Lukoil, whose foreign currency rating is at the sovereign's level. There have been cases where Standard & Poor's has refused to publish ratings on individual FIG banks when insufficient information was available regarding the broader FIG structure. (insert chart/diagram) The impact of FIGs on the assessment of credit risk can be approached by assessing different obligor types. The main categories can be divided as follows: financial institutions, industrial enterprises, regional governments, and the sovereign risk-assessment of the Russian state. Bank Rating Implications When the bank acts essentially as a house bank for an industrial conglomerate, this argues for the evaluation of the bank's creditworthiness to be close to, if not entirely equal to, that of the conglomerate as a whole. Given the relative sizes and importance to the economy of some of the industrial enterprises, this might serve to raise the ratings of the bank if the owner clearly signals a willingness to marshal the resources of the entire group to support the bank, and if the bank is seen as performing vital functions for the group. To be able to evaluate the bank on a stand-alone basis, an important issue to examine is the degree to which it has diversified its client base and its strategy away from the group. In this aspect, there is often a vast discrepancy among the banks. Some have built up an infrastructure surrounding the lending function and other product lines, while others have not. Often the sentiment is repeated that it is dangerous to lend to companies the bank does not control, given the legal and informational infrastructure of Russia at this stage of development. While there is often much truth in this, the ability to deal with such risks, nevertheless, is the essence of a true bank. A step in this direction is often to finance the customers for purchases of group products, much like a captive finance company would do. In this case, the issue is still the extent to which the transactions are on market terms and made at arm's length. Equity holdings in industrial companies are considered to be among the riskier assets in a bank balance sheet because of potential fluctuations in value. As the shares in many of the industrial holdings are not publicly traded, this fluctuation is difficult to track. When the portfolio of investments is fairly diversified, as with Rossiyskiy Kredit and Inkombank, for example, Standard & Poor's analyzes the holdings much as it would a venture capital operation. That is, it inquires into the managerial expertise that can be brought to bear on restructuring the enterprises in the portfolio, into valuation techniques, into the means by which the financial performance of the enterprises is tracked, and whether they are profitable. In addition, the investment and exit strategy is important. A specific strategy to restructure and then sell the enterprises is looked upon more favorably than an intent to hold indefinitely. As to the valuation of shares, given that many of the holdings were accumulated at fire-sale prices in a hurried privatization process, one can only assume that there is enormous latent value in many of the enterprises, as long as the companies remain viable. Unfortunately, the ownership of industrial enterprises is rarely as transparent as in the case of Inkombank, which publishes consolidated statements. For one thing, regulations prohibit equity holdings over 25% of bank capital by the bank itself. More often, the issue is one of a common owner or small group of owners, who own both the bank and the industrial companies, often through anonymous shell companies. Sometimes, the bank may fund the purchases of the shares, though ownership of shares may be outside the bank. In any case, the industrial group can cloud the basis of the bank's client relationships, casting doubt as to whether they are purely commercial or serving the larger needs of the group as a whole. The interconnectedness of the group means that the ratings of its members can never be analyzed in isolation. Given the relative sizes of the institutions, the rating of the industrials is likely to be an overwhelming factor. That is, while the bank is analyzed on a stand-alone basis to the extent possible, where the rating of the industrial is higher than the bank's it can serve to pull up the bank's rating; where it is lower, it can pull the bank's rating down. The ratings will not necessarily be equalized. The degree to which the bank has individuated itself from the group will be an important consideration. Some banks will have developed a client base outside the group, a risk-management infrastructure, and a line of products that enables them to compete. Others will be completely focused on fulfilling the needs of the group. Also, an important consideration will be some gauge of the parent's willingness to support the bank. Willingness is gauged not only on the basis of professions of support, but on the business incentives to do so. SideBarField001 Corporate Rating Implications As with financial institutions, analysis of an industrial enterprise within a FIG structure gives rise to the assessment of the role that the particular enterprise plays within the FIG. Some industrials may serve as the key strategic holding within a FIG, and therefore may be viewed as having the greatest priority in receiving equity or debt financing from the FIG bank—whether directed specifically by the bank or by the ultimate managers controlling the FIG. Other firms may play a less strategic role, and therefore could be subject to less preferential access to intragroup finance. Hence, liquidity risks need to be understood and reflected in the rating. The role of management in industrial restructuring is an important analytical factor in the rating of any enterprise in a transition economy, whether or not the firm is part of a larger FIG structure. In the case of FIG enterprises, management assessment is required, not only of the manager of the enterprise itself. However, where relevant, it is also important to understand the attitude of the FIG managers toward industrial restructuring. Rating factors to be assessed in this context include the extent to which: Restructuring and adaptation to the competitive market economy is being implemented through requisite changes in management, organization structure, headcount, products, technologies, and markets; Corporate governance is being promoted to protect the interests of all stakeholders, including minority shareholders and creditors; FIG managers may use their financial holdings to ensure that FIG industrials have access to long-term funding to facilitate industrial restructuring ,as well as short-term funding to provide a stable base of liquidity and working capital; Intercompany arrears problems are being addressed and the role of barter in commercial transactions is diminishing; Relevant financial and operating data are available, providing managers with the necessary analytical tools and information systems to properly manage their companies; and Financial and operating data are made public to provide the necessary transparency to attract external investors of debt and equity capital on a stable basis. Even though the FIG may not be organized formally in a holding company structure, strategic and financial interdependencies call for an analytical approach similar to that of examining holding structures—and the resultant parent-subsidiary relationships. Inevitably, a group affiliation gives rise to the potential for credit enhancement or contingent liabilities that can be difficult to identify and incorporate into a rigorous credit analysis. However, the absence of consolidated and consolidating financial statements that facilitate holding company analysis can pose significant challenges of FIG industrials in this context. Stand-alone business and financial risk assessments of the individual FIG industrial remain at the heart of the rating analysis. Absent an unambiguous and legally valid guarantee from another FIG member, these fundamental risk factors are likely to be constraining factors for the rating of any FIG enterprise. Even in situations where guarantees are in place, a rating assessment must take into consideration management control systems and motivations of a guarantor to provide confidence that guarantees will be honored on a timely basis. In the case of FIGs operating in sectors with related industrial holdings, the credit assessment of an individual firm necessitates an awareness of direct or indirect financial support structures within the group. Such support can be granted by intercompany advances, investments, or in commercial transactions (such as transfer pricing) that are conducted on preferential, as opposed to arm's length, terms. Given that such information is unlikely to be disclosed publicly, assessment of the general operating and financial positions of other group industrials may be required to provide some indication as to the possibility of one FIG group company being used to support another. In sum, membership in a FIG can be a source of credit strength for weak FIG industrials that are members of a stronger FIG structure. However, for the stronger FIG industrials, weaker group members might actually pose a contingent liability—either to support weaker industrial enterprises in the FIG, or to provide ultimate support to the FIG bank. From a rating perspective, opportunities for rating enhancement as a result of FIG group membership are likely to be infrequent, and granted only in those cases where evidence of broader FIG group support is overwhelming. However, it is a somewhat more likely scenario that assessment of potential contingent liabilities to other group companies could limit or reduce the rating level of the stronger companies within the FIG. Regional Government Rating Implications Though FIGs are associated primarily with interlinked banks and industrial enterprises operating in the competitive sector, it is the case that regional governments can also be affected by groupings of financial and industrial companies. The City of Moscow, for example, is often referred to as an "unofficial" FIG, given its various financial and industrial holdings. Other cities and regional governments have similar exposures. While financial and industrial holdings by regional and local governments fall outside the traditional FIG structure, nevertheless it is the case that the credit assessments and ratings of Russian regional governments can be affected by such holdings. Similar to the assessment of contingent liabilities brought by weaker FIG companies to the stronger members of a FIG, credit analysis of regional governments must also reflect potential contingent liabilities that weak companies with regional government ownership pose to the regional government itself. This is of particular importance in cases where the regional government has an explicit policy of taking positions in financial and industrial companies. For example, the City of Moscow's past purchase of an equity stake in the automotive firm Zil represented the city's approach to providing support to troubled industrial firms of strategic importance to the city. This action raises questions as to what extent Moscow, or other regional governments, might be similarly motivated to provide support to other important regional enterprises in distress. Sovereign Rating Implications FIGs have been associated with the Russian federal government in part through their influence on the political process, notably the 1996 elections, and in part through past and ongoing involvement of key FIG managers—Vladimir Potanin and Boris Berezovsky, for example—in important government positions. Indeed, the loans-for-shares programs and government sales of state-owned companies often have provided great financial advantages to FIGs and have raised concerns of establishing a "crony capitalism" that serves the interests of a small group of entrepreneurs at the expense of broader national social and economic concerns. While these issues remain important to Russia's political economy, they are not the most immediate concerns from a credit-rating perspective. The main credit issue, particularly relating to how FIGs might affect the sovereign credit rating, relates to the potential contingent liability that FIGs as a whole may pose to Russia's central government. Certainly, in the case of Korea, the weakness of the chaebol had a direct impact on the sovereign, in that the sovereign ultimately was motivated to take actions to financially support the chaebol, which in turn damaged Korea's own credit quality. This reflects the intrinsic interconnectedness of the private sector and the public sector in national economies. However, in the case of Russia, contingent liabilities posed by potential financial weakness of FIGs are less likely to have a similarly damaging effect on Russia's own credit quality compared with the impact that the weakness of the chaebol had this past year on the Korean economy. This is specifically because Russian FIGs are less leveraged than Korean FIGs. Research conducted by Standard & Poor's (see CreditWeek Dec. 10, 1997) demonstrated that while the absolute risk of Russia's financial system is high, the relative size of the financial system relative to the economy as a whole is low. For example, in Russia, the amount of domestic credit extended by the banking system to the private sector and nonfinancial public enterprises is about 14% of Russian GDP, whereas in Korea the level is about 74% of GDP. Consequently, Russian industrial enterprises, including those that are members of FIGs, have relatively limited financial debt, given that neither domestic nor international financing has been readily available in the past. Hence, while FIG companies individually, and FIG groups as whole structures, are susceptible to financial stress, the magnitude of financial debt that might be adversely affected by such stress by itself is not sufficiently large to trigger a widescale macroeconomic crisis in Russia, compared to what was experienced recently in Korea. As such, FIGs pose less of an immediate threat to Russia's sovereign credit quality and rating than might be the case in other more leveraged economies. However, though the actual contingent liability posed by FIGs may be relatively small compared with the size of the Russian economy, failure of a FIG—or more specifically, a leading FIG bank—would certainly have a negative impact on Russia's economy. The impact of such an event would likely be a loss of confidence of both domestic and foreign investors in Russia. In turn, this could create a liquidity crunch and lead to capital flows out of Russia. Longer term, the impact of FIGs on Russia's real economy and microeconomic transition stand to affect Russia's sovereign credit risk. To the extent that FIGs fail to promote economic restructuring, many key Russian industrial enterprises will not be in a position to compete effectively in the global market economy. Lack of restructuring and insufficient attention to reforms in corporate governance will have the effect of muting the "real" economy in Russia. Such a scenario would bring knock-on effects at the sovereign level. On the fiscal side, it would impact negatively the size of both the corporate and individual tax bases. On the external front, there would be the effect of discouraging foreign direct investment. Such factors are not likely to pull down Russia's rating by themselves, but could play a role in holding back improvements in the rating over time. Conversely, to the extent that FIGs adopt a more progressive role, the impact they exert on the Russian economy could be very positive—enabling Russian industry to compete more effectively on the world stage. This would obviously go a great distance to building financial strength at a microeconomic level in Russia. In turn, macroeconomic improvements could lead over time to improvements in credit quality at the sovereign level. In sum, it is premature to make definitive conclusions regarding the role of FIGs in Russia's economy. As individual issuers, their credit assessment remains problematic, and will continue to be so until standards of disclosure and transparency improve enough to allow for greater understanding of the complex interconnections within FIGs. With regard to their impact on Russia's economic development as a whole, FIGs have yet to establish themselves as positive agents for change in Russia. Going forward, their progress—or lack thereof—will play a role in determining how Russia's credit quality evolves: both at a micro- and a macro-economic level. Chart 1