

ACRA

Methodology for Analyzing Member Company Relationships Within Corporate Groups

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1 Scope of methodology

The Methodology for Analyzing Member Company Relationships Within Corporate Groups is used to evaluate and account for the influence of parent entities registered in the Russian Federation, on the creditworthiness of rated entities, i.e., both financial and non-financial organizations.

Not being a comprehensive document, this methodology contains references to other methodologies of the Analytical Credit Rating Agency (hereinafter, ACRA or the Agency) methodologies; in particular, to those for assigning credit ratings under the national scale. This methodology is inapplicable for ratings of regional and municipal authorities or small and medium-sized businesses.

Rated entities, whose standalone creditworthiness assessments (SCA) are group structure adjusted, are classified as group influenced rated entities. This implies that creditworthiness of a rated entity, in addition to its standalone creditworthiness, is determined by both its significance within the supporting institution (SI) and the SI's influence on the operations and financial dealings of the rated entity. Furthermore, a group influenced entity's creditworthiness depends on its SI's ability to provide it with extraordinary support or, when necessary, use the rated entity's resources to the benefit of its other affiliates or shareholders.

The use of this methodology usually calls for a preliminary SCA calculation of a rated entity, for which purpose ACRA applies methodologies developed specifically for different types of rated entities, with possible adjustments for the influence of foreign SI. If an SCA cannot be performed but the rated entity has a high degree of relationship with the SI, the Agency either establishes parity between the credit rating and the SICA rating, or discounts the SICA.

If the Agency regards a rated entity as government-associated, with the latter's support playing the most significant role for this rated entity, then, in order to account for external support, ACRA shall use the Methodology for Analyzing Relationships Between Rated Entities and the State.

This methodology shall be applied on a permanent basis until a new edition is approved by the ACRA Methodological Committee.

Credit ratings assigned according to this methodology shall be revised in compliance with the Federal Law of 13 July 2015 No 222-FZ On the Activities of Credit Rating Agencies in the Russian Federation, On the Amendment to Article 76.1 of the Federal Law 'On the Central Bank of the Russian Federation (Bank of Russia)' and the invalidation of certain provisions of legal acts of the Russian Federation, as well as in accordance with ACRA internal documents, but not later than 365 days past the date of the latest rating action.

In order to keep this methodology up to date, ACRA shall review and amend it in the following cases:

- over three instances of deviation from this methodology while performing rating activities over the course of one quarter;

- requirement for amendments based on the results of methodologies application monitoring conducted by the methodology group;
- conflict between this methodology and Federal Law of 13 July 2015 No 222-FZ On the Activities of Credit Rating Agencies in the Russian Federation, On the Amendment to Article 76.1 of the Federal Law 'On the Central Bank of the Russian Federation (Bank of Russia)' and the invalidation of certain provisions of legal acts of the Russian Federation;
- request for immediate revision of this methodology filed by the Compliance and Internal Control Service of ACRA.

ACRA shall review this methodology in accordance with its internal documents within one calendar year after the latest review date. A review may bring amendments to the methodology, or leave it unchanged until the next review.

Any deviation from this methodology in the course of its application shall be documented and disclosed on ACRA's official website www.acra-ratings.ru simultaneously with a credit rating or a credit rating outlook publication and with an indication of reasons for such deviation.

If any errors that already affected or may potentially affect credit ratings and/or credit rating outlooks are detected in this methodology, ACRA shall conduct its analysis and review in accordance with the established procedure. Reports of each such instance and the updated versions of the methodology shall be submitted to the Bank of Russia in accordance with the set procedure. If errors discovered in this methodology may impact any previously assigned credit ratings, ACRA shall disclose such information on its official website www.acra-ratings.ru.

If the planned amendments to this methodology are significant and affect or may potentially affect the current credit ratings, ACRA shall do the following:

- 1) file with the Bank of Russia and disclose on its official website www.acra-ratings.ru the full information about the planned amendments to the current methodology, with an indication of reasons and consequences that such changes may entail, including impact on credit ratings assigned in accordance with this methodology;
- 2) assess the need for revision of all credit ratings assigned in accordance with this methodology within six months after the latest amendment date;
- 3) revise credit ratings within six months after the latest amendment date, if the assessment results identify a need for revision.

2 Methodology basic principles

One of the main criteria that call for SCA adjustments within the framework of this Methodology is the likelihood of a SI providing extraordinary support to a Rated Entity in the event of potential severe deterioration of the latter's financial standing. Another criterion is the likelihood of the SI appealing to a member Rated Entity for extraordinary support in the event of potential severe deterioration in the SI's finances. Thus, SCA adjustments can be made both upward and downward.

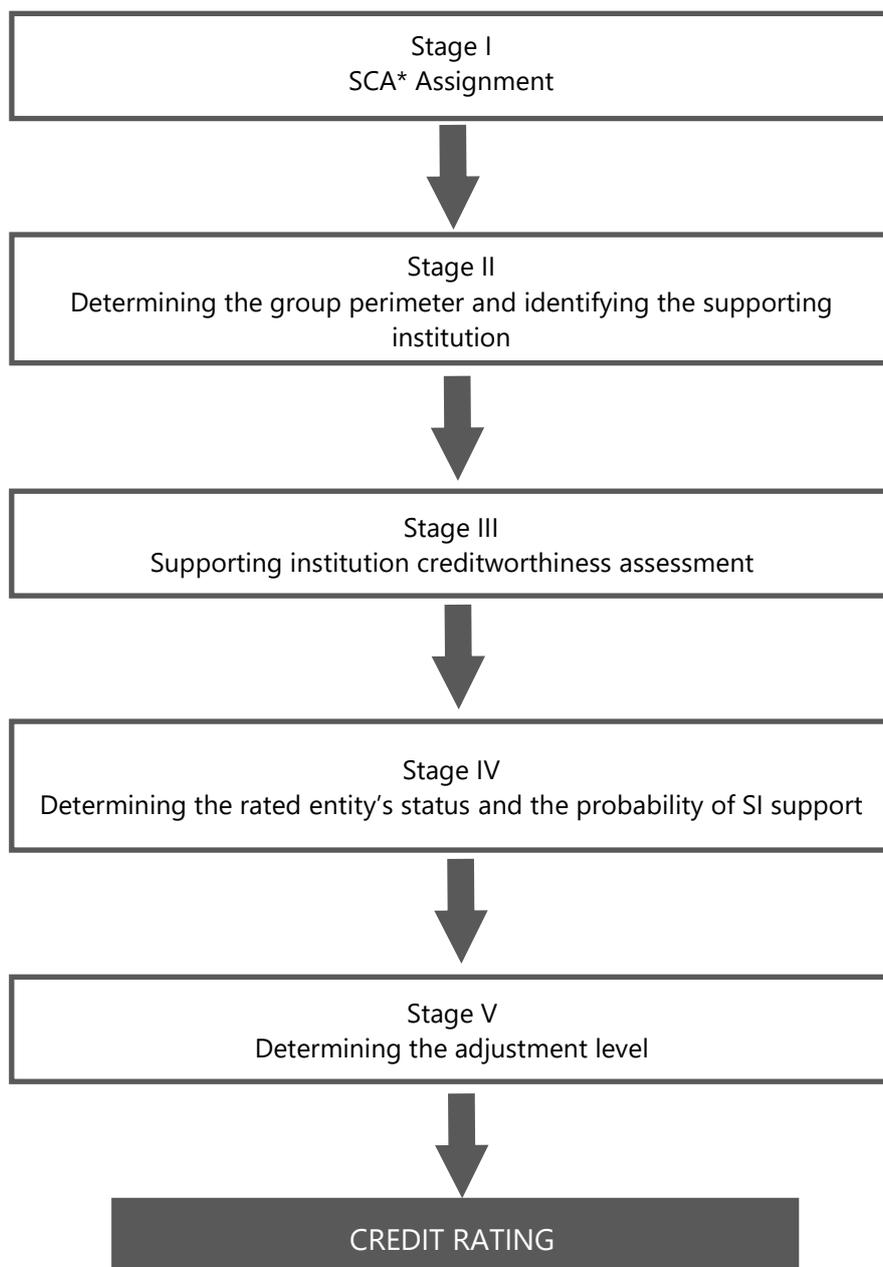
When determining the final SCA adjustment level, ACRA performs assessments of SI creditworthiness (SICA) and analyzes the degree of relationships between SI and its member Rated Entities.

A substantial SI's stake in the share capital of a Rated Entity is not regarded as sufficient condition for a rating adjustment.

The Group Influenced Rated Entity's SCA cannot exceed the SICA level.

3 Analysis structure

Figure 1. Analysis structure of member company relationships within corporate groups



* If it is deemed impossible or impractical to determine the rated entity's SCA, Stage I can be omitted.

Source: ACRA

4 Analysis Procedure

4.1. Determining the group perimeter and identifying the supporting institution

The terms "group" and "group members" refer to the ultimate parent company and all of the entities, over which it has direct or indirect control. A group consolidation perimeter is reflected in the audited consolidated financial statements of the parent (holding) structure, along with their proportionate shares in joint ventures (individually or jointly controlled).

In most cases, ACRA interprets control as the ability to manage the financial and operating activities of a rated entity. Control can also be interpreted as the ability to manage a group member company's development strategy and cash flows. In many cases, the key indicator of control is ownership of over 50% shares of the rated entity. However, control may potentially be exercised even if a parent company owns less than 50% of the voting stock (shares) and, on the contrary, control may potentially not be exercised even if the parent company owns more than 50% of the voting stock (shares).

Identifying the supporting institution

By supporting institution, ACRA means a company within the group perimeter that provides emergency support to the rated entity. In most cases, this role is played by the parent (holding) structure, but other scenarios are also possible. For example, in a rating analysis context, the supporting institution can be a large operating company within the group that guarantees a substantial portion of the rated entity's loan portfolio.

It should be noted that the supporting institution may not be rated by ACRA. In such an event, the creditworthiness of the SI shall be assessed by ACRA rating analysts, but the Agency reserves the right not to publish the SICA. A SICA is not the same as a credit rating.

If the Agency is of opinion that an SI is an entity registered in the Russian Federation and the rated entity is classified as group influenced, analysis shall be performed in line with this methodology. If the Agency believes that an SI is an entity registered outside the Russian Federation and the rated entity is classified as being under external foreign influence, then the Methodology for Analyzing Member Company Relationships Within Corporate Groups is unapplicable, and analysis shall be performed based on the Methodology for Analyzing Relationships Between Rated Entities and Supporting Organizations Registered Outside the Russian Federation.

4.2. Supporting institution creditworthiness assessment

If a supporting institution is assigned an ACRA credit rating, that rating shall be used in place of the SICA.

If a supporting institution does not have an ACRA credit rating, the Agency shall determine its SICA through the use of the applicable rating methodology and on the basis of public information and data provided by the rated entity. The calculated result is a SICA level expressed in terms of a relevant rating scale. SICA is not the same as a credit rating, since it

serves merely as an auxiliary factor in the rating analysis of a rated entity; neither can it be regarded as a credit quality indicator of a specific debt obligation.

SCAs of rated entities shall be compared with SICAs of their supporting institutions' (or their credit ratings, if available). The results shall be used for determining SI categories.

Weak

If a SICA (or an SI credit rating, if available) is three or more notches below the rated entity's SCA, the SI may potentially face the risk of financial distress and require the use of monetary resources of the rated entity, namely, via paying higher dividends, borrowing inside the group, applying for loan rollovers, having additional share issues, or other mechanisms.

Moderately weak

This category is assigned if a SICA (or an SI credit rating, if available) is 1-2 levels below the rated entity's SCA. In this category, the likelihood that a supporting institution will itself need support, is lower than in the "Weak" category, but it is likely that financial resources of the rated entity will be employed, specifically, via paying higher dividends, borrowing inside the group, having additional share issues, or other mechanisms.

Similar to the rated entity in terms of credit quality (Neutral)

This category is assigned if a SICA (or an SI credit rating, if available) is on the same level as the rated entity's SCA.

When assigning this category, ACRA considers it unlikely that the supporting institution will indeed provide support to the rated entity. On the other hand, ACRA assesses the probability of negative influence by the SI on the rated entity as low.

Moderately strong

This category is assigned if a SICA (or an SI credit rating, if available) is 1-2 level levels above the rated entity's SCA. When assigning this category, ACRA believes that the supporting institution is likely to be able to support the rated entity should the need arise.

Strong

This category is assigned if a SICA (or an SI credit rating, if available) is three or more levels above the rated entity's SCA. When assigning this category, ACRA believes that the supporting institution is highly likely to be able to support the rated entity should the need arise.

4.3. Determining the degree of relationship and likelihood of SI support

In order to determine the likelihood of support provided to a rated entity by the parent company (holding) or another structure acting as its SI, it is necessary to analyze the degree of relationship between the rated entity and the SI.

ACRA identifies five degrees of such relationships, as follows:

- Very weak,
- Weak,
- Moderate,

- Strong,
- Very strong.

The degree of relationship is determined by the following factors:

- Existence of a legal relationship;
- Existence of contingent liabilities (including sureties and guarantees);
- Strategic importance;
- Operational integration.

Legal relationship

In the framework of analyzing legal relationships, ACRA shall assess an SI's ability to successfully manage finances and operations of a rated entity. As a rule, a supporting institution is understood to have control over a rated entity, if the former owns more than 50% of the latter's voting shares (shares). At the same time, ACRA believes that in the absence of a controlling stake, the stronger legal relationship between the companies will be aligned with the largest share of ownership.

Operational control helps to facilitate the establishment of strong relationships between companies. In a similar vein, control over company operations is also instrumental in the development of various support mechanisms when the need for them arises.

ACRA takes into account the fact that a stake in the share capital structure may not always correspond to the actual degree of legal relationship with society at large, e.g., in cases when shareholders are bound by special agreements (predominantly, by shareholder agreements), or when other conditions affect their shareholder powers.

Contingent liabilities

➤ **Guarantees and sureties**

Guarantees (sureties) can be issued either by a supporting institution in favor of a rated entity, or vice versa.

ACRA shall take into account the amount of guaranteed debt (both in absolute and relative terms): a significant amount thereof indicates a strong relationship. ACRA shall also perform analyses of the economic nature of issued guarantees (sureties); specifically, with regards to terms of recourse, validity, exceptions, etc.

Experience in the area of issuing guarantees (sureties), e.g. unsecured loan guarantees, shall be taken into account as an auxiliary indicator of contingent liability assessment.

➤ **Cross defaults**

ACRA believes that a presence of a cross-default provision indicates a strong relationship between the supporting institution and the rated entity. In an event when an assumption of a rated entity defaulting on its obligations necessarily calls for the SI to fully repay its obligations, the latter is more likely to take steps to prevent the rated entity from defaulting.

ACRA shall also take into account the existing corporate lending practices and judicial practices for cross-default case rulings.

ACRA shall also analyze the significance of the relative size of debt instruments in cross-defaults and the availability of exceptions.

Strategic value

The main criteria that determine the strategic value of a subsidiary for the parent structure (holding) are as follows:

- Subsidiary plays a significant role in the implementation of the group business strategy.
- Subsidiary performs well in terms of profitability, and according to the parent company (holding) forecasts, is expected to maintain its performance.
- Relative size of assets and/or income base, which the parent (holding) company receives from its subsidiaries.
- Dependency of the parent (holding) company or other structures within the corporate group on the subsidiary's cash flows.
- Coverage by the subsidiary of a client base or territory that is key to the parent (holding) company.
- Probability of the subsidiary being put up for sale.
- Negative impact of the financial performance of the subsidiary on the consolidated financial statements, which creates a substantial risk of assets deconsolidation.
- Actual long-term debt financing and equity financing provided by the supporting institution to the subsidiary.

Lack of the above characteristics or other specifics of the relationship between the subsidiary and the parent (holding) company may indicate a low degree of significance of the subsidiary within the corporate group.

ACRA shall also take into account the following:

- History of failing to support the subsidiary in times of financial distress. With that, the very fact of providing such support in the past is not a sufficient condition for assessing the degree of significance of such a subsidiary as high.
- Dependence of financial performance of the subsidiary and its financing sources on the group, including the probability of the subsidiary remaining financially stable if the parent structure financial performance deteriorates.
- Probability of the subsidiary failing to disclose the fact that it has defaulted on its obligations in the event of the parent company or the group as a whole going bankrupt.

ACRA shall take into account letters of comfort from supporting institutions as an auxiliary assessment indicator for contingent liabilities and strategic value.

Operational integration

When analyzing this particular factor, one should pay special attention to the following characteristics:

- Dependency of operating activities of the parent (holding) company or other company within the group on the rated entity;

- Percentage of cash flow generated by the interaction between the rated entity and the other companies within the group;
- With regards to the corporate sector, the general profile of the group's vertical integration and the role the rated entity plays therein;
- Existence of mutual long-term agreements;
- Existence of a justified economic interest on the part of the parent (holding) structure in maintaining the creditworthiness of the rated entity;
- Existence of restrictions on cash transfers from the rated entity to the parent (holding) structure and back.

As additional characteristics, ACRA can also take into account other factors that indicate the existence of a strong relationship between the supporting institution and the rated entity.

As an example, a supporting institution is not legally bound to fulfill the obligations it has to the supported party, but still it decides to provide support. Among other things, it can be motivated by the objective to minimize its reputational risks, e. g., if the market perceives the companies as having a strong relationship or even as being one and the same (as in the event of them using of identical brands, or for any other reason). Other factors to be considered can be informal relationships between shareholders or shareholder interests.

4.4. Final credit rating assignment

The stronger the degree of relationship between a supporting institution and a rated entity, the more likely the correlation between their creditworthiness levels.

If the SICA (or supporting institution's rating, if any) is weaker than the rated entity's SCA, the final credit rating of the rated entity will be to a certain extent capped by the SICA level (or by supporting institution's rating if any).

In case of a weak degree of relationship, the final credit rating of the rated entity may exceed the SICA (or supporting institution's rating if any).

A positive SCA adjustment is only possible if the SICA has been defined at a level not lower than "BB-(RU)".

Table 1. Final credit rating assignment to rated entities

		Degree of relationship				
		Very strong	Strong	Moderate	Weak	Very weak
Supporting institution category	Strong	not higher than SICA*	not higher than SCA + 4, but not higher than SICA* - 1	not higher than SCA + 3, but not higher than SICA* - 2	not higher than SCA + 2	SCA
	Moderately strong	not higher than SICA*	not higher than SCA + 2	not higher than SCA + 1	SCA	SCA
	Neutral	SCA	SCA	SCA	SCA	SCA
	Moderately weak	SICA*	not higher than SICA* + 1	SCA	SCA	SCA
	Weak	SICA*	not higher than SICA* + 1	not higher than SICA* + 2	SCA	SCA

*SICA or supporting institution's credit rating if any.

Source: ACRA

It should be noted that a potential situation is possible when other members of the group may get support at the expense of the rated entity. In this case, ACRA reserves the right to adjust the rated entity's credit rating maximum by one notch downward.

If a rated entity or a supporting institution are not part of one identifiable group, ACRA shall take into account the instances of additional support from a shareholder and/or companies owned by this shareholder. In case of absence of support precedents, the Agency may consider written statements by the shareholder and/or companies owned by such shareholder expressing willingness to support the rated entity. If the Agency believes that the probability of such support is high, it reserves the right to adjust the SCA one notch upward.

However, if ACRA sees a high probability of equity (liquidity) withdrawal from a rated entity by a shareholder, the SCA may be adjusted one notch down.

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