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Criteria for Rating Pure Holding Company Groups

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Approach Focuses on Assessing Group Cohesiveness

Rating and Investment Information, Inc. (R&I), announced its "Criteria for Rating Pure Holding Company Groups" on October 30. R&I emphasizes group cohesiveness when it assigns a rating for a pure holding company. It believes that a holding company's rating could potentially be lower than those of its operating subsidiaries if the cohesiveness among the holding company and the operating subsidiaries is weak. This is because there could conceivably be cases when a holding company that is an umbrella structure for numerous operating companies with minority shareholders is unable to freely use the cash flow of its subsidiaries.

ASSESSING GROUP COHESIVENESS

When assigning a rating to a pure holding company, it is important to first evaluate the creditworthiness of its consolidated group, which consists of the holding company and its operating subsidiaries. In this respect the rating process is the same as in the case of an ordinary operating company. Ultimately, however, the parties responsible for repaying debt are by definition the individual entities that incur such liabilities, and repayment obligations are not necessarily assumed on a group-wide basis. In particular, the strength of the connections that bind a group together greatly affects a holding company's debt repayment capacity since that company does not engage in operations itself. R&I, which uses the term "cohesiveness" to describe the strength of these connections, considers various points in order to gauge the extent of true, seamless cohesiveness among a group's companies. These points include 1) the course of events leading up to the creation of a holding company framework and the purpose of its establishment, 2) a holding company's chief functions and its authority and responsibilities, 3) the existence of contracts and statutory regulations that strengthen (or weaken) cohesiveness, and 4) such group-wide dynamics as business relationships and synergies within a group as well as risk diversification.

Depending on the state of cohesiveness, R&I may assign a holding company a Senior Long-term Credit Rating that differs from those given to its operating subsidiaries. A holding company and its operating subsidiaries will have ratings identical to their group's creditworthiness when group cohesiveness is exceptionally high. If it is not high, though, a holding company's rating could conceivably fall below its group's creditworthiness. The lower the level of cohesiveness, the more likely it is that operating subsidiaries' ratings will be determined by their individual creditworthiness.

A pure holding company group is just one configuration that is used to connect enterprises, and the applicability of the rating approach described above can also be expanded to include ordinary operating company groups.

PROBLEM POINTS PARTICULAR TO HOLDING COMPANIES

A holding company's assets consist chiefly of subsidiary stock and its loans to subsidiaries. A holding company consequently does not directly receive any cash flow from operations, and its earnings basically depend on loan interest and dividends paid by its operating subsidiaries. When a holding company takes on debt and acquires subsidiary stock, there could potentially be a scenario of default solely by that holding company because dividends from its subsidiaries are in

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arrears. In terms of assessing just the risk of default, this potential is not regarded as a major concern as long as group cohesiveness is exceptionally strong and a holding company's control over the cash flow of its subsidiaries is sufficiently great. In the case of non-payment by both a holding company and its subsidiaries, though, the rate of recovery for the holding company's debt could possibly be less than the rate for its subsidiaries' debt, since subsidiary stock is one source of funds for meeting the holding company's obligations. Ratings may therefore reflect individual bonds' post-default recovery potential.

A CONCRETE EXAMPLE OF A LOWER HOLDING COMPANY RATING

Take, for instance, a pure holding company group that is expanding its operations through a series of frequent mergers and acquisitions. The group's operating subsidiaries implement independent strategies and raise funds on their own. Although the holding company possesses the majority of subsidiary stock, the existence of minority shareholders means that its control over its subsidiaries' cash flow is not strong. Operational interconnectivity among the subsidiaries is extremely low, and synergies are not anticipated. Cohesiveness is thought to be low in such a case. Additionally, a holding company's Senior Long-term Credit Rating is likely to be substantially lower than its group's creditworthiness if a considerable portion of subsidiary stock is financed by debt because the holding company's purpose is to seek tax advantages.

Details concerning these rating criteria are available (in Japanese only) through the subscription-based website "R&I Credit Express" and in the December 2002 issue of R&I Credit Information, which can be purchased starting in late November.

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