



## R&I's Analytical Approach to Parent and Subsidiary Companies

( This report is an English translation of the original report in Japanese. )

- When assigning a rating to a parent company, R&I closely examines the effect of subsidiary business and financial risk on the parent company earnings and financial position and incorporates its findings into its rating. Using the consolidated financial statements of the parent company as the starting point for its evaluation, R&I will judge an affiliated company's debt to be substantively equal to parent company debt when there appears to be a very high probability the parent will provide strategic support if operating results of the affiliated company deteriorate, even if the affiliated company is not accounted for by the equity method or the scope of consolidation. Conversely, when a company has a strong subsidiary and there is a strong probability the parent company can control the subsidiary's earnings, this can have a positive effect on the parent's creditworthiness.
- A subsidiary company rating begins with an evaluation of creditworthiness on a standalone basis, and then incorporates the pros and cons of that company as a member of a group centered on the parent company. As a result, to the extent the entire group is substantively managed as a single firm and possesses strong cohesiveness, the firms in the group will converge to a single rating. On the other hand, when individual firms are in reality independent even though they form a group through capital relationships, and the probability of a firm receiving support from the other companies is low even if it has stumbled into difficulty, or conversely when there is a strong company and the probability that its earnings will be used to support other companies or for other purposes is low, firms will not be very much affected by other companies in the group.

### R&I approach to parent companies – Adjusting consolidated financial statements to reflect actual circumstances

As a rule, when rating a parent company R&I will evaluate the cash flow generation capacity and financial structure as a group, including the subsidiaries and affiliated companies under the parent. Although a group consists basically of the companies subject to consolidation, R&I will make various adjustments to the consolidated financial statements to reflect actual circumstances. Several examples are provided below.

Assume an operating Company P and Company S, a company subject to application of equity method accounting. Company S manufactures critical components for parent Company P's products, making its existence indispensable for Company P. Because Company S makes capital investments using funds it raises on its own, the Company P's interest-bearing liability is not reflected in the consolidated financial statements of Company P. What will happen if Company S

cannot repay its loans and fails? Because the parent company cannot manufacture its products without the components from Company S, Company P will significantly inconvenience its customers and suffer a corresponding opportunity loss if parts delivery does not continue. If the creditworthiness of Company S deteriorates, Company P can easily grasp the situation because of its close day-to-day business relationship. When it can comprehend that Company S appears likely to fall into financial difficulty, Company P will study the size of the effect from failure beforehand. Company P can be expected to devise some assistance measure, such as stepping in to provide funds to refinance Company S's loan or substantively purchasing the operating division of Company S. Consequently R&I will consider the probability of Company P offering support to Company S during a difficult period to be high and will add the interest-bearing liability to the consolidated financial statements, even though the assets and liabilities of Company S, which is subject to equity method accounting, are not reflected in Company P's consolidated financial statements. Even when there is no capital relationship, if there is a strong probability a parent company will provide some type of support to a company if that company's management deteriorates, R&I will consider the level and amount of support and include this in its evaluation of the parent company.

Consider the case of a company with a strong subsidiary. The subsidiary earnings and financial position are reflected in the parent company consolidated financial statements. Especially when there is strong control over the subsidiary, and if the parent company can utilize the subsidiary's robust cash flow, the presence of the subsidiary company has a positive effect on the parent company rating. On the other hand, even if a company has a leading subsidiary, incorporating the subsidiary earnings and cash flow into the evaluation of the parent company to an excessive degree is not suitable when the subsidiary's independence is strong, or when there are legal or contractual restrictions and the parent cannot easily control the subsidiary's cash flow. The reason is that the parent company is unable to simply request the subsidiary to provide a loan or guarantee or pay large dividends, even if the parent is having financial difficulties. In some cases, R&I will perform its evaluation by limiting positive factors to regular dividend income and the asset value of the subsidiary company stock.

Consolidated financial statements can be useful for understanding a summary of the operating conditions at a parent company and its group. As can be seen from the above explanation, however, financial statements alone cannot in fact be considered adequate for judging parent company creditworthiness. R&I will consider the probability of support being provided to the affiliated companies, and if necessary evaluate the affiliated company obligations to be equivalent to parent company debt, after receiving the balance sheets of affiliated companies that do not appear in the consolidated financial statements. R&I also strives to match the existence of subsidiaries and/or affiliated companies to the actual circumstances when incorporating these into the parent company rating. For example, R&I will judge at a discount the earnings of a leading subsidiary that are included in the consolidated earnings of the parent

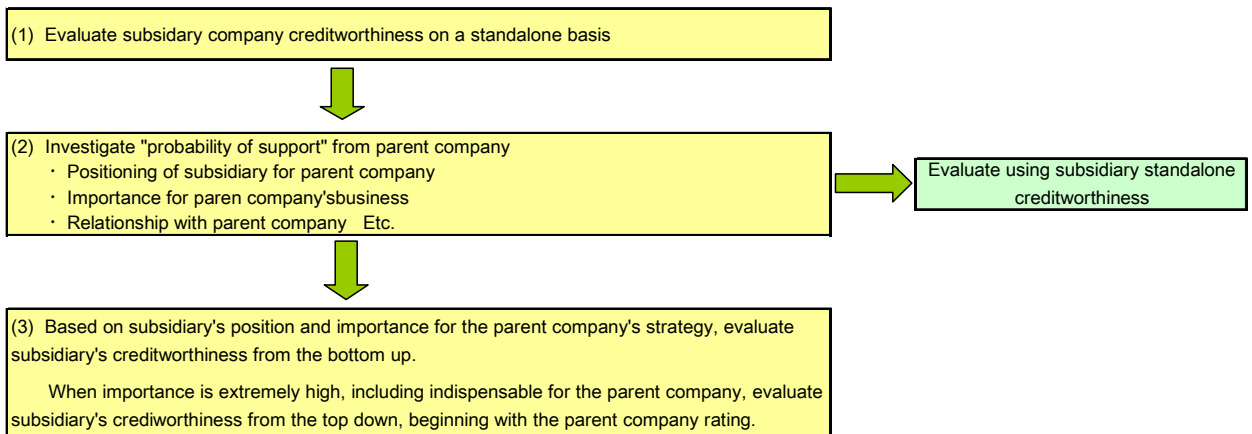
company if using the earnings as funds for repayment of parent company debt would in fact be difficult. R&I expresses the creditworthiness evaluated using such an approach as “group creditworthiness,” and uses it as a base for group core company and pure holding company evaluations.

### Approach to subsidiary company Issuer Ratings – Based on a standalone evaluation of the subsidiary

When assigning a subsidiary company Issuer Rating, R&I begins with a standalone evaluation (subsidiary on a non-consolidated basis). This is because the obligor that must ultimately repay a debt is the subsidiary itself, and even if the subsidiary company's name begins with the name of a blue-chip parent, support from the parent company may not necessarily be forthcoming.

If the presence of the subsidiary is important to the parent company, however, R&I will sometimes consider the existence of the parent in its rating of the subsidiary. Regardless of the level of importance, if it judges there is a strong probability the parent company will provide some type of support should the subsidiary experience financial difficulties, R&I will sometimes assign a rating that is higher than if it evaluated the subsidiary based on the subsidiary's financial statements. R&I refers to evaluating information such as the issuer's financial statements and business structure as a base and adding the probability of parent company support as a positive factor a “bottom-up approach.” Under the bottom-up approach, R&I tempers its evaluation of standalone creditworthiness with considerations such as (1) tangible and intangible advantages from the use of group operating resources and (2) probability of support from other group companies if the subsidiary falls into financial difficulties. In many cases a firm is already reflected in the current financial statements when it has been active as a member of the group over a long period of time, however, and care must be exercised when evaluating (1) to avoid overlap or double counting.

#### ■ Basic approach to parent-subsidary relationships



When the issuer is an extremely significant subsidiary whose existence is absolutely essential for the parent company's business, on the other hand, R&I might assign a rating by using the parent company rating or group creditworthiness as a base and notching down the rating according to the subsidiary's importance. R&I refers to this methodology as the "top down approach" and has applied this thinking to many actual ratings of financial group subsidiaries. If R&I judges a company is indispensable to the parent company or the core company of a group, or has a vital presence that positions it substantively as a division of the core company, or that the parent company or group will have to support the subsidiary if its operations have deteriorated and there is high probability the fallout will spread nearly simultaneously to the parent and core company if the subsidiary fails, R&I may assign the same rating as the parent company.

R&I judges the importance of a rated company to the parent company and the group from the following viewpoints.

- Percentage of voting rights (note that many companies cannot necessarily be called important just because of 100% ownership).
- Existence of a legally binding agreement such as a keep-well agreement from the parent company to the subsidiary (note that a guarantee of individual debts alone is not a deciding factor for adopting the top down approach for an Issuer Rating).
- Is the company's existence essential to the parent company or core company of the group from a functional aspect, and is the company irreplaceable?
- Are the same activities as the parent company and core company essentially allocated to each company in the group, and are the same customers shared?
- Does it contribute significantly to the consolidated earnings and cash flow of the parent company and holding company, and is it related closely to the businesses of the parent company or core company of the group?
- Would failure of the subsidiary cause significant harm to the brand value and business value of the parent company and other group companies?

Even strong capital or personnel ties do not necessarily indicate a strong strategic importance. This is because there also are cases where a subsidiary will procure capital solely through an investment from the parent company, or accept personnel dispatched from the parent, because its business is new or small-scale. Producing a certain level of earnings and having a certain level of financial health (in the case of a newly established company, when there is a good prospect of shortly eliminating negative equity) are prerequisites for R&I to adopt the top down approach. Even assuming a company's presence was extremely vital strategically for the parent company at a certain point in time, the company is likely to become the target of a strategic review if it is not economically rational. R&I cannot adopt the top down approach if a company's importance is not ongoing.

Here it is necessary to note the point that while the parent company existence is indispensable for the subsidiary, the existence of the subsidiary might not necessarily be essential for the parent, even if the subsidiary can not survive without support of the parent. Decisions to support a subsidiary are always made on the parent company side. Even if the subsidiary company thinks, “They’ve supported us with substantial funds until now when we’ve had a funds shortfall, so they’ll continue to support us in the future,” the parent company could sever its ties to the subsidiary based on a strategic decision if the prospects for improvement are not strong. R&I fundamentally judges debt repayment capacity based on ability to generate cash flow and the level of interest-bearing liabilities after considering the business risk of the obligor. To the extent the character of subsidiary debt is considered close to parent company debt, R&I will require grounds for the special existence of the subsidiary in order to adopt the top down approach based on parent company creditworthiness. When the subsidiary company Issuer Rating does not diverge from that of the parent company and is identical based on the top down approach, R&I will judge the two companies to nearly share the default risk.

### **Rating of a strong subsidiary – Parent company rating generally is the upper bound but in some cases a rating will be higher than the parent rating**

So far we’ve looked at the ratings from the standpoint of “to what extent can parent company creditworthiness be evaluated as a positive factor for a subsidiary rating?” when evaluating a subsidiary with a strong parent. In some cases, however, the subsidiary company can also exist as a strong company on a standalone basis. How should R&I evaluate the rating of a subsidiary company whose ability to generate substantial cash flow is greater than that of the parent company and whose financial structure also is strong?

Even when a subsidiary’s financial position is excellent, R&I generally considers the parent company rating to be the upper bound for a subsidiary rating. This is because of a subsidiary company’s latent risks, including (1) management intervention and direct or indirect control over earnings by the parent company through various transactions, (2) siphoning away of capital in the form of dividends and (3) the possibility of an absorption and merger at the desire of the parent company based on the ratio of voting rights. In fact, there are instances in which the risk was actualized in the form of a parent company swallowing the subsidiary as part of a corporate reorganization. Another unprecedented and symbolic event involved a subsidiary company was forced to reverse its internal reserves and reduced its equity capital in order to pay dividends at a dividend payout ratio exceeding 100% at the insistence its top shareholder.

In other situations, however – when a subsidiary is isolated from the parent and not easily reached by parent company risk, or when maintaining a high subsidiary company value has significant advantages for the parent firm – the subsidiary Issuer Rating can be higher than the parent company rating.

The following factors are the key points for judging whether a rating can exceed the parent company rating.

- (1) For a joint subsidiary company where shareholder other than the parent company exists, there is an agreement among the shareholders to maintain creditworthiness, such as preservation of net assets of the subsidiary company, and the probability of the agreement being terminated is low.
- (2) Maintaining the subsidiary company creditworthiness at a high level coincides with the interests of the parent company and group.
- (3) It is difficult to conceive of a scenario in which the subsidiary company supports the parent company or other group companies, given the character of the business.
- (4) The subsidiary can continue operating even if separated from the parent company and group.

Because a parent company's control will still be substantively strong in some cases even if these points are formally fulfilled, it is necessary to realistically ascertain the extent to which the risks have been expunged. R&I will judge the subsidiary company rating by considering factors such as the level of the voting rights percentage, the parent company creditworthiness, whether the subsidiary company's stock is listed and the corporate governance mechanisms, and by closely examining the probability of the potential risks from the parent company being realized in each individual instance.

Even in these cases, normally it is difficult to envision a subsidiary company's Issuer Rating greatly exceeding that of the parent company. Even if the financial positions of the two companies are quite distinct, there must be a reason why the parent company holds the subsidiary's stock. On the other hand, while it is unsuitable to excessively incorporate a subsidiary's strong cash flow, the subsidiary's financial position will be reflected in consolidated financial statements of the parent. The difference in the ratings of both companies is likely to remain within a narrow range.

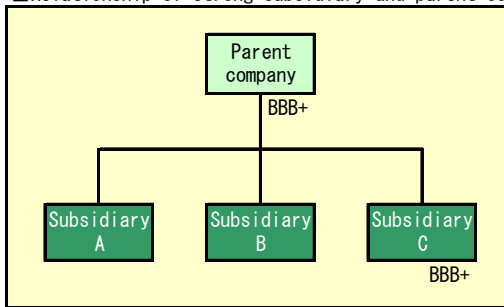
### Verification

When rating a parent and subsidiary, R&I is careful to ensure there are no contradictions in its approach. For example, if R&I assumes the probability of receiving support from the parent company in an emergency to be high and has given the subsidiary a stronger evaluation than it would have given on a stand-alone basis, R&I also must sufficiently reflect the risk of support for the subsidiary in the parent company rating.

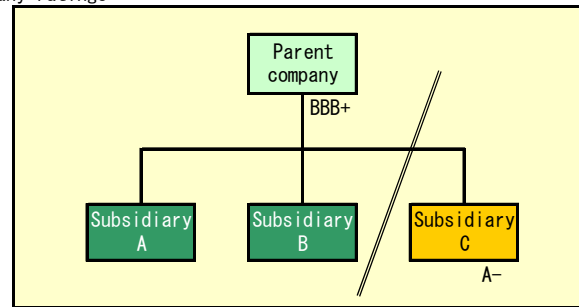
When it has assigned a subsidiary a rating higher than the rating of the parent company for the reason that the subsidiary is isolated from the parent company for legal or contractual reasons, or because of its business activities or positioning, for example, R&I will be careful to not consider the subsidiary's ample cash flows excessively when judging the parent company's creditworthiness. Because it has assigned a rating that is higher than the parent company precisely because the parent cannot freely use subsidiary's cash flow, R&I will evaluate the parent company by discounting the parent's consolidated financial statements, which reflect the strong earnings and financial position of the subsidiary.

## Rating Methodologies

### ■ Relationship of strong subsidiary and parent company ratings



Normally, the rating of strong Subsidiary C will not be higher than the parent company rating.



When Subsidiary C is not easily affected by the deterioration of the parent company or other companies in the group, and the probability of latent risks being realized is low, the parent company rating is not necessarily the upper bound. On the other hand, the cash flow of Subsidiary C is not incorporated excessively in the parent company rating.

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