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# Rating Methodology for Investment Holding and Operating Holding Companies

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Standard & Poor's makes an analytical distinction between industrial conglomerates and investment holding companies (see the article Financial Flexibility Key to Investment Holding Companies' Ratings, published on Feb. 22, 2001, on RatingsDirect, Standard & Poor's Web-based credit analysis system). Industrial conglomerates are companies that are involved in several industry sectors, with the business aim of increasing shareholder value by generating profits and cash flow from their industrial activities. Investment holding companies, on the other hand, may be equally diversified, but often own mainly minority stakes in companies, with the business aim of increasing shareholder value by buying and selling assets and realizing capital gains. While the traditional business risk and cash flow-based model is applicable for industrial conglomerates, with due consideration made for the diversification of operations, the analysis for investment holding companies is primarily geared toward an evaluation of the entities' financial flexibility, in particular its ability to sell assets at short notice.

Since 2001, however, Standard & Poor's has rated a growing number of companies that are neither pure industrial conglomerates nor pure investment holding companies, but are positioned somewhere in between. The portfolios of these companies often include a substantial portion of wholly or majority-owned companies, in addition to minority stakes. Furthermore, although these companies often have long-term portfolios of core assets, they are also in the business of buying and selling holdings over time. These companies, which Standard & Poor's calls operating holding companies, require a combination of the two analytical approaches to factor in their hybrid nature, to reflect their exposure to the operating performance of the subsidiaries and the financial flexibility provided by the asset portfolio. The balance between these two approaches will differ from company to company, and will depend on a number of factors, including management's strategy and track record, as well as Standard & Poor's assessment of the holding company's ability to distance itself from the operating risks of its subsidiaries.

## Investment Holding Companies

Pure investment holding companies, like Investor AB (AA-/Stable/A-1+) and AB Industrivärden (A+/Stable/A-1), primarily have minority stakes in a wide range of listed holdings. Standard & Poor's also includes in this category investment holdings companies that have controlling shares or stakes in unlisted subsidiaries, as long as they are not significantly exposed to a few core holdings. One example is IFIL SpA (A/Negative/A-1), which owns majority stakes in many of its investments, such as retail and tourism activities. IFIL's overall diversification, with nine core holdings and minority stakes in the publicly listed and widely traded FIAT and San Paolo IMI, mean that it has investment holding characteristics. Another example is Wendel Investissement (BBB+/Stable/A-2), with a diversified portfolio of mainly minority owned holdings. The fact that Wendel is rated lower than the previously mentioned investment holding companies reflects its portfolio's moderate liquidity, as its main assets are unlisted.

The rating methodology for investment holding companies has several factors in common with Standard & Poor's analytical approach for investment trusts. The rating methodology for U.K. trusts is described in the article U.K. Investment Trust Industry Analysis published in December 2001 on RatingsDirect. The investment holding rating methodology also shares some similarities with that used for venture capital companies such as 3i Group PLC (A+/Negative/A-1).

The key rating factors for investment holding companies are the:

- Portfolio's liquidity;
- Level of diversification within the portfolio;
- Company's willingness to sell assets if necessary;
- Company's ability to manage the portfolio;
- Creditworthiness of companies included in the portfolio;
- Track record of the company and management;
- Investment strategies and attitude toward risk;
- Financial policies;
- Cash flow at the holding company level;
- Proportion of controlling versus minority stakes;
- Regulatory framework;
- Portfolio's size;
- Volatility of share prices of listed companies in the portfolio; and
- Valuation policy and valuation volatility for unlisted holdings.

It is normally difficult to separate an investment holding company's business profile from its financial profile.

Financial flexibility is fundamental to assessing investment holding companies, and traditional cash-flow-oriented analyses do not necessarily apply. For most investment companies, weak cash flow can be compensated for by the company's liquid investment portfolio. The lack of immediate liquidity may partly be offset by long-term debt maturities (the maturity of the debt at the holding level is thoroughly scrutinized). Sources of cash flow include stock-dividend payments; cash flow up-streamed by wholly owned operating subsidiaries; trading activities; and periodic asset sales. Several investment companies have a policy of distributing all dividends that they receive from their holdings. Assuming dividends received by the company are distributed and consolidated subsidiaries provide no operating cash flow, net financial expenses and administrative expenses would have to be covered mainly by asset sales.

The risk profile, diversification, and liquidity of an investment portfolio are fundamental to an investment holding company's creditworthiness. A holding company investing mainly in liquid quoted securities in well-developed markets--especially in blue-chip companies--has a lower risk profile than a company investing mainly in unquoted companies, quoted investments are generally easier to liquidate than non-quoted ones. In addition, large concentrations may sometimes have a negative effect on the holding company's liquidity.

The issue of controlling stakes versus minority stakes also has a bearing on the portfolio's liquidity. Ownership of controlling stakes may reduce a company's willingness to sell shares; on the other hand, it provides better control over dividends and increases selling value because the control is worth a premium. Selling restrictions are normally viewed as a negative rating factor because they can affect an investment's value and liquidity. Some holding companies would, for instance, be very reluctant to sell assets as this would result in a hefty tax burden. Standard & Poor's therefore carefully analyzes holding companies' divestment policies, and looks at management's track record to gain confidence that a company is prepared to sell assets in a timely manner.

Standard & Poor's believes that a broad spectrum of investments reduces risks and increases financial flexibility, and a critical mass is usually needed to achieve a certain degree of diversification. Diversification is based on several

factors, such as the number of holdings, the variety of industries in which a company operates, and geographical exposure. A portfolio consisting only of shares traded in one country can still have limited exposure to that country if the portfolio includes highly international companies.

Since investment holding companies are in the business of buying and selling holdings, the structure and the risk profile of these companies could change significantly over time. Standard & Poor's therefore attaches great importance to management's investment strategies and financial policies, and a strong financial position today carries little weight if management is expected to consider additional debt-financed acquisitions. A company and its management's track record is one factor in Standard & Poor's assessment of policies and strategies. Unlike ordinary industrial companies, investment holding companies are constantly monitoring their portfolio of assets. Their business is fundamentally to try to maximize shareholders returns through disposals and acquisitions. As the timing of disposals does not necessarily match that of acquisitions, capital structure may change over time; for instance, an investment holding company may have recourse to additional debt at some point to take advantage of short-term acquisition opportunities or to bridge-finance expected disposal proceeds. When assessing the credit quality of an investment holding company, therefore, Standard & Poor's takes into account the actual level of debt-based ratios as well as the maximum level that the company's financial policy allows.

### **Pivotal ratios.**

The key ratio that Standard & Poor's uses to assess the creditworthiness of investment holding companies is net debt to estimated portfolio value. This ratio is crucial to measuring a company's financial flexibility and its ability to redeem debt. Standard & Poor's looks for strong financial flexibility because holding companies do not have access to operating cash flow, only dividends, with little control over the payout ratio and the timing of the distribution. When evaluating this ratio, however, consideration also has to be given to the quality of the portfolio. While a certain percentage may be viewed as conservative for a company with a liquid and diversified portfolio, the same percentage may be seen as moderate for a company with a less liquid portfolio.

Net debt is calculated as gross financial debt less the company's cash position, as reflected in the company's audited statements. A number of companies hold significant portfolios of short-term marketable securities or control assets that are liquid by nature or as a result of structural features; these are included on the assets side of the ratio rather than being deducted from gross debt. Standard & Poor's also analyzes after-tax portfolio values. A solid ratio is particularly relevant and meaningful at times of high volatility in capital markets, as has been the case recently. When assessing estimated portfolio value, Standard & Poor's is very careful to measure possible fluctuations of share prices, especially in industrial sectors with a track record of volatility. For unlisted assets, Standard & Poor's uses conservative benchmarks on the basis of earnings multiples and market values for similar listed companies. Earnings multiples are typically compared with those used in recent M&A transactions in similar sectors.

Another crucial ratio to gauge a portfolio's liquidity is that of net debt to listed and liquid assets. This ratio is particularly important since the reasoning behind the investment holding company methodology rests on financial flexibility, in particular near-term financial flexibility (that is, liquidity), replacing the traditional focus on cash flow.

Nevertheless, Standard & Poor's also analyzes the ratio of dividends received to the sum of net interest expenses, plus overhead costs (that is, ongoing cash flow at the holding company level) as it provides an estimate of how much the company needs to realize in terms of disposals proceeds, if at all, in order not to incur a cash flow deficit. This relationship is, however, less critical than in traditional analysis because investment holding companies often have greater financial flexibility, which can compensate for the lack of cash flow generation.

## Industrial Conglomerates

Industrial conglomerates usually have full control of their subsidiaries, and are extensively involved in the management. They maximize returns by helping the subsidiaries grow and optimizing profitability. Examples of rated industrial conglomerates include Siemens AG (AA-/Stable/A-1+), Smiths Group PLC (A-/Negative/A-2), and General Electric Co. (GE; AAA/Stable/A-1+).

When an industrial conglomerate is assessed, each segment is analyzed separately. A composite is formed from these building blocks by weighting each element according to its overall importance to the group. The potential benefits of diversification--which may not be apparent if the segments are analyzed separately--are then considered. Only limited recognition will be awarded if the various business lines share similar dynamics. Most critical is the company's ability to manage diverse operations, as the skills and experience needed to run a business differ greatly among industries.

Conglomerates usually enjoy above-average business profiles owing to their high degree of diversification. The overall business score is sometimes higher than the average business scores of the different businesses compounded by their contribution to cash flows. Diversification can provide a protection against cyclicity, and makes cash flow generation less volatile as long as the different subsidiaries have different business dynamics. Diversification can also mitigate structural subordination issues.

The financial analysis of conglomerates uses traditional consolidated financial measures centered on cash flows. Financial flexibility is usually boosted by the conglomerates' ability to divest one business line without jeopardizing their other activities. Financial flexibility can also be provided by the company's ability to sell one or more operating companies. In most cases, however, this is not a major factor in the rating as the base assumption for this type of company is that it will continue to run its operating subsidiaries as going concerns. Furthermore, the disposal of operating subsidiaries is often a rather complex and slow process, and does therefore not provide the same kind of immediate flexibility as, for instance, the disposal of listed shares can.

## Operating Holding Companies

Like investment holding companies, operating holding companies such as Franz Haniel & Cie GmbH (A-/Stable/A-2) and Worms & Cie (--/--A-2) and LE Lundbergföretagen AB (Lundbergs; A/Stable/A-1) maximize their returns by buying and selling holdings over time. The main difference between the two types of holding companies, though, is that operating holding companies invest in a mix of minority-, majority-, and, sometimes, wholly owned companies, while investment holding companies mainly hold minority stakes. Although some investments may be regarded as core assets, operating holding companies are usually not committed to keeping them for the long term and their portfolios are often subject to modifications, owing to their generally very dynamic trading activity. Operating holding companies are, furthermore, often represented on the boards of their subsidiaries and in some cases play an executive role. In addition, it is not unusual for operating holding companies to have a few core holdings that account for a large portion of their portfolio's estimated value, leading a higher degree of vulnerability from a credit standpoint (the investment holding company approach would normally be used for holding companies with an extremely diversified portfolio, even if most holdings are majority owned). For instance, the investment in U.K.-based paper group Arjo Wiggins (100% owned) accounts for about 45% of Worm's estimated portfolio value. To take into account both the investment holding company-like characteristics and the

indirect exposure to operating activities, a mixed approach is required when analyzing an operating holding company.

As a starting point, Standard & Poor's assesses the credit quality of the main subsidiaries, estimating both business and financial profiles for these companies. For companies with one subsidiary that represents a vast majority of the portfolio, the final rating would likely be greatly influenced by the credit quality of its main subsidiary. The rating on the parent company could be higher if the other assets provide sufficient diversification and liquidity or if the holding is less indebted. Conversely, the rating on the parent company could be lower if the subsidiary enjoys strong credit qualities through substantial cash flow generation but if the indebted parent company only has access to dividends (if it does not have full ownership). For example, the long-term corporate credit rating on Bellon S.A. is 'BB'--four notches below that on its main subsidiary Sodexo Inc. (BBB+/Negative/A-2), but such a distinction is relatively rare.

As with investment holding companies, the ratio analysis for operating holding companies focuses on financial flexibility and net debt to estimated portfolio value. An important and often difficult aspect of assessing portfolio values is estimating values for non-quoted holdings. As mentioned earlier, non-quoted holdings could represent a large portion of total assets for an operating holding company. Standard & Poor's uses conservative benchmarks when estimating values for these holdings; its estimates are based on market values for similar listed companies and earnings multiples used in recent mergers and acquisitions transactions in similar sectors. Standard & Poor's assessments of values could, therefore, be significantly lower than the values presented by the operating holding company.

Although the main subsidiaries are sometimes listed, the operating holding often has a controlling stake and the shares are, most frequently, fairly illiquid and difficult to divest of quickly, which represents a significant negative rating factor (see the Investment Holding Companies section for details on liquidity of controlling stakes). Standard & Poor's normally takes a very conservative view of the liquidity of non-quoted holdings. Some holdings can take several years to divest. Consequently, the portfolio is at best only moderately liquid, and this weaker short-term liquidity is one reason for which operating holdings usually have a riskier credit profile than investment holdings. From a credit analysis viewpoint, however, by holding majority stakes a company could exert significant influence over the subsidiary's management, strategy, and cash flow. Furthermore, controlling stakes are sometimes worth a premium in the event of divestment.

Standard & Poor's also uses its traditional consolidated leverage and operating cash flow ratios when analyzing the credit quality of operating holding companies. The financial profile of an operating holding company is dependent on that of its main subsidiaries, given the weight of the subsidiary on the overall estimated portfolio value. If a highly leveraged subsidiary accounts for the bulk of its holding company's portfolio value, the financial profile of the holding is negatively affected even if the debt of the subsidiary is nonrecourse. In the event of bankruptcy of the subsidiary, the operating holding company bears the risk of losing 100% of its investment. Unless there are guarantees or cross-default clauses, the subsidiary's default would not necessarily entail a default of the operating holding company on its own debt. Even in the absence of guarantees and other such measures, however, Standard & Poor's would in some cases take the view that the operating holding company would support some core holdings in a distressed situation (for example, loans or new equity). When assessing the likelihood of potential ownership support, Standard & Poor's takes into consideration a large number of factors such as historical links, shared name, integration with the holding company, track record of supporting holdings and investment's portion of the holding company's total portfolio. Expected support would in most cases apply to majority or wholly owned subsidiaries,

but also to minority holdings in some rare cases. For example, the rating on Stena AB (BB/Positive/--) was for several years held back by its exposure towards Stena Line despite Stena controlling less than 50% of the shares. Stena acquired all outstanding shares in Stena Line in January 2001.

As with investment holding companies, Standard & Poor's attaches great importance to investment strategies and financial policies of operating holding company management. A single investment or divestment could significantly change the risk profile for an operating holding company, and it is key to the analysis to take these scenarios into account in the rating. The rating should thus not just factor in how the portfolio looks at a specific moment in time, but also how it may change in the future in accordance with management's investment strategies. Changes in the portfolio risk can, however, be offset or mitigated by changes in the portfolio's funding structure. As with investment holding companies, two operating holding companies with a similar target for, for example, net debt to estimated portfolio value, might have significantly different ratings, reflecting the different risk profiles of the portfolios. A dynamic financial policy that takes into consideration changes in portfolio risk can be a way of achieving rating stability. Unlike industrial companies, an operating holding company's leverage is primarily a reflection of the company's appetite for growth and debt, rather than a reflection of a market or an industrial sector's economic condition at any point in time.

The assessment of operating holding companies therefore requires more than a mere combination of the methodology for investment holding companies and that for industrial conglomerates. The balance between the two approaches is decided on a case-by-case basis, reflecting the specific nature and characteristics of the respective companies. A few key factors for tailoring an appropriate methodology are:

- The extent to which management would support certain investments in a distress situation;
- The level of diversification within the portfolio;
- The proportion of controlling versus minority stakes (which partly determines the portfolio's liquidity);
- Exposure to the operating performance of the subsidiaries; and
- Management's strategy (for example, with regard to investment policies, willingness to sell core holdings, and the normal investment horizon).

For example, the traditional consolidated cash flow-driven approach is used for Stena AB, a diverse family-owned company with several different activities within shipping, real estate, oil drilling, and other sectors (the portfolio changes as assets are bought and sold over time). This approach reflects Stena's dependence on a few wholly owned core holdings. The rating is, however, partly supported by its diversified portfolio of assets, which could be disposed of if necessary.

The analysis of Lundbergs, which has real estate operations and a portfolio of listed holdings, is based more on the methodology for investment holding companies, reflecting a more diversified portfolio of mainly listed holdings. The rating is therefore supported by the relative liquidity of Lundberg's portfolio (some holdings are relatively illiquid due to Lundberg's large shareholdings in these companies), and ratios such as the company's ability to cover total debt by liquidating listed holdings, and net debt to estimated portfolio value are used. The rating is constrained by Lundberg's real estate operations, which have been analyzed separately (with regard to both business and financial profile), and for which traditional cash flow and leverage ratios are used.

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