MARC RATING METHODOLOGY

HOLDING COMPANY

A Holding Company's (HC) ultimate strength is a function of the consolidated strength of its subsidiaries and affiliated companies.

Cash flow becomes an important analytical issue as the HC must be able to obtain sufficient upstream interest and dividends from its subsidiaries to cover its overhead expenses and service its debt. A typical HC will have as its operating cash flow source, dividends from subsidiaries, interest on loans, rental income and management fees while the bulk of its cash flow uses would comprise interest expense. One key cash flow ratio which MARC uses is the Cash Flow Match which measures the operating cash flow sources over cash flow uses, indicating roughly the number of times operating cash inflow cover interest and overheads.

The analyst would need to consider the diversity of the dividend stream. We would be concerned if the HC is reliant on dividends from just one subsidiary or heavily dependent on a subsidiary which operates in a volatile industry, for example a stockbroking subsidiary.

To assess the reliability of dividend income, the analyst should analyse the financial health and prospects of the major operating subsidiaries. Apart from evaluating their capacity to pay dividends, a study of their financial condition would also enable us to ascertain whether any of the subsidiaries pose a potential risk where the HC would need to come in

Contacts:

Ahmad Feizal Sulaiman Khan
Chief Business Officer
feizal@marc.com.my

Yap Ngee Heong
Head, Business Origination
ngeeheong@marc.com.my

+603 2717 2900
www.marc.com.my

and support. Conversely, it could indicate the level of assistance the subsidiaries/affiliates can provide to the HC's by means of advances, in the event the latter meets with a liquidity shortfall. In the event a weak subsidiary does in fact call on HC's funds for support, the amount left to meet its own debt obligation would be reduced. To mitigate this, we like to see the establishment of a sinking fund to set aside funds upstreamed from the stronger(s) subsidiary to be ear-marked for the redemption of the debt.

For **Financial HCs**, the extent to which dividends can be declared may be subject to regulatory considerations such as in the case of a financial institution whereby BNM's approval would need to be obtained. In the event of problems at a financial institution subsidiary, BNM would most likely direct the financial institution's financial resources to pay its creditors first before any dividends are upstreamed to the FHC.

The analyst is also expected to look prospectively at the relationship between the subsidiaries' future dividend-paying capacity and the debt servicing burden of the HC. What is the expected dividend payout ratio of each major subsidiary? A low payout ratio gives the HC more flexibility to upstream additional dividends and allows room for future earnings disappointment.

We are also interested to know whether management has any contingency liquidity plan such as committed back up lines, to meet the redemption of the bonds when they fall due.

Next the analyst looks at the capital structure of the FHC. Two key ratios are the Debt to Equity and Double Leverage ratios.

Firstly, the Debt to Equity ratio. A level above 50% merits closer examination. Questions which may be raised include:

- What portion of its debt is short term and long term, and do its funding policies match the type and tenure of investment?

- Are repayments spread out over a number of years or is it a bullet repayment upon maturity?

- What are management's plans regarding further debt issues and the expected effect on HC debt level and debt service capacity? This is especially pertinent if the company pursues acquisitions as part of its growth plans.

- What is debt used for? More often than not, the answer is to increase capital at subsidiaries.

This brings us to our second capital ratio i.e. the Double Leverage ratio. Double leverage exists when HC's debt is used to finance the excess of equity investments in subsidiaries.

Double leverage occurs when a HC uses debt to purchase subsidiaries and/or increase its shareholding in subsidiaries. The leverage is calculated by dividing HC equity investments in subsidiaries and associated companies with HC equity. The leverage exists to the extent this ratio exceeds 100%, and the excess investments is presumed to be funded by HC debt.

Why is high Double Leverage a concern? HCs which use debt to increase equity stakes in subsidiaries are one step removed from the actual productive utilization of those funds which are, in turn, used to finance subsidiaries' operations.

Upon maturity of the debt, what is to be the source of repayment? Here the analyst should distinguish between a corporate debt issue and a HC debt issue. Corporate debts, used directly to fund operations, are expected to generate revenues which are accumulated and subsequently used to repay the debt. But a HC which issues debt to increase its investment in subsidiaries, will have as return on investment, only the upstreamed dividends it receives from its subsidiaries. This may be hardly sufficient to repay the debt.

A double leverage above 115% raises the red flag. It should be noted however, that this is just the starting point for further investigation.

This methodology should be read in relation to Corporate Debt and Financial Holding Companies methodologies available at www.marc.com.my.

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MALAYSIAN RATING CORPORATION BERHAD 199501035601(364803-V)
19-07, Level 19, Q Sentral, 2A Jalan Stesen Sentral 2, Kuala Lumpur Sentral, 50470 KUALA LUMPUR
Tel: [603] 2717 2900 Fax: [603] 2717 2910
Email: marc@marc.com.my Website: www.marc.com.my