Investment Holding Companies Rating Methodology

Corporates

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1. Introduction

This proposed methodology details Scope Ratings' approach to rating investment holding companies and complements the General Corporate Rating Methodology.

We define an investment holding company as a legal entity with the primary purpose of holding a portfolio of investments. These portfolios generally consist of a mix of majority and minority equity stakes in companies that are typically unrelated to each other. Investment holding companies have diverse business models, ranging from wealth management, co-investment, closed-end funds or private equity to providing a platform for financial investments.

An investment holding company is different to a corporate group or an operating holding company, which both consist of a parent company and its subsidiaries, act with a defined global strategy and have synergies and financial links. Our assessment of corporate groups is outlined in our General Corporate Rating Methodology.

This methodology describes how we analyse the credit risk of investment holding corporates, which is based on our assessment of their business risk and financial risk profiles complemented with an analysis of supplementary rating drivers. The methodology is predominantly applicable to European investment holding companies, but can also be applied selectively to non-European issuers.

2. Definition of an investment holding company

An investment holding company is a corporate entity that has the primary purpose of holding stakes in other companies. The company uses the income generated from the portfolio to cover operating expenses and remunerate shareholders.

The three minimum criteria to qualify a corporate as an investment holding company are:

1. More than one core holding[1]. A company can still qualify with one core holding if the shareholder agreement confirms a lack of control and influence on said core holding.
2. Investments are done for the sole purpose of generating returns from dividends or profit-sharing agreements, management fees for services provided to the portfolio companies, interest on shareholder loans provided to the portfolio companies and/or capital appreciation; and
3. No operational integration and limited shared services or synergies between core holdings.

We also consider other criteria as outlined in Figure 1. Further, we differentiate between investment holding companies and a corporate group or operating holding, with the main differences relating to i) the level of operational integration; ii) the investment approach; and iii) influence over core holdings.

An investment holding company's intention is to build and manage a diversified portfolio of assets. One of its primary aims is to maximise portfolio value and periodically rotate assets to realise capital gains and generate funds for reinvestment. We therefore expect investment holding companies to maintain an arm's length relationship with their portfolio companies to reduce operating risk. Cross-default clauses and/or guarantees are therefore rare between an investment holding company and its portfolio companies.

The investment portfolio is the most important element in the credit rating of an investment holding company. This is because the rated entity's value depends on the value of all its portfolio assets. An issuer may prepare its financial reports using International Financial Reporting Standards (IFRS) or generally accepted local accounting principles depending on its jurisdiction and size. IFRS require assets to be measured using market value, while local accounting standards may only require book value (purchase price plus transaction costs). We ensure comparability by estimating the market value of the assets held by the investment holding, which can be based on either share price, the latest valuation by an accredited valuer, or recent purchase offers/bids for the assets. We may apply a discount factor depending on the reliability of the source that determined the market value. In the absence of the above information, we use book value and apply any necessary discount.

We also take an investment holding company's regional specificities and ownership context into consideration. For example, it may be less common in certain countries to define and separate investment management and supervisory board functions, a situation that may indicate that a portfolio company is controlled by or integrated with the investment holding company. We examine 'soft' factors such as managerial philosophy, which can show the existence of an entrepreneurial approach by founders

[1] We define core holdings as portfolio assets of investment holding companies whose share in gross asset value is more than 5%.

and/or owning families, their long-term view and potential strategic dependence on core holdings. This means an investment holding company is independently financed and there is no expectation of material recurring and/or extraordinary financial support. Figure 8 in the Appendix (page 12) illustrates the process we use to determine whether to apply this methodology or another corporate methodology.

Figure 1 – Investment holding company criteria

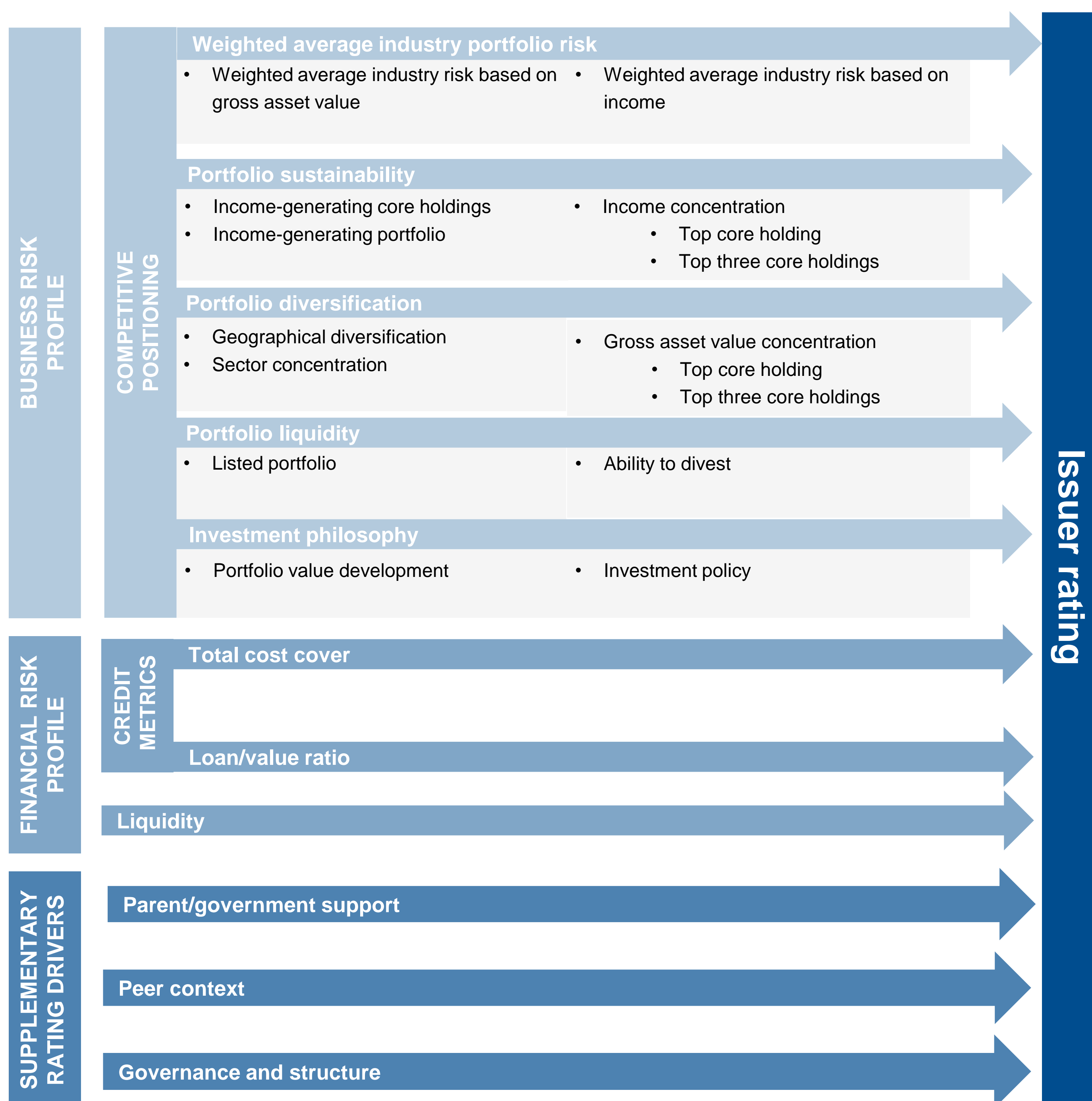
		Investment holding company	Corporate group
Operational integration		• None	• Strong in each business line, generating potential synergies and shared services
Main source of income		• Dividend/interest income, management fees and capital gains	• Cash flow from consolidated operations
INVESTMENT APPROACH	Investment horizon	• Holding periods typically over several years • Dynamic portfolio structure	• Long-term static portfolio structure
INVESTMENT APPROACH	Investment type	• Mostly equities or debt	• Mostly shareholder loans and/or intercompany loans
INVESTMENT APPROACH	Portfolio split	• Mostly core holdings without strategic importance/dependence	• Only operational holdings
INFLUENCE	Ownership	• Mix of minority and majority stakes	• Mostly majority stakes
INFLUENCE	Management decisions	• Influence over strategy but not over managerial decisions	• Full management control
INFLUENCE	Ringfencing	• Mostly standalone financial covenants • No use of cash pooling • Limited use of cross-default clauses or financial guarantees	• Presence of financial covenants on consolidated level • Use of cash pooling • Presence of cross-default clauses and/or financial guarantees

Source: Scope Ratings

3. Rating drivers

This methodology is applied as outlined in Figure 2. The rating analysis specific to investment holding companies addresses factors specific to this industry. The methodology should be read in conjunction with General Corporate Rating Methodology which provides for rating factors common to all industries such as management, liquidity, legal structure, governance and country risks. The following business risk and financial risk indicators are non-exhaustive and may overlap; some may not apply to certain corporates. We may add issuer-specific rating factors. A rated entity's business model determines the applicable indicators. No rating driver has a fixed weight in the assessment.

Figure 2 – General rating grid on investment holding corporates



Source: Scope Ratings

3.1 Business risk profile

3.1.1 Competitive positioning

The assessment of an investment holding company's competitive positioning takes into account i) the weighted average industry portfolio risk; ii) portfolio sustainability; iii) portfolio diversification; iv) portfolio liquidity; and v) investment philosophy.

Weighted average industry portfolio risk

We analyse an investment holding company's industry risk profile based on the weighted average of the underlying industry risks of its portfolio companies. For each industry, we apply the General Corporate Rating Methodology and the sector-specific methodology when applicable.

The industry risk of portfolio companies is important because an investment holding company's debt tends to be serviced by cash income[2] from core holdings, which are discretionary and subordinated to all other internal payments, reflecting the dependence on the cyclicality and entry barriers of portfolio companies.

We assign industry risk level for the investment holding company, which is expressed as a rating category. The level is based on analyses[3] of weighted average industry risk by gross asset value (IR_{GAV}) and by recurring income (IR_{Income}), calculated as follows:

1. IR_{GAV}: weighted average of the underlying industry risk profiles of holdings based on gross asset value (GAV);
2. IR_{Income}: weighted average of the underlying risk profiles of holdings based on recurring up streamed cash income.

When a core holding is a group, investment fund or venture capital firm that combines a variety of business models and industry risks, we might consider the characteristics of the individual group companies rather than treat the core holding as a singular entity. This is based on an analytical judgement on the financial policy and management philosophy of core holdings.

This approach does not apply when cash flows come from financial corporates such as financial institutions.

Portfolio sustainability

The sustainability of the portfolio determines the strength, efficiency and stability of the issuer's cash income through the economic cycle, as estimated by the number of cash income-generating holdings, the portion of cash income-generating assets in the portfolio, and the concentration of cash income-producing portfolio companies.

The risk associated with changing market conditions during portfolio ramp-up is crucial to our assessment of portfolio sustainability. We distinguish between early-stage and mature assets. A high share of mature assets in the portfolio is credit-positive because it increases the visibility and predictability of cash inflow and therefore partially mitigates the exposure to a transformation in the underlying market. In contrast, a high proportion of early-stage investments is likely to lead to significant volatility in the income-generating share of the investment portfolio and/or ultimately its cash generation.

We assess how each equity holding may impact the portfolio's credit risk. For example, covenants applicable to a core holding may set restrictions on dividend payments, limiting cash upstream potential. We also take into account the robustness and reliability of cash flow.

Figure 3 – Portfolio sustainability by rating category

		AA and above	A	BBB	BB	B and below
Number of Income-generating core holdings		>7		6 to 4	3 to 2	<2
Income generating portfolio (% of GAV)		>90		90 to 60	60 to 30	<30
Income concentration	**Top core holding (%)**	<10	10 to 20	20 to 30	30 to 50	>50
	Top three core holdings (%)	<30	30 to 50	50 to 70	70 to 90	>90

Source: Scope Ratings

[2] Dividends, interest and management fees
[3] The rating committee decides the relative importance of each rating driver.

Portfolio assets can be held through indirect or direct stakes. Indirect investments are typically made via intermediate companies. We apply a look-through approach for intermediate holding companies because they typically do not have material operations other than holding equity stakes or incur any debt.

Portfolio diversification

Our assessment of portfolio diversification is based on the top core holdings concentration, the underlying industry concentrations and geographical diversification.

Broad diversification and a limited concentration of core holdings are important for stable and high credit quality. This is because a material reduction in the value of one investment should only have a limited impact on the portfolio's total value.

An investment holding company can have portfolio companies that are engaged in different countries/regions[4] and sectors. Credit-positive would-be geographically diversified assets and/or investments in comparison to peers. We analyse revenue and/or EBITDA contribution of core holdings by geographies to assess diversification.

Figure 4 – Portfolio diversification by rating category

		AA and above	A	BBB	BB	B and below
Geographical diversification		Reflects global market		More than one region	One region	One country
Sector concentration (% of GAV)		<10	10 to 20	20 to 50	50 to 80	>80
GAV concentration	**Top core holding (%)**	<10	10 to 20	20 to 30	30 to 50	>50
	Top three core holdings (%)	<20	20 to 35	35 to 50	50 to 70	>70

Source: Scope Ratings

Portfolio liquidity

The analysis of portfolio liquidity includes a risk assessment of the rated entity's ability to liquidate its portfolio assets, including whether it can sell quickly at a fair price and not at a significant discount (e.g. fire sale). Portfolio companies listed on a stock exchange are more liquid than unlisted ones, all else being equal.

We also assess soft factors that may constrain an investment holding's ability or willingness to liquidate an asset or investment. These include a desire to maintain a controlling equity stake, loss of minority veto rights, debt covenants requiring the holding company to maintain a minimum stake and the existence of shares used as collateral by the investment holding company.

Figure 5 – Portfolio liquidity by rating category

	AA and above	A	BBB	BB	B and below
Listed portfolio (% of GAV)	>90	90 to 70	70 to 50	50 to 30	<30
Ability to divest	Unrestricted			Limited	

Source: Scope Ratings

Investment philosophy

We review portfolio dynamics to assess the investment philosophy. These may include rotation of investments and the approach to value creation (e.g. long-term growth). We measure changes in portfolio value based on the development of net asset value between reporting periods. To analyse investment holding companies with frequent portfolio rebalancing, we might use the internal rate of return on divested core holdings to measure the ability to generate disposal gains.

[4] We identify the following seven global regions: Europe, North America, Latin America, Oceania/Australia, Asia, Africa and the Middle East.

The long-term visibility on a business model and an investment holding company's competitive position can benefit from i) a defined investment strategy; ii) an excellent record of execution and low risk of significant transition of the portfolio; and iii) clearly defined investment guidelines. We review the documented investment policy (i.e. investment horizon[5] and exit strategy) and determine whether it is applied in the existing portfolio.

Our assessment captures management's risk appetite for discretionary spending (such as acquisitions and share buybacks) and the extent to which these are funded by debt, notably in cases of debt-funded acquisitions that lead to short-term deviations from stated financial policy.

Figure 6 – Investment philosophy by rating category

	AA and above	A	BBB	BB	B and below
Portfolio value development	Strong track record			Limited track record	
Investment policy	Long-term investment horizon and/or defined exit strategy			Medium investment horizon with defined portfolio rebalancing targets	

Source: Scope Ratings

3.2 Financial risk profile

We assess an investment holding company's financial strength based on credit metrics calculated using the rated entity's standalone financial accounts. We do not use consolidated financial accounts as the rated entity may be unable to access a portfolio company's cash flow or liquidity as reported in the consolidated accounts or have no influence over its dividend policy.

The financial risk profile assessment of an investment holding company focuses on recent and forward-looking financial data. The main parameter is total cost cover, supplemented by the Scope-adjusted loan/value ratio (LTV) and the liquidity assessment, especially for non-investment grade issuers (detailed definitions are contained in the appendix).

The financial risk profile indicates a company's financial flexibility and viability in the short to medium term. A company with a strong financial risk profile is more likely to be resilient to economic downturns, adverse industry dynamics, unfavourable regulation or an unexpected loss of a revenue stream. The ability to retain financial flexibility during an economic downturn is a key rating driver for investment holding companies as it indicates an ability to invest at all phases of the economic cycle.

Aspects of financial flexibility not captured in our assessment of investment philosophy are reflected in the financial risk profile assessment. These may include shareholder remuneration, headroom to financial covenants and commitment to certain rating or net debt levels.

3.2.1 Credit metrics

The key indicator for an investment holding company is total cost coverage. This measure is supplemented with our assessments of leverage (as measured by the LTV) and liquidity. Total cost coverage is the cash inflow relative to non-discretionary cash outflow at the holding company level, which indicates its ability to cover non-discretionary payments. LTV signals the headroom for external funding to cover debt maturities.

Our assessment of credit metrics takes the key ratios shown in Figure 7 into account

Figure 7 – Credit metrics

	AA and above	A	BBB	BB	B	CCC and below
Total cost cover (x)	>4.0	4.0 to 2.0	2.0 to 1.0	1.0 to 0.5	<0.5	No recurring income
LTV (%)	Net cash	<15	15 to 30	30 to 50	50 to 70	>70
Portfolio market value volatility	Low to medium			Medium to high		

Source: Scope Ratings

[5] A long-term investment horizon corresponds to a holding period of portfolio assets exceeding five years.

We assume that the nature of dividend payments is akin to a discretionary cash outflow. To calculate total cost coverage, we treat dividend payments as non-discretionary until the investment holding company publicly declares a significant change to its dividend policy.

We calculate LTV at investment holding company level, using Scope-adjusted debt against the portfolio's market value. Scope-adjusted debt includes short-term and long-term financial debt, adjusted for pension provisions, operating leases and off-balance sheet items such as guarantees (see the General Corporate Rating Methodology for the full definition).

We use LTV to reflect a holding company's ability to either raise financing or repay debt if needed. Changes in the price of listed assets are more relevant to the credit analysis if an investment holding company[6] has debt that will mature in the next 12-24 months. Therefore, price changes in listed assets are only relevant when judged in relation to debt maturities. The LTV on its own can therefore be misleading as it does not capture debt maturities. We capture the market value volatility an investment holding company can withstand, affected by the share price of listed assets and/or valuation of portfolio companies, as the supplementary factor of LTV. The higher volatility of the market value of investments will likely result in a lower credit quality and relatively limited access to the capital markets.

When an investment holding company does not account for its portfolio assets at fair value (e.g. using local accounting standards) and a third-party assessment is not available, we use net investment value to conservatively assess portfolio market value and reduce the effect of market sentiment. We calculate net investment value as the book value of investments plus development costs. In cases where the holding company uses local accounting standards while a portfolio company applies IFRS, we use the net asset value[7] of the portfolio company.

The calculation of portfolio market value considers whether asset rotation has led to a large cash balance. If we believe the cash will likely be reinvested, we will include it in the portfolio value calculation. If reinvestment is unlikely, we may include it in Scope-adjusted debt, which would reduce the LTV. The detailed treatment of cash balances in Scope-adjusted debt is outlined in the General Corporate Rating Methodology.

3.2.2 Liquidity

We assess the liquidity of an investment holding company as we would for any other non-financial company. We assess the ability to pay back short-term debt using free operating cash flow, unrestricted cash and marketable securities, unused committed bank facilities and unused committed factoring lines.

Our general assessment of liquidity is outlined in the General Corporate Rating Methodology.

3.3 Supplementary rating drivers

3.3.1 Parent/government support

Our assessment of parent support is described in the General Corporate Rating Methodology. When assessing the credit quality of an investment holding company that may benefit from government support (i.e. Sovereign wealth funds), we incorporate the sovereign's or sub-sovereign's capacity and willingness to provide support in cases of financial distress of the entity, as laid out in Government Related Entities Rating Methodology.

3.3.2 Peer context

We assess explicitly portfolio size of company as we consider critical mass for portfolio management is important even to reach robust portfolio structure incorporating characteristics of both business and financial risk profile. We analyse size of portfolio based on gross asset value of portfolio. An IH will have a higher overall credit quality if they have a portfolio size above EUR 5.0bn, while smaller IH (below EUR 0.2bn) generally be seen of weaker credit quality assuming a comparable business and financial risk profile.

Our assessment based on a comparison with peers is described in the General Corporate Rating Methodology under supplementary rating drivers.

[6] An investment holding company that can cover non-discretionary cash outflow internally, as indicated by its total cost cover, will not need additional external funding.

[7] The difference between net asset value and shareholder equity is that equity is calculated including intangible assets, which can include goodwill and patents, while the calculation of net asset value only includes tangible assets.

3.3.3 Governance and structure

Our assessment of governance and structure is described in the General Corporate Rating Methodology under supplementary rating drivers.

3.4 Environmental, social and governance (ESG) assessment

Credit-relevant environmental and social factors are implicitly captured in the rating process, while corporate governance is explicitly captured at the 'governance and structure' analytical stage (see 3.3.3).

The rating analysis focuses on credit quality and credit assessment drivers. An ESG factor is only credit-relevant when it has a discernible and material impact on the issuer's cash flow, and by extension, its overall credit quality.

Credit-relevant ESG factors can directly and indirectly affect all elements of the business risk profile, financial risk profile and supplementary rating drivers. This is in contrast to ESG ratings, which are largely based on quantitative scores in various rating dimensions.

In the context of investment holding companies, we see the main credit-relevant ESG factors in the following areas:

- Reputation risk (e.g. tax evasion)
- Transparency (e.g. corporate structure, hidden assets)
- Investment criteria and exposure to the ESG profiles of portfolio companies

The General Corporate Rating Methodology further details how ESG factors and supplementary rating drivers are incorporated in the credit analysis.

4. Issuer rating

The final issuer rating is based on our analysis of the business risk profile, financial risk profile and supplementary rating drivers. The rating committee decides on the relative importance of each rating driver. The business risk profile and financial risk profile are generally weighted equally for companies that are perceived as crossover credits between investment-grade and non-investment-grade related to the final issuer rating. The business risk profile is typically emphasised for investment-grade companies, while the financial risk profile is mostly the focus of ratings assigned to companies that are perceived to have high yield credit profiles. However, the latter also depends on the level of the financial risk profile. Less focus is granted to strong financial risk profiles of companies showing a weak/vulnerable business risk profile (in the B or low BB category) since for such companies the financial risk profile is subject to higher volatility. This takes into account that the credit rating of companies with business risks that reflect weak or moderate credit quality should not be bolstered by a temporary strong financial risk profile. Hence, the weighting between the business risk and financial risk profiles is adapted to each issuer's business model and market(s).

5. Additional methodology factors

Refer to the General Corporate Rating Methodology for more detail on our rating Outlooks for corporate debt ratings, short-term ratings, the recovery analysis, instrument ratings and rating categories.

6. Debt ratings

We usually do not carry out a specific assessment of debt instrument ratings for investment grade issuers. Our general assessment is outlined in the General Corporate Rating Methodology.

For non-investment grade issuers, we believe that liquidation is the most likely scenario for an investment holding company in default. This view is driven by the asset-heavy balance sheet of most investment holding companies as well as the separation between the operations of core holdings and the rated issuer. We estimate the liquidation value at default by adding the significant discounted values of portfolio assets, assuming a similar asset structure to the one at default. The calculation mostly includes the net asset values of portfolio companies together with other investments and receivables. Items such as inventory and plant and equipment typically are not material for investment holding companies and are therefore excluded from our assessment. For portfolio companies, discounts to book value are a function of the relevant jurisdiction and incorporate market value volatility.

7. Appendix

7.1 Definitions of financial items and key performance indicators applicable only to investment holding companies

Scope-adjusted loan/value ratio (%)	
Debt measure	This ratio compares an issuer's debt payment obligations with the portfolio market value.
$$\frac{\text{Scope-adjusted debt}}{\text{Portfolio market value}}$$	Market value is calculated as the fair value of portfolio assets excluding cash and equivalents as well as the positive value of derivatives.

Total cost cover	
Cash flow measure	This ratio indicates the issuer's ability to cover non-discretionary expenses using recurring cash inflows.
$$\frac{\text{Recurring cash income}}{\text{Total costs}}$$	Recurring cash income mainly consists of: • Cash inflows from portfolio companies such as dividends or cash payments triggered by profit-sharing agreements; • Cash-interest inflows from treasury activities such as investment in debt securities; • Distributions from other investments such as investment funds or money market funds; and • Any other recurring cash-effective payments received from portfolio companies such as management fees or interest on shareholder loans provided to portfolio companies. Total costs mainly consist of: • Cash outflows from debt servicing (cash interest); • Dividend payments by the investment holding to its shareholders; and • General holding costs such as administrative expenses, staff costs and taxes.

Gross asset value (GAV)	
Balance sheet measure	GAV is the total equity value of companies in the portfolio.
Market value of investments ± Adjustments such as unrestricted cash and cash equivalents or receivables = GAV	

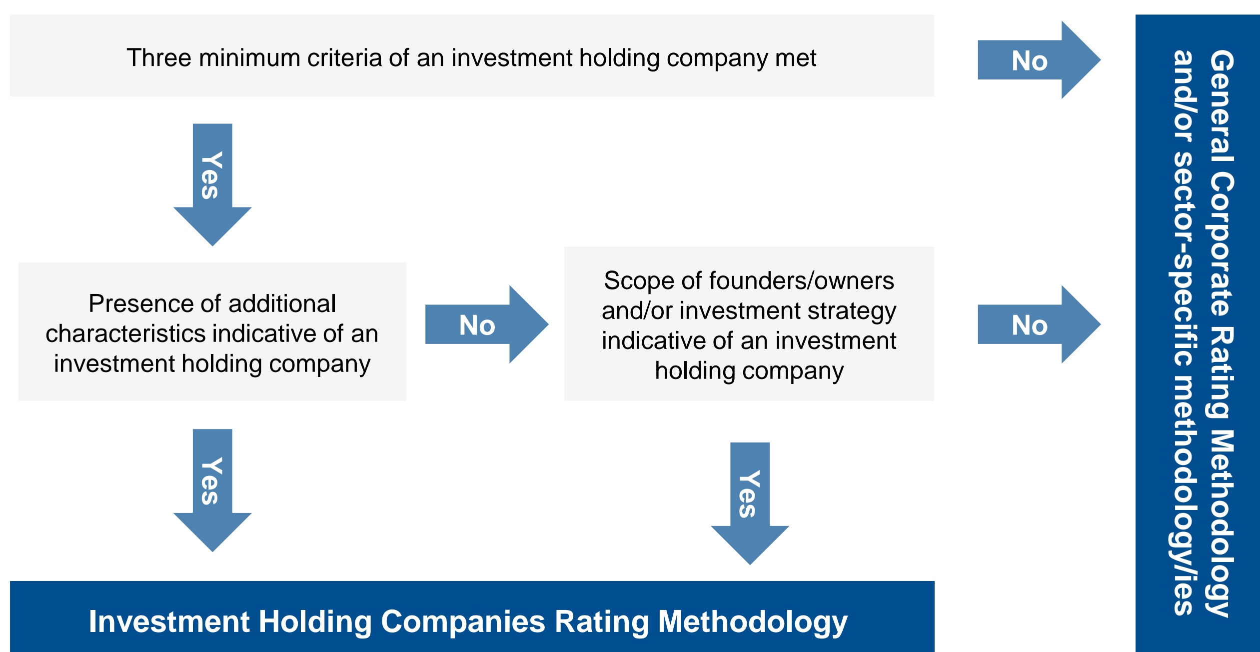
Levered internal rate of return **(%)**	
Efficiency measure	This ratio measures realised multiples on portfolio companies divested by the issuer. The levered internal rate of return (IRR) is calculated by comparing the total proceeds of a specific portfolio company with its total investment. The levered IRR also considers related financing costs.
$$\sum_{t=1}^{n} \frac{\text{Cash flow}_t}{(1+\text{IRR})^t} - \text{investments} = 0$$	

Weighted average industry portfolio risk	This ratio is used to measure the weighted average industry risk of underlying assets. Assessments of industries are provided in sector-specific methodologies using the industry risk matrix defined in our General Corporate Rating Methodology.
Industry risk measure $IR_{GAV} = \sum weight_{Industry\ i} \times \text{assessment}_{Industry\ i}$ $IR_{Income} = \sum weight_{Industry\ i} \times \text{assessment}_{Industry\ i}$	

The definition how Scope's computes liquidity ratios is laid out in Scope's General Corporate Rating Methodology.

7.2 Description of investment holding methodology application process

Figure 8 – Flowchart



7.3 Related documents

For more information, please refer to the following documents:

- General Corporate Rating Methodology
- Government Related Entities Rating Methodology
- Credit Rating Definitions

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