



## **Morningstar Credit Rating Methodology – Captive Finance Entities**

### *The Spectrum of Rating Linkage From Inextricable to Independent*

Morningstar's credit rating methodology recognizes the broad spectrum of possible relationships that could exist between parent corporations and their captive finance entities (herein designated as CFEs). At one end of the spectrum is an inextricably linked credit rating relationship. In these cases, the parent and the CFE operate as a single, homogeneous entity for all practical purposes. At the opposite end of the spectrum is the case of a parent and CFE that are independent, where there is no relationship other than the parent's ownership, leading to disparate credit ratings of the parent and the CFE. Morningstar determines the relationship between a parent and a CFE based on the results of our analysis of financial statements, business fundamentals, strategy, organizational structure, credit agreements, bond indentures, and any agreements between the parent and the CFE, under the framework of our overall credit rating methodology.

A CFE may be set up as a strategic business unit, a separate legal entity subsidiary, a bank, or various combinations of all three, with the stated purpose of supporting its parent company's business. The CFE typically does this by providing financing that enables dealers to stock the parent's products for resale to customers, enabling customers to purchase or lease the parent company's products, or both.

Because of such close business ties, Morningstar believes, in the vast majority of cases, that the linkage between the parent and the CFE will be meaningful, resulting in credit ratings that are the same. An inextricable ratings link usually exists due to the close business ties between the parent and the CFE. To the degree that the CFE's objectives deviate from this general business model and to the degree that there are differences in the financial means by which the parent and the CFE perform their respective business activities, the rating linkage between the parent and the CFE moves along the spectrum from inextricable to independent.

In extremely rare situations, a more independent rating may be appropriate. In the rare case where the rating linkage is considered detached, the respective creditworthiness of the parent and the CFE may or may not lead to both having the same credit rating. In addition, the respective credit ratings may or may not move in tandem with each other given any changes in the respective credit profiles of the parent and the CFE. Under the extremely rare circumstance where Morningstar has determined that some degree of rating independence exists, the likelihood of default for either the parent or the CFE is independent of one another. In such cases we believe adequate protections exist against either a distressed parent or CFE pulling the other into bankruptcy.

The flow chart graphically depicts the Morningstar rating methodology for captive finance entities. It is not intended to imply a rigid step-by-step process nor is it meant to imply mutually exclusive conclusions. Rather, the flow chart is a graphical representation of the general framework by which Morningstar determines the location of the credit rating linkage along the spectrum from an inextricable link (and equivalent credit ratings) at one end to completely independent credit ratings of the parent and the CFE (with potentially disparate or equal rating results) at the other end.

## Beginning the Process

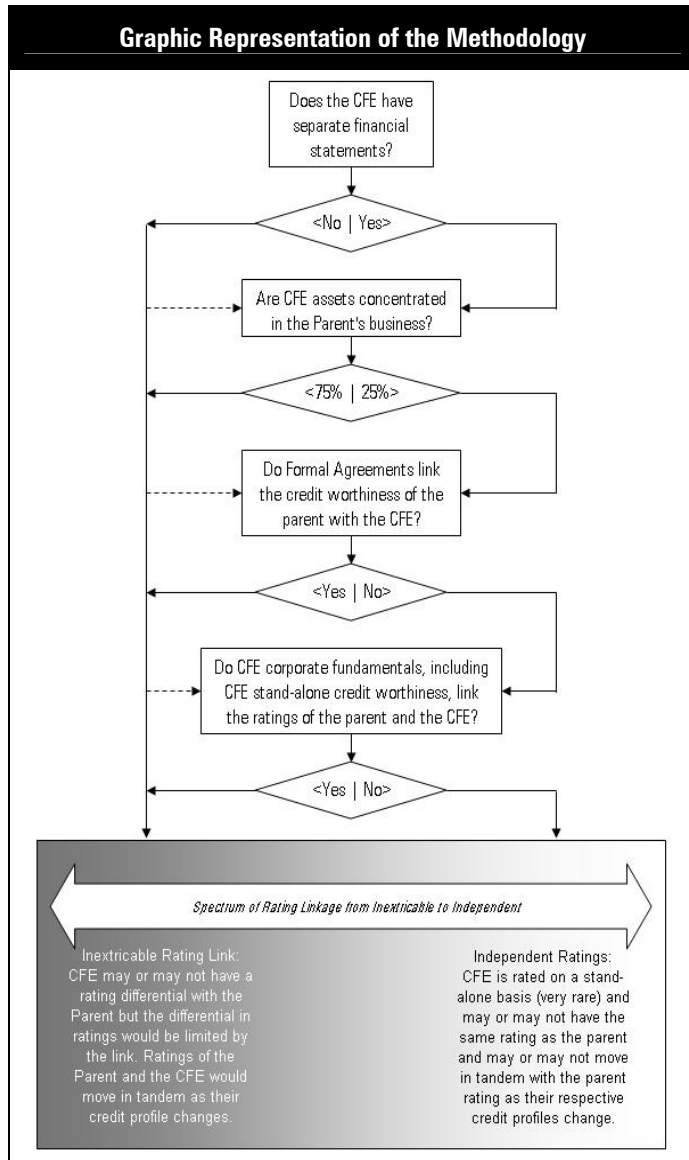
### *Ability to Create Pro Forma Financials as the First Indicator*

For the purpose of determining each entity's credit worthiness, Morningstar analysts begin the credit rating process by determining whether or not independent pro forma financial statements of the parent and the CFE can be created, such that the captive finance entity can be accounted for on an equity basis on the parent's pro forma financial statements and the CFE's pro forma financial statements can be analyzed on a stand-alone basis. If the CFE is organizationally treated as a strategic business unit to provide financing only for the parent's products, is not separately incorporated under a subsidiary legal structure, is not required to file separate financial statements with governing authorities, and is reported only as part of the consolidated financial statements of the parent, then the link between the parent and the CFE is inextricable, and we assign the same credit rating to both entities.

## The Next Indicator

### *Business Concentration*

Once pro forma financial statements have been created, Morningstar analysts then begin preparation of a credit rating recommendation for the parent and for the CFE to present to the credit rating committee by using our credit rating methodology. Our analysts begin by examining the composition of the CFE's asset portfolio. In most cases, Morningstar will consider the rating of the parent and the CFE as inextricably linked if 75% or more of the CFE's financial asset portfolio is derived from the parent. In addition, Morningstar will consider the ratings independent if 25% or less of the CFE's financial asset portfolio is derived from the parent. However, we emphasize that these percentages are not hard-and-fast breakpoints.



## **A Preponderance of the Evidence**

### *The Impact of Formal Agreements and Corporate Fundamentals on Credit Rating Linkage*

The existence of separate financial statements and the general levels of business concentration are analyzed in light of formal agreements between the parent and the CFE as well as the CFE's corporate fundamentals, including its stand-alone credit-worthiness. The formal agreement and corporate fundamental credit research performed by Morningstar analysts will either produce a preponderance of evidence (expected to be frequent), or the lack thereof (expected to be rare), that a credit rating link between parent and CFE exists.

The impact of formal agreements and corporate fundamentals varies on a case-by-case basis, broadening the potential spectrum of ratings linkage between the parent and the CFE. The degree to which the rating linkage is impacted by these considerations can dramatically alter the conclusions that Morningstar analysts derive from the first two steps of the CFE rating methodology.

Case in point: A CFE may have significantly less than 75% business concentration with the parent, but due to a guarantee of the CFE's debt by the parent, cross-default provisions, parent marketing reliance on subvented interest rates or leasing, use of the same corporate identity, and substantial parent control of CFE asset quality and lending policies, the rating linkage between the parent and the CFE may be considered inextricable.

In addition, a CFE may have more than 75% of business concentration with the parent, but due to a lack of any formal agreements, cross-default provisions, and distinct treasury functions, and a relatively poorer credit profile than the parent, the CFE may be linked due to the business concentration but could potentially have a lower rating than the parent.

Conversely, Morningstar can envision a scenario where a CFE has less than a 25% business concentration derived from the parent but has an inextricable link because the parent shares its treasury function with the CFE; the CFE uses the parent's brand identity for marketing purposes and to raise capital; the CFE regularly issues substantial cash dividends to the parent; the parent has made sizeable capital contributions to the CFE. Morningstar may determine that a credit rating link exists but the parent and the CFE likely would be disparately notched to reflect their respective credit-worthiness. However, the amount of rating differential would be limited by the existing rating linkage between the parent and the CFE.

In addition, a CFE could have significantly more than 25% business concentration, but due to the lack of any formal credit agreements, distinct corporate identities, distinct treasury functions, and an infrequent, limited amount of dividend payments from the CFE to the parent, Morningstar could determine that the credit rating linkage is more independent than inextricable. However, this does not imply that the credit ratings of the parent and the CFE have to necessarily be different. Even so, it does imply that Morningstar derives the parent's and the CFE's credit ratings independent of one another and, depending on changes in either the parent's or the CFE's credit-worthiness, could change each entity's respective credit rating without changing the credit rating of the other.

In extremely rare instances, our rating methodology may produce a ratings differential, even though the credit worthiness of the CFE and the parent are inextricably linked. An inextricable ratings link can exist due to certain intracorporate fundamentals or formal agreements. As a result, the credit ratings of the parent and CFE, while potentially differentiated, likely will move in tandem with each other. Ultimately, where a ratings differential exists with an inextricable link, Morningstar has concluded that if either the parent or the CFE were to become distressed, the distressed entity would potentially pull the other into bankruptcy; but even so, a court-ordered substantive consolidation is improbable. In such a case, the rating differential reflects Morningstar's belief that the debtholders of an issue from the less-distressed entity may potentially have better recovery.

### *Formal Agreements*

In many cases, there are formal credit-related agreements between the parent and the CFE in the form of guarantees, cross-default provisions, support agreements (also known as financial threshold or keepwell), and comfort letters. Morningstar analysts study credit agreements and bond indentures of the parent and the CFE looking for these agreements and the potential impact to the linkage between the rating of the parent and the CFE. For example, if a parent were to provide an irrevocable guarantee of the CFE's debt and if there were cross-default provisions in the credit agreements or the bond indentures of either the parent or the CFE, Morningstar may consider the credit rating linkage of the parent and the CFE to be inextricable.

#### **Formal Agreements That Could Determine the Existence of a Credit Rating Link**

- ▶ Guarantees
  - Debt of the CFE guaranteed by the parent
  - Receivable purchases
  - Residual value
  - First-loss deficiency
- ▶ Cross-default provisions
  - Parent and CFE credit agreements or bond indentures contain provisions such that if one entity defaults, the other also is considered to be in default.
- ▶ Support agreements
  - Capital requirements
  - Maintenance of financial covenants
  - Profitability requirements
  - Restricted dividends
- ▶ Comfort Letter
  - Expressly states parent's intentions to support the CFE

## Corporate Fundamentals

Apart from formal agreements is the economic reality of the relationship between the CFE and the parent. If the two entities are tightly bound economically, Morningstar factors that into the assessment.

The first and primary consideration here is the purpose served by the CFE. This consideration is partially answered in Morningstar's initial steps in determining credit rating linkage, as the existence or lack of separate financial statements and the degree of business concentration may be indicative of the CFE's purpose. In researching corporate fundamentals, a top-down analysis of the CFE is performed, including an analysis of the stand-alone credit rating of the CFE. Some cases in which corporate fundamentals play a significant part could include situations where formal agreements between the parent and the CFE are not present, but management of the parent firm directly influences asset quality and lending policies of the CFE; substantial dividend payments to the parent from the CFE are regularly made; a history of financial subvention exists between the parent and the CFE. In these cases, Morningstar likely would consider these corporate fundamentals and the economic implications of intracompany transactions as creating an inextricable link between the credit ratings of the parent and the CFE.

### Corporate Fundamentals That Could Determine the Existence of a Credit Rating Link

- ▶ Purpose of the CFE
  - CFE is a strategic necessity for parent
    - Competing firms' use of CFEs
  - Operational integration
    - Supports dealer network
    - Enables consumer purchases
    - Formal operating agreement
  - Integral to marketing
    - Interest-rate subvention, lease subvention
  - Shared corporate identity
- ▶ Management
  - Parent percentage ownership
  - Board members and executive team
  - Treasury function
    - Use of the same funding sources
    - Shared credit facilities
  - Parent Influence over asset quality and lending policies
- ▶ Financial subvention between parent and CFE
  - Historical support provided by parent
  - Intercompany loans
  - Dividends paid to the parent
    - Regularity
    - Amount
- ▶ Regulated entity
  - Bank subsidiary may have legislated capital requirements
  - Local statutes may limit the extension of parent bankruptcy to a subsidiary

## Tying It All Together With Our Credit Rating Methodology

In order to better determine the flow of funds between the parent and the CFE and highlight situations where healthy cash flows from either the parent or the CFE may offset a deterioration in the other's credit-worthiness, we rate each entity using pro forma financial statements, where the parent's financials include the CFE on an equity basis and the CFE's financials are on a stand-alone basis.

To rate the CFE, we use the same four pillars as our bank credit rating methodology: Business Risk, Stress Test, Solvency Score, and Distance to Default. However, portions of the individual pillars may be affected by the credit rating of the parent depending on the degree of shared credit risk between

the parent and the CFE. For more details regarding Morningstar's Four Pillars of Credit, our general credit rating methodology, and our bank credit rating methodology, see *Morningstar Credit Rating Methodology* (November 2009) and *Bank Credit Rating Methodology* (July 2010) at [www.morningstar.com/Cover/Bonds.aspx](http://www.morningstar.com/Cover/Bonds.aspx).

### *Business Risk*

Morningstar may make a number of adjustments to the underlying scores of the Business Risk Analysis section to account for the shared business risk between a parent and a CFE. *Product/Customer Concentration* of the parent and the *Geographic/Business Line Concentration* of the CFE are adjusted based on the percent of finance receivables originated in support of the parent's operations. The *Dependence on Capital Markets* score may or may not be related to the parent depending on the use of a common treasury department, reliance on commercial paper markets, the use of accounts receivable securitization programs, reliance on a common line of credit, the degree of financial subvention between parent and CFE, or the use of bank deposits as a means to funding CFE business activities. In addition, the CFE's *Size* in terms of the total finance receivables portfolio is taken into consideration in this section.

For the scores associated with Morningstar's *Economic Moat* rating and *Equity Uncertainty* rating, key components in the Business Risk section, we consider the parent's economic moat and the uncertainty of the equity residual, but also factor in characteristics of the CFE. So adjustments to these measures may or may not be necessary, and may depend on the level of the parent's ownership in the CFE plus the concentration of assets in the CFE's receivables portfolio underwritten in support of the parent's operations. In the overwhelming majority of cases, Morningstar expects that the *Economic Moat* and *Equity Uncertainty* rating of the CFE will be the same as that of the parent. However, in circumstances where the parent's ownership in the CFE is less than 100%, or where the parent's portion of the CFE's receivables portfolio is less than 100%, the *Economic Moat* and *Equity Uncertainty* ratings may be positively or negatively impacted relative to the parent's rating.

### *Stress Test Score*

Morningstar considers the CFE's *Underwriting Quality* in the *Stress Test* section and assesses the captive's potential underwriting standards under stress conditions of the parent. Formal agreements like debt guarantees and cross-default provisions between the parent and CFE can directly tie the default risk of the parent to the CFE, and vice versa. In addition, the corporate fundamentals of the parent and the CFE may be equally impacted by the market demand for the parent's products and are exposed to the same industry structural and economic factors. The materiality of the captive's earnings and cash flow to its parent's operations may also provide a strong economic incentive for the parent to support the finance subsidiary, even in the absence of formal agreements, creating an inextricable linkage.

We weigh the Cash Flow Cushion™ and Stress Test scores of the parent and the CFE, respectively, in the consideration of an inextricable ratings link. Our methodology includes rating each entity using pro forma financial statements where the parent's financials include the CFE on an equity basis and

the CFE's financials are on a stand-alone basis, to better determine the flow of funds between the parent and the CFE. The respective Cash Flow Cushion™ and Stress Test scores highlight situations where healthy cash flows from either the parent or the CFE may offset a deterioration in the other's credit-worthiness. If the CFE issues cash dividends to the parent, the Cash Flow Cushion™ improves; if the parent makes a capital contribution to the CFE, the Stress Test score improves. If both scores are poor, the parent may not be able to get cash from the CFE to support operations and the CFE may not be able to get a much-needed capital infusion.

### *Solvency Score™*

Morningstar's *Solvency Score™* takes into consideration the interest rate risk, delinquency, loan loss reserves, and leverage (debt/equity) of the CFE. Morningstar's *Solvency Score™* for the parent, in cases where formal agreements and corporate fundamentals closely tie credit risk, potentially could indicate a need for cash to be transferred from the CFE to the parent in the form of dividends. Conversely, if management's lending policies have led to high delinquency and loan-loss reserves, formal agreements may require cash to be transferred from the parent and to the CFE in the form of equity contributions.

### *Distance to Default*

Since the funding flexibility of the parent or the CFE can become impaired before problems are fully reflected in the respective pro forma financial statements, Morningstar believes the market-driven nature of the Distance to Default algorithm is a key indicator of the capital market's appetite for providing the group--both the parent and the CFE--with additional liquidity sources at a given point in time.

Given the inherent ties between the parent and the CFE and because equity pricing information is generally not available for a CFE, Morningstar uses the parent's Distance to Default score for the CFE.

## **Summary Remarks**

The spectrum of credit rating linkage between a parent and a captive finance entity ranges from inextricable at one extreme to completely independent at the other. Morningstar expects that, in most cases, credit rating linkage will be inextricable, but recognizes the potential for disparate credit ratings. To summarize our process:

- To begin the credit rating process, analysts first create pro forma financial statements for the parent and the CFE, which enables the rating of the parent using financials that account for the CFE on an equity basis and to enable the rating of the CFE using financials as if the CFE were a separate entity. The inability to create pro forma financial statements may be indicative of an inextricable credit rating link.
- Analysts then determine the business concentration of the CFE. Morningstar considers as general guidelines a 75% or higher concentration of portfolio assets derived from the parent

as an indication of an inextricable link, while a concentration of 25% or lower is considered to indicate credit ratings independence between the parent and the CFE.

- Analysis of formal agreements and corporate fundamentals can reveal a significant impact or lack thereof on rating linkage and is determined on a case-by-case basis. Morningstar uses the analysis of the credit rating linkage of the parent and the CFE to make adjustments to each entity's credit rating components.
- The Morningstar Credit Rating Committee votes separately on the parent and the CFE to determine the final credit ratings.