July 1, 2003

Rating Viewpoints on Pure Holding Companies (Domestic Industrial Corporations)

Introduction

The number of domestic industrial corporations adopting the system of pure holding company is increasing. This trend is likely a result of the growing importance of efficient group management, improved governance, and other needs, in addition to the ongoing development of the legal structure, such as the revision of the Antimonopoly Act and Commercial Code. Among the organizations to be rated by the Japan Credit Rating Agency (JCR), four companies adopted the pure holding company system in fiscal 2001 and five in fiscal 2002. Another company moved to the system in fiscal 2003, and three companies announced their plan to move in the current fiscal year (Figure 1). JCR announced its policy for ratings of holding companies in December 1999 in response to the emergence of companies announcing their intention to move to the pure holding company system. While the basic policy remains generally unchanged, this article is based on JCR's experience of rating domestic industrial corporations. The term, "holding company," in this article refers to a pure holding company.

A holding company holds the right to take part in the management of each subsidiary based on shareholdings, while taking into account the management of the entire group. It allocates management resources such as by using its authority to receive necessary funds from some of the subsidiaries and then distributing them to other companies. A holding company can exert great power over its businesses without much difficulty, such as by assigning funds as deemed necessary to the group's operations by using the cash flow generated by each subsidiary. The debt redemption capacity of a holding company, therefore, is considered equivalent to that of the consolidated credit standing of combined subsidiaries. Therefore, as in rating ordinary businesses, holding companies are rated based on the assessment of their consolidated credit profile.

A holding company, in principle, does not operate its own business, does not have the ability to generate cash flow and often holds only a small amount of assets, except for shares of subsidiaries. Therefore, they need to generally rely on cash received from its subsidiaries to repay its external financial liabilities. These holding company characteristics can, in some cases, force its creditors to become subordinate holders of its debt relative to creditors of subsidiaries. Thus, in rating a holding company, we consider the degree of subordination to its subsidiaries while examining areas such as (1) governance, (2) income- and-expenditure structure, (3) recovery risk in case of default. In general, in examining point (1) above, we focus on the framework of the entire group while placing the holding company on top of the structure. For point (2), we look into the actual cash flows within the pure holding company framework. For point (3) above, we primarily examine the financial structure of the company. This article outlines the perspective of rating unique to holding companies.

Figure 1: Rated companies: Their shift to a holding company system

Time of Shift	Name of Holding Company	Rating of Holding Company	Rating of Subsidiary	
			Name of Subsidiary	Rating
Jul. 1999	Nippon Telegraph and Telephone Corporation (NTT)	-	Nippon Telegraph and Telephone West Corporation (NTT West)	J-1+
			Nippon Telegraph And Telephone East Corporation (NTT East)	J-1+
			NTT Docomo	AAA
Oct. 1999	Softbank Mobile	BBB-	-	-
Mar. 2001	Nippon Unipac Holding	A+	Nippon Paper Group	A+
Jun. 2001	Coca-Cola Central Japan	A+	-	-
Jul. 2001	Nisshin Seifun Group	AA	-	-
Oct. 2001	Tostem Inax Holding	AA-	-	-
Apr. 2002	Takara Holdings	A	-	-
Aug. 2002	Japan Telecom Holdings	#AA	-	-
Sep. 2002	Nippon Mining Holdings	BBB-	Japan Energy	BBB-
Sep. 2002	JFE Holdings	A+	JFE Steel	A+
Oct. 2002	Japan Airlines System	-	Japan Airlines	A-
Apr. 2003	Konica	#A	-	-
(Future Plans)	(Current Company Name)			
Jul. 2003	Sapporo Breweries			
Jul. 2003	Godo Shusei			
Oct. 2003	Fuji Electric			

Note: The ratings are as of May 31, 2003 (except financial institutions)
Only the long-term rating is presented for companies given a long-term rating. Only the short-term rating is presented for companies given a short-term rating.

1. Perspective of Rating Holding Companies

(1) Governance

A holding company and its subsidiaries are considered to have created a strong unity when the holding company has established solid governance and a system for the holding company to receive adequate cash flows from all of the group's subsidiaries. The rating of a holding company is based on on their consolidated credit standing. In other cases, a holding company may not have much authority over the management resources of its subsidiaries for such reasons as its small capital contribution and low relevance to the core business of the group. The holding company in this case would have difficulty receiving adequate cash flow, and thus would be rated based on the effectiveness of its governance and the possibility of receiving cash flow. The governance of a holding company and strength of its group unity are verified specifically based on the following criteria:

- Whether the holding company sufficiently participates in the management of its subsidiaries, in addition to its capital contribution and assignment of its executives to the subsidiaries
- Whether the strategies of the entire group are consistent with the management plans of each subsidiary
- Whether the holding company oversees the financial planning and management of each subsidiary and promotes fund efficiency of the entire group
- Whether the policies for asset management and investment/lending of the entire group are

consistent with the policies for capital expenditure and investment/lending of each subsidiary, and whether any redundancy is eliminated

- Whether there are no obstacles, such as dividend limitation, that prevent the flow of cash to the holding companies
- Whether the position of each subsidiary, such as the its own business portfolio, is clearly defined, and whether the position reflects the management policy of the entire group
- Whether the holding company intends to continue owning major subsidiaries, and whether it is financially capable of ownership
- Whether continuous holding of shares in the subsidiaries is required by provisions such as financial covenants attached to bond issuance
- Whether the holding company holds the right to make decisions such as business closure, alliances with other companies, business integration
- What roles the holding company plays in adjustments within the group.

(2) Income-and-expenditure structure

Income of a holding company consists of (a) management guidance fees received as compensation for its function for a strategic sector, brand license fees, operating fees for the group management, etc.; (b) rent for facilities received as compensation for assets held; and (c) dividends received as proceeds from investments in the group's subsidiaries, etc. Some companies assign brand license fees as compensation for intangible assets.

A holding company of a corporate group with strong unity has the authority to be deeply involved in policies regarding the amount and time taken to receive income such as (a) and (b) above, as well as dividends, or (c) above, from group companies during the development of strategies for the entire group. This allows the holding company to receive stable and relatively reliable income of (a) to (c), making its credit mostly equivalent to the credit of the entire group. While receiving dividends often provides tax benefits, such as exclusion from gross revenue, there is less stability than in the case of (a) and (b) due to limitations, such as the range of amount specified by the Commercial Code and the period allowed for dividend payment. The examination of the income-and-expenditure structure of a holding company, therefore, takes into account the balance of income sources (a) through (c) and the timing involved in receiving funds.

When adopting a holding company system, corporate groups with strong unity, in many cases, centralize their fund management at their holding companies in order to reduce the burden of administrative work and procurement cost as well as to improve fund efficiency. The holding company in this case lends funds that it has procured externally to its subsidiaries, and the funds to repay external debts of the holding company are, in general, the principal and interest on the loans to the subsidiaries. In terms of both the amount and timing, if the principal and interest received from the subsidiaries ensure cash flow that is sufficient to repay the principal and interest on the external debts of the holding company, the credit of the holding company becomes virtually equivalent to the credit of the entire group. More specifically, we examine whether the holding company holds certain authority over the fund management of its subsidiaries, whether a system for receiving funds through CMS and other means has been built, and whether the timing of income and expenditure has been adjusted.

Holding companies of corporate groups with weak unity, on the other hand, receive less cash, such as management guidance fees, and rely on relatively unstable dividends and capital gains. The credit of a holding company in this case does not represent the credit of the entire group, and the rating reflects the subordination as necessary.

Figure 2: Income-and-expenditure structure of holding companies

Income (cash in)		Expenditure (cash out)
Function of strategic sector	Management guidance fees, etc.	Operating expenses of holding company such as labor and facility maintenance
Assets held	Rent, leasing payments, etc.	
Investment	Dividends received from subsidiaries, etc.	Dividend payment, etc.
Centralization of fund management	External financing	Lending within the group
	Recovery of principal and interest from the group	Payment of principal and interest to external parties

- This table summarizes the major income-and-expenditure structures of holding companies.
- Corporate groups with strong unity in many cases maintain the balance of income and expenditure broadly for each item.

(3) Recovery Risks in Case of Default

Rating of a holding company incorporates recovery risks based on factors including: (a) source of funds to finance the shares of subsidiaries; (b) the senior/subordinate relationship between the holding company and subsidiaries; and (c) supplementary credit. This merely estimates the level of recovery in case of a default, and the higher the credit of a holding company and its corporate group, the less the effect of such factors on the rating.

(a) Funds for Financing the Shares of Business Companies

When considering recovery risks, first, we identify whether the funds to finance the shares of subsidiaries are equity capital or external debt. Even after a company establishes a holding company system, we review the source of funding periodically in order for us to make decisions from a medium- to long-term perspective. This is because the asset-and-debt composition of a holding company changes as a result of events such as sales and purchases of assets, a decline in the market value of assets, retirement of treasury stock.

If both a holding company with no substantial assets—except the shares of its subsidiaries—and its major subsidiaries default on debt, the repayment funds of the holding company are virtually limited to liquidating dividends received as a shareholder of subsidiaries. The liquidating dividends are residual assets after prioritized repayments are made to the creditors of subsidiaries and if subsidiaries are insolvent, the amount disbursed would be less than the initial investment. As a result, if subsidiary shares are financed through external debt, the holding company is unable to ensure adequate repayment of funds and creditors of the holding company are unable to directly demand subsidiaries for repayment, making holding company creditors subordinate to those of subsidiaries.

Figure 3: Recovery risk from the perspective of a holding company BS

Case 1

Assets	Liabilities/Capital
Cash and Cash Equivalents	Accounts Payable, etc.
Loans to Group Companies	CP Short-term Debts Corporate Bonds Long-term Debts
Subsidiary Shares	Equity Capital

Case 2

Assets	Liabilities/Capital
Cash and Cash Equivalents	Accounts Payable, etc.
Loans to Group Companies	CP Short-term Debts Corporate Bonds Long-term Debts
Subsidiary Shares	Equity Capital

Case 3

Assets	Liabilities/Capital
Cash and Cash Equivalents	Accounts Payable, etc.
Loans to Group Companies	CP Short-term Debts Corporate Bonds Long-term Debts
Subsidiary Shares	Equity Capital

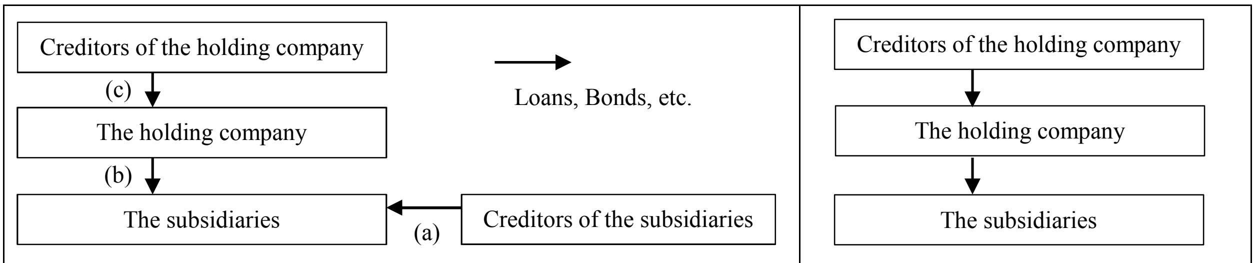
In Case 1, the shares of subsidiaries that are unlikely to be collected in the total amount at the time of subsidiary liquidation are financed partly through external loans. The creditors of the holding company in Case 1, therefore, are subordinate to the creditors of the subsidiaries. Like in this case, the structure in which a holding company establishes a subsidiary using funds from external financing and the subsidiary further finances external loans (double leverage) is an example of creating subordination of the holding company.

In Cases 2 and 3, on the other hand, the creditors of the holding company would not be significantly subordinated to the creditors of subsidiaries unless the recovery of loans to group companies involves particular subordination.

(b) Senior/Subordinate Relationship between the Holding Company and Creditors of Subsidiaries

When a holding company lends funds procured through external loans to its subsidiaries, and there are creditors of both the holding company and subsidiaries, the creditors of the holding companies would not be significantly subordinate to the creditors of subsidiaries so long as the holding company and creditors of the subsidiaries are equally ranked. If, however, the creditors of the subsidiaries are entitled to priority repayment based on collateral, for instance, the holding company and ultimately the creditors of the holding company would be subordinate. Therefore, we must examine the senior/subordinate relationship between creditors of the holding company and the subsidiaries and apply our findings, as necessary, to the bond rating of the holding company.

Figure 4: Senior/Subordinate Relationship between the holding company and creditors of the subsidiaries



When (a) and (b) are equally ranked, (c) would not be significantly subordinate to (a) and (b). When (b) is subordinate to (a), (c) would be subordinate to (a).

When there are no creditors of subsidiaries, there is no subordinate structure.

(c) Supplementary credit

By receiving supplementary credit, a holding company is able to improve the level of structural subordination. The most obvious example is when subsidiaries provide a guarantee to a holding company. In this example, we would incorporate our findings into the ratings by studying the position of the subsidiaries within the group and the amount of assets and cash flow of these subsidiaries. In this instance, the subsidiaries that are guaranteeing the holding company is required to have a high composition ratio within the group if it were maintain the rating made on the assumption of ensuring consolidated cash flow. In some cases, this involves a guarantee of multiple or all of the major subsidiaries.

To date, there has not been a case in which publically offered corporate bonds issued by a holding company are backed by collateral. Providing assets of a holding company (shares of major subsidiaries, etc.) or assets held by a third party, such as a subsidiary, as collateral serves as credit supplementation. Depending on the details and scale of this arrangement, this would affect the rating of a holding company.

2. Ratings of Subsidiary Companies

Creditworthiness of business companies affiliated with a holding company is evaluated both as a group and individually. In addition, we assign ratings based on factors such as the subsidiaries' position within the group and the possibility of cash movement between the subsidiaries through the holding company. Ratings of subsidiaries that operate core businesses of the group or create a strong synergy with other subsidiaries, thereby facilitating mutual financing, are likely to reflect the credit of the entire group.

It is highly likely that we would assign a rating equivalent to their individual assessment, if individual subsidiaries are responsible for their own funding based on the policy of their holding company or each subsidiary.

3. Case Studies: Shift to Holding Company System of Various Formats

Companies that JCR has rated under the holding company system so far have these features in common: they share a strong unity between the holding company and subsidiaries; and upon a rating to a holding company system, that does not necessarily have to reflect structural subordination to a great extent. Meanwhile, there are variations among companies in the reasons cited for the recognition of unity within the system and financing schemes after their shift to a holding company system. This is because of the format taken when shifting to a holding company system. We will organize each type, based on characteristics, below. The formats we have reviewed in the past are: (a) creation of a holding company ranking above the existing companies by moving the shares of the existing subsidiaries (share transfer method); and (b) transforming an existing subsidiary into a holding company by moving its business to subsidiaries (cast-off shell method).

(1) Shift to Holding Company System through Share Transfer Method

Examples of a shift to a holding company system through the share transfer method include Nippon Unipac Holding, Coca-Cola Central Japan, Nippon Mining Holdings, and JFE Holdings. They are holding companies founded in association with the management integration of the companies. We consider these companies to be strongly united entities because the holding company maintains unity with its subsidiaries under the management goal of achieving integration benefits.

Corporate groups that have shifted to a holding company system through the share transfer method in the past are characterized by (a) a structure in which both the holding company and subsidiaries carry external debts, requiring the consideration of the holding company's subordination and (b) a tendency to restructure each business separately to increase the effect of integration.

A shift to a holding company system is generally accompanied by centralization of the group's fund management at the holding company. A shift through the share transfer method, however, makes it difficult to make the holding company repay the liabilities of the existing subsidiaries due to the absence of provisions in laws and regulations on corporate spin-offs. After integration, therefore, the holding company is in charge of new funding and the subsidiaries repay the existing debt for a certain period of time. This results in a situation in which both the holding company and subsidiaries deal with creditors, thus, requiring examination of the degree of subordination of creditors. In our actual ratings, for the four companies above, we acknowledged strong unity maintained under the management goal of achieving integration benefits and the relatively high credit standing of each corporate group. As a result, we considered that structural subordination is unlikely to appear as a risk for these companies, and thus, not necessary to be applied to their credit ratings. In particular, Coca-Cola Central Japan maintains the entire group's outstanding amount of interest-bearing debt at a low level, and the necessity to consider its subordination in the rating is minimal.

In connection with corporate bonds issued by a holding company, a scheme in which subsidiaries guarantee the corporate bonds of their holding company is emerging. This is aimed at eliminating inconsistencies between bonds issued by subsidiaries and those by the holding company, given a corporate bond's characteristic that they are purchased by an unspecified large number of investors and the market prices are publicly known. More specifically, the first and second series of the bonds of Nippon Unipac Holding were guaranteed by Nippon Paper Group. JFE Holdings has also announced that its subsidiary, JFE Steel, plans to guarantee the corporate bonds of its holding company. This is viewed positively from the perspective of protecting the creditors of the holding company's bond issuance. In many cases, existing business corporations are reorganized through spin-offs of each business to increase the benefits of integration. The rating of subsidiaries after reorganization is generally performed using the previously described approach of rating subsidiary subsidiaries (see "2. Ratings of Subsidiary Companies"). Companies that have been rated to date reflects the credit standing of the entire group based on possible financing among subsidiaries under the aegis of the holding company. These companies are Nippon Paper Group affiliated with Nippon Unipac Holding, Japan

Energy affiliated with Nippon Mining Holdings, and JFE Steel affiliated with JFE Holdings. Nippon Paper Group and JFE Steel, in particular, are assessed positively as core companies that are largely responsible for creating cash flow for their groups.

Note: The Commercial Code prescribes that in business reorganizations that utilize spin-offs, the company is responsible to a certain extent for repayment at the time of the spin-off to creditors who cannot be given an individual notice (Article 374-10-2 and Article 374-26-2 of the Commercial Code). Our rating of subsidiaries takes into account such "quasi joint and several debt."

(2) Shift to Holding Company System via Cast-off Shell Method

Examples of a shift to a holding company system through the cast-off shell method include Nisshin Seifun Group, Tostem Inax Holding, Takara Holdings, and Konica Minolta Holdings. In all these cases, the companies shifted to a holding company system after transferring their existing businesses to affiliated subsidiaries through creating subsidiaries. Despite subsidiaries having a legal personality under the Commercial Code, there is no major difference observed in group management before and after the shift to a holding company system. The holding company maintains strong governance, which is considered to represent the strong unity of these groups. The relatively high credit standing of each corporate group is also taken into consideration. Further, considering any "quasi joint and several debt" resulting from corporate spin-offs when assigning a rating is the same as in the case for the share transfer method.

Corporate groups that have shift to a holding company system through the cast-off shell method in the past are characterized by: (a) financing, including debt carried over from the period before the shift to a holding company system, being concentrated on the holding company and finance company (in some cases, a business corporation obtains external financing on its own), and (b) emergence of management integration through the cast-off shell method.

Centralization of financing at the holding company and finance company prevents subordination that affects the rating of the holding company. In some cases, a subsidiary that existed before the shift to the holding company system continues to carry its external debt after it becomes a subsidiary of a subsidiary (a second-tier subsidiary of the holding company). JCR considers that the rating of a holding company does not need to reflect subordination if the group has established a system that allows the holding company to centralize the control and redistribution of cash flow of its group companies, including second-tier subsidiaries, through the governance of the entire group. A shift to a holding company system through the cast-off shell method, therefore, is characterized by group management that does not change its shape before and after the shift and the ease of developing a scheme that prevents the subordination of the holding company.

One example of management integration can be seen in the case of Tostem Inax Holding. First, the business division of the former Tostem was separated and transformed into a pure holding company, Tostem Inax Holding, on the assumption that Tostem and Inax would merge. Inax subsequently became affiliated with the holding company through an exchange of shares with Tostem Inax Holding. JCR has determined that the credit standing remains unchanged based on unity maintained after the group's shift to the holding company system. In addition, the rating was left unchanged after determining that the integration with Inax was positive in terms of consolidated credit standing.

As for Konica, the company was converted into a holding company through corporate spin-offs in April 2003. And in August, management integration was implemented through an exchange of shares that made Konica the wholly owning parent and Minolta a wholly owned subsidiary. Business restructuring was, then, planned for October. JCR reviewed the rating in the context of the shift to the holding company system in April and determined that no particular difference existed among the credit standing of the subsidiaries. Changes in the consolidated credit standing associated with the integration with Minolta, however, require a close examination in the future. JCR continues to monitor their credit status.

4. Basic Points to Confirm when Shifting to a Holding Company System

JCR confirms the following points with companies in writing or through interviews to review their ratings when a business corporation shifts to a holding company system:

- Objectives of the shift to a holding company and major functions of the holding company
- Income plan (a breakdown of items such as brand license fees, management guidance fees, dividends, and their amount) of the holding company
- Expenditure plan (a breakdown of items such as personnel expenses and dividends and the amounts) of the holding company
- Human resource allocation, such as the number of members belonging to the holding company and subsidiaries
- Plans for fund management and CMS operation within the group
- Plans for ownership and disposal of assets not relevant to the business operation of each subsidiary (investment securities, idle real estate, etc.)
- The level and means of involvement of the holding company in the management of subsidiaries
- Correlation, synergy, etc. among the subsidiaries
- The status of assets and liabilities of the holding company and each subsidiary at the time of shift to a holding company system
- The treatment and preservation of financial obligations before and after the shift and protecting creditors (particularly returning corporate bonds/CP that have been issued)
- Method and status of group management and operation, such as new financing methods after the shift

These are examples that may be added or eliminated depending on the individual schemes and other conditions of the shift to a holding company system.

5. Future prospects

As seen above, the ratings of holding companies conducted by JCR in the past have not included cases in which structural subordination significantly affects the rating. This is a result of our view that the groups have established a system that allows the holding company to receive considerable cash flow from the subsidiaries in an effort to allow the newly formed holding company system to increase the value of corporate integration and improve governance as well as existing solid group unity and control of the holding company. JCR will continue to observe whether these companies increase their competitiveness through efficient group operation.

Meanwhile, as more companies adopt the holding company system in the future, some may face difficult in establishing strong unity. Benefits of adopting a holding company system include prompt management decision-making by delegating authority to subsidiaries and facilitation of purchase and sale of businesses. Unity is difficult to assess when governance is considered neglected in the pursuit of promptness or when cash flow of a business planned to be sold cannot be regarded as cash flow of the entire group.

If there is corporate reorganization that includes external corporate groups after a shift to the holding company system, any change in the consolidated credit standing and financing structure would require re-rating. Such cases are expected to arise in the future.