Intercompany Finance:

Applying The Arm’s Length Principle

Intercompany financing transactions now at record levels, have come under increasing scrutiny from tax authorities globally.

At the same time internationalization and offshoring, already common practices in production and distribution, have extended to financing activities. Intercompany loans and guarantees have been added to the list of available options to fund growth in businesses within large multinational enterprises (MNEs).

Key business drivers for intercompany financing could include:

- Ideal allocation of debt versus equity within the MNE to support shareholder value creation
- Optimal capitalisation of entities within a group to meet investment requirements
- Leveraging the different levels of access to funding of various entities within a group.

A key challenge for market participants, in this environment, is the lack of a formalised framework for assessing and reporting on whether the terms used in intercompany financing transactions are fit for purpose. There is a risk that corporations are organising these transactions in ways that could be interpreted as ‘thin capitalisation’, ‘profit shifting’ or other tax avoidance practices.

The most recent discussion papers from the OECD provide an initial framework for consideration, but in effect it mostly presents key questions around the varied approaches currently enforced by tax authorities throughout several jurisdictions. Therefore uncertainty and varying levels of sophistication in terms of transfer pricing analysis, whether by tax authorities, accountants or the corporations themselves, are expected to continue to prevail over the medium term.

This report leverages findings on the most complete approach encountered in the application of the “arms’ length principle”. It is typically enforced by most advance tax authorities and supports the two most salient considerations around:

1. Determining the borrowing entity could and would potentially get access to a similar level of debt, with similar terms & conditions, from a third party lender.

2. Considering whether the interest rate is priced in accordance with arm’s length transactions in which comparable, unrelated parties would enter into similar agreements.

We have also generated a case study analysis of the top five multinational companies headquartered in Luxembourg to help demonstrate:

- The benefit of incorporating independent quantitative credit risk models into the calculations of one of the most important input parameters, namely the credit risk assessment, of an arm’s length rate

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1 OECD “BEPS Action 4: Interest deductions and other financial payments” [Published 18 December 2014].
• How a market-aggregates approach for deriving sector, currency- and maturity specific spreads minimises the requirement for proprietary analytics to the extent of incorporating specific debt characteristics [e.g. optionality, collateralization]
• The potential pitfalls in deriving reference benchmark pricing across geographies on the back of private loan data alone

Assessing The Credit Risk Of The Affiliate: Less Room For Guessing

The analysis of every intercompany financing transaction starts with the determination of the creditworthiness of the affiliate with which the parent company is entering a financial transaction. There are various analytical methods and tools with different levels of sophistication available for this assessment.

One of the simplest approaches of arriving at a credit risk assessment is based on calculating different financial ratios based on interest expenses, EBITDA, debt, equity, or assets in varied combinations. These ratios are then compared to aggregated ratio data based on that of publicly-rated companies. However, this approach typically results in a flawed outcome.

Using this comparative approach to determine the credit quality of an affiliate may lead to ambiguous outcomes and raises a number of issues:

• how comparable in terms of size are the rated companies and the subsidiary
• how do the ratio norms differ across geographies and industries
• questions about standardisation of the input ratios and their potential manipulation
• questions about the aggregation mechanisms [cross-sectional & time-wise] and validity of ratios

Table 1 below shows an example of this method applied across four years for a sample of European Non-Financial Issuers.

**TABLE 1: Ratio Aggregation [Mean] – European Non-Financial Issuers Sample**

<table>
<thead>
<tr>
<th></th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC</th>
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</thead>
<tbody>
<tr>
<td><strong>Net Debt/EBITDA</strong></td>
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<tr>
<td>2014 NA</td>
<td>2.7x</td>
<td>1.9x</td>
<td>2.7x</td>
<td>3.2x</td>
<td>5.2x</td>
<td>9.9x</td>
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<tr>
<td>2013 0.3x</td>
<td>6.9x</td>
<td>2.1x</td>
<td>3.2x</td>
<td>3.5x</td>
<td>6.6x</td>
<td>100.0x</td>
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<tr>
<td>2012 0.4x</td>
<td>6.7x</td>
<td>2.2x</td>
<td>2.7x</td>
<td>3.4x</td>
<td>9.4x</td>
<td>12.4x</td>
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<tr>
<td>2011 0.5x</td>
<td>2.8x</td>
<td>2.2x</td>
<td>2.4x</td>
<td>3.1x</td>
<td>10.0x</td>
<td>16.2x</td>
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<td><strong>Int Expense/EBIT</strong></td>
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<tr>
<td>2014 NA</td>
<td>28.18%</td>
<td>14.65%</td>
<td>25.03%</td>
<td>48.94%</td>
<td>121.96%</td>
<td>423.00%</td>
<td></td>
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<tr>
<td>2013 9.90%</td>
<td>29.22%</td>
<td>18.03%</td>
<td>62.57%</td>
<td>82.44%</td>
<td>195.18%</td>
<td>575.12%</td>
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<tr>
<td>2012 4.50%</td>
<td>36.14%</td>
<td>16.46%</td>
<td>25.62%</td>
<td>42.63%</td>
<td>139.02%</td>
<td>156.28%</td>
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<tr>
<td>2011 47.37%</td>
<td>28.04%</td>
<td>18.68%</td>
<td>22.39%</td>
<td>45.07%</td>
<td>93.82%</td>
<td>1694.42%</td>
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<tr>
<td><strong>EBITDA/Avg Assets</strong></td>
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<tr>
<td>2014 NA</td>
<td>14.82%</td>
<td>11.86%</td>
<td>10.90%</td>
<td>11.87%</td>
<td>8.97%</td>
<td>4.43%</td>
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<tr>
<td>2013 17.79%</td>
<td>15.97%</td>
<td>12.66%</td>
<td>12.21%</td>
<td>12.59%</td>
<td>10.23%</td>
<td>6.55%</td>
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<tr>
<td>2012 48.02%</td>
<td>13.81%</td>
<td>12.90%</td>
<td>12.04%</td>
<td>13.15%</td>
<td>10.16%</td>
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<td>2011 17.89%</td>
<td>17.37%</td>
<td>12.63%</td>
<td>12.39%</td>
<td>12.79%</td>
<td>10.90%</td>
<td>5.63%</td>
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<tr>
<td><strong>EBITDA/Interest Expense</strong></td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>2014 NA</td>
<td>85.6x</td>
<td>33.8x</td>
<td>25.5x</td>
<td>7.4x</td>
<td>2.6x</td>
<td>0.0x</td>
<td></td>
</tr>
<tr>
<td>2013 17.8x</td>
<td>46.2x</td>
<td>28.0x</td>
<td>18.3x</td>
<td>31.0x</td>
<td>3.0x</td>
<td>1.5x</td>
<td></td>
</tr>
<tr>
<td>2012 30.4x</td>
<td>20.2x</td>
<td>27.5x</td>
<td>20.6x</td>
<td>16.4x</td>
<td>4.1x</td>
<td>1.8x</td>
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<td>3.6x</td>
<td>1.8x</td>
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</tbody>
</table>

Source: Standard & Poor’s Ratings Services and S&P Capital IQ, as of 27 February 2014.
As a consequence of these issues, auditing firms and corporations have begun to incorporate quantitative credit risk assessment models – effectively treating the affiliate as an entirely independent entity from the MNE – to arrive at a far more credible credit rating.

The most effective of these models calculate 'through-the-cycle' metrics in the form of probabilities of default (PDs) or Credit Scores (typically in lower case nomenclature to distinguish them from public credit ratings) trained on observed defaults or ratings dispersion. These approaches enable a holistic assessment of financial and business risks altogether, rather than focusing on ratio analysis alone. The globally comparable output of these quantitative tools is typically considered independent and objective credit risk assessments, where judgment and therefore disagreement between MNEs and tax authorities is minimised.

Case Study: Assessing Affiliate Credit Risk For The Top 5 Luxembourg-Based MNEs²

To demonstrate the application of the arm’s length approach, we have analysed the affiliate credit risk of the top five multinational companies [identified by LTM revenues] headquartered in Luxembourg.

This group is particularly valuable for illustrative purposes, as the number of affiliates publicly reported by each corporation ranges from 69 to 433. The five companies we reviewed are Arcelor Mittal, Tenaris SA, RTL Group SA, Regus plc and Eurofins Scientific SA, and their main operations span five different industries – Materials, Energy, Consumer Discretionary, Industrials, and Healthcare.

CHART 1: Subsidiary Exposure of the Top 5 Luxembourg-based MNEs by Sector and Region

Source: S&P Capital IQ, as of 27 February 2015.

² This illustrative analysis relies on fundamental and reference data available on the S&P Capital IQ platform as of 27 February 2015 and might not take into consideration the most complete or up-to-date information for any of the MNE or affiliates referred to.
In analysing the top 15 subsidiaries of each of these five companies, it is evident that all of them operate across a minimum of two of the above sectors and in a minimum of seven countries. This demonstrates the need to factor sector and country activity into creditworthiness assessment.

CHART 2: Standalone Credit Risk Assessment – PD Model Fundamentals (Implied Credit Score)

Source: S&P Capital IQ PD Model Fundamentals, as of 27 February 2015.

Although some commonalities could be expected from a sample including top MNEs in a single country, our results proved this hypothesis to be incorrect.

Based on the latest available data, an analysis of 75 entities using S&P Capital IQ’s proprietary quantitative fundamentals-based probability of default model [Chart 2] showed evidence of a large dispersion of standalone credit risk ranging from credit scores of ‘a- ‘ to ‘cc’. 3

For those interested in additional levels of sophistication, it is worth highlighting that some tax jurisdictions find the estimation of the standalone credit risk assessment 4 insufficient and also require the assessment of benefits of a company’s passive association of its parent entity (either with a parent corporation or a related subsidiary). Quantitative models and additional qualitative overlays have been developed more recently to enhance credit risk assessment, but these have not been applied to this illustrative example.

The Art of Credit Risk Pricing

Once the credit risk assessment of the affiliate is completed, either by considering it as a separate standalone entity or factoring in enhancements derived from its group affiliation, there are a variety of techniques to determine the ‘comparable uncontrolled market interest rate’. Essentially, this is the cost at which the affiliate could have accessed comparable finance if it had engaged with an unrelated, independent party.

The accuracy of this approach relies on having full access to the details of the financial transaction to be able to establish a realistic price that the affiliate might have been expected to pay in the

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3 This analysis of the aggregated credit risk of affiliates was carried out using the financial data available on the S&P Capital IQ platform. In the instances where information gaps were found, this report used proxy data instead.

4 S&P Capital IQ has developed a family of statistical quantitative models to assist our clients with evaluating credit risk across public, private, rated and unrated counterparties across asset classes and timeframes. Parent and Government ownership adjusted scores have also been introduced as a new aspect of this offering.
In other words, the ‘uncontrolled market interest rate’ or benchmark yield should be determined from ‘observed’ prices for entities sharing the same credit risk, sector and country exposure, maturity and so on; this ensures the calculation of the benchmark is both independent and objective.

The public bond market provides a valuable starting point to credit risk pricing because of:

- The availability of historical and up-to-date price references, given the existence of a ‘deeper’ secondary market
- The depth of available coverage in terms of geographical and industry representation
- The full transparency of the comparable debt instruments given their public nature.

**Case Study: Determining Affiliate Credit Risk Pricing For The Top Five Luxembourg-Based MNEs**

If we then revisit the example from earlier, using the top five Luxembourg-based MNEs, further analysis through a public bond market lens of 75 of their subsidiaries, uncovers a wide range of option-adjusted spreads.

To ensure the benchmark rates in this analysis were sufficiently robust they were calculated using corporate bond yields derived from pre-trade observed prices segregated into industry, currency and maturity-specific empirical curves. From the four-years-to-maturity yield levels presented in Chart 3 we see that, given the credit risk dispersion of affiliates, even the inter-sector spread dispersion can easily deviate by up to 10% (Financials [B, EUR] in comparison to Energy [B, USD] as of 31/01/2015).

And if we dig deeper, focusing on just one sector, in this case Consumer Discretionary, the yield plot in Chart 4 confirms the variation of term structure across all ratings categories.

**CHART 3: Option-Adjusted Spread Dispersion – 4 Years to Maturity**

**CHART 4: OAS Consumer Discretionary [EUR] – 31/01/2015**

Source: S&P Capital IQ Corporate Yield Curves, as of 27 February 2015.

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This public bond market driven analysis lends itself to the incorporation of further layers of risk pricing components in addition to the sector, currency, credit risk and maturity levels in our example above.

More specifically, additional credit risk markup can be incorporated into a risk free reference rate; layering swap rates versus government rates for specific currencies and/or locations. Similarly, specific debt characteristics like embedded options, convertibility features and additional collateralisations can also be used as parameters in an objective framework of risk price aggregation to refine and arrive at a yield which best reflects an uncontrolled market price.

While corporate yield curves are one of the most empirical and objective approaches for determining a defensible market benchmark rate, one of the aspects that this broader capital market approach excludes is the additional risk premium that private companies could be expected to incur. It is at this intersection between the public bond and private loan markets where such a premium can be empirically quantified and estimated, for those MNEs interested in applying the additional levels of sophistication.

**CHART 4: Spread – Loans Vs. Bonds (4Y BB)**

![Graph showing spread between loans and bonds over 4 years for BB rating, with data points for EUR and USD between 01/12/2012 and 01/12/2015.]

Source: S&P Capital IQ Leveraged Commentary & Data (LCD) and Corporate Yield Curves, as of 27 February 2015.

To provide a quantum illustration of such a premium, Chart 5 compares the aggregate spread of secondary loan data derived from S&P Capital IQ Leveraged Commentary and Data [LCD]\(^5\) and Corporate Yield Curves. Although our analysis does not point to a globally applicable pattern, some of the regional considerations highlight important differences.

For example, in the case of U.S.-domiciled loans, no meaningful markup can be observed over the time frame and level considered. Given that a greater proportion of American corporations of all sizes are active in the bond markets, one plausible explanation might be that this is leading to more competitive loan pricing.

In contrast, findings for the Eurozone point to a very clear markup, as of recent years, which highlight the striking differences across both regions. In effect, the implied spread of the four-
years-to-maturity ‘bb’ rated companies has risen from nearly zero at the end of 2012 to 250 basis points in December 2014; it does not therefore reflect the lower refinancing costs from the bond markets, which have fallen by an approximately similar amount.

These important regional differences indicate that a premium of private loans, depending on illiquidity for instance, in comparison to bonds is not naturally priced in and is time-dependent.

In Conclusion

Even though currently available transfer pricing guidelines leave ample room for varied interpretations, leading industry practitioners have already developed fairly sophisticated practices and mechanisms that ensure transparency, objectivity, consistency and speed in the calculation of an arm length uncontrolled market pricing.

The potential pitfalls are significant in deriving reference benchmark pricing across geographies on the back of private loan data alone. Assessing the credit risk and the appropriateness of the associated pricing, therefore, is not without its challenges.

By leveraging sophisticated independent credit risk assessment tools and mechanisms to compare “observed” prices for entities sharing the same credit risk, sector and country exposure, maturity and specific debt characteristics helps to ensure transparency, objectivity, consistency and speed and limits the room for guessing, and therefore potential conflicts with tax authorities.

About S&P Capital IQ

S&P Capital IQ, a business line of McGraw Hill Financial, is a leading provider of multi-asset class and real time data, research and analytics to institutional investors, investment and commercial banks, investment advisors and wealth managers, corporations and universities around the world. We provide a broad suite of capabilities designed to help track performance, generate alpha, and identify new trading and investment ideas, and perform risk analysis and mitigation strategies.

Through leading desktop solutions such as the S&P Capital IQ, Global Credit Portal and MarketScope Advisor desktops; enterprise solutions such as S&P Capital IQ Valuations, and Compustat; and research offerings, including Leveraged Commentary & Data, Global Markets Intelligence, and company and funds research, S&P Capital IQ sharpens financial intelligence into the wisdom today’s investors need.

For more information about the S&P Capital IQ platform and additional solutions, please visit www.spcapitaliq.com or contact us at emea-marketing@spcapitaliq.com.