The Pakistan Credit Rating Agency

Correlation Between Long-term and Short-term Rating Scales Criteria

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This criterion explains the correlation between PACRA's long-term and short-term rating scales. The correlation shown is indicative and, in certain scenarios, may not hold due to specific circumstances.

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Introduction

PACRA's Credit Ratings reflect forward-looking opinions on the creditworthiness of an underlying entity or instrument. More specifically, a rating depicts the relative ability of an entity or instrument to honor its financial obligations. The primary factor captured on PACRA's rating scale is the relative expectation of credit risk or credit quality, where the AAA (triple A) category reflects the highest credit quality while the C (single C) category reflects the highest credit risk. The addition of plus "+" and minus "-" provides a way to create relative distinctions within rating categories that range from the AA (Double A) to B (Single B) categories. The AAA and CCC (Triple CCC) to C (Single C) categories have no plus "+" or minus "-" attached to them. PACRA expresses its opinions in terms of:

1. **Long-term ratings:** A long-term rating denotes vulnerability to default on a medium to long-term horizon (>12 months). Hence, the primary rating considerations while assigning a long-term rating are factors that highly impact the long-term sustainability of the underlying entity/issuer.
2. **Short-term ratings (where applicable):** A short-term rating is an opinion on the short-term vulnerability to default for obligations coming due within 12 months. Hence, while assigning a short-term rating, the primary rating considerations are factors that can materially alter credit quality in the short-term. A key factor for determining short-term ratings is the liquidity position of an entity/issuer.

PACRA rates entities/issuers on a short-term rating scale from A1 (A-one) to A4 (A-four). Within the A1 category, it can be designated with a plus sign (+). This denotes the highest capacity for timely repayment, whereas "A4" captures the likelihood of an inadequate capacity to ensure timely repayment.

PACRA has a single category (D) to denote obligations that are currently in default. PACRA assigns a "D" rating to capture an event of default (For further details, refer to PACRA default recognition policy "What is Default" on www.pacra.com).

Correlation Between Long-term & Short-term Ratings

Long-term and short-term ratings are linked to each other, although long-term opinion is evolved first and then annexed with supporting short-term scale. PACRA's short-term rating approach is similar to that used for long-term rating. However, two factors gain more prominence in short-term rating assignment, namely: i) liquidity position and ii) financial flexibility.

1. **Liquidity Position:** When assessing liquidity, PACRA focuses mainly on the cash flow and working capital management of the entity to assess repayment ability. In addition to this, the availability of unencumbered liquid investments and/or other liquid current assets ensures a cushion for urgent cash in stressed times.
2. **Financial Flexibility:** Financial flexibility allows an entity the latitude to meet its debt service obligations and manage stress without eroding credit quality. While one aspect of financial flexibility is an entity's capital structure (thoroughly assessed during long-term rating assignment), alternative sources include support available from a sponsor (in the form of a line of credit or otherwise) and commercial credit lines available to the entity.

Two different long-term ratings may carry the same short-term rating and each short-term rating corresponds to a band of long-term ratings. This is because there are fewer short-term rating grades. For instance, the "A1" short-term rating corresponds to the long-term rating band from "AA-" to "A-" and assigned separately. The rating matrix for long-term and short-term ratings is indicative and designed for illustration purposes to facilitate understanding. In some extraordinary cases, such as when a firm has an exceptional liquidity position or is experiencing a liquidity crisis, the long-term and short-term relationship may not hold.

Long-Term and Short-Term Rating Correlation Scale: