METHODOLOGY

SUKUK

Sukuk rating reflects forward-looking opinion on credit worthiness of underlying instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Content

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1. UNDERSTANDING SUKUK

A sound financial ecosystem is critical for functioning of any economy. It is defined by interaction of providers of funds - savers, users of funds - borrowers, financial institutions, and regulators. This system ensures smooth flow of funds between savers and borrowers; wherein, financial institutions provide platform for their interaction. Regulatory oversight safeguards the sanctity of this system. Like all systems, financial system has its own set of challenges. The most prominent being "Risk"; the risk that some participant may not be able to meet its commitments. All participants do their best to manage this risk to maximize their return. This is not possible unless we have independent information on this risk. Here comes expertise of rating agencies, providing independent opinion on credit risk. Flow of funds is only possible when the provider of funds has confidence that user of funds will be able to return these in a timely manner and as committed. Ratings help build this confidence. A higher rating means higher likelihood of timely repayment compared to a low rating. Our ratings are forward-looking and reflect our expectations for future financial and operating performance. However, historical results are helpful in understanding patterns and trends of a company's performance as well as for peer comparisons.

1.1 Sukuk (plural of sakk – legal instrument), frequently referred as "Islamic bonds", are certificates with each sakk representing a proportional undivided ownership right in tangible assets or a business venture (Accounting and Auditing Organization for Islamic Financial Institutions - AAOIFI). Sukuk may take any mode of financing – Musharaka, Modarabah, Murabaha, Waqala, Salam, Istisna, Ijarah.

1.2 **Sukuk Rating:** Sukuk Rating is an opinion on relative creditworthiness of an instrument to fulfil committed obligations. The credit risk to Sukuk holders is that the promise to honour financial obligations that interalia include rentals, profit sharing, buying back the assets, as and when due may not be fulfilled. Sukuk rating has benefits to both investor and issuer. For investor, rating quantifies the risk of timely honoring of financial risk relative to other Sukuks. For issuer, Sukuk rating has multitude of benefits: i) It supports pricing or assessment of required returns, ii) It increases accessibility to capital markets, and iii) increases confidence of investors. In many jurisdictions, Sukuk rating has been made mandatory.

1.2.1 Rating opinion follows a forward looking, through the cycle approach and is assigned after a rigorous analytical process. Sukuk Rating, in line with other financial instruments rating scales, follows nine alphanumeric categories ranging from AAA to C. "AAA" is the highest rating that can be assigned.

1.2.2 This rating reflects highest credit quality of instrument reflecting extremely strong capacity for repayment. D is for "default" and reflects the factual state of default of Sukuk.

1.3 **Sukuk Structure:** From rating and risk perspective, the underlying structure of Sukuk is important. Sukuk are either Asset based or Asset backed. In an Asset based Sukuk, issuer sells certain assets to Sukuk holders with a promise to buy these back in an agreed manner. Although an asset is used in the structure, it may not drive the return to Sukuk holders and issuer's promise is not entirely depended on performance of underlying asset. Thus assessment of issuer's overall profile is critical to form a rating opinion. Asset backed Sukuks provide separately identified ring fenced assets to Sukuk holders. Here commitments to Sukuk holders are met through cash flows emanating from these assets.

1.3.1 Rating methodology for Asset based and Asset backed Sukuk follow different factors. Following analysis helps ascertain which methodology to utilize: **1.3.2** In addition to the specific methodologies for Asset based and Asset backed Sukuk, the rating team also refers to segment or industry specific PACRA methodologies.

Distinguishing framework for Asset backed and Asset based structure		
Sukuk Structure	Asset Backed	Asset Backed (Issuer Backed)
Transaction	Identified assets are transferred to a separate entity that makes the sale to Sukuk holders and raises funds	Assets are sold by Issuer to the Sukuk holders with a promise to buy back
Ownership of Asset	Legal ownership of assets with exclusive rights	Beneficial ownership of asset with liquidation rights at par with other creditors
Source of repayments	Cash flows from underlying assets	Issuer's cash flows
Asset location	Separate entity carries the asset	Asset stays on Issuer's balance sheet
Credit Risk	Value and Performance of underlying asset	Performance of issuer
Event of Default	No recourse to Issuer	Recourse to Issuer and underlying security if it is explicitly earmarked in favour of Sukuk holders
Recovery	Clawback/liquidation of identified assets	Sukuk holders' rights are similar to unsecured creditors; subject to security structure

2. RATING METHODOLOGY | ASSET BASED (ISSUER BACKED) SUKUK

2.1 The credit risk in an asset based Sukuk terminates into the issuer of the Sukuk. Most often Asset based Sukuk are known as Issuer backed Sukuk. Here, in case of default, Sukuk holders have recourse to issuer not the asset. Therefore Sukuk holders would not have any preferential positon and would stand along other unsecured creditors. This clearly means that to establish credit quality, rating agency would evaluate issuer's business model and supporting organizational structure, governance standards, risk management and technological framework, and performance trends. Evaluation of financial risk remains one of the critical rating factors to arrive at Sukuk rating opinion. **2.2** They key risk elements are divided into three qualitative – Ownership, Governance, and Management - and two quantitative - Business and financial risk – factors. Analytical assessment of each factor is conducted in the following manner:

Qualitative Factors

Qualitative risk profile is assessed by soliciting information from client and most of the time having a direct interaction with sponsors, management, and/or directors and conducting a visit to plant site and head offices.

Profile	
Key Assessment Area	
Structure	Legal structure of the entity
Background	Evolution of the company since its inception
operations	Diversity, geographic spread of operations and diversification of major customers and suppliers

Ownership	
Key Assessment Area	
Structure	Study of shareholding mix in order to disentangle the structure of ownership
Stability	Formal succession plans and clarity of role amongst family members
Business Acumen	Owner's business understanding and knowledge of market dynamics
Financial Strength	Ability of sponsor to arrange funds or find alternate resources when in need and willingness of sponsor to support the issuer measured by looking at shared brand name, size of investment versus other investments of sponsors

Governance	
Key Assessment Area	
Board Structure	Number of board members relative to size and complexity of business operations. Independence is another key factor. Independence of chairman is considered a good governance practice. Level of delegation of board oversight to committees of the board.
Members' Profile	Qualification and experience of board members
Board Effectiveness	Number of board meetings, attendance and level of active participation
Financial Transparency	Composition of audit committee, quality of internal and external auditors, and public disclosure of the issuer

Management	
Key Assessment Area	
Organizational Structure	Complexity or Simplicity of organizational structure relative to organizational and business needs, adequacy of staffing, cohesiveness amongst management team
Management Team	Qualification and relevant experience of management team, market reputation and integrity
MIS	Type and frequency of information used by the senior management
Control Environment	Policies and procedures, risk management framework, technology – plant and machinery

Quantitative Factors

Quantitative factors are more focused towards analysing economic conditions, industry dynamics, regulatory framework, entities own performance - through financial statements, projections, financial strategy and cash flow analysis. This is very much numbers driven:

Business Risk	
Key Assessment Area	
Industry Dynamics	Macroeconomic analysis, classification of business cycle, demand and supply dynamics of products, cost structure relative to other players, competitive positioning in the industry, regulatory framework
Relative Position	Placement of entity in the related market
Revenues	Diversification, stability and quality of earnings. Diversification from each dimension – product , customers , geographical
Margins	Margins and profitability, Sources of profitability –volume vs price
Sustainability	Future plans of the company, expected developments in industry and view on economic indicators

Financial Risk	
Key Assessment Area	
Working Capital	Working capital management – Inventory, trade receivables, trade payables, financing of working capital , leverage philosophy of management, asset liability mismatch
Coverages	Sources of cash flows – core business, dividends, gain on sale of assets. Stability is also critical. Trend of cash flow growth and sustainability

Capitalization	Adequacy of working capital management and cash flows to cover ongoing business operations and ensure effective implementation of strategy Cushion against net trade assets, Interest and debt coverage, debt payback etc

2.3 All these factors are assessed thoroughly to form an opinion on credit risk of the issuer. Proposed Sukuk is analysed to assess the objective of raising funds, the tenor, pricing, and availability of cash flows from issuer's overall business to cover the committed repayments.

3. SECURITY STRUCTURE EVALUATION

3.1 Sukuk rating incorporates an assessment of the issuer and view on expected loss to be covered in the event of default through the "security structure" underlying the debt instrument. Sukuk rating, hence, is a blend of two factors, likelihood of default and recovery prospects. This enables the rating to be notched either "higher" (in case of a secured instrument) or "lower" (in case of a subordinated instrument) as compared to its corresponding issuer's rating. A Sukuk, whereby security structure equalizes it any unsecured instrument would have the same credit rating as the entity issuing it. The weight given to the two factors, default and loss/recovery, blended in the Sukuk rating opinion, varies up and down the credit spectrum, depending on how immediate or distant the likelihood of default. For instance, for a Sukuk of a very low rated entity, where the likelihood of default is high, considerable weight would be given to the recovery prospects (or lack thereof) in determining the rating of the instrument. Therefore, as entity approach the high rating level, weight given to the recovery prospects is gradually scaled back and, consequently, the quantum of notching.

4. RATING METHODOLOGY | ASSET BACKED SUKUK

4.1 PACRA's Structured Finance methodology is utilized to assess or rate such type of Sukuks. In case of deficiency in cash flows, Sukuk holders retain complete recourse to underlying assets. However, they have no recourse beyond those assets to underlying issuer. Establishing the quality of expected cash flows and their sufficiency to meet commitments is critical. Quality primarily focuses on likely changes in cash flow pattern in response to entity specific, industry wide, or economic changes. The level of rating would be dependent on quantum and sustainability of coverages against the commitments during Sukuk life. We also consider potential of recovery from underlying assets in case of default

Asset backed Sukuk - Rating Factors	
Key Assessment Area	
Asset risk - Quality of Expected Cash flows	Underlying Assets are unique and so are the cash flow ; this requires analysis of ability of assets to generate cash flows Likely changes in cash flow pattern in response to economic, industry, and entity specific factors Data heavy analytical approach; analysis of past trends and future projections of cash flows from securitized assets
Payment risk - Sufficiency of Expected Cash flows	Adequacy or timing of cashflows vis-à-vis payment terms Quantum of cash flows to meet commitments – full cash flows or carved out cash flows Evaluation of payment structure – right and priority of investors to receive cashflow Availability of credit enhancements
Recovery Risk - Potential of Recovery	Legal structure for sale and realization of Sukuk assets Loss in case of default

4.2 Globally, Asset based structures are most preferred owing to ease in structuring of such instruments and expertise available to structure and market these Sukuks. Around 90% of Sukuks issued globally are asset based. Generally high rated issuers can easily raise finances by issuing Asset based Sukuk.

4.3 Asset backed Structures are more preferred by those issuers where intention is to isolate issuer's own financial strength from new financing. This facilitates attracting investors particularly for relatively weak issuers, but having some established asset (with respective cash flows) that can be carved out.

ANNEXURE: ISLAMIC MODES OF FINANCING

Each asset backed or asset based Sukuk can follow different modes of Islamic financing. Since 2001 Morabaha based Sukuk dominate the total Sukuk issued around the globe. Brief explanation of each mode of financing follows as:

Mode	Objectives	Details
Musharaka	Partnership in business	A relationship for sharing of profits and losses in the business. Islamic bank provides funds, which are mixed with the funds of the business enterprise. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre- agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions.
Mudarabah	Partnership in business	One party provides the funds while the other provides expertise and management. The latter is referred to as the Mudarib. Any profits accrued are shared between the two parties on a pre-agreed basis, while loss is borne only by the provider of the capital.
Murabaha	Working Capital Financing Inventory	The client (obligor) requests the bank (financer) to purchase certain goods for it. The bank then sells goods to the client on credit. The bank does that for a definite profit over the cost, which is stipulated in advance.
Waqala	Working Capital Financing Receivable	An arrangement whereby one party entrusts another party to act on its behalf. Its akin to an agency arrangement. A principal (the financer) appoints an agent/wakeel (the obligor) to invest funds provided by the principal into a pool of investments or assets and the wakeel lends it expertise and manages those investments on behalf of the principal for a particular duration, in order to generate an agreed upon profit return.
Salam	Short term financing	On spot buying of underlying assets and sale of asset to finance at a later date. Obligor purchases the asset at a later date.
Istisna	Project financing	Advance payment of capital cost of the project by financier. Obligor reimburses the capital cost plus profit on project.
Ijarah	Lease financing	Purchase of tangible assets at a pre-agreed price with permission to use the asset against rentals. Obligor pays fixed periodic rentals

Sukuk Rating Scale & Definitions

Sukuk credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Rating Symbol	Definition
AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch Alerts to the possibility of a rating change subsequent to, or in anticipation of, a) some material identifiable event and/or b) deviation from expected trend. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating Watch may accompany Outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, e) the entity/issuer defaults., or/and f) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.