



RATING METHODOLOGY

DEBT INSTRUMENT RATING

Debt instruments 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

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1. INTRODUCTION

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 The Debt Instrument Market: Pakistan has a relatively small debt instrument market. Financing through bank loans is the preferred route for corporates, rather than utilizing the capital markets to raise funding through issuing debt instruments like bonds. Therefore, when instruments are issued, they are plain-vanilla and secured by the assets of the company. Retail investors have only recently been tapped and generally the instruments are the domain of institutional investors – banks, mutual funds, and retirement benefit schemes. Instrument denominations and tenor also remain on the lower side. Given relatively small base and held to maturity stance of most investors, secondary market is yet to evolve in a meaningful platform.

1.2 **Scope:** A debt instrument is a security with an underlying contractual obligation owed by the issuing entity (also called issuer) to make interest payments and principal repayments to the debt instrument holders (also called lenders) for the life of the debt instrument.

1.3 Key types of debt instruments are term finance certificates (TFCs), commercial papers and sukuk. These debt instruments can be differentiated by: (i) maturity (money market versus capital market debt instruments), (ii) type of issuing entities (government, financial institutions, corporate, etc.), (iii) types of markets in which these are issued (conventional versus Islamic), (iv) accessibility (listed, privately-placed), and (v) Security (secured, unsecured, or subordinated). Structured debt instruments are dealt with separately under PACRA’s methodology “Structured Finance Rating”.

2. RATING DEBT INSTRUMENT

2.1 PACRA undertakes debt instrument ratings for all kinds of short-term and long-term instruments.

2.2 A debt instrument credit rating is an assessment of a specific debt issue of an entity and provides: (i) an opinion of the issuing entity’s ability to meet on a timely basis its principal and interest obligations pertaining to the debt instrument being rated, and (ii) loss-given-default (LGD). For the purpose of the rating assessment, both the payment of interest and repayment of principal are considered “contractual obligations” by PACRA.

2.3 The credit rating incorporates an assessment and subsequent opinion upon the expected loss to be covered in the event of default through the “security structure” underlying the debt instrument.

2.4 A debt instrument rating, hence, is a blend of two factors, likelihood of default and recovery prospects. This enables the debt instrument 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 issuing entity’s rating. An unsecured instrument would have the same credit rating as the entity issuing it.

2.5 The weight given to the two factors, default and loss/recovery, blended in the debt instrument rating opinion, varies up and down the credit spectrum, depending on how immediate or distant the likelihood of default. For instance, for an instrument 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.

2.6 The debt instruments that carry third party guarantee to make good the amount obligated to the lenders by the issuer may provide additional support to its rating. In this case, in determining the rating of the instrument, key factors to assess are the financial profile of the guarantor [or its credit rating, where available] and the extent of coverage it provides to the instrument holders.

2.7 Few debt instruments are secured by a cash collection mechanism, whereby cash flows generated from a particular stream of revenue are used to fund the debt service reserve or fund. While arriving at its rating opinion, PACRA's assessment incorporates the issuer's operational viability to continue to serve its customers from whom the cash flows are expected to generate. In this case, PACRA attempts to assess the financial profile of these customers and the level of diversification in related customer base. Provision of any upfront liquid asset / cash collateral may also improve instrument's rating.

3. ISSUER PROFILE

3.1 While forming an opinion on an issuer, PACRA evaluates the underlying entity as per the specific methodology applicable to it. For instance, for an industrial corporate issuer, Corporate Rating Methodology would apply while for an independent power producer, IPP Rating Methodology would be used to arrive at entity rating of the issuer. Broadly rating criteria to assess are following:

| Qualitative Factors | |
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| 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 | |

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| 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 |
| Effectiveness | High or low staff turnover from the core team, key man risk – redundancy and succession plan |
| 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 | |
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| 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 |

3.2 In local environment, banks usually issue unsecured and subordinated debt instruments; though secured instruments can be issued but with specific permission of the regulator. In these cases, PACRA follows its respective entity rating methodology (e.g. Bank Rating Methodology, Microfinance Institutions Rating Methodology, etc.) to arrive at entity rating opinion. This is then notched according to security structure. Meanwhile, PACRA considers lock-in and loss absorbency clauses as mentioned in Basel-III and how these can impact the rights of instrument holders given underlying entity's projections for growth visà-vis regulatory capital adequacy requirement over the tenor of the instrument.

Debt Instrument Rating Scale & Definitions

Debt Instrument 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. |

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| 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 surveil the opinion due to lack of requisite information. | Harmonization A change in rating due to revision in applicable methodology or underlying scale. |
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Disclaimer: PACRA's ratings are an assessment of the credit standing of entities/issue in Pakistan. They do not take into account the potential transfer / convertibility risk that may exist for foreign currency creditors. PACRA's opinion is not a recommendation to purchase, sell or hold a security, in as much as it does not comment on the security's market price or suitability for a particular investor.