



The Pakistan Credit Rating Agency Limited

# **RATING METHODOLOGY**

## **PREFERENCE SHARES**

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## 1. INTRODUCTION

- Purpose of document
- Preference shares and its types

**1.1** This methodology document highlights PACRA’s approach to assigning credit ratings to preference shares.

**1.2** Preference shares are hybrid instruments with both debt and equity characteristics. Like traditional fixed-rate debt, they pay a fixed-rate dividend. Further, like equity instruments, their right to receive dividend payments ranks below debt-holders.

**1.3** Preference shares offer greater financial flexibility to the issuer than traditional debt as there is no contractual obligation of paying dividend when it falls due. On the other hand, they present investors with an advantage over ordinary shares in terms of priority order of dividend payments, whenever these are paid out. Hence, they are considered riskier than debt but less risky than ordinary shares from an investor’s point of view.

**1.4** There are several types of preference shares:

**1.4.1 Cumulative and non-cumulative:** Dividend payments on cumulative preference shares, if not paid, are accumulated and have to be paid before any payment is made out to ordinary shareholders. While, dividends on non-cumulative preference shares is not accumulated if not paid.

**1.4.2 Convertible and non-convertible:** Convertible preference shares can be converted into ordinary shares as per conditions stipulated in the agreement. The conversion may happen at behest of the investor or the issuer. Usually, the conversion takes place after fulfilling certain conditions. Non-convertible preference shares are ‘vanilla’ in nature with no convertibility feature. Other types of preference shares include redeemable, irredeemable, zero coupon, and participatory preference shares. They have distinct features and are considered accordingly.

## 2. HOW TO RATE PREFERENCE SHARES?

- Adjusted issuer rating
- Notching criteria

**2.1** Ratings of preference shares reflect the relative risk that the issuer will not be able to make dividend payments and principle redemption as per agreement. Preference share rating is done in the same manner as any other instrument rating. Firstly, PACRA assesses the issuer’s debt repayment capacity based on its respective entity rating methodology (e.g. Bank Rating Methodology, Corporate Rating Methodology etc.) to determine issuer rating.

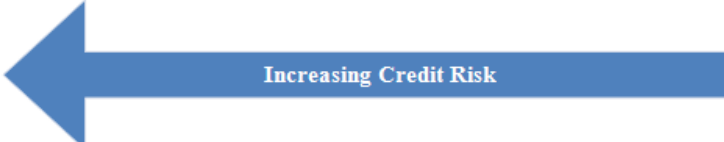
**2.2 Adjusted issuer rating:** While determining the issuer rating, it is important to understand that preference shares may have a potential economic impact on the overall financial profile of the issuer. The dividend due each year will deplete the issuers reserves, and in turn, its risk absorption capacity. Hence, it is necessary to incorporate this impact in the issuer rating. For this purpose, PACRA updates issuer’s coverages by including dividend payable on preference shares along with debt servicing components. The issuer rating is then aligned with modified debt service coverages and other ratios. Finally, PACRA adjusts this rating depending on the individual terms and conditions and features of the preference shares.

**2.3 Notching:** Preference shareholders have a right to dividend and principle repayment which is subordinate to debt-holders but superior to ordinary shareholders. Hence, PACRA’s credit rating for preference shares will usually be below the adjusted issuer rating.

**2.4** The extent of notching down is dictated by the terms and conditions of preference shares. The closer it is to debt in its characteristics, the lesser will be the notching down. Meanwhile, if preference shares replicate equity in their characteristics,

it will be further notched down from issuer rating. The table below explains the relationship:

	Equity	Hybrid (Preference Shares)	Debt
Permanence	Perpetual	Based on tenure	Based on tenure
Legal obligation to service	None	As per agreement	Yes
Risk absorption capacity	Very high	Moderate	None
Notches down	2-3 Notches	1-2 Notches	0-1 Notches



**2.4.1 Permanence:** Equity is perpetual in nature. The issuer has no legal obligation to buy back the equity. Even when winding up, equity holders will only be paid if there are resources left after settling all other liabilities. Hence, equity fortifies the issuer's risk absorption capacity. On the other hand, debt does not provide any loss absorption as it is time-bounded and has to be repaid, regardless of the issuer's financial condition.

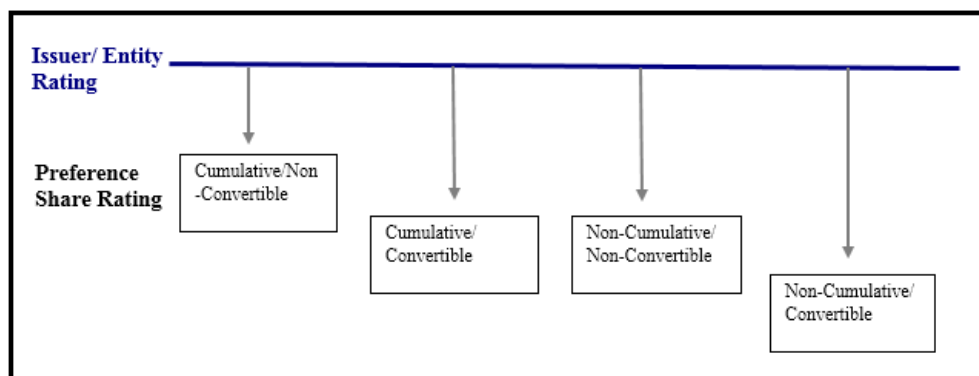
**2.4.2 Legal obligation to service:** Debt servicing is mandatory on the issuer. While, the issuer may choose to delay or cancel dividends on preference shares. In case of cumulative preference shares the dividends can be accrued and paid at a later date once all other liabilities have been settled. While dividends on non-cumulative preference shares are cancelled if not paid in any particular period. Since, debt has to be serviced regardless of financial condition of issuer, it provides no risk absorption capacity. Hence, PACRA considers preference shares more flexible in nature and believe that they augment the issuer's financial profile more than traditional debt.

**2.5** It is pertinent to note that instruments favor issuers at expense of the investor, and vice versa. Hence, equity-like instruments, which are beneficial to issuers as explained above, carry the highest risk for an investor. Hence, they will have the lowest ratings from an investor's point of view.

**2.6** Preference shares may fall under any of the three categories, equity, hybrid or debt. PACRA decides on the placement depending on their individual characteristics. Based on their characteristics, preference shares are notched down from issuer rating:

- **Cumulative/Convertible:** Dividend on such shares accumulates instead of being cancelled which is a positive rating factor. However, convertibility can be either positive or negative for the investor depending on which party has the right to exercise the conversion. PACRA normally views conversion option with investor as positive, while mandatory conversion or conversion at issuer's discretion is usually considered negative.
- **Cumulative/Non-convertible:** PACRA generally considers such preference shares as superior to other types since there is no conversion provision and the dividend accumulates.

- **Non-cumulative/Convertible:** These carry higher risk as investors may never receive any dividends. The final rating depends on which party has the right to exercise the conversion as explained above.
- **Non-cumulative/Non-Convertible:** Non-accumulation of dividend is a negative, while, non-convertibility is generally positive from an investor's stand point.



**2.7** PACRA uses this grid as a general guide. The actual ratings may differ depending on the terms and conditions of the preference share issue. Since ratings depict the risk to investor, the more protection the terms offer for the investor, higher will be the rating, and vice versa.

**2.8** Moreover, PACRA may draw exceptions from this grid depending on the issuer's financial profile. Issuers rated in BBB and higher rating categories have a superior ability to repay their obligations. Hence, the distance between ratings of such issuers and their preference shares tend to be lesser. Whereas, for issuers rated in the speculative band are exposed to higher risk. Therefore, PACRA deems their preference shares as even riskier and the notching down tends to be greater.

### 3. RATING CHANGES

- Downgrade and default

**3.1** The ratings assigned as per afore-mentioned criteria may change from time to time. As these are linked to the issuer rating, any change in issuer's ability to meet financial obligations will have a direct impact on preference shares rating. However, preference shares rating may also change without any change in issuer ratings. For instance, when preferred dividends are not declared, PACRA generally downgrades the preference shares rating to reflect the non-payment situation. Further downgrades may occur, under the following circumstances:

- the overall rating of the issuer may be downgraded as a result of a negative situation that relates to the decision not to pay preferred share dividends.
- Expectation that non-payment of dividends may continue in coming periods

**3.2 Default:** According to PACRA's definition, dividend payment missed or delayed does not constitute default. Also, any conversion in accordance with pre-determined terms is not regarded default. Default on preference shares occurs in the following cases:

- The firm is forced into bankruptcy.
- Contractual obligations (such as sinking fund payments or principal redemption) are not met.



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- Preference shareholders are forced to exchange the issue with one of lower economic value.

Preference shares rating reflects forward-looking opinion on credit worthiness of underlying issue; more specifically it covers the relative risk that the issuer will not be able to make dividend payments and principal redemption as per agreement. The primary factor being captured on the rating scale is relative likelihood of default.

Rating Scale (Preference Shares)	Definitions
AAA (pf)	Excellent credit quality
AA (pf)	Very good credit quality
A (pf)	Good credit quality
BBB (pf)	Adequate credit quality
BB (pf)	Speculative
B (pf)	Highly speculative
C (pf)	High default risk
D (pf)	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 surveil the opinion due to lack of requisite information

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