The Pakistan Credit Rating Agency Limited

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

Table of Contents

Summary

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

Analyst Contacts
Zoya Aqib
+92-42-3586 9504
zoya.aqib@pacra.com

The Pakistan Credit Rating Agency Limited
Head Office
FB1 Awami Complex
Usman Block, New Garden Town
Lahore
Phone +92 42 3586 9504

Karachi Office
PNSC Building,
3rd Floor
M.T. Khan Road, Lalazar, Karachi
Phone +92 21 35632601

0. Introduction

- Long-term rating: Vulnerability to default for period >12 months
- Short-term rating: Vulnerability to default for period <12 months

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 (intermediaries), and regulators (oversight). 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 the 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.

0.1 Ratings reflect forward-looking opinion on creditworthiness 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.

0.2 PACRA expresses its opinion in terms of:

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

0.3 PACRA's long-term credit ratings range from AAA (Triple A), reflecting the highest credit quality, to C (Single C) denoting imminent default. The addition of plus "+" and minus "-" provides a way to create relative distinctions within rating categories that range from AA (Double A) to B (Single B) category. The AAA and CCC (Triple CCC) to C (CCC – C) categories have no plus "+" or minus "-" attached to it.

0.4 PACRA rates entities / issuers on a short-term rating scale from A1 (A One) to A4 (A Four 4). 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.

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

1. Correlation between Long-term and Short-term Rating Opinion

- Short-term rating derived from long-

1.1 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 term rating with additional focus on liquidity position and financial flexibility

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.

1.1.1 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, availability of unencumbered liquid investments and/or other liquid current assets ensures a cushion for urgent cash in stressed times.

1.1.2 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 sponsor (in the form of a line of credit, or otherwise) and commercial credit lines available to the entity.

1.2 Two different long-term ratings may carry the same short-term rating. This is due to the reason that there are fewer short-term rating grades and each short-term rating corresponds to a band of long-term ratings. 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 rating is indicative and designed for illustration purposes to facilitate understanding. There may be cases when the relationship may not hold due to factors explained. above.

Long-Term and Short-Term Rating Correlation Scale
An Illustrative Representation