The Pakistan Credit Rating Agency Limited

Methodology
Debt Instrument Rating

Table of Contents

Summary

This methodology describes PACRA's approach to rating short-term and long-term debt instruments. The debt instrument rating takes into account the probability of default on a particular instrument. PACRA uses the credit rating of the issuing entity (referred to as "issuer") as a baseline for determining the rating of the debt instrument of such entity. It then goes on to incorporate the unique characteristics of the instrument into its analysis. These include, but are not limited to, seniority of the debt instrument relative to other obligations of the issuer, underlying collateral and credit enhancements, if any exist. When rating short-term debt instruments, PACRA additionally considers the liquidity and financial flexibility of the issuer. Based on PACRA's analysis of these factors, the instrument is either notched higher or lower than the issuer's rating.

Effective Date: 1st July, 2020

This methodology updates and replaces "Debt Instrument", last updated in June, 2019.

Analyst Contacts
Usama Liaquat
Assistant Manager - Criteria
+92-42-3586 9504
usama.liaquat@pacra.com

The Pakistan Credit Rating Agency Limited
FB1 Awami Complex
Usman Block, New Garden Town
Lahore
Phone +92 42 3586 9504 - 6

Disclaimer: PACRA has used due care in preparation of this document. Our information has been obtained from sources we consider to be reliable but its accuracy or completeness is not guaranteed. PACRA shall owe no liability whatsoever to any loss or damage caused by or resulting from any error in such information. Contents of PACRA documents may be used, with due care and in the right context, with credit to PACRA. Our reports and ratings constitute opinions, not recommendations to buy or to sell.

0. Introduction

- Debt instrument market
- Key types of debt instruments

Introduction

0.1 Debt instrument market: Pakistan has a relatively small debt instrument market. Financing through bank loans is the preferred route for corporates, rather than utilizing 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 also been tapped but 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.

0.2 Key Types of Debt Instruments: Key types of debt instruments are: term finance certificates (TFCs), commercial papers and Sukuk. These can be differentiated on the basis of: (i) maturity (money market vs. capital market debt instruments), (ii) issuing entities (government, financial institutions, corporates, etc.), (iii) markets in which they are issued (conventional vs. Islamic), (iv) accessibility (listed vs. privately-placed), and (v) security (secured, unsecured or subordinated). PACRA has evolved separate methodologies to cater to the distinct features of structured debt instruments, Sukuk, Basel III Compliant debt instruments and preference shares.

Debt instruments	• Securities with underlying contractual obligation owed by the issuer to make interest payments and principal repayments to the debt instrument holders (or "lenders") for the life of the debt instrument.
Structured debt instruments	• Debt instruments designed to cater to complex financing needs through securitization.
Sukuk	• Islamic debt instruments also referred to as "Shariah-compliant bonds".
Basel III compliant debt instruments	• Debt instruments issued by banks to enhance capital adequacy, based on regulatory requirement prescribed by the State Bank of Pakistan.
Preference shares	• Hybrid instruments sharing both debt and equity characteristics, with fixed-rate dividend and principal redemption agreement.

1. Rating Debt Instruments

- Issuer Profile
- Notching
- Credit Enhancements

Rating Debt Instruments

1.1 A debt instrument rating is an assessment of a specific debt issue of an entity and provides an opinion on the issuing entity's ability to meet on a timely basis its principal and interest obligations pertaining to the debt instrument being rated. For the purpose of the rating assessment, both the payment of interest and repayment of principal are considered "contractual obligations" by PACRA.

1.2 PACRA undertakes debt instrument ratings for all kinds of short-term and long-term instruments. For any given debt instrument rating, the entity rating of the issuer is used as a baseline (also called issuer rating). The debt instrument rating is then notched either "higher" or "lower" compared to its corresponding issuer rating.

1.3 Issuer Profile: 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, the rating criteria applied is as follows:

Qualitative Factors	
Qualitative risk profile is assessed by soliciting information from client and direct interaction with sponsors, management, and/or directors and conducting a visit to plant site and head offices.	
Profile	
Background	Evolution of the company since its inception
Operations	Range of products/services, diversity, scale of operations
Ownership	
Ownership Structure	Study of legal structure of entity and shareholding mix in order to disentangle the structure of ownership and identify the man of the last mile
Stability	Formal succession planning (in case of family owned concerns: clarity of role amongst family members)
Business Acumen	Sponsors' industry-specific working knowledge and strategic thinking capability
Financial Strength	Ability of sponsor to arrange funds or find alternate resources when needed, and willingness of sponsor to support the issuer measured by looking at shared brand name, size of investment versus other investments of sponsors
Governance	
Board Structure	Size of board, composition, degree of independence, 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
Transparency	Composition of audit committee, quality of internal and external auditors, and public disclosures
Management	
Organizational Structure	Complexity or simplicity of organizational structure relative to business needs, adequacy of staffing, cohesiveness amongst management team
Management Team	Qualification and relevant experience of management team, market reputation and integrity
Management Effectiveness	Type and frequency of information used by the senior management to assist decision making
Control Environment	Policies and procedures, risk management framework, technology

Quantitative Factors	
Quantitative risk profile is assessed by looking at economic conditions, industry dynamics, standalone performance relative to peers – through financial statements, projections, financial strategy and cash flow analysis. This is very much numbers driven.	
Business Risk	
Industry Dynamics	Macroeconomic analysis, business cycle, demand and supply dynamics of products, cost structure relative to other players, regulatory environment
Relative Position	Placement of entity in the related market in terms of market share, growth trend and competitiveness
Revenues	Stability and diversification of revenue (diversification from each dimension – product , customer , geographical), non-core income
Cost Structure	Conversion cost relative to peers, 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	
Working Capital	Working capital management – inventory, trade receivables, trade payables, financing of working capital, cushion against net trade assets, 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
Capital Structure	Leverage philosophy of management, reliance on external financing and level of financial flexibility

1.4 Notching: The primary factors impacting notching of the debt instrument, relative to the issuer profile, are: i) Relative seniority of the instrument, compared to the issuer's other obligations, and ii) Underlying collateral, since these can impact recovery prospects in case of default. A summary of notching guidance is presented in the table below:

Instrument Type	Likely Notching Impact
Senior Unsecured Instrument	0
Senior Secured Instrument	+1
Subordinated Instrument	-1, -2

1.4.1 Relative Seniority of the Instrument: A senior unsecured instrument carries the same rating as its issuer. Meanwhile, notching for legally subordinated instruments is minus one for high-rated issuers. However, minus two notches may be applied in case of lower rated issuers where the instrument is deemed to be deeply subordinated (i.e. represents a small share of the issuer's total debt).

1.4.2 Collateral: Where an instrument is secured, the extent of notching is also influenced by the quality of the underlying collateral it is secured against, since this determines recovery prospects in case of default. PACRA looks at the following features of the collateral:

- Current valuation and associated volatility thereof; the more volatile the value of a security is deemed to be, the less favorable the notching impact

- Liquidity/marketability; the higher the likelihood of the security being monetized in a timely manner with minimal premium, the more favorable the notching impact
- Nature of charge

1.4.3 In certain cases, PACRA's ratings may differ from the notching guidance specified in the table above. For example, where an issuer maintains an unbalanced capital structure whereby the particular instrument comprises either a very significant or insignificant proportion of total debt, and/or where there is significant complexity in the legal structure of the terms of the instrument, among other considerations.

1.5 **Credit Enhancements**: The presence of certain structural features may enhance the rating of a particular debt instrument relative to its issuer or its issuer's other debt instruments. Two common forms of such features are third party guarantees and cash collection mechanism.

1.5.1 **Third Party Guarantees:** 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.

1.5.2 **Cash Collection Mechanism:** 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.

1.6 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 collateral. 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 vis-à-vis regulatory capital adequacy requirement over the tenor of the instrument.

2. Additional Considerations for Short-term Instruments

- Linkage between Short-term and Long-term

Additional Considerations for Short-term Instruments

2.1 PACRA's approach to rating short-term debt instruments is similar to that used for long-term debt instruments. However, two factors are given more focus when rating short-term debt instruments, namely: i) short-term liquidity position, and ii) financial flexibility of issuer.

2.1.1 **Short-term Liquidity Position**: When assessing short-term liquidity, PACRA focuses mainly on the cash flow and working capital management of the issuer to assess repayment ability. In addition to this, an important factor is reviewing unutilized working capital lines of credit from financial institutions. This is essential for assessing the cushion available to an issuer to avoid a liquidity shortfall at the time of instrument maturity.

2.1.2 **Financial Flexibility**: Here, PACRA looks at the alternative sources of liquidity available to an issuer, apart from the ones discussed above. While one aspect of financial flexibility is the issuer's capital structure (thoroughly assessed when analyzing issuer profile), alternative liquidity sources include support available from sponsor (in the form of a line of credit, or otherwise) and availability of unencumbered liquid investments and/or other liquid current assets.

2.2 Linkage between Short-term and Long-term: When assessing an issuer's liquidity profile, some temporary features may appear to skew the short-term rating for an issuer such as high or low cash balances which could simply be a reflection of cyclicality or seasonality within a given industry or sector. Thus, PACRA focuses on the sustainable liquidity profile of an issuer. Herein, long-term credit quality plays a key role, thus creating a linkage between short-term and long-term ratings. This is due to two main reasons. Firstly, an entity with higher long-term credit quality has a stronger ability to refinance, and/or gain access to other sources of funding. Secondly, many short-term instruments tend to get rolled over and, therefore, call for a longer-term rating view. Thus, long-term ratings cannot be disregarded when assigning short-term ratings.

3. Surveillance

Surveillance

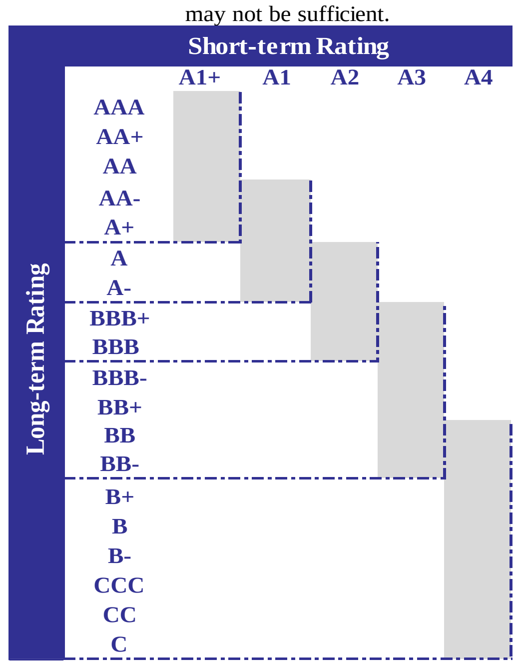
3.1 Once a debt instrument is issued, PACRA provides a valuable tool for investors by monitoring and reporting on its performance. In this regard, relationship with trustee of each instrument is established. Each profit and principal payment is confirmed from the trustee. The surveillance frequency depends on payment terms and frequency of payments. However, a formal review is undertaken once in every six months.

Credit Rating

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.

Long-term Rating	
Scale	**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.

Short-term Rating	
Scale	**Definition**
A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.



**The correlation shown is indicative and, in certain cases, may not hold.*

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 some material identifiable event with indeterminable rating implications. 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 rating 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) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) 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.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note. This scale is applicable to the following methodology(s):

Entities

a) Broker Entity Rating
b) Corporate Rating
c) Financial Institution Rating
d) Holding Company Rating
e) Independent Power Producer Rating
f) Microfinance Institution Rating
g) Non-Banking Finance Companies (NBFCs) Rating

Instruments

a) Basel III Compliant Debt Instrument Rating
b) Debt Instrument Rating
c) Sukuk Rating

Disclaimer: PACRA has used due care in preparation of this document. Our information has been obtained from sources we consider to be reliable but its accuracy or completeness is not guaranteed. PACRA shall owe no liability whatsoever to any loss or damage caused by or resulting from any error in such information. Contents of PACRA documents may be used, with due care and in the right context, with credit to PACRA. Our reports and ratings constitute opinions, not recommendations to buy or to sell.