The Pakistan Credit Rating Agency Limited

Rating Report

Pakistan Services Limited | Sukuk | Mar-18

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
21-May-2019	AA-	-	Stable	Maintain	-
19-Nov-2018	AA-	-	Stable	Maintain	-
29-Mar-2018	AA-	-	Stable	Initial	-
26-Oct-2017	AA-	-	Stable	Preliminary	-

Rating Rationale and Key Rating Drivers

The ratings reflect Pakistan Services Limited’s (The Company) strong position in the hospitality industry as the market leader drawing comfort from its association with Hashoo Group. Pakistan Services Limited has witnessed growth over the years (in line with Industry dynamics) amid improving security conditions and progression of CPEC with stable margins. However, ongoing geopolitical scenario coupled with slowdown in domestic economic activity has impacted the Company's revenues and profitability through 9MFY19. The Company has taken cost control measures to improve margins, however, a significant impact is yet to be seen. The Company has modest leveraging and a large asset base. Relatively higher borrowings and rising interest rates have put coverages under pressure. This trend is expected to continue as cashflows may remain suppressed till new properties commence operations. The management intends to dispose off some of its properties (real estate assets) to supplement its liquidity. The Company has liquid investments and cash to meet its obligations and maintaining this liquidity cushion will be important.

Ratings are dependent on effective implementation of envisaged strategy while maintaining modest leveraging and strengthening coverages. Any significant delay in commencement of new projects and/or further deterioration in margins leading to lower coverages and liquidity will have a negative impact on ratings. Meanwhile, maintaining sufficient liquidity for debt repayment remains critical.

Disclosure

Name of Rated Entity	Pakistan Services Limited | Sukuk | Mar-18
Type of Relationship	Solicited
Purpose of the Rating	Debt Instrument Rating
Applicable Criteria	Methodology | Sukuk(Jun-18),Methodology | Criteria | Rating Modifier(Jun-18),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-18)
Related Research	Sector Study | Hotels & Retail Industry(May-19)
Rating Analysts	Adnan Dilawar | adnan@pacra.com | +92-42-35869504

Profile

Legal Structure Pakistan Services Limited (the Company) is a public limited company with its share listed on the Pakistan Stock Exchange.

Background The Company was incorporated in 1958 by the Government of Pakistan and Pakistan International Airlines, with four hotels in Karachi, Lahore, Rawalpindi and Peshawar. The hotels were managed by Intercontinental Hotel up until 1985, after which they took an exit from Pakistan. Subsequently, Hashoo Group successfully bid for the hotels in the same year and commenced operations under the brand 'Pearl Continental Hotels'.

Operations The Company operates six luxury hotels under 'Pearl Continental' and one budget hotel under 'Hotel One'. The hotels are spread across all major cities of Pakistan with 1,556 rooms in total.

Ownership

Ownership Structure Major shareholding of the Company lies with Hashoo Group (~90%) through foreign affiliates (~65%), associated companies (~23%) and directors (2%). Remaining shareholding is split between the general public and financial institutions.

Stability Ownership structure of the Company is stable as there is limited free-float and no ownership changes are expected.

Business Acumen Hashoo Group was established in 1960 by Sadruddin Hashwani, Chairman of the Group. The Group penetrated the hospitality industry by setting up its first hotel in 1978 and the second in 1981 under the brand 'Holiday Inn'. In the following years, the Group acquired Pakistan Services Limited and gained franchise rights for Marriott Hotels by Marriott International.

Financial Strength The Company's financial strength is derived from the support of its Group. The Group has business ventures spread across various industries, both, locally and internationally, with a dominating position in Pakistan's hospitality industry. In addition to operating Pearl Continental through Pakistan Services Limited. The Group, through Hashwani Hotels Limited, operates two Marriott Hotels (Islamabad and Karachi) and one property of Pearl Continental located in Gawadar. Moreover, the Company operates a chain of budget hotels under Hotel One (Private) Limited. The Group has a total of ~2,777 rooms across the country.

Governance

Board Structure Board of Directors comprises nine members including three executive directors, five non-executive directors and one independent director.

Members' Profile The Board members have strong profiles and specialize in banking, finance and legal matters, in addition to hospitality.

Board Effectiveness The Company has in place two Board committees, namely, Human Resources and Remuneration Committee and Audit Committee. During FY18 the Board four times, with high attendance by members.

Financial Transparency M/s KPMG Taseer Hadi & Co., Chartered Accountants, classified in category 'A' by SBP and having a satisfactory QCR rating, are the external auditors of the Company. They have expressed an un-qualified opinion on the financial statements of the Company for the year ending in June, 2018.

Management

Organizational Structure The Company has a well-defined organizational structure. The highest level of authority lies with the Chief Executive who is aided by the Deputy Chairman and Vice Chairman. Similarly, management of the Hospitality division is headed by President of Hospitality.

Management Team Mr. Murtaza Hashwani, the Chief Executive Officer, has over two decades of experience relating to hospitality, oil & gas and pharmaceuticals. He is ably supported by Mr. Tahir Mahmood Satti who has recently been appointed as the Chief Financial Officer.

Effectiveness In order to ensure efficient operations, the Company relies on constructing and implementing strict budgets. Moreover, to devise future strategies while evaluating current performance, top management are submitted various reports on a frequent basis.

MIS The Company has implemented 'Opera', an integrated, cloud-based, management system designed specifically for the hospitality industry by Oracle.

Control Environment The Company has formed an efficient internal audit department, which reports to the Audit committee formed by the Board. The department works primarily in three dimensions i) Assurance, ii) Consulting and (iii) Investigation.

Business Risk

Industry Dynamics Recent growth in the economy, coupled with improving security conditions, has led to growth in Pakistan's hospitality sector. Additionally, progression of China Pakistan Economic Corridor (CPEC) has further boosted the industry. The luxury hotels space in Pakistan is largely dominated by a few major players as barriers to entry exist due to the capital intensive nature of the business.

Relative Position Pakistan Services Limited (PSL), operating under the brand 'Pear Continental' is the leading 5 star brand in the country with 1,526 rooms, followed by Sarena Hotels 828 rooms, Avari Hotels 508 rooms and Marriott Hotels 505 rooms.

Revenues The Company generates its revenue from four sources, namely, rooms, food & beverage, other related services and shop license fee. Bulk of sales revenue is sourced from room and food & beverage (95% in 9MFY19), with the Company's property in Lahore contributing the highest share (~39%) towards total revenue. During 9MFY19, net revenue witnessed a decline of 5%, YoY, standing at ~PKR 7,810mln (9MFY18: PKR 8,214mln). Though both major segments (rooms and food & beverage) registered a slowdown, decline was primarily brought about by a ~7% reduction in revenues from rooms, with food and beverage reporting a marginal decline of ~2%. Moreover, the Company's biggest property, PC Lahore, registered a substantial reduction sales. Poor performance can be traced to elections held during the first quarter of FY19, marginal impact of heightened tensions with India and growing inflationary pressures.

Margins Gross margin during 9MFY19 decreased by 6 bps and fell to 43% as compared to 49% in the preceding period. A reduction in margins in attributable to lower occupancy rates across all properties. The Company's properties located in Peshawar, Lahore and Rawalpindi were significantly impacted, registering an average decline of ~18% in occupancy rates during 9MFY19. Moreover, inability to increase Average Daily Rate (ADR) for its property in Lahore, due to slowing demand, further impacted profitability. Operating expenses only witnessed a slight increase (1 bps) during 9MFY19, however, owing to lower profitability at gross level, operating margin declined by 7 bps and stood at ~12% in 9MFY19 (9MFY18: ~19%). The situation was aggravated by a 98% surge in financial costs, increasing to ~PKR 1bln in 9MFY19 (9MFY18: ~PKR 505mln). Coupled with an unrealized loss on investments, the Company posted a loss of ~PKR 401mln as compared to a net profit of ~PKR 672mln.

Sustainability The Company is in process of constructing two projects - PC Multan and PC Mirpur. PC Multan is expected to be ready for a soft launch in July 2019. Similarly, PC Mirpur is under development and is expected to come online early next year. In addition to the above, the Company, through its subsidiary, is developing a high end residential building in Lahore. The project has started booking from January, 2019 and is expected to generate significant cashflows.

Financial Risk

Working Capital Due to the largely cash based nature of the business, the Company was able to maintain a satisfactory position on its working capital management. Though trade receivable days registered a slight increase during 9MFY19, the Company was able to improve trade payable days, bringing down net working capital days to 14 days (9MFY18: 18 days). Additionally, reduction in short-term borrowings during the period helped the Company improve cushion to borrow additional funds, if needed. Though, improvement is still required.

Coverages Coverages for the Company have been deteriorating, remaining weak during 9MFY19 and require a significant improvement. The Company witnessed interest coverage fall to 1.6x in 9MFY19 as compared to 3.1x in FY18 (9MFY18: 3.5x). Similarly, total coverage also maintained a downward trend, coming down to 0.6x (FY18: 1.0x; 9MFY18: 1.4x). Adverse movements in coverage ratios are a factor of increased interest costs and higher debt obligations. Similarly, weakening profitability and resulting cashflows have aggravated the matter further. Upcoming principal repayments of instrument, commencing in March 2020, will stretch the Company's financial profile as cashflows remain subdued. However, comfort can be drawn from adequate liquid investments and cash which can be used to meet financial obligations.

Capitalization The Company issued a privately placed Sukuk worth PKR 7,000mln during FY18. All three tranches of the instrument have been fully drawn by the Company, with repayment commencing from March 2020. Total borrowings during 9MFY19 witnessed an increase of ~33% primarily on the back of full draw down of the instrument, as other borrowings registered a decline during the period. Despite a surge in borrowings, the Company was able to maintain a modest leveraging ratio, standing at ~30%in 9MFY19 (FY18: 24%), on the back of a strong equity base.

Financials (Summary) in PKR mln
PKR mln

Pakistan Services Limited

Listed Public Limited

BALANCE SHEET	Mar-19 *Management* 9M	Jun-18 *Audited* 12M	Jun-17 *Audited* 12M	Jun-16 *Audited* 12M
a Non-Current Assets	**43,706**	**41,495**	**34,789**	**32,864**
b Investments (Incl. Associates)	**7,295**	**6,236**	**2,462**	**2,291**
Equity Instruments	5,209	4,166	1,038	1,038
Debt Instruments	2,025	2,010	1,374	1,209
Investment Property	60	60	50	45
c Current Assets	**3,196**	**2,808**	**5,090**	**1,498**
Inventory	105	86	83	96
Trade Receivables	856	705	602	529
Others	2,235	2,018	4,405	873
d Total Assets	**54,196**	**50,540**	**42,340**	**36,653**
e Debt/Borrowings	**15,368**	**11,557**	**7,662**	**2,705**
Short-Term	559	554	340	-
Long-Term (Incl. Current Maturity of Long-Term Debt)	7,809	8,670	7,322	2,705
Sukuk	7,000	2,333		
Other Short-Term Liabilities	2,223	2,203	1,752	1,688
Other Long-Term Liabilities	1,123	939	810	696
f Shareholder's Equity	**35,481**	**35,840**	**32,116**	**31,564**
g Total Liabilities & Equity	**54,196**	**50,540**	**42,340**	**36,653**

INCOME STATEMENT				
a Turnover	**7,810**	**10,527**	**9,812**	**9,151**
b Gross Profit	3,332	4,880	4,382	4,379
c Net Other Income	152	146	115	(634)
d Financial Charges	(1,002)	(726)	(412)	(168)
e Net Income	**(401)**	**496**	**1,149**	**625**

CASH FLOW STATEMENT				
a Free Cash Flow from Operations (FCFO)	1,386	2,014	1,981	1,806
b Total Cashflows (TCF)	1,536	2,069	2,023	1,806
c Net Cash changes in Working Capital	(379)	134	4	357
d Net Cash from Operating Activities	235	1,574	1,643	2,013
e Net Cash from InvestingActivities	(4,677)	(3,949)	(6,137)	(4,006)
f Net Cash from Financing Activities	3,777	3,373	4,386	1,605
g Net Cash generated during the period	(666)	997	(108)	(387)

RATIO ANALYSIS				
a Performance				
Turnover Growth	-5%	7%	7%	16%
Gross Margin	43%	46%	45%	48%
Net Margin	-5%	5%	12%	7%
ROE	-2%	1%	4%	2%
b Coverages				
Debt Service Coverage (X) (FCFO/Gross Interest+CMLTD+Uncovered STB)	0.5	1.0	2.2	3.0
Interest Coverage (X) (FCFO/Gross Interest)	1.6	3.1	4.8	18.4
Debt Payback (Years) (Total Debt (excluding Covered Short Term Borrowings) / FCFO)	22.5	8.0	4.7	1.6
c Working Capital Management				
Net Cash Cycle (Inventory Days + Receivable Days - Payable Days)	14	11	14	11
d Capital Structure (Total Debt/Total Debt+Equity)	30%	24%	19%	8%

Rating Scale

Credit Rating Scale & Definitions

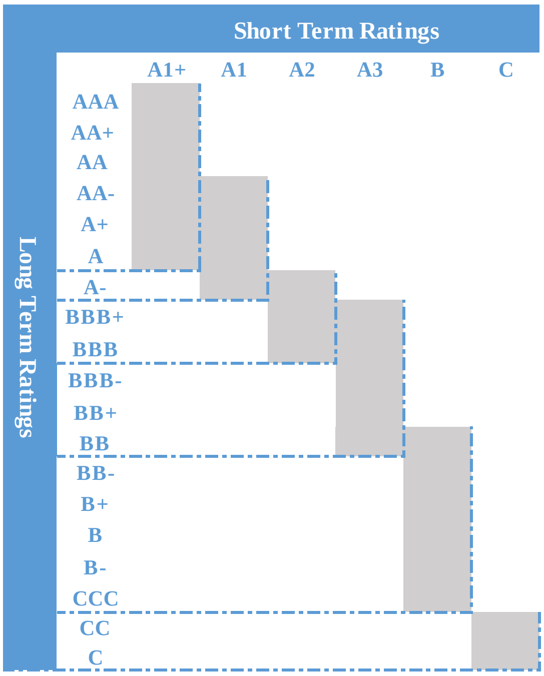
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long Term Ratings

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 Ratings

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 conditions.
B	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.
C	An inadequate capacity to ensure timely repayment.



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.

Regulatory and Supplementary Disclosure
(Credit Rating Companies Regulations,2016)

Rating Team Statements
(1) Rating is just an opinion about the creditworthiness of the entity and does not constitute recommendation to buy, hold or sell any security of the entity rated or to buy, hold or sell the security rated, as the case may be | Chapter III; 14-3-(x)

2) **Conflict of Interest**
i. The Rating Team or any of their family members have no interest in this rating | Chapter III; 12-2-(j)
ii. PACRA, the analysts involved in the rating process and members of its rating committee, and their family members, do not have any conflict of interest relating to the rating done by them | Chapter III; 12-2-(e) & (k)
iii. The analyst is not a substantial shareholder of the customer being rated by PACRA [Annexure F; d-(ii)] Explanation: for the purpose of above clause, the term “family members” shall include only those family members who are dependent on the analyst and members of the rating committee

Restrictions
(3) No director, officer or employee of PACRA communicates the information, acquired by him for use for rating purposes, to any other person except where required under law to do so. | Chapter III; 10-(5)
(4) PACRA does not disclose or discuss with outside parties or make improper use of the non-public information which has come to its knowledge during business relationship with the customer | Chapter III; 10-7-(d)
(5) PACRA does not make proposals or recommendations regarding the activities of rated entities that could impact a credit rating of entity subject to rating | Chapter III; 10-7-(k)

Conduct of Business
(6) PACRA fulfills its obligations in a fair, efficient, transparent and ethical manner and renders high standards of services in performing its functions and obligations; | Chapter III; 11-A-(a)
(7) PACRA uses due care in preparation of this Rating Report. Our information has been obtained from sources we consider to be reliable but its accuracy or completeness is not guaranteed. PACRA does not, in every instance, independently verifies or validates information received in the rating process or in preparing this Rating Report.
(8) PACRA prohibits its employees and analysts from soliciting money, gifts or favors from anyone with whom PACRA conducts business | Chapter III; 11-A-(q)
(9) PACRA ensures before commencement of the rating process that an analyst or employee has not had a recent employment or other significant business or personal relationship with the rated entity that may cause or may be perceived as causing a conflict of interest; | Chapter III; 11-A-(r)
(10) PACRA maintains principal of integrity in seeking rating business | Chapter III; 11-A-(u)
(11) PACRA promptly investigates, in the event of a misconduct or a breach of the policies, procedures and controls, and takes appropriate steps to rectify any weaknesses to prevent any recurrence along with suitable punitive action against the responsible employee(s) | Chapter III; 11-B-(m)

Independence & Conflict of interest
(12) PACRA receives compensation from the entity being rated or any third party for the rating services it offers. The receipt of this compensation has no influence on PACRA´s opinions or other analytical processes. In all instances, PACRA is committed to preserving the objectivity, integrity and independence of its ratings. Our relationship is governed by two distinct mandates i) rating mandate - signed with the entity being rated or issuer of the debt instrument, and fee mandate - signed with the payer, which can be different from the entity
(13) PACRA does not provide consultancy/advisory services or other services to any of its customers or to any of its customers’ associated companies and associated undertakings that is being rated or has been rated by it during the preceding three years unless it has adequate mechanism in place ensuring that provision of such services does not lead to a conflict of interest situation with its rating activities; | Chapter III; 12-2-(d)
(14) PACRA discloses that no shareholder directly or indirectly holding 10% or more of the share capital of PACRA also holds directly or indirectly 10% or more of the share capital of the entity which is subject to rating or the entity which issued the instrument subject to rating by PACRA; | Reference Chapter III; 12-2-(f)
(15) PACRA ensures that the rating assigned to an entity or instrument is not be affected by the existence of a business relationship between PACRA and the entity or any other party, or the non-existence of such a relationship | Chapter III; 12-2-(i)
(16) PACRA ensures that the analysts or any of their family members shall not buy or sell or engage in any transaction in any security which falls in the analyst’s area of primary analytical responsibility. This clause shall, however, not be applicable on investment in securities through collective investment schemes. | Chapter III; 12-2-(l)
(17) PACRA has established policies and procedure governing investments and trading in securities by its employees and for monitoring the same to prevent insider trading, market manipulation or any other market abuse | Chapter III; 11-B-(g)

Monitoring and review
(18) PACRA monitors all the outstanding ratings continuously and any potential change therein due to any event associated with the issuer, the security arrangement, the industry etc., is disseminated to the market, immediately and in effective manner, after appropriate consultation with the entity/issuer; | Chapter III | 18-(a)
(19) PACRA reviews all the outstanding ratings on semi-annual basis or as and when required by any creditor or upon the occurrence of such an event which requires to do so; | Chapter III | 18-(b)
(20) PACRA initiates immediate review of the outstanding rating upon becoming aware of any information that may reasonably be expected to result in downgrading of the rating; | Chapter III | 18-(c)
(21) PACRA engages with the issuer and the debt securities trustee, to remain updated on all information pertaining to the rating of the entity/instrument; | Chapter III | 18-(d)
Probability of Default
(22) PACRA´s Rating Scale reflects the expectation of credit risk. The highest rating has the lowest relative likelihood of default (i.e, probability). PACRA´s transition studies capture the historical performance behavior of a specific rating notch. Transition behavior of the assigned rating can be obtained from PACRA´s Transition Study available at our website. (www.pacra.com). However, actual transition of rating may not follow the pattern observed in the past | Chapter III | 14-(f-VII)
Proprietary Information

Regulatory and Supplementary Disclosure

Sukuk	
Placement	Unlisted, Secured, Privately Placed Sukuk
Issue size	PKR 7,000mln (inclusive of Green Shoe option of PKR 2,000mln)
Issue date	1st Tranche: March 2018 (PKR 2,333mln); 2nd Tranche: July 2018 (PKR 1,362mln); 3rd Tranche: January 2018 (PKR 3,305mln)
Tenor	6 Years from the date of issue with a 1.5 year grace period
Profit Rate	6Months KIBOR + 1% .
Principal Repayment	Nine (9) semi-annual installments commencing from the 6th month after the expiry of the grace period and subsequently every six (6) months thereafter till the issue tenor.
Call Option	Early redemption can be made after three years from the date of disbursement of 1st tranche with thirty (30) days notice. Early redemption will only be allowed on a principal installment date and in integral multiples of PKR 50mln. a pre-payment fee at 0.10% will be charged on the pre-paid amount.
Security	First Pari Passu Hypothecation charge over present and future moveable assets and First Pari Passu Equitable Mortgage on present and future immovable assets of PC Lahore with 25% margin.
Latest Book Value of Security-30-Jun-17	PKR 15,608mln
Latest Market Value of Security-30-Jun-18	PKR 18,602mln
Trustee	Pak Brunei Investment Company Limited

Semi-Annual Installments	Year	Due Date	Days	Principal	Mark Up	Total Installment	Outstanding Balance
					------------PKR 000's ------------		
0	2018	Mar-18	-	-	-	-	2,333,333
1	2018	Sep-18	183	-	108,500	108,500	3,694,879
2	2019	Mar-19	182	-	210,423	210,423	6,999,999
3	2019	Sep-19	183	-	438,550	438,550	6,999,999
4	2020	Mar-20	182	777,778	438,550	1,216,328	6,222,222
5	2020	Sep-20	183	777,778	389,822	1,167,600	5,444,444
6	2021	Mar-21	182	777,778	341,094	1,118,872	4,666,666
7	2021	Sep-21	183	777,778	292,367	1,070,144	3,888,889
8	2022	Mar-22	182	777,778	243,639	1,021,417	3,111,111
9	2022	Sep-22	183	777,778	194,911	972,689	2,333,333
10	2023	Mar-23	182	777,778	146,183	923,961	1,555,555
11	2023	Sep-23	183	777,778	97,456	875,233	777,778
12	2024	Mar-24	182	777,778	48,728	826,505	-