PACRA
INSIGHT

PACRA Insight is a medium to communicate with the users of ratings

– harmonizing knowledge; assimilating expertise….in essence, leading the rating industry's development along high standards of integrity and transparency

The Pakistan Credit Rating Agency Limited

INSIDE…….

Issue III, February 2014

The Pakistan Credit Rating Agency Limited

PACRA INSIGHT

EXECUTIVE SUMMARY

Communication…………………*reflecting* upon issues…..putting *thoughts* into ideas…ideas into words…..**PACRA INSIGHT** – a *medium to communicate* with the users of ratings - is an *endeavor* undertaken by PACRA to facilitate *and* harmonize the development of ratings' business. The matters taken up in PACRA Insight are *diverse* – trends and activity in the rating universe, the economic environment and *issues* and *views* on credit quality.

In this issue of **PACRA INSIGHT**, PACRA's rating universe is *presented* in snapshot. This includes the entity, instrument and asset management ratings' universe.

The ratings industry in Pakistan comprises *two* players. Pakistan's rating universe is shown in snapshot. There is *insight* into the credit quality of the universe.

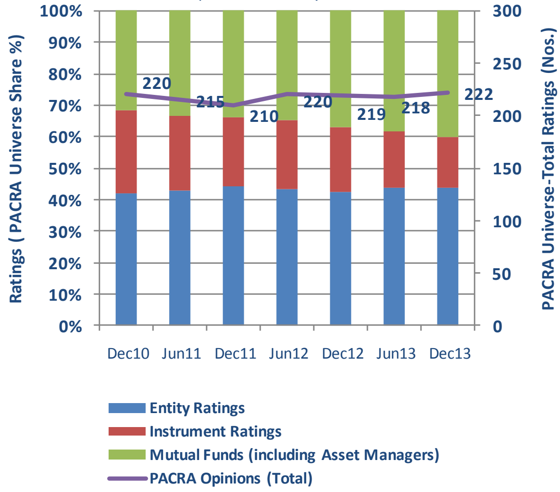
PACRA INSIGHT concludes by *presenting* an industry view into eight sectors of the economy – general insurance, microfinance, asset management companies, energy, cement, textiles, and refining.

LIST OF ILLUSTRATIONS

PACRA'S RATINGS UNIVERSE

FIGURE I

SNAPSHOT - *PACRA Ratings Composition (Dec10- Dec13)*



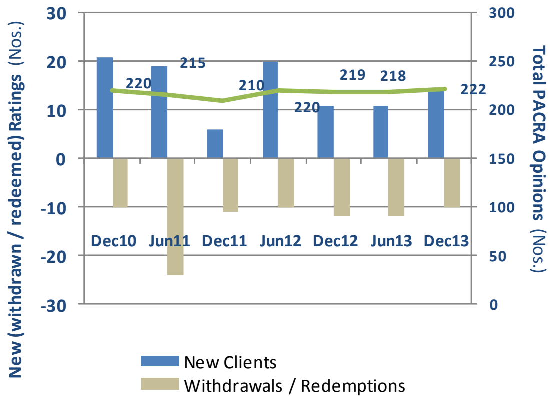
PACRA Ratings Universe *comprises* a diverse range of opinions - entity and instrument ratings, mutual fund ratings and rankings and asset manager ratings.

The universe composition has remained largely the same in **CY13**. It is dominated by entity and instrument ratings followed by *various* kinds of opinions for asset manager companies (AMCs).

Over recent years, PACRA ratings universe has not experienced much growth due to *low ratings penetration* in Pakistan and the *2008-onwards* subdued trend seen in issuance of debt instruments. With the slowdown in the economy, the sluggish trend in ratings universe growth is clearly evident during the last few years. Despite the fact that *withdrawals* have stayed higher, the universe's overall size is supported through new ratings.

FIGURE II

SNAPSHOT - *PACRA Ratings Universe Growth (Dec10 - Dec13)*

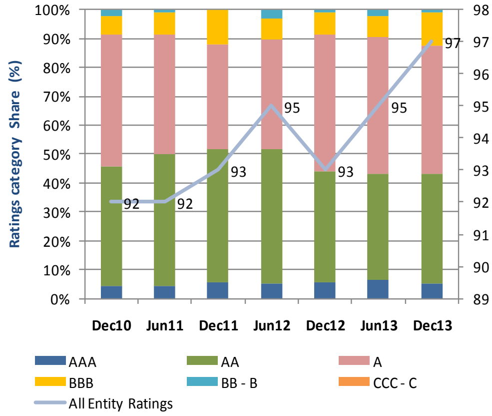


During **CY13**, on a net basis, PACRA ratings universe experienced three additions. Universe-wide, twenty-five **(25)** initial ratings were assigned twenty-four **(22)** were withdrawn as well. Of the new entrants, two **(2)** entities – Kohsar Hydro Power and Mangla Metals belonged to a single group, while two (2) – *SME Bank* and *BMA Asset Management Company* – switched from JCR-VIS to PACRA. The Pakistan General Insurance Company has a dual rating from both PACRA and JCR-VIS. Saudi Pak Insurance Company also maintained a dual rating for a couple of months before being withdrawn by JCR-VIS in **AprCY13**. Of the withdrawn ratings, fifteen **(15)** rating opinions were instrument redemptions, while one was the withdrawal of preliminary instrument rating of *Engro Fertilizer Limited Sukuk II*, where the plan to issue the instrument was stalled. Moreover, all six **(6)** withdrawn entities have so far chosen to stay unrated. Withdrawals were spread *across the universe with an almost equal split between* financial institutions and corporates.

PACRA ENTITY RATING UNIVERSE

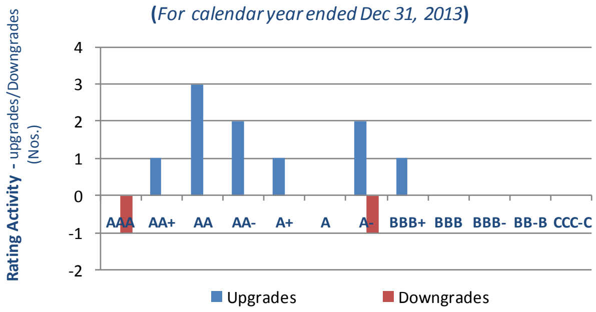
PACRA Entity rating Universe comprises **97** entity ratings as at *December 31, 2013*. It is heavily tilted towards the investment grade categories (*BBB and above*). However, with the last few years' pressure increasing upon *credit quality*, the lower rungs of the rating scale have seen *inhabitance*. Sector-wise distribution shows heavy concentration in financial institutions (Banks **18%**; insurance companies **18%**; non-banking financial institutions **11%**) followed by energy (**13%**) and oil and gas (**7%**).

FIGURE III
PACRA Entity Ratings Composition & Growth
(Dec10 - Dec13)



During **CY13**, in terms of rating activity, **90%** of the universe was reviewed and actions taken thereupon. Of the ninety-two (**91**) ratings *under surveillance*, there were eleven (**11**) upgrades (*Descon Oxychem had its short-term rating upgraded from* **A2** *to* **A1**) and two (**2**) downgrades. Sixty-nine (**69**) ratings were *affirmed*. One (1) Triple-A **'AAA'** lost footing and came down a notch (*National Refinery Limited*) after holding fort for nine years (*initially rated* **'AAA'** *in FY05*).

FIGURE IV
Entity Rating Activity across Rating Categories
(*For calendar year ended Dec 31, 2013*)



A review of the rating actions, however, shows that the *size* of the rating activity, upgrades and downgrades, exhibits low *volatility*. A single multinotch downgrade (*Shaheen Insurance*) occurred, however, no *rising stars*[1] and *fallen angels*[2] existed. Moreover, upgrades far *outpacing* downgrades exhibit positive tone. Upgrades were highly concentrated **(9 out of 11)** in the financial sector (*banking, insurance, leasing*). PACRA entity ratings universe had ten **(10)** new entrants. The sector-mix was diverse – banks **(2)**, engineering **(1)**, technology **(1)**, energy **(2)**, insurance **(2)**, oil & gas **(1)** and cement **(1)**. *Maple Leaf Cement Factory* is treated as an initial rating in PACRA's universe after emergence from default. Technology is a new sector for PACRA and Autosoft Dynamics's entity rating is the first rating opinion that PACRA has assigned in technology sector.

[1] **Rising Star:** A rating rising directly from a speculative grade rating category into an investment grade rating category
[2] **Fallen Angel:** A rating falling directly from an investment grade rating category into a speculative grade rating category

*R*ating Outlooks are *qualifiers* that indicate the likely direction of a *rating change* in the present rating, hence, serving to *enhance* the information content of the opinion. On **July 1, 2013**, there were nine **(9)** *positive* and six **(6)** *negative* rating outlooks. During the *next six months*, **11%** and **50%** of the positive and negative outlooks respectively *translated* in indicated rating changes.

Ratings Outlook Analysis	Positive	Negative
Opening @ July 1, 2013	**9**	**6**
Translated in Rating Change (-)	1	3
Translated in Outlook Change (-)	2	0
Maintained (+)	5	3
Ratings Not Reviewed (+)	0	0
Withdrawn (-)	1	0
During 1HFY14: New (+)	4	2
Opening @ Jan 01, 2014	**9**	**5**

Also, four **(4)** *new* positive rating outlooks were assigned to ratings across *diverse* sectors (*banking, insurance and technology*). Two **(2)** of the ratings were assigned a negative outlook.

CY14 opened at nine **(9)** positive outlooks and five **(5)** negative outlooks.

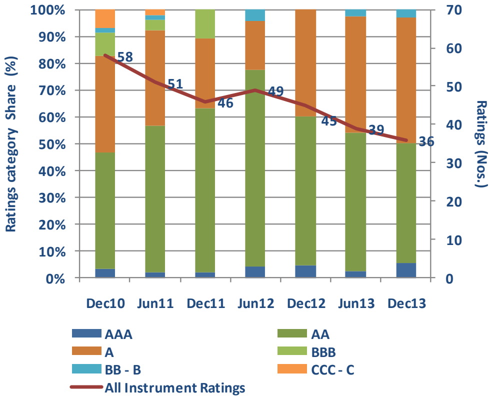
PACRA ENTITY RATING UNIVERSE (Entry / Exit)
(For calendar year ended Dec 31, 2013)

	Entities	*Initial L/T Ratings*		*Withdrawn Entities*	*Last L/T Ratings*
	Financial Institutions				
1.	SME Bank	BBB	1.	Pak Brunei Investment Company	AA
2.	The Pakistan General Insurance Company	A-	2.	Arif Habib Investments	A+
3.	Waseela Microfinance Bank	BBB+			
4.	Saudi Pak Insurance Company	A-			
	Corporates				
5.	Autosoft Dynamics	A-	3.	Ahmed Fine Textile Mills	A-
6.	Mangla Metals	BBB	4.	Hussain Mills	A-
7.	Kohsar HydroPower	BBB	5.	FFC Energy	A
8	Pakistan Refinery	A-	6.	Halmore Power Generation Company	A
9.	Islamabad Electric Supply Company	A+			
10.	Maple Leaf Cement Factory Limited	BB			

PACRA INSTRUMENT RATING UNIVERSE

*P*ACRA Instrument Rating Universe comprises **36** instrument ratings as at *December 31, 2013*. It is mainly *concentrated* in the investment grade categories. However, the impact of *fall* in credit quality is still highly evident within this universe. Due to this very reason, fresh debt issuances have remained *sluggish* and the universe has shrunk due to redemptions.

FIGURE V
SNAPSHOT - PACRA Instrument Rating Universe Composition & Growth
(Dec10- Dec13)



*D*uring **CY13**, *in terms of rating activity*, **81%** of the universe was *reviewed* and actions taken thereupon. Of the thirty **(30)** ratings reviewed, all were affirmed.

*T*he growth in new instrument ratings, *however*, remained sluggish as only seven (**7**) initial instrument ratings were added to the universe. New debt issuance underlying these seven instruments amounted to **PKR 20,8bln of which PKR 15,3bln has already been issued..** (*Excluding the restructured sukuk of Maple Leaf Cement Factory Limited of PKR 8bln*).

PACRA INSTRUMENT RATING UNIVERSE (Entry / Exit) *(For calendar year ended Dec 31, 2013)*		
	[Initial ratings] *Issuers / Instruments*	***Initial Instrument Ratings***
1.	NIB Bank | **TFC II: Upto PKR 5,000mln (including a green shoe option of PKR 1,000mln) TFC TBI**[1]	A+
2.	PAIR Investment Company | **CP: PKR 500mln CP TBI**	AA
3.	Bank Alfalah | **TFC V: PKR 5000mln TFC V issued Feb13**	AA-
4.	The Pakistan Water & Power Development Authority | **PPTFC**[2]**: PKR 9,327mln TFC issued Sept13**	AAA
5.	Pakistan Refinery Limited | **TFC I: PKR 500mln issued Aug13**	A
6.	Pakistan Refinery Limited | **TFC II: PKR 500mln issued Aug13**	A
7.	Maple Leaf Cement Factory Limited | **Restructured Sukuk: PKR 8bln Sukuk restructured Sept12**	BB+
	[Withdrawn[3] **ratings] *Issuers / Instruments***	***Last Instrument Ratings***
1.	Engro Fertilizers | **Sukuk II: PKR 1,500mln TBI**	A

[1] TBI: To be issued
[2] Privately Placed TFC
[3] CY13 had 15 Instrument Redemptions

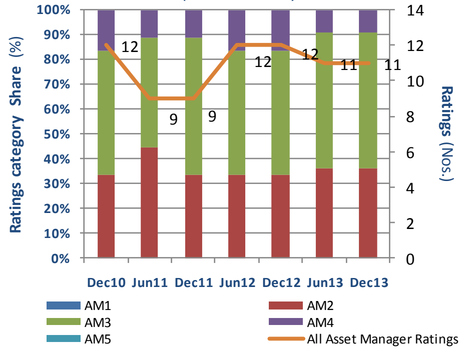
PACRA ASSET MANAGEMENT OPINIONS UNIVERSE

PACRA Asset Management Opinions' Universe *comprises* four kinds of opinion:

1. **Asset Manager Ratings**
2. **Capital Protection Ratings**
3. **Fund Stability Ratings**
4. **Mutual Fund Rankings**

FIGURE VI

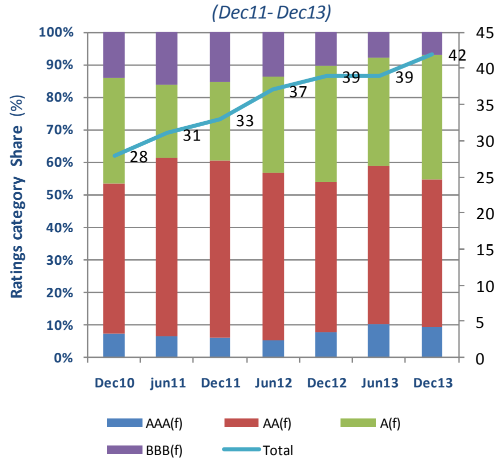
SNAPSHOT - *Asset Manager Ratings Composition & Growth (Dec10- Dec13)*



***P**ACRA* provides a *comprehensive* coverage on asset managers. PACRA's asset manager ratings are an opinion upon the quality of the asset manager and its *systems and controls*. In **CY13**, PACRA asset manager rating universe experienced two **(2)** withdrawals and one **(1)** initial rating. One of the withdrawals (*IGI Funds*) was the result of the acquisition of IGI Funds by Alfalah GHP Investment Management, also rated by PACRA. The other, *Primus Investment Management*, switched to JCR-VIS after being withdrawn by PACRA.

FIGURE VII

SNAPSHOT - *Fund Stability Ratings Composition & Growth (Dec11- Dec13)*

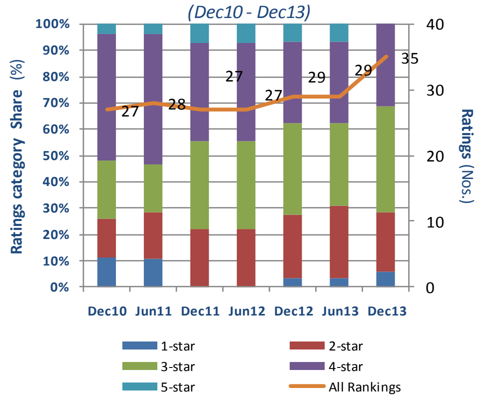


***F**und* Stability ratings, furnishing an opinion upon the prospective relative stability of a fund's returns, have seen a surge in recent years. During the year, PACRA fund stability rating universe has seen an expansion by three **(3)** new opinions by two **(2)** asset managers – IGI Funds and JS Investments.

***M**utual* fund performance rankings, conveying an opinion upon how skillfully a fund has been managed, are becoming increasingly popular amongst investors as the equity market is maintaining its uptrend. In CY13, PACRA mutual fund performance ranking universe saw six (6) new entrants. Five (5) of the six new funds belonged to a single asset manager, JS Investments.

FIGURE VIII

SNAPSHOT - *Mutual Fund Rankings Composition & Growth (Dec10 - Dec13)*



COMMENT ON CREDIT RISK

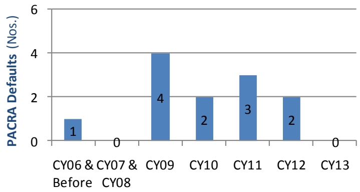
A Rise in Credit Risk			
Entities	Ratings		
	New (Action date)	Prev	Notches
Shaheen Insurance	BBB- (01Aug13)	A-	3
National Refinery	AA+ (23Oct13)	AAA	1

***T**he rating activity is establishing a positive trend as upgrades have consistently been **~10%** of the entity ratings universe for the last three **(3)** years - **CY10 to CY13**. During **CY13**, PACRA ratings universe experienced no default. However, two entities (*a financial institution and a corporate*) were downgraded.

FIGURE XII

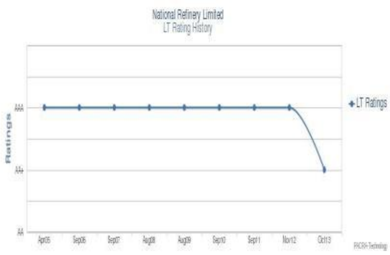
FALL IN CREDIT QUALITY

PACRA Defaulted Entity Ratings



***F**rom 2008 onwards, as the economic environment *toughened*, the DCRAs saw some of their opinions failing to stand the *test* of time. As their universe was heavily concentrated on the higher side of the rating scale, defaults also *emanated* from investment grade rating categories. In **CY13**, the default trend has *leveled off* but credit quality still remains *subservient to prevailing issues* in the operation environment – security risks and power crisis.

Shaheen Insurance Company (SIC): The entity has been downgraded by three **(3)** notches to Triple B Minus **'BBB-'** and assigned a *fresh* **negative outlook**. The grounds for this multinotch downgrade were firming up as Shaheen Insurance's A minus **'A-'** rating has been carrying a negative outlook since **Dec10** exhibiting unresolved business and financial constrains that the company continued to face. When the downgrade eventually occurred, the rating reflected stressed liquidity profile, magnified by sizeable illiquid and non-earning assets. This coupled with the core underwriting business - both volume and profitability – remaining under pressure. Moreover, the company, struggling to instill a cohesive management team, was seen having diminished ability to implement a clear and comprehensive business plan.



National Refinery (NRL): The entity has been downgraded a notch from its Triple A 'AAA' rating that it held steadfast eversince it's initial assignment in Apr05. The high investment grade rating of Double A Plus 'AA+' incorporates NRL's strong financial profile which emanates from its sizeable equity base and established ability to profits from operations. The downgrade reflects a relatively heightened financial risk profile for the company as it intends to expand and modernize its capacities and decides to fund it by inducing debt into its capital structure. However, NRL should be able to manage based on current business performance that would be supplemented by alignment of debt repayments with commencement of new cashflows. Also, the company's association with the country's only fully integrated oil group - Attock Group (AG) which on a net basis remains low leveraged – remains a source of synergistic benefits.

PAKISTAN'S RATINGS UNIVERSE

*P*akistan's Ratings Universe is *shared* amongst two domestic credit rating agencies (DCRAs) – PACRA and JCR-VIS. Between *themselves*, they have ~200+ public entity ratings. On a YoY basis, the universe size has stayed almost the same with some shuffling between categories.

FIGURE IX

Pakistan Ratings Universe Growth

(CY09 - CY13)

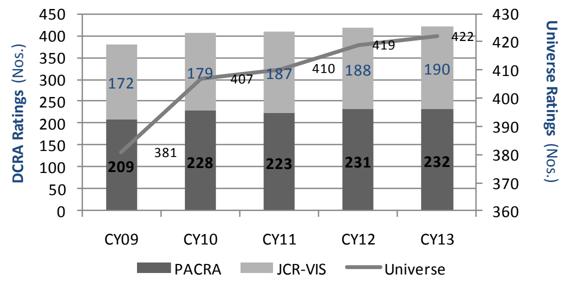
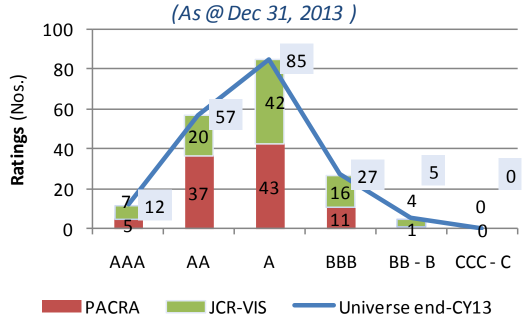


FIGURE X

Pakistan Entity Ratings Universe Compostion in Rating Categories

(As @ Dec 31, 2013)



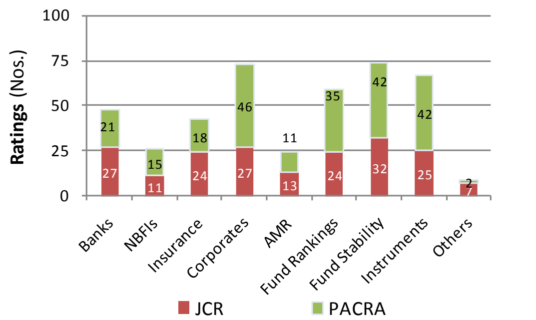
*T*he ratings universe is *concentrated* mostly in investment-grade categories (**Mean Universe Entity Rating Category:** Single A **'A'** *as shown in* **FIGURE XII**) as most rated entities are either financial institutions (*where ratings are mostly mandatory by the regulator*) or prominent corporate having *very high* credit quality. Rating penetration, thus, remains low in Pakistan, especially amongst corporate, where ratings are *optional* and primarily driven by their need to employ de bt financing - mainly *through* debt instruments.

*P*akistan rating universe has a wide range of products for various classes of ratings such as banks, non-bank financial institutions, insurance, corporate, asset managers, mutual funds, instruments, etc.

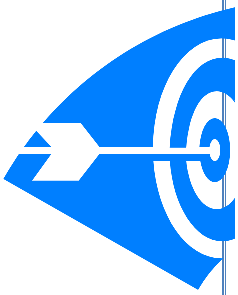
FIGURE XI

Pakistan Ratings Universe Compostion in Rating Classes

(As @ Dec 31, 2013)



THE INDUSTRY VIEW



THE INDUSTRY VIEW		
	Industry *Performance*	*Medium-term* **Outlook**
General Insurance	***T**he sector's gross premium grew decently in 9M13 by 11% YoY, after experiencing muted growth (9M12: 4% YoY). The growth has been fueled primarily by the fire segment (12%). Improved loss ratio in all segments, expect marine (due to few large claims) *cushioned* the overall net loss ratio, hence, the underwriting performance. The sector also benefitted from increased equity market conditions.	The industry is actively exploring non-conventional avenues, especially personal line insurance. Herein, industry players with *better* marketing strategies and extensive outreach would have strategic advantage. Actual results would materialize only *gradually*. The industry is fully poised to capitalize improved technology platform; which should transpire in improving operational efficiencies.
Microfinance	***G**ross Loan Portfolio increased to an all-time high of PKR 50 billion during 3QCY13 with the number of active borrowers reaching 2.8 million. Growth in GLP was *primarily* driven by MFBs (58% share at end-Sep13), followed by RSPs (18% at end-Sep13). Yet, the average loan size remained largely similar on YoY basis (~PKR 26,000). Overall penetration rate increased to 10% in 3QCY13 owing to increase in number of branches by 52, primarily in the province of Sindh.	The microfinance sector depicts an optimistic outlook. The entry of new players indicates *supportive regulatory environment* and growth potential. The approval of the Microinsurance Rules 2014 by SECP, delineating basic rules as well as client protection requirements, is expected to bode well for the industry. Meanwhile, branchless banking is expected to play a more prominent role. Sector is reliant on sustainable deposit mobilization.
AMCs	***T**he industry AUMs continued the growth momentum with an increase of 14% during CY13. The growth was dominated by the *strong* performance of the capital market which led to an increase in the system share of the equity and equity-related funds. However, due to *risk-averse* investor sentiment, such funds experienced a net redemption, whereas, money market funds were able to mobilize fresh AUMs. The industry's fund slate has expanded (Dec13: 168, Dec12: 156) mainly in capital preservation and asset allocation categories.	The industry *continues* to benefit from the tax arbitrage opportunity available to the investors. Any unfavorable change in the tax structure would hamper the industry's overall growth momentum. In line with the investors' *risk averse appetite*, lately capital preservation schemes have become an attractive avenue. In addition to that Government bond funds alongwith the advisory portfolios would remain the key areas of focus for the industry participants. While realizing the importance of retail investor base the industry participants continue to focus on improving the level of services.
Energy	***I**n order to address the issues facing the power sector, the government took some important initiatives - paying off outstanding dues to the IPPs and Pakistan State Oil, *prioritizing* fuel efficient power plants, policy decision to convert less efficient plants to coal, and raising the power tariff. In June 2013, the government released ~PKR 503bln to clear the circular debt that lent temporary respite, however, the underlying issue is yet to be permanently resolved.	Accumulation of receivables and debt repayment behavior *remain* important indicators of financial risk for generation companies. The financial risk of T&D companies would be gauged from the trend of T&D losses and recovery of bills, *ultimately* having a bearing on the cashflows. Inter-corporate debt was ~PKR 194bln during Jan14 and may increase unless structural reforms are brought into play.

Cement	***P**akistan's cement industry has an oligopolistic structure – top five players (*out of a total of 18*) control above 55% share. Geographically production facilities are concentrated in north (83%) of the country, while south has around 17%. Lately, the price stability, indeed improving pattern, supported better margins, thus improved profitability for the sector. During IHFY14, the total production stood at 16mln tons (1% YoY rise) mainly on the back of sustained local sales.	Currently, cement exports are under pressure, however ongoing infrastructure development programmes and *uptick* in economic sentiments are likely to keep domestic demand strong. Once plagued by stressed financial profile, strong profitability of recent days has helped the sector in building financial strength.
Textiles	***C**hina, being the largest consumer of cotton, has built *huge* cotton stocks in recent years and continued to offer support price to its farmers. This, in turn, has created *uncertainty* about global cotton pricing on account of China's behavior regarding release of stocks. During 1HFY14, overall export quantities continued to *rise*. Weaving segment, on account of sustained quantities, continued to be the major contributor in terms of both value and quantity in the overall exports of Pakistan.	Pro-demand factors including FTA with China and recently *approved* GSP Plus status which will allow duty free access to Pakistani textile products in Europe favor the sector. However, with a *time lag* to establish new clientele and uncertainty about the behavior of the other players in GSP Plus universe, the *quantum* of additional volumes and profitability is yet to be established. On the other side, there exist supply constraints to meet the growing demand.
Refining	***S**ectoral performance remained *healthy* during 1HCY13, mainly owing to relative stability observed in the GRMs - a result of largely stable international crude oil prices. With an upsurge in the crude oil prices during most part of the 2HCY13, the domestic refining margins remained *under* pressure. In addition, steep currency devaluation exhibited huge exchange losses, further hampering the domestic refining sector's performance during 2HCY13.	With the *relative* stability in the international crude prices alongwith a largely stable domestic currency the refining sector is expected to perform well. Currently, a *favorable* duty structure continues to contribute significantly towards the *overall profitability* of the refining sector. Any unfavorable change in the pricing regime would *undermine* the operational viability of the sector. Most of the industry players have started focusing on expansion projects tilted towards high margin products.
Fertilizer	***P**akistan urea offtake grew to **4.2mln tons during 9M13** (9M12: 3.7mln tons), *wherein* the contribution from local producers increased (9M13: 84%, 9M12: 73%). Government's policy of ensuring higher gas availability – *a vital raw material* – and less reliance on imported urea benefitted the local industry. In addition to lower imports (down 66% YoY), the government *increased* the price of imported urea, reducing the gap with domestic urea price.	The plan of *procuring* gas directly from the gas fields; ensuring sustainability of gas supplies in the long-run has been finalized with the previous government wherein GSAs have been signed with gas fields. *Reaffirmation* of incumbent government has been sought for KPD. KPD is the largest field in the long term solution and would involve sizeable *capex*. Depending on ECC reaffirmation, capex on KPD is expected to *commence* which would take upto six months to complete.

About PACRA

PACRA – Pakistan's pioneer credit rating agency – is continuing its journey in its second decade of operations. The company distinguishes itself through a culture of constant innovation, improvement and service quality. PACRA offers a complete range of credit rating services. It has a comprehensive organizational structure and set of resources to support its business. PACRA team of 30 analysts comprises a mix of highly qualified business professionals and accountants. To date, PACRA has assigned over three thousand opinions

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