The Pakistan Credit Rating Agency Limited

Issue IV, October 2014

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

INSIDE…….

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 ratings universe, the economic environment and *issues* and *views* on credit quality.

In this issue of **PACRA INSIGHT**, PACRA's ratings 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 ratings universe is shown in terms of numbers, composition and key developments.

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

LIST OF ILLUSTRATIONS

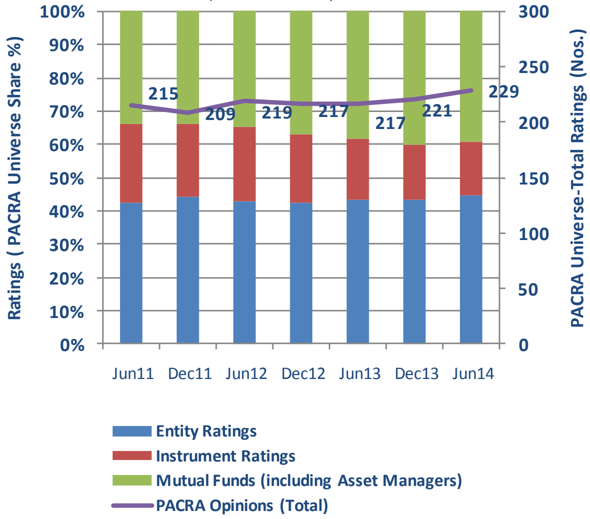
PACRA RATINGS UNIVERSE

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 **FY14**. It is dominated by entity ratings followed by *various* kinds of opinions for asset manager companies (AMCs) and instrument ratings.

FIGURE I

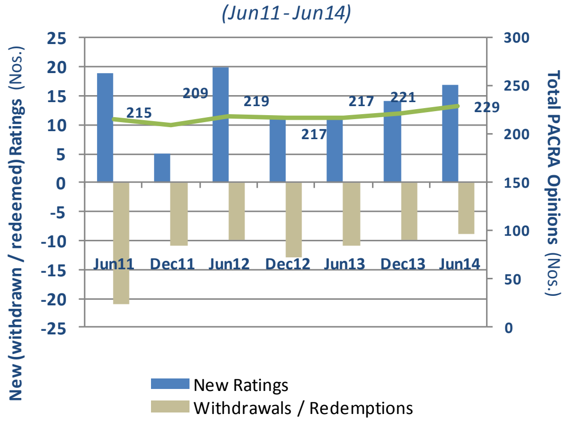
SNAPSHOT - *PACRA Ratings Composition (Jun11-Jun14)*



Fresh instrument issuance still remains sluggish and the number of instruments outstanding in the universe number only thirty-seven **(37)** at **end-year** as compared to fifty-one **(51)** at **end-FY11.** In **FY14**, a regulatory regime conducive to increasing ratings penetration is taking *shape* on the same premise it did in neighboring Bangladesh and India, where the *size* of the ratings industry experienced exponential growth following *supportive* regulations (**For details: See the Section:** *Pakistan's Ratings Universe*).

FIGURE II

SNAPSHOT - *PACRA Ratings Universe Growth (Jun11 - Jun14)*



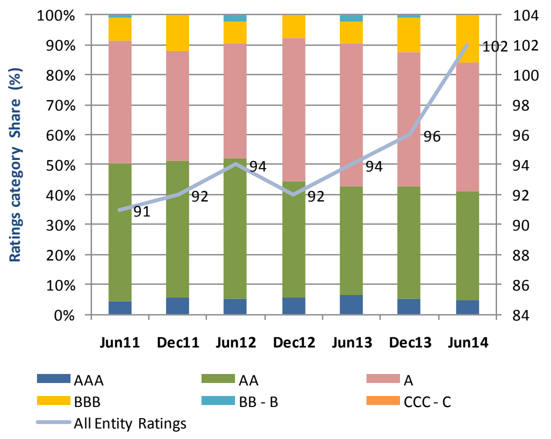
During **FY14**, PACRA ratings universe experienced **~6%** growth; twelve **(12)** additions. Universe-wide, thirty-one **(31)** initial ratings were assigned and nineteen **(19)** were withdrawn. Of the initial ratings, ten **(10)** came from entity ratings, eight **(8)** from instrument ratings and thirteen **(13)** from asset manager ratings. Withdrawn ratings comprised two **(2)** entities, eleven **(11)** instruments and six **(6)** mutual fund ratings.

One **(1)** entity rating **- SME Bank** switched from JCR-VIS to PACRA, while one **(1)** entity rating **- The Universal Insurance Company** - is maintaining a dual rating from both PACRA and JCR-VIS. Moreover, the two **(2)** withdrawn entities have so far chosen to stay unrated. Of the withdrawn instrument ratings, ten **(10)** 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.

PACRA ENTITY RATING UNIVERSE

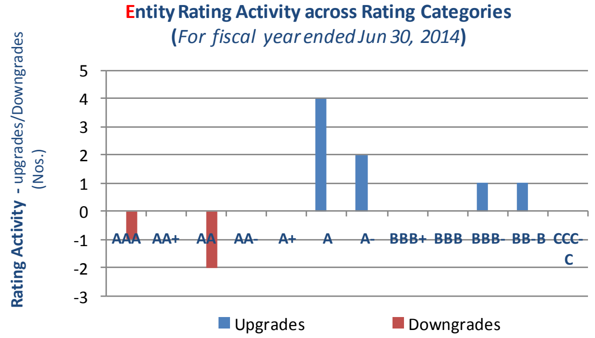
PACRA Entity rating Universe comprises **102** entity ratings as at June 30, *2014*. It is heavily tilted towards the investment grade categories (*BBB and above*). However, with the last few years' pressure increasing upon *credit quality*, the lower rungs of the rating scale have seen *inhabitance*. Sector-wise distribution shows heavy concentration in financial institutions (Commercial and microfinance banks and joint venture financial institutions **(25%)**; energy **(21%)**; insurance companies **(20%)** followed by non-banking financial institutions **11%**).

FIGURE III
PACRA Entity Ratings Composition & Growth
(Jun11 - Jun14)



During **FY14**, in terms of rating activity, **96%** of the universe was reviewed and actions taken thereupon. Of the ninety-eight (**98**) ratings *under surveillance*, there were nine (**9**) upgrades (*Descon Oxychem had its short-term rating upgraded from* **A2** *to* **A1**) and three (**3**) downgrades. Eighty-six (**86**) ratings were *maintained*. 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 fiscal year ended Jun 30, 2014*)



A review of the rating actions shows that the *size* of the rating activity, upgrades and downgrades, exhibits high *volatility*. A single multinotch downgrade (*IGI Investment Bank*) was matched by four **(4)** multinotch upgrades. Also, one **(1)** *rising star*[1] was born (*Maple Leaf Cement Factory*). No *fallen angels*[2] existed. Moreover, upgrades far *outpacing* downgrades (**9-to-3**) exhibit positive tone. Upgrades were concentrated **(3 out of 9)** in the insurance sector. PACRA entity ratings universe had ten **(10)** new entrants. Of these, seven (7) were corporates from diverse sectors: *(Energy **(2)** and Chemical, Cement, Textile, Technology and Engineering one **(1)** each)*. The remaining three **(3)** were financial institutions *(Insurance companies **(2)** and bank **(1)**)*. 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

Ratings Outlook Analysis		
	Positive	**Negative**
Opening @ Jan 01, 2014	**9**	**5**
Translated in Rating Change (-)	1	2
Translated in Outlook Change (-)	1	0
Maintained (+)	7	3
Ratings Not Reviewed (+)	0	0
Withdrawn (-)	0	0
During 2HFY14: New (+)	4	2
Opening @ Jul 01, 2014	**11**	**5**

Rating outlook 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. On **January 1, 2014**, there were nine **(9)** *positive* and five **(5)** *negative* rating outlooks. During the *next six months*, **11%** and **40%** of the positive and negative outlooks respectively *translated* in rating changes.

Also, four **(4)** *new* positive rating outlooks were assigned to ratings across *diverse* sectors (*banking, insurance and oil & gas*). Two **(2)** of the ratings (*one commercial and one investment bank*) were assigned a negative outlook.

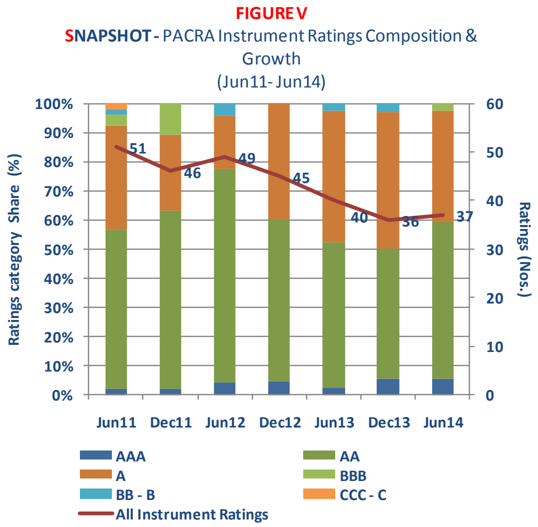
FY15 opened at eleven **(11)** positive outlooks and five **(5)** negative outlooks.

PACRA ENTITY RATING UNIVERSE (Entry / Exit) *(For Fiscal year ended June 30, 2014)*					
	Entities	***Initial[1] L/T Ratings***		***Withdrawn Entities***	***Last L/T Ratings***
Financial Institutions					
1.	The Universal Insurance Company	BBB+			
2.	Crescent Star Insurance	BBB+			
3.	SME Bank Limited	BBB			
Corporates					
4.	Engro Polymers & Chemicals	A	1.	Ahmed Fine Textile Mills	A-
5.	Bestway Cement	A+	2.	Hussain Mills	A-
6.	Foundation Wind Energy	A			
7	Kohinoor Textile Mills	A-			
8.	Autosoft Dynamics	A-			
9.	Mangla Metals	BBB			
10.	Kohsar Hydro Power	BBB			

[1] The rating assigned by PACRA for the first time. Ratings are also termed "Initial" when a previously: (i) Private Rating converts into a Public Rating; (ii) Preliminary Rating is finalized; (iii) Withdrawn rating comes back to PACRA with a fresh Mandate, and (iv) Defaulted rating emerges from default and assigned a rating

PACRA INSTRUMENT RATING UNIVERSE

PACRA Instrument Rating Universe comprises **37** instrument ratings as at *June 30, 2014*. It is mainly *concentrated* in the investment grade categories. Fresh debt issuances have remained *sluggish* and the universe has shrunk due to redemptions. This is attributed to subdued new investments due to a tough operating environment dampening the need to borrow by corporates.



During **FY14**, *in terms of rating activity*, **100%** of the universe was *reviewed* and actions taken thereupon. Of the thirty-seven **(37)** ratings reviewed, there were six (**6**) upgrades and nil (**0**) downgrades. Thirty-one (**31**) ratings were *maintained*.

PACRA INSTRUMENT RATING UNIVERSE (Entry / Exit) *(For Fiscal year ended June 30, 2014)*		
	[Initial / Preliminary ratings] ***Issuers / Instruments***	***Initial / Preliminary[3] Instrument Ratings***
1.	Engro Fertilizers | **Sukuk III | TBI[1]**	A+
2.	AlBaraka Bank (Pakistan) | **Sukuk | TBI**	A+
3.	Pakistan Mobile Communications Limited **Sukuk | TBI**	AA
4.	NIB Bank | **TFC II: PKR 4,198mln issued | Jun14**	A+
5.	Engro Corporation | **Sukuk: PKR 4,000mln TFC | issued Jul14**	AA
6.	Jahangir Siddiqui & Company | **TFC VIII: PKR750mln | issued Apr14**	AA+
7.	The Pakistan Water & Power Development Authority | **PPTFC[2]: PKR 9,327mln | issued Sept13**	AAA
8.	PAIR Investment Company | **Commercial Paper: PKR 500mln | issued May14**	AA
	[Withdrawn[3] ratings] ***Issuers / Instruments***	***Last Instrument Ratings***
1.	Engro Fertilizers | **Sukuk II: PKR 1,500mln | TBI**	A

[1] TBI: To be issued

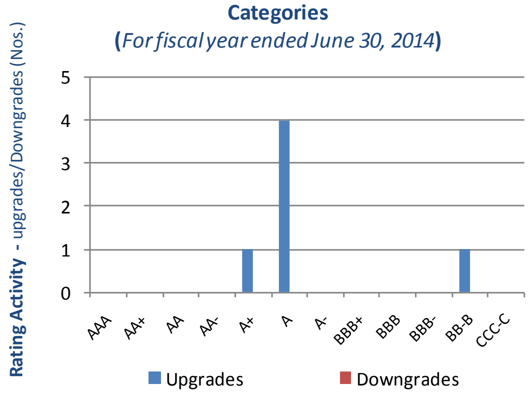
[2] Privately Placed TFC

[3] TBI Instruments are assigned a Preliminary Rating defined as the rating assigned to an instrument / mutual fund yet to be issued based upon its proposed terms and conditions

[4] FY14 had 10 Instrument Redemptions

A review of the rating actions shows that it is uni-directional (*nil downgrades*) and the *size* exhibits a moderate level of *volatility*. There were two **(2)** multinotch upgrades and five **(5)** out of the six **(6)** upgrades were concentrated in one issuer (*Engro*).

FIGURE VI
Instrument Rating Activity across Rating Categories
(*For fiscal year ended June 30, 2014*)



The growth in new instrument ratings, *however*, remained sluggish as only eight (**8**) new instrument ratings were added to the universe. These included five **(5)** Initial Ratings and three **(3)** Preliminary Ratings,. New debt issuance underlying these eight instruments amounted to **PKR 31.3bln of which PKR 18.8bln has already been issued.**

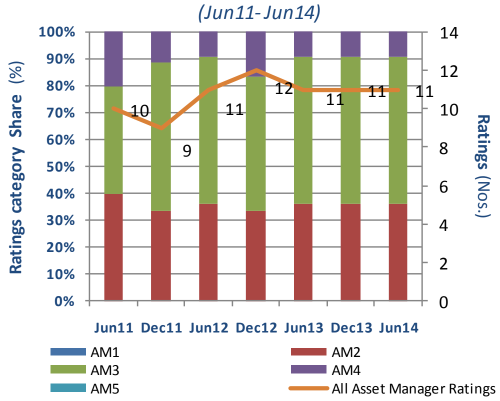
PACRA ASSET MANAGEMENT OPINIONS UNIVERSE

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 VII

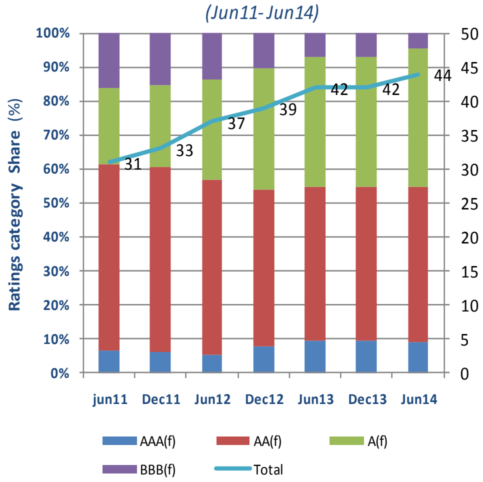
SNAPSHOT - *Asset Manager Ratings Composition & Growth (Jun11-Jun14)*



***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 **FY14**, PACRA asset manager rating universe experienced one **(1)** withdrawal and one **(1)** initial rating. The withdrawal (*IGI Funds*) was the result of the acquisition of IGI Funds by Alfalah GHP Investment Management, also rated by PACRA. The Initial Rating (*BMA Asset Management*) has previously been rated by JCR-VIS from **Dec06 to Jul11**.

FIGURE VIII

SNAPSHOT - *Fund Stability Ratings Composition & Growth (Jun11-Jun14)*

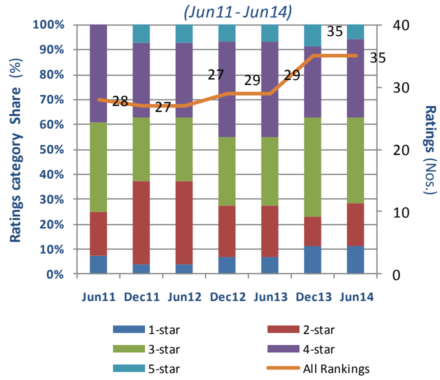


***F**und* Stability ratings have seen a surge in recent years. During the year, PACRA fund stability rating universe has seen an expansion by three **(3)** new opinions. This includes the initial rating of Primus Investment Management Limited (PIML) Income Fund – a Fund created by PIML by converting Primus Cash Fund (PCF), a money market fund, into an income fund, The rating of PCF has subsequently been withdrawn by PACRA.

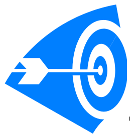
***M**utual* fund performance rankings are becoming increasingly popular amongst investors as the equity- market is maintaining its uptrend. In FY14, PACRA mutual fund performance ranking universe saw eight (8) new entrants. Five (5) of the eight new funds belonged to a single asset manager, JS Investments.

FIGURE IX

SNAPSHOT - *Mutual Fund Rankings Composition & Growth (Jun11-Jun14)*



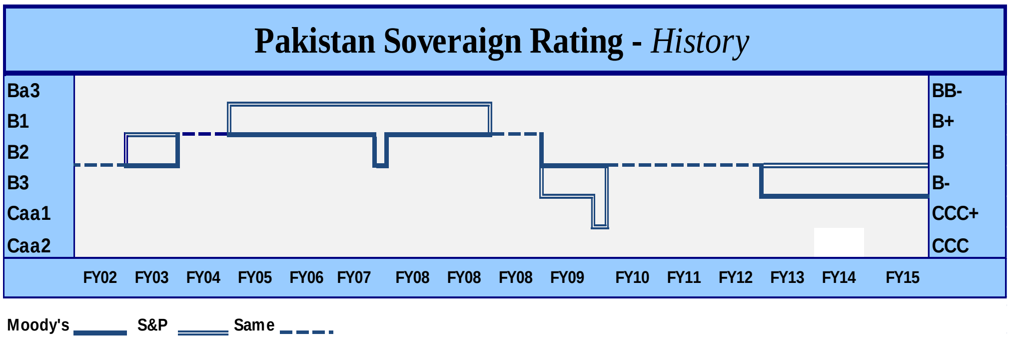
COMMENT ON CREDIT RISK



Two years after downgrading Pakistan to **Caa1**, Moody's Investors Service (Moody's) has revised the outlook on Pakistan's foreign currency government bond rating to **STABLE** from **NEGATIVE**. The rating drivers are as follows:

Pakistan Sovereign Credit Rating Action		
Moody's	**Current** *(14-Jul14)*	**Previous** *(13-Jul12)*
Rating (Maintain)	Caa1	Caa1
Rating Modifier *(Outlook Revision)*	Stable	Negative

Rating Driver: An improving external liquidity position: External liquidity position has improved based upon a number of factors: **(i)** the current-account deficit (considered modest) estimated at 1.0% of GDP for the fiscal year ended Jun14, **(ii)** Increased financial inflows due to a $2bln



Eurobond sale, privatization proceeds, and multilateral and bilateral funding, and **(iii)** Tapering off of repayments to the IMF from the previously suspended program, even as disbursements from the ongoing program continue, leading to rise in foreign reserves, to $9.0bin by the end of Jun14.

Red Flag for Ratings: Moody's Special Comment

05 Sept14: Pakistan's Political Turmoil Threatens Reform Progress, a Credit Negative

08 Sept14: Pakistan's Prolonged Political Standoff Delays Chinese Aid, a Credit Negative

Rating Driver: Progress on structural reforms: Pakistan is making steady progress in meeting reform benchmarks under the current, 36-month $6.8 billion Extended Fund Facility with the IMF, which it signed in September 2013.

RATIONALE FOR MAINTAINING THE RATING

The **Caa1** rating captures Pakistan's structurally large fiscal imbalances and weak debt metrics relative to **B**-rated peers. The sovereign's 'Very Low' institutional strength assessment reflects implementation risks associated with economic reforms. It also factors in high susceptibility to event risk.

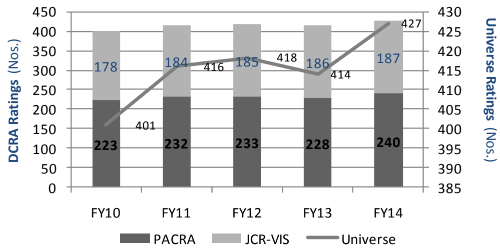
WHAT COULD *MOVE THE RATING UP/DOWN*

- *Upward triggers to th*e rating would stem from the successful completion of the IMF program, further improvements in the external liquidity position, continued fiscal consolidation, progress on structural reforms and political stability.
- Conversely, a stalling of the ongoing IMF program, deterioration in the external payments position or a worsening political environment would be viewed as credit negative.

PAKISTAN'S RATINGS UNIVERSE

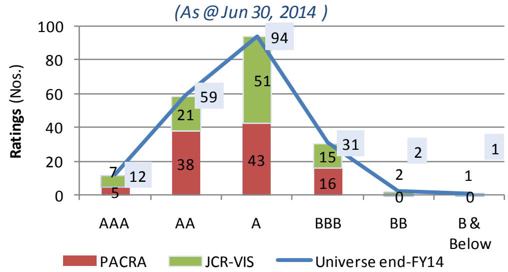
***P**akistan's Ratings Universe* is *shared* amongst two domestic credit rating agencies (DCRAs) – PACRA and JCR-VIS. Between *themselves*, they have ~200+ public entity ratings. On a YoY basis, the universe size has seen an addition of thirteen (13) new opinions.

FIGURE X
Pakistan Ratings Universe Growth
(FY10- FY14)



***T**he ratings universe* is *concentrated* mostly in investment-grade categories (**Mean Universe Entity Rating Category:** Single A **'A'** *as shown in* **FIGURE XI**) 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 debt financing - mainly *through* debt instruments.

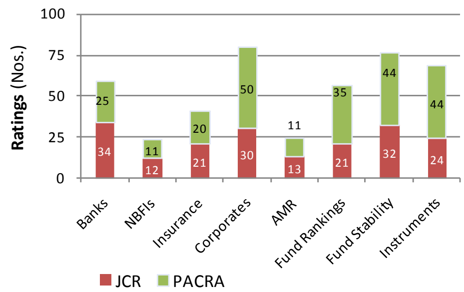
FIGURE XI
Pakistan Entity Ratings Universe Compostion in Rating Categories
(As @ Jun 30, 2014)



***H**owever*, Pakistan Ratings Universe's penetration may get a boost from a *landmark* development in which the State Bank of Pakistan has instructed banks and development finance institutions to *weigh* large unrated corporate exposures (*PKR 3bln or above*) with a higher (*previously 100%*) risk weight (125%). The significance of being rated is highlighted in the SBP communication: **"It is advised that large private sector borrowers should be encouraged to get themselves rated since default of such entities may pose systemic risk. The independent opinion on the credit quality would provide better insight into the financial health of such borrowers, support bank's internal credit risk assessment, may result in critical savings and lead to rationalized cost of borrowing for these entities."**[3]

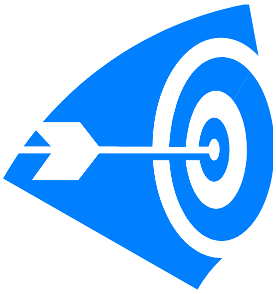
***P**akistan rating universe* has a wide range of products for various classes of ratings such as banks, non-bank financial institutions, insurance, corporate, asset managers, mutual funds, instruments, etc.

FIGURE XII
Pakistan Ratings Universe Compostion in Rating Classes
(As @ June 30, 2014)



[3] **State Bank of Pakistan BPRD Circular Letter No. 25 of 2014 titled "***Risk weight for unrated Large corporate – Implementation of Basel Capital Framework***".**

THE INDUSTRY VIEW



THE INDUSTRY VIEW		
	Industry *Performance*	*Medium-term* **Outlook**
Life Insurance	The life insurance sector in Pakistan continued to witness stupendous growth (25%) in premium in CY13 and settled at PKR 113bln. The profitability of the sector remained robust, which was further augmented by one off capital gain (Unilever shares) realized by SLIC; the sector's income over claims and expenditure took unprecedented hike (46%) in CY13.	There is growing awareness among masses supported by diversified distribution channel – bancassurance led by private sector. This is changing the competitive landscape of the industry; private sector outpacing industry's growth and, hence, increasing its market share (CY13: 41%, CY09: 34%).
AMCs	The industry AUMs continued the growth momentum with an increase of 11% during FY14. The growth was supported by the strong performance of the capital market enabling the equity funds to maintain its system share despite net redemption during the period. Risk averse investor sentiment prevailed as the Government Bond Funds due to its attractive returns in comparison to money market funds alongwith capital preservation schemes were able to mobilize fresh AUMs.	With the reduction in the tax arbitrage opportunity, the AMCs would enhance its focus towards real investors. Capital preservation schemes alongwith the Government Bond Funds would continue to remain the attractive products highlighting the investors' risk averse appetite. In addition to that advisory portfolios would also remain a key area of focus for industry participants. Moreover, if the industry succeeds in bringing sophistication in relation to the banking related products it would bode well for the retail volume accretion.
Energy	In the absence of any long term solution, inter-corporate debt has accumulated again in recent times. Though the government has taken structural reforms by prioritizing fuel efficient power plants, policy decision to convert less efficient plants to coal, and raising the power tariff. However, the underlying issue regarding the inter-corporate debt 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. Meanwhile, the government may continue providing temporary respite to the industry players.
Textiles	Pakistan's textile sector continued to dominate the country's total exports by maintaining its share at 52% during FY14. The textile exports registered YoY increase of 5% with highest contribution by weaving segment. Due to China – a major	Key risks to local textile sector include: (i) Continuing energy crisis, (ii) Ability to tap potential demand originating from GSP Plus status in terms of related investment in infrastructure and establishing relationship with buyers, and (iii)

	avenue for Pakistan's spinning exports – led change in spinning dynamics, the export quantities of yarn witnessed decline (~10%), thereby reducing its contribution (FY14: 14%, FY13: 17%) in overall exports value. Nevertheless, with industry's focus on value-addition, the demand for final textile products has emerged strongly. Resultantly, the profitability of the sector remained healthy.	Absorption of decline in spinning demand from China by local industry. On the global front, the cotton prices are expected to achieve new equilibrium. However, given reduced delta between global cotton production and consumption along with China's policy to hold stocks at current level, the likelihood of further price drop would be low.
Refining	During most of FY14, domestic refinery sector performance remained subdued owing to constrained global GRMs on account of fluctuations in the international crude prices. The high volatility during the 1HFY14 exerted significant pressure on the local refineries. However, with the non-OPEC producers easing the supply during 2HFY14, the crude prices stabilized and provided some relief to domestic refineries' performance. Although, the steep currency depreciation during 1HFY14 exhibited huge exchange losses, the impact was largely nullified for the domestic refinery sector on an annual basis with the sizeable appreciation during later half of the year.	The continuous decline in the international crude prices owing to (i) downgrade in global oil consumption forecast, (ii) reluctance by OPEC members to cut output in expectation of another big boost in the shale oil, would bode well for the domestic refinery sectors performance. Largely stable domestic currency would also support the sectors performance. In addition to that the refining sector would continue to benefit from the favorable duty structure which contributes significantly to the overall profitability. Any unfavorable change in the pricing regime would undermine the operational viability of the sector.
Fertilizer	Pakistan's fertilizer offtake declined by 2% to 3.5mln during 1H14 due to lower demand; relatively unfavorable weather conditions for Kharif crops caused delayed sowing. Major decline witnessed in urea (5%) and DAP (4%), whereas CAN and NP increased by 7% and 29%, respectively. The urea market share of local producers continued to increase (1H14: 86%, 1H13: 81%) as higher gas availability to a leading plant was ensured and price differential was eradicated.	Sustainability of gas supply is yet to be seen as the reaffirmation of long-term supply agreement with plants on SNGPL network is still pending. The Government's decision of imposition of GIDC on feedstock of new plants has been challenged in Sindh High Court, and stay order has been obtained. Meanwhile, the Supreme Court has ordered cancellation of GIDC Act. The implementation of GIDC – the impact of which on the sector is noticeable – hence remains uncertain.

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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