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…….

PACRA'S RATINGS UNIVERSE

- Stagnancy in *size* as ratings' penetration remains *low* and fresh issuances *scarce*…… **2**

PAKISTAN'S RATINGS UNIVERSE

- Potential *untapped*…. **8**

THE INDUSTRY VIEW

- Investors remain *risk averse*…amongst operating environment *challenges* of security and energy shortages **9**

Issue II, August 2013

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 – banking, general insurance, Pakistan joint venture financial institutions, microfinance, power, refining, textiles, and asset management companies.

LIST OF ILLUSTRATIONS

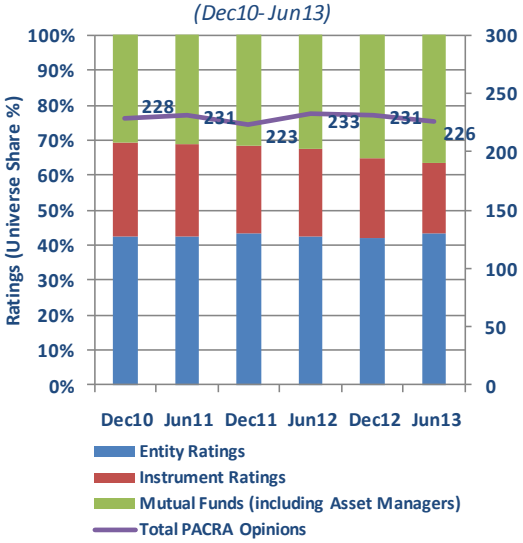
Figure I	SNAPSHOT: PACRA Ratings Composition
Figure II	SNAPSHOT: PACRA Ratings Universe Growth
Figure III	PACRA Entity Ratings Composition & Growth
Figure IV	Entity Rating Activity across Rating Categories
Figure V	PACRA Instrument Rating Universe Composition & Growth
Figure VI	Instrument Rating Activity across Rating Categories
Figure VII	Fall in Credit Quality (*PACRA Defaulted Entity Ratings*)
Figure VIII	PACRA Asset Manager Ratings Composition & Growth
Figure IX	PACRA Fund Stability Ratings Composition & Growth
Figure X	PACRA Mutual Fund Rankings Composition & Growth
Figure XI	Pakistan Entity Ratings Universe Growth
Figure XII	Pakistan Entity Ratings Universe Composition in Rating Categories

PACRA'S RATINGS UNIVERSE

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

The universe composition has remained largely the same in FY13. It is dominated by entity and instrument ratings followed by *various* kinds of opinions for asset manager companies (AMCs).

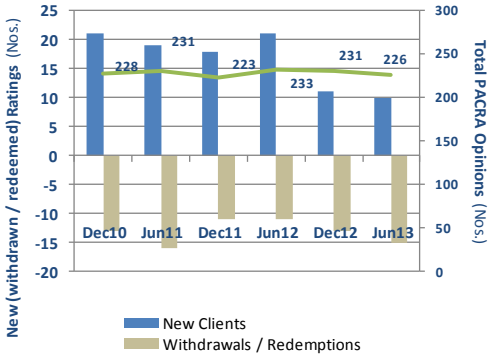
FIGURE I
SNAPSHOT - *PACRA Ratings Composition (Dec10- Jun13)*



Over the years, PACRA ratings universe has *increased* in size gradually; though the pace of growth has remained inconsistent due to *low ratings penetration* in Pakistan and the *2008-onwards* dearth seen in the instruments market *post-default* of certain corporate instruments. With the slowdown in the economy, the sluggish trend in ratings universe growth is clearly evident during the last few years. From FY08 onwards, *withdrawals* picked up and have stayed higher. Nevertheless, the universe's overall size is supported somewhat through new ratings.

During **FY13**, the growth in PACRA ratings universe took a *hit* as no support emanated from *new entity ratings* and not *many* instrument rating mandates materialized to provide any *material* support. Seven **(7)** initial entity ratings were *assigned*; however, this was *matched* by seven **(7)** entity ratings being *withdrawn* as well. Universe-wide, twenty-three **(23)** initial ratings were assigned, whereas, twenty-eight **(28)** rating opinions were withdrawn. Of these, thirteen **(13)** rating opinions were instrument redemptions and one **(1)** rating opinion stands suspended[1]. Moreover, four **(4)** of the withdrawn entities exited Pakistan's ratings universe and two **(2)** entities switched to JCR-VIS. Two **(2)** previously defaulted entities (along with their three **(3)** instruments) are subsequently withdrawn in **FY13**. Three **(3)** mutual fund rankings were also withdrawn. Withdrawals were spread *across the universe with an almost equal split between* financial institutions and corporates.

FIGURE II
SNAPSHOT - *PACRA Ratings Universe Growth (Dec10 - Jun13)*

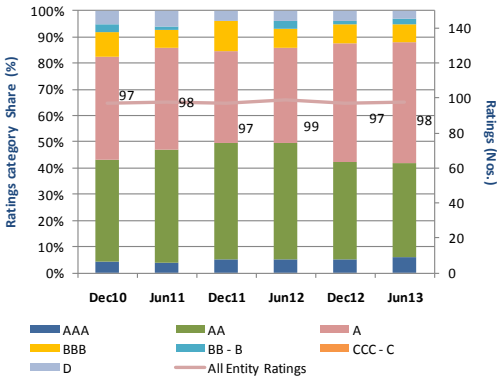


[1] Rating suspension usually takes place in circumstances where a client fails to provide PACRA sufficient information to form and update an opinion. As a result, the ratings are suspended with the notice that these are not being updated as a result of insufficient information. Upon the receipt of requisite information, the opinion is re-instated after being reviewed.

PACRA ENTITY RATING UNIVERSE

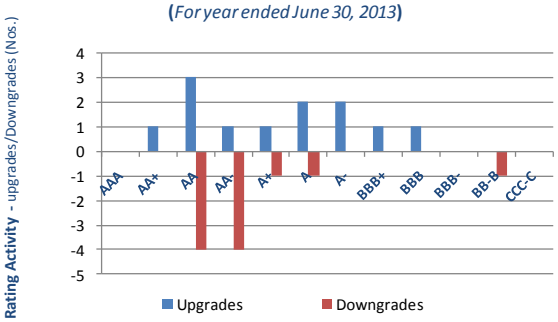
PACRA Entity rating Universe comprises **98** entity ratings as at *June 30, 2013*. It is heavily tilted towards the investment grade categories (*BBB and above*). However, with the last few years' pressure increasing upon *credit quality*, the lower rungs of the rating scale have seen *inhabitance*. Sector-wise distribution shows heavy concentration in financial institutions (Banks **22%**; insurance companies **18%**; non-banking financial institutions **13%**) followed by energy (**12%**) and oil and gas (**7%**).

FIGURE III
PACRA Entity Ratings Composition & Growth
(Dec10 - Jun13)



During FY13, in terms of rating activity, **87%** of the universe was reviewed and actions taken thereupon. Of the eighty nine (**89**) ratings *under surveillance*, there were twelve (**12**) upgrades and thirteen (**13**) downgrades (*including two downgrades into default category*), whereas, sixty-four (**64**) ratings were *affirmed*. Upgrades were spread across rating categories, whereas the **AA** category housed the majority of downgrades.

FIGURE IV
Entity Rating Activity across Rating Categories
(*For year ended June 30, 2013*)



A review of the rating actions, however, shows that the *size* of the rating activity, upgrades and downgrades, exhibits low *volatility*. Multinotch downgrades (*concentrated in energy sector entities*) are present in FY13, though, much *subdued* as compared to previous years. However, no *rising stars*[2] and *fallen angels*[3] exist. PACRA entity ratings universe had Seven **(7)** new entrants. The sector-mix was led by insurance (3) followed by one rating each from microfinance banks, oil & gas, energy and cement (*Maple Leaf Cement Factory Limited is treated as an initial rating in PACRA's universe after emergence from default*).

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

Rating 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. **FY13** began with ten **(10)** *positive* and eleven **(11)** *negative* rating outlooks. During **FY13**, **50%** and **18%** of the positive and negative outlooks respectively *translated* in indicated rating changes.

Ratings Outlook Analysis		
	Positive	**Negative**
Opening @ July 1, 2012	**10**	**11**
Translated in Rating Change (-)	5	2
Translated in Outlook Change (-)	1	6
Maintained (+)	2	3
Ratings Not Reviewed (+)	1	0
Withdrawn (-)	1	0
During FY13: New (+)	6	3
Opening @ July 1, 2013	**9**	**6**

Also, six **(6)** *new* positive rating outlooks were assigned to ratings across *diverse* sectors (*banking, insurance, microfinance, fertilizer and textiles*). Three **(3)** of the ratings were assigned a negative outlook.

FY14 opened at nine **(9)** positive outlooks and six **(6)** negative outlooks.

PACRA ENTITY RATING UNIVERSE (Entry / Exit)
(For year ended June 30, 2013)

	Entities	***Initial L/T Ratings***		***Withdrawn Entities***	***Last L/T Ratings***
Financial Institutions					
1.	Waseela Microfinance Bank	BBB+	1.	Arif Habib Investments	A+
2.	Saudi Pak Insurance Company	A-	2.	Pak Brunei Investment Company	AA
3.	Silver Star Insurance Company	A-	3.	KASB Securities	A-
4.	The Pakistan General Insurance Company	A-	4.	Trust Investment Bank	D
Corporates					
5.	Maple Leaf Cement Factory	BB	5.	FFC. Energy	A
6.	Pakistan Refinery	A-	6.	Halmore Power Generation Company	A
7.	Islamabad Electric Supply Company	A+	7.	Pace Pakistan	D

PACRA INSTRUMENT RATING UNIVERSE

PACRA Instrument Rating Universe comprises **45** instrument ratings as at *June 30, 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.

During FY13, *in terms of rating activity*, **74%** of the universe was *reviewed* and actions taken thereupon. Of the thirty-one (**31**) ratings reviewed, there were nil (**0**) upgrades and eleven (**11**) downgrade (*including two **(2)** downgrades into default category*), whereas, twenty **(20)** ratings were affirmed. The **AA** category witnessed the *majority* of downgrades, mainly on account of a *single* issuer, Engro Corporation and its *related* entities.

FIGURE V
SNAPSHOT - PACRA Instrument Rating Universe Composition & Growth
(Dec10- Jun13)

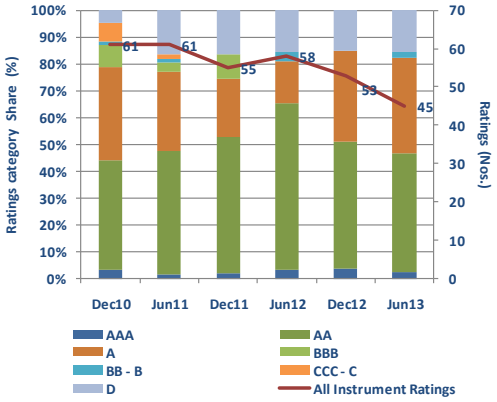
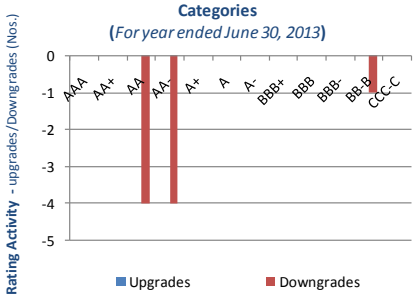


FIGURE VI
Instrument Rating Activity across Rating Categories
(*For year ended June 30, 2013*)



The growth in new instrument ratings, *however*, remained sluggish as only five (**5**) initial instrument ratings were added to the universe. New debt issuance underlying these five instruments amounted to **PKR 18bln** (*including the restructured sukuk of Maple Leaf Cement Factory Limited*).

PACRA INSTRUMENT RATING UNIVERSE (Entry / Exit) *(For year ended June 30, 2013)*		
	[Initial ratings] *Issuers / Instruments*	***Initial Instrument Ratings***
1.	Bank Alfalah | **TFC V: PKR 5bln TFC issued Feb13**	AA-
2.	Pakistan Refinery Limited | **TFC I: PKR 3,000mln (including a green shoe option of 500mln) TFC TBI[1]**	A
3.	Pakistan Refinery Limited | **TFC II: PKR 1,000mln TFC TBI**	A
4.	Maple Leaf Cement Factory Limited | **Restructured Sukuk: PKR 8bln Sukuk restructured Mar10**	BB+
5.	Jahangir Siddiqui & Company | **TFC VII: PKR 1Bln; issued Oct12**	AA+
	[Withdrawn[2] ratings] *Issuers / Instruments*	***Last Instrument Ratings***
1.	Trust Investment Bank | **TFC III: PKR 600mln issued Jul08**	D
2.	Pace (Pakistan) | **Sukuk: PKR 400mln issued Oct09**	D
3.	Pace (Pakistan) | **TFC I: PKR 1.5Bln issued Feb08**	**D**

[1]TBI: To be issued
[2]FY13 had 13 Instrument Redemptions

PACRA ASSET MANAGEMENT OPINIONS UNIVERSE

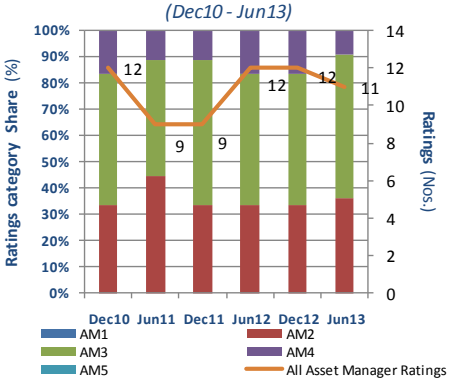
PACRA Asset Management Opinions' Universe *comprises* four kinds of opinion:

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

PACRA 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*.

FIGURE VIII

SNAPSHOT - *Asset Manager Ratings Composition & Growth (Dec10 - Jun13)*



With a *risk-averse* environment prevailing in the country, the asset management industry remained focused on the *launch* of money market and government bond funds – considered *safe havens* by the investors. Both these fund categories, being *eligible* for fund stability ratings, resulted in a *sizeable* increase in PACRA's universe for this product.

FIGURE IX

SNAPSHOT - *Fund Stability Ratings Composition & Growth (Dec10-Jun13)*

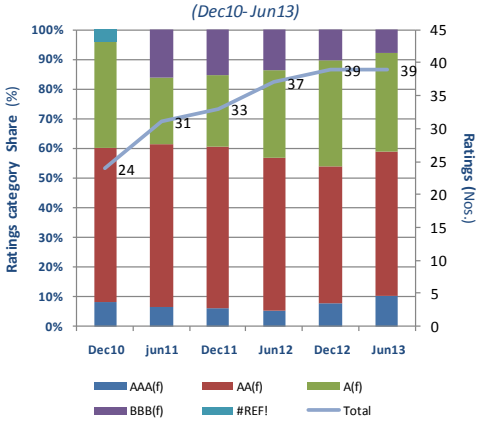
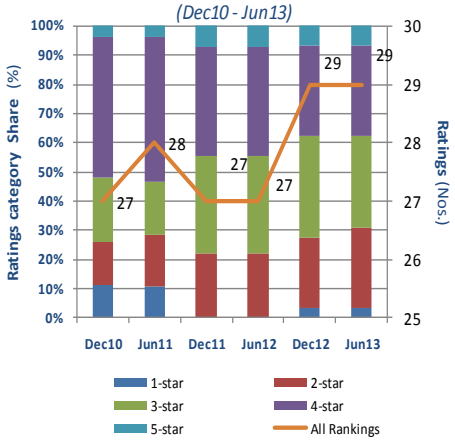


FIGURE X

SNAPSHOT - *Mutual Fund Rankings Composition & Growth (Dec10 - Jun13)*



Owing to *strong* performance of the equity market in recent period and the industry's efforts to *diversify* its product slate, investors have shown some interest towards equity-related funds. Few AMCs completed their product slate by adding equity funds; hence, the *growth* seen in the mutual fund ranking universe of PACRA.

FALL IN CREDIT QUALITY

During **FY13**, PACRA's credit quality has *leveled off* in terms of defaults. The operating environment *remains* tough for borrowers as lenders are *reeling* from the shock of bad corporate debts of recent years, preferring the *safe haven* provided by government securities' investments. Borrowers, themselves, are risk averse and shy of opening new avenues. Two entities (*a financial institution and a corporate*) defaulted on their obligations and their entity and *affected* instrument ratings were taken into **D** category.

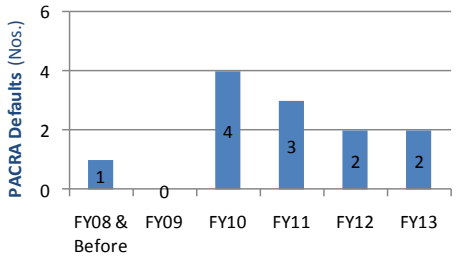
Fall in Credit Quality
(For year ended June 30, 2013)

Entities	Ratings			
	New	Previous (Action date)		Notches
Trust Investment Bank	D	C	**(02Oct12)**	1
WorldCall Telecom	D	BB+	**(11Jul12)**	9

Trust Investment Bank (TIBL) - October 02, 2012: The entity and the *delinquent* instrument ratings were put in default category as the bank failed to pay its TFC III installment [PKR 91mln] which, with an extended grace period of 90 days, was due on October 2, 2012. Although the management was *hopeful* of generating liquidity via various options but could not achieve material progress. TIBL's ratings of (Single C) **"C"** had been carrying *a negative outlook* since Jan12. TIBL has subsequently been withdrawn in Nov12. At that time, the bank was in the process of *restructuring* of its financial obligations.

Trust Investment Bank	Ratings		
	New	Previous	Notches
Listed & Secured TFC III • **Issue:** PKR 600mln • **Outstanding:** PKR 225mln	**D**	**C**	**One (1)**

FIGURE VII
FALL IN CREDIT QUALITY
PACRA Defaulted Entity Ratings



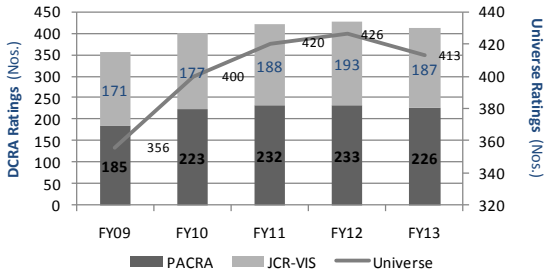
WorldCall Telecom (WTL) - July 11, 2012: The ratings were put in the default category on account of missed payment. The company failed to perform on its TFC obligations and missed its TFC III installment [PKR 693mln (Principal: PKR 545mln; Interest: PKR 148mln)] which, with an *extended grace period* of 75 days, fell due on June 21, 2012. During this timeframe, the company was hopeful of receiving the second tranche of funds (US$35mln) from its parent – Omantel. Lately, though respective arrangements with Omantel and commercial banks had achieved material progress, WTL was unable to receive *regulatory approvals* for completion of the transaction. Furthermore, investors of TFC III have also not extended further deferment for redemption of the due installment. WTL's ratings had been under **Rating Watch** since Jun10 and had a **Negative Outlook** since Oct11.

WorldCall Telecom	Ratings		
	New	Previous	Notches
Listed & Secured TFC III **Issue:** PKR 4,000mln **Outstanding:** PKR 2,178mln	**D**	**BB+**	**Nine (9)**

PAKISTAN'S RATINGS UNIVERSE

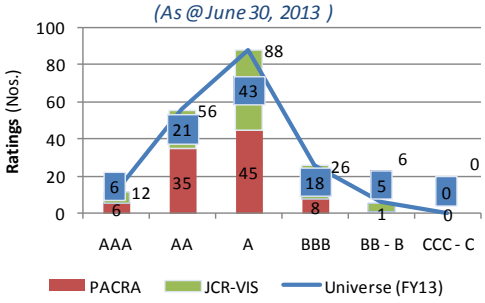
Pakistan's Ratings Universe is *shared* amongst two domestic credit rating agencies (DCRAs) – PACRA and JCR-VIS. Between *themselves*, they have ~200+ public entity ratings. On a YoY basis, the universe size has stayed almost the same with some shuffling between categories.

FIGURE XI
Pakistan Ratings Universe Growth
(FY09 - FY13)



The ratings universe is *concentrated* mostly in investment-grade categories 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 XII
Pakistan Entity Ratings Universe Compostion in Rating Categories
(As @ June 30, 2013)



From 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 FY13, the default trend has *leveled off* but credit quality still remains *subservient to prevailing issues* in the operation environment – security risks and power crisis.

THE INDUSTRY VIEW

THE INDUSTRY VIEW		
	Industry *Performance*	*Medium-term* **Outlook**
Banking	The *landscape* of the banking industry has significantly changed in comparison to last year. The primary reason has been the sizeable *cut* in the policy rate by the State Bank of Pakistan. Induced by the cut, the industry witnessed growth, *albeit slight*, in the finances towards the end of 2012. However, having an ADR of ~52% at the industry level, there is significant room for finances *growth*.	The growth in finances depends upon the *financial discipline* of the incumbent government and fresh demand from the business houses. The sentiments are *sanguine* yet the solution lies in the sustainable resolution of *structural* issues faced by the country including energy and security concerns.
General Insurance	Since CY11 the *growth* in gross premium written is picking up, yet, at slower pace. The motor segment *declined* with shrinking leasing portfolio of banks. On the other hand, the fire segment witnessed *expansion*, and health emerged another area of growth to the portfolio. Moreover, the sector shifted to a more risk adverse investment strategy, post stock market bump, diverting funds into risk free securities. This helped to attain *relatively stable investment income* to support the bottom line.	Increasing risk of catastrophic disturbance due to recent geographical changes in Pakistan is critical. Thus, reinsurers' *strong backing* and *favorable treaty* would remain vital. Also, reasonable premium pricing, which is on *declining trend*, plays its role. The business growth is expected to follow *random walk* amidst slow demand and high competition. Hence, the core underwriting profitability remains uncertain.
Pakistan Joint Venture Financial Institutions (JVFIs)	The advances portfolio of JVFIs has remained *stagnant*. Increase in assets came from rising investment portfolio alongwith JVFIs' ability to *enhance* the net interest income fueled by the players' enhanced – indeed active – participation in the money market to *exploit* arbitrage spreads. This was further supported by increased capital market income. However, operating cost as percentage of total revenue remained significantly *high* and escalated provisioning due to deteriorated asset quality and diminution in the value of investments has placed a *drag* on the profitability.	With *limited* asset growth as compared to the banking sector, JVFIs continue to be less than 1% of the total banking asset base. The sector faces *governance* and *inadequate regulatory framework* issues. Moreover, few viable funding sources have resulted in higher cost. Limited *outreach* is another constraint. However, equity based structure provides large room for leveraging; in turn, funding strength. Significant potential for industrial/infrastructure projects in the country provides *opportunity*.
Microfinance	The *regulatory role* for Microfinance banks (MFBs) has been supportive till date. The biggest development of CY12 is launch of Microfinance-exclusive Credit Information Bureau (MF-CIB). This is expected to enable the industry players to *evaluate* and *monitor* their risk exposure in better ways. The industry has yet to achieve *cost efficiencies* and required profitability to *augment* its risk absorption capacity. Funding constrains remain particularly for those which are heavily reliant on *donors'* funds.	Microfinance sector is *young* and *growing*. With a high level of untapped potential, there is a lot of room for growth. New players in the microfinance banking segment is a sign of good investment opportunities in the industry. Meanwhile, *branchless banking* is expected to play a more prominent role in expansion and profiling of MFBs. The industry needs to build a *sustainable retail deposit base* to pursue growth and sustainability.

Power	The key participants of power sector include generation, transmission, and distribution (T&D) companies. The sector remains in the grips of the circular debt issue. Moreover, inefficiency in power generation system is one of the reasons of higher subsidy. Transmission & distribution losses and recovery of bills remain the key issues. A significant portion of money is lost mainly due to theft of electricity. Though mentionable initiatives have been taken, no tangible results are apparent as yet.	Generation companies including IPPs face low business risk as sale of all the electricity generated is guaranteed by the off-taker. Pileup of receivables, working capital management, and debt repayment behavior would remain important indicators of financial risk of generation segment. Cash flow impact of T&D losses would be an indicator of financial risk of T&D companies in the sector.
Refining	Owing to *lower* capacity utilizations due to circular debt issue, Pakistan's import of refined products has been high in recent years. Also, with the *declining* trend in the international refining margins and fluctuations in the petroleum product prices, the domestic refining margins stay under *pressure*.	At present, a *favorable duty structure* contributes significantly towards the overall profitability of the refining sector. Any unfavorable change in the pricing regime would *undermine* the *operational viability* of the sector. However, if the circular debt issue resolves, the demand-surplus nature of the sector provides room for the domestic refinery sector to *enhance* its refining capacities.
Textiles	Over the years, there has been no *consistent pattern* in the sector's performance. Historically, the *cyclicality* in performance − *as measured by profitability and exports* − has been *primarily* a function of the price of cotton, which in turn depends on the quantum of local cotton production. During FY13, overall export quantities witnessed an increase. Weaving segment, on account of sustained quantities and better YoY rate, continued to be the major contributor in terms of both value and quantity in the overall exports of Pakistan.	Although the sector has *gradually* ventured into the production of fairly high quality textile products, it still represents a *significant* size in low value-added segments. The gradual increase in the share of China, India and Bangladesh in the world textile and clothing exports represents severe competition from the regional markets. Even though Pakistan enjoys availability of good quality raw material, yet acute energy crisis, high inflation, precarious security situation, fiscal and economic imbalances continue to pose a challenge.
AMCs	The industry AUMs, having experienced a *massive decline* owing to the dampened investor confidence (end-CY08), regained momentum in recent years. This is led by *conducive* interest rate environment creating room for heavy inflows into relatively risk averse avenues; money market and government bond funds. Despite the continuity of the growth momentum, a *sizeable volatility* was observed in the industry AUMs during 2012 and is still persisting mainly benefiting from the tax arbitrage opportunity without increasing the risk profile of the investments.	Government bond funds would *continue* to remain the main focus for the investors. However with the strong performance of domestic capital market, the equity and equity-related funds are also gaining investors' interest. The launch of *commodity funds* has lately increased the *diversity* of product slate. On the side, industry participants realizing the *importance* of retail investor base have started focusing on improving the *level* of services.

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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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