



Methodology Corporate Rating

Table of Contents

Introduction	2
Profile	3
Ownership	3
Governance	4
Management	5
Business Risk	7
Financial Risk	11

Summary

This methodology provides an umbrella framework guiding PACRA's ratings for corporate entities. PACRA's analysis is based on a mix of qualitative and quantitative factors, namely: Profile, Ownership, Governance, Management, Business Risk and Financial Risk. While standalone credit quality is addressed, PACRA incorporates the relative positioning of an entity to arrive at the final rating. In certain cases, the final rating may be constrained by the nature of the industry in which an entity operates.

The corporate universe consists of a broad range of entities of different sizes operating in various industries and other distinguishing characteristics. PACRA has evolved separate methodologies to cater to the distinct features of some them. Respective sector methodologies take precedence while this methodology supports when rating such entities.

Analyst Contacts

Zoya Aqib
+92-42-3586 9504
zoya.aqib@pacra.com

The Pakistan Credit Rating Agency Limited

Head Office

FB1 Awami Complex
Usman Block, New Garden Town
Lahore
Phone +92 42 3586 9504

Karachi Office

PNSC Building, 3rd Floor
M.T. Khan Road, Lalazar, Karachi
Phone +92 21 35632601

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

0. Introduction

- Qualitative and quantitative factors
- All factors assessed on standalone *and* relative basis

A sound financial ecosystem is critical for functioning of any economy. It is defined by interaction of providers of funds (savers), users of funds (borrowers), financial institutions (intermediaries), and regulators (oversight). This system ensures smooth flow of funds between savers and borrowers; wherein, financial institutions provide platform for their interaction. Regulatory oversight safeguards the sanctity of this system. Like all systems, financial system has its own set of challenges. The most prominent being “Risk”; the risk that some participant may not be able to meet its commitments. All participants do their best to manage this risk to maximize their return. This is not possible unless we have independent information on the risk. Here comes expertise of rating agencies, providing independent opinion on credit risk. Flow of funds is only possible when the provider of funds has confidence that user of funds will be able to return these in a timely manner and as committed. Ratings help build this confidence. A higher rating means higher likelihood of timely repayment compared to a low rating. Our ratings are forward-looking and reflect our expectations for future financial and operating performance. However, historical results are helpful in understanding patterns and trends of a company’s performance as well as for peer comparisons.

0.1 Scope: This methodology applies to corporate entities. These are regulated primarily by Securities and Exchange Commission of Pakistan. The regulator has designed a comprehensive set of laws and regulations for corporate entities. This methodology document covers all corporate entities. However, in certain cases, taking lead from distinct features of underlying businesses, PACRA has evolved separate methodologies. In such cases, those methodologies take precedent while this corporate methodology provides support.

0.2 Rating Framework: PACRA’s framework for assessing credit quality makes use of both qualitative and quantitative analyses. Overall factors are categorized under six key areas: Profile, Ownership, Governance, Management, Business Risk and Financial Risk.

0.2.1 The quantitative factors help in achieving objectivity in the rating process while the qualitative side helps in establishing the sustainability of the relevant factors in the foreseeable future. Neither all factors can be quantified nor do quantitative values portray the whole story. PACRA, therefore, seeks to employ an optimal combination of both and would stick to it to ensure comparability between ratings over time. Meanwhile, PACRA achieves a clearer perspective on relative position of an entity in its peer group. In addition, a sensitivity analysis is performed through several “what if” scenarios to assess its capacity to cope with changes in its operating environment. Analysis typically involves at least three years of operating history and financial data as well as entity and rating agency forecasts of future performance. Short-term and long-term ratings are based on an entity’s fundamental credit characteristics, a correlation exists between them (see PACRA’s Criteria document “Correlation between Short-term and Long-term Rating Scale”).

0.2.2 Ratings are an assessment of the entity’s capacity and willingness to service financial obligations in a timely manner and are intended to be comparable across industry groups. This methodology helps in identifying key rating drivers that may create vulnerability in capacity and willingness to service financial obligations in a timely manner. Key rating drivers are pivotal for assessing the financial flexibility of the entity, which depends, in large part, on the entity’s ability to generate cash from operations.

1. Profile

- **Background:** Evolution and past strategy
- **Operations:** Key facts including nature of business, product slate, geographical location etc.

1.1 Background: PACRA reviews the background of the entity to understand its evolution from where it started to where it currently stands. We analyze how and through what means the entity has achieved the desired expansion. PACRA looks at the progress of the entity from its historical past. This helps PACRA in determining the ability of the entity to successfully realize its strategy. The significant factor here for PACRA is to assess whether the entity has achieved the desired expansion through organic growth or acquisitions. Meanwhile, the source of funding for growth is also critical.

1.2 Operations: The operational profile of the entity is important because it greatly influences the sustainability of its operations. This helps in understanding the entity’s ability to manage its supply chain and access to critical resources – customer, supplier, and human resources. Analysis of manufacturing facility’s useful life, production capacity and efficiency are critical factors that provide competitive advantage. Meanwhile, operational location provides meaningful insight. The assessment of operations depends on the type of the industry and lifecycle stage the business is in. Here, PACRA also reviews the diversity of product slate, geographic spread of operations, scale, growth and expected life of production capacity. In commodity industries, scale of operations, at times takes lead, since the ability of one participant to influence price is usually not significant and cost position brings advantages. Meanwhile, entities with geographically concentrated production facilities generally face greater operational risk while entities with production facilities near raw material sources enjoy greater flexibility during supply and demand imbalances. PACRA also places the entity in the value chain of its industry, as value-added products typically have more stable revenues.

2. Ownership

- **Ownership Structure:** Identification of man at the last mile
- **Stability:** Succession planning at shareholder’s level
- **Business Acumen:** Knowledge, skills and experience of key shareholders
- **Financial Strength:** Willingness and ability of key shareholders to provide extra-ordinary financial support

2.1 Ownership Structure: The assessment of ownership begins by looking at the legal status of the entity. Legal status determines the level of expected stability of an entity. The level of perceived stability gradually increases from a sole proprietor to a listed entity. This is followed by an in-depth study of the shareholding mix in order to disentangle structure of ownership. Key factors that are considered for this purpose, inter-alia, include: i) shareholding structure which includes whether the individual(s) own the entity directly or indirectly, ii) foreign or local shareholders, iii) whether the entity is owned by a single group or through a combination of entities and individuals, and iv) whether it is part of a group or is a standalone entity. All these deliberations are done to identify the man at the last mile. PACRA further considers how an entity is actually run, as, at times, entities are run as family concerns despite being legally structured as companies.

***Complex shareholding/ownership structures:** In cases where an entity has a complex ownership structure, there are unique challenges in evaluating the decision-making process, lines of hierarchy and financial obligations and liabilities. In analyzing these entity’s, the fundamental issue is to explore the underlying reason or motivation for the complexity of the structure.*

***Entities owned by private individuals and families:** On the one hand, the concentration of equity ownership might indicate that the majority shareholders have a strong vested interest in creating long-term value and closely monitoring management behavior. On the other hand, a potential concern in such cases is that the owners might rely heavily on extracting funds from the entity as source of income or to fund other business activities, potentially undermining the financial stability of the entity.*

2.2 Stability: In order to analyze the stability of ownership, a critical factor to be taken into account is succession planning. A very important part of our background analytical work is an

attempt to assess whether, and under right of succession, the entity’s prospects would be supported and by whom. This is particularly relevant in case of family-owned businesses and joint ventures, where fall out among shareholders could have a contagious effect on the sustainability of the entity. A stable ownership with clarity in succession, perhaps major shareholding residing with one family or group, is considered positive for ratings. On the contrary, high free float (in case of listed concerns) leads to risk of take over and may anchor lower ratings.

2.3 Business Acumen: PACRA gauges the shareholder’ business acumen. Having a strong business acumen set is considered critical for sustainable success. PACRA analyzes business acumen through two primary areas: i) industry-specific working knowledge, and ii) strategic thinking capability. Meanwhile, a deep and applicable understanding of the system is critical in order to determine how a business achieves its goals and objectives. The scope includes the assessment and understanding of how the sponsors of the entity deliberate over and successfully make the right business decisions.

2.4 Financial Strength: PACRA analyzes the ability and willingness of the major shareholders to support the entity both on a continuing basis, and support in times of crisis. Here, PACRA gives due importance to: i) behavior of the major shareholders to provide timely and comprehensive support in times of need in the past, ii) prospective view of key shareholders, in case such need arises, iii) other businesses of major shareholders, and iv) the level of commitment of the major shareholder with the entity in providing capital support. In case of no explicit commitment, PACRA attempts to form a view on availability of likely support. Support, in this context, refers strictly to financial support, rather than operational support. The scope for looking at other business includes overall profiling of the key shareholders in the context of identifying the resources they have, outside the entity. Here, the standalone rating of the entity can benefit from having majority shareholders with very strong financial strength and commitment to the business. If, in a group structure, the financial strength of the shareholders is deemed to be weaker than that of the entity, this may bode negatively for the entity’s standalone rating given the possibility that the entity may at some point of time be bound to extend financial support to its weaker parent.

Information Required on Ownership

- Shareholding pattern
- Details of major shareholder’ other businesses
- Shareholders’ financial information
- Past pattern of support provided by the shareholders

3. Governance

- **Board Structure:**
Composition of board in terms of size, independence and committees
- **Members’ Profile:**
Relevance and diversity of board members’ skills, knowledge and experience
- **Board Effectiveness:**
Extent to which board properly discharges its responsibilities

3.1 Board Structure: This comprises assessment of board on various criteria including overall size, presence of independent members, duration of board members’ association with the entity, overall skill mix and structure of board committees. Size of the board may vary as per the scope and complexity of the operations of the entity. While a very small board is not considered good, similarly, reaching a decision in an effective and efficient manner may not be possible in case of a very large board. A healthy composition of board includes the presence of independent/non-executive members having limited relationship with the sponsoring group of the entity. Meanwhile, same individual holding chairman and CEO positions is considered weak governance practice. The chairman is expected to have a non-executive role. Compliance with the code of corporate governance is also examined. PACRA also considers independence of governance practices from major shareholders. Lastly, PACRA evaluates number of board committees, their structure, and how these committees provide support to the board. A board with higher number of members should have higher number of committees in place to assist in performing its role.

- **Transparency:**
Quality and extent to which financial and non-financial information is disclosed to stake holders

3.2 Members’ Profile: PACRA collects information regarding profile and experience of each board member. This helps in forming an opinion about the overall quality of the board. Moreover, diversification in terms of knowledge background and experience is considered positive. However, a fair number of board members should have related experience.

3.3 Board Effectiveness: In PACRA’s view, the role of the board is to work with management in steering the entity to its performance objectives and to provide critical and impartial oversight of management performance. PACRA analyzes the type and extent of information shared with board members, and quality of discussions taking place at board and committee levels. Effective oversight requires frequent sharing of detailed information covering various aspects of business and market development. Meanwhile, PACRA also reviews the number of board meetings held during the year as these should be justified with the number of issues/matters arising. Board members’ attendance and participation in meetings is important, and is gauged by viewing board meeting minutes.

3.4 Transparency: Quality of governance framework is also assessed by the procedures designed by the board to ensure transparent disclosures of financial and other information. This can be achieved through: i) ensuring independence of the audit committee, ii) strengthening the quality of internal audit function, which may be in-house or outsourced, and iii) improving quality of external audit by engaging auditors which are included in the State Bank of Pakistan’s panel of auditors and/or have a satisfactory QCR rating.

***Accounting Quality:** PACRA reviews the quality of an entity’s accounting policies as reflected in its notes to accounts, auditors’ comments and other disclosures which are part of its financial statements. Adherence to accounting standards is assessed, particularly for unlisted concerns.*

***Quality of disclosures:** A well-established information system is required for adequate disclosures. The characteristics of quality information includes timeliness, disclosures beyond the minimum regulatory requirements to improve transparency and consistency of such disclosures.*

Information Required on Governance

- Size and composition of board
- Details of board committees including ToRs
- Profile of board members
- Information packs used by the board
- Minutes of board meetings
- Internal auditor detail (if outsourced)
- External auditor detail

4. Management

- **Organizational Structure:** Alignment of organogram with entity size, nature of business and requirements
- **Management Team** Relevance and diversity of skills, knowledge and experience of top management

4.1 Organizational Structure: The assessment of management starts with PACRA conducting an in-depth analysis of organizational structure of the entity. On a standalone basis, PACRA looks into the hierarchal structure, reporting lines and coherence of the team. However, PACRA also places the organizational structure in the entity’s relative universe for comparison in order to form an opinion on optimal structure within the sector in context of its complexity. Number of management committees established to monitor performance and assure adherence to the policies and procedures is considered. PACRA measures the effectiveness of the entity by forming an opinion on the quality of management committees.

4.2 Management Team: Analysis of management includes evaluating experience profile of key individuals, management’s track record to date in building up sound business mix, maintaining

- **Management Effectiveness:** Extent to which top management properly discharges duties and role of technology infrastructure therein
- **Control Environment:** Robustness of systems and processes

operating efficiency and strengthening the entity’s market position. Although judgment about management team is subjective, performance of the entity over time provides a more objective measure. PACRA analyses the quality and credibility of management’s strategy, examining plans for achieving growth. Frequent turnover and/or loss of key personnel, particularly members of senior management, can have potentially adverse effects on overall standing of the entity relative to peers. Hence, HR turnover is reviewed to determine the stability of critical staff, with particular focus on key departments. Similarly, dependence of the management team on one or more persons is considered risky. In addition, the entity’s human resource policies are also reviewed to gauge its emphasis on retaining and recruiting vital staff.

***Key-man Risk:** Key-man risk occurs when an entity is heavily reliant on an individual, or a limited number of individuals, who are accepted as the key holder(s) of important intellectual capital, knowledge or relationships. While this type of risk is more common in small to medium-sized entities, it can also exist in larger entities and is relatively challenging to benchmark and, hence, mitigate. PACRA attempts to identify the extent to which an entity is dependent on the expertise of such individual(s) and to ensure policies exist for succession/redundancy to limit the adverse impact of such a person unexpectedly leaving, on the entity.*

4.3 Management Effectiveness: PACRA conducts a qualitative review of management systems and technology infrastructure to assess management effectiveness. A key measure of management effectiveness is its track record of delivering on past projections and sticking to strategies. One of the key tools available to management to effectively run an organization is the information provided to it. It is critical that information available to management be concise, clear and timely, so it can be interpreted and understood, and the management can respond accordingly. An important part of this analysis is looking at the entity’s MIS. PACRA further assesses whether management has developed any critical success factors to evaluate performance of various business segments and their efficacy. Management meeting minutes are also reviewed, wherever available, to assess the quality of discussion.

***MIS:** System generated – real-time based – MIS reports add more efficiency in decision making whether related to operational, financial or strategic issues. PACRA evaluates the quality and frequency of the MIS reports used by the management team to ascertain that decision-making within the entity is information-based.*

4.4 Control Environment: A robust control environment ensures that the entity is driven by processes instead of being dependent upon individuals. Therefore, evaluation of the quality of policies and procedures, and invariable adherence to these, remains pivotal in the assessment of control environment. Segregation of duties and occupancy of all positions would provide comfort as to the minimization of operational risk. PACRA also assesses the integration of the entity’s operations into technology would be pivotal. Built-in controls should demonstrate that conflict of interest is avoided.

- Information Required on Management**
- Latest organogram
 - Details of management committees
 - Profile of senior management
 - Redundancy pattern
 - MIS reports
 - Minutes of management committees’ meetings

5. Business Risk

- **Industry Dynamics:** Systematic risks and opportunities in operating environment
- **Relative Position:** Current standing among peers
- **Revenues:** Volume, stability and diversification of inflows from core and non-core operations
- **Cost Structure:** Key costs and associated risks, as well as ultimate impact on profitability
- **Sustainability:** Soundness and viability of long-term strategy

5.1 Industry Dynamics: The process for anchoring corporate ratings of the entity builds on PACRA’s understanding of the industry dynamics. This understanding, following an in-depth research approach, is documented as a sector study. The analysis captures the placement of the local industry in the international context to see the points of identity and distinction. In points of identity, the risks and challenges identified for the international industry are re-evaluated for the local industry players, with a view to see whether the local players have established effective mitigants against those risks and taken due measures to meet the challenges. At the same time, we identify the risks and challenges specific to the local context of the industry. While conducting the analysis, PACRA takes a view on the industry alone, independent of the market players. This exercise helps PACRA to form a view on industry’s significance in the economic environment of the country, its attractiveness for investment, barriers to entry, and the power of suppliers and customer.

5.1.1 PACRA explores the possible risks and opportunities for an industry resulting from social, demographic, regulatory and technological changes. It considers the effects of geographical diversification and trends in industry expansion or consolidation required to maintain a competitive position. Industry overcapacity is a key issue because it creates pricing pressure and, thus, can erode profitability. Also important are the stages of an industry’s life cycle and the growth or maturation of product segments, which determine the need for expansion and additional capital spending.

5.1.2 PACRA determines an entity’s rating within the context of each its industry fundamentals. Industries that are in decline, highly competitive, capital intensive, cyclical or volatile are inherently riskier than stable industries with oligopolistic structures, high barriers to entry, national rather than international competition and predictable demand levels. Major industry developments are considered in relation to their likely effect on future performance. Entities belonging to cyclical sectors are considered inherently riskier compared to those belonging to sectors displaying predictable demand levels. This may result in an absolute ceiling for ratings within that industry unless the entity exhibits unique attributes to mitigate industry specific risks. Therefore, an entity in such an industry is unlikely to receive the highest rating possible (‘AAA’) despite having a conservative financial profile, while not all entities in low-risk industries can expect high ratings. Instead, many credit issues are weighed in conjunction with the risk characteristics of the industry to arrive at an accurate evaluation of credit quality.

***Cyclicality:** Industries can be cyclical based on their sensitivity to: i) overall economic conditions, ii) seasonal demand or iii) commodity prices. Entities belonging to cyclical industries see their performance correlated to these factors and thus witness significant volatility in performance metrics including revenues and profitability. This can significantly impact their debt servicing ability and ensuing credit quality. In rating such entities, PACRA analyzes credit protection measures and profitability through the cycle to identify an entity’s equilibrium or mid-cycle position. The primary challenge in rating a cyclical entity is deciding when a fundamental shift has occurred in financial policy or the operating environment that would necessitate a rating change.*

***Regulatory Environment:** Regulatory role of the government in the form of taxes and subsidies, price controls and import/export restrictions (incl. tariffs and customs), among others, can range from that of a facilitator to a controller. This can significantly impact industry structure and level of competitiveness. In some cases, it may lead to monopolistic or oligopolistic industry structures, such as the OMCs and utilities sectors with stiff competition and high barriers to entry.*

5.2 Relative Position: Relative position reflects the standing of the entity in the related market. The stronger this standing is, the stronger is the entity’s ability to sustain pressures on its business volumes and profit margins. This standing takes support from three major factors: i) market share ii) growth trend, and iii) competitiveness.

***Market Share:** Market size represents the entity’s penetration in the chosen market. Size is advantageous as it provides ability to acquire larger business, pricing power and better expense management. There is a positive correlation between an entity’s absolute and relative size and its market position and brand value. The large entities exercise greater power over the pricing, while ensuring commensurate profits. Small entities struggle to obtain business; and with less flexibility in the cost structure, their profits remain low. While absolute size is important, it is basically the relative proportion which provides a clear yardstick to analyze the comparative strength of the market players. The more distant a player is from the average on the positive side, the stronger is its ability to reflect the characteristics just mentioned. In a dynamic industry, which is not characterized by concentration, PACRA believes that relative size would better capture the strength of the entity’s standing in the related market.*

***Growth Trend:** While evaluating the size, PACRA looks at the rate of growth. Growth is important as it ensures that the entity continues to have the ability to meet the industry’s benchmarks. As the industry grows, it uplifts the scale of its operational context. This reflects in the ability of the players to invest in human resource, upgrade the control environment, enhance the product slate, increase the outreach and improve the quality of product/service. To lag the industry’s growth trend means to remain short on these avenues, putting pressure on the market position.*

***Competitiveness:** PACRA looks for what differentiates an entity from its competitors – this could be a strong brand, established relationships with customers, easy access to raw material, wide distribution network or technological advantage. Ultimately, this competitive advantage determines the robustness of an entity’s business model. While assessing this, a key concern is the durability of the competitive advantage. If it is one which is temporary or easily replicable, it is unlikely to prevent the entity from losing its competitive position over time.*

5.3 Revenues: In measuring revenue quality of an entity, stability and diversification are very important factors. Revenue stability is measured through historical trend analysis of the entity’s revenues. Meanwhile, PACRA assesses diversification at product, customer and geographical levels. In addition, the analysis of target markets to which an entity serves forms a part of the assessment.

5.3.1 Diversification: Diversification is desirable since it enhances the entity’s ability to meet challenges, both present and upcoming. Lack of diversification limits the entity’s ability to ensure sustainability in its business. At the same time, it increases the risk of disruption if the area of concentration goes wrong. This does not entail that a company specializing in a certain product/segment would necessarily be at a disadvantage. The disadvantage would only arise if the company’s business model gives rise to concentration risk.

Type of Diversification	Description
Product	Entities that have a wider range of product or service offerings are exposed to lower revenue risk compared to entities deriving revenues from a single/narrow range of products. However, simply having a larger variety is insufficient to diversify risk; the competitive standing of products and their positioning in the product life cycle is crucial to this analysis.
Customer	PACRA looks at concentration in an entity’s customer base. A narrow customer base or overreliance on a large customer can expose an entity to unpredictable variability in demand if there is disruption in the business from the large customer. Even so, PACRA recognizes the value of long-term relationships with established customers (particularly in B2B models) and factors the same in its analysis.
Geographic	An adequate degree of geographic diversification is desirable to the extent that it can protect an entity from variability in demand of a certain region. However, it must be weighed against exposure to other risks such as currency risk (if overseas diversification) and regulatory restrictions (e.g. protectionism, consumer protection laws etc.)

5.3.2 Non-operating Income: Any income derived from non-core activities of the entity is treated as non-operating income. Income may emanate from financial assets (including dividends from equity investments and interest payments from fixed-income investments, in related and unrelated parties) and non-financial assets (including rental income from property). While non-operating income is usually not critical to the entity’s overall success, it can often provide a valuable contribution, particularly during times when core operations are stressed. PACRA positively views entities which have recurring non-operating income streams in place to support core profitability and boost liquidity. This factor gains prominence especially when ratings move into the higher bands as this is usually accompanied by increase in entity size, wherein deriving inflows from multiple sources becomes important.

Equity Investments: PACRA classifies equity investments into three main categories:

<p>Core: The investments where an entity has operational control and are essentially a part of it or treated as a wholly owned subsidiary. It is very unlikely that the entity would decide to divest its stake.</p>	<p>Strategic: These can be subsidiaries, associates, joint venture or partnerships. Core investments can translate into strategic investments upon divesture of stake.</p>	<p>Trading: These comprise equity stakes held in unrelated companies. These investments are least integrated with the entity and are held primarily with the intention of deriving capital gains.</p>
---	---	--

5.4 Cost Structure: It is essential to analyze the entity’s cost structure to assess its impact on performance. PACRA looks at the key costs of the entity including raw material procurement (sources and terms with suppliers), energy and labor to assess the entity’s conversion cost. A key concern here is supplier concentration. PACRA reviews the extent of an entity’s reliance on a single supplier for any of its raw materials, since this can lead to disruption in operations, compromising operational efficiency and possibly impacting relationships with customers. Moreover, the capacity utilization of production facilities is also reviewed. Ultimately, the goal is to gauge the entity’s operating efficiency relative to peers. It is utmost desirable for entities,

particularly in the commodity business, to minimize fixed costs and per unit variable costs as this allows for price competitiveness which can become the key to survival in scenarios where demand declines significantly or there is oversupply.

5.4.1 Margins: While PACRA performs traditional ratio analysis, e.g., Gross margin, Operating margin, Net profit margin, due weightage is given to EBITA margins. This is due to its importance as a cash flow generation measure. Overall analysis of business margins suggests the level of strength of the entity’s business profile and is viewed in comparison to its industrial peers.

Foreign Currency Risk: *If there is a currency mismatch between entities’ revenues and costs, or, their assets/cash flows and sources of funding, foreign currency risk becomes an important concern. This is especially relevant for export-oriented sectors and sectors dependent largely on imported raw material. PACRA gauges the magnitude of the currency risk relative to the entity’s overall business profile and its ability to pass on the risk to its consumers, which, in certain cases, may be a function of the industry it operates in.*

5.5 Sustainability: PACRA evaluates the strategy of the management and the viability of designed path to reach to the goal. Earnings prospects are monitored, based on budgets and forecast prepared by the management. A reality check is performed while analyzing underlying assumption taken by the management as well as management’s track record in providing reliable budgets and forecasts.

Project Risk: *In the case of entities implementing a project of significant size, PACRA evaluates the risks associated with that project and factors in these risks while arriving at the overall rating. The relative size of the project as compared with the overall operations of the rated entity would indicate the relative significance of the project risk within the overall rating opinion. The project’s business risk, particularly in relation to the entity’s existing product line, and the management’s track record in implementing such projects are key factors. An assessment is made of the implementation risks such as time and/or cost over-runs, technology risk, and the impact of these on project’s viability. Furthermore, funding risks with regard to project’s capital structure and funding arrangements are also evaluated.*

Event Risk: *Incorporating the risk of unforeseen events into an entity’s rating opinion is challenging, given their unpredictable nature and magnitude of impact. These events may be external (M&As, regulatory changes, litigations, or natural disasters) or may be internally driven (unrelated diversification or strategic restructuring) and can lead to substantial rating changes. PACRA applies its analytical judgment in assessing the likelihood of such occurrences and potential impact, insofar as may be possible, and assesses the entity’s track record, expertise of management team and level of financial discipline to incorporate the same into its ratings.*

Information Required on Business Risk

- Market share (%) along with marketing strategy
- Quarterly financial statements of the entity for the past three years
- Geographic breakup of revenue
- Product-wise breakup of revenue
- Top ten largest customers, for each business segment respectively
- Top five suppliers along with respective contribution
- Current capacity utilization of the plant and projected trend for the following year
- Financial projections, along with detailed assumptions

Business Risk – Key Ratios

- Revenue growth (%)
- Gross margin (%)
- Operating margin (%)
- EBITDA margin (%)
- Net non-core income (expenses) / Net income (%)
- Cash conversion efficiency (%)
- Net margin (%)

6. Financial Risk

- **Working Capital:** Management of cash cycle and extent of reliance on external funding for day-to-day operations
- **Coverages:** Sufficiency of cashflows to service debt, especially from core operations
- **Capital Structure:** Dependence on borrowed funds, level of risk tolerance and financial flexibility

6.0 In its financial risk analysis, PACRA emphasizes cash flow measures of working capital, coverages and capitalization. Cash flows from operations provide an entity with more secure credit protection than dependence on external sources of capital. PACRA’s approach gives more weight to cash flow measures than equity-based ratios. The latter rely on book valuations, which do not always reflect current market values or the ability of the asset base to generate cash flows. Measures such as debt-to-equity are less relevant to a credit analysis because they are based on formalized accounting standards, which are subject to varying interpretation. As the equity account is presented at book value, it does not provide the most accurate assessment of an entity’s asset base to generate future cash flows. Thus, asset values may be overstated or understated, while the entity’s liabilities remain close to fair market value. However, use of such ratios is prevalent in many parts of the world and they have relevance in helping investors understand an entity’s financial profile. The entity may consider that these transactions provide the best return of available investments, and the reduction in book equity has no effect on its cash flow generating ability.

6.0.1 Notwithstanding the above discussion, the accruals or fair-value based measures are not disregarded entirely. In entity financial analysis, PACRA considers many key measures that are not captured in the cash flow statement, as many financial events that do not have an immediate cash flow impact, may have medium-term and long-term implications for cash flows for which the book adjustments serve as a useful indicator. Examples may include marking of assets to market, taking an impairment charge through a major write-down of goodwill or the entry into a long-term derivative. Other book adjustments – a write-down in inventory, for example – could signal a much more immediate impact on the entity’s financial prospects. Another limitation of the cash flow perspective can be observed in the case of movements in foreign currency exposure that are typically not revealed from the cash flow statement, but would be evident from income statement measures and/or the reconciliation of the opening and closing balance sheet data.

6.1 Working Capital: PACRA’s financial risk analysis assigns significant importance to an entity’s working capital management. In its assessment, PACRA evaluates working capital cycle of the entity. Lengthy working capital cycle may dent the entity financial health in times of even slight external (economic or industry specific) shocks. On the other side, evaluation of funding mix to finance working capital needs becomes important. Higher the funding from equity or profit retention, lesser would-be reliance on short-term borrowing by the entity. Thus, high level of cushion in short-term assets vis-à-vis short-term borrowings is seen positively.

***Asset-liability Mismatch:** Borrowing short-term to finance long-term investments and/or fund long-term borrowing is viewed negatively by PACRA as the resultant asset-liability mismatch exposes the entity to interest rate risk and refinancing risk. This is an important concern particularly in case of smaller business which carry relatively high operational risk and lower financial flexibility than their larger counterparts. PACRA evaluates the quantum of the mismatch and whether it is a one-off feature or a recurrent feature in an entity’s working capital history.*

6.2 Coverages: Key elements in determining an entity’s coverages are its cash flows, which affect the maintenance of operating facilities, internal growth and expansion, access to capital and the ability to withstand downturns in the business environment. The availability of funds to repay debt without external funding is given special consideration. PACRA also examines capital expenditures to distinguish among maintenance amounts necessary to support an entity’s competitive position, regulatory requirements and discretionary expenditures that support growth. PACRA’s analysis focuses on the stability of earnings and the continuity of cash flows from the entity’s major business lines. Sustained cash flow provides assurance of the entity’s ability to service debt and finance operations and capital expansion without sizeable amounts of external funding.

***Credit Enhancement:** The entity that carry third party commitment to make good an amount obligated to the lenders may provide additional support to its financial risk profile. In this case, in determining the impact on rating, key factors to assess are the financial profile of the third party and the extent of coverage – quantum and duration – it provides.*

6.3 Capital Structure: PACRA analyzes capital structure to determine an entity’s reliance on external financing. To assess the credit implications of an entity’s leverage, several factors are considered, including the nature of its business environment and the funds flows from operations. As industries differ significantly in their need for capital and capacity to support high debt levels, the assessment of leverage in the capital structure is based on industry norms.

***Financial Policy:** PACRA looks at the entity’s financial policy to develop a view on its level of risk tolerance and likely direction of future financial decisions. Documented financial policies with clearly defined leverage metrics are viewed positively. Moreover, PACRA assesses the entity’s commitment towards its financial policy by looking at its track record of sticking to targets through different economic and industry cycles, along with managing to balance the interests of shareholders and creditors.*

***Financial Flexibility:** Financial flexibility allows an entity the latitude to meet its debt service obligations and manage stress without eroding credit quality. In terms of debt, the more conservatively capitalized an entity, the greater its flexibility. Other factors that contribute to financial flexibility include the ability to redeploy assets and revise plans for capital spending, strong banking relationships and equity markets access. Committed, multiyear bank lines along with provide additional strength. The inherent choice of dividend expense and capex investments may warrant an examination of reduction / suspension of one or both for stress cases. Further, presence of contingent obligation such as potential legal liabilities and guarantees extended can pressurize an entity’s financial profile in case these materialize. Thus, PACRA considers these in its analysis.*

Table 5. Information Required on Financial Risk

- Optimal inventory levels
- Aging analysis of receivables
- Payment terms with creditors
- Complete schedule of all long term borrowings
- Bank wise detail of available credit lines
- Nature and status of intergroup lending and borrowing positions

Financial Risk – Key Ratios

Working Capital Management:

- Gross working capital cycle (days)
- Net working capital cycle (days)
- Short-term leveraging (%)
- Current ratio (times)

Coverages:

- EBITDA / Gross interest (times)
- FCFO / Gross interest (times)
- FCFO / Gross interest + Current maturity of long-term borrowing (times)
- Debt payback (years)

Capital Structure:

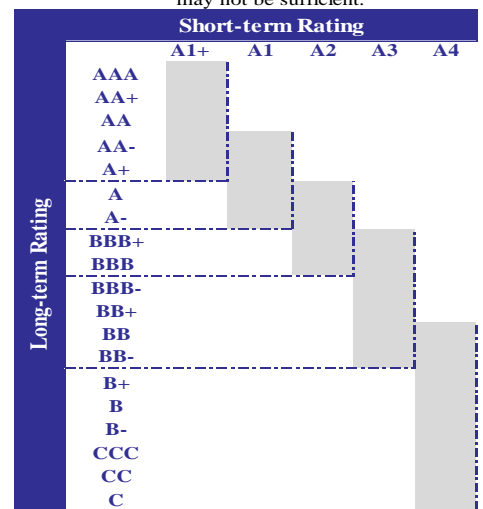
- Total Borrowing / Total Borrowing + Equity (%)
- Average borrowing rate of entity (%)

Credit Rating

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

Scale	Long-term Rating Definition
AAA	Highest credit quality. Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
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.
AA-	
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.
A-	
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.
BBB-	
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.
BB-	
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.
B-	
CCC	
CC	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.
C	
D	Obligations are currently in default.

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



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

Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. ‘Stable’ outlook means a rating is not likely to change. ‘Positive’ means it may be raised. ‘Negative’ means it may be lowered. Where the trends have conflicting elements, the outlook may be described as ‘Developing’.

Rating Watch Alerts to the possibility of a rating change subsequent to, or, in anticipation of some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating watch may accompany rating outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults, or/and e) PACRA finds it impractical to surveil the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

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

Note. This scale is applicable to the following methodology(s):
 a) Broker Entity Rating
 b) Corporate Rating
 c) Debt Instrument Rating
 d) Financial Institution Rating
 e) Holding Company Rating
 f) Independent Power Producer Rating
 g) Microfinance Institution Rating
 h) Non-Banking Finance Companies Rating

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