RATING METHODOLOGY

CORPORATE RATING

An independent forward looking opinion on credit worthiness of a corporate

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UPDATED: JUN 2016

Issued by: The Pakistan Credit Rating Agency Limited

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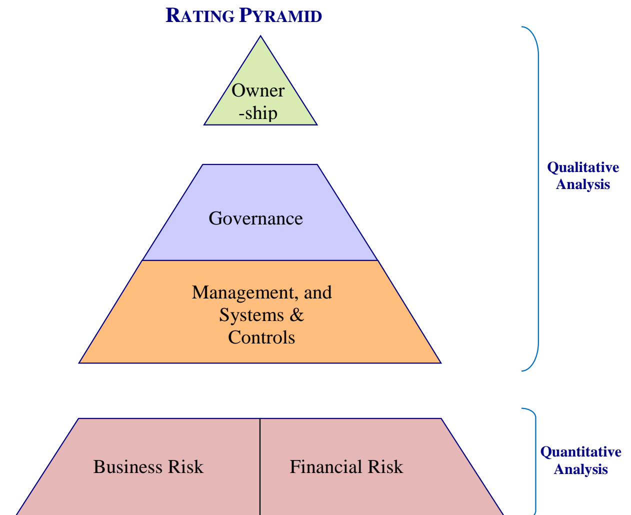
1. INTRODUCTION

- Applies to corporate entities
- SECP – the apex regulator

1.1 This methodology applies to corporates. 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.

1.2 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 supports.

1.3 PACRA's framework for assessing credit quality makes use of both qualitative and quantitative analyses to assess the business and financial risks of a corporate entity. 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. Because short-term and long-term ratings are based on a company's fundamental credit characteristics, a correlation exists between them (see PACRA's Criteria document "Correlation between Short-term and Long-term Rating Scale"). Analysis typically involves at least three years of operating history and financial data as well as company and rating agency forecasts of future performance.



1.4 Overall analysis is covered under three key areas.

Key Rating Factors

The Entity's Profile	Buisness Risk	Financial Risk
Ownership	Operating Environment (Economic Risk+Industry Risk)	Working Capital Management
Governance	Relative Positioning	Debt Service Coverages
Management and Control Framework	Quality of Earnings	Capital Structure

1.5 To achieve a clearer perspective on relative performance, a company's performance is compared with that of others in its peer group. In addition, a sensitivity analysis is performed through several "what if" scenarios to assess a company's

capacity to cope with changes in its operating environment. A key rating factor is financial flexibility, which depends, in large part, on the company's ability to generate cash from operations. The risks associated with the implementation of any large project undertaken by the entity, and its funding and business risks are also evaluated, with relative significance assigned proportionate to the project size.

2. THE ENTITY'S PROFILE

- Ownership – identification of "man at the last mile"
- Likelihood of support
- Governance structure
- Management quality and control framework

2.1 Ownership and support: The ownership of and potential support available to a corporate is important in rating analysis. Understanding relationships between different group companies is an important aspect. Ultimately, PACRA attempts to identify the owner and more importantly "man at the last mile" in its ownership analysis. A clear and straight ownership of an entity is considered better than a complex structure where ownership is measured through various cross-holding among different group entities.

2.2 Post-identification, PACRA forms an opinion as to the owner's ability to support the entity in case the need arises. The support can be classified as ongoing or extra-ordinary support. Ongoing support encompass the sponsor's view on dividend policy, in turn, the level of retained profits. Whereas extra-ordinary support is in time of crises, when funding requirements are less-likely to be met from external sources, e.g. bank loans, raising capital from capital or debt markets etc.

2.3 Governance: PACRA's assessment of corporate governance involves both systematic analyses of governance data and information, and the more contextual reviews of an individual entity's governance practices. PACRA considers the independence and effectiveness of the board of directors to be an essential element of a robust corporate governance framework. The board's oversight of such related party transactions that may lead to conflicts of interest is evaluated. Board oversight of the audit function is also assessed, being an important safeguard in protecting the integrity of an entity's financial reporting.

Governance Structure		
Board Structure	1	Size of the board
	2	Positions of Chairman and CEO
	3	Independent directors
	4	Association of directors with the company
	5	Skills mix
	6	Compensation of directors
	7	Sub-committees of board
Members' Profile	1	Directors trainings
	2	Availability / commitments of individuals
	3	Experience of board members
Board Effectiveness	1	No. of board meetings per year
	2	Attendance of board meetings
	3	Quality of board meeting minutes
	4	Robustness of package of board meetings
Financial Transparency	1	Composition of Audit committee
	2	Extent of public disclosures
	3	Internal audit function
	4	External auditor

2.4 Management and Control Framework: PACRA's assessment of management focuses on corporate strategy, risk tolerance and funding policies. Corporate goals are evaluated to determine if management has an aggressive style dedicated to rapid growth that maximizes near-term earnings at the expense of future performance or a conservative style geared toward optimizing cash flow over the long term. A policy of growth through acquisition is not necessarily a negative credit factor, especially in a consolidating industry in which new projects would dampen prices for all participants. Key factors considered are the mix of debt and equity in funding growth, the company's ability to support increased debt, and the strategic fit of new assets. The historical mode of financing acquisitions and internal expansion provides insight into management's risk tolerance. Although a judgment on the quality of management is subjective, financial performance over time provides a more objective measure.

3. BUSINESS RISK

- Operating environment – economy and industry analysis
- Relative positioning
- Quality – Diversification and stability – of earnings
- Profitability and EBITDA margins
- Strategic focus

3.1 Operating Environment: PACRA explores the possible risks and opportunities in a company's operating environment 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 stage of an industry's life cycle and the growth or maturation of product segments, which determine the need for expansion and additional capital spending. In rating cyclical companies, PACRA analyzes credit-protection measures and profitability through the cycle to identify a company's equilibrium or mid-cycle position. The primary challenge in rating a cyclical company is deciding when a fundamental shift has occurred in financial policy or the operating environment that would necessitate a rating change.

3.1.1 PACRA determines a company's rating within the context of each company's 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. The inherent riskiness and/or cyclicality of an industry may result in an absolute ceiling for ratings within that industry. 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.

3.2 Relative Position: Several factors determine a company's ability to withstand competitive pressures, including its share in key markets, product dominance and the ability to influence price. Maintaining a high level of operating performance depends largely on product diversity, geographic spread of sales, diversification of major customers and suppliers and comparative cost position. Size may be a factor if it confers major advantages in terms of operating efficiency and competitive position. In commodity industries, size at times take lead, since the ability of one participant to influence price is usually not significant and cost position brings advantages.

3.3 Quality of Earnings:

Earnings - Impotant Ratios
Turnover Growth (%)
Gross Margin (%)
Operatign Margin (%)
EBITDA Margin (%)
Net Non-core Income (Expenses) / Net Income (%)
Cash Conversion Efficiency (%)
Net Profit Margin (%)

In measuring earning's quality of a corporate, diversification and stability are very important factors. An entity with a diverse product slate with more than one revenue streams is considered better than an entity with a concentrated earning profile. PACRA sees concentration at both product and customer levels. In addition, the analysis of target markets to which a corporate serves forms a part of the assessment. Stability is measured through historical trend analysis of the corporate's revenues.

3.3.1 In addition to an analysis of the earnings profile of the corporate, overall performance measurement encompasses its cost structure and profitability. 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 in comparison to its peers.

3.3.2 PACRA assesses management's track record in terms of its ability to create a healthy business mix, maintain operating efficiency and strengthen market position. PACRA also gives management significant credit for delivering on past projections or maintaining previously articulated strategies when evaluating future growth plans and related financial projections.

4. FINANCIAL RISK

- Working capital management
- Funding sources for working capital needs
- Cash flows and coverages
- Capital structure
- Project related risks

4.1 In its financial risk analysis, PACRA emphasizes cash flow measures of earnings, coverage and leverage. Cash flows from operations provide a company 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 and debt-to-capital 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 a company's asset base to generate future cash flows. Thus, asset values may be overstated or understated, while the company'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 a company's financial profile. Stock buybacks do not necessarily have negative ratings implications if they are not made with additional debt. The company 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.

4.2 Notwithstanding the above discussion, the accruals or fair-value based measures are not disregarded entirely. In corporate 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.

4.3 Working Capital Management:

Working Capital Management - Important Ratios
Gross Working Capital Cycle (days)
Net Working Capital Cycle (days)
Short-term Leveraging (%)
Current Ratio

PACRA's financial risk analysis carry significant importance for 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.

Debt Service Coverages - Important Ratios
EBITDA/Gross Interest (%)
FCFO/Gross Interest (%)
FCFO/Gross Interest+Current maturity of LT Loans (%)
Debt Payback (years)

4.4 Cash Flows and Coverages: Key element in determining a company's overall financial health is 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 a company'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 company's major business lines. Sustained cash flow provides assurance of the company's ability to service debt and finance operations and capital expansion without sizeable amounts of external funding.

4.4.1 The evaluation of debt adjusts for off-balance-sheet debt, which consists of borrowings of partly owned companies or unconsolidated subsidiaries that may involve claims on the parent company. Typically, debt associated with receivables securitizations, a form of off-balance-sheet financing, is added back to the total debt figure. In the event of debt that is nonrecourse to the rated entity, PACRA reviews each situation to ascertain the relevance of including the debt as part of the total debt calculation. In situations where debt is excluded, the analyst will also make certain that any related cash flow or income is also excluded from the evaluation. Preferred stock issues providing the holders with conversion options may be considered as quasi debt instruments.

4.5 Capital Structure: PACRA analyzes capital structure to determine a company's reliance on external financing. To assess the credit implications of a company's leverage, several factors are considered, including the nature of its business environment and the principal 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.

4.5.1 Financial Flexibility: Having financial flexibility allows a company the latitude to meet its debt service obligation and manage stress without eroding credit quality. In terms of debt, the more conservatively capitalized a company, the greater its flexibility. In addition, a commitment to maintaining debt within a certain range allows a company to cope with the impact of unexpected events on the balance sheet. Other factors that contribute to financial flexibility are the ability to redeploy assets and revise plans for capital spending, strong banking relationships and equity markets access. Committed, multiyear bank lines 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.

4.6 Project risk evaluation: In the case of companies 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.

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ENTITY RATING SCALE & DEFINITIONS

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

LONG TERM RATINGS

Rating	Definition
AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments.
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk**. Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

SHORT TERM RATINGS

A1+: The highest capacity for timely repayment.

A1:. A strong capacity for timely repayment.

A2: A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.

A3: An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.

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

C: An inadequate capacity to ensure timely repayment.

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

Rating Watch
Alerts to the possibility of a rating change subsequent to, or in anticipation of, a) some material identifiable event and/or b) deviation from expected trend. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating Watch may accompany Outlook of the respective opinion.

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

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

Disclaimer: PACRA's ratings are an assessment of the credit standing of entities/issue in Pakistan. They do not take into account the potential transfer / convertibility risk that may exist for foreign currency creditors. PACRA's opinion is not a recommendation to purchase, sell or hold a security, in as much as it does not comment on the security's market price or suitability for a particular investor.