



8th International Course on Islamic Capital Markets

Course theme: Financial Institutions within Shariah
Compliant Framework; Past Experience and Future Outlook

Rating Methodology for Islamic Financial Instruments (Sukuk)

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Substance OR Form

“Listen: this world is the lunatic’s sphere,
Don’t always agree it’s real,
Even with my feet upon it
And the postman knowing my door
My address is somewhere else” —

حافظ

Financial System

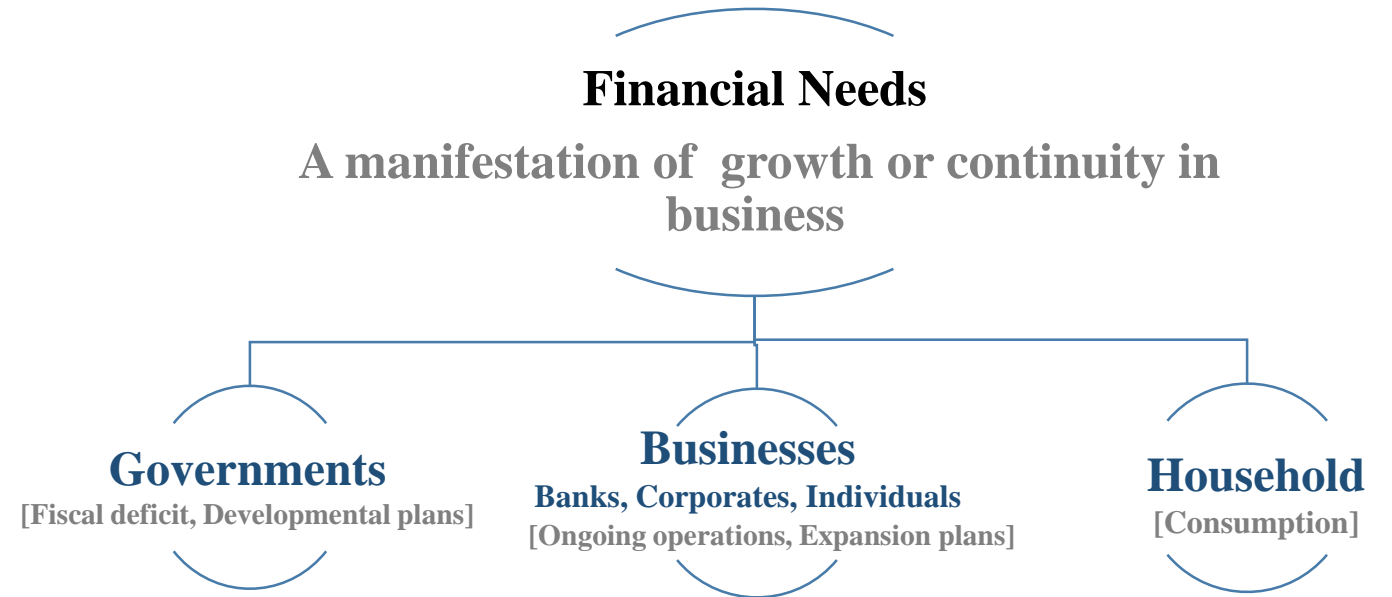
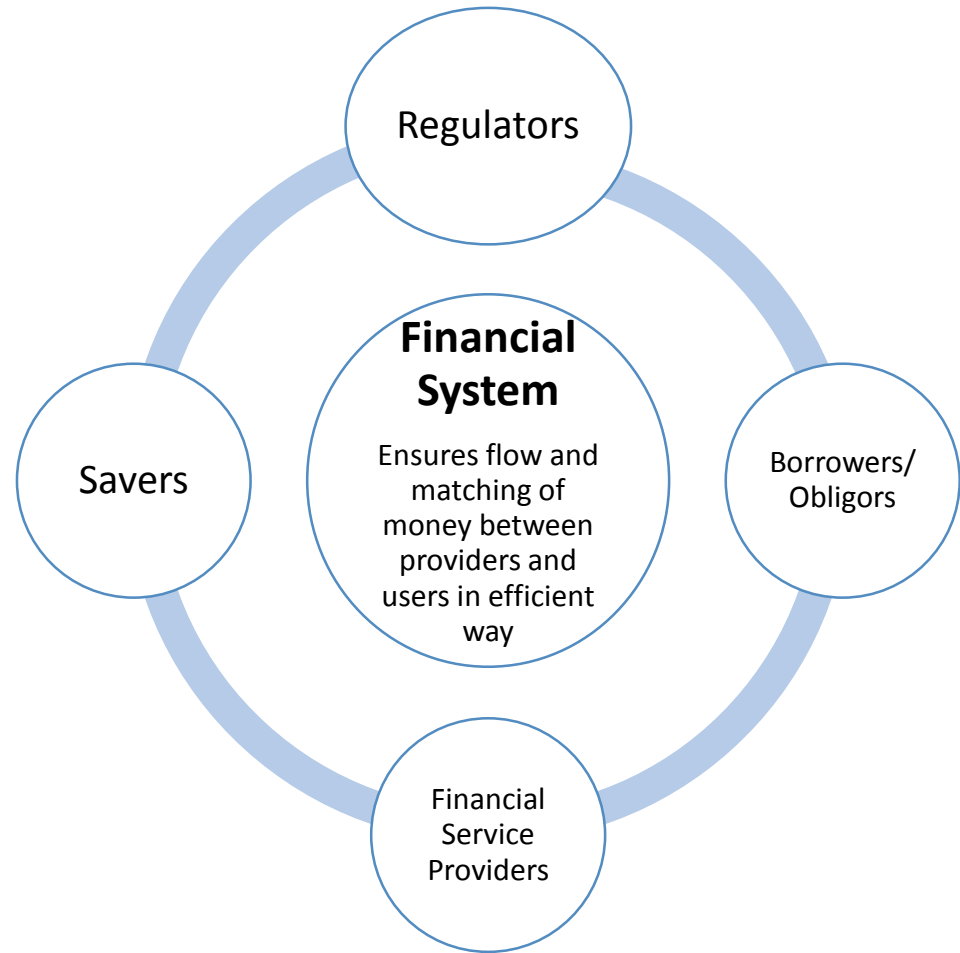
Understanding
Sukuk

Rating
Methodology

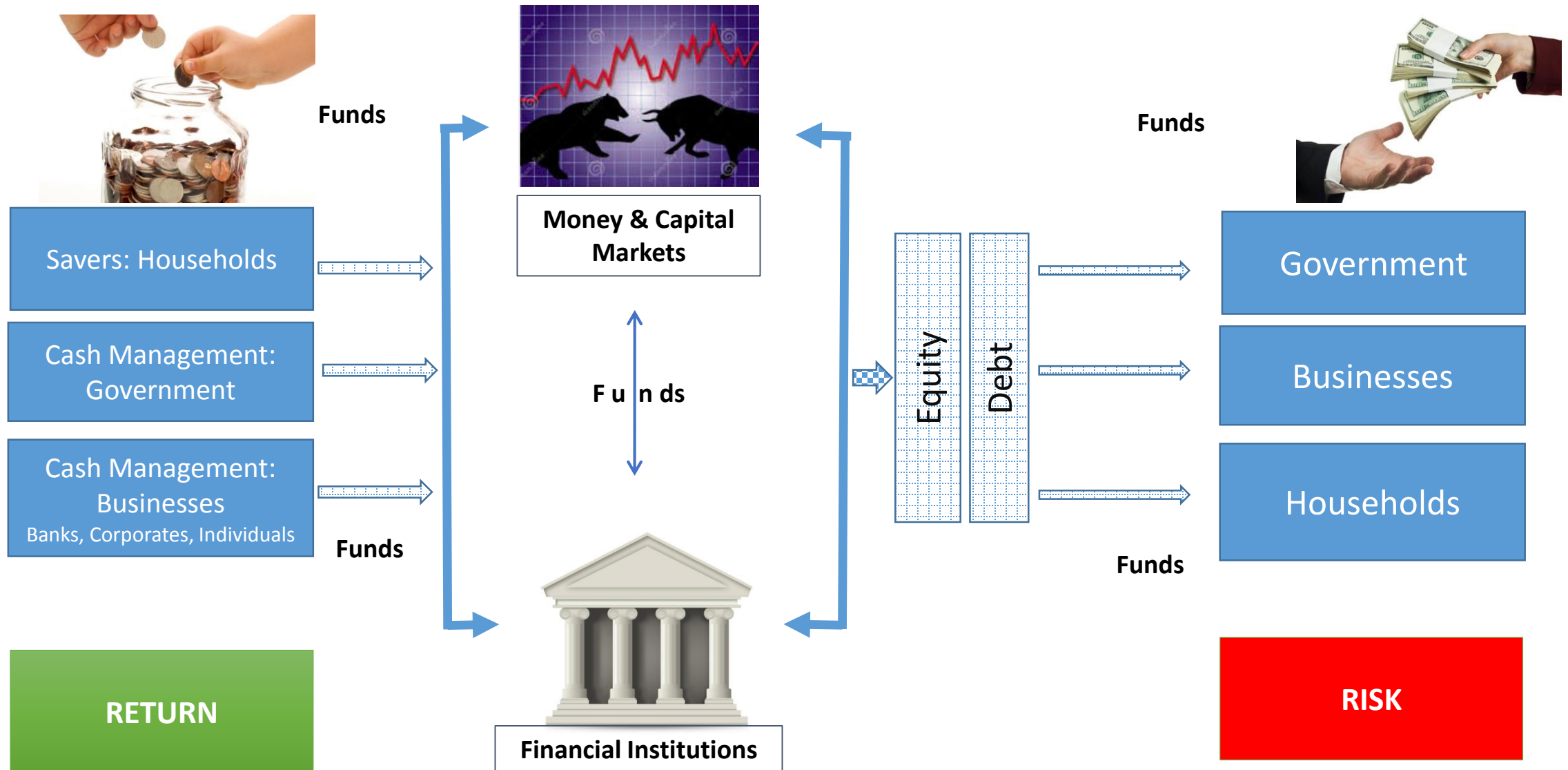
Statistics

Rating - Case
studies | Pakistan

Financial Ecosystem



Flow of Funds



Islamic Modes of financing

Mode	Objective	Details	Mode
Musharaka	Partnership in business	A relationship for sharing of profits and losses in the business. Islamic bank provides funds, which are mixed with the funds of the business enterprise. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions.	مشاركة
Mudarabah	Partnership in business	One party provides the funds while the other provides expertise and management. The latter is referred to as the Mudarib. Any profits accrued are shared between the two parties on a pre-agreed basis, while loss is borne only by the provider of the capital.	مضاربة
Murabaha	Working Capital Financing Inventory	The client (obligor) requests the bank (financer) to purchase certain goods for it. The bank then sells goods to the client on credit. The bank does that for a definite profit over the cost, which is stipulated in advance.	مرا بحة

..... Islamic Modes of financing

Mode	Objective	Details	Mode
Waqala	Working Capital Financing Receivable	An arrangement whereby one party entrusts another party to act on its behalf. Its akin to an agency arrangement. A principal (the financier) appoints an agent/wakeel (the obligor) to invest funds provided by the principal into a pool of investments or assets and the wakeel lends it expertise and manages those investments on behalf of the principal for a particular duration, in order to generate an agreed upon profit return.	وكالة
Salam	Short term financing	On spot buying of underlying assets and sale of asset to finance at a later date Obligor purchases the asset at a later date.	سلم
Istisna	Project Financing	Advance payment of capital cost of the project by financier. Obligor reimburses the capital cost plus profit on project.	استصناع
Ijarah	Lease Financing	Purchase of tangible assets at a pre-agreed price with permission to use the asset against rentals. Obligor pays fixed periodic rentals.	اجاره

Sukuk

صكوك

Sukūk (plural of sakk), frequently referred to as “Islamic bonds”, are certificates with each sakk representing a proportional undivided ownership right in tangible assets or a business venture²

Surplus funds



Need of funds

Understanding Sukuk	Asset Backed	Asset Based [Issuer backed]
Transaction	Identified assets are transferred to a separate entity that makes the sale to Sukuk holders and raises funds	Assets are sold by Issuer to the Sukuk holders through agent with a promise to buy back
Ownership of Asset	Legal ownership of assets with exclusive rights	Beneficial ownership of asset with liquidation rights at par with other creditors
Source of rentals/profit payments	Cash flows from underlying assets	Issuer's cashflows
Asset location	Separate entity carries the asset	Asset stays on Issuer's balance sheet
Credit Risk	Value and Performance of underlying asset	Performance of issuer
Event of Default	No recourse on issuer/obligor Recourse only to underlying asset	Recourse on issuer/obligor in case of non-honouring of promise
Recovery	Assets clawback/liquidation	Sukuk holders' rights are similar to unsecured creditors

Sukuk Rating



Sukuk Risk | Promise to honour financial obligations – Rentals, Profit Sharing, buying back of asset – as and when these fall due may not be fulfilled

Investor

- Rating quantifies the risk of timely honouring of financial obligations
- Capture relative risk

Issuer

- Supports pricing or return assessment
- Increased access to capital markets
- Confidence of investors

Sukuk Rating Scale

Rating	Definition	Details
AAA	Extremely Strong	Highest credit quality. Lowest expectation of credit risk. Exceptionally strong capacity for timely payments
AA	Very Strong	Very high credit quality. Very low expectation of credit risk. Very strong capacity for timely payments
A	Strong	High credit quality. Low expectation of credit risk. Strong capacity for timely payment
BBB	Adequate	Good credit quality. Currently a low expectation of credit risk. Adequate capacity for timely payment
BB	Inadequate	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
B	Poor	High credit risk. A limited margin of safety remains against credit risk. Capacity for continued payment is contingent upon a sustained, favorable business, and economic environment.
CCC-C	High Default Risk	Very high credit risk. “CCC” Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments.
D	Default	Obligations are currently in default.

Rating Methodology

Asset Based Sukuk

Credit Risk

Ability of issuer to generate cash flows to timely meet financial obligations

Assess the ISSUER

Rating Factors

Rating Agency assesses issuer's standalone as well as relative strength. Rating is a forward looking, through the cycle opinion. It is assigned after a rigorous analytical process. Understanding of issuer's strategy is critical.

Qualitative

Ownership

Governance

Management

Quantitative

Business Risk

Financial Risk

BBB

A+

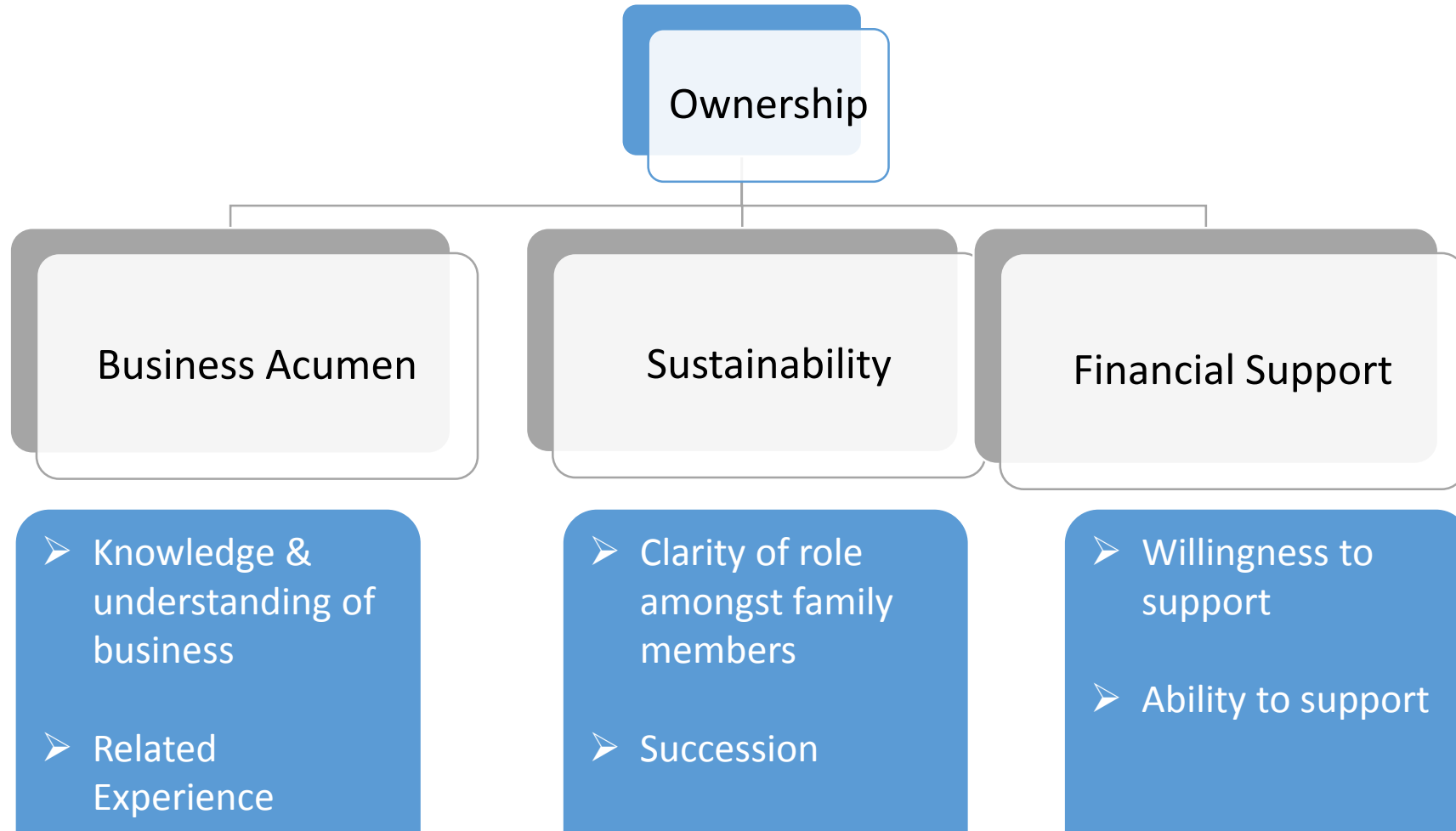
D

CCC

AA-

A2

BB



Rating
Methodology

Asset Based Sukuk

Governance

Governance

Board Structure

Board profile

Board Effectiveness

Financial Transparency

- Size
- Independence
- Committees

- Training
- Commitment
- Experience

- Meetings
- Attendance
- Participation

- Audit Committee Composition
- Public Disclosure
- Internal & External Auditor

Rating
Methodology

Asset Based Sukuk

Management

Management

Organizational
Structure

- Robustness of organogram
- Adequate Staffing

Management
Profile

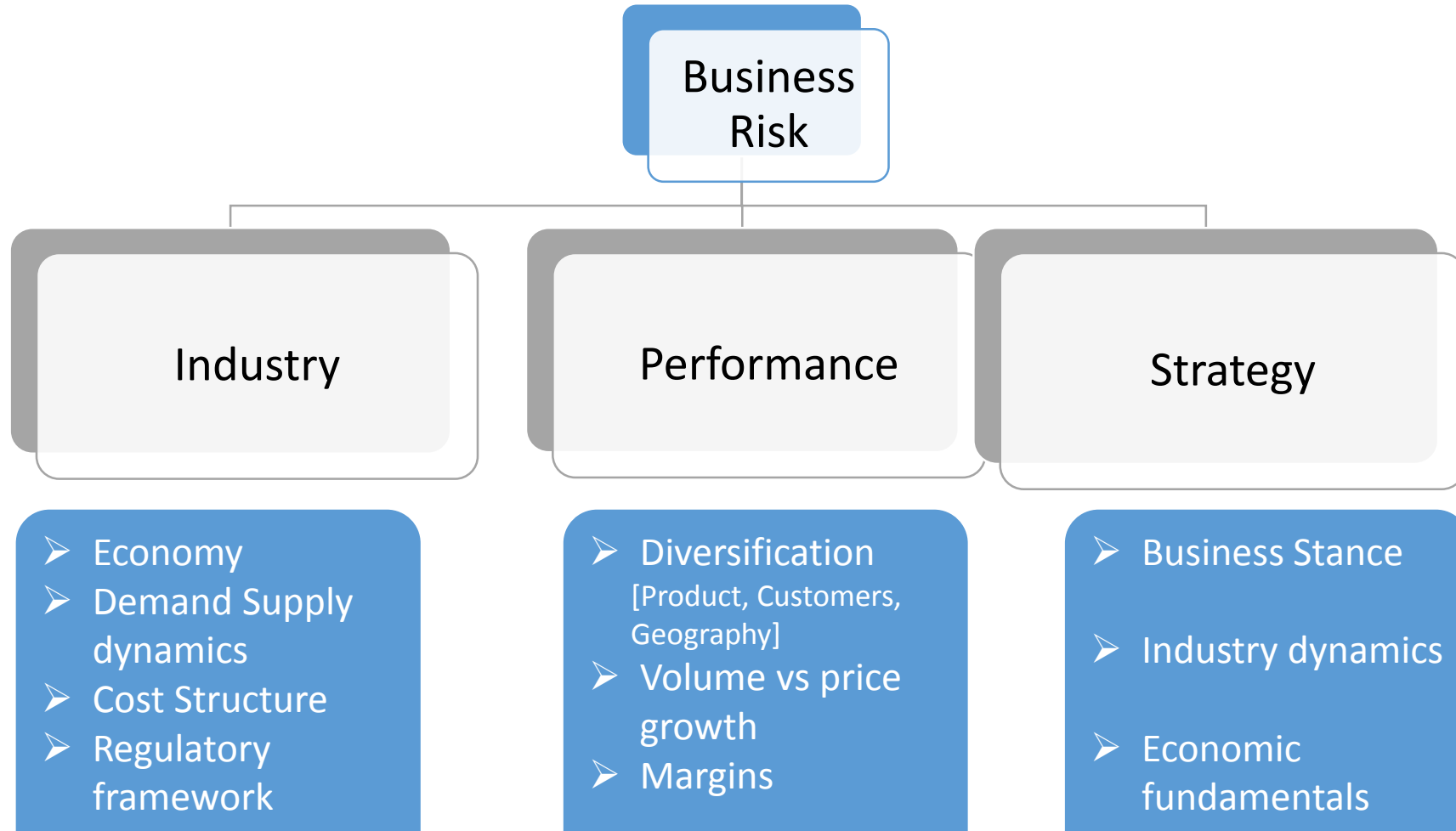
- Educational background & experience
- Reputation/ Integrity

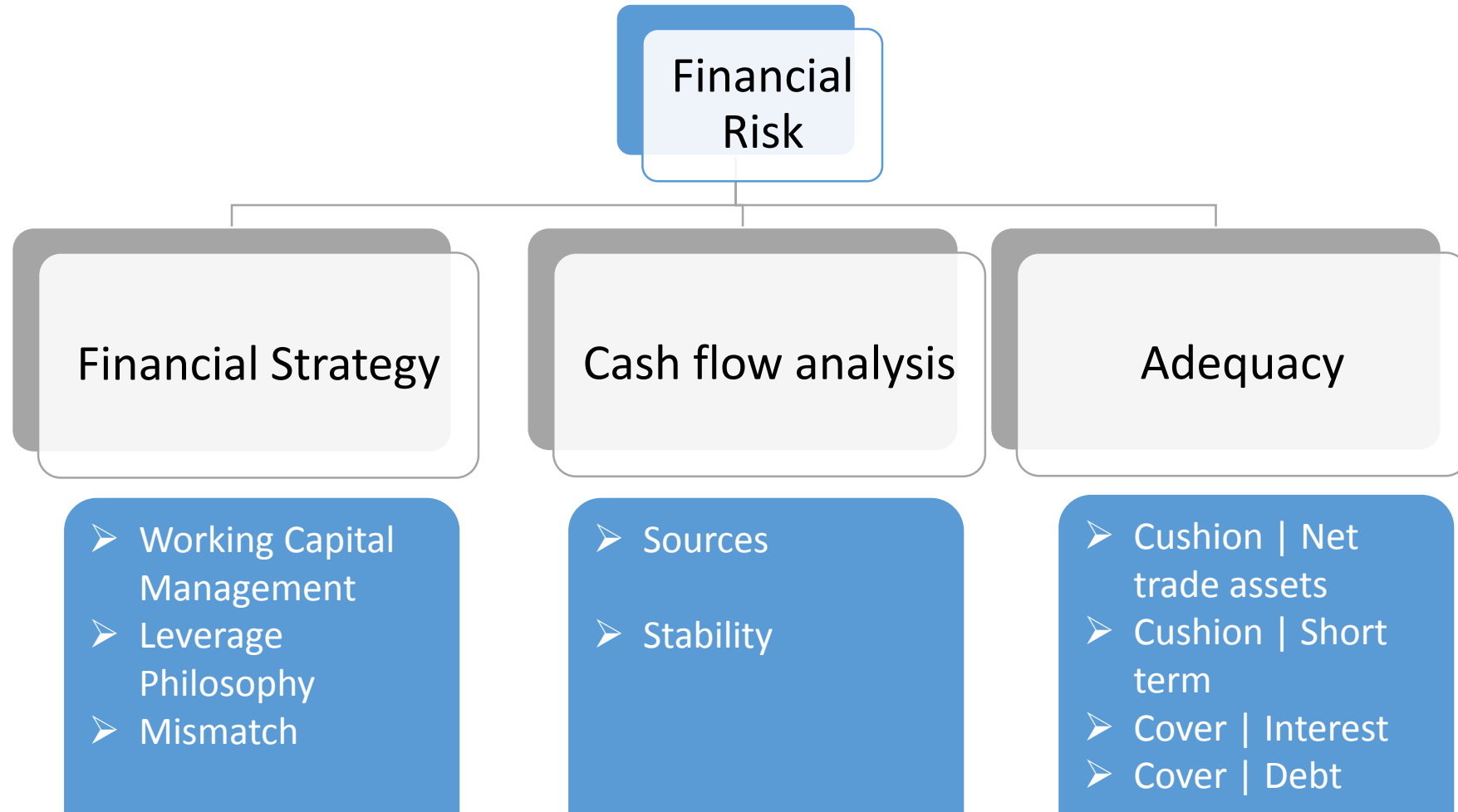
Stability

- Staff turnover
- Key-man Risk

Operational Risk

- Policies & Procedures
- MIS reporting





Assess the ASSET

Rating Factors

Quality

Sufficiency

Recovery

BBB

A+

D

CCC

AA-

A2

BB

Rating Methodology

Quality of Expected Cash flows | Asset Risk

- Underlying Assets are unique and so are the cash flow ; this requires analysis of ability of assets to generate cash flows
- Likely changes in cash flow pattern in response to economic, industry, and entity specific factors
- Data heavy analytical approach; analysis of past trends and future projections of cash flows from securitized assets

Rating Methodology

Sufficiency of Expected Cash flows | Payment Risk

- Adequacy or timing of cashflows vis-à-vis payment terms
- Quantum of cash flows to meet commitments – full cash flows or carved out cash flows
- Evaluation of payment structure – right and priority of investors to receive cashflow
- Availability of credit enhancement

Rating Methodology

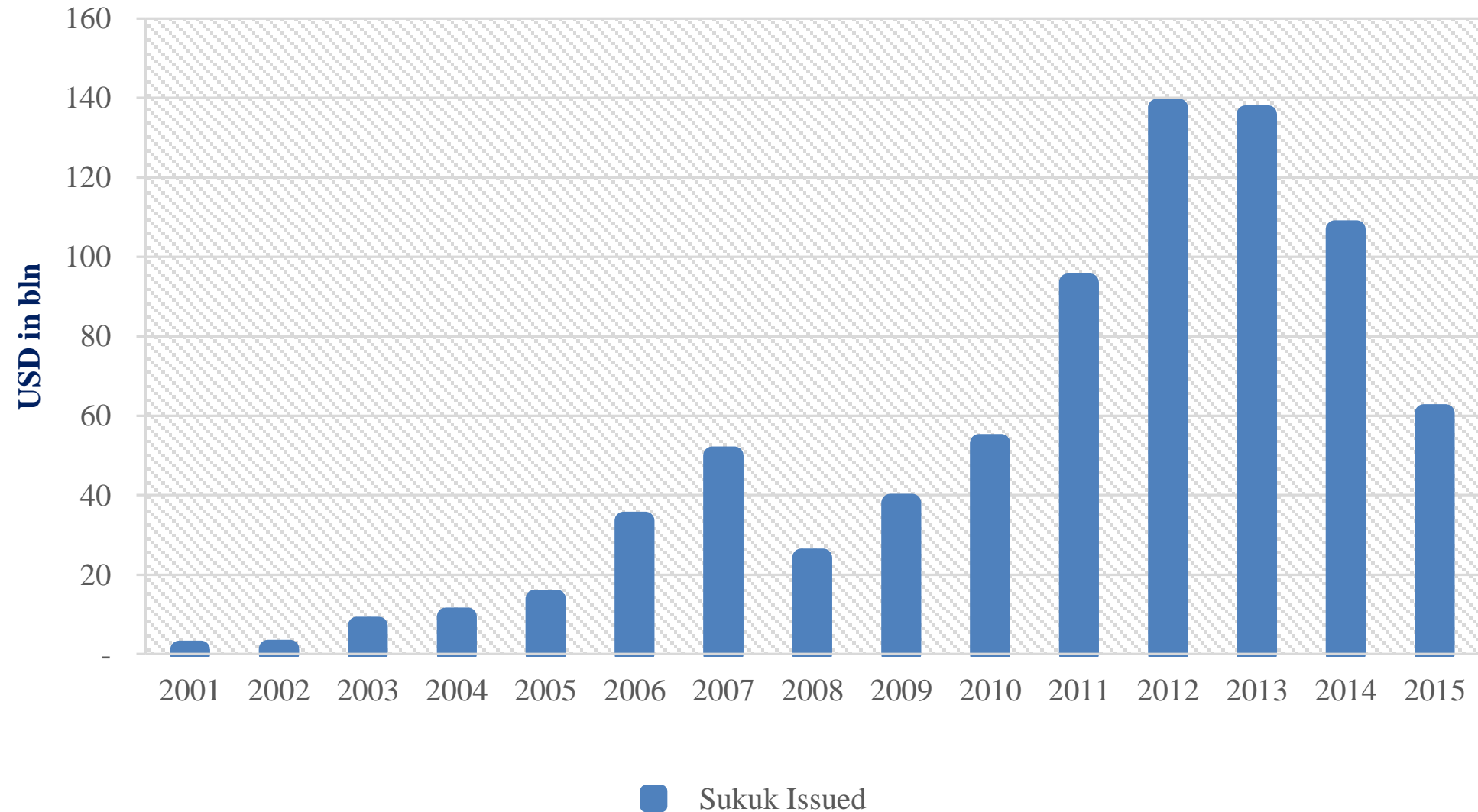
Potential of recovery

- Legal structure for sale and realization of Sukuk assets
- Loss in case of default

Sukuk Market | Statistics

Global | Sukuk Issuance trend

2001-2015



Sukuk Issued 2001-2015					
Issuer Mix			Total		
Geography	Corporate	Sovereign	US\$ bln	Mix %	
International	71	78	149	19%	
Domestic	184	435	619	81%	
Total	US\$ bln	255	513	768	100%
	%	33%	67%	100%	

Sukuk Issued 2015					
Issuer Mix			Total		
Geography	Corporate	Sovereign	US\$ bln	Mix %	
International	8	13	21	35%	
Domestic	15	25	40	65%	
Total	US\$bln	23	38	61	100%
	%	38%	62%	100%	

Outstanding Sukuk End 2015					
Issuer Mix			Total		
Geography	Corporate	Sovereign	US\$ bln	Mix %	
International	40	50	90	28%	
Domestic	117	114	231	72%	
Total	US\$bln	157	164	321	100%
	%	49%	51%	100%	

Sukuk Modes | Trend

Sukuk Issued 2001-2015					
Structure Mix			Total		
	Intl	Domesti	US\$ bln	Mix %	
Sukuk Al Morabaha	7	352	359	47%	
Sukuk Al Ijarah	58	97	155	20%	
Sukuk Al Musharakah	12	80	92	12%	
Sukuk Al Wakalah	44	6	50	7%	
Hybrid & Others	18	26	44	6%	
Bai Bithaman Ajil		35	35	5%	
Sukuk Al Modharaba	9	12	21	3%	
Sukuk Al Salam	2	6	8	1%	
Sukuk Al Istisna		4	4	1%	
Total	US\$bln	150	618	768	100%
	%	20%	80%	100%	

Sukuk Issued 2015					
Structure Mix			Total		
	Intl	Domesti	US\$ bln	Mix %	
Sukuk Al Morabaha	1	25	25	41%	
Sukuk Al Ijarah	3	6	9	14%	
Sukuk Al Musharakah		3	3	5%	
Sukuk Al Wakalah	13	3	16	26%	
Hybrid & Others	3	1	4	7%	
Bai Bithaman Ajil			0	0%	
Sukuk Al Modharaba	2	2	3	6%	
Sukuk Al Salam		1	1	2%	
Sukuk Al Istisna			0	0%	
Total	US\$bln	21	40	61	100%
	%	35%	65%	100%	

OUTSTANDING SUKUK MAP



The size of the outstanding Sukuk market globally as of 23 Apr 2016



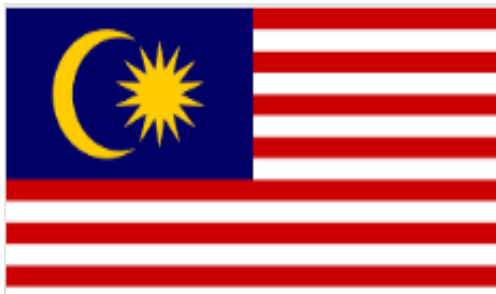
Issuance Currency 2001-2015	%	Issuance 2001-2015	Domestic	%	Intl	%	Total	%
MYR	64%	Malaysia	486	79%	30	20%	516	67%
USD	18%	GCC	72	12%	97	65%	169	22%
GCC	10%	Others	60	9%	22	15%	82	11%
Others	8%							
Total	100%	Total	618		149		768	

Outstanding Sukuk Issues	
Amount outstanding (End -2015)	USD 321bln
No. of Issues Outstanding	2,411

Top three countries

Malaysia

Amount Outstanding :
USD 168bln
No. of Issues: 1,798



Saudi Arabia

Amount Outstanding:
USD 54bln
No. of Issues: 73



UAE

Amount Outstanding:
USD 32bln
No. of Issues: 58

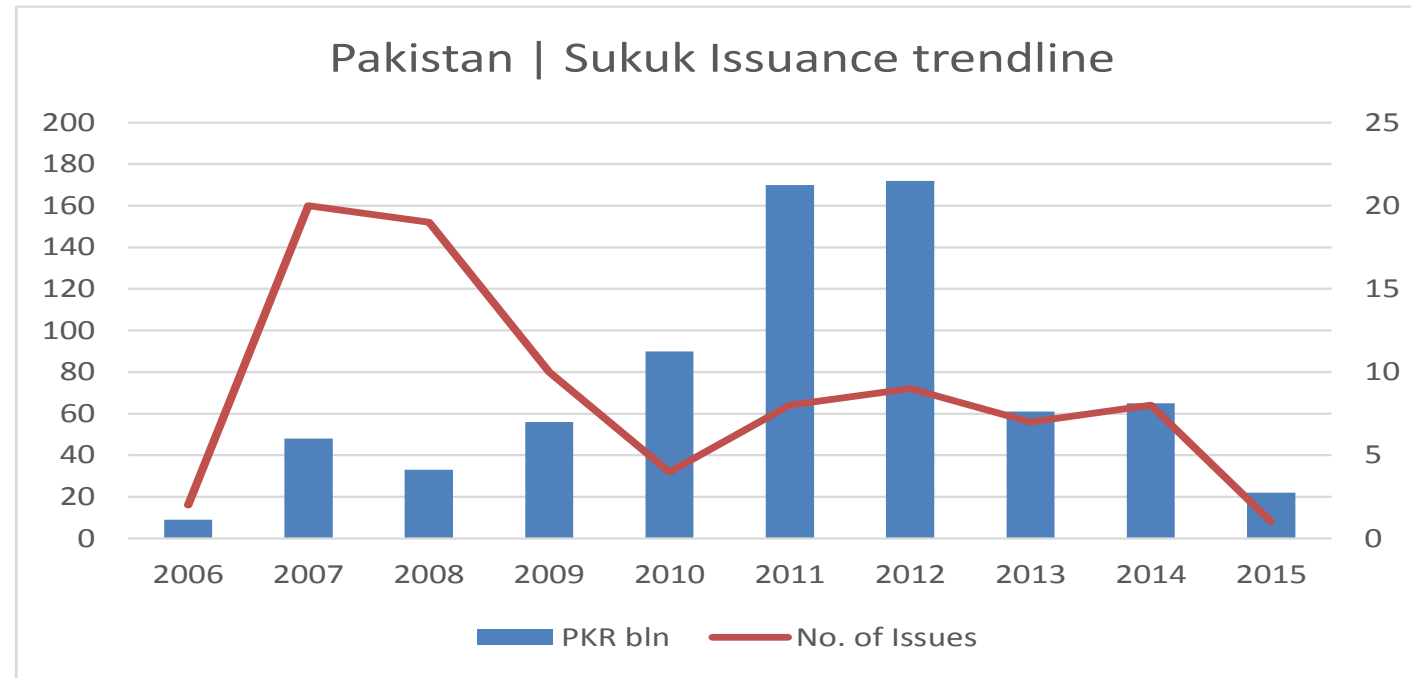


Sukuk | Statistics



	No. of Issues	PKR bln
Privately Placed	82	694
Listed	6	32
Total	88	726

Corporate	Sovereign
11%	89%



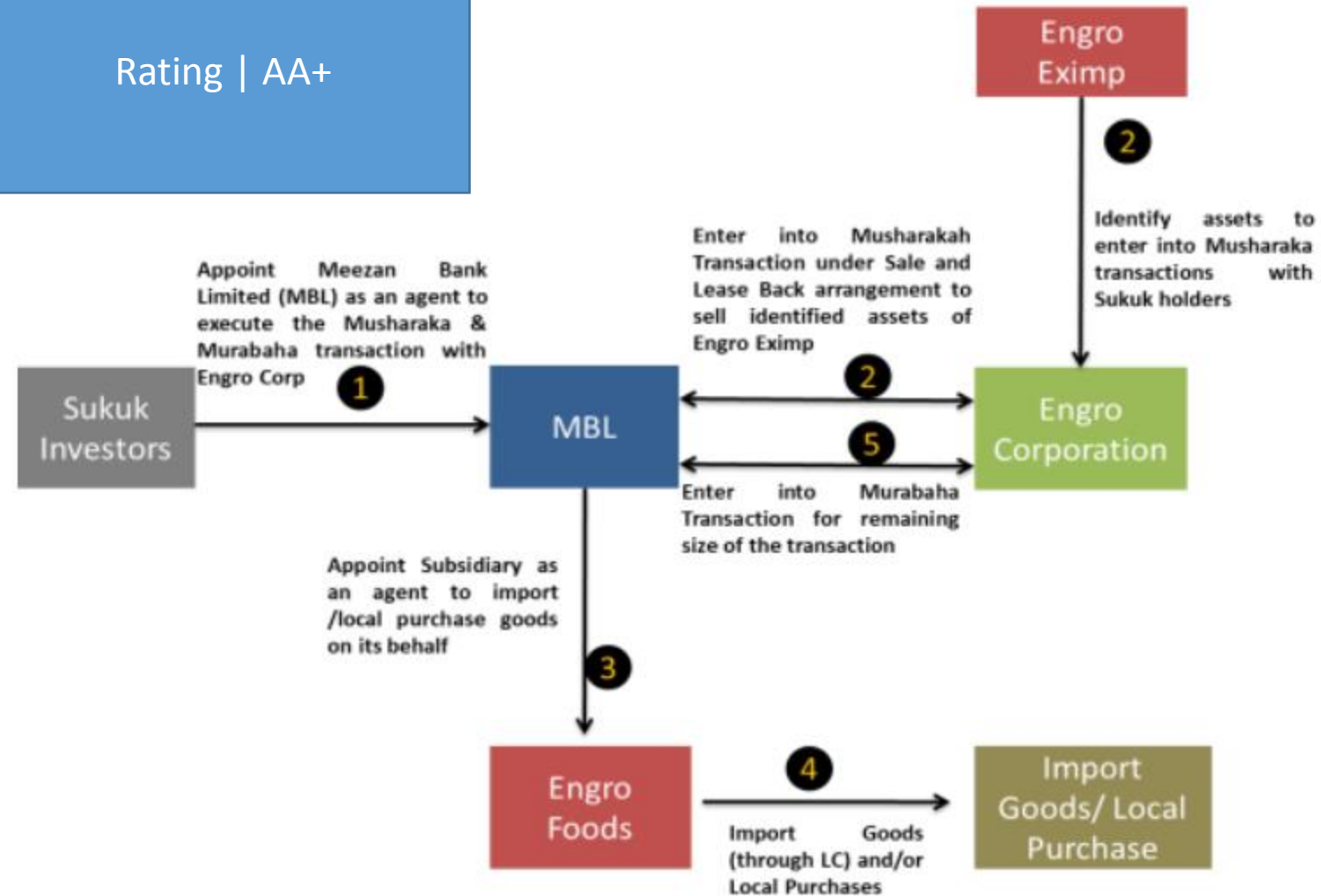
Sukuk Rating | Case Studies



Sukuk Ijaratul Musha & Murabaha Transaction Structure

Rating | AA+

Sukuk holder will assume proportionate ownership in Pool of assets which consists of assets leased (Identified plant & machinery of Engro Eximp) to Engro Corporation and Murabaha sale transactions (Milk, Rice or any other raw material to be purchased). The profit accruing from the lease and Murabaha transactions will be distributed to the Sukuk holders on profit payment dates.





Sukuk | Key Rating Factors

Engro is Pakistan's leading conglomerate. It has significant interest in Pakistan's fertilizer, food, and energy segments. It has evolved an efficient holding structure. Engro Corporation is the parent with separate subsidiaries for each line of business.

Ownership: Engro Corp is majority (above 40%) owned by Hussain Dawood group, an established business family of Pakistan.

Governance: The group puts lots of emphasis on nurturing good governance practices. Boards of its different companies are characterized by diversity and depth of experience profile of its members.

Management: Engro follows well laid structures. It has seasoned management teams with robust profiles for their respective assignments.

Business Risk: The group's fertilizer business is having stellar performance. This emanates from consistent availability of key raw material (natural gas) in recent periods. It carries aggressive market penetration stance in its food business. Hence, though profitable, volume focus keeps bottom line contribution low. Energy generation business provides stable income. It has few struggling segments. With enhanced profitability and diverse asset slate the group looks out for growth.

Financial Risk: The group faced financial stress few years back owing to debt driven significant expansion in its fertilizer business. Here cash flows took more than expected time to yield decent coverages. Now it enjoys decreasing leverage and robust financial cushion.

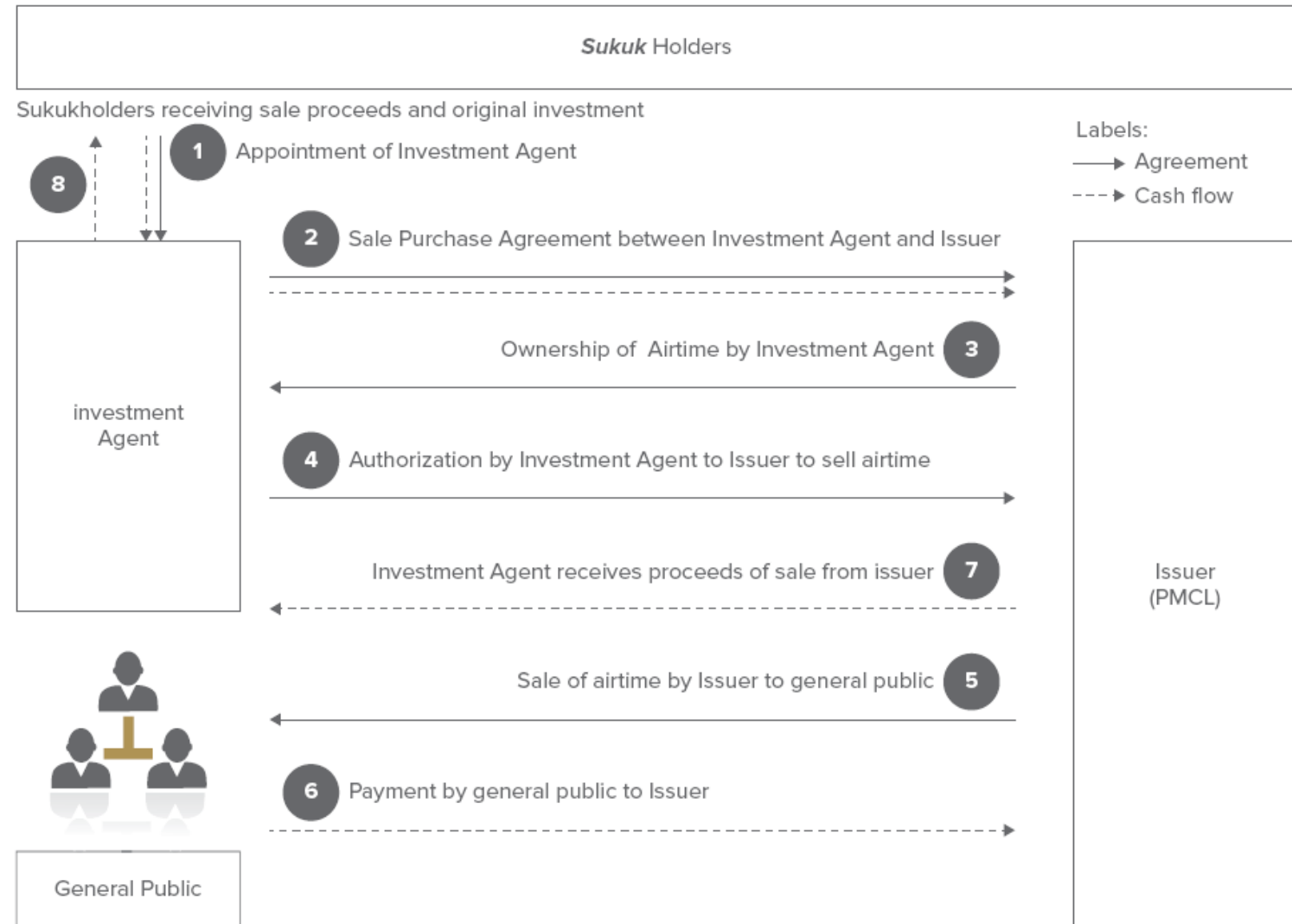


Mobilink

Rating | AA-

Pakistan Mobile Communication Limited (PMCL) Sukuk is Pakistan's first airtime based Sukuk. This airtime Sukuk is backed by underlying ownership in airtime - prepaid cards. The repayment of the Sukuk will be through sale of prepaid cards of PMCL. Where the Investment Agent, on behalf of the financiers has agreed to purchase airtime from PMCL against payment of the purchase consideration. PMCL will continue to sell these prepaid cards on behalf of the Investment Agent according to the due payments.

Ijarah Sukuk





Sukuk | Key Rating Factors

Pakistan Mobile Communications Limited (Mobilink) is the largest cellular telecommunication service provider in Pakistan. It enjoys ~30% market share.

Ownership: The ultimate sponsors of the company are Vimpelcom (a Russian origin group) with 51% holding.

Governance: The seven-member Board of Directors (BoD) is majorly composed of representatives from Vimpelcom. The board comprises highly qualified and experienced professionals holding senior positions in group companies.

Management: Mobilink has an experienced management team with requisite background and qualification. It has witnessed changes at the positions of CFO, CCO and CTO in CY15. However, the parent now retains the ability to draw talent from a global pool.

Business Risk: During CY15, PMCL's top-line largely remained the same, with slight improvement in ARPUs. Going forward, the company would continue its efforts to strengthen its margins. Merger with Warid (the smallest of Pakistan's five operators telco industry) is in process. This should bring cost efficiencies, increase market share, and add 4G services to PMCL's product portfolio.

Financial Risk: The company maintains reasonably good cash conversion ratio; though it has declined considerably YoY (FCFO adjusted for WC/sales Sep15: 24%; Sep14: 46%) due to increase in working capital requirements. Free cash flows of the company witnessed decent improvement; resultantly improvement in coverages. The company continues to enjoy negative net cash cycle (Sep15: -73days) mainly benefiting from stretched creditors' days as agreed with the suppliers. PMCL's capital structure, though improved, remains leveraged and is expected to increase further post-merger (Debt/Debt+Equity Dec16(E): 74%; Sep15: 56%).

Sukuk Rating

Conclusion

Islamic Finance | Significant growth potential

Sukuk | Instrument of choice to broaden investor base

Sukuk Issuance | Concentrated in few regions [Malaysia and GCC]

Risk Disclosure | Gradually increasing rating penetration ; regulatory push

Rating Asset backed Sukuk | Analysis of cash flows emanating from underlying assets

Rating Asset based Sukuk | Analysis of issuer – ownership, governance, management, business and financial risk

Recovery | Questions remain regarding sukuk's treatment in bankruptcy ; the interaction between religious and secular laws make any means of redress more uncertain and less straightforward

Loss given default | With recourse to assets in Asset backed Sukuk, recovery should be high; Sukuk holders loss (being at par with unsecured creditors in case of Asset based Sukuk) will be high

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PAKISTAN CREDIT RATING AGENCY



TWENTY YEARS OF KNOWLEDGE JOURNEY

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