

The Pakistan Credit Rating Agency



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Preference Shares Rating

Criteria

Methodology

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Summary

PACRA’s methodology documents lay out the umbrella framework guiding its credit ratings. This document describes PACRA’s approach to rating preference shares, a hybrid instrument with both debt and equity-like characteristics. While a preference share rating is done in the same manner as any other instrument rating, a critical element is the assessment of the individual features of an issue to determine the degree of protection it offers to investors versus issuers.

Since ratings depict the risk to investors, the more protection the terms offer for the investor, the higher the rating will be. PACRA begins by determining the issuer’s debt repayment capacity, adjusted to reflect the financial impact of preference shares dividend obligations on the issuer’s financial profile. Given the subordinated nature of preference share dividends, this is usually followed by further notching down, the extent of which depends on the terms and conditions of the issue.

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Introduction

In accounting terms, preference shares are classified as equity. Preference shares, however, are hybrid instruments as they possess characteristics of both debt and equity instruments. Like traditional fixed-rate debt, they pay a fixed-rate dividend. However, like equity instruments, an issuer reserves the right not to pay any dividend on preferred shares. Thus, preference shares offer greater financial flexibility to the issuer than traditional debt. While in the case of debt, failure to make a due payment would trigger a default, there is no recourse against non-payment of the preference share dividend when it falls due. Further, if and when dividends are paid out, preferred shares have an advantage over ordinary shares in terms of priority order of dividend payments. Hence, they are considered riskier than debt but less risky than ordinary shares from an investor’s point of view. The following are the features of preference shares:

Redemption

The term “redemption” refers to “repayment”. Redemption of preference shares occurs when the issuer pays back the entire amount due to preference shareholders.

Permanence

Equity is perpetual in nature. The issuer has no legal obligation to buy back the equity. Even when winding up, equity holders will only be paid if there are resources left after settling all other liabilities. Hence, equity fortifies the issuer’s risk absorption capacity. On the other hand, debt does not provide any loss absorption as it is time-bounded and has to be repaid, regardless of the issuer’s financial condition.

Legal obligation to service

Debt servicing is mandatory for the issuer. While the issuer may choose to delay or cancel dividends on preference shares. In case of cumulative preference shares, the dividends can be accrued and paid at a later date once all other liabilities have been settled. Meanwhile, dividends on non-cumulative preference shares are cancelled if not paid in any particular period. Since debt has to be serviced regardless of the financial condition of the issuer, it provides no risk absorption capacity. Hence, PACRA considers preference shares more flexible and believes that they augment the issuer’s financial profile more than traditional debt.

	EQUITY	HYBRID (PREFERENCE SHARES)	DEBT
Permanence:	Perpetual	Based on tenure	Based on tenure
Legal obligation to service:	None	As per the agreement	Yes
Risk absorption capacity:	Very high	Moderate	None



Types of Preference shares: There are several types of preference shares:

REDEEMABLE & PERPETUAL:	CUMULATIVE & NON-CUMULATIVE:	CONVERTIBLE & NON-CONVERTIBLE:
<p>Redeemable shares are issued for a definite period of time and are redeemed by the issuer in cash. Redemption may be done at a predetermined price.</p> <p>Perpetual shares have no maturity date. Perpetual preference shares will continue paying dividends indefinitely.</p>	<p>Dividend payments on cumulative preference shares, if not paid, are accumulated and have to be paid before any payment is made out to ordinary shareholders.</p> <p>Dividends on non-cumulative preference shares do not accumulate if not paid.</p>	<p>Convertible shares are shares that can be transformed into ordinary shares given certain conditions/events (for instance, an IPO).</p> <p>Non-convertible shares, naturally, do not possess the right to transform into ordinary shares.</p>

Other types of preference shares include zero coupon and participatory preference shares. They have distinct features and are considered accordingly.

It is pertinent to note that instruments favor issuers at expense of the investor, and vice versa. Hence, equity-like instruments, which are beneficial to issuers as explained above, carry the highest risk for an investor. Hence, they will have the lowest ratings from an investor's point of view.

Preference shares may fall under any of the three categories, equity, hybrid, or debt. PACRA decides on the placement depending on their individual characteristics. Based on their characteristics, preference shares are notched down from issuer rating:

CUMULATIVE/CONVERTIBLE:	CUMULATIVE/NON-CONVERTIBLE:	NON-CUMULATIVE/CONVERTIBLE:	NON-CUMULATIVE/NON-CONVERTIBLE:
<p>Dividend on such shares accumulate instead of being cancelled which is a positive rating factor. However, convertibility can be either positive or negative for the investor depending on which party has the right to exercise the conversion. PACRA normally views conversion option with investor as positive, while mandatory conversion or conversion at issuer's discretion is usually considered negative.</p>	<p>PACRA generally considers such preference shares as superior to other types since there is no conversion provision and the dividend accumulates.</p>	<p>These carry higher risk as investors may never receive any dividends. The final rating depends on which party has the right to exercise the conversion as explained above.</p>	<p>Non-accumulation of dividend is a negative, while, non-convertibility is generally positive from an investor's stand point.</p>

Rating Preference Shares

Ratings of preference shares reflect the relative risk that the issuer will not be able to make dividend payments and redeem as per the agreement. For any given preference shares rating, the entity rating of the issuer is used as a baseline (also called the issuer rating). In case the issuer is unrated, PACRA first arrives at a baseline rating. The preference shares rating is then “notched” either higher or lower compared to the corresponding issuer rating.

Issuer Profile

While forming an opinion on an issuer, PACRA evaluates the underlying entity as per the specific methodology applicable to it. For instance, for an industrial corporate issuer, Corporate Rating Methodology would apply, while for an independent power producer, IPP Rating Methodology would be used to arrive at the entity rating of the issuer. While determining the issuer rating, it is important to understand that preference shares may have a potential economic impact on the overall financial profile of the issuer. The dividend due each year will dent the issuer's profitability, and in turn, its risk absorption capacity. Hence, it is necessary to incorporate this impact in the issuer rating. For this purpose, PACRA updates the issuer’s coverages by including dividend payable on preference shares along with debt servicing components. The issuer rating is then adjusted with modified debt service coverages and other ratios.

Preference Shares Rating Considerations

Preference shareholders have a right to dividends and principal repayment, which is subordinate to debt-holders but superior to ordinary shareholders. Hence, PACRA’s credit rating for preference shares will usually be below the adjusted issuer rating. PACRA adjusts this rating depending on the individual terms and conditions and features of the preference shares.

The extent of notching down is dictated by the terms and conditions of preference shares. The closer it is to debt in its characteristics, the less will be the notching down. Meanwhile, if preference shares replicate equity in their characteristics, it will be further notched down from the issuer rating. The table below explains the relationship:

	CUMULATIVE	NON-CUMULATIVE
Convertible	2 notches	2-3 notches
Non-convertible	1-2 notches	2-4 notches

PACRA uses this grid as a general guide. The actual ratings may differ depending on the terms and conditions of the preference share issue. Since ratings depict the risk to investors, the more protection the terms offer for the investor, the higher the rating will be, and vice versa. Moreover, PACRA may draw exceptions from this grid depending on the issuer’s financial profile. Issuers rated in the BBB and higher rating categories have a superior ability to repay their obligations. Hence, the distance between ratings of such issuers and their preference shares tends to be less. Whereas, for issuers rated in the speculative band are exposed to higher risk. Therefore, PACRA deems their preference shares as even riskier, and the notching down tends to be greater.

Rating Changes

The ratings assigned as per the aforementioned criteria may change from time to time. As these are linked to the issuer rating, any change in the issuer’s ability to meet financial obligations will have a direct impact on the preference shares rating. However, preference shares rating may also change without any change in issuer ratings. For instance, when

preferred dividends are not declared, PACRA generally downgrades the preference shares rating to reflect the non-payment situation. Further downgrades may occur under the following circumstances:

- Overall rating of the issuer may be downgraded as a result of a negative situation that relates to the decision not to pay preferred share dividends
- Expectation that non-payment of dividends may continue in the coming periods

Default

According to PACRA's definition, a dividend payment missed or delayed does not constitute default. Also, any conversion by predetermined terms is not regarded as default. Default on preference shares occurs in the following cases:

- The firm is forced into bankruptcy
- Contractual obligations (such as sinking fund payments or principal redemption) are not met
- Preference shareholders are forced to exchange the issue with one of lower economic value

Surveillance

Once preference shares are issued, PACRA undertakes a formal review once every six months. Surveillance frequency may be higher depending on the unique characteristics of a particular issue. PACRA also establishes a relationship with the issuer to monitor its performance.

Rating Scale

The methodology explained above results in a rating of preference shares on the PACRA's issuer rating scale. To distinguish this rating from that of the issuer, PACRA uses the suffix 'pf' along with the ratings.

Preference Shares Rating

Preference Shares rating reflects the relative risk that the issuer will not be able to make dividend payments and principal redemption on the preference shares as per the agreement.

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

*Where "pf" denotes preference shares

Rating Modifiers | Rating Actions

<p>Outlook (Stable, Positive, Negative, Developing)</p> <p>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'.</p>	<p>Rating Watch</p> <p>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.</p>	<p>Suspension</p> <p>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.</p>	<p>Withdrawn</p> <p>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.</p>	<p>Harmonization</p> <p>A change in rating due to revision in applicable methodology or underlying scale.</p>
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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. Rating actions may include "maintain", "upgrade", or "downgrade".

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