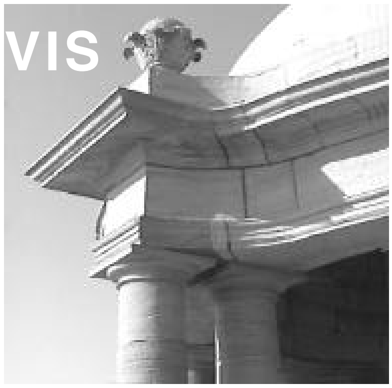
JCR-VIS



LODGING INDUSTRY

Rating Methodology

The fundamental goal of JCR-VIS' credit analysis is to determine the probability of timely repayment of any debt. The obvious focus is on the sufficiency of current cash reserves and future cashflows to meet obligations. JCR-VIS factors in four key parameters of cashflows, namely, strength, volatility, predictability and restrictions.

JCR-VIS also looks at the nature of the industry to see whether it is cyclical or non-cyclical. Non-cyclical industries are not largely affected by changes in the economy. On the other hand cyclical industries have a few defining traits such as correlation of sales volume and price with any macroeconomic indicator like GDP or interest rate. Usually such companies are fixed-capital intensive and require regular capital expenditures. Their profitability is relatively more sensative to unit costs and they lack control over market prices (if there are a large number of market participants). These traits lead us to infer that the company operating in a cyclical industry will generally experience a growth in sales and earnings disproportionately higher than the expansion in economy. Conversely, the decline will be disproportionately larger than the contraction in the economy. Accordingly, in an economic upturn, the company operates at higher capacity levels to benefit from economies of scale (low fixed cost per unit and high marginal revenues).

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In comparison with a non-cyclical company, a cyclical one will typically exhibit higher volatility and lower predictability in cashflows. Strength is dependent on the performance of the economy whereas restrictions stem from the policies of the regulatory authorities towards the industry in which the company operates. Restrictions can also be in the form of covenants by creditors or shareholders that may affect cashflows.

Strength refers to potential of available cashflows to service debt and meet capital expenditure or other obligations. We estimate strength by calculating historical and projected cashflow coverages at various operating levels to assess the ease with which the company carried out/will carry out its investment and debt repayment.

To ascertain volatility - the variability of cashflows across business cycles due to sensitivity to economic factors - we interpolate downside and upside scenarios of sales and earnings based on various phases of the cycle. Predictability refers to actual cashflows being above or below what is expected from typical business cycles due to non-cyclical factors. We judge this by studying the dynamics of the industry and assigning weightages to various non-economic factors. For example, adverse geopolitical conditions might have a greater impact on the lodging industry than the economy.

The high level of uncertainty associated with cyclical companies necessitates better credit-protection measures and/or risk mitigants through a cycle, than for a non-cyclical company. For example, a company that is a low-cost commodity producer, or service provider, will generally be able to outlast its high-cost competitors in an economic downturn. Similarly, a higher business risk can be set-off to some extent by lowering financial risk. A company can contain its financial risk by lowering its leverage. For cyclical companies the attention is more on alternative sources of cash it can potentially tap, like equity floatation or asset sales, during economic downturns to avoid excessive borrowing.

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SECTOR OVERVIEW

The two major factors affecting the lodging industry (LI) are leisure and business travel. The former is dependent on the country's tourism industry and its dynamics, whereas the latter has obvious correlation with business activity in a country. Per-capita income and availability of discretionary income also impacts the leisure industry.

Unfortunately, progress of Pakistan's LI has been afflicted by several adverse factors. Geopolitical tensions in the South-Asian region, as well as volatile law and order situation, have led to the exodus of both expatriates and international travelers. Tourism and foreign investment in Pakistan have suffered accordingly. Thus, demand for hospitality has remained weak in the recent past and occupancy rates continue to fluctuate around the 50% mark.

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Despite its problems, the industry has shown resilience and continues to grow, albeit sluggishly. Growth in the organized sector of the LI has been observed in the form of additional rooms to existing properties, new properties of existing hotels and completely new hotels. In the upscale segment established hotels like Inter Continental (now Pearl Continental), Sheraton and Avari are joined in competition by new entrants like Serena. However, this five-star category remains largely dominated by the Hashoo Group, which owns and operates the Pearl Continental Hotels and the Marriott franchise. The mid-scale segment of the LI also persists, providing standard accommodation at reasonable prices. It has not been affected greatly by the reflux of international travelers, as it caters primarily to a local customer base.

Amongst the discernable trends in the upscale segment of the LI are the changes in its clientele. The number of local customers has grown to be more than foreigners, while the ratio of leisure to business clients is more tilted towards business. Ballrooms have been remodeled to serve as convention and conference halls and marketing is strongly directed towards multinationals, corporates and businessmen. There is also emphasis on revenues from food and beverage (F&B) sales in addition to room sales. Recent opening of authentic restaurants, extensive promotion schemes and events (like food-festivals) are initiatives in this regard and upscale hotels have recently been earning around half their revenues from F&B sales. Other complements of upscale lodging services include event management, entertainment, health-clubs, laundry, bakery, travel agency and tourism. Some five-star hotels have managed to win as much as ten percent of their total revenues through provision of such aforementioned ancillary services. These services are also being used as marketing tools to attract potential customers.

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Other trends in the upscale lodging sector include a renewed focus on branding, customer loyalty programs, reservation systems, yield management systems, and back-to-back room bookings for corporates.

ANALYTICAL FRAMEWORK

This rating methodology applies to operators of lodging facilities in the organized sector in Pakistan, which include both local and international chains. A hotel's diverse clientele includes tourists, businessmen, guests of multinational companies and airline crews. Lodging is a service indus-

MACRO ENVIRONMENT

Economic Climate
Political Climate
Occupancy Trends

INDUSTRY SPECIFIC CONSIDERATIONS

F&B and Ancillary Services Trends
Cyclicality & Seasonality
- *Income Source Diversification*
- *Geographical Diversification*
- *Fixed Income Revenues*

Manpower
Quality and Location of Lodging Properties
Capex Strategy
Brand Equity
Franchise and Brands
Quality of Management
Revenues & Costs

STANDARD RATING CONSIDERATIONS

Profitability and Cash Flows
Capital Structure and Liquidity
Budgets & Projections
Internal Control & Audit
Management Information Systems
Sponsor Support

try and as such has a significantly different set of dynamics from those of a manufacturing industry. Any sustainable competitive advantage over other lodging companies will support the rating if it translates into a higher market share and more control over supply and prices.

Economic and Political Climate

The LI is affected by Government's fiscal policies, which may be supportive or suppressive. Import restrictions, tariffs and high taxation may create hurdles in operations whereas tax holidays, cheaper interest rates and excellent infrastructure can accelerate the industry's growth.

A variety of adverse political factors may retard the LI's growth. Risks like political uncertainties, civil commotion, terrorism and impact of international events can cause well-performing companies to falter, and discourage prospective investors and entrepreneurs. Large companies are often better off when faced with adverse economic conditions as they usually have financial resources, or access to these, to fall back upon for extended periods and have enough fixed assets to raise funds through sale or mortgage. However, it may not always be possible to sell a property, especially if it is perceived to be an unviable prospect.

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Occupancy Trends

The foremost objective of the analysts at JCR-VIS is to ascertain the prospects for leisure and business travel in the country, the two broad client segments of the LI. Bright prospects can serve to support the ratings, as strong future demand will lead to growth of the industry and the company under review.

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The occupancy rate, which is the ratio of number of rooms let to the number of rooms available, is the best indicator for demand. Our analysts study highest, lowest (worst case) and average annual occupancy rates and then utilize them for trend analysis and estimating the market share. It is imperative to look at the company under review vis-à-vis its competitors as changes in its relative cost and market share could spell survival or bankruptcy. In a competitive environment, chances are that only companies with stable/increasing market shares and lower-than-average industry costs will be able to stay afloat.

F&B and Ancillary Services Trends

Since more than half of the LI's revenues are attributable to F&B and ancillary services, it is relevant to study these trends. These include cultural events and tourism services, wedding banquets, seminars and conferences (trade, professional, educational or political). Business related activities may be noticeably predominant in metropolitan cities, whereas tourism related activities like cultural shows and food festivals are season-related.

Companies that can use restaurants and events to promote their core business of lodging are generally more successful in the LI, while others with ample lodging capacity but lacking in facilities to host large events will lose out on potential revenues and eventually, market share.

Cyclicality & Seasonality

The LI is extremely sensitive to economic changes and thus ratings of lodging companies, like all cyclical companies, seldom fall in higher rating bands (i.e. Double A and above). We review a company's performance through the business cycle to estimate the extent to which revenues and profits can vary, and arrive at a rating which would not ordinarily warrant a rating change as the company moves from one phase of the cycle to the other. Demonstrated ability of a company to withstand prolonged slumps in industry cycle and fuel growth once the trends reverse, is an important rating criteria for JCR-VIS.

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Apart from normal business cycles, LI undergoes the impact of seasonality as it depends heavily on tourist and business activity in the country. With a properly segmented client base, seasonal variations can be smoothened out successfully. JCR-VIS gauges how effectively the company manages through seasonal fluctuations by using appropriate marketing techniques.

JCR-VIS considers the absence of alternative income sources negatively, as hotels with single income sources are highly vulnerable to impacts of cyclicality and seasonality. The company should demonstrate maintaining its cash flows through income source diversification. Examples of other income sources include services such as event management, resort management, tour operations etc.

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Another possible strategy to stave off the impact of cyclicality/seasonality is geographic diversification, which is achieved by establishing a presence in other cities, and especially foreign countries. Our methodology checks for such mitigation of the adverse effects of regional economic or political disruptions through geographic diversification.

Some companies, with requisite managerial, organizational and marketing skills, are qualified to undertake contracts to operate hotels in which they do not have any ownership. The reward for this is either management fees or performance-based incentive fees or both. Renowned international chains, like Sheraton and Marriott, may sell franchise and earn a fixed and recurring income for the use of their franchise. Both contract operators and franchisers benefit in that they have the opportunity to grow quickly without spending a lot of their own capital and are insulated, to some extent, from economic downturns. JCR-VIS studies the mix of fixed and variable income and analyses its hedging benefit.

Manpower

Another characteristic of the LI is that it is labor intensive and requires trained human capital, owing to its status as a service industry. We evaluate the effectiveness of training procedures, competitiveness of pay scales and motivation techniques, provision of cordial ambiance and opportunity for constructive feedback, all of which contribute to the quality and stability of manpower. As is practice in labour-intensive industries, a union of the labour force plays an important role in upholding morale and curtailing employee turnover. We check for the level of harmony between the union and the management, in light of previous disagreements and their resolutions.

Quality and Location of Lodging Properties

The analysts at JCR-VIS give due importance to the hotel's quality and location of lodging properties, as they determine the company's earning power. the quality and location should be in accordance with the company's target market. Properties located in city centers are in a better position to capture repeat business from tourist and business clientele because of the awareness and access afforded by its centrality. Similarly, properties with exclusive rights, like a strip of private beach or a golf course, attract more customers.

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As the dominant form of hotel companies in Pakistan is owner/operators, an additional factor that comes into play is real estate value. In an economic boom the value of the properties go up. Besides the obvious gain, financing can be obtained easily with prime properties used as collateral. However, we recognize that real estate investment is essentially illiquid, and thus might not generate cash when required.

Capex Strategy

Amongst the entry and exit barriers of the lodging business are the huge initial capital expenditure and higher break-even point due to fixed recurring expenses that are necessitated to retain market share and fend off competition. Management's long-term plans generally earmark internal and/or borrowed funds to develop or acquire new properties (strategic capital expenditure). Furthermore, a yearly budget is allocated for renovation of the existing properties (regular capital expenditure), which is typically carried out from internally generated funds. Our analysts study the amount of regular capex required and ascertain whether the cashflows will meet them and still have surplus to partly finance strategic capex.

Huge initial capital expenditure and recurring expenses are necessitated to retain market share and fend off competition

Repairs and maintenance (R&M) expenses - cash spent annually on the upkeep of the properties, fixtures and equipment - are one of the critical heads of operating expenses because the standard of services provided by a hotel needs to be consistently maintained and improved. R&M, like regular and strategic capex, are discretionary in nature and management can delay repairs to preserve liquid resources or perhaps to show better profits. However, continuous deferment might result in loss in productivity and reduced asset life.

Our analysts judge management's willingness or the level of discretion exercised in deciding capex and R&M by using the ratio of sum of capital expenditure and R&M to depreciation. This ratio denotes how effectively the company is maintaining the earning capacity of its assets. A ratio greater than one indicates increasing earning assets and probable future cash inflows.

The quality of market research that a company conducts before it carries out strategic capital expenditure and the probability of success of projects in the pipeline is also analyzed. A consistent project-success record will support the company's rating.

Brand Equity

Brand equity, which is the company's established market reputation, is a critical rating factor as it leads to customer loyalty and recognition, repeat business, hence higher occupancy rates and rising cash flows. A company which can cash in on its established brand equity by charging higher room rates and avoid suffering a fall in occupancy at the same time is considered positively as compared to a company with little or no brand equity. A strong brand also helps to diversify geographically and compete internationally, attract attention of prospective franchisees and win favor of financiers and investors. Similarly, for independent contract operators, strong brand equity improves their chances of winning management agreements.

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Franchise and Brands

Ownership of a reputable franchise is considered positively because a franchise can serve to increase revenues, as international travelers might already be familiar with the brand name. Also, a franchisee can charge a premium on the room rate because of its conformance to international standards. The franchisee benefits from the assistance provided by the franchiser in terms of latest developments in hospitality (knowledge transfer), efficiency enhancements (training etc.), better marketing techniques and ancillary services. To gauge the value of the franchise and its resultant benefits, our analysts study the number of years the franchise has been held, the level of cordiality in the relationship with the franchiser, the conformance to prescribed standards and assistance provided.

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After completion of detailed study of the lodging industry and its dynamics, our analysts study a host of qualitative and financial rating considerations that are standard for most industrial corporates. Qualitative factors include competence and stability of management, sponsor support, IT systems, internal controls and audit etc. For quantitative analysis, an in-depth review of the company's performance over the last few years is carried out with particular emphasis on return ratios and margins. The financial policies that our analysts delve into include dividend-payout and profit-retention policies, capital structure, hedging policies and contingency liquidity plans e.g. unutilized standby lines of credit, access to capital markets etc.

Quality of Management

Success of a company is directly attributable to the management's professional abilities and thus the analysts at JCR-VIS give due weight to the quality of management by taking into account its qualification, experience, and track record. The CEO's vision and strategic direction are evaluated with respect to being realistic and implementable. Ideally, the vision should trickle down to all department heads and especially the lower-level employees.

Demonstrated preventive measures, contingency planning and strategies employed for damage-control after any threatening incident, are indicative of the management's competence, confidence and foresightedness

Our methodology rewards stability in management only if it is competent, otherwise, an ineffective, stable management might retard the company's performance with time. Demonstrated preventive measures, contingency planning and strategies employed for damage-control after any threatening incident, are indicative of the management's competence, confidence and foresightedness. The management style is also taken into account, especially with reference to the authority and responsibility vested in the general managers of the company's properties.

Our methodology checks for effective functioning of the board-level and department-head level management committees. The frequency of the meetings, depth of discussions and the quality of decisions taken by the committees are all analyzed.

Revenues & Costs

The Average Daily Room Rate (ADRR) is the standard yardstick to measure the average revenue per room-night. We measure this by using the ratio of total room revenues to total rooms let in a year. A falling ADRR does not necessarily mean shrinking revenues as occupancy and aggregate revenue might have gone up due to the rate cut. Therefore, an alternate measure - the Revenue Per Available Room (RevPAR), which takes into account occupancy rates as well - is commonly used. A hotel with rising RevPAR is considered favorably as it indicates growth in cashflows over time.

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Cost-control ability of an operator is given due weight in our methodology. Two of the largest heads of operating expenses are payroll and utility charges. Hotels that are able to successfully curtail their overhead and increase efficiency are viewed favorably by JCR-VIS as it enhances their ability to service debt. In addition cost-cutting might also help the company to withstand downturns.

Profitability and Cash Flows

Profitability is an important aspect during our rating exercise. We use trend analysis of margins at various sales levels to read the direction of the company's future. Ratios like Return on Average Assets and Return on Average Equity are used to gauge the earning power of the company's assets and the return on common shareholders' funds. Equity growth, ascertained through the retained earning ratio shows the company's internal capital generation capability.

Although profitability is important, our greatest emphasis is on cash flows. Despite robust profitability, the company may default on its obligations due to a liquidity crunch. Cash flows should be significant enough to meet the debt servicing requirements and regular capex, and still have enough surplus to partly carry out strategic capex and/or dividend payout. A sensitivity analysis of cash flows for probable future scenarios is beneficial in ascertaining impact on coverages. JCR-VIS ascertains whether a lodging company has significant revenue concentration in any geographic region, which might weaken cash flow coverages when faced with a downturn for that region.

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Capital Structure and Liquidity

We analyze capital structure thoroughly by ascertaining the company's various sources of funds and its costs. Furthermore, we study the nature of the source and determine their associated burdens to ascertain the 'true leverage'. For example, although preference shares are equity instruments, they entail fixed payments out of profits giving them essential traits of debt. Conversely, directors' loans often carrying no interest and not having a fixed tenor may be considered to be part of the equity. Our analysis involves studying level of debt that a company utilizes using the leverage and gearing ratios. The company should have enough available room for additional debt to capitalize on new investment opportunities as they arise. The effectiveness of leverage is also tested using financial leverage index i.e. ratio of ROAE to ROAA. We consider unfavorably, any negative covenants on debt that interfere with the company's financial flexibility. The ability to negotiate terms on existing or new loans to suit the company is considered a credit positive by JCR-VIS.

The company should have enough available room for additional debt to capitalize on new investment opportunities as they arise

Liquidity position is gauged by analyzing how successfully the company has matched its funds to maturing and long term liability. Skillful working capital management is essential to meet the maturing liabilities, in order to avoid cash stress.

Budgets & Projections

Budgets and medium-term projections are studied for realistic assumptions and flexibility. Current performance is compared with previous budgets to see the level of variance and the reasons attributed for it. Regular comparisons with budgets highlight management's ability, or inability as the case may be, to achieve its planned targets. As the emphasis of credit analysis is more on the actual cashflows than accounting profits, downside scenarios are prepared and used to estimate the strength, variability and predictability of cashflows.

Management Information Systems

Our rating methodology gives key consideration to Management Information Systems (MIS) and technology. Yield Management Systems help optimize revenues from rooms by helping decide upon the ideal price and occupancy setting. These systems also track customers' preferences and help earn more mileage per marketing rupee. Database systems are mission-critical as all the reservations, inventory and accounting data have to be continuously recorded, consolidated and accessed. Similarly, statistical reports for executive decision-making must be meaningful and readily available.

Yield Management Systems help optimize revenues from rooms by helping decide upon the ideal price and occupancy setting

High quality reservation systems ensure client convenience and build loyalty and repeat business. Affiliation with international hotel reservation systems attracts international travelers and hence give the company a competitive edge.

Internal Control & Audit

JCR-VIS considers the efficacy of internal control an important rating factor. The probability of smooth operations is high in a company where procedures and policies are documented and stringently enforced. The internal audit department and/or external consultants can impose checks and balances at various critical junctions to ensure minimal errors and frauds.

Sponsor Support

Exhibited sponsor support during a liquidity crunch is a positive factor in our rating exercise. This support may be in the form of an equity injection or interest free loan. If the company is part of a larger group, intra-group synergies and assistance are considered positively as in most cases, the group's strength and financial flexibility have a direct impact on the company. If the parent/sponsor, with a credit rating higher than that of the company under review, gives an explicit guarantee of repayment of any maturing loans of its subsidiary, then the rating of the company may be notched upwards to reflect this added measure of safety. Also, we qualitatively consider the merits of implicit support and incorporate it into our ratings. JCR-VIS

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Faheem Ahmad
President & CEO, JCR-VIS
Founder, VIS Group

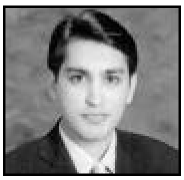
Faheem Ahmad has diverse experience with international consulting agencies in USA & Middle East. He has also held senior positions with local industrial and financial groups. In 1994, he established Vital Information Services (Pvt.) Limited, which is a leading capital market research house. VIS has the largest data bank of corporate Pakistan. His major research work includes copyrighted F&J financial strength rankings, Musharaka Variable Income Securities and stock market indices. VIS group includes JCR-VIS Credit Rating Company Limited and News-VIS Credit Information Services (Pvt.) Limited, the first private credit bureau of Pakistan. The majority of shareholders in group companies include the largest publication house in Pakistan and major financial institutions.

He obtained his B.S in Civil Engineering from NED University of Engineering and Technology, Karachi. He also has Masters degrees in Engineering and Business Administration from USA. His research work has been published in various international journals.

Jamal Abbas Zaidi
Executive Vice President

Jamal Abbas Zaidi has more than three decades of rich experience in financial and general management at the local and international level. Prior to joining JCR-VIS, he was the CEO of a leasing modaraba and a senior executive of the then largest leasing company having IFC and ADB equity. Internationally he worked for World Bank at a multi-million dollar project in Nigeria. He has held key positions in the industrial and financial sectors and has contributed many papers in international and local conferences and workshops. He is also the Vice-Chairman and Director of Islamic International Rating Agency, Bahrain.

He is a Fellow member of the Institute of Cost and Management Accountants of Pakistan.



Mohammad Ali Chawla
Analyst

Mohammad Ali Chawla is actively involved in the ratings of industrial corporates, with particular emphasis on the textile sector. He has also worked on rating assignments concerning financial institutions and islamic finance. Prior to joining JCR-VIS, he was heading the research department at a brokerage company.

He holds a Masters degree in Business Administration from the Institute of Business Administration, Karachi. He is also a candidate for Level II of the Chartered Financial Analyst (CFA) program.

Jahangir Kothari Parade (Lady LLoyd Pier)
Inspired by Her Excellency, The Honorable Lady Lloyd, this promenade pier and pavillion was constructed at a cost of 3 Lakhs and donated to the public of Karachi by Jahangir Kothari to whose genrosity and public spirit the gift is due. Foundation stone laid on January 5, 1920. Opened by Her Excellency, The Honorable Lady Lloyd on March 21, 1921.

Dome: A roof or vault, usually hemispherical in form. Until the 19th century, domes were constructed of masonry, of wood, or of combinations of the two, frequently reinforced with iron chains around the base to counteract the outward thrust of the structure.

Origins: The dome seems to have developed as roofing for circular mud-brick huts in ancient Mesopotamia about 6000 years ago. In the 14th century B.C. the Mycenaean Greeks built tombs roofed with steep corbeled domes in the shape of pointed beehives (tholos tombs). Otherwise, the dome was not important in ancient Greek architecture. The Romans developed the masonry dome in its purest form, culminating in a temple built by the emperor Hadrian. Set on a massive circular drum the coffered dome forms a perfect hemisphere on the interior, with a large oculus (eye) in its center to admit light.

Jahangir Kothari Parade

National Excellence, International Reach

JCR-VIS Credit Rating Company Limited is committed to the protection of investors and offers a blend of local expertise and international experience to serve the domestic financial markets. With its international reach, JCR-VIS is positioned to aim for an international mark. In this regard, the global experience of our principal, Japan Credit Rating Agency, Ltd. has been invaluable towards adding depth to our ongoing research endeavors, enriching us in ways, that enable us to deliver our responsibilities to the satisfaction of all investors.

The edifice of the Jahangir Kothari Parade has stood proudly through the years and is a symbol of our heritage. Its 'Dome' as the most stable of building structures, exemplifies architectural perfection. Committed to excellence, JCR-VIS continues its endeavor to remain an emblem of trust.

JCR-VIS Credit Rating Company Limited

Affiliate of Japan Credit Rating Agency, Ltd.
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