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DRAFT

JCR-VIS
RATING METHODOLOGY

Government Supported Entities

Understanding the influence of corporate relationships is integral to complete credit analysis. As business dynamics continuously reconfigure corporate families, its implications for the investor should be out lined. Different corporate structures give rise to diverse support mechanisms, and the degree of credit enhancement implied by any support agreement varies accordingly. Where support agreements are entirely enforceable and completely dependable, ratings of the supported entity may even be at par with the supporting entity, implying maximum possible credit enhancement. The credibility of the supporting entity is the key variable in the equation. Where the organization being rated is a member of a large corporate family, the influence on this entity may work both ways, i.e. both the stress and support arising from its position within the family, determines its credit standing.

A rating agency analyzes factors that strengthen or weaken the standalone viability of an entity. The inter play of these factors results in a continuum of support levels, that in turn determines the appropriate degree of credit enhancement. Support levels may be distinguished by relative strength of supporting entities. Traditionally, the strongest providers of support have been the governments. Factors influencing the analysis of support agreements are similar for both government and nongovernment relationships. This methodology attempts to distil some of the key features common to most Government Supported Entities (GSEs) and addresses their impact on ratings assigned by JCR-VIS. GSEs are a universal feature, prevalent in all economies, and mostly function as organizations of national importance. Their role often assumes greater significance in a developing economy, where market mechanisms have not matured and the involvement of the state is perceived as being vital to balanced economic growth. The presence of GSEs in Pakistan is a similar phenomenon. Over the period with greater emphasis being placed on market based economy supported by a well planned privatization program, GSEs focus has shifted to areas of strategic and social importance. As such, many of the parameters, relevant in the analysis of a government supported entity has now become fluid. GSEs exhibit a large degree of diversity in terms of their form, financial viability and significance of their role in the national economy, all of which have a distinct effect on the level, commitment and continuity of support for the entity.

Fundamental Analysis

The approach towards analysis of standalone strength and risk profile of a GSE is no different from the general rating approach towards non-GSEs. To arrive at a basic rating, the institution’s inherent strengths and financial risks are analyzed in conjunction with its future strategy. The rationale of the exercise is the evaluation of an entity’s ability to withstand stress incase government support is not forthcoming. The nature of support available to a GSE is then layered into the rating assessment to arrive at an appropriate credit rating. It is worth emphasizing that ignoring external support factors completely, is neither realistic nor useful for an investor, or any other user of credit rating, as support features substantially affect the likelihood of repayment, particularly in times of stress. The significance of external support available to a GSE can also be understood in terms of ‘risk diversification’. As the supporting entity is external to the supported entity and not necessarily affected by the internal credit risks of the entity being rated, its support can be viewed as protection against any eventuality within the GSE itself.

Categories of Support

Support available to all GSEs can be distinguished as being either

1) Explicit support or
2) Implicit support.

Explicit Support:

In Pakistan, many of the public sector entities carry government guaranteed debt. In case of explicit guarantees, it is important to discriminate a 'full faith and timely payment guarantee' vis-à-vis an 'ultimate repayment guarantee'. Where explicit guarantees for timely support exist, GSEs are typically assigned the same rating as the government. In case of a local currency rating assigned on a national scale, federal governments are typically rated 'AAA' and therefore debt obligations that are explicitly guaranteed by the federal government, are rated as equivalents. However, entities as a whole may not enjoy the same rating as the sovereign, if only a portion of total obligations is so guaranteed. JCR-VIS minimizes the rating differential between GSEs and the government, depending on the proportion of explicitly guaranteed debt to total financial obligations. Further, where the guarantee does not ensure timely payment, the rating will be lower than that of the guarantor.

Implicit Support:

Where support is implied, rather than explicit, determining the extent of external credit enhancement, appropriate for the GSE being rated, warrants further deliberation. Having arrived at an assessment of the standalone rating, we assess the extent of support to be expected, and enhance the rating by an appropriate number of rating notches. In case of implied support, standalone ratings are enhanced by a maximum of three notches. We have highlighted below, some of the key points taken into consideration by JCR-VIS, while assessing external support.

Degree of integration/Significance of the GSE's Mandate:

The degree of integration of an entity into the government itself is one indicator for assessing a GSE's significance. Entities that have a constitutionally determined place in the government, or which undertake business that cannot be undertaken on a commercial basis or signify regulatory barriers exist to enter or exit the concerned business, are usually assigned ratings equivalent to the government. In Pakistan's context, certain special industries like armament industries or nuclear facilities may be considered suitable examples. What needs to be determined is the incentive a government may have, to extend timely support. In other words, estimation is required of the cost that the economy may have to bear, in the event of GSE failure vis-à-vis the cost of preventing a default through timely support. This would require an assessment of how a GSE fits into the state machinery and the extent to which it fulfills the government's key policy objectives. Mandates assigned to GSEs may not be long-term in nature. These GSEs may exist only as interim solutions to the requirements of a developing economy. Over time the government's interest in such an entity is bound to diminish. Therefore, possible erosion of the GSE's value to the state must be factored into the assigned rating.

Government Ownership/Control:

The extent of ownership of the government and its involvement in the entity's business affairs may be an indication of the interest exhibited towards the GSE under evaluation. Appointment of board members and/or top management defines the government's stake in the company's wellbeing. Direct majority shareholding or management control of an entity makes it an extension arm of the government and hence the support for its continued operations assumes importance.

Availability of Financial Resources/Track Record:

The financial strength of the government and its continued access to financial markets is a primary concern, which is assessed together with expected strain on these resources due to a large number of GSEs that may be financially distressed. In this respect the total quantum of the government's contingent liabilities should be evaluated to arrive at a measure of expected support to a particular GSE. Form and level of assistance extended in the past may be a relevant indicator in this respect. In many instances, the government may have extended loans or grants to a GSE. The terms of such credits and/or the size of grants provided help assess the degree of support available.

Social & Political Costs:

Allowing a GSE to fail may be accompanied by varying degrees of social cost. Failure of entities that carry public debt or are listed on the stock exchanges may result in severe public recrimination. As such the government may offer different levels of support to these GSEs, depending on its assessment of expected public reaction.

Credit Standing of Supporting Governments:

Government supported entities may not necessarily be directly related to the federal government. Entities supported by a sub-sovereign i.e. provincial governments, or other forms of local government, e.g. municipalities, often feature similar forms of support. The various factors taken into account while evaluating sovereign supported entities are directly applicable to entities owned or controlled by a sub-sovereign. The only point of difference being the relative credit standing of the sub-sovereign, vis-à-vis the federal government. Interesting forms of government supported entities are those set up as joint ventures. In case of a joint venture between two sovereigns, where the GSE is incorporated in one of the sovereigns, a local currency rating of the GSE would also take into account, the international credit standing of the foreign government, and the local currency rating of the country of incorporation. Moreover, the rating considers whether support is available jointly or severally. If the international credit rating of the foreign government is superior to that of the sovereign where the GSE is incorporated, with liabilities denominated in the GSE's local currency, the ratings are appropriately enhanced. In such cases, the standalone rating of the GSE may be enhanced by more than three notches.

Privatization

Privatization of GSEs has significant implications in this regard. While assigning credit ratings, the possibility of privatization over the near term whether partial or complete is to be considered. Though a GSE may continue to assist the government in policy implementation even after privatization, its role in the workings of the public sector would be substantially reduced, thereby reducing or even eliminating the possibility of state support. As such the financial viability of the GSE, in the absence of government support, requires thorough consideration. The credit standing of the buyer will be a critical factor in the post privatization scenario that cannot be evaluated prior to sell off. However, a standalone rating based on intrinsic financial strength, does provide investors with a reliable estimate of the entity's risks, for entities where the government is expected to offload its holding, either through partial sell off or complete privatization. To ease the transition of credit ratings into an entity's post privatization credit standing, JCR-VIS, publicly discloses these standalone ratings.

EXPLAINING THE RATING SCALE

A credit rating is an independent third party opinion of the capability and willingness of an entity to repay its obligation in a timely and complete manner. JCR-VIS assigns both long and short term rating opinions to entities, where long term indicates a period of up to 3 years while short term signifies a period of up to one year. The long-term rating scale is spread across 20 notches from 'AAA' to 'D'; 'AAA' ratings denote highest credit quality and lowest probability of default while a 'D' rating denotes a defaulted obligation. Any rating below the 'BBB' rating band is considered a non-investment grade rating. The short-term rating comments on the liquidity profile and near-term vulnerability of default of the rated entity. Short-term rating scale is spread across 6 notches from 'A-1+' to 'C' with 'A-1+' denoting the highest certainty of timely payments while a 'C' rating denoting doubtful capacity of timely payment of obligations. Relationship between short and long-term ratings has also been developed by JCR-VIS and can be accessed through the following link on JCR-VIS's website (http://www.jcrvis.com.pk/images/Correlation.pdf).

JCR-VIS assigns ratings of debt instruments on the same rating scale as used for entity ratings of micro-finance banks. However, no short term rating is assigned to debt instruments as JCR-VIS comments on the overall repayment ability over the term of the particular instrument.

Rating Scale - Medium to Long-Term

AAA
Highest credit quality; the risk factors are negligible, being only slightly more than for risk-free Government of Pakistan's debt.

AA+, AA, AA-
High credit quality; Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.

A+, A, A-
Good credit quality; Protection factors are adequate. Risk factors may vary with possible changes in the economy.

BBB+, BBB, BBB-
Adequate credit quality; Protection factors are reasonable and sufficient. Risk factors are considered variable if changes occur in the economy.

BB+, BB, BB-
Obligations deemed likely to be met. Protection factors are capable of weakening if changes occur in the economy. Overall quality may move up or down frequently within this category.

B+, B, B-
Obligations deemed less likely to be met. Protection factors are capable of fluctuating widely if changes occur in the economy. Overall quality may move up or down frequently within this category or into higher or lower rating grade.

CCC
Considerable uncertainty exists towards meeting the obligations. Protection factors are scarce and risk may be substantial.

CC
A high default risk

C
A very high default risk

D
Defaulted obligations

Rating Scale - Short-Term

A-1+
Highest certainty of timely payment; Short-term liquidity, including internal operating factors and /or access to alternative sources of funds, is outstanding and safety is just below risk free Government of Pakistan's short-term obligations.

A-1
High certainty of timely payment; Liquidity factors are excellent and supported by good fundamental protection factors. Risk factors are minor.

A-2
Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Access to capital markets is good. Risk factors are small.

A-3
Satisfactory liquidity and other protection factors qualify entities / issues as to investment grade. Risk factors are larger and subject to more variation. Nevertheless, timely payment is expected.

B
Speculative investment characteristics; Liquidity may not be sufficient to ensure timely payment of obligations.

C
Capacity for timely payment of obligations is doubtful.

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Mr. Ahmad possesses 30+ years experience in financial risk assessment with focus on Islamic finance, venture capital and general management. He has top level management experience at international level in the fields of credit ratings, Islamic and conventional financial risk assessment modeling, industrial management and construction engineering. Mr. Ahmad is an active participant at international forums on Credit Ratings. 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. He could be contacted at faheem@jcrvis.com.pk

Javed A. Callea

Advisor

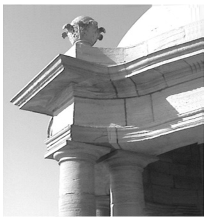
Mr. Callea is a professional in the financial sector with over 35 years of experience mostly in the financial institutions with certain exposure to service and infrastructure sectors in Pakistan. He has held the position of Chief Executive of a leasing company for 10 years. His core areas of expertise cover leasing, development financing, project management, investment & merchant banking, strategic investment management and real estate.

Major financial institutions he worked for include Pakistan Industrial Credit and Investment Corporation, State Life Insurance Corporation, Bankers Equity, Crescent Leasing Corporation and Saudi Pak Ind. & Agri. Inv. Company. He has also served as Member Finance of Water & Power Development Authority of Pakistan and as member of the Inquiry committee on stock exchange crises in 2000 commissioned by the SECP. He earned his MBA degree from the Institute of Business Administration in 1974.

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

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