JCR-VIS

NON-BANK FINANCIAL COMPANIES

Rating Methodology

Over the last many years, the non-bank financial sector has carved out a place for itself in Pakistan's financial market, even though a large portion of financial assets continue to be managed by commercial banks. Prior to December 2002, leasing companies, investment banks, house finance companies, brokerage houses and others largely operated in their respective niches, while the State Bank of Pakistan and the Securities & Exchange Commission of Pakistan (SECP) shared regulatory responsibilities within the non-bank financial sector. All of these companies have since been classified as the non-bank financial companies (NBFCs) and are now regulated by the SECP, gradually blurring the distinction between the various sub-sectors of NBFCs. Regulatory amendments that accompanied the shift, introduced a tiered capital requirement framework, for operating in different activities allowed to non-bank financial institutions under a single roof. Capital requirement for qualifying an institution for all financial activities, except commercial banking, is currently under Rs. 1.0b.

The regulatory environment in Pakistan has strengthened over time with increased comprehensiveness in prudential regulations, and improved standards of corporate governance. External factors that tend to impact credit ratings include the effectiveness of the regulatory environment and external monitoring tends to have a positive impact on the protection available to creditors.

Cross-Sector Comparability

Assigned ratings are considered to be comparable across sectors. Our assessment endeavors to position each company that JCR-VIS rates, vis-à-vis any other company in the rated universe, thereby maximizing the utility of ratings for the common investor by providing a single yardstick for assessing the creditworthiness of any institution. While assessing the ratings, sector related risks are taken into account in addition to firm-specific risks. Therefore changes in economic indicators along with those in the financial sector in general, are factored into ratings of any financial institution. Furthermore, the underlying concept and the basic principles of arriving at a rating for

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any NBFC remain largely similar to that used for any other sector.

Resilience and Market Power

The size of an entity, though not the only indicator of an issuer's strength, correlates strongly with market position. Given a comparable performance track record, larger entities will tend to be rated higher. While evaluating an organization on attributes like asset quality or access to financial resources, the benefit of diversification, which is generally greater in larger entities, is to be taken into account.

There are tangible reasons behind the effect of size being visible in ratings. Firstly, it generally affords an organization more market power in all facets, i.e ability to attract the best quality people, attracting financial resources, access to better infrastructure and of course pricing power. If however, these strengths are somehow absent in a large organization or are present in smaller ones, ratings will be mindful of such instances, although such cases are exceptions rather than a norm.

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This is not to imply that agile and small organizations lose their competitive edge over time. While they may continue to be successful as business models, market power will inevitably be accounted for as one of the variables in the risk equation. Particularly, in growing economies, as the business environment becomes increasingly competitive and mergers and acquisition related activity also increases as its natural outcome, economies of scale generally assume greater significance.

Capitalization And Leverage: Building blocks for the future

Capital is viewed by JCR-VIS as a cushion available to an entity against unforeseen losses. It is the foremost indicator of the degree of protection that an organization provides to its creditors against future losses and its sufficiency is to be assessed in relation to risks being carried by the company. Credit risk, market risk and operational risks being the primary sources of risk, are assessed to determine whether the entity is appropriately capitalized. NBFCs may also diversify their operations into money and capital market operations and the presence of market risk in addition to potential for loan and lease losses is quantified in relation to equity. Hidden reserves if any are also to be accounted for.

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Leverage, or the amount of debt in relation to the capital base, is a crucial factor in assigning ratings. JCR-VIS believes that in a growing economy and in dynamic organizations, capitalization levels generally trek towards optimization and higher than average capitalization levels are ultimately leveraged to obtain higher value for shareholders.

Nevertheless, organizations may be less or more risk averse and higher levels of capital, both in absolute and relative terms are viewed favorably in ratings. Therefore, understanding the propensity of both owners and management to take risk is part of our judgment process. Though prudential regulations allow leverage up to ten, this level indicates a steeper risk profile by JCR-VIS benchmarks.

We also focus on an NBFC's ability to grow its capital base through retention of earnings, as this is the most reliable source for stable growth. This brings into focus the dividend payout policy as even strong profitability can be diluted through heavy cash payouts. A substantial capital base, provides management with the ability to make circumspect decisions regarding growth and funding alternatives.

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Funding & Liquidity:

In case of NBFCs, the degree of leverage has to be considered in the context of the nature of liabilities, which is time-based in contrast to demand liabilities as in case of commercial banks. Therefore, liquidity indicators required to qualify for higher ratings are often lower for NBFCs as compared to commercial banks. More specifically, we evaluate the degree to which it has been able to match its assets and liabilities, and whether short-term and long-term debt corresponds with the maturity and interest rate profile of the financing and investment portfolios. Liquidity available to meet its short-term obligations is judged through the assessment of all near-term claims against short-term sources of cash. JCR-VIS considers the quality, diversity, stability and immediacy of the sources of cash. The generation and prudent management of these cash flows is a key issue in our assessment.

Access to funding is another important rating factor. NBFCs largely rely on secondary sources of funding such as institutional borrowings, although a number of them have also accessed public funds through the issuance of Certificates of Investments (COIs) or other forms of debt instruments. Consequently, the ability to access the short, medium, and long-term markets at competitive rates is critical to their ongoing viability. The diversification and stability of funding sources in turn determines liquidity requirements for an institution. Ideally, an NBFC's funding strategy should include a variety of funding sources.

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JCR-VIS evaluates an entity's flexibility to deal with market events and capacity to fund new business. We place high value on its access to debt markets and the portion of assets that can be liquidated without any significant impairment to value.

Asset Quality: Managing The Portfolio

Appraising the asset quality is a key factor in the rating process. Fundamental to this process is analyzing the asset mix. NBFCs are increasingly diversifying their scope of operations into a variety of avenues as afforded under the NBFC rules, in addition to the traditional financing portfolios. While this translates into diversification of revenue stream, it also exposes NBFCs to a variety of risks including market risk in addition to interest rate risk and credit risk. Increased treasury and capital market operations warrant an in-depth analysis of the mechanisms used to adjust to the changing environmental dynamics and maintenance of the liquidity position.

As far as the financing portfolios are concerned, cash recoveries against these are critical to the timely servicing of debt obligations. Since improvement or deterioration in the portfolio can lead to significant changes in the financial strength of the company, JCR-VIS seeks to conduct a comprehensive analysis of asset quality. Our analysts assess the level of infection and the effectiveness of the management policies regarding recoveries and risk assessment procedures.

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The size of the portfolio on both an absolute and relative basis is another consideration. There is less risk associated with a portfolio that is diversified in terms of geography, customer base, and type of product. Management's philosophy regarding concentration is reviewed, along with its growth plans. Weaker companies are more sensitive to changes in the environment and the nature and intensity of changes in market conditions has a substantial impact on their financial strength and ratings.

Profitability: The key to financial Strength

Improvement in profitability in a single year generally does not add significantly to risk protection available to creditors. However, sustained profitability over a number of years leads to a strong institution. The quality of earnings is given as much importance as its level, with emphasis on the continuity and predictability of revenues. Our analysis segregates recurring earnings, which are expected to provide a better picture of a company's future earning potential, from non-core earnings.

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Earnings reflect the efficacy of the management's strategy and capacity of an institution to generate capital internally. The level of basic earnings (excluding provisions, taxes and any other extraordinary items) determines the institution's capacity to create reserves for potential losses.

Corporate Governance

To the extent that poor governance jeopardizes the interest of creditors, its impact is factored into credit ratings. The objective of our assessment of corporate governance is to ensure that the organization is structured to allow for an effective internal control environment to develop, and minimize the possibility of the misuse of power by dispersing it optimally within the organization. Among other variables are the various features of the board of directors. In the context of the board's structure, JCR-VIS focuses on the role played by the board, the quality of its vision, the blend of its professionals and their relevance to the business, and the efficacy of its committees. Other key areas are the strength of the supervisory functions including internal and external audit. The degree of sophistication in risk management systems being employed is also a paramount consideration in our evaluation. Eventually good governance and sound risk management protects the value of a company's resources and optimizes their utilization, allowing the entity to honor its commitments to all its stakeholders including the creditors 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.

Sabeen Saleem
Group Head - Financial Institutions

Ms. Sabeen Saleem leads ratings of Financial Instituions at JCR-VIS Credit rating Company Limited. Prior to joining JCR-VIS, she worked on several projects with local financial consultants. She holds a Masters degree in Business Administration, graduating from the Institute of Business Administration, Karachi in 1997.

Sobia Maqbool
Manager

Sobia Maqbool is in Non-Bank Financial Companies Group. She holds a Masters degree in Business Administration from the Institute of Business Administration.

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.
Founder Shareholder of Islamic International Rating Agency, Bahrain
JV Partner in CRISL, Bangladesh
Member Association of Credit Rating Agencies in Asia

First Floor, PIDC House
M.T. Khan Road, Karachi - Pakistan
Tel: (92-21) 5680766, 5680996, 5671822, 5671833
Fax: (92-21) 5681105, 5671600
E-mail: vispk@cyber.net.pk
Website: www.jcrvis.com.pk