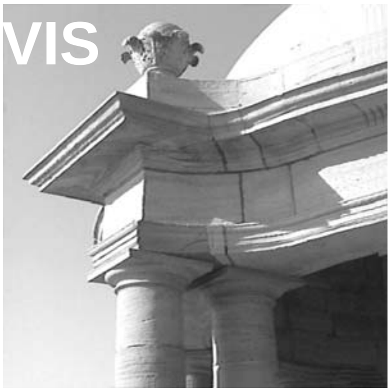
JCR-VIS



SMALL & MEDIUM ENTERPRISES

Rating Methodology

JCR-VIS Credit Rating Co Ltd. has prepared the first rating methodology for small & medium enterprises (SMEs) in Pakistan. This pioneering effort puts JCR-VIS and Pakistan in the forefront of global research in the newly developing field of SME ratings. SME ratings as a separate rating service initially started in 2005 and have so far been introduced in Japan and India. Some rating agencies have opted for purely quantitative approaches while others are taking into account qualitative aspects as well.

SCOPE OF METHODOLOGY

For the purpose of this methodology, JCR-VIS will classify organizations as SMEs using the same guidelines as notified by the State Bank of Pakistan in the Prudential Regulations for SMEs, i.e. organizations with an asset size (excluding land and buildings) of less than Rs 50m and Rs 100m for trading/service and manufacturing concerns respectively, less than 50 and 250 employees for trading/service and manufacturing concerns respectively and turnover of less than Rs 300m.

However, organizations currently meeting the SME guidelines but with definite plans in hand that would see them exit the SME category within the next one year would not be covered by this methodology. It should also be noted that this methodology only covers entity ratings of SMEs and does not apply to debt issuances by these SMEs.

JCR-VIS has developed the methodology for SMEs keeping in view the market demand for reliable independent credit opinions in the SME sector also, rather than only relying on the credit history of SMEs. At the same time, we are cognizant of the fact that the current level of costs of the rating exercise, as well as the detailed information and interaction requirements of a conventional corporate rating exercise would not be manageable for most SMEs.

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The main challenge in developing a methodology for SMEs stemmed from the fact that the need was for a product that addressed the above-mentioned issues, i.e time and cost to the client, while still producing a highly reliable credit opinon.

After careful consideration, JCR-VIS has come to the conclusion that the relatively unsophisticated nature of business in most SMEs means that it would be possible to significantly increase the weight of historical financial indicators in the rating exercise. This departure from the scoring model traditionally used- to arrive at corporate credit ratings would have a direct impact on the information requirements (for example, detailed financial projections would not be required), time required by analysts per assignment and therefore the associated costs.

RATING SCALE

Like all other rating agencies that have introduced SME ratings, JCR-VIS is using a separate scale to rate SMEs.

The reason for use of a separate scale is that in the absence of robust databases for the SME sector, it is not currently possible to map the results of any of the newly created SME rating mechanisms to the default probabilities that underpin the conventional rating scale. Therefore, there is a high probability that ratings on the conventional scale would result in relatively lower ratings for most SMEs, increasing the capital charge for this sector as a whole under the standardized approach for calculating capital adequacy of banks as laid down in the Basel II Accord.

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Over time, as the SME ratings history and default data develops, it may be possible to harmonize the SME rating scale with the conventional rating scale. For the time being, the SME ratings will only be an indicator of relative creditworthiness between the rated SMEs.

RATING DEFINITION

SME-1
Highest credit quality compared to that of other SMEs.

SME-2
High credit quality compared to that of other SMEs. Protection factors are stronger and risk is modest, relative to lower rated obligors, but may vary slightly from time to time because of economic conditions.

SME-3
Good credit quality compared to that of other SMEs. Protection factors are also relatively adequate but risk factors may vary with possible changes in the economy.

SME-4
Adequate credit quality compared to that of other SMEs. Protection factors are relatively reasonable and sufficient. Risk factors are considered relatively variable if changes occur in the economy.

SME-5
Weaker capacity to meet obligations compared to that of other SMEs. Protection factors are capable of relatively weakening with changes in the economy.

SME-6
Less likelihood of obligations being met as compared to other SMEs. Protection factors are capable of fluctuating relatively widely if changes occur in the economy

SME-7
High default risk as compared to other SMEs. Protection factors are relatively scarce and risk may be substantial.

SME-8
Default

Note: No +/- qualifiers will be used for the assigned ratings, nor will 'Outlooks' or 'Rating Watch' be assigned.

RATING HORIZON & SURVEILLANCE

The rating horizon of SME ratings is a maximum of one year from the date of issuance of the rating, provided that no major developments take place in the interim period that could have a material impact on the rated entities risk profile. SME ratings are a one-time exercise and are not kept under surveillance, keeping in view the expected unavailability of reliable interim data due to record keeping issues as well as to curtail costs associated with the rating exercise. However, ratings could be updated earlier if requested by the client.

DISSEMINATION

Rating dissemination of SME Ratings will not be through press releases as is the existing practice for all other kinds of ratings. However, a current rating list of publicly disclosed ratings will be maintained on our website, www.jcrvis.com.pk.

RATING METHODOLOGY

The core rating methodology for SME ratings will remain the same as that used for JCR-VIS' corporate ratings, i.e the analysis of industry, business and financial risk, with the differences being more in the areas of emphasis and manner of execution.

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We are giving below a brief recap of the areas covered in a corporate rating exercise followed by a discussion on what variations in execution and areas of emphasis would be involved in SME ratings.

INDUSTRY RISK

- Industry Characteristics (e.g. cyclicality, stage of product life cycle etc.)
- Industry financials (including local and global perspectives)

BUSINESS RISK

- Market Position
- Operating Efficiency
- Management Risk
- Regulatory Issues

MANAGEMENT & GOVERNANCE RISK

- Legal Structure
- Management Track Record & Credibility
- Succession Planning
- Supervisory risk

FINANCIAL RISK

- Asset Size
- Earnings and Cash Flows
- Capital Structure
- Liquidity
- Coverages
- Payment history with lending banks.

Probably the biggest difference in the rating process would be seen in the level of interaction with the rated organisation. Generally, JCR-VIS' credit rating process is a highly interactive one, because while dealing with sophisticated business models our analysts want to ensure that they clearly understand the management's business plans and the relative risks attached to the various courses of action that the rated organization may opt between. The uncertainty attached to any future course of action is enhanced by the relatively longer rating horizon of three to five years for conventional medium to long-term ratings.

On the other hand, a substantial proportion of SMEs qualifying to be rated under this methodology would have comparatively simpler business models, along with a much shorter rating horizon of one year laid down by this methodology. Therefore, JCR-VIS will decide on a case-to-case basis on the level of client interaction required and its form. Visits to client premises, which form a key part of our corporate rating methodology will not be given as much importance in the case of SME ratings. However, direct interaction may be expected in most SME rating assignments with key suppliers, major customers and lenders of the rated SME, while being a rarity in corporate ratings. The main reason for this is the dearth of other sources of information for most SMEs.

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In keeping with the above-mentioned expected business profile of most SMEs, JCR-VIS is of the opinion that we will be able to arrive at a reasonably accurate financial risk profile of the rated organization simply through application of a quantitative model supported by limited quantitative inputs.

It would be pertinent to clarify here that the above mentioned changes are not meant in any way to produce a 'lower quality' credit opinion as compared to conventional issuer ratings and represent changes in the methodology solely based on the inherent characteristics of SMEs.

In addition to the above-mentioned changes, JCR-VIS adjusts weightage of various analytical aspects in order to ensure that they truly reflect the risk profile of the SME sector. Examples of areas where the weightage would be increased would be asset size, cash flows and liquidity.

Asset size, would also be a key determinant in arriving at the SME rating. While in the case of corporates, asset size is generally seen only as an indicator of whether a company has reached economic size (indeed too large an asset base may actually indicate uneconomic size), the possibility of diseconomies of scale in SMEs is very low due to the asset and turnover limits defined to qualify as an SME.

Apart from asset size extra emphasis will also be given to the area of liquidity, because access to capital of SME is generally not very strong and is expected to become even more constrained in times of stress. Therefore the company must have sufficient internal resources to be able to weather short-term pressures on cashflows. This change is also a factor of the rating horizon (liquidity also carries enhanced weightage while assigning short-term ratings using the corporate methodology).

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The two key areas considered at the time of assessment of liquidity would be the level of the SME's cash and cash equivalents in relation to its debt and working capital management (based on an analysis of the net trade cycle and the liquidity index). Cashflows would also be analysed, based on EBITDA related analysis, to develop an expectation of the SMEs ability to maintain liquidity levels over the rating horizon

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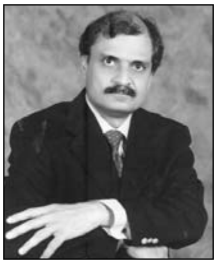

Faheem Ahmad
President & CEO, JCR-VIS
Founder, VIS Group

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.

Saad Ahmed Madani
Group Head Corporates & structured Finance

Saad Ahmed Madani currently heads the Structured Finance and Industrial Corporates Group. He also supervises Corporate Governance Ratings. Prior to Joining JCR-VIS, in July 2000, he had completed his articles at a leading Chartered Accountancy firm in Karachi. Mr. Madani is an Associate member of the Institute of Chartered Accountants of Pakistan.

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

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