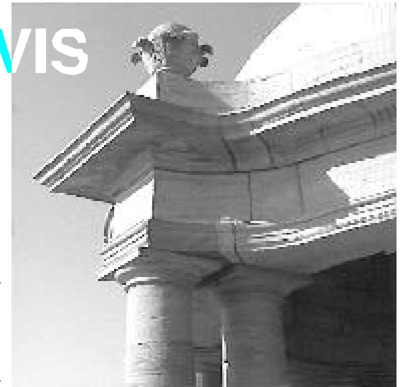
JCR-VIS

PRIMER

Leasing Companies



Pakistan

1

INTRODUCTION

Rapid expansion in the number of financial institutions over the last decade, along with political expediencies and volatile market conditions have led to company closures and billions of rupees in bad loans. This situation has underscored the need for credit rating in Pakistan to safeguard the interest of investors. JCR-VIS Credit Rating Company Limited (JCR-VIS) is meeting this requirement by providing an unbiased, third party opinion of the credit quality of companies to aid the investors, creditors and regulators.

Our first primer dealt with the JCR-VIS methodology that provides a foundation for the ratings assigned to commercial banks. In this publication, we intend to highlight the pillars that support our rating assessment of leasing companies. These companies rely on institutional borrowings, Certificates of Investment (COIs) and the debt market as their primary sources of funding.

The importance of ratings is underlined by the fact that not only do the leasing companies in Pakistan have Rs. 29 billion of outstanding debt, but approximately 40% of this amount comprises unsecured debt in the form of COIs, as of June 30, 2001

The importance of ratings is underlined by the fact that not only do the leasing companies in Pakistan have Rs. 29 billion of outstanding debt, but approximately 40% of this amount comprises unsecured debt in the form of COIs, as of June 30, 2001. Leasing companies are assigned local currency ratings, which are a measure of a firm's ability to repay senior unsecured obligations in rupee terms. So far, JCR-VIS has rated a large number of leasing companies and several of their Term Finance Certificates (TFCs). Our appraisals provide an opinion on the credit worthiness of these companies by assessing their strengths and weaknesses and the capacity to maintain their financial strength in the face of adverse events. An entity's vulnerability to changing market conditions and upheavals in the economy is also factored into the ratings.

2

NUMBERS & BEYOND

At JCR-VIS, we have developed a comprehensive system of assigning ratings, using both qualitative and quantitative factors to assess the credit quality of a company. Our analysts are trained to look at the big picture, to go beyond the numbers and scrutinize the company and its environment in depth. Our ratings are not the result of the analysis of a few key ratios but the sum of a detailed examination and critique of all qualitative and quantitative factors that drive the performance of a company. Our job is to assess, based on historical performance and indicators for the future, where the company is headed in the days to come.

A company's present financial condition plays an important role in our analysis, however, over the long term, franchise value and management quality are strong key drivers of an institution's financial strength. The franchise value is a company's ability to generate earnings over the long run based on its competitive advantages. Some key factors such as asset quality, efficiency, market share and funding capability can help a company build its franchise value. This is manifested in its profitability, and each company can use a distinctive strength or competitive advantage to improve it. The larger companies in the leasing sector have utilized their franchise value to raise debt, as evident by the fact that 90% of total COIs are currently held by the 5 largest companies in the sector. JCR-VIS analyzes the competitive strengths of entities and the ability to sustain and convert these strengths into an effective franchise value.

A company's present financial condition plays an important role in our analysis, however, over the long term, franchise value and management quality are strong key drivers of an institution's financial strength

The larger companies in the leasing sector have utilized their franchise value to raise debt, as evident by the fact that 90% of total COIs are currently held by the 5 largest companies in the sector

In emerging markets, like Pakistan, where volatile economic cycles and sudden shocks are translated on the asset portfolio, protection against deteriorating credit quality is very important. This unstable nature of our economy has highlighted the importance of capital. A strong capital base can provide protection against unanticipated losses. Furthermore, substantial capital provides a leasing concern with greater flexibility to leverage its balance sheet. On the other hand, for leasing companies in developed markets, deterioration in the asset quality usually occurs over the long run, thus enabling them to increase general reserves/provisioning against potential losses over a period of time.

JCR-VIS also views high and sustainable levels of pre-provision earnings/basic earnings as the primary buffer against worsening asset quality as they enable a company to build capital and reserves against potential losses. The Securities and Exchange Commission of Pakistan (SECP) has recently made it mandatory for leasing companies to maintain

their capital at a minimum level of Rs. 200 million. This regulatory step has served to enhance the capital of leasing companies and encouraged mergers and acquisitions, which JCR-VIS believes will assist in strengthening the sector.

> **JCR-VIS also views high and sustainable levels of pre-provision earnings/basic earnings as the primary buffer against worsening asset quality as they enable a company to build capital and reserves against potential losses**

A serious issue plaguing the leasing sector is the high rate of non-performing leases and loans (NPLs), a situation that can be attributed primarily to the inadequacy of risk assessment procedures and, to a lesser degree, limited industrial growth that has led to sectoral concentration. Leasing across a spectrum of industries reduces the risk of impairment in the asset quality. Strict credit policies and continuous monitoring of the portfolio are looked upon favorably by JCR-VIS. We review accounts closely to establish a company's exposure in each sector, which if exceeds 20% of Net Investment in Leases (NIL) prompts a further examination. Similarly, a drag on ratings may occur if exposure to a single client exceeds 15% of total equity. SECP is paying increasing attention to this factor and has recently proposed an amendment in the rules that govern the leasing sector by restricting exposure to a single party to 30% of unimpaired capital and reserves instead of the earlier limit of 20% of NIL.

> **We review accounts closely to establish a company's exposure in each sector, which if exceeds 20% of NIL prompts a further examination. Similarly, a drag on ratings may occur if exposure to a single client exceeds 15% of total equity**

Transparency with reference to the extent of disclosure of company information has consequential significance for the ratings and our analysts examine the conformance of annual statements to accounting standards. Another issue that concerns our analysts is that at present leasing companies do not disclose the amount or classification of NPLs in their accounts. Thus, we endeavor to seek full cooperation from management to access this information.

When the financial performance of a company is weakened or external factors have an unexpected negative impact, the presence of parent or associate support gains greater importance. However, unlike banks, there is no lender of last resort for the leasing industry, therefore, sponsor support is of paramount importance. The failure of a bank could have a domino effect impacting not only the performance of the whole sector but weakening the economy as well. The banks, therefore, usually have the support of the central bank to overcome temporary stress. In order to judge the availability and composition of assistance received from the parent/associate company, analysts at JCR-VIS examine, apart from the financial strength of the parent, any past instances when aid was received and the level of support it afforded the

> **Unlike banks, there is no lender of last resort for the leasing industry, therefore, sponsor support is of paramount importance**

JCR-VIS examines, apart from the financial strength of the parent, any past instances when aid was received and the level of support it afforded the company

company. The financial position of a company is strengthened by external backing and may consequentially enhance the rating.

We seek to determine the effective and judicious utilization of company resources by the management. Corporate governance is assessed in light of the application of transparency, accountability and responsibility in the company's dealings with its financial stakeholders. SECP has recently introduced such a code that attempts to establish good corporate governance within the company. JCR-VIS views this development as an extremely significant and necessary step for the regulation of management practices in the corporate sector of Pakistan.

3

LEASING SECTOR OVERVIEW

The last 20 years have been witness to a number of changes in the financial sector of Pakistan, specifically with the incorporation of an increasing number of Non Bank Financial Institutions (NBFIs), including leasing companies. The first lease in Pakistan was written in 1983, by Natover International (Private) Limited, which pioneered leasing of vehicles in Pakistan, whereas National Development Leasing Corporation was the first listed leasing company, incorporated in 1984. The growth of the leasing industry initially lacked momentum due to a general lack of awareness of its operations and benefits as during the eighties only six companies had started operations. However, between 1991 and 1997, 25 companies were further incorporated.

The reason for this boom was the deregulation of the economy in the nineties with liberal government policies opening up avenues for growth in the leasing sector. What also helped was the growing awareness of the advantages of leasing as compared to borrowing from banks. Leasing requires a relatively simple procedure, which coupled with the tax advantages, has become a very popular alternate source of finance for consumers and companies alike. However, the growth of leasing companies, like all financial institutions, is invariably tied to the economy of the country and the level of investment activity.

Leasing follows an evolutionary path, becoming more complex as markets mature. In Pakistan due to the relative underdevelopment of the financial system, the concentration has been predominantly in finance leases as compared to operating leases, as the risks associated with the latter are more varied. While a finance lessor has to contend with credit oriented risks, the operating lessor also has to take into account higher asset risk. The residual value of the asset has more important ramifications here and operating lessors are exposed to a higher level of equipment obsolescence risk. Therefore, secondary market for the asset is of prime importance and operating lessors need to have the specific expertise required to deal with the resale and maintenance of the type of assets leased.

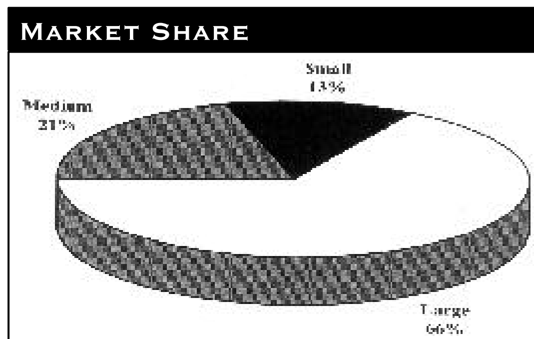
Structure of the Leasing Sector

JCR-VIS categorizes leasing companies as small, medium and large on the basis of their asset size. At present, companies having an asset base of less than Rs.1 billion are categorized as small, between Rs. 1 billion and Rs. 3 billion as medium and above Rs. 3 billion as large. In the leasing sector, not counting the inactive or merged firms, out of 29 companies as on June 30, 2001, 5 qualify as large, 7 as medium and 17 as small.

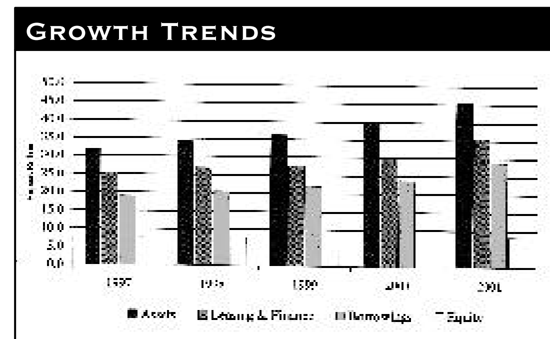
Companies having an asset base of less than Rs.1 billion are categorized as small, between Rs.1 billion and Rs.3 billion as medium and above Rs.3 billion as large

However, it is the 5 largest leasing companies that have 66% of the total market share on the basis of assets, followed by medium sized companies which have 21% market share and the small companies, though being the most in number, have the least market share at 13%.

MARKET SHARE



GROWTH TRENDS



A large as set and eq uity base serves to pro tect the com pany against any ad verse influences of the eco nomic cy cle. Com pa nies with a small as set base tend to con cen trate their ex po sure and have a lack of prod uct di ver sity that makes them vul ner able to competition from the relatively larger con cerns. Suc ces sion and depth of lead er ship, viewed in tan- dem with the ef fi cacy of fi nan cial con trols, are also a key man age- ment is sue for smaller con cerns. How ever, the sig nifi cance of a large as set base lies in the abil ity of the com pany to ex ploit its size in or der to con tinu ously im prove its per- form ance and in crease mar ket share.

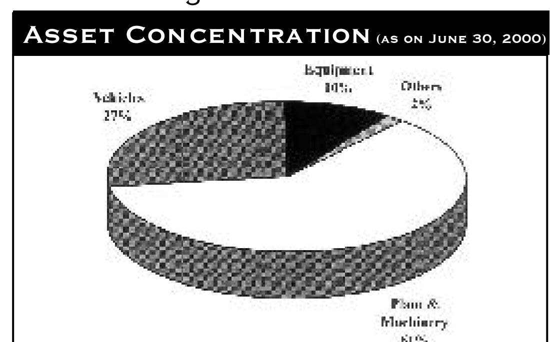
Rs. Bil lion	'01	'00	'99	'98	'97	CAGR %
No. of Cos.	29	31	32	32	32	-
Total Assets	45.3	39.6	36.2	34.3	31.8	9.3
Borrowings	28.8	23.8	22.0	20.4	18.9	11.5
Equity	8.2	8.2	7.9	7.8	7.5	2.2
Paid up Cap.	5.0	4.7	4.6	4.4	4.3	3.8
Net Profit	0.3	0.5	0.5	0.6	0.9	(23.0)
Leas ing & Financing	35.6	29.6	27.7	27.0	25.3	9.0
Dividends*	0.3	0.4	0.4	0.3	0.4	-

** in clude bo nus shares*

The as set base of the leas ing sec tor has shown con sis tent ex- pan sion over the years with to tal leasing and fi nanc ing also in creas- ing at about the same rate. The in tro duc tion of leas ing as a fund- ing source for capi tal ex pan sion of manu fac tur ing con cerns has led to an ele ment of sub sti tu tion over the years with leas ing start ing to re place some of the more tra di- tional sources of fi nanc ing.

The as set con cen tra tion in the leas ing sec tor is in plant and ma- chin ery, which makes up 61% of the to tal dis burse ments. Ve hi cles and equip ment fol low with 27% and 10% re spec tively. This clearly shows that fu ture growth will re main de pend ent on in creased in vest ment in the manu fac tur ing sec tor.

ASSET CONCENTRATION (AS ON JUNE 30, 2000)



The nomi nal rise in eq uity over the pe ri od is not an in di ca tor of im prov ing prof it abil ity but is the re sult of a slight in crease in paid up capi tal, fu eled by is su ance of

rights and bonus shares as most of the companies are trying to increase their paid up capital to meet SECP's minimum capital requirement. Over this four year period there has been a continuous decline in net profits (with the exception of 2000), which has been the outcome of a high number of non-performing leases, increasing competition and shrinking spreads.

Growth in leasing and financing has been funded primarily through borrowings. Initially, leasing companies relied heavily on bank borrowings. This trend changed later with COIs becoming a major source of funding. More recently, companies in this sector have also obtained funding through issuance of TFCs, though this source does not, as yet, constitute a significant portion of total funding.

Rating is not mandatory for leasing companies, but since COIs are not secured instruments, the SECP does not give permission for issuance of these certificates if the company is rated below investment grade (BBB-). Similarly, issuance of TFCs requires a rating if the certificates are listed.

Majority of funding is through local financial institutions and COIs, with the latter comprising a higher proportion of the total borrowings in 2001. COIs have become a very substantial source of funding since bank borrowings are a more costly alternative. As the numbers clearly show, the larger companies fund their assets mostly through unsecured instruments for the reason that they have greater funding access due to a stronger franchise value. Smaller companies, on the other hand, fund majority of their assets through institutional borrowing. Even though TFCs comprise a very small proportion of total funding, they have emerged as an extremely important source of finance for leasing companies, in view of the fact that they help reduce the asset liability mismatch and provide the advantage of disintermediation from banks.

The larger companies fund their assets mostly through unsecured instruments for the reason that they have greater funding access due to a stronger franchise value

Borrowings as on June 30, 2001 (Rs. Billion)

	Total	COIs	FIs	FAs	TFCs
Large Leasing Cos.	20.5	10.4	5.9	2.2	2.0
% of Sector Total	*71.0*	*90.0*	*53.9*	*59.2*	*72.8*
Medium Leasing Cos.	5.7	0.8	3.0	1.4	0.5
% of Sector Total	*19.8*	*7.2*	*27.4*	*38.4*	*18.0*
Small Leasing Cos.	2.6	0.3	2.0	0.1	0.2
% of Sector Total	*9.2*	*2.3*	*18.7*	*2.4*	*9.1*
Sector Total	28.8	11.5	10.9	3.7	2.7
% of Sector Total	–	*39.8*	*37.9*	*12.8*	*9.5*

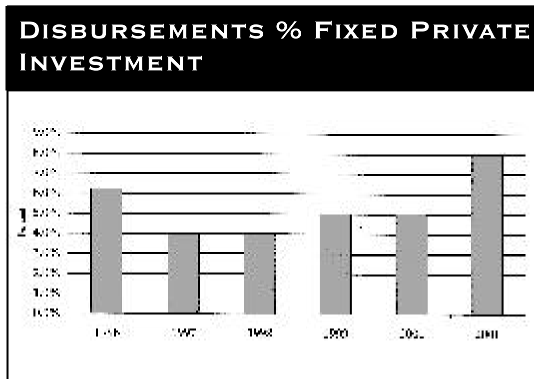
FIs: Financial Institutions, FAs: Foreign Agencies

An untapped source of funding is asset securitization. This could be a significant tool for the creation of relatively low cost funding by selling a portfolio of leases to a Special Purpose Vehicle (SPV). However, in Pakistan, the leasing sector has not been able to develop this source due to ambiguity concerning tax-related issues.

Factors Impeding the Growth of the Leasing Sector

In the mid nineties, the leasing sector had made growing contributions to the investment in the economy through funding Balancing, Modernization & Replacement (BMR), however it was not able to sustain this contribution. A breakup of total disbursements as a percentage of total fixed private investment in the country reveals that the leasing sector had been initially providing around 6% of total investment in the country in 1996, which decreased to 4% in the later years. The general decline in the economy and low level of BMR activity from mid to late nineties had a major role to play in the reducing contributions made by leasing companies. However, there has been an improvement in 2001 with contribution increasing to 8%. This is attributable to the stabilization of the economy and expansion in the textile industry where leasing is one of the important sources of finance.

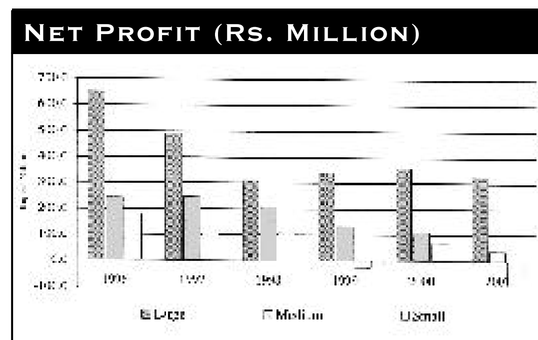
DISBURSEMENTS % FIXED PRIVATE INVESTMENT



The worsening economic condition of the country during the mid nineties had a negative impact on the industrial sector leading to a higher ratio of NPLs.

Furthermore, attracted by the stock market boom in the early nineties, the leasing companies had made a number of equity investments to maintain liquidity and benefit from capital gains. However, the subsequent decline in the stock market led to huge losses and consequently greatly affected the financial strength of the sector. The profitability enjoyed by the leasing industry in the earlier years had also prompted the formation of a number of smaller companies that increased the competition in the sector. When the economy took a downturn, these smaller companies experienced severe difficulties and their profitability gradually declined.

NET PROFIT (RS. MILLION)



In Pakistan, until recently, leasing had been confined to specialized leasing companies and modarabas. However, with the tax benefits now also applicable to financial institutions, commercial and investment banks have recently entered the market, though with certain regulatory restrictions. As the banks have access to cheaper funding, they have subjected the specialized leasing companies to severe price pressure. Thus, in order to maintain market share, the leasing sector needs to

become more innovative in all aspects of its operations and maintain its competitive edge of being more customer-oriented.

What the Future Holds

The financial sector is fragmented into commercial banks, leasing concerns and other financial companies competing in one or more segments. In the past two years, the trend in this industry has been towards consolidation with a number of mergers and acquisitions taking place. One feature of this trend is that these transactions are taking place across different sectors with a number of investment banks and modarabas merging with leasing companies to provide diversified financial services under one umbrella. These mergers have taken place both for strategic reasons and to fulfill minimum regulatory capital requirements.

Another step towards consolidation in the sector is a recent announcement by the SECP concerning changes in the regulations of all NBFIs from the next fiscal year. This step was taken in order to realign these institutions with present and future requirements of the economy. Under this proposed regulation, SECP is bringing all NBFIs under one head, known as the Non Bank Finance Company (NBFC), which will undertake all financial services except banking functions. The objective of these regulations is to create greater depth in the financial markets by having fewer but stronger players in the field. This has an added advantage of creating a level playing field, as all NBFCs will have to operate under the same regulations.

Furthermore, the economy is showing signs of improvement with the government introducing and implementing reforms that have led to an improvement in the balance of payments, increase in foreign exchange reserves, low rate of inflation and stabilization of the exchange rate. If these improvements persist, JCR-VIS envisages that it could have an impact on the leasing sector.

4 METHODOLOGY

The rating objective of JCR-VIS is to assess the ability of a leasing company to make timely payment of its obligations. The basis of the agency's analysis is a set of qualitative and quantitative factors, evaluated in the light of a company's strengths and weaknesses and their possible impact on the company's future operating performance and financial strength. Our ratings intend to provide a forward looking opinion of a company's ability to meet its debt obligations in the future.

Our analysts factor in all the beneficial and adverse implications of changing environmental conditions, and the companies' response to these market events. The ratings are not based purely on historical performance since JCR-VIS gives due consideration to anticipated future performance as well. Exceptional performance enjoyed temporarily, or under performance with better times anticipated, is discounted. Sensitivity to environmental factors varies along the rating spectrum. 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. However, changes in market conditions do not necessarily have a significant impact on the ratings for stronger companies, unless the factors are more profound than what were anticipated or have a unique impact on the company.

> **Weaker companies are more sensitive to changes in the environment and the nature and in tensity of changes in market conditions has a substantial impact on their financial strength and ratings**

While assessing the quantitative factors there are four major areas of concentration: asset quality, funding & liquidity, profitability and capitalization.

Asset quality: Managing the portfolio

Evaluating the asset quality is a key factor in the rating assessment of leasing companies because their main source of debt repayment is asset conversion; cash recoveries against lease receivables. Therefore, the maintenance of a high quality receivables portfolio is necessary in order to ensure 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 the asset quality of a leasing concern. We look at past trends in NPLs, the current position and the ability of the company to keep its head above water in the event that the asset quality deteriorates significantly in the future. Our analysts assess the level of infection and the effectiveness of the management policies regarding recoveries and risk assessment procedures. We identify major clients of the firm to study total exposure and concentration issues that may impact the ratings. Furthermore, we analyze the strengths and weaknesses of the industry in which a significant portion of assets are employed as well as the geographic diversification of investments in leases and loans.

Measuring the asset quality

JCR-VIS employs a number of ratios to gauge the level of infection and protection against losses, potential and actual. The NPLs as a % of gross leases and loans give us a picture of the outstanding principal of infected leases against the total exposure. This ratio draws attention to the quality of the company's assets by underscoring the size of the potential losses and serves as an indicator of the health of the portfolio. If the ratio exhibits deterioration over time, it opens up another line of questioning to understand the reasons behind this affliction and the quality of the risk assessment procedures.

We look at provisions as a % of total NPLs to measure how well a company is cushioned against potential losses resulting from infection in the portfolio. In Pakistan, general provisions are not a tax-deductible expense due to which most leasing companies are reluctant to make such provisions, resulting in lack of protection against unforeseen losses. We also measure the possible impairment of equity by comparing the amount of unprovided NPLs against the total equity of the company. As NPLs are not disclosed in the annual statements, the following asset quality ratios only represent leasing companies that have been rated by JCR-VIS.

AVERAGE (2000-01)	
NPLs % Gross Leases & Loans	13.2
Net NPLs % Net Leases & Loans	10.4
Provisions % Total NPLs	30.5
Net NPLs % Equity	22.1

We have observed substantial variation in the infection levels, which digress from as high as 40% to as low as 1.1% signifying disparity in the risk assessment policies of the leasing companies.

The analysis conducted at JCR-VIS not only incorporates the evaluation of the company but also the role played by the regulatory body in ensuring that all policies are adhered to and such regulations are brought into effect which will serve to fortify the sector and improve the performance of the companies.

Recently SECP has proposed a number of amendments in regulations governing the leasing sector. As mentioned earlier, exposure to a single client has been restricted to 30% of unimpaired capital and reserves, substantially reducing the risk of having a significant amount of investment in lease finance tied up with one client. However, at the same time, SECP has proposed relaxing the regulations concerning classification of rescheduled leases giving companies the luxury of recognizing income from such leases much quicker than previously permitted. In this case, JCR-VIS applies its own more stringent benchmark. A rescheduled lease is not considered performing until 30% of the rescheduled amount has been repaid and 30%

A rescheduled lease is not considered performing until 30% of the rescheduled amount has been repaid and 30% of the time has elapsed, without delay or default, since the rescheduling

of the time has elapsed, without delay or default, since the rescheduling. In the event that a lease is rescheduled for the second time, JCR-VIS does not consider that lease to be performing until 50% of the rescheduled amount has been serviced.

Funding & Liquidity: The essence of operations

Access to funding is another key rating determinant as it is the fuel for all future growth. Liquidity is the life blood of leasing companies, the lack of which could lead to stagnant growth or even failure. The aim of this analysis is to judge the ability of companies to raise funds with emphasis on their funding strategy. Ideally, a leasing concern's funding strategy should include a variety of funding sources to provide risk diversification. More specifically, we evaluate the degree to which the company has been able to manage its interest rate sensitivity by matching its assets with liabilities, resulting in a mix of short-term and long-term debt that corresponds with the maturity and interest rate profile of the portfolio.

Ideally, a leasing concern's funding strategy should include a variety of funding sources to provide risk diversification

The evaluation of liquidity includes a review of all funding sources available to the firm to meet its debt obligations. These sources include balance sheet items, such as marketable securities and maturing receivables, and alternative funding sources such as unutilized bank lines and access to debt markets. JCR-VIS, in the determination of a rating, also reviews the depth, diversity and resilience of funding sources in the event of a liquidity crisis by analyzing the limit of a company's access to capital markets or ability to raise committed bank facilities in stress situations. This results in an understanding of the sensitivity of a particular company to unanticipated adverse events. The liquidity of the company to meet its short-term obligations is judged through the assessment of all near term claims against short-term sources of cash by applying the following ratios:

Current Ratio (x) (1999-2001)

Category	Avg.	Q1	Q2	Q3
Large	1.4	1.2	1.3	1.5
Medium & Small	1.7	1.1	1.3	1.8

Q1: First Quartile, Q2: Median, Q3: Third Quartile

ST Debt % ST Assets (1999-2001)

Category	Avg.	Q1	Q2	Q3
Large	73.5	67.4	77.3	86.1
Medium & Small	70.0	39.1	68.2	83.7

Q1: First Quartile, Q2: Median, Q3: Third Quartile

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. The amount of liquid assets a company has at its

Liquid assets % Total Borrowings (1999-2001)

Category	Avg.	Q1	Q2	Q3
Large	13.2	9.6	12.4	14.0
Medium & Small	31.8	10.4	16.8	33.3

Q1: First Quartile, Q2: Median, Q3: Third Quartile

disposal to meet its debt also helps to determine the strength of the liquidity.

As apparent by the numbers, smaller companies maintain higher liquidity as compared to larger concerns simply because they do not have the same degree of access to funding that the large firms do, based on their franchise value.

Smaller companies maintain higher liquidity as compared to larger concerns simply because they do not have the same degree of access to funding that the large firms do, based on their franchise value

Generally, leasing companies use cash flow from maturing receivables/rentals to fund new originations and tap other funding sources to fuel growth. Their core liquidity comes from the ability to replace maturing debt and obtain new funds, which is an indicator of confidence in the company. In light of this scenario, JCR-VIS carefully evaluates a company's flexibility to deal with market events and capacity to fund new business. We place a high value on a company's access to debt markets and the portion of assets that can be liquidated without any consequential impairment to value.

Capitalization and leverage: Building blocks for the future

Capital is viewed by JCR-VIS as a cushion available to a leasing company in the event of adverse economic conditions. We focus on a company'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 of the company as even strong profitability can be diluted through heavy cash payouts. A substantial capital base, apart from fortifying a company's solvency, provides management with the ability to make circumspect decisions regarding growth and funding alternatives. In addition, it also shapes the market's perception of how well the company is protected against future losses. The following ratio gives the company's capital formation rate:

A substantial capital base, apart from fortifying a company's solvency, provides management with the ability to make circumspect decisions regarding growth and funding alternatives

Capital Formation Ratio (%) (2000-2001)

Category	Avg.	Q1	Q2	Q3
Large	4.0	0.8	2.3	6.1
Medium & Small*	3.8	1.5	3.8	7.0

**excluding loss making companies*

Q1: First Quartile, Q2: Median, Q3: Third Quartile

Another consideration in our analysis is a leasing company's leverage profile. A high level of leverage often indicates an aggressive risk strategy, which should always be accompanied by high returns. A high ratio of debt would also lead to less flexibility when the company requires increased funding. Heavy reliance on capital, on the other hand, suggests the use of a more risk averse strategy, although an extremely low leverage is not a very healthy sign since it implies inability of the management to avail growth opportunities. But low leverage does provide greater flexibility to the firm when looking for increased funding.

DEBT LEVERAGE (X) (1999-2001)

Category	Avg.	Q1	Q2	Q3
Large	5.5	4.2	5.4	6.3
Medium & Small	1.9	0.8	1.5	2.9

Q1: First Quartile, Q2: Median, Q3: Third Quartile

GEARING (X) (1999-2001)

Category	Avg.	Q1	Q2	Q3
Large	5.2	4.0	5.1	6.1
Medium & Small	1.7	0.6	1.2	2.6

Q1: First Quartile, Q2: Median, Q3: Third Quartile

The large companies are comparatively highly leveraged than the smaller ones, as they are able to accept greater risk on the basis of their franchise value. Furthermore, at JCR-VIS, we also seek to assess effective utilization of leverage through the financial leverage index, calculated by dividing return on average equity by the adjusted return on average assets.

ROAE/ADJUSTED ROAA (X) (1999-2001)

Category	Avg.	Q1	Q2	Q3
Large	0.9	0.6	0.9	1.3
Medium & Small	0.9	0.6	1.0	1.2

**excluding loss making companies*
Q1: First Quartile, Q2: Median, Q3: Third Quartile

A ratio greater than 1 would signify a favorable effect from leverage, but as evident from the numbers, neither the large nor the small companies, apart from a few, have been able to effectively manage their leverage in the recent past.

Profitability: The key to financial strength

Earnings are one of the key determinants in the success or failure of a leasing company. It is the most specific expression of a firm's franchise strength and has a direct impact on the ability of the leasing firm to attract equity and debt in terms of amount and cost. Profits have to cover operating expenses, debt service and credit losses, apart from providing a stable source of capital for future growth. The quality of earnings is given equal importance as the quantity, with emphasis on the continuity and predictability of revenues. This breeds confidence amongst investors and helps the leasing companies to secure a continuous access to funding.

ROAA (%) (1999-2001)

Category	Avg.	Q1	Q2	Q3
Large	1.6	1.0	1.6	1.9
Medium & Small	4.0	1.2	3.0	6.1

**excluding loss making companies*
Q1: First Quartile, Q2: Median, Q3: Third Quartile

An effective measure of profitability is the return on assets that serves as a check of the soundness of management strategy and comparison with peer firms. This is a measure of a leasing firm's efficiency in generating revenues from

ROAE (%) (1999-2001)

Category	Avg.	Q1	Q2	Q3
Large	9.5	5.1	9.6	13.7
Medium & Small	8.6	4.0	9.9	11.9

**excluding loss making companies*
Q1: First Quartile, Q2: Median, Q3: Third Quartile

its balance sheet and defines the firm's earning power. Our analysis also incorporates the trend and stability of these earnings.

The larger companies due to being highly leveraged have a lower return on assets as compared to the smaller firms. Therefore, return on equity acquires added significance in comparing the profitability of larger firms to the smaller ones. Apart from evaluating profitability, returns can also have implications for availability of funds in the future. In case a company has not been able to meet its targeted return it will be pressurized to amend its policies and possibly undertake more risk, which could sound a warning to creditors that the company is in stress, leading to a decline in the firm's credit standing.

A variation of the return on equity measure is the Basic ROAE that is focused on recurring operating earnings rather than net return. This ratio highlights the importance of pre provision earnings as it determines the ability of the company to make required provisions against future credit losses without having any significant impact on the bottom line. We also seek to discern between earnings from core activities and non-leasing operations. Though non-lease income does serve to provide a modicum of protection against unanticipated losses or declining profits, majority of earnings should be derived from the company's core business.

Basic ROAE (%) (1999-2001)

Category	Avg.	Q1	Q2	Q3
Large	18.7	14.5	19.9	21.4
Medium & Small	12.7	8.3	13.4	17.0

**excluding loss making companies*

Q1: First Quartile, Q2: Median, Q3: Third Quartile

Qualitative factors: Substantiating the quantitative findings

While quantitative considerations are an important component of JCR-VIS's rating assessment, we give similar importance to qualitative factors. The subjective factors (ownership structure, regulations, franchise strength, management and industry position) can have either a positive or negative impact on the overall rating assessment. An important consideration is franchise strength that is the company's ability, based on competitive advantage, to generate a reasonable risk adjusted return on capital for the ascertainable future. A strong and defensible business franchise with sustainable core profitability provides the greatest protection for the creditor.

> **An important consideration is franchise strength that is the company's ability, based on competitive advantage, to generate a reasonable risk adjusted return on capital for the ascertainable future**

Significance of ownership structure

The different forms of ownership structure can have considerable implications as varying degrees of parental support may influence JCR-VIS ratings. The analysis of this issue is based on the evaluation of the availability and degree of such support; whether the support is explicitly outlined or is implicitly inferred.

Consequently, the credit quality of the supporting entity is also analyzed, as support for the associated concern is dependent upon the financial well being of the parent. The key question remains: what is the probability that the parent/associate will support the subsidiary/affiliate in a stress situation and, if received, what will be the nature of such support?

Management Quality: Translating the vision

Management's operating strategies are the fountainhead of successful performance as they have a direct influence on all aspects of a company's operations. As such, the soundness of the strategy and successful application of vision can affect the future performance of a company. In order to comprehend the strategy and vision it is necessary to assess the management's competitive strengths and strategic weaknesses. Equal consideration is also given to the quality of management in terms of the depth of experience in the leasing sector, and qualifications of not only the top executives but other key officials in the company as well. Succession planning and the translation of the vision and strategy in everyday management of the firm, evaluated in the light of historical performance, puts the analyst in a stronger position to predict managerial decisions and their financial outcomes.

Competency of management is necessary to reduce operational risks, as inept management would lead to errors and frauds risking the reputation and franchise value of the entity. This highlights the significance of internal controls and the importance given to such measures within the company. A lax approach towards internal controls would ultimately have a negative impact on the financial strength of the company and as such, JCR-VIS gives due weightage to this factor in the ratings evaluation. Our assessment also takes into account the Management Information Systems employed in a company with reference to the adequacy of the systems to generate useful data that can be utilized by the management in timely decision making.

A lax approach towards internal controls would ultimately have a negative impact on the financial strength of the company

Even though the assessment of management is a qualitative factor, JCR-VIS does use a few ratios to judge the efficiency of operations. Efficiency ratios are given due weightage because a low cost base and efficiency of employees enables a company to maintain profitability even while it faces a strain on revenues. Peer group comparisons such as cost per employee and profit per employee are useful in highlighting the difference between companies in their relative efficiencies.

AVERAGE (2000-01)	EFF (%)	PFT/ EMP	CST/ EMP
Large	42.23	0.58	0.79
Medium & Small	56.25	0.33	0.82

EFF: Efficiency, PFT/EMP: Profit per Employee (Rs. m), CST/EMP: Cost per Employee (Rs. m)

As the numbers indicate, the large companies are more efficient

than the smaller ones, subsequently, they also have a higher net profit per employee and a comparatively lower cost per employee.

JCR-VIS also considers a leasing company's market share in terms of total assets, expense efficiencies and pricing power. Furthermore, a company's operating environment is also given due consideration and the influence of economic factors, policy shifts and regulations is also analyzed because the environment in which the leasing company operates is key to understanding its operations.

The warning signals that analysts at JCR-VIS are on the lookout for are stagnant growth in assets, increasing ratio of NPLs, impairment of equity due to losses not provided for, lack of liquidity and declining operating margins. By picking up such signals and conducting an in-depth analysis we endeavor to provide the concerned parties with our timely opinion on a company's future.

GLOSSARY

Asset Quality:

Non-performing leases and loans (NPLs): Total outstanding principal amount for leases and loans (net of lease key money) whose rentals are outstanding for more than 180 days.

NPLs % Gross Leases and Loans : NPLs as a percentage of gross leases and loans (net of lease key money).

Provisions % Total NPLs: Total provisions as a percentage of total NPLs.

Net NPLs % Equity : Total NPLs net of provisions as a percentage of total equity.

Net NPLs % Net Leases & Loans NPLs (net of provisions) as a percentage of leases and loans (net of provisions & lease key money).

Funding & Liquidity:

Liquid assets: cash, bank balances and marketable securities (valued at lower of cost or market).

Current Ratio: Current assets (net of current portion of lease key money) divided by current liabilities (net of current portion of lease key money).

Short Term Debt % Short Term Assets: Short term borrowings (including current maturities) as a percentage of leases and loans due in one year (net of current portion of lease key money) plus liquid assets.

Liquid assets % Total borrowings: Liquid assets as a percentage of total borrowings.

Capitalization & Leverage:

Capital Formation Ratio: Net profit less cash dividend as a percentage of equity at the beginning of the year.

Debt leverage: Total liabilities (net of lease key money) divided by total equity.

ROAE/ Adj. ROAA: Return on average equity divided by return on average assets adjusted for financial charges, net of the tax shield.

Gearing: Total borrowing divided by total equity.

Profitability:

ROAA : Net profit as a percentage of average assets (net of lease key money).

ROAE : Net profit as a percentage of average equity.

Basic ROAE : Profit before taxation and provisions as a percentage of average equity.

Efficiency:

Efficiency : Operating expenses as a percentage of total revenues, net of financial charges.

Net profit per employee: Net profit divided by the total number of employees in a company.

Cost per employee: Total operating expenses divided by the total number of employees in a company.

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 finance and general management, at local and international level. Prior to joining JCR-VIS, he was CEO of a leasing modaraba and SEVP 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. Mr. Zaidi has held key positions in the industrial and financial sector and has contributed many papers in international and local conferences and workshops. He is a member of rating committee of JCR-VIS.

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

Kiran Lakhwani
Senior Financial Analyst

Kiran Lakhwani, CFA, currently leads ratings of leasing companies, industrial concerns and structured finance transactions. She is also involved in ratings of commercial banks and DFIs.

She holds a Masters degree in Business Administration from the Institute of Business Administration, Karachi.

Nadia Zubairi
Junior Analyst

Nadia Zubairi is involved in the credit analysis of various leasing companies and commercial banks. She holds a Bachelors degree in Business Administration from the College of Business Management, Karachi.

JCR-VIS Credit Rating Company Limited

Affiliate of Japan Credit Rating Agency, Ltd.

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

Information herein was obtained from sources believed to be accurate and reliable; however, JCR-VIS does not guarantee the accuracy, adequacy or completeness of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. Rating is an opinion on credit quality only and is not a recommendation to buy or sell any securities. Copyright 2001 JCR-VIS Credit Rating Company Limited. All rights reserved. Contents may be used by news media with credit to JCR-VIS.