



BANK LOAN RATINGS

Rating Methodology

In response to the introduction of Basel II Accord, which sought to arrive at significantly more risk-sensitive capital requirements, Bank Loan Ratings (BLRs) have begun to take root in some of the emerging economies of the world. In India, bank facilities of more than 15,000 entities have so far been rated. Likewise, the number of bank loan ratings outstanding in Bangladesh is also increasing progressively. In the developed world, the concept of BLRs had already been well established by the turn of the century.

BLRs are aimed at enhancing the liquidity and transparency of the bank loan market. BLRs incorporate the underlying credit risk of the borrower and the support provided by the collateral and covenants package, which improve the recovery prospects of specific financings. A BLR combines JCR- VIS's assessment of an organization's ability to meet its unsecured financial obligations with the likelihood of ultimate repayment of the particular financing being rated through the enforcement of securities by the lender. The higher the entity (i.e.

senior unsecured debt) rating, the more importance is given to timeliness of repayment of the financing as the probability of default diminishes; the lower the entity rating, more emphasis is placed on the recovery prospects of the financing in the post- default scenario.

The initial process of assigning a BLR is similar to that of an entity rating i.e. JCR- VIS's analysts examine all qualitative and quantitative factors that impact the credit quality of the borrower. Once the entity rating has been arrived at, our analysts review the specific characteristics and the structure of the financing being rated in order to determine the extent to which the lender is advantaged or disadvantaged with respect to the unsecured creditors of the borrower in the case of default on that particular financing.

The financing structure is analyzed to cover such factors as the positioning of the financing in the capital structure (e.g. the higher the positioning, the better will be the chances of ultimate recovery), the repayment schedule of the financing (e.g. shorter tenor and

faster amortization of the financing may mitigate the level of uncertainty associated with the future performance of the borrower), quality and reliability of security against the financing.

Assessment of quality of securities includes, among other factors, their current valuation (including forced sales values), nature of charge, probability of obsolescence, and the level of enforceability of the securities as incorporated in the legal documentation. The asset valuation technique used will vary according to the nature of the business of the borrowing entity and of the underlying securities. Assets that do not have sellability or utility outside of the business of the entity, such as media & telecommunication equipment, refineries, may not be taken into account for notching relative to the entity rating. Presence of other covenants does not automatically translate into a higher rating. However, the covenants can serve to reinforce the security package.

The above explained analysis determines the degree of variation of the BLR from the entity rating of the borrower. While recovery statistics may not be readily available in Pakistan, the practice of notching is in line with global studies on ultimate recoveries that continue to reinforce the importance of debt structure for facility level recoveries. Generally speaking, at the facility level, recoveries are likely to be higher where there is a larger cushion of structurally subordinated debt. The legal environment also has signif-

icant bearing on the effectiveness of enforcing collateral and the length of time required for recovery. Impact of the same is incorporated in BLRs assigned by JCR-VIS.

Secured financings may normally receive a rating that is one to three notches higher than the entity rating of the borrower. JCR-VIS adjusts its notching policy as the rated entities approach investment grade resulting in smaller variations from their entity ratings for higher rated entities. As the ratings become higher, the reliance on collateral becomes progressively lower. Conversely, in the lower rating grades, the ultimate recovery prospects and claim priority assume greater importance. An unsecured loan that is effectively subordinated to other senior unsecured debt may be rated below the entity rating of the borrower.

BLRs provide important independent risk appraisals of specific financings, ease in financing syndication and an objective basis for pricing of bank financings linked to the risk factor indicated by the rating. A further potential benefit is the possible creation of a secondary market for repackaged rated financings (such markets already exist in most developed economies) providing lenders with a fresh source of funding and increasing the flexibility of the lender's asset portfolio.

JCR-VIS places the BLRs under surveillance for their outstanding tenor and will monitor the financial performance of the

borrower, status of security and enforcement of covenants of the financing being rated and specific BLRs may be maintained, upgraded or downgraded at any time during their tenor. For the purpose of maintaining uniformity, JCR-VIS rates BLRs on its issuer/issue rating scale. Short term instruments such as working capital finance are mapped on to the short term scale, whereas ratings of long term loans will be mapped to the long term issuer/issue rating scale. This is in line with JCR-VIS's methodology on rating debentures. Such ratings are appended with the suffix (BLR) to distinguish from other credit ratings.

Important Rating Considerations in BLRs

(these are more elaborately explained in Corporate Credit Risk methodology)

I. Industry Risk

- Sensitivity to economic & fiscal changes
- Competitive landscape
- Life scale stage indicating earnings & profit prospects
- Buyer & supplier markets
- Barriers to entry (*including sensitivity to technological advancements)

II. Management Risk Factors

- Corporate profile
 - Organization structure
 - Corporate governance standards
 - Managerial depth & experience

- Turnover and succession planning
- Payment track record
- Business Strategy
- Automation and management information systems
- Internal controls
- Risk management practices

III. Operational Risk Factors

- Brand value / Market share
- Competitive edge
- Diversification
- Access to raw material
- Access to finance
- Labor relations
- Growth potential
- Quality of plant & machinery
- Availability of substitutes

III. Financial Risk Factors

- Cash flow & liquidity
 - Cash flows (level, growth, seasonality /cyclicality)
 - Debt servicing coverage
 - Availability of un-utilized credit lines
 - Matching of funds
- Capital structure
 - Existing capital structure
 - Proposed capital structure with induction of new financing
 - Position of the prospective financing in the proposed capital structure
- Earnings quality
 - Sources of earnings
 - Diversity & volatility in earnings
 - Operational efficiency

- Effective utilization of financial leverage
- Asset quality
- Asset mix: deployment of assets
- Future BMR / capex requirements

IV. External Support

- Financial strength and support of the sponsors
- Third party guarantees, if any.

V. Financing Structure

- Tenor & repayment schedule
- Nature of collateral
- Determination of asset value secured as collateral against the prospective financing – Legal documentation
- Realizability of collateral – time to realize collateral and extent of value protection in distressed sale.



Faheem Ahmad

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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.



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Sobia Maqbool, CFA is in charge of rating assignments across a diverse range of sectors, including corporates, sub-sovereigns and financial institutions, including commercial banks, insurance companies, investment banks, leasing and modaraba companies (Islamic finance), microfinance institutions, brokerage houses & mutual funds. In addition to this, she is also involved in research activities, development of methodologies & staff training. She has spoken at both local and international forums. She has a Master's degree in Business Administration from the Institute of Business Administration, Karachi and is also a CFA charter holder.

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.

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