PREFERENCE SHARES

RATING METHODOLOGY

Preference shares rating reflects the relative risk that the issuer will not be able to make dividend payments and principle redemption as per agreement

Contents

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PAKISTAN CREDIT RATING AGENCY

RATING METHODOLOGY – PREFERENCE SHARES

1. INTRODUCTION

- Purpose of document
- Preference shares features
- Preference shares and its types
- Legal aspects

1.1 This methodology document highlights PACRA's approach to assigning credit ratings to preference shares.

1.2 Preference shares are hybrid instruments with both debt and equity characteristics. Like traditional fixed-rate debt, they pay a fixed-rate dividend. Further, like equity instruments, their right to receive dividend payments ranks below debt-holders.

1.3 Preference shares offer greater financial flexibility to the issuer than traditional debt as there is no contractual obligation of paying dividend when it falls due. On the other hand, they present investors with an advantage over ordinary shares in terms of priority order of dividend payments, whenever these are paid out. Hence, they are considered riskier than debt but less risky than ordinary shares from an investor's point of view.

1.4 Preference shares features:

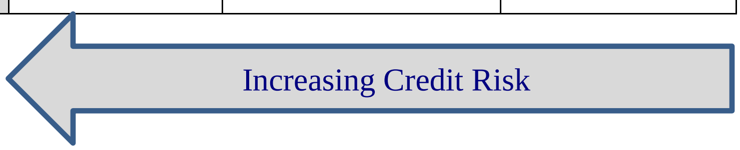
1.4.1 Redemption: The term "redemption" refers to "repayment". Redemption of preference shares occurs when the entire amount due to preference shareholders is paid back by the issuer.

1.4.2 Permanence: Equity is perpetual in nature. The issuer has no legal obligation to buy back the equity. Even when winding up, equity holders will only be paid if there are resources left after settling all other liabilities. Hence, equity fortifies the issuer's risk absorption capacity. On the other hand, debt does not provide any loss absorption as it is time-bounded and has to be repaid, regardless of the issuer's financial condition.

1.4.3 Legal obligation to service: Debt servicing is mandatory on the issuer. While, the issuer may choose to delay or cancel dividends on preference shares. In case of cumulative preference shares the dividends can be accrued and paid at a later date once all other liabilities have been settled. While dividends on non-cumulative preference shares are cancelled if not paid in any particular period. Since, debt has to be serviced regardless of financial condition of issuer, it provides no risk absorption capacity. Hence, PACRA considers preference shares more flexible in nature and believe that they augment the issuer's financial profile more than traditional debt.

1.4.4

	Equity	Hybrid (preference shares)	Debt
Permanence	Perpetual	Based on tenure	Based on tenure
Legal obligation to service	None	As per agreement	Yes
Risk absorption capacity	Very high	Moderate	None



1.5 Types of Preference shares: There are several types of preference shares:

1.5.1 Redeemable and perpetual: Redeemable shares are redeemed after a certain period of time. Redemption may be done at a predetermined price. Perpetual shares have no maturity date. Preference shares will continue paying dividends indefinitely.

1.5.2 Cumulative and non-cumulative: Dividend payments on cumulative preference shares, if not paid, are accumulated and have to be paid before any payment is made out to ordinary shareholders. While, dividends on non-cumulative preference shares is not accumulated if not paid.

1.5.3 Convertible and non-convertible: Convertible preference shares can be converted into ordinary shares as per conditions stipulated in the agreement. The conversion may happen at behest of the investor or the issuer. Usually, the conversion takes place after fulfilling certain conditions. Non-convertible preference shares are *'vanilla'* in nature with no convertibility feature.

1.5.4 Other types of preference shares include zero coupon and participatory preference shares. They have distinct features and are considered accordingly.

1.6 It is pertinent to note that instruments favor issuers at expense of the investor, and vice versa. Hence, equity-like instruments, which are beneficial to issuers as explained above, carry the highest risk for an investor. Hence, they will have the lowest ratings from an investor's point of view.

1.7 Preference shares may fall under any of the three categories, equity, hybrid or debt. PACRA decides on the placement depending on their individual characteristics. Based on their characteristics, preference shares are notched down from issuer rating:

- → **Cumulative/Convertible:** Dividend on such shares accumulates instead of being cancelled which is a positive rating factor. However, convertibility can be either positive or negative for the investor depending on which party has the right to exercise the conversion. PACRA normally views conversion option with investor as positive, while mandatory conversion or conversion at issuer's discretion is usually considered negative.
- → **Cumulative/Non-convertible:** PACRA generally considers such preference shares as superior to other types since there is no conversion provision and the dividend accumulates.
- → **Non-cumulative/Convertible:** These carry higher risk as investors may never receive any dividends. The final rating depends on which party has the right to exercise the conversion as explained above.
- → **Non-cumulative/Non-Convertible:** Non-accumulation of dividend is a negative, while, non-convertibility is generally positive from an investor's stand point.

2. HOW TO RATE PREFERENCE SHARES?

- Adjusted issuer rating
- Notching criteria

2.1 Ratings of preference shares reflect the relative risk that the issuer will not be able to make dividend payments and redeem as per agreement. Preference share rating is done in the same manner as any other instrument rating. Firstly, PACRA assesses the issuer's debt repayment capacity based on its respective entity rating methodology (e.g. Bank Rating Methodology, Corporate Rating Methodology etc.) to determine issuer rating.

2.2 Adjusted issuer rating: While determining the issuer rating, it is important to understand that preference shares may have a potential economic impact on the overall financial profile of the issuer. The dividend due each year will dent the issuers profitability, and in turn, its risk absorption capacity. Hence, it is necessary to incorporate this impact in the issuer rating. For this purpose, PACRA updates issuer's coverages by including dividend payable on preference shares along with debt servicing components. The issuer rating is then aligned with modified debt service coverages and other ratios.

2.3 Notching: Preference shareholders have a right to dividend and principle repayment which is subordinate to debt-holders but superior to ordinary shareholders. Hence, PACRA's credit rating for preference shares will usually be below the adjusted issuer rating. . PACRA adjusts this rating depending on the individual terms and conditions and features of the preference shares.

2.4 The extent of notching down is dictated by the terms and conditions of preference shares. The closer it is to debt in its characteristics, the lesser will be the notching down. Meanwhile, if preference shares replicate equity in their characteristics, it will be further notched down from issuer rating. The table below explains the relationship:

	Cumulative	Non-cumulative
Convertible	**2 notches**	**2-3 notches**
Non-convertible	**1-2 notches**	**2 notches**

2.5 PACRA uses this grid as a general guide. The actual ratings may differ depending on the terms and conditions of the preference share issue. Since ratings depict the risk to investor, the more protection the terms offer for the investor, higher will be the rating, and vice versa.

2.6 Moreover, PACRA may draw exceptions from this grid depending on the issuer's financial profile. Issuers rated in BBB and higher rating categories have a superior ability to repay their obligations. Hence, the distance between ratings of such issuers and their preference shares tend to be lesser. Whereas, for issuers rated in the speculative band are exposed to higher risk. Therefore, PACRA deems their preference shares as even riskier and the notching down tends to be greater.

3. RATING CHANGES

- Downgrade and default

3.1 The ratings assigned as per afore-mentioned criteria may change from time to time. As these are linked to the issuer rating, any change in issuer's ability to meet financial obligations will have a direct impact on preference shares rating. However, preference shares rating may also change without any change in issuer ratings. For instance, when preferred dividends are not declared, PACRA generally downgrades the preference shares rating to reflect the non-payment situation. Further downgrades may occur, under the following circumstances:

→ the overall rating of the issuer may be downgraded as a result of a negative situation that relates to the decision not to pay preferred share dividends.

→ Expectation that non-payment of dividends may continue in coming periods

3.2 **Default:** According to PACRA's definition, dividend payment missed or delayed does not constitute default. Also, any conversion in accordance with pre-determined terms is not regarded default. Default on preference shares occurs in the following cases:

→ The firm is forced into bankruptcy.

→ Contractual obligations (such as sinking fund payments or principal redemption) are not met.

→ Preference shareholders are forced to exchange the issue with one of lower economic value.

4. RATING SCALE

- Scale to map ratings

4.1 The methodology explained above results in a rating of preference shares on the PACRA's issuer rating scale. In order to distinguish this rating from that of the issuer, PACRA uses the suffix 'pf' along with the ratings.

PREFERENCE SHARES RATING
RATING SCALE & DEFINITIONS

Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

LONG TERM RATINGS	
AAA (pf)	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments.
AA+ (pf) AA (pf) AA- (pf)	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ (pf) A (pf) A- (pf)	**High credit quality.** Very low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ (pf) BBB (pf) BBB- (pf)	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are most likely to impair this capacity.
BB+ (pf) BB (pf) BB- (pf)	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ (pf) B (pf) B- (pf)	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC (pf) CC (pf) C (pf)	**Very high credit risk.** "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Outlook (Stable, Positive, Negative, Developing)
Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch
Alerts to the possibility of a rating change subsequent to, or in anticipation of, a) some material identifiable event and/or b) deviation from expected trend. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating watch may accompany Outlook if respective opinion.

Suspension
It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn
A rating is withdrawn on a) termination of rating mandate, b) the rating remains suspended for six months, and d) PACRA finds it impractical to surveill the opinion due to lack of requisite information.