VIS

Credit Rating Company Limited

GOVERNMENT SUPPORTED ENTITIES

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SCOPE OF CRITERIA

Understanding the influence of corporate relationships is integral to complete credit analysis. As business dynamics continuously reconfigure corporate ownership, its implications for the investor should be outlined. Different corporate structures give rise to diverse support mechanisms, and the degree of credit enhancement implied by any support agreement varies accordingly. Where support agreements are entirely enforceable and completely dependable, ratings of the supported entity may even be at par with the supporting entity, implying maximum possible credit enhancement. The credibility of the supporting entity is the key variable in the equation. Where the organization being rated is a member of a large corporate conglomerate, the influence on this entity may work both ways, i.e. both the stress and support arising from its position within the conglomerate, determines its credit standing.

A rating agency analyzes factors that strengthen or weaken the standalone viability of an entity. The inter play of these factors results in a continuum of support levels, that in turn determines the appropriate degree of credit enhancement. Support levels may be distinguished by relative strength of supporting entities. Traditionally, the strongest providers of support have been the governments. Factors influencing the analysis of support levels/agreements are similar for both government and nongovernment relationships.

This methodology attempts to distil some of the key features common to most Government Supported Entities (GSEs) and addresses their impact on ratings assigned by VIS. GSEs are a universal feature, prevalent in all economies, and mostly function as organizations of national importance. Their role often assumes greater significance in a developing economy, where market mechanisms have not matured and the involvement of the state is perceived as being vital to balanced economic growth. The presence of GSEs in Pakistan is a similar phenomenon. GSEs are generally controlled and/or owned by the government. An entity is analyzed as a GSE when it is believed that the entity because of its peculiar status in economic stabilization and/or the socio-economic development goals could, if under stress, benefit from extraordinary government support, which could enhance the entity's capacity and willingness to meet its financial commitments as they come due. Over the period with greater emphasis being placed on market-based economy supported by a well planned privatization program, GSEs focus has shifted to areas of strategic and social importance. As such, many of the parameters, relevant in the analysis of a government supported entity has now become fluid. GSEs exhibit a large degree of diversity in terms of their form, financial viability and significance of their role in the national economy, all of which have a distinct effect on the level, commitment and continuity of support for the entity.

SUMMARY OF CRITERIA CHANGES

Government Supported Entities (GSEs) rating methodology issued in July 2020 remains largely unchanged. However, the formal classification of SOEs as per the Ownership and Management Policy, 2023, has been laid out and further guidance on ratings of GSEs formed as Joint Ventures (JVs) with foreign governments has been provided.

AN OVERVIEW OF RATINGS FRAMEWORK

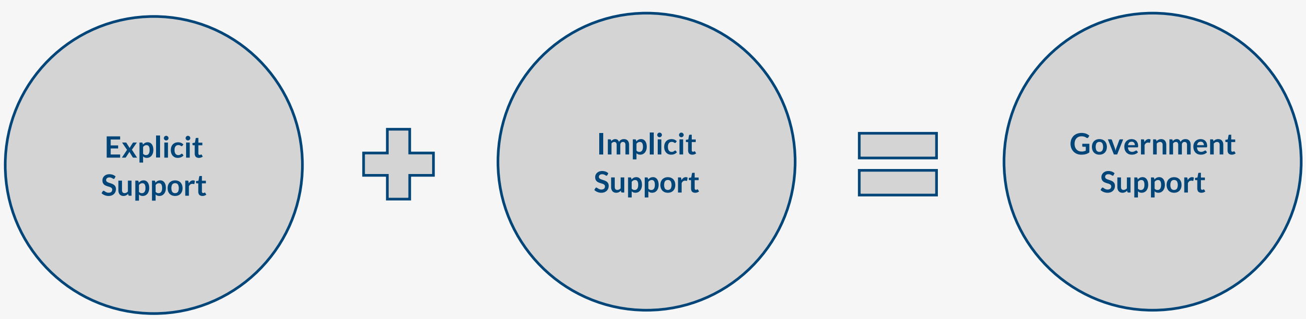
The rating framework for Government Supported Entities (GSEs) involves a two-step approach: first, assessing the entity's standalone financial strength and risk profile without assuming government support, and second, factoring in the nature and likelihood of explicit or implicit support. VIS evaluates external support for GSEs based on their strategic importance, level of government ownership and control, the government's financial capacity and support history, potential social or political fallout from default, and the creditworthiness of the supporting government (including sub-sovereign or foreign entities).

FUNDAMENTAL ANALYSIS

The approach towards analysis of standalone strength and risk profile of a GSE is no different from the general rating approach towards non-GSEs. To arrive at a basic rating, the institution's inherent strengths and financial risks are analyzed in conjunction with its future strategy. The rationale of the exercise is the evaluation of an entity's ability to withstand stress incase government support is not forthcoming, that is on standalone basis. The nature of support available to a GSE is then layered into the rating assessment to arrive at an appropriate credit rating. It is worth emphasizing that ignoring external support factors completely, is neither realistic nor useful for an investor, or any other user of credit rating, as support features substantially affect the likelihood of repayment, particularly in times of stress. The significance of external support available to a GSE can also be understood in terms of 'risk diversification'. As the supporting entity is external to the supported entity and not necessarily affected by the internal credit risks of the entity being rated, its support can be viewed as protection against any eventuality within the GSE itself.

CATEGORIES OF SUPPORT

Support available to all GSEs come in two broad forms.



A. EXPLICIT SUPPORT:

In Pakistan, many of the public sector entities carry government guaranteed debt. In case of explicit guarantees, it is important to discriminate a 'full faith and timely payment guarantee' vis-à-vis an 'ultimate repayment guarantee'. Where explicit guarantees for timely support exist, GSEs are typically assigned the same rating as the government. In case of a local currency rating assigned on a national scale, federal governments are typically rated 'AAA' and therefore debt obligations that are explicitly guaranteed by the federal government, are rated as equivalents. However, entities as a whole may not enjoy the same rating as the sovereign, if only a portion of total obligations is so guaranteed. VIS minimizes the rating differential between GSEs and the government, depending on the proportion of explicitly guaranteed debt to total financial obligations. Further, where the guarantee does not ensure timely payment, the rating will be lower than that of the guarantor.

B. IMPLICIT SUPPORT:

Where support is implied, rather than explicit, determining the extent of external credit enhancement, appropriate for the GSE being rated, warrants further deliberation. Having arrived at an assessment of the standalone rating, we assess the extent of support to be expected, and enhance the rating by an appropriate number of rating notches. In case of implied support, standalone ratings may be enhanced by more than three notches. We have highlighted below, some of the key points taken into consideration by VIS, while assessing external support.

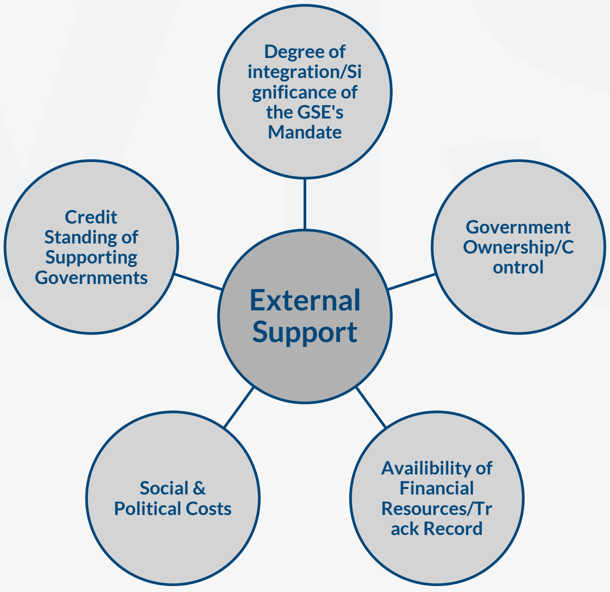
(i) Degree of integration/Significance of the GSE's Mandate:

The degree of integration of an entity into the government itself is one indicator for assessing a GSE's significance. Entities that have a constitutionally determined place in the government, or which undertake business that cannot be undertaken on a commercial basis or signify regulatory barriers exist to enter or exit the concerned business, are usually assigned ratings equivalent to the government. In Pakistan's context, certain special industries like armament industries or nuclear facilities may be considered suitable examples. A GSE may be important to the government because it implements a key national policy or provides an important public service, or because it affects the proper functioning of an important economic sector. The qualitative assessment is supported by quantitative indicators that vary depending on the nature of the GSE's activity and may include, for instance, the GSE's revenues as a percentage of the country's GDP, its share in national exports, its share in the production of energy for the country, or its share in national deposits for a bank.

What needs to be determined is the incentive a government may have, to extend timely support. In other words, estimation is required of the cost that the economy may have to bear, in the event of GSE failure vis-à-vis the cost of preventing a default through timely support. This would require an assessment of how a GSE fits into the state machinery and the extent to which it fulfills the government's key policy objectives. Mandates assigned to GSEs may not be long-term in nature. These GSEs may exist only as interim solutions to the requirements of a developing economy. Over time the government's interest in such an entity is bound to diminish. Therefore, possible erosion of the GSE's value to the state must be factored into the assigned rating.

(ii) Government Ownership/Control:

The strength and durability of the link between a GSE and the government needs to be analyzed primarily by evaluating the degree to which the government determines the GSE's strategy and operations and its level of supervision. Analytical considerations include the percentage of ownership of the GSE, the existence of a partial or ultimate government guarantee of the GSE's obligations, public statements of support, and/or reputational risk to the government if the GSE defaults. The extent of ownership of the government and its involvement in the entity's business affairs may be an indication of the interest exhibited towards the GSE under evaluation. Appointment of board members and/or top management defines the government's stake in the company's wellbeing. Direct majority shareholding or management control of an entity makes it an extension arm of the government and hence the support for its continued operations assumes importance.



Under the Ownership and Management Policy, 2023 of State-Owned Enterprises (SOEs), the federal government shall own and retain ownerships of SOEs that are either Strategic or Essential.

Strategic SOEs perform functions critical to national security, sovereignty, and public interest such as in defense, energy and finance while **Essential SOEs** support the execution of government policies, especially where the private sector is unable or unwilling to operate, such as healthcare, educational and welfare.

(iii) Availability of Financial Resources/Track Record:

The financial strength of the government and its continued access to financial markets is a primary concern which is assessed together with expected strain on these resources due to a large number of GSEs that may be financially distressed. In this respect the total quantum of the government's contingent liabilities should be evaluated to arrive at a measure of expected support to a particular GSE. Form and level of assistance extended in the past may be a relevant indicator in this respect. In many instances, the government may have extended loans or grants to a GSE. The terms of such credits and/or the size of grants provided help assess the degree of support available.

(iv) Social & Political Costs:

Allowing a GSE to fail may be accompanied by varying degrees of social cost. Failure of entities that carry public debt or are listed on the stock exchanges may result in severe public recrimination. As such the government may offer different levels of support to these GSEs, depending on its assessment of expected public reaction.

(v) Credit Standing of Supporting Governments:

Government supported entities may not necessarily be directly related to the federal government. Entities supported by a sub-sovereign i.e. provincial governments, or other forms of local government, e.g. municipalities, often feature similar forms of support. The various factors taken into account while evaluating sovereign supported entities are directly applicable to entities owned or controlled by a sub-sovereign. The only point of difference being the relative credit standing of the sub-sovereign, vis-à-vis the federal government. Interesting forms of government supported entities are those set up as joint ventures. In case of a joint venture between two sovereigns, where the GSE is incorporated in one of the sovereigns, a local currency rating of the GSE would also take into account, the international credit standing of the foreign government, and the local currency rating of the country of incorporation. Moreover, the rating considers whether support is available jointly or severally. If the international credit rating of the foreign government is superior to that of the sovereign where the GSE is incorporated, with liabilities denominated in the GSE's local currency, the ratings are appropriately enhanced. In such cases, the standalone rating of the GSE may be enhanced by more than three notches. However, foreign governments international rating of BBB+ or below may not qualify to match the local currency rating of local government of the GSE.

PRIVATIZATION

Privatization of GSEs has significant implications in this regard. While assigning credit ratings, the possibility of privatization over the near term whether partial or complete is to be considered. Though a GSE may continue to assist the government in policy implementation even after privatization, its role in the workings of the public sector would be substantially reduced, thereby reducing or even eliminating the possibility of state support. As such the financial viability of the GSE, in the absence of government support, requires thorough consideration. The credit standing of the buyer will be a critical factor in the post privatization scenario that cannot be evaluated prior to sell off. However, a standalone rating based on intrinsic financial strength, does provide investors with a reliable estimate of the entity's risks, for entities where the government is expected to offload its holding, either through partial sell off or complete privatization. To ease the transition of credit ratings into an entity's post privatization credit standing, VIS, publicly discloses these standalone ratings.

RATING SCALE & DEFINITIONS

Rating scale and Definitions may be accessed at (https://docs.vis.com.pk/docs/VISRatingScales.pdf)

Jahangir Kothari Parade (Lady LLoyd Pier) Inspired by Her Excellency, The Honorable Lady Lloyd, this promenade pier and pavilion was constructed at a cost of 3 Lakhs and donated to the public of Karachi by Jahangir Kothari to whose generosity 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.

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, VIS is positioned to aim for an international mark. In this regard, the global experience of our international affiliates and partners have 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, VIS continues its endeavour to remain an emblem of trust.

INTERNATIONAL

Affiliates

Islamic International Rating Agency – **Bahrain –** iira.com

Credit Rating Information & Services Ltd. – **Bangladesh –** crislbd.com

Collaborations

Japan Credit Rating Agency, Ltd. - **Japan**

China Chengxin International Credit Rating Company Limited - **China**

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