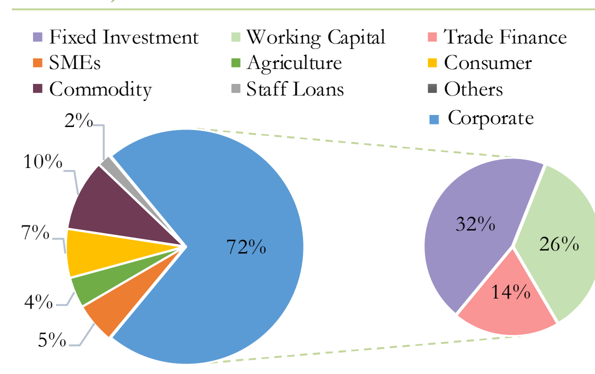
6. The Corporate Sector

Despite challenging conditions, the performance of non-financial corporate sector remained mixed; a view based on a sample of top-100 listed firms. The profitability and debt repayment capacity showed improvement while sales, solvency and asset efficiency indicators trended downwards. Disaggregated analysis highlighted that automobiles, energy and cement sectors faced major contractions in sales. The investors' perception about the corporate sector oscillated with the movement of macro-fundamentals. While the probability of defaults had increased, the levels remained on the lower side. The concerted efforts of the policy makers, however, may further improve the environment related to ease of doing business. The on-going COVID-19 pandemic could have strong repercussions for the corporate sector.

The interconnectedness between the corporate sector and the banking sector remained strong…

In Pakistan, banks are the key source of financing for the corporate sector, as the capital market depth remains limited. Lending to corporations constituted 71.94 percent (PKR 5.97 trillion) of banks' domestic loan portfolio as of end CY19 **(Chart 6.1)**. As such, strong interconnectedness existed between the two sectors. Thus, a shock in any one of the two sectors can adversely affect the operating performance and solvency of the other.

Chart 6.1: Segment wise distribution of domestic advances, as of end December 2019



Source: SBP

A select sample of firms forms the basis for the analysis of the corporate sector…

Since the financial statements of only listed companies were publicly available, the assessment of the corporate sector's performance was based on the financial statements of top 100 listed companies. These companies belonged to various sectors and, in aggregate, comprised 77.94 percent share in the asset base of all the listed companies.[260] As the listed companies, among the corporates, are generally more organized, managed professionally and have better financials, their performance could be treated as the upper bar for other firms. As such, the insights gained from the analysis of this restricted sample presents a partial view of the performance of the entire corporate sector.

Despite challenges, the overall performance of the selected sample of corporates remained stable…

During the period under review, tighter financial conditions and higher input prices pushed the cost of doing business up and demand for goods down for the corporate sector **(Chapter 1 and Chapter 3.1)**. There was deceleration in the growth of corporate sector's assets (7.1 percent in CY19 against 16.1 percent in CY18) and domestic sales went down by 1.6 percent **(Table 6.1)**. Owing to higher interest expense, firms partially shifted their current liabilities from short-term borrowings to trade credit and other payables.

Nevertheless, despite dip in the sales, the corporates were able to improve profitability, primarily, backed by efficiency in administrative expenses and curtailments of cost of goods sold (**COGS**)—a short-term profit preservation strategy. Higher profitability, on the one hand, enhanced the debt repayment capacity of the firms

[260]For 2019, the detailed financial position and performance of the selected companies were taken until September 2019, as reported by them.

and, on the other hand, masked the underlying weakness in demand.

Moreover, the liquidity indicators (e.g. current ratio), along with gearing and leverage, remained intact over the year. The increase in long-term investment hinted at enhanced capacity. Asset turnover, though, declined due to subdued sales during CY19.

Overall, the assessment indicated preservation of financial soundness and stable operating performance by the top 100 corporates.

Though sector-wise performance portrayed a mixed picture…

A few sector-specific risks were the highlight of the year. Cement sector faced over-production and price risks. Energy and oil sectors were confronting the problem of circular debt. Auto sector was dealing with the dwindling sales due to lower demand. Textile sector faced the risk of increased competitive pressures due to devaluation of the regional currencies against US dollar and hike in the cotton prices.

While the investors in the stock market gave more weight to the macro fundamentals…

Market sentiments mainly reflected the changing macro-financial dynamics as indicated by high volatility in KSE-100 index during the year **(See Chapter 2)**. The credit worthiness remained stable as reflected by the improvement in the credit ratings.[261]

Table 6.1: Financial Statements of PSX Listed Companies and Ratio Analysis

	CY15	CY16	CY17	CY18	CY19*	*growth*
			PKR billions			
Balance Sheet						
Non-Current Assets	2,624	2,761	2,853	3,069	3,269	*6.52%*
Net Operating fixed assets	*1,659*	*1,710*	*1,884*	*2,374*	*2,542*	*7.11%*
Intangible assets	*161*	*168*	*178*	*162*	*159*	*-1.48%*
Long term investments	*544*	*561*	*442*	*403*	*448*	*11.38%*
Other non-current assets	*69*	*79*	*78*	*131*	*119*	*-9.26%*
Current Assets	2,037	2,154	2,694	3,368	3,623	*7.58%*
Cash & bank balance	*182*	*216*	*219*	*193*	*196*	*1.47%*
Inventories	*373*	*379*	*462*	*709*	*742*	*4.73%*
Trade Debt / accounts receivables	*826*	*823*	*1,001*	*1,397*	*1,575*	*12.75%*
Short term loans and advances	*46*	*57*	*86*	*119*	*117*	*-1.99%*
Short term investments	*154*	*174*	*287*	*212*	*179*	*-15.60%*
Other current assets	*456*	*505*	*638*	*738*	*814*	*10.35%*
Total Assets	4,661	4,914	5,546	6,436	6,892	*7.08%*
Shareholders' Equity	2,274	2,478	2,732	3,009	3,195	*6.20%*
Issued, Subscribed & Paid up capital	*490*	*493*	*539*	*552*	*554*	*0.30%*
Reserves	*1,623*	*1,825*	*2,035*	*2,287*	*2,475*	*8.21%*
Surplus on revaluation of fixed assets	*161*	*160*	*158*	*170*	*167*	*-1.82%*
Non-Current Liabilities	769	788	837	862	937	*8.67%*
Long term borrowings	*381*	*376*	*404*	*440*	*457*	*3.83%*
Subordinated loans / Sponsor's loans	*2*	*3*	*4*	*7*	*6*	*-13.83%*
Debentures/TFCs (bonds payable)	*16*	*19*	*12*	*3*	*-*	*-100%*
Employees benefit obligations	*75*	*68*	*75*	*75*	*82*	*10.11%*
Other non-current liabilities	*295*	*321*	*341*	*337*	*391*	*16.17%*
Current Liabilities	1,618	1,649	1,977	2,566	2,760	*7.57%*
Trade credit & other accounts payables	*962*	*965*	*1,173*	*1,304*	*1,560*	*19.55%*
Short term Borrowings	*426*	*437*	*516*	*804*	*812*	*1.02%*
Current portion of non-current liabilities	*120*	*124*	*133*	*168*	*168*	*-0.18%*
Other current liabilities	*109*	*122*	*155*	*290*	*221*	*-23.72%*
Total Equity & Liabilities	4,661	4,914	5,546	6,436	6,892	*7.08%*
Income Statement						
Sales	4,640	4,059	4,717	5,603	5,550	*-0.95%*
Local sales (Net)	4,271	3,730	4,382	5,214	5,130	*-1.60%*
Export sales (Net)	369	329	335	389	799	*105.29%*
Cost of sales	3,847	3,278	3,871	4,640	4,563	*-1.67%*
Gross profit / (loss)	793	782	846	963	987	*2.50%*
General, administrative & other expenses	285	333	345	388	230	*-40.58%*
Other income / (loss)	144	138	154	132	97	*-26.58%*
EBIT	652	587	655	707	854	*20.68%*
Financial expenses	106	79	77	93	110	*18.76%*
of which, Interest expenses	88	64	65	67	79	*17.98%*
Profit / (loss) before taxation	546	508	578	614	743	*20.97%*
Tax expenses	128	122	143	156	216	*38.60%*
Profit / (loss) after tax	418	386	435	459	528	*14.99%*
Financial Ratios						
Gross Profit Margin (%)	17.09	19.25	17.93	17.18	17.78	
Net Proft Margin (%)	9.01	9.50	9.23	8.19	9.51	
Return on Equity (%)	18.39	15.57	15.93	15.25	16.52	
Return on Assets (%)	8.97	7.85	7.85	7.13	7.66	
Current Ratio (units)	1.26	1.31	1.36	1.31	1.31	
Asset Turnover (%)	99.56	82.59	85.05	87.05	80.53	
Capital to Total Assets(%)	65.29	66.45	64.35	60.14	59.95	
Debt Equity Ratio (units)	1.05	0.98	1.03	1.14	1.16	
Debt to Capital Employed (units)	0.78	0.75	0.79	0.89	0.89	
Interest Coverage Ratio (units)	7.38	9.12	10.07	10.59	10.84	
Financial Leverage (units)	2.05	1.98	2.03	2.14	2.16	

Source: SBP

*Data of 100 companies were used that represent 73% of listed non-financial entites. CY19 represents actual unaudited reported data as of Q3CY19.

261 Further, most firms fell under investment grades.

Corporates followed cost minimization strategies in the wake of difficult operating environment…

The consolidated pro-forma financial statement exhibited augmented profitability, despite dip in local sales, higher financial cost and growing tax expense. As such, corporates managed to make a marked reduction in their administrative and general expenses along with lower COGS. This cost minimization strategy resulted in after tax profit increasing by 14.99 percent in CY19 (5.45 percent in CY18) and improving all profitability indicators. Higher earnings preserved the debt repayment capacity of the corporates as the interest coverage ratio increased.

They also rebalanced their assets and liabilities…

The growth of the asset base of the corporate sector almost halved to 7.08 percent in CY19 compared with a healthy increase of 16.05 percent in CY18. Primarily, the current assets caused the slowdown. There was slackness in inventory build-up and trade receivables. Under the non-current assets, however, long-term investments increased indicating some continuation of expansion plans by the corporates.

On the contrary, both long-term and short-term borrowing decelerated owing to rise in interest rates. This is consistent with the marked deceleration in the financing offtake for working capital and fixed investment advances (**see Chapter 3.1**). However, trade credit and other account payables increased by 19.55 percent in CY19 (11.17 percent in CY18). Thus, corporates replaced short-term borrowings with trade debts and payables.[262] This ability of the high-end corporates to shift the funding to interest-free trade credit also reflects their bargaining power in the supply chain of their production process. Due to limited scope of debt market in Pakistan, the borrowing through TFCs/debentures remained limited.

While the domestic focused firms witnessed decline in sales, the export oriented ones benefited…

Domestic macroeconomic dynamics adversely influenced the sales performance of the corporates during CY19. The total domestic sales contracted by 1.60 percent against a rise of 19.0 percent in CY18. As the stabilization measures gathered traction, the aggregate demand and incomes fell but inflation remained at elevated levels. This affected the purchasing power of the consumers and the spending activity contracted further. All this reflected in the drop in domestic sales of the selected sample firms.

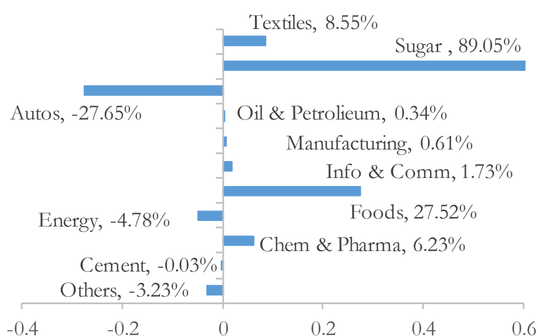
However, alignment of exchange rate with market fundamentals increased the competitiveness of exportable goods. Consequently, there was 105.29 percent rise in export sales, which constituted 14.40 percent of total sales in CY19 (export sales were 6.95 percent of total sales in CY18).

In terms of various economic sectors as well, the divide in sales was quite visible. The sectors that experienced most stress were automobiles, followed by energy and cement sectors. Together, they accounted for around 23.34 percent of the total corporate sector sales. On the contrary, firms operating in sectors having outward orientation, like textiles, sugar, manufacturing etc. saw their sales rising **(Chart 6.2)**.

[262] Trade debt and payables had 50.84 percent and 31.32 percent share, respectively, in the short-term liabilities in CY18, which increased to 56.50 percent and 29.41 percent, respectively, in CY19.

Chart 6.2: Sector-wise Sales Growth, CY19

(Percentages)



Source: SBP

Despite slight increase in leverage, the debt repayment capacity remained intact…

Due to higher Earnings before Interest and Taxes (**EBIT**), the debt repayment capacity of the corporate sector improved during CY19. The interest coverage ratio inched up from 10.59 in CY18 to 10.84 in CY19 **(Table 6.2)**. The solvency indicator, in terms of capital to total assets, deteriorated slightly during the reviewed year, as the growth in capital could not match the rise in asset base.

Table 6.2: Key Financial Indicators

	CY17	CY18	CY19
Profitability; Return on Equity (%)	15.93	15.25	16.52
Liquidity; Current Ratio (units)	1.36	1.31	1.31
Operational Effeceincy; Asset Turnover (%)	85.05	87.05	80.53
Solvency; Capital to Total Assets (%)	64.35	60.14	59.95
Leverage; Debt Equity Ratio (units)	1.03	1.14	1.16
Debt Repayment Capacity; Interest Coverage Ratio (units)	10.07	10.59	10.84

Source: SBP

Rise in taxation burden, besides other factors, resisted further rise in profitability…

The Return on Equity (**ROE**) increased from 15.25 percent in CY18 to 16.52 percent in CY19 **(Table 6.3)**. The Extended DuPont analysis revealed that improvement in operating profit margin (EBIT over sales) and slightly higher leverage (asset over equity) supported the earnings. On the contrary, the tax burden of the corporates increased. Similarly, decline in the asset-usage efficiency due to subdued sales limited the rise in ROE.

Table 6.3: Extended DuPont Analysis

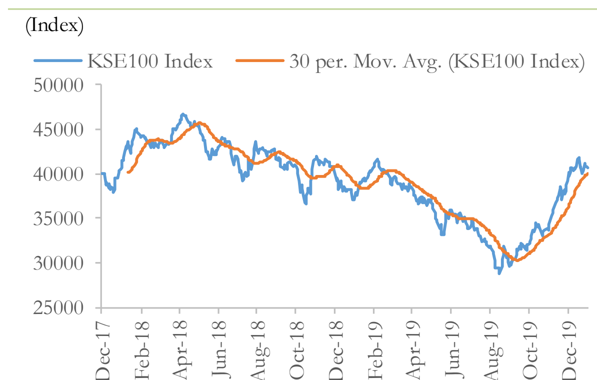
	CY17	CY18	CY19
Tax Burden (A)	0.75	0.75	0.71
Interest Burden (B)	0.88	0.87	0.87
Operating Profit Margin (C)	0.14	0.13	0.15
Asset Use Effeciency (D)	0.85	0.87	0.81
Financial Leverage (E)	2.03	2.14	2.16
Return on Equity (ROE) % (AxBxCxDxE)	**15.93**	**15.25**	**16.52**

Source: SBP

Market sentiments about corporate performance reflected the changing economic conditions…

KSE-100 index is a proxy to gauge the market sentiments about the current and future performance of the corporate firms operating in Pakistan **(Chart 6.3)**. During CY19, increase in interest rates, rise in energy prices, fiscal measures to enhance tax revenues, uncertainty among market participants over IMF program, and geo-political tensions kept the equity market under stress until August 2019 as it fell by 24.30 percent. However, in the last quarter of CY19, KSE-100 index rebounded by 41.62 percent. The strong recovery happened because of marked improvement in current account due to exchange rate alignment with the market and bilateral and multilateral financial inflows, inversion in yield curve, signing of the IMF program, and upgrade in Pakistan's credit rating by S&P and Moody's. **(See Chapter 2)**.

Chart 6.3: KSE-100 Index



Source: PSX, SBP

Cement sector faced challenges owing to softening demand…

Cement sector's capacity expansion was materializing as planned that could cause risk of oversupply. In CY19, feeble demand—driven by lower pace of economic activity and subdued PSDP expenditures—for cement caused downward pressure on cement prices and capacity utilization levels. In addition, crackdown on housing projects by FBR dented construction activity during H1CY19. As a result, the revenue of the cement sector declined by 18.20 percent in the reviewed year. However, in year-on-year comparison, cement local dispatches showed growth of 6.77 percent in December 2019 (negative 3.27 percent year-on-year growth in December 2018).[263]

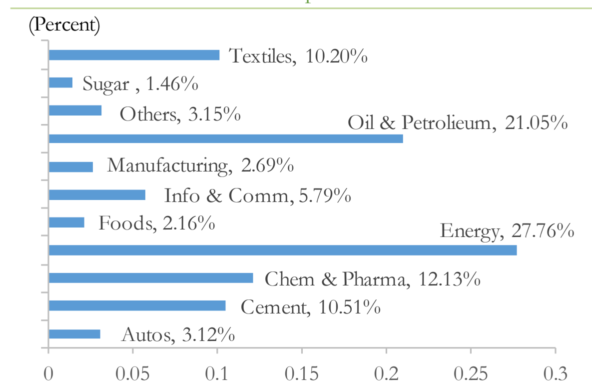
On the contrary, cement exports increased by 38.00 percent.[264] The exchange rate adjustment supported the price competitiveness of the sector; however, exports were only a nominal part of the aggregate cement sales. The outlook for the sector also seemed tough as overproduction might cause downward pressure on prices coupled with higher operating leverage.[265] The surcharges in energy and gas tariffs could also inflate input costs. Moreover, outbreak of global pandemic might delay expected major public sector development projects that could aggravate the sector's challenges. Furthermore, it might have negative impact on the export sales.

Power sector continued to face challenges in CY19…

Power sector continued to hold the major asset share of corporate sector during CY19 **(Chart 6.4)**. Though the operational performance of the power sector improved in the reviewed year, it remained vulnerable to the rising circular debt.[266] The circular debt—with addition of PKR 465 billion—reached PKR 1,618 billion in CY19 (4.20 percent of GDP).[267] Increasing level of circular debt created liquidity issues for the power sector entities (**See special box 3.1**).

Materialization of capacity expansion plans increases the burden of capacity payments, as there was limited growth in demand and revenue collection.[268] However, the government took measures to contain circular debt and to ease liquidity stress. The issuance of Pakistan Energy Sukuk II worth PKR 250 billion, would help address liquidity problems of the power sector.[269]

Chart 6.4: Asset-wise break-up of sectors



Source: SBP

263 All Pakistan Cement Manufacturer Association (APCMA)
264 BMA Capital (2020). Pakistan Strategy 2020. *Karachi, January.*
265 Operating leverage can be defined as the capability of the firm to use its fixed expenses to generate better returns.
266 Rise in circular debt is due to recovery shortfall of electricity bills, increase in transmission and distribution losses, delayed tariff adjustments and rise in finance costs.
267 International Monetary Fund, IMF Country Report No. 19/380
268 Capacity payments are charges paid to power producers for unused and unproduced but agreed level of electricity.
269 Ministry of Finance, Press release, PR No. 239

Circular debt kept Oil & Gas sector under stress as well…

Oil & Gas is the leading sector in terms of both market capitalization as well as the quantum of borrowings from the banking sector. During the period under review, the local production of hydrocarbon weakened as compared to last year. The impact was countered by the increase in global oil prices and currency depreciation. Thus, the sector remained profitable in CY19. To meet the tight fiscal deficit targets, the government was planning to offload its stake in OGDC and PPL, where the government's share stands at 7 percent and 10 percent, respectively.[270]

Power generation via furnace oil continued to decline in CY19 and anticipation is that this trend could continue in the future. Although domestic prices of the furnace oil declined, the production cost parity between furnace oil and other fuel sources remained high. High Speed Diesel (**HSD**) demand declined during the year due to economic slowdown and sale of cheaper Iranian products.[271] Even though, automobile sales declined, the motor petrol sales remained positive. Moreover, the gas tariff on the CNG reduced the price differential between CNG and motor petrol. Consequently, some vehicle users switched back to motor petrol as a fuel choice. Moreover, the number of on-road vehicles remained high, despite the decrease in automobile sales during the year.

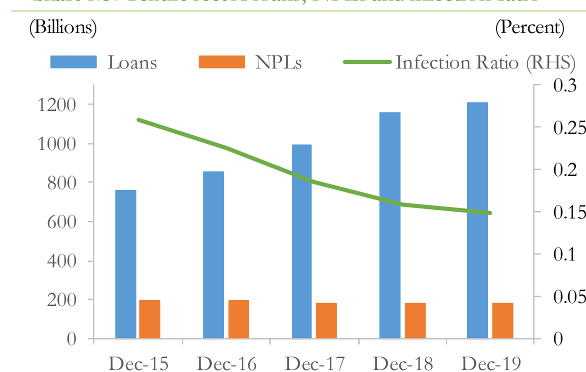
Textile sector incentivized to enhance their exports…

Textile sector, being the major export-oriented sector, benefited most from the macroeconomic adjustments in CY19 especially the exchange rate alignment. Besides higher credit offtake, the NPLs and infection ratio of the sector also witnessed declining trend **(Chart 6.5)**. Further, the governments incentivized the sector to boost its exports through subsidized financing and utilities. To improve the sector's liquidity, the government retired the previously issued promissory notes to the tune of PKR 30 billion.[272] However, withdrawal of zero-rating facility and delay in sales tax refunds pressurized the liquidity of the sector.

Last year, shortfall in the cotton production coupled with constrained imports from India led to rise in cotton prices. To remedy that, government withdrew duties on imported cotton and allowed cotton imports from Afghanistan and Central Asian States. Thus, the cotton prices might ease off in CY20. Moreover, the implementation of China Pakistan Free Trade Agreement-II (**CPFTA-II**) would enable Pakistan to export new products to China.

Nevertheless, devaluation of the regional currencies against US dollar could result in increased competitive pressure for Pakistan's textile exports. Given that domestic industry relies heavily on natural fiber, the hike in the cotton prices, along with stagnant final product price, might hurt the profit margins of the textile entities.

Chart 6.5: Textile sector loans, NPLs and infection ratio



Source: SBP

Automobiles sector witnessed worst sales performance in CY19…

[270] https://www.brecorder.com/2019/11/30/549117/spo-for-ogdcl-ppl-expected-to-fetch-rs88bn/

[271] BMA Capital, Pakistan Strategy- A new market high in 2020

[272] The government has approved Rs30 billion for redemption of sales tax refund bonds issued by the Federal Board of Revenue (**FBR**)Ministry of Finance, Press Release, PR No. 215

Automobiles sector faced challenges because of dwindling consumer demand. Government imposed ban on sales to non-filers of tax returns and increased excise duties on imported vehicles.[273]. On top of that, price hike within the range of 24 percent - 36 percent, owing to exchange rate depreciation further weakened the demand for automobiles.[274] Consequently, sales of passenger car plunged by 43 percent during CY19[275].

Additionally, increase in competition due to new entrants, Kia and Hyundai, and sanction of Electric Vehicles policy might put downward pressure on the price levels in the coming years. However, if the ban on imported vehicles continues it could benefit the local assemblers.

Probability of default for the corporate sector decelerated …

The weighted average 1-year PD of selected firms of the corporate sector increased to 0.17 percent in CY19 (0.15 percent in CY18) **(Chart 6.6)**.[276] The rise was, primarily, due to increased volatility in the market, which remained under stress for majority of the time in CY19. However, the growth in PD decelerated compared to last year due to improvements in operating performance and increased investors' confidence as bolstered by successful implementation of stabilization program. Further, the quantum of PDs, itself, is at the lower side and does not pose notable default risk to the lenders of corporate firms. As such, these corporate firms maintained strong financial soundness and decent operating performance despite challenging macro-financial conditions.

Chart 6.6: Weighted avg 1 year PD of Corporate Sector

Source: Bloomberg, SBP

…and the credit risk of the non-financial corporate firms could have improved in CY20

An econometric investigation into the impact of financial and macroeconomic factors on the possible corporate delinquencies during CY20 revealed that most of the firms could remain in the *safe zone* and that limited number of firms could fell in the default zone. As such, the number of firms expected to default in CY20 is lower than firms actually defaulted in CY19, 44 against 49 **(Box 6.1)**.

However, the outbreak of COVID-19 and uncertainty surrounding its repercussions changes the scenario altogether. If the pandemic prolongs, it will have severe consequences for the economy and the number of defaults of non-financial corporate firms could rise substantially.

Credit risk ratings culture showed improvement…

In recent years, the rating culture in Pakistan showed improvement as, out of the 544 listed entities, about 82.35 percent of them were rated in CY19.[277] However, in the universe of total registered public companies, the rated companies comprised merely 14.36 percent, which was on the lower side. Many companies in Pakistan rely on indirect source of financing like banks or their internal sources (profit plough backs etc.) but

[273] Federal Budget Speech 2019-20, pg,32, FED on Cars
[274] Optimus Capital Management, Market Strategy 2020
[275] Optimus Capital Management, Market Strategy 2020
[276]The PD (1 Year PD) is mainly driven by the quality of firm's liquidity management and ability to honor short-term obligations.
[277] In CY18, out of 558 listed entities only 55.56 percent were rated.

remain less reliant on capital market for their funding needs **(See Chapter 3.1)**. Out of the rated entities, major chunk of the companies lie in investment grades (AAA to BBB-), which advocates high credit quality in terms of long-term ratings **(Table 6.4)**.

Table 6.4: Ratings of Listed Companies in CY19

Long-term		Short-term	
Ratings	**Percent**	**Ratings**	**Percent**
AAA	3.6%	A1+	15.8%
AA+	4.0%	A1	26.3%
AA	6.0%	A2	43.8%
AA-	7.4%	A3	9.8%
A+	8.7%	Others	4.2%
A	13.4%		
A-	27.5%		
BBB+	7.8%		
BBB	8.5%		
BBB-	6.0%		
Others	7.1%		

Source: PACRA, JCR-VIS

Whereas, in terms of short-term ratings, majority of the companies were rated as A2 that was satisfactory capacity for timely repayment.[278] Companies rated in this category might be vulnerable to adverse changes in business, economic and financial conditions.

Ease of Doing Business ranking significantly improved during CY19…

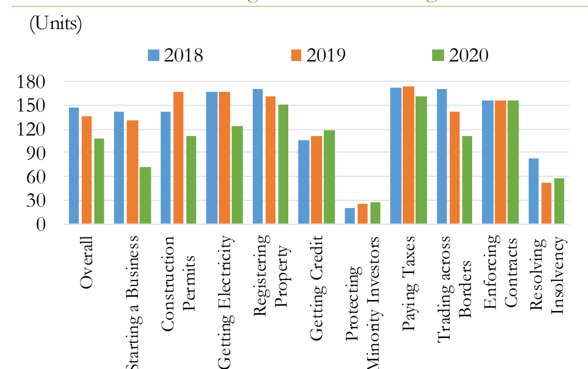
According to the World Bank, Pakistan's ranking in terms of "Ease of Doing Business" improved notably to 108 in 2019 from 136 in the previous year.[279] The score improved on account of getting electricity (from 44.8 to 64.0), trading across borders (from 60.1 to 68.8), construction permits (from 53.6 to 66.5) and starting a business (from 81.9 to 89.3) **(Chart 6.7)**.

Other areas where score improved included registering a property and paying taxes.

Enhancement in the functionalities of the online one-stop shop by Government of Pakistan aided in starting a business segment. Furthermore, introduction of online payment modules for value added tax and corporate income tax streamlined the tax payment process.

Moreover, integration of various agencies in the Web-Based One Customs (**WEBOC**) electronic system and coordination of joint physical inspection at the port improved the score in the segment of trading across borders. Enhancement in the approval process and regular building quality inspections made procurement of construction permit relatively easier and safer. Moreover, the enforcement of service delivery time frames, launch of an online portal for new applicants and transparency in electricity tariffs enhanced the getting electricity segment.

Chart 6.7: Ease of Doing Business - Rankings



Source: World Bank, SBP

278 PACRA. (2019). Rating Scale. Pakistan, March. http://www.pacra.com.pk/uploads/doc_report/PACRA_Rating%20Scale_Corporate_FY18.pdf

279 World Bank. (2020). Doing Business 2020: Economy Profile Pakistan. Pakistan, March https://www.doingbusiness.org/content/dam/doingBusiness/country/p/pakistan/PAK.pdf