3.7 Risk Analysis of the Corporate Sector

The financial health of corporate sector is satisfactory with steady growth in asset base and high ROA and ROE, though profitability ratios are trending downwards. The extended DuPont analysis reveals that decline in ROE is, primarily, due to dismal sale performance particularly in textile and energy sectors. The listed corporate companies are mostly relying upon own resources due to strong profitability, and adequate cash flows from operations. From the risk management perspective, rating culture needs to be developed while concerted efforts are needed for utilizing alternative financing avenues.

Corporate sector, by virtue of its deep connections with the financial sector, is an important player from the financial stability perspective throughout the business cycle. Unchecked corporate leveraging in upswings, in anticipation of higher profit margins, adds momentum to the expansion but sometimes leads to overheating in the economy. In any downturn, however, the capacity of the corporates to repay and take on new risk shrinks thereby accelerating the pace of contractions. The behavior of corporates, along the business cycle, has adverse implications for the real economy as well as for the stability of the financial sector. Escalating defaults concomitantly with squeeze in lending activities severely impacts financial institutions profitability and solvency.

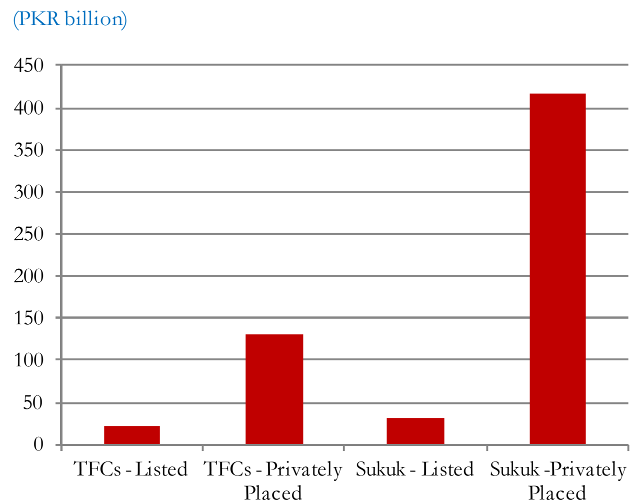
Banks play a lead role in corporate financing…

In Pakistan, as is the case with other jurisdictions, corporate sector is a key player of the financial system. As of end December 2016, domestic corporate sector borrowing from banking sector has reached PKR 3.8 trillion which is around 68 percent of domestic loans (of which, PKR 3.1 trillion pertains to private sector). On the other hand, corporate financing through capital market debt instruments (mostly Sukuk) only stands at PKR 600 billion **(Figure 3.7.1)**.[151] Though equity plays a significant part in asset financing, fresh equity through IPOs has been limited in the last few years **(See Chapter 2).** Thus, the corporate debt structure, in Pakistan, is mostly bank centric with limited reliance on capital debt market or overseas borrowings.[152]

Figure 3.7.1

Pakistan 's corporate debt market is limited and mainly confined in privately placed Sukuk

Corporate Debt Market of Pakistan as of June 30, 2016 (Outstanding)



Source: SECP

Performance of corporate sector in CY16 is mixed…

Since aggregate numbers of corporate sector for CY16 are not available, the analysis has been carried out using two sets of information i.e. (a) a pro forma (projected) balance sheet and income statement for CY16 based on last 5-years average growth (2010-

151 Source: Securities and Exchange Commission of Pakistan (SECP).

152 Overseas private borrowing (i.e. loans) as of end December, 2017 stands at USD 2.64 billion (approximately PKR 277 billion) or around 6.5 percent of corporate's bank borrowing)
Source: http://www.sbp.org.pk/ecodata/pakdebt.pdf

2015) of listed companies and (b) actual financials of top-100 listed companies with available data for CY16 on Pakistan Stock Exchange (PSX).[153]

The total assets of the corporate sector have increased, on average, by 9.9 percent over the last 6 years (2011-2016) **(Table 3.7.1)**. Besides the normal course of business, the sector has witnessed a huge growth of 32.7 percent, on average, in long term investments and 16.2 percent, on average, in short-term investment. Particularly, corporate investment witnessed the growth as high as 83.3 percent (PKR 307.3 billion) in 2013. Funds are mainly invested in government securities especially in PIBs. The profitability of the sector is impressive with high ROA and ROE; though falling over time.

It has been observed that listed companies reflect limited quantum of overall corporate debt from financial institutions. Corporate sector borrowings (PSX Listed Companies only) constitute only 25 percent of the total advances of the banking sector. Further, the growth in borrowing has been 6 percent (lower than the overall credit growth of 8.4 percent) with negative growth in 2013 and 2015. This may be attributed to the following:

a. Corporate sector is cash rich (high cash flows from operation) with current ratio consistently higher than 1 and high profitability (average ROA and ROE are 9.5 percent and 25.5 percent, respectively). This enables the sector to rely on their retained earnings (average growth: 19.7 percent) as the core funding source.

b. The financing demand has remained restricted due to energy crisis, declining inflation, falling oil prices and lower demand in the world market.

c. The borrowings of two major sectors (energy and textile) are lower since 2014. Both sectors are facing challenges, as depicted in their declining sales.

Table 3.7.1

Financial Statements of KSE Listed Companies and Ratio Analysis

(Amount in PKR billion, ratios in percent)

	2013	2014	2015	2016*
Balance Sheet				
Non-Current Assets	**3,112**	**3,430**	**3,745**	**4,207**
of which Long term investments	509	559	607	806
Current Assets	**2,300**	**2,703**	**2,873**	**3,253**
of which Short term investments	167	211	200	233
Current Liabilities	**2,239**	**2,601**	**2,713**	**3,004**
of which Short term Secured loai	653	810	700	757
Non-Current Liabilities	**1,119**	**1,180**	**1,233**	**1,332**
of which Long term secured loai	548	524	606	635
Debentures/TFCs	22	18	38	42
E. Shareholders Equity	**2,053**	**2,351**	**2,671**	**3,031**
of which Paid up capital	634	669	674	708
Reserves	1,125	1,356	1,655	1,986
Total Assets	**5,412**	**6,132**	**6,618**	**7,460**
Income Statement				
Sales	**6,183**	**6,768**	**6,211**	**6,751**
Gross Profit	945	964	964	1,052
Financial expenses	185	182	176	185
of which: (i) Interest expenses	141	145	152	166
Net profit before tax	520	557	571	645
Net Profit After Tax	**383**	**398**	**419**	**482**
Cash Flow from Operations	745	371	517	662
Key Ratios				
Current Ratio	1.0	1.0	1.1	1.1
Debt Equity Ratio	1.6	1.6	1.5	1.4
Return on Assets	9.7	9.7	9.0	9.7
Return on Equity	27.1	25.3	22.7	22.6
Interest Coverage Rtaio	4.7	4.9	3.5	3.4

Source: SBP

*CY16 represents proforma balance sheet and income statement projected based on 5-years average growth

The sector has low debt to equity ratio (1.4 in CY16) which has gradually fallen from 2.0 percent in CY12. The high profits and low debt-equity ratio have strengthened the sector's debt repayment capacity which is reflected through interest coverage ratio at 3.4 in CY16 (though slightly reduced overtime but still seems quite comfortable).

[153] Top-100 listed companies had around 44 percent share in total assets of all corporate and 61.5 percent in private sector corporate as of June 2015.

ROE is falling continuously, though still stands high…

Since there is continued decline in ROE, an extended DuPont analysis on the actual data of top-100 companies for CY16 has been performed to further explore the reasons behind its fall.[154,155] The financial performance of top-100 listed companies as of June 30, 2016, appears mixed. While the net income and assets have grown in 2016, sales have gone down and so has the ROE **(Table 3.7.2)**.

The extended DuPont analysis decomposes the ROE into various financial ratios, and provides helpful insight to assess profitability, leverage and operating performance, altogether.

During the year 2016, ROE of top-100 listed companies has declined to 17.3 percent despite the cushion provided by reduced tax and interest cost burdens (higher ratios indicate reduced burden). While declining corporate tax rates in recent years explains lower tax burden, easy monetary policy with significant downfall in weighted average lending rates has resulted in lower interest burden (**Please see Chapter 3.1)**.[156]

Operating profit margin, though showing some improvement, is mainly due to higher decline in sales compared to rise in profit before interest and taxes (PBIT). The dismal performance in sales, however, is explicitly reflected in asset turnover ratio, which has declined from 1.10 in 2015 (and 1.34 in 2014) to 0.85 in 2016. Similarly, decline in financial leverage also contributed to falling ROE.[157]

Table 3.7.2

Extended Dupont Analysis- Top 100 Non- Financial Companies of KSE-100*

(Amount in PKR billion, ratios in percent)

	2014	2015	2016
Net Income (NI)	260	232	254
Profit Before Tax (PBT)	354	320	337
Profit Before Tax and Interest (PBIT)**	64	68	50
Revenue/Sales	3,511	3,097	2,581
Assets	2,723	2,916	3,167
Equity	1,199	1,382	1,563
Average Assets (Av. A)	2,616	2,819	3,041
Average Equity (Av. E)	1,114	1,290	1,472
Extended Dupont Components			
Tax Burden (a=NI/PBT)	0.73	0.72	0.76
Interest Burden (b=PBT/PBIT)	5.52	4.73	6.74
Operating Profit Margin (c=PBIT/Sales)	0.02	0.02	0.02
Asst Turn Over (d=Sales/Av. A)	1.34	1.10	0.85
Financial Leverage (e=Av. A/Av. E)	2.35	2.19	2.07
ROE (after tax) [axbxcxdxe]x100	**23.38**	**17.96**	**17.27**

*Asset-wise Top-100 companies of 2016 have been taken with available financials on KSE website as of March 15, 2017.
**Financial Charges have been taken as proxy of interest expense
Source: PSX

Dwindling sales performance affecting corporate sector…

Dwindling sales have taken their toll in terms of reducing ROE since last couple of years. Sector-wise investigation reveals that diminishing sales are broad based and more pronounced in the oil & gas and Refinery sectors, most likely, due to continued plunge in oil prices **(Figure 3.7.2)**.

The revenue stream of textile sector – the largest borrower of banking sector, is also on the downside. In FSR-2015, we did highlight several challenges for

154 There are some limitations of combining the balance sheets of corporate for top-100 companies. First, corporates in different sectors have different financial year closing dates. Second, there could have been mergers/acquisitions/closures. These issues have been addressed by keeping the sample of firms constant over time in the analysis.

155 As per DuPont: ROE = Net Income (NI)/Equity (E) = NI/Profit before tax (BPT) x PBT/profit before interest and taxes (PBIT) x PBIT/Sales x Sales/Assets x Assets/Equity
NI/PBT: tax burden, PBT/PBIT: interest burden, PBIT/Sales: gross profit margin, Sales/Assets: sales turnover, Asset/Equity: financial leverage

156 With effect from fiscal year 2014-15, the government has reduced maximum corporate tax rate by 1 percent annually to bring it down to 30 percent by 2018.
http://www.finance.gov.pk/budget/FinalBudgetSpeech_13_14_english.pdf

157 Equity is more expensive source of capital than debt and, thus, reduces ROE.

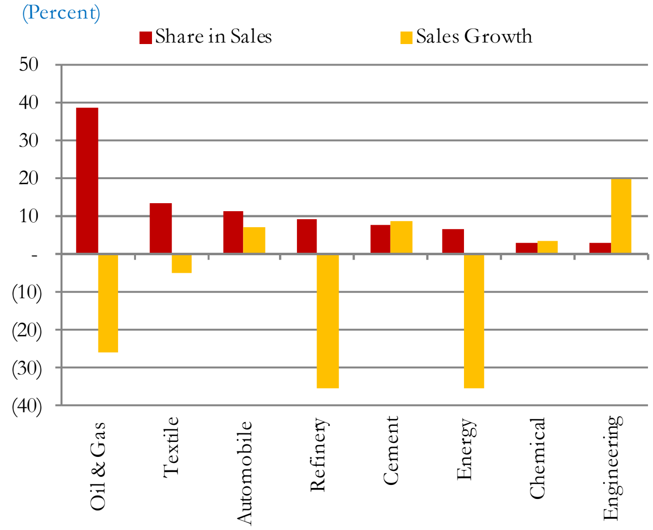
the textile sector including (a) inadequate energy supply, (b) reduced external demand and textile exports, (c) decrease in global commodity prices (particularly cotton prices), (d) reduced demand from China – a major importer of Pakistani textile products etc.[158] Few of these challenges still prevail.

Figure 3.7.2

Sales growth of key corporate sectors has declined in 2016

Sales grwoth long with relative shares of of key sectors during FY16

(Percent)



Source: PSX

However, the outlook for these sectors is positive as oil & gas sector may benefit from the recent rebound in international oil prices while textile sector is expected to recover owing to positive economic outlook, better energy supply, improved security condition[159], and recently announced package from the government enabling the sector to avail several cuts in duties.[160]

Rating culture is not yet developed in Pakistan…

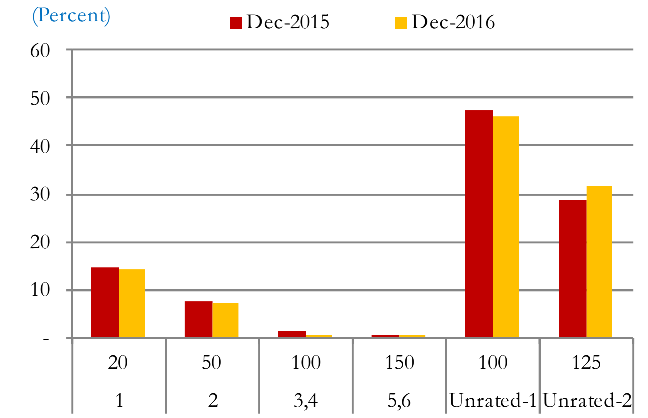
Besides financial health, debt repayment capacity of the corporate borrowers can also be gauged through their credit risk ratings. Generally, different rating grades provide specific probability of default. In this regard, credit rating agencies play a pivotal role. They assign ratings to debt securities, structured finance instrument or issuers of the instruments (i.e. institutions).

Figure 3.7.3

Most of banks' lending to corporate sector falls in unrated segment

Share of outstanding banks' lending to corporate sector against SBP's supervisory mapped rating grade*

(Percent)



** Banks are required to map the rating grades assigned by rating agency with SBP supervisory rating grades ranging from 1 to 6. For example, AAA to AA- fall in grade 1 with 20 percent risk weight.*

Source: SBP

The rating culture in Pakistan is, however, not widely spread as major portion of corporate entities remains unrated **(Figure 3.7.3)**. Most corporate borrowers of banks have not been rated by any authorized External Credit Assessment Institution (ECAI: i.e. the rating agency). As a result, banks that may use corporate borrower's/instrument's ratings for capital adequacy purposes under Basel III (better the rating, lower the capital charge) might suffer in terms of higher capital charge.

Banks appear to be unable to persuade their borrowers to get them rated by ECAI. The reasons may be (i) fee cost associated with the rating (b) CAR is already well above the regulatory required level (little incentive to save capital) etc. However, going forward, considering the dynamics of international and domestic regulatory environment, ratings could gain more traction. Further, SBP is

[158] See State Bank of Pakistan "Financial Stability Review – 2015"
[159] http://oicci.org/wp-content/uploads/2015/12/BCI-Wave-12.pdf
[160] Recently, government has announced package of PKR 180 billion giving several incentives to textile sector to boost export.

also playing its part to promote the rating culture in Pakistan.[161]

High financing concentration exposes the equity of banks …

The banks' lending to corporate sector seems to carry concentration risk with top 30 group borrowers holding around 31.66 percent share in total private sector corporate loan portfolio as of December 31, 2016. The low granularity of loan portfolio exposes banks' equity to default of large borrowers with systemic repercussions. It has been observed during 2010-11 that large exposure defaults hit the banks' bottom lines and, consequently, eroded their equity base.[162]

Business friendly environment needs to flourish…

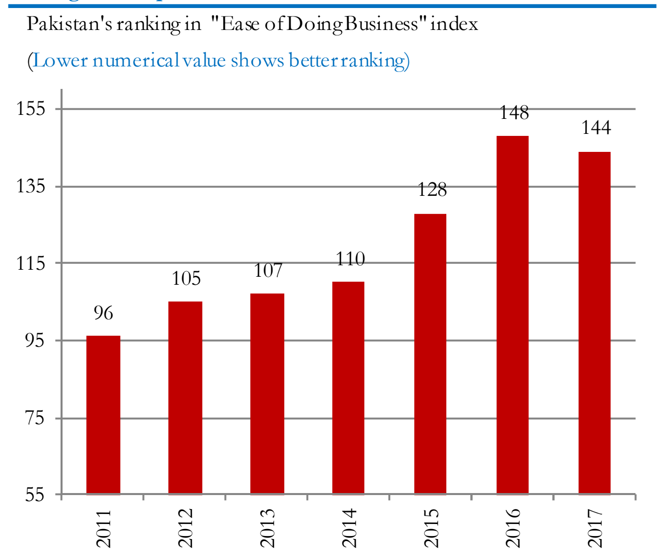
Financing demand requires investor friendly business environment. Pakistan's ranking in terms of "Ease of Doing Business" is 144 (out of 189 countries) in the year 2017. Though the ranking has improved compared to year 2016 (148), it is still on the lower side **(Figure 3.7.4)**.[163] Noticeably, the rankings are low on several accounts: inadequate electricity (Pakistan's rank 170), trading across border (rank 172), registering property (rank 169), enforcing contract (rank 157) etc.

Financing through capital market is limited…

Given the balance sheet strength of the corporates, the non-issuance of debt instruments at local bourse is understandable. Non listed corporates may also do not prefer financing from capital market, to (a) evade market disclosure (one of the listing requirements) for tax evasion purpose and (b) prevent dilution of business ownership. The below potential usage of capital market creates frictions and, consequently, features of free market operations such as price discovery, liquidity, and low cost are not fully met.

Figure 3.7.4

Pakistan's ranking in "Ease of Doing Business" index is low, though has improved



Source: World Bank

Outlook for the corporate sector is positive …

The better performance of the corporate sector is likely to continue in CY17, given the positive economic outlook. The strong cash generation through operations and high profits may result in some plough back of the earnings for sustaining the growth.

Taking a holistic view, the risks to financial sector coming out of the corporate sector appear marginal in short to medium term. However, given the enabling environment, the corporate sector also needs to innovate in terms of production processes, product development, quality controls, price rationalizations and financing avenues.

161 For example, banks are required to rate their corporate (and consumer) borrowers through their internal risk rating system where SBP monitors the compliance regularly. Further, as of 31-12-2015, SBP imposed risk weight of 125 percent on unrated corporate borrower with loan size of PKR 3 million and above.
Source: BSD Circular No.8 of 2007 (http://www.sbp.org.pk/bsrvd/2007/C8.htm) and BSD Circular No.9 of 2015(http://www.sbp.org.pk/bprd/2015/CL2.htm)

162 See FSR, 1st Half, 2011
http://www.sbp.org.pk/fsr/2011/pdf/Chap-02.pdf

163 Source: World Bank
http://www.doingbusiness.org/data/exploreeconomies/pakistan