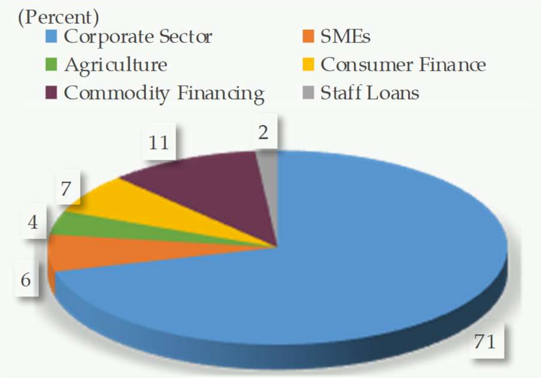
5 Performance and Risk Analysis of the Corporate Sector

The tighter macro-financial conditions and uncertainty about future economic prospects has dampened the performance of the corporate sector. The asset base shows growth, while sales growth decelerates and the profitability, liquidity and operational efficiency indicators trend downwards. Disaggregated analysis highlights that operational efficiency indicators of cement and power sectors face major contraction. The investors' perception about the corporate sector has also weakened as illustrated by the decline in equity market and leading market indicators. However, the key financial and performance indicators remain in a comfortable range. The concerted efforts of the policy makers, however, may further improve the environment related to ease of doing business.

The interconnectedness remains strong between the corporates and the banking sector…

In Pakistan, financial institutions (banks and DFIs) are the key source of financing for the corporate sector, as the capital market depth remains limited. Lending to corporations constitutes 71 percent of banks and DFIs' domestic advances portfolio as of end CY18 (**Chart 5.1, Chapter 3.1 and Chapter 4.1**). As such, strong interconnectedness exists between the two sectors, thus, a shock in any one of them can adversely affect the operating performance and solvency of the other.

Chart 5.1: Segment-wise outstanding banks & DFIs advances, as on 31 December 2018



Source: SBP

Corporate sector's performance dipped in CY18 in the wake of challenging macroeconomic environment…

The increase in the interest rate from 5.75 percent in CY17 to 10 percent by end CY18 has jacked up the financial cost for the corporates across the board contributing to the fall in profitability **(Chapter 1)**. Exchange rate depreciation, on the other hand, has had mixed impact on the performance of the firms. It has caused a hike in the cost of production of corporations that rely on imported components, while export-oriented firms may have benefited in terms of price competiveness in the international markets.

Overall, the assessment indicates signs of slackening in the operating performance and financial strength of corporates **(Table 5.1)**.[214] The pro-forma financial statements (covering 84.17 percent of total assets of listed companies) indicate that the gearing and leverage of the corporates have inched up.[215] Whereas, the liquidity indicators, along with debt repayment capacity and profitability, have depicted a slight decline.

[214] The corporate sector performance has been assessed using financial statements of 303 companies listed on Pakistan Stock Exchange (PSX). As such, the analysis entails generalization for the entire corporate sector.

[215] For 2018, the detailed financial position and performance have been interpolated based on the key summary statistics (i.e. Total Assets, Shareholder's Equity, Sales and Profit) which had been reported by these companies at the time of this assessment exercise.

Table 5.1: Financial statements of PSX listed companies and ratio analysis

	CY14	CY15	CY16	CY17	CY18*	Growth (Percent) CY18
	PKR Billion					
Balance Sheet						
Non-Current Assets	**2,608**	**2,851**	**3,047**	**3,194**	**3,865**	**21.03**
Net Operating Fixed Assets	1,809	1,952	2,073	2,213	2,660	20.16
Long-term Investments	429	473	488	401	596	48.50
Current Assets	**2,229**	**2,295**	**2,474**	**3,116**	**3,468**	**11.30**
Inventories	480	436	450	582	671	15.38
Trade Receivables	871	901	839	1,070	1,271	18.79
Short-term Investments	181	147	180	273	265	-3.05
Total Assets	**4,837**	**5,146**	**5,521**	**6,310**	**7,333**	**16.22**
Shareholders' Equity	**2,219**	**2,427**	**2,658**	**2,950**	**3,234**	**9.63**
Non-Current Liabilities	**810**	**883**	**947**	**1,045**	**1,286**	**23.06**
Long-term Secured Borrowings	399	424	460	519	629	21.01
Debentures/TFCs	15	50	44	42	51	23.74
Current Liabilities	**1,808**	**1,836**	**1,915**	**2,315**	**2,813**	21.53
Trade & Account Payables	1,020	1,058	1,129	1,370	1,633	19.23
Short-term Secured Borrowings	473	456	463	582	705	21.26
Total Equity & Liabilities	**4,837**	**5,146**	**5,521**	**6,310**	**7,333**	**16.22**
Income Statement						0.00
Sales	**5,931**	**5,414**	**4,851**	**5,739**	**6,507**	**13.39**
Cost of sales	5,060	4,556	4,001	4,757	5,447	14.49
Gross profit / (loss)	**871**	**859**	**851**	**982**	**1,060**	**8.02**
General, administration and other expenses	315	340	394	419	439	4.97
Other income / (loss)	127	162	161	171	135	-21.31
EBIT	682	681	618	734	756	2.91
Financial expenses	119	117	93	93	111	19.88
Profit / (loss) before tax	563	563	526	642	644	0.46
Tax expenses	160	152	145	170	150	-11.42
Profit / (loss) after tax	**403**	**411**	**381**	**472**	**494**	**4.74**
Financial Ratios (Percent)						
Gross Profit Margin	14.68	15.86	17.54	17.11	16.30	
Net Profit Margin	6.79	7.59	7.85	8.22	7.59	
Return on Assets	8.33	7.99	6.90	7.47	6.74	
Return on Equity	18.16	16.94	14.32	15.99	15.27	
Asset Turnover Ratio	1.23	1.05	0.88	0.91	0.89	
Current Ratio	1.23	1.25	1.29	1.35	1.23	
Debt to Equity Ratio	1.18	1.12	1.08	1.14	1.27	
Capital to Asset Ratio	0.46	0.47	0.48	0.47	0.44	
Liabilities to Asset Ratio	0.54	0.53	0.52	0.53	0.56	
Interest Coverage Ratio	5.73	5.81	6.67	7.92	6.80	

Source: SBP, PSX and Bloomberg

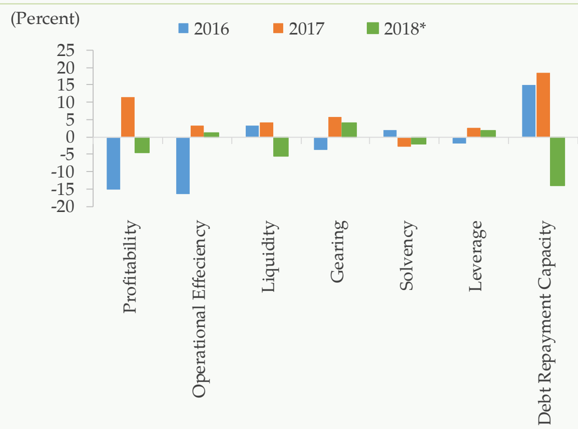
*CY18 represents pro forma balance sheet with provisional reported figures of Total Assets, Shareholder's Equity, Sales and Profit. The sub-categories in Balance Sheet are calculated as a percentage of Total Assets based on average share of preceeding 4 years. The sub-categories in Income Statement are calculated as a percentage of Sales based on average share of preceeding 4 years.

Corporate sector's reliance on borrowings for growth and liquidity rises…

The asset base of the corporate sector has observed 16.22 percent growth in CY18 at the expense of increased leverage. The growth has largely been contributed by operating fixed assets, which have been growing in line with the capacity enhancement in a number of sectors. Long-term lending by financial institutions, comprising 45.21 percent of total lending to the corporate sector, experienced a growth of 18.16 percent in CY18. Consequently, the corporate entities have witnessed increase in their gearing and leverage. A 23.06 percent growth in non-current liabilities has been recorded in CY18, which is greater than preceding three years' average growth of 8.86 percent

Moreover, the key liquidity indicator i.e. current ratio has contracted from 1.35 in CY17 to 1.23 in CY18. The current liabilities, mainly because of short-term borrowings, have witnessed faster growth compared to current assets (Chart 5.2). The accelerated 38.76 percent YoY growth (19.77 percent in CY17) in financial institutions' lending for working capital further substantiates this phenomenon.

Chart 5.2: Percentage change in key financial indicators



Source: SBP, PSX

…and the sales growth decelerates…

During the year under review, the sales growth decelerates to 13.39 percent (18.29 percent in CY17), as rising inflation and a challenging economic outlook affected both the purchasing power as well as the spending activities in the economy. Simultaneously, the cost of sales has also risen. Cumulatively, they have had a major impact on the profitability of the corporates as reflected by a subdued growth in operating profit that stands at 2.91 percent in CY18, against 18.75 percent in CY17.

Despite some drop, the debt repayment capacity remains comfortable…

The debt repayment capacity of the corporate sector has somewhat softened in CY18 as the interest rate has spiked and sector's leverage has further risen. Besides the inch up in the debt to equity ratio, the interest coverage ratio has deteriorated from 7.92 in CY17 to 6.80 in CY18. However, these indicators still seem better than what they used to be a few years back.

Financial leverage has supported the profitability, however, it entails risks…

Among the profitability indicators, the base line indicator ROE has decreased from 15.99 percent in CY17 to 15.27 percent in CY18 (**Chart 5.3**). The Extended DuPont analysis reveals that ROE has declined in CY18 due to increase in interest burden. Besides, decline in operating profit margin and asset usage efficiency further contributes towards the contraction in ROE (**Table 5.2**).

Table 5.2: Extended DuPont analysis

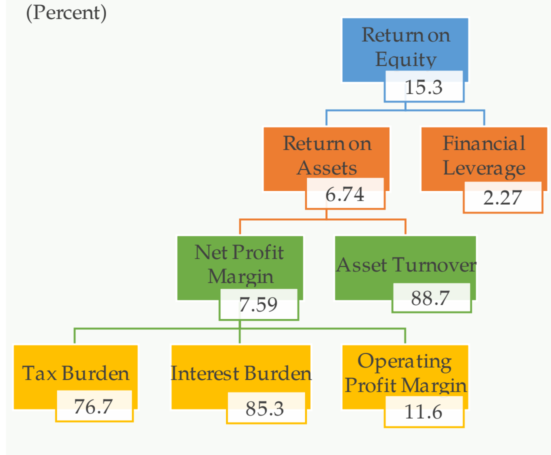
	CY16	CY17	CY18
Tax Burden (A)	0.72	0.74	0.77
Interest Burden (B)	0.85	0.87	0.85
Operating Profit Margin	0.13	0.13	0.12
Asset Use Effeciency (D)	0.88	0.91	0.89
Financial Leverage (E)	2.08	2.14	2.27
Return on Equity (ROE) (Percent) (AxBxCxDxE)	**14.32**	**15.99**	**15.27**

Source: SBP, PSX

On the contrary, drop in the corporate tax rate from 31 percent (CY17) to 30 percent in CY18 has reduced the tax burden of corporates. [216] Similarly, increase in the financial leverage supported the ROE as it has absorbed a part of the dampening impact coming from weakening operating performance and rising interest rate burden.[217] The use of borrowing to support the declining liquidity and profitability is not sustainable. This is because after surpassing a certain threshold, the interest burden will supersede the benefits from the financial leverage. Thus, the increased financial leverage will entail risks in terms of solvency, gearing and debt repayment capacity.

Chart 5.3: Extended DuPont analysis as on December 2018

(Percent)



Source: SBP, PSX

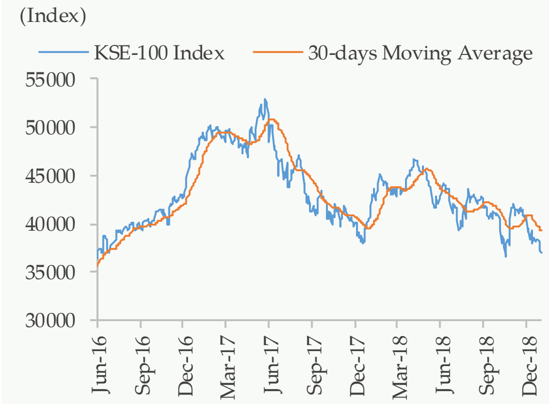
KSE-100 index reflects the weakened market perception regarding the corporate sector…

The slacking operating performance of the corporates is also reflected in the downward movement as well as high volatility of the KSE-100 Index in CY18 (**Chart 5.4**). During CY18, the KSE-100 index after touching a reviewed year's peak of 46,580 points in April 2018 has declined to 37,067 points that translates to a dip of 20.4 percent. During the same period, the P/E ratio has dipped to 8.9 from 10.8, illustrating a decline of 17.59 percent. The reduced valuation reflects a general decline in investors' confidence about the operating performance and future prospects of the corporates (**See Chapter 2**).

[216]http://www.finance.gov.pk/budget/budget_speech_english_2018_19.pdf

[217] Keeping the Financial Leverage constant for the CY18 at 2.14, the ROE will fall to 14.4 percent. Thus, the increase in financial leverage has provided cushion to the declining ROE.

Chart 5.4: KSE-100 Index Price Movement



Source: Bloomberg

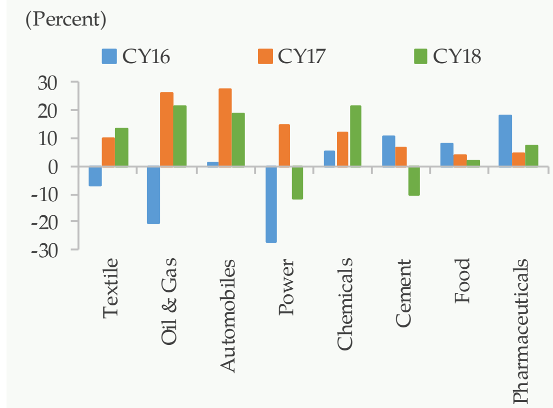
The sector-wise analysis reveals mixed performance…

Macroeconomic stress has directly affected the sales performance of corporate entities in various sectors. The cement and power sectors experienced negative sales growth. Whereas, the oil & gas sector, along with textiles and automobiles have enjoyed the positive sales growth (**Chart 5.5**). Cumulatively, these three sector comprise of 66.9 percent of the aggregate corporate sector sales in CY18. Comparatively, last year all sectors experienced a positive sales growth. Power, food and textile sectors turned out to be the most leveraged sectors in comparison to other sectors and they lag in liquidity and operating performance indicators.

Rising input costs and lower demand pulls down the cement sector…

Cement sector's financial and operational performance has declined in CY18, mainly due to, rising input costs (rise in coal and fuel prices) and reduction in demand (as fiscal constraints have led to a reduction in Public Sector Development Program (PSDP)). As a result, the revenues of the cement sector have declined by 10.26 percent. The positive aspect for the sector is the growth in exports, which have increased by 36 percent.[218] The exchange rate adjustment has supported the competitiveness of the sector; however, exports at present are only a nominal part of the aggregate cement sales. The outlook for the cement sector is positive in the context of material developments regarding Mohmand and Diamer-Bhasha dams and an expected pick-up in construction and housing activities.

Chart 5.5: Sales growth in different sectors



Source: SBP, PSX

Power sector is burdened with the circular debt…

Power sector's performance has slowed down during this year. The sales have decreased by 11.49 percent on year-on-year basis, mainly due to lower power generation during the year.[219] Primary risk faced by the power sector is the accumulation of circular debt mainly due to incomplete recovery of electricity bills and increasing transmission and distribution losses. However, the government is taking measures to curb the levels of circular debt by banning furnace oil imports, increasing the energy prices and moving towards coal and RLNG power generation.

Oil & Gas, the leading sector, performs better in CY18…

Oil & Gas is the leading sector in terms of both market capitalization as well as the quantum of

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[218] JS Global (2019). Pakistan Equity Strategy 2019. Karachi, January.

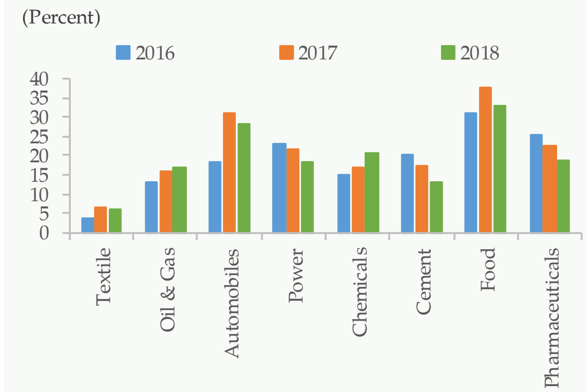
[219] HUBCO and KAPCO (market share approximately 64 percent) revealed that they generated 11469 GWh in CY18 (13986 GWh in CY17).

borrowings from the banking sector. In CY18, its profitability has improved primarily due to the rise in sales by 21.39 percent. However, it has faced higher financial charges due to magnitude of its borrowings coupled with monetary policy tightening during the year under review. Moreover, most of the refineries are in an expansion phase and require funding to keep the work flowing. During the year under review, this sub-sector effectively weathered some pressures i.e. devaluation of the currency, exchange rate losses and slowdown in economic activity. Going forward, the performance of this sub-sector will largely depend on the demand and prices of automobile fuel. Moreover, the general abolishment of the Super Tax will have positive impact on the sector. [220]

Textile sector stands at the bottom in terms of profitability and liquidity…

The textile sector has recorded the lowest profitability amongst all sectors, though it has improved in CY18 **(Chart 5.6)**. Although, devaluation of the currency has made textile exports competitive and the government's incentive to provide uniform gas prices has helped profitability, the dependency on imported cotton, imported machinery and aggressive competition in value-added segment from Bangladesh and Vietnam confines the textile sector's revenues and margins.

Chart 5.6: Sector-wise profitability



Source: SBP, PSX

The outlook may improve if the government targets higher cotton production as the currency devaluation has made imported cotton less competitive in the local market. Nevertheless, some challenges need to be addressed that include improvement in product quality and research and development.

Automobiles sector's high performance is expected to attract capacity enhancement in coming years…

Automobile sector has the highest operational efficiency in the corporate sector. It has, however, faced a contraction in the gross profit margin in CY18, as the bar on non-filers against purchase of new car affected the demand and the devaluation of the currency put pressure on production costs and profit margins. Resultantly, local assemblers increased their prices to sustain profitability. The outlook is positive in terms of enhanced production capacity as Kia, Hyundai and Renault are expected to enter the market in the coming years. Further, the enhancement of federal excise duty (FED) on imported vehicles could increase the demand for locally assembled vehicles. However, because of increase in FED on the imported parts, automobile

[220]Government introduced the Super Tax on individuals, association of persons (AOPs) and companies earning income above PKR 500 million in tax year 2015 at rate of 4 percent of income of banking companies and 3 percent on other categories for rehabilitation of temporarily displaced persons through Finance Bill (2015-16). http://www.finance.gov.pk/budget/budget_speech_english_2018_19.pdf

assemblers, who mostly rely on imported components, might be negatively affected. [221]

Altman Z-Score highlights the growing credit risk in some of the key sectors…

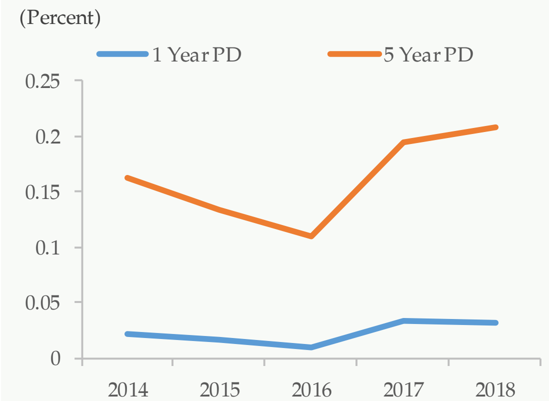
The slowdown in economic activity and the challenging macroeconomic environment have dented the business operations and performance of corporate entities. The increased volatility and a general decline in stock prices negatively affected the fair market value of firms and weakened their financial position in terms of the solvency cushion. These developments also reflect a general decline in these firms' weighted average Altman Z-score that is used to assess the firm's financial health and likelihood of failure.

In CY18, the sub-sectors including textiles, cement and power faced the greatest decrease in the market value. Thus, they are ranked lowest on the Altman's z-score model. The credit worthiness of the other sub-sectors also decreased as their Z-score contracted; however, they are still within the safe range. (For details please refer to **Box 5** which discusses the overview of Altman Z-Score model and detailed assessment of Pakistan's corporate sector on this model.)

Probability of default (PD) has observed some increase for most of the sectors…

The weighted average PD of corporate sector, from CY16 to CY18, depicts an increasing trend, for both 1 year and 5 year horizon **(Chart 5.7)**.[222] In CY18, weighted average PD of the corporate sector stands at 0.03 percent and 0.21 percent for 1 year and 5 year respectively. The disaggregated assessment indicates that textile sector has the highest PD, in CY18, for both 1 year and 5 year, 0.98 percent and 4.31 percent, respectively. Given the adverse economic and political factors, the trend of 1 year PD has increased for all the sectors, except chemicals and oil & gas sectors **(Chart 5.8)**. Similar trend also appears in the 5 year PD.

Chart 5.7: Weighted average PD of corporate sector



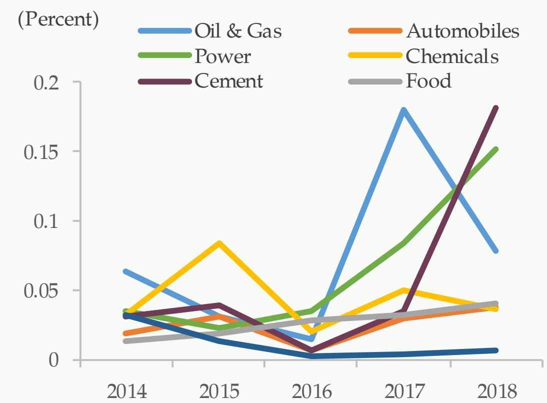
Source: Bloomberg

The trend of PD supports the findings of the Altman's Z-score as both models estimate increasing PD due to the weakening and increased volatility in firms' market value. The softening of financial and operating profit indicators have somewhat contracted the solvency cushion and contributed indirectly to the volatility of the market value of the firms. Therefore, the lower market valuation, besides sentiments of the investors, is also being driven by weaker fundamentals.

[221] FED on imported vehicles amended from 20 percent on vehicles above 1800cc to 25 percent for vehicles between 1800cc and 3000cc, and 30 percent for 3000cc or above.

[222] The short-term PD (1 Year PD) is mainly driven by the quality of firm's liquidity management and ability to honor short-term obligations, while long-term PD (5 Year PD) is mainly influenced by solvency position and overall financial soundness of the firm.

Chart 5.8: Bloomberg's 1 year PD sector-wise



Source: Bloomberg

Credit risk ratings culture, though not wide spread, shows improvement…

Besides financial health, the ability of the entities to honor their financial obligations can be gauged by their credit risk ratings. However, the rating culture in Pakistan is not wide spread, as a major portion of entities remain unrated. Out of the selected sample of listed entities, only 31.68 percent of them were rated in CY18. However, the rating culture showed improvement as in CY17 only 18.15 percent of the sampled entities were rated (See Chapter 3.1).

It is generally the case that well performing corporate entities get themselves rated and mediocre performing entities avoid being rated. The inherent nature of bank-dominated finance and costs associated with the ratings discourages the companies to get themselves rated.[223] However, going forward, considering the dynamics of international and domestic regulatory environment, ratings could gain more traction.

Table 5.3: Number of rated companies, December 2018

Long-term		Short-term	
Ratings	Percent	Ratings	Percent
AAA	2.08	A1+	19.79
AA+	3.13	A1	41.67
AA	10.42	A2	29.17
AA-	10.42	A3	2.08
A+	20.83	Others	7.29
A	13.54		
A-	21.88		
BBB+	7.29		
BBB	2.08		
BBB-	1.04		
Others	7.29		

Source: PACRA, JCR-VIS

Out of rated entities, major chunk of the companies lie in high credit quality cluster in terms of long-term ratings, which includes ratings of A+,A and A- (Table 5.3). Whereas, in terms of short-term ratings, majority of the companies are rated as A1 that is strong capacity for timely repayment.[224]

Ease of Doing Business ranking has improved…

An enabling business environment stimulates the growth of entrepreneurship in a country. The ease of doing business index, issued by World Bank, measures the extent to which the policy and regulatory frameworks support the ease of doing business. According to the World Bank's latest report, Pakistan has improved its ranking from 147 to 136 out of 190 countries in 2019.[225]. Noticeably, the improvement in the ranking has come on the back of score improvement in different indicators of the doing business index. The major three indicators, which have witnessed significant improvement in scores included, resolving insolvency (from 45.8 to

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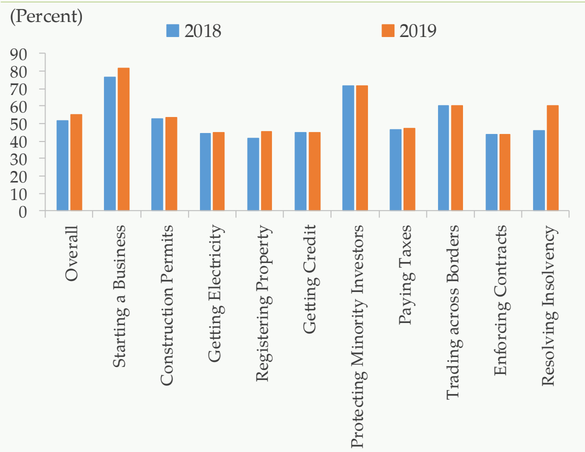
[223] State Bank of Pakistan is following a strategy to promote the rating culture through indirect measures. In this regard, SBP requires banks and DFIs to hold higher capital against large exposures to unrated firms.

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

[225] World Bank. (2019). Doing Business 2019: Training for Reform, Economy Profile Pakistan. Pakistan, March http://www.doingbusiness.org/content/dam/doingBusiness/country/p/pakistan/PAK.pdf

59.9), starting a business (from 76.6 to 81.9), and registering a property (from 41.3 to 45.6) and **(Chart 5.9)**. Some other areas where the score has improved are dealing with construction permits, getting electricity and paying taxes.

Chart 5.9: Ease of doing business score



Source: World Bank

The resolving insolvency score has improved due to the introduction of reorganization procedures and improvement in continuation of the debtor's business during insolvency proceedings.[226] Likewise, enhancement of online one-stop registration system by Government of Pakistan has aided the starting a business segment. Fundamentally, several forms for incorporation of a business have been replaced with a single application and information sharing between registry and tax authorities have been introduced.

Although the ease of doing business score, which forms the basis of the ranking, has improved to 55.31, it is still below the South Asian regional average score of 56.71. In order to improve the score and, therefore, the rankings, substantial reforms, under various indicators, at both the provincial and federal levels need to be accelerated. For instance, development of a new container terminal and enhancing the customs platform i.e. National Single Window for electronic document submission will help in improving our score in the trading across borders indicator. [227]

Outlook for the corporate sector is positive…

The performance of the corporate sector in the coming year is dependent upon various factors.

Improvement in the macroeconomic conditions, especially the current and fiscal account deficits are necessary for economic stability. The government is enthusiastically endeavoring to overcome these economic challenges. It is expected that further positive developments and the conclusion of the agreement on IMF program could subside these challenges and pave the way for strong growth in the future.

In the short run, the IMF Program might accelerate inflation and subside the growth in the economy; however, in the long-run, it may stabilize the growth in the economy and restore investor's confidence in the equity and forex markets.

Furthermore, the abolishment of the Super Tax on the non-banking companies and reduction of corporate tax rate in the coming years can augment the performance of the corporate sector. However, imposition of any additional taxes could impede the performance of the corporate sector.

Additionally, under the umbrella of CPEC, some initiatives have been taken to develop special economic zones to promote the collaboration of Chinese and local industries. The development of the Gwadar port with the aim of transforming it into a trade hub could also open up business opportunities. These developments can potentially contribute positively to the economy and the corporate sector of Pakistan.

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[226] Pakistan Doing Business Reforms http://boi.gov.pk/ViewNews.aspx?NID=3089

[227] It is a digital central trade hub for clearance of cross-border consignments https://www.thenews.com.pk/print/408956-pakistan-customs-green-signaled-to-implement-national-single-window