Chapter 7: The Corporate Sector

The overall performance and standing of non-financial corporate sector improved in CY21, as the global and domestic economy posted recovery. A sample of top-100 listed firms witnessed improvements in their profitability, liquidity and business turnover indicators while debt levels inched up due to lower interest rates, increased demand for working capital and fixed investment loans. Disaggregated analysis highlighted that automobiles, textiles and petroleum sectors faced notable expansion in sales. The investors' perception about these firms, i.e. how they value these firms and their share stocks, was reinforced with economic recovery; however this confidence oscillated towards the year-end due to building macroeconomic imbalances and consequent stabilization measures. Going forward, the dynamics of the ongoing geopolitical and macroeconomic conditions will be the key determinants of the corporate sector's performance. Nevertheless, the corporate sector seems to have adequate resilience to maintain its solvency and operating performance and continue to comfortably serve its obligations to financial institutions and banks.

Despite the recurring pressures of the pandemic, the overall performance of the corporate sector remained positive in CY21 as the government and SBP's efforts to cope with the pandemic remained effective …

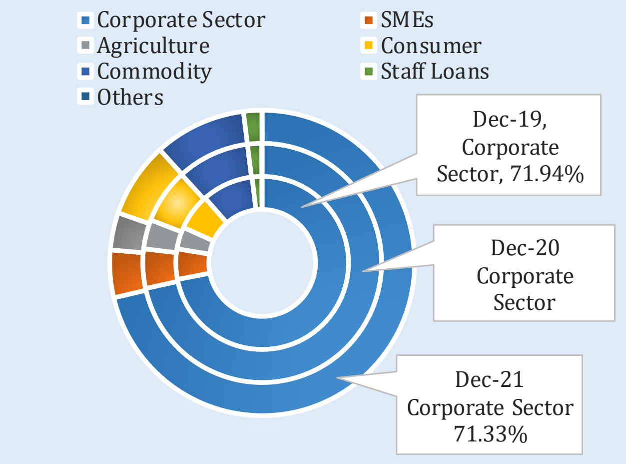
CY21 was marked by relaxation in pandemic restrictions, as global economies and businesses began transitioning towards normalcy on the back of improved pandemic management techniques and mass-vaccine rollout in most of the countries, including Pakistan. The country particularly performed well in managing and controlling the impact of COVID-19 on human life, economic activity and the financial system. For this purpose, SBP also introduced a number of support measures which helped in achieving the policy objectives against the pandemic (see **Box 3.3**).

Although, newer variants of coronavirus and couple of waves continued to emerge during the year, however, the economic recovery largely remained on track. All major manufacturing sectors witnessed robust turnaround including, textiles, food products, pharmaceuticals, chemicals, cement and rubber products. Growth in LSM index surpassed the pre-COVID level as output gap also witnessed a contraction and Business Confidence Index remained above its baseline.

Strong relationship between the non-financial corporate sector and banks continued…

Banking sector remains the major financier of non-financial corporate sector of the country as the depth and outreach of capital market remains limited in the country. The corporate sector utilized 71.3 percent (PKR 7.25 trillion) of the banking sector's domestic loan portfolio at the end of CY21 (**Chart 7.1**). Therefore, the performance and standing of these corporate firms and their underlying sectors remain crucial for the financial stability of the banking sector.

Chart 7.1: Segment wise distribution of domestic advances, as of end December 2021



Source: SBP

The listed firms have more formal and organized corporate governance and internal control frameworks and they also publically share their financials with external stakeholders. Accordingly, this assessment of the corporate sector's financial soundness and performance is based on the financial statements and market-based indicators of selected top 100 listed non-financial firms which belong to different economic sectors.[169] In aggregate, these entities comprise around 70 percent share in the asset base of all the listed companies. Thus, the insights gained from the analysis of this sample of firms present a fair view of the standing and performance of the overall corporate sector.

Corporate firms enjoyed revenue and sales growth though some downside risks remained around the corner…

The financial statements exhibited augmented sales and after-tax profits in CY21. The recovery on macroeconomic front played a vital role in uplifting the corporate sales volume which translated into bottom-line growth for the year. This was supplemented by the resumption of the IMF program and announcement of a pro-growth Federal Budget for FY22 (including subsidies and relaxation in regulatory duties).[170] However, rise in international commodity prices, soaring inflation, trade imbalances and consequent stabilization measures including monetary tightening towards the end of the year, ended CY21 for corporate sector on a slightly negative note in terms of future outlook.

Asset base of the corpporate firms grew at an accelerated pace and their borrowings surged during CY21. However, overall leverage slightly declined as equity rose at a higher pace…

There was acceleration in the growth of select firms' assets base: 18.4 percent growth in CY21 against 5.7 percent in CY20 **(Table 7.1)**.[171] Primarily, the current assets caused the acceleration, as the firms needed greater amount of working capital in the wake of increased economic activity and lifting of lockdowns. Inventory levels increased significantly due to increased aggregate demand and higher commodity prices, leading to overall assets growth for the year.

[169] The 100 non-financial listed firms were selected in such a manner to cover all the economic sectors. The 100 significant entities from all the sector were sampled out of 376 total non-financial listed corporates.

[170] Finance Division's Federal Budget 2021-22: [Budget in Brief](). Accessed on May 15, 2022

[171] The data of earnings and expenditure projected/annualized to arrive at annualized indicators of returns e.g. ROE, etc.

Table 7.1: Excerpt Financial Statements of PSX Listed Companies and Ratio Analysis

	Q3 CY19	Q4 CY19	Q1 CY20	Q3 CY20	Q4 CY20	Q1 CY21	Q3 CY21	Q4 CY21	*growth YoY*
					PKR billions				
Balance Sheet									
Non-Current Assets	3,344	3,522	3,555	3,710	3,757	3,753	4,023	4,132	*10.0%*
Current Assets	3,754	3,867	4,042	4,039	4,057	4,284	4,854	5,123	*26.3%*
Total Assets	7,098	7,389	7,597	7,749	7,814	8,036	8,878	9,255	*18.4%*
Shareholders' Equity	3,211	3,304	3,323	3,496	3,647	3,748	4,050	4,150	*13.8%*
Non-Current Liabilities	968	1,057	1,097	1,225	1,314	1,280	1,392	1,449	*10.3%*
Current Liabilities	2,919	3,029	3,177	3,028	2,853	3,009	3,436	3,656	*28.2%*
Total Equity & Liabilities	7,098	7,389	7,597	7,749	7,814	8,036	8,878	9,255	*18.4%*
Income Statement									
Sales	1,525	1,566	1,364	1,536	1,579	1,665	2,153	2,300	*45.7%*
Cost of sales	1,271	1,308	1,142	1,252	1,282	1,320	1,766	1,859	*45.1%*
Gross profit / (loss)	254	259	222	284	297	345	387	441	*48.4%*
General, admin. & other exp.	104	122	101	102	116	120	137	155	*32.9%*
Other income / (loss)	38	44	43	40	52	42	70	46	*-11.8%*
EBIT	188	181	164	222	233	268	319	332	*42.6%*
Financial expenses	46	51	57	32	30	33	35	41	*35.6%*
Profit / (loss) before tax	142	131	107	190	203	235	285	292	*43.6%*
Tax expenses	43	50	38	47	57	63	78	78	*36.2%*
Profit / (loss) after tax	99	81	69	142	146	172	207	214	*46.5%*
Financial Ratios									
Gross Profit Margin (%)	16.6	16.5	16.3	18.5	18.8	20.7	18.0	19.2	
Net Profit Margin (%)	6.5	5.1	5.1	9.3	9.3	10.3	9.6	9.3	
Return on Equity (%)	12.3	9.8	8.3	16.3	16.0	18.4	20.4	20.6	
Return on Assets (%)	5.6	4.4	3.6	7.4	7.5	8.6	9.3	9.3	
Current Ratio (units)	1.3	1.3	1.3	1.3	1.4	1.4	1.4	1.4	
Asset Turnover (%)	85.9	84.8	71.8	79.3	80.8	82.9	97.0	99.4	
Capital to Total Assets(%)	58.9	59.0	58.2	60.9	63.5	62.6	61.3	60.5	
Debt Equity Ratio (units)	1.2	1.2	1.3	1.2	1.1	1.1	1.2	1.2	
Interest Coverage Ratio (units)	4.1	3.6	2.9	6.9	7.8	8.2	9.2	8.2	

*Data of 100 companies were used that represent 73% of total assets of all listed non-financial entitles
Source: SBP

Over CY21, long-term borrowings augmented owing to reduced interest rates and funds borrowed under SBP's concessionary refinance schemes e.g. TERF which aim to support long-term investment. Whereas, short-term borrowings climbed due to higher demand for inventories, rise in input costs, and increased working capital needs amid acceleration in business activity and economic growth. This phenomenon was also reflected in the marked acceleration in the banking sector's domestic lending to corporate sector for fixed investment and working capital loans over the year (see **Chapter 3**)

Corporates reported accelerated growth in earnings during CY21…

The corporates were able to improve profits primarily backed by resumption of economic activities and accelerated sales. Economic recovery after the effective vaccination drive favorably influenced the sales performance of the corporates during CY21 (45.7 percent growth by the year end on YoY basis). Both domestic sales and exports witnessed tremendous growth in CY21. Besides the functioning of market-based exchange rate regime, the government measures boosted exports and production supported the recovery.

Profitability improved due to enhancement in asset use efficiency and increased leverage…

The ROE of selected large firms increased from 16.0 percent in CY20 to 20.6 percent in CY21 **(Table 7.2)**. The Extended DuPont analysis revealed that improvement in asset usage efficiency along with increase in leverage augmented the ROE. The leverage increased as the firms increased their borrowings and enhanced their other liabilities in line with expansion in business. On the other hand, interest expenses vis-à-vis revenues slightly declined as despite significant increase in borrowings, lower interest rates which prevailed during most part of the year benefitted the firms.

Table 7.2: Extended DuPont Analysis

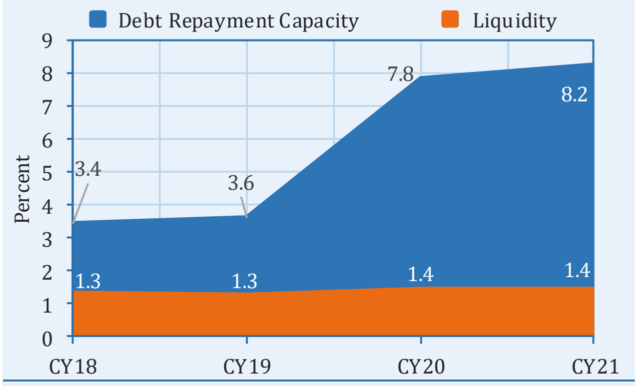
	CY18	CY19	CY20	CY21
Tax Burden (A)	0.55	0.62	0.72	0.73
Interest Burden (B)	0.71	0.72	0.87	0.88
Operating Profit Margin (C)	0.08	0.12	0.15	0.14
Asset Use Efficiency (D)	0.95	0.85	0.81	0.99
Financial Leverage (E)	2.16	2.24	2.14	2.23
Return on Equity (ROE) % (AxBxCxDxE)	**6.51**	**9.76**	**16.02**	**20.64**

Source: SBP

Debt repayment capacity improved immensely and remained in comfortable zone…

Despite the marginal increase in financing costs, the debt repayment capacity of the corporate sector improved throughout the year and remained in comfortable zone. Higher Earnings before Interest and Taxes (**EBIT**) was the primary reason for the improvement. The growth in EBIT was at a much greater pace than the growth in the finance costs of the corporates. The interest coverage ratio inched up from 7.8 in Q4CY20 to 8.2 in Q4CY21 **(Chart 7.2).**[172]

Chart 7.2: Key Financial Indicators - Debt Repayment Capacity and Liquidity



Source: SBP

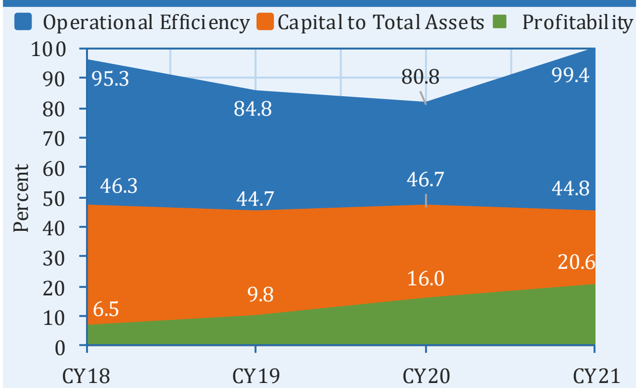
Liquidty indicators remained steady despite increase in short-term borrowings ...

Moreover, the liquidity indicators (e.g. current ratio) remained stable as the firms increased their reliance on long-term funding. There was also significant increase in short-term borrowings and current portion of long-term loans, however, enhanced short-term investments and inventories provided the cushion to absorb the impact of growth in current liabilities. The increase in short-term investments and assets hints at the tendency of the firms to maintain higher liquidity in the face of economic recovery.

Along with that, solvency indicators remained steady...

The funding strategy of the large firms in terms of long-term capital employed to total assets witnessed improvement during the reviewed year, indicating lowering in the risk to solvency due to any financial crunch. The financial leverage slightly increased as shareholder's equity to total assets ratio came off to 44.8 percent, however it remained in line with past trends i.e. 46.7 percent in CY20 and 44.7 percent in CY19. Similarly, total debt to equity ratio slightly inched up. Nevertheless, improvements in the operating efficiency, earnings and repayment capacity vis-à-vis increased leverage but more conservative funding strategy indicate steady solvency and strong financial standing of the firms to service their financial obligations (**Chart 7.3**).

Chart 7.3: Key Financial Indicators - Profitability, Capital to Total Assets and Operational Efficiency



Source: SBP

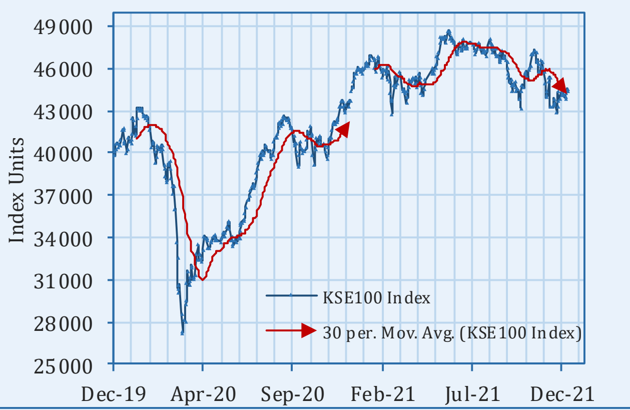
Market indicators reflected investors' mixed sentiments over the year mainly reflecting the uncertainities surrounding the pandemic and macroeconomic stresses vis-à-vis firms performance...

KSE-100 index reflected the market sentiments about the current and future performance of the corporate firms operating in Pakistan as well as the macro-financial conditions within both Pakistan and abroad **(Chart 7.4)**. CY21 commenced at the index of 44,434 points and gained due to the reopening of global economies and a slowdown in COVID infection ratios for the country. However, recurring COVID-19 waves, pressure on the external account, rising inflation, and downgrading of Pakistan Stock Exchange in the MSCI list etc., weighed on the market. With the tightening of monetary policy in the second half of CY21, the investors' preference switched from equity market into fixed income assets amidst this higher interest rate environment. The index, however, closed on 44,596 points generating a 1.9 percent return during the year. **(**see **Chapter 2)**

[172] Debt Repayment Capacity is measured by Interest Coverage Ratio and Liquidity is measured by Current Ratio.

The sectors which contributed to the increase in the index include technology and communication which benefitted from re-rating and foreign interest, followed by commercial banks which posted robust profits despite low-interest rates in most part of the year. On the other side, sectors which dragged down the index in CY21 include cement which was affected by multi-year high coal prices raising concerns about their profit margins and oil and gas marketing companies which were affected by rising circular debt.

Chart 7.4: KSE-100 Index



Source: PSX and SBP

The ongoing momentum of economic activity as reflected by some high-frequency statistics on consumption and production (e.g. POL and cement off take, LSM growth, etc.) reflect a positive outlook for corporate sector that will also drive the sentiments of investors in CY22. However, macro financial conditions in context of some key developments (e.g. dynamics of international commodity prices, political and geostrategic situation, traction on IMF program, and magnitude of monetary and fiscal stabilization measures) will remain important for the investors' sentiments in the period ahead.

Cement sector's overall performance and prospects turned positive by the end of CY21…

Cement sector remains a significant borrower of the banking industry. During CY21, this sector posted growth in profitability and operational performance. The fiscal year ended up with healthy growth as the government incentivized the construction activity to revive the economy thus increasing the demand for cement. However, demand remained relatively low in the second half of CY21 due to slowdown in construction activities on the back of higher input cost and cut of PKR 300 billion in Public Sector Development Program (**PSDP**) amid the government's drive to seek fiscal consolidation in the wake of emerging imbalances.

Regarding cement exports, the COVID related economic uncertainty around the globe along with the surging global freight costs affected the exports potential all across the globe. These factors also affected Pakistan's cement exports, which declined by 15.6 percent as the volumes reduced to 538,002 tons in Dec-21 from 637,511 tons in Dec-20.[173]

Besides, rise in interest rate towards the year-end coupled with higher inflation and depreciation in exchange rate further put pressure on profit margins of the sector. Most of the cement companies had planned expansion projects. Though the TERF has supported this initiative, the rise in interest rate may put some pressures on the expansion plans as well as the profit margins of the cement sector.

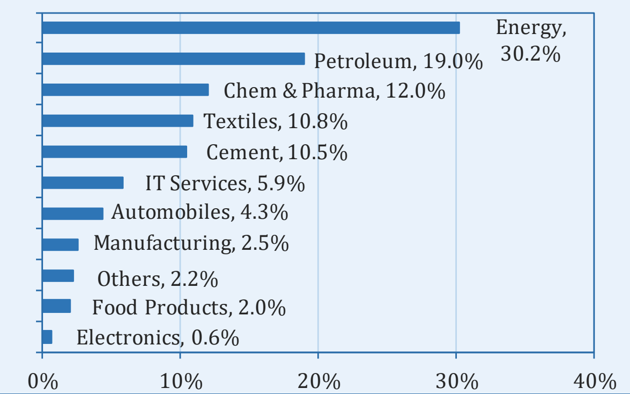
In the later half, the economic recovery started to gain pace strongly which led to increased global coal demand from multiple industries including cement, steel, and power generation. Resultantly, the coal prices witnessed historic highs in the international market. Historically it has been observed that with the surge in global coal prices, the prices of cement rise, on the contrary when coal prices decline, prices of cement show stickiness and remain relatively unchanged. Hence, any downward correction in coal prices may lead to significant margin recovery for the sector, thus being beneficial for the manufacturers.

[173] Cement exports volume data is taken from All Pakistan Cement Manufacturers Association (APCMA)

Power sector is under stress due to the issue of rising circular debt ...

Power sector (power producers and exploration companies) is among the large borrowers of banks and it continued to hold the major share of assets among the sampled top firms selected for this assessment **(Chart 7.5)**. During the reviewed year, higher international oil prices and depreciation of PKR provided the support to the power sector in terms of operating performance. The power sector savored the inventory gains and elevated retail prices in terms of increased margins.

Chart 7.5: Share in total assets of selected 100 firms CY21



Source: PSX

The power sector's circular debt increased to PKR 2.47 trillion by the end of CY21. This mounting circular debt and attendant decline in production as well as increased financing costs and lower payout due to cash flow constraints are the major concerns for the power sector.

Petroleum sector enjoyed a boost in sales and revenue as the economic activity resumed...

Oil Marketing Companies or petroleum sector quickly recovered from the effects of the pandemic during CY21, as sales experienced double-digit growth during the first half and continued the momentum by the end of the year amid a short-term recovery in international oil prices, surging demand from the automobile sector, and resumption of economic activities.

Expansion of automobile sector in terms of increased demand leads to growth for the petroleum sector, especially motor spirit (**MS**). However, introduction of electric vehicles (**EV**) and Hybrid vehicles may dampen MS sales in the long run, but in the short run they do not pose any threat to MS sales because of low adaptability rate in Pakistan and scarce availability of charging infrastructure. Moreover, higher electricity demand and constraints in the availability of gas might also help in lifting up furnace oil (**FO**) sales. Besides this, biweekly price revision has proved beneficial for firms in terms of curtailing inventory losses and minimizing the price volatility driven from exchange rate and international oil prices.

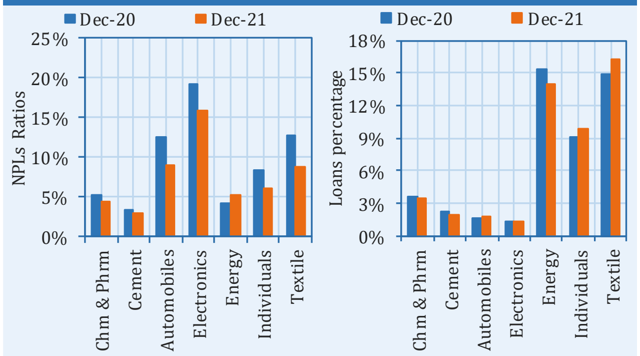
On the other hand, the economy faced the building pressures of CAD and inflation by the end of CY21 which necessitated stabilization measures. These measures coupled with resultant constraints on demand and high global commodity prices may impact oil consumption as well as sales volumes and earnings of OMCs. Moreover, the OMCs facing the circular debt issue may face increase in financing costs in the backdrop of higher interest rates.

Textile sector reported strong performance as its exports grew substantially...

Textile is traditionally the largest user of bank credit and a leading contributor in the economy. After taking a sharp hit during strict lockdowns in the last year, Pakistan's textile exports bounced back to post a noteworthy performance in the year under review. This revival resulted from the policy support measures of the government, effective management of the pandemic and continuity of business activities in the country, and robust economic recovery in the main export markets.[174]

During the year, ROE of textile sector firms (as selected for the instant assessment) jumped from 8.0 percent to 22.8 percent on YoY basis in year 2021. With boost in revenue and profitability, the debt repayment capacity (interest coverage ratio) improved by 2.5 times over the year to 6.9 times in year 2021. Strong performance of the textile sector translated in the increase in lending and decrease in the infection ratio for the sector in CY21 **(Chart 7.6).**

Chart 7.6: Sector-wise NPLs Ratio and Loans Shareholding



Source: SBP

The government provided incentives to the exporting sectors in the form of subsidized utility tariffs and interest rates (which shielded firms in a rising interest rate environment). These factors have increased competitiveness of the sector, whereas the market-based mechanism of exchange rate determination is likely to further boost growth as export competitiveness enhances in the global market.

Domestic cotton industry heavily relies on natural cotton fiber for which local production is subject to weather conditions and the decline in acreage under cultivation (due to multiple reasons farmers are compelled to shift their cultivated area to other competing crops). Hence any shortfall in the local production and supply of natural fiber and hike in the cotton prices might hurt the operating efficiency and profit margins of the textile sector.

Automobiles sector sales significantly increased during the year...

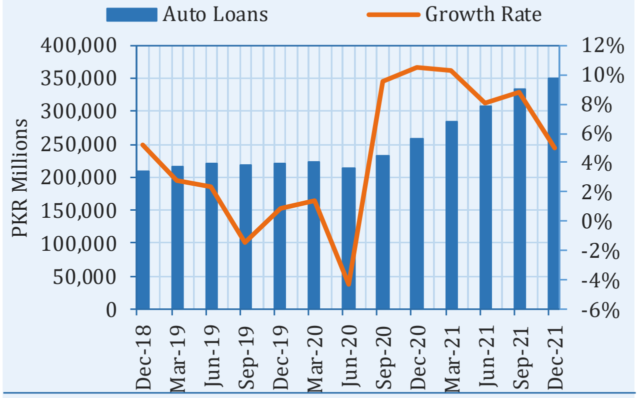
After facing a sharp fall in sales and production in last year due to the pandemic related challenge, automobiles sales volumes registered tremendous growth during CY21. Among various supply-side and demand-side factors, fiscal measures such as reduction in Federal Excise Duty (**FED**) and sales tax, penalty on late deliveries of vehicles and reduction in custom duties on auto parts in July 2021 remained the primary drivers of increased demand for automobiles and sales volume. Along with the backlog of demand due to the pandemic, introduction of new models by Korean and Chinese auto manufacturers coupled with low auto financing rates, drove up demand and sales.

However, towards the end of CY21, industry sales witnessed a gradual decline, attributed to longer lead times because of parts shortages and monetary tightening. In addition, SBP also introduced several macro prudential measures to address the vulnerabilities emerging from CAD and increase in consumer finance, including maximum facility limit of PKR 3 million on auto finance and complete ban on financing of imported Completely Built Units (**CBUs**) **(Chart 7.7).**[175]

[174] Government policies to support the export include concessionary utility tariffs, export refinance schemes and duty cutbacks.

[175] For further details about changes in prudential regulations for consumer financing, please refer Chapter 03.

Chart 7.7: Auto Loans and its growth rate



Source: SBP

*Probability of default (**PD**) for the corporate sector slightly increased in the second-half of CY21…*

The weighted average 1-year PD of selected firms of the corporate sector deteriorated to 0.41 percent in CY21 (0.33 percent in CY20) **(Chart 7.8)**.[176] During the first half of CY21, the PD lowered due to economic recovery and general improvement in the overall performance and outlook for these firms. Improvements in operating performance of these firms increased investors' confidence and led to relatively low volatility in stock prices —bolstered by the successful recovery of macro-economic variables — and contributed to the fall in default probabilities.

Chart 7.8: Weighted average 1 year PD

Source: Bloomberg, SBP

By the year-end, the PD however started to inch up mainly due to increased volatility in stock prices which emerged in the wake of building macroeconomic pressures and attendant stabilization measures. Emergence of the fourth wave of the pandemic and geopolitical situation in the context of Afghanistan further added to the uncertainty among investors. Nevertheless, the financial performance of firms remained quite encouraging over the period.

Incidentally, the general level of PDs of these selected firms is at the lower side and does not pose notable default risk to the lenders. As such, these large firms maintained strong financial soundness and decent operating performance despite challenging macro-financial conditions.

Repayment behavior and financial standing of the leading borrowing firms/groups of the banking sector remained strong…

In order to assess the credit risk of banks from large borrowers, a more granular analysis at borrower-level has been conducted, covering the top 30 borrowing firms. This analysis indicates that banks seem to prefer large and well-established borrowers which have better credit worthiness. In CY21 most of the top borrowing companies showed improvement in credit worthiness, better financial performance and steady investors' sentiments (**Box 7.1**).

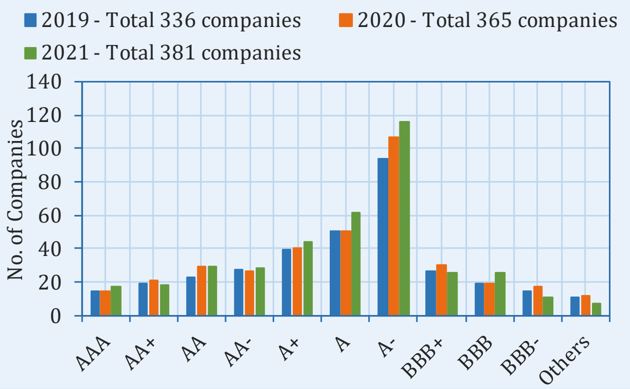
Growing number of rated firms indicate a general improvement in the governance and internal control mechanisms among corporate firms which bodes well for banks' credit risk as well as future growth of capital market and its instruments …

In recent years, the rating culture among large firms has shown improvement, as the firms with adequate governance mechanism and internal controls on financial reporting tend to get themselves rated. During the reviewed year, this trend got further traction as the number of rated non-financial listed firms further increased to 90.3 percent (88.8 percent in last year). However, in the universe of all incorporated public companies,

[176]The PD (1 Year PD) demonstrates firms' credit risk and ability to honor short-term obligations. The PD is calculated using Merton Model, which uses value of equity and volatility of equity to measure default probability.

the rated companies remain on the lower side. This is because many companies in Pakistan rely on indirect sources of financing like banks or their internal sources (profit plough backs, etc.) and rely less on capital market for their funding needs. Out of all the rated companies in the country, a major chunk of the companies lies in investment grades (AAA to BBB-), which advocates high credit quality in terms of long-term ratings **(Chart 7.9)**.

Chart 7.9: Long-term Ratings of Companies



Source: PACRA, VIS, SBP

Whereas, in terms of short-term ratings, majority of the companies were rated as A2 that represents satisfactory capacity for timely repayment.[177]

Outlook for the corporate sector rests on economic and political dynamics ...

CY21 ended with the building macroeconomic pressures and challenges compounded by domestic politcal developments as well as Russia-Ukraine conflict which have strong potential to disturb supply and prices of global commodities. . The operating enviroment might remain challenging for the corporate and real sector during the outgoing year. Inflationary pressures along with mounting CAD and exchange rate uncertainities might pose material risks for the corporate sector in terms of operational performance. On top of that, monetary tightening and fiscal measures to ward off the emerging economic imbalances may dampen the aggregate demand in the economy resulting in subdued sales for the corporate sector.

Nevertheless, the corporate sector has successfully weathered such challenges and posted steady performance in the past. The large firms in general have the adequate opertaional capabilities, established supply chains for their inputs and outputs, and strong financial cushions to maintain their finanical performane and continue to serve their obligations to banks and financial institutions.

177 PACRA. (2021). Rating Scale