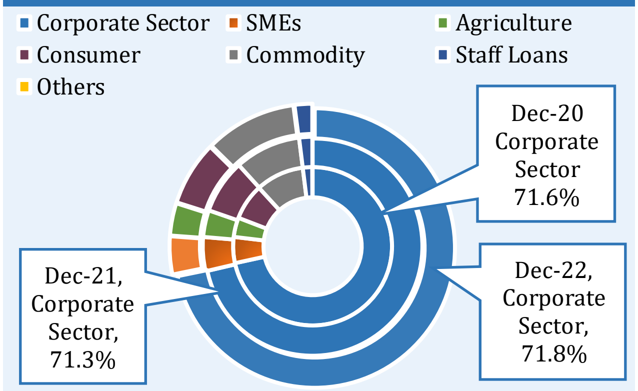
Chapter 7: The Corporate Sector

In the face of building macroeconomic challenges, the overall financial standing of the non-financial sector remained resilient during CY22. Profitability of the sector was lower than last year as increase in input costs and financial expenses neutralized the growth in sales while tax charges also increased. The tightening of monetary policy and stressed economic conditions affected the debt servicing capacity of corporate sector. However, large firms in general continued to operate smoothly and service their obligations. Interest coverage ratio, despite significant decline, remained in comfortable range, and liquidity and overall solvency indicators remained steady. The disaggregated analysis highlighted that the chemicals and pharmaceutical, and petroleum exploration sectors posted growth in sales while the sales of textile, manufacturing and automobile sectors experienced notable decline. Investors' perception about the value and prospects of large firms oscillated over the year in line with the ongoing domestic and global macroeconomic developments. Going forward, the corporate sector's outlook rests on the future geopolitical and domestic macroeconomic conditions.

Non-financial corporate sector's performance remained crucial for financial stability …

Large corporate firms accounted for 71.8 percent of the banking sector's total loan portfolio. Therefore, the performance and soundness of the large firms has great significance for financial stability in the economy (**Chart 7.1**). The following paragraphs assess the financial performance and standing of large corporate firms.

Chart 7.1: Segment wise distribution of domestic advances, as of end December 2020-22



Source: SBP

The corporate sector's financial standing generally remained steady in CY22, though leading performance indicators showed signs of slackness amid challenging macroeconomic environment …

CY22 was marked by a significant deterioration in the business environment for non-financial corporate sector as the macroeconomic challenges, which started to build up in CY21, further intensified over the period. A number of global and domestic developments that compounded the challenges include Russia-Ukraine war, domestic political instability, unprecedented flooding in the country, and tightening of monetary policy by AEs (**see Chapter 1**). Different stabilization measures that were introduced in fiscal, monetary and macro-prudential policy spheres to mitigate economic imbalances and risks to economic stability also slowed down business activities in the economy.

Accordingly, growth in LSM index significantly decelerated in H2CY22, and average growth for CY22 remained significantly lower than last year. Moreover, Business Confidence Index persistently declined and remained below the benchmark, reflecting business sector's meek expectations about the rebound in production and economic activity.

In the face of these challenges, some key indicators of corporate sector's financial performance showed signs of slackness during CY22. Bottom line (after tax profit) was 12.8 percent lower than last year's level due to increase in debt servicing costs and taxation charges. However, the sector by and large remained stable and continued to serve its financial obligations. Strong operating performance during CY21 may have supported the financial cushion and resilience of the sector.

Growth in the asset base of the corporate sector accelerated during CY22 due to strong increase in current assets …

The top 100 selected firms experienced significant growth of 17.0 percent (YoY) in their asset base by end CY22, as compared to 13.2 percent in CY21 (**Table 7.1**). This growth can be attributed to increased cost of inventory and other inputs in the wake of high inflation and investments in long-term assets such as properties, plants, and equipment.

To finance the expanding base of current asset, the firms relied on short-term borrowing and efficient cash flow management. Additionally, long-term borrowing also increased to finance the firms' growing capital expenditures. This growth in long-term borrowings was also augmented by SBP's refinance schemes e.g., LTFF and TERF for long-term investments in capital goods.

Overall, the strong growth in the asset base of these top 100 selected firms in CY22 reflects their ability to adapt to changing market conditions and make strategic investments in their future growth. Moreover, firms' funding strategy remained prudent as they continued to finance the growth in long-term assets with concomitant long-term funding (i.e. capital + long-term borrowings) and current ratio over the years remained steady, indicating that firms did not rely on short-term borrowing to finance long-term assets.

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

	Q4 CY20	Q1 CY21	Q3 CY21	Q4 CY21	Q1 CY22	Q3 CY22	Q4 CY22	*Growth YoY*
	PKR Billions							*Percent*
Balance Sheet								
Non-Current Assets	3,767	3,763	3,748	3,824	3,915	4,344	4,369	14.2
Current Assets	4,034	4,262	4,699	5,007	5,401	6,146	5,963	19.1
Total Assets	7,802	8,025	8,446	8,831	9,316	10,491	10,332	17.0
Shareholders' Equity	3,621	3,726	4,005	4,131	4,304	4,593	4,624	11.9
Non-Current Liabilities	1,341	1,303	1,162	1,186	1,220	1,457	1,432	20.7
Current Liabilities	2,840	2,996	3,280	3,513	3,791	4,441	4,276	21.7
Total Equity & Liabilities	7,802	8,025	8,446	8,831	9,316	10,491	10,332	17.0
Income Statement								
Sales	1,565	1,650	2,085	2,272	2,401	2,933	2,790	22.8
Cost of sales	1,261	1,302	1,708	1,840	1,942	2,493	2,384	29.6
Gross profit / (loss)	303	348	377	432	459	441	406	(6.0)
General, admin. & other expenses	114	119	130	150	136	168	142	(5.4)
Other income / (loss)	54	44	66	45	74	89	69	52.8
EBIT	244	273	313	327	397	361	332	1.7
Financial expenses	31	31	31	34	41	72	63	81.9
Profit / (loss) before taxation	213	242	281	292	356	289	270	(7.7)
Tax expenses	52	63	76	79	96	105	84	6.1
Profit / (loss) after tax	161	178	205	213	260	184	186	(12.8)
Financial Ratios								
Gross Profit Margin (%)	19.4	21.1	18.1	19.0	19.1	15.0	14.6	
Net Profit Margin (%)	10.3	10.8	9.8	9.4	10.8	6.3	6.7	
Return on Equity (%)	17.7	19.1	20.5	20.6	24.2	16.0	16.1	
Return on Assets (%)	8.2	8.9	9.7	9.7	11.2	7.0	7.2	
Current Ratio (units)	1.4	1.4	1.4	1.4	1.4	1.4	1.4	
Asset Turnover (%)	80.2	82.2	98.7	102.9	103.1	111.8	108.0	
LT Capital to Total Assets(%)	63.6	62.7	61.2	60.2	59.3	57.7	58.6	
Debt Equity Ratio (units)	1.2	1.2	1.1	1.1	1.2	1.3	1.2	
Interest Coverage Ratio (units)	7.8	8.8	10.0	9.5	9.7	5.0	5.3	

Source: SBP

Earnings slightly declined as promising growth in sales was more than off-set by increase in cost of sales, financing costs, and surge in tax charges….

After tax profit of select firms for Q4CY22 was 12.8 percent lower than the corresponding period of last year – compared to 32.8 percent YoY growth in profits for Q4CY21. Although, the corporate sector posted impressive growth in sales and operating efficiency in terms of asset-turnover ratio, pre-tax profit remained 7.7 percent lower than last year's level due to stronger growth in cost of sales and significant surge in financing costs. Significant increase in taxation charges further pushed down the after tax profit, as a result after tax ROE declined to 16.1 percent in Q4CY22 from 20.6 percent in Q4CY21.

An extended DuPont analysis revealed that the downward pressure on ROE came from rise in tax rates and input and financing costs over the year. On the other hand, the efficient usage of assets, along with increase in leveraging buttressed the ROE (**Table 7.2**).

Table 7.2: Extended DuPont Analysis

	Dec-19	Dec-20	Dec-21	Dec-22
Tax Retention Rate (A)	0.62	0.76	0.73	0.69
Interest Burden (B)	0.72	0.87	0.89	0.81
Operating Profit Margin (C)	0.12	0.16	0.14	0.12
Asset Use Efficiency (D)	0.85	0.80	1.03	1.08
Financial Leverage (E)	2.23	2.15	2.14	2.23
Return on Equity (ROE) % (AxBxCxDxE)	**9.77**	**17.73**	**20.64**	**16.07**

Source: SBP

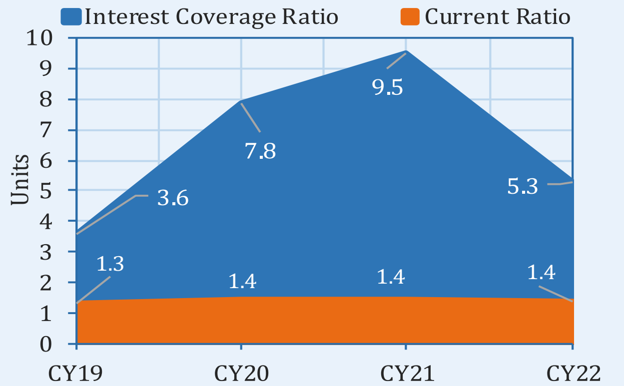
Liquidity indicators remained steady ...

Despite relying heavily on short-term borrowing, the sector managed to maintain a stable liquidity level, as evidenced by its current ratio (**Chart 7.2**). This was accomplished by increasing inventories and short-term investments in tandem with the growth of short-term liabilities. The ability to maintain a stable current ratio during economic headwinds is a testament to effective cash flow management, which has the potential to support the financial position of the corporate sector.

However, indicators of debt repayment capacity came under pressure due to increase in financing cost in the wake of monetary tightening...

The corporate sector's debt repayment capacity in terms of interest coverage ratio experienced a sharp reversal as ratio of select firms dropped from 9.5 times in CY21 to 5.3 times at end CY22 (**Chart 7.2**). Although Earnings before Interest and Taxes (EBIT) remained stable, the cost of financing almost doubled as the interest rates significantly hiked. However, the interest coverage ratio remains within reasonable bounds even under higher interest rate environment.

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



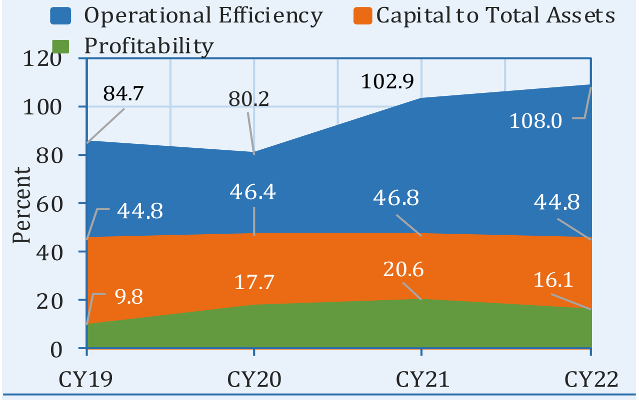
Source: SBP

Solvency indicators showed slight slackness, however overall solvency position in general remained steady ...

The solvency indicators of select firms showed some signs of weakening as compared to their levels in CY21. The financial leverage slightly increased as the proportion of shareholder's equity in asset base slightly declined to 44.8 percent by end CY22 (46.8 percent in CY21) (**Chart 7.3**). In addition, the debt-to-equity and debt-to-capital employed ratios increased slightly.

On the other hand, the corporate sector was able to post adequate operating performance and generate sufficient revenues to meet its financial obligations. However, it is important for the firms to proactively monitor and manage their operations and solvency position in face of stressed macroeconomic conditions.

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

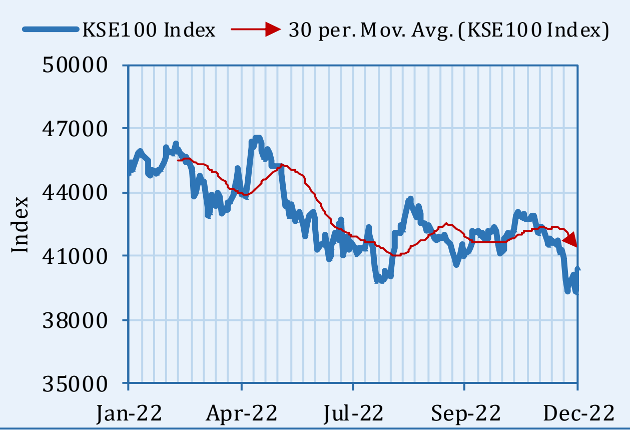


Source: SBP

With mixed market sentiments, the KSE-100 index closed below the CY21 level...

The KSE-100 index is the leading indicator of market sentiment towards the corporate sector, in terms of both its present performance and future prospects. In CY22, the index closed at 40,420 points – 9.4 percent lower level than previous year. Sectoral analysis shows that, with the exception of two, all other sectors contributed to the index's decline (**Chart 7.4**).[159]

Chart 7.4: KSE-100 Index during CY22



Source: PSX and SBP

Throughout the year, the KSE-100 index experienced higher volatility due to a variety of factors, including rising global commodity prices, higher inflation, current account pressure, monetary tightening, political dynamics, uncertainties surrounding the revival of IMF program, and the reclassification of PSX from emerging market to frontier market index in November 2021 by Morgan Stanley Capital International (MSCI). These issues caused uncertainty among investors, leading many to shift their investments toward fixed-income assets.

Textile Sector experienced diminishing sales, however, exports sales improved ...

The textile sector continued to be the largest borrower of the banking sector's loans and a leading contributor in the economy of Pakistan. During the last year, the textile sector posted a significant rebound in its performance backed by effective management of the pandemic and supportive government policies. However, during CY22 the sector could not maintain its momentum in the wake of growing macroeconomic challenges and damages caused by the floods during 2022.[160]

During CY22, the sales of select firms in textile sector declined by 5.2 percent (YoY) as compared to growth of 48.5 percent in last year. Moderation in sales performance was also translated onto the sector's overall profitability, which declined by 81.6 percent (YoY basis). With diminishing profits, the debt repayment capacity (interest coverage ratio) dropped to 1.9 times from 6.0 times at end CY21. Being the leading borrower of banking sector loans, the performance of the textile sector holds significance for financial stability. Positively, by the end of CY22, the infection ratio of banks' loans to textile sector declined to 8.1 percent as compared to last year's 8.7 percent (**Chart 7.5**).

[159] Sugar and Synthetic sector generated positive return during CY22.

[160] The State of Pakistan's Economy – Second Quarterly Report, 2021-2022.

Chart 7.5a: Sector-wise NPLs Ratio

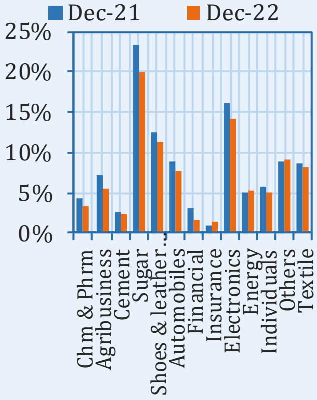
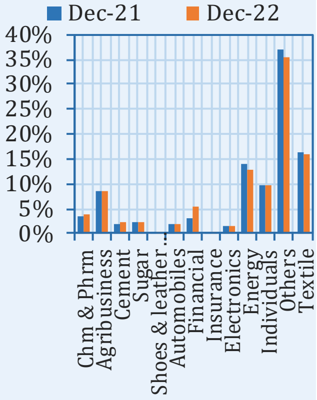


Chart 7.5b: Sector-wise Share in Bank Loans



Source: SBP

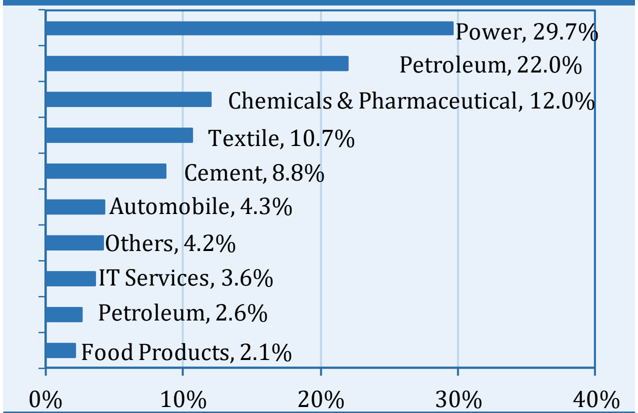
Textile exports posted notable recovery as global demand for textile intermediaries (cotton fabric and yarn) gained momentum. In addition to the price impact supported by PKR depreciation, higher export quantum was also realized because of capacity expansion in the textile industry. This was partly supported by conducive government policies along with SBP's concessionary refinance schemes for fixed investment –LTFF and TERF.[161] However, the decision to link the concessionary mark rates of LTFF and Export Finance Scheme (EFS) with the policy rate might put pressure on operating performance especially when the exports are already facing contractionary pressures.

Power Sector continued to face the issue of mounting circular debt...

The power sector, which includes power producers and exploration companies, remained the dominant industry in terms of assets among the firms selected for this analysis (**Chart 7.6**). Additionally, the power sector was the second largest user of banks' loans, trailing only behind the textile sector. The sector was able to generate high-profit margins due to increased retail prices and inventory buildup. Despite this, the issue of rising circular debt persisted, with the debt reaching PKR 2.3 trillion by the end of June 2022.[162]

Rising and persistently high levels of circular debt put significant cash flow pressure on the sector and burdened its liquidity position as well as operating performance due to increase in financing cost on borrowings, which were obtained for meeting funding gaps created by the stuck up recoveries.

Chart 7.6: Share in total assets of selected 100 firms CY22



Source: PSX

Petroleum sector's performance showed mixed trend, driven by unique dynamics of exploration and marketing companies ....

The petroleum sector comprises firms involved in exploration and marketing of oil and gas. In case of exploration companies, increase in international oil prices and exchange rate depreciation augmented the sales of the sector. Higher investments in exploration activities led to the discovery of new gas/ condensate reserves, which bodes well for future earnings of the sector[163]. The implementation of the weighted average cost of gas (WACOG) was also a crucial development, as it may help to alleviate the issue of circular debt that previously resulted in liquidity constraints for the sector.

For oil and gas marketing companies, the escalating conflict between Russia and Ukraine

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161 The State of Pakistan Economy – First Quarterly Report, 2021-22.
162 NEPRA – State of Industry Report, 2022.
163 Mari Petroleum Company Ltd – Press release dated 01-06-2022. For details, please visit https://mpcl.com.pk/discoveries/

disrupted the global supply chain and caused energy prices to surge. This resulted in periods of escalation and de-escalation between the two countries, leading to volatility in energy prices and possible inventory losses for the sector.

On the domestic front, lower automobile sales and inflationary pressures, caused by exchange rate depreciation and widespread flooding, affected the demand for petroleum products, while tightening in monetary policy raised the financing cost.

Cement sector's performance remained overshadowed by declining aggregate demand…

The cement sector struggled to maintain its growth momentum as local sales contracted by 15.1 percent (YoY) during CY22 as compared to 0.9 percent growth during the corresponding period of the last year.[164] In the domestic market, cement producers faced headwinds in the form of rising cost of inputs (primarily coal), exchange rate depreciation, lower Public Sector Development Program (PSDP) expenditures, and higher cost of financing.

Cement exports, on the other hand, faced a major setback as sales declined by 49.0 percent (YoY) during CY22. This can be attributed to decline in clinker exports, sharp increase in shipping freight costs, and reduced exports to Afghanistan due to disruption in the country's construction activities.

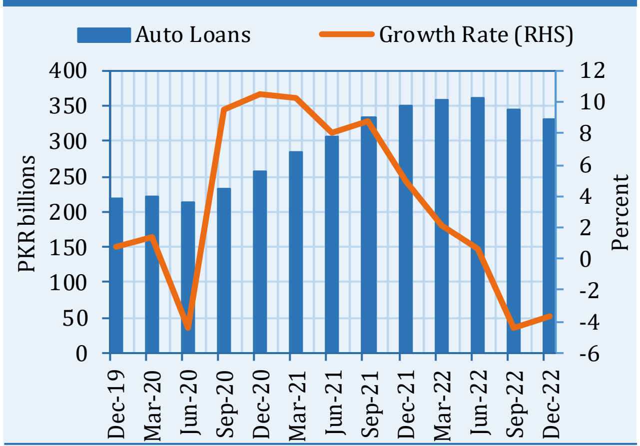
Automobile Sector faced significant headwinds …

The automobile industry in Pakistan heavily relies on imported engines and components as well as parts and other accessories of vehicles. However, in CY22, the sector experienced a dismal performance, with sales plunging by 18.3 percent.[165] This can be attributed to vulnerabilities emerging from the current account deficit as well as the stabilization measures on the fiscal, monetary and macro-prudential policy fronts. These measures contracted the imports and thus adversely affected the performance of the sector – also highlighting the need on the part of the sector to enhance the deletion, which will also contribute towards sustainability and resilience of its operations against any external account pressures.

While the decline in sales volume was modest during the first half of CY22, the second half witnessed significant decline of 44.3 percent. One of the major reasons for this was the introduction of an import ban, inter alia, on completely built unit (CBU) vehicles by the government of Pakistan to curb the import bill and ease pressures on external account as well as achieve PKR rupee parity against the US dollar.[166] In addition, import restrictions on completely knocked down (CKD) units were also imposed, which led to plant closures and delays in delivery times.

In the face of uncertain economic conditions, automobile assemblers closed down advance bookings and also announced multiple price hikes in order to offset overhead costs. This price impact on consumers greatly affected the demand for automobiles; this, along with the imposition of the macroprudential measures led to a decline in auto loans during CY22 (**Chart 7.7**).

Chart 7.7: Auto Loans and its growth rate



Source: SBP

[164] Source: All Pakistan Cement Manufacturers Association.
[165] Data is taken from Pakistan Automotive Manufacturers Association.
[166] Source: S.R.O 598(I)/2022, Ministry of Commerce.

Reversal in investors' sentiments and operating performance led to fall in firms' market capitalization and consequent rise in average probability of default indicators, which however remained within manageable range ...

In CY22, the weighted average 1-year probability of default (PD) deteriorated to 0.6 percent from 0.36 percent in CY21 (**Chart 7.8**).[167] During the first half of CY22, the 1-year PD slightly rose to 0.45 percent by the end of June 2022. Subsequently, operating performance of firms was unfavorably affected by building macroeconomic challenges that also impacted investors' sentiments. Decline in investors' confidence led to increased volatility and fall in stock prices that reduced the market value of listed firms' equity and thus led to rise in average PD.

Chart 7.8: Weighted avg 1 year PD of Corporate Sector

Source: Bloomberg, SBP

In the third quarter of CY22, market sentiments improved as the IMF concluded its combined seventh and eighth reviews under the EFF for Pakistan and released USD 1.1 billion tranche to ease the adverse external conditions.[168] However, by the end of CY22, the average PD again experienced a sharp reversal due to change in investors' sentiments which were dampened by political instability, re-emergence of macroeconomic imbalances, and consequent additional stabilization measures, such as monetary tightening and LC restrictions.

While the average PD over the year inched up closer to the levels that were observed during early pandemic period, its levels are still within comfortable bounds and do not pose a significant default risk to lenders as firms continue to post steady earnings and attractive price earnings (P/E) multiples present the prospects of rise in share prices.

However, banking sector's leading borrowing firms demonstrated strong financial standing and performance...

Given that a bank's financial soundness is significantly influenced by the performance of its large borrowing firms and some of these firms and their business groups have systemic importance for the entire banking sector, an assessment of banking sector's top 30 borrower groups (along with their 231 identified firms) was made. These identified firms together account for around 21.3 percent of the banks and financial institution's combined loan portfolio.

In the current year, CY22, the top borrowing groups demonstrated steady financial performance and continued to show adequate debt repayment capacity. Further, banks in general continued to reflect preference for better rated firms. (**Box 7.1**).

Credit worthiness of large firms in terms of credit rating also continued to show steady debt servicing capacity and resilience ....

It has been observed that firms in Pakistan tend to rely on bank financing vis-à-vis capital market funding due to several structural issues in the capital markets. Credit rating is one of the key requirements for a firm to issue capital market

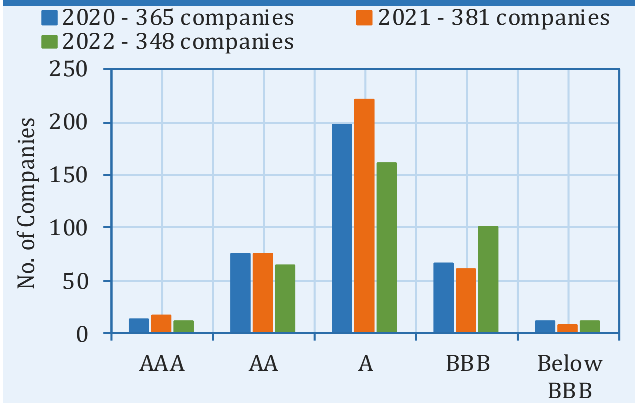
167 The PD (1 Year PD) demonstrates firms' credit risk and ability to honor short-term obligations. The PD is calculated based on Merton Model, which uses value of equity and volatility in stock prices to measure default probability
168 International Monetary Fund. (2022). IMF Staff Country Reports. Country Report No. 2022/288. *Washington, April.* For details, please visit https://www.imf.org/en/Publications/CR/Issues/2022/09/01/Pakistan-Seventh-and-Eighth-Reviews-of-the-Extended-Arrangement-under-the-Extended-Fund-522800

instruments through public offering, as it is also considered a good marker of the firm's credit worthiness.[169]

By the end CY22, there were around 183,744 companies registered with SECP. Of these public limited companies, 531 were listed on PSX[170].

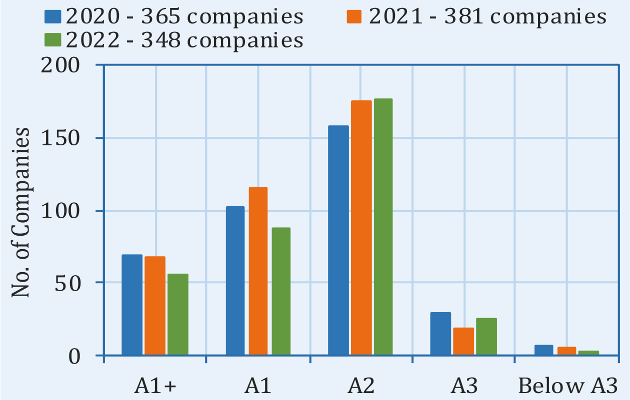
An analysis of long-term credit ratings of firms showed that the credit worthiness of firms in general remained steady as most firms were in comfortable ranges of investment grade ratings. The majority of the companies were rated A (i.e. 46.3 percent of the companies), followed by BBB category and AA category (**Chart 7.9**). As for short-term ratings, about 92 percent of firms held an A2 or better rating, indicating satisfactory capacity to meet their short-term financial obligations (**Chart 7.10**).[171] This rating scenario suggests that most of the large firms in Pakistan have the potential to access long and short-term financing from capital market at favorable costs, to finance their capital expenditures and operating activities.

Chart 7.9: Long-term Ratings of Companies in CY20, CY21 & CY22



Source: PACRA

Chart 7.10: Short-term Ratings of Companies in CY20, CY21 & CY22



Source: PACRA

Corporate sector's outlook remains contingent on the ongoing political and macroeconomic landscape…

The corporate sector faced significant challenges in CY22 due to emergence of global and domestic macroeconomic challenges that were further compounded by geopolitical tension in Eastern Europe and domestic political uncertainty. The government had responded with stabilization measures and current account deficit had reduced significantly in recent quarters. However, inflationary pressures have intensified and uncertainties prevail about the macroeconomic conditions. All these factors make the operating environment quite challenging for businesses.

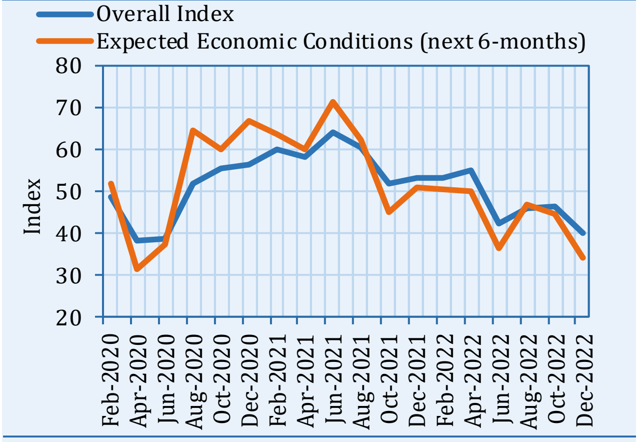
Looking ahead, businesses do not expect these conditions to improve over the first half of CY23 (**Chart 7.11**). Nevertheless, large firms have sufficient liquidity and strong financial cushions to finance their operations while also meeting their financial obligations to financial institutions.

[169] In order to facilitate the growth of capital market and improve corporate governance regime, SBP aims to encourage the rating culture. Along with other tools, SBP incentivizes the large firms to get themselves rated by applying higher capital charge on banks' exposures on unrated firm whose total exposure exceeds PKR 3 billion).

[170] PSX 5-year Progress Report.

[171] PACRA rating of companies. For details, please visit https://www.pacra.com/rating_resources/1, accessed on 26-03-2023.

Chart 7.11: Business Confidence Index



Source: Business Confidence Survey, SBP