

Corporate Sector

Corporate sector showed steady solvency with improved debt-servicing capacity and posted improved financial performance during CY23, despite a significantly stressed macro financial environment. The large corporate firms in general improved their profit margins as their efficiency indicators demonstrated improvement. The large borrower groups of banking sector, especially observed steady repayment capacity with sound financial performance and standing. Accordingly, the delinquencies in banks' corporate loans remained well-contained; the credit-risk rating profile of firms also suggest that they have strong ability to honour financial obligations. Going forward, the performance of corporate sector will largely depend upon the macro financial conditions which have started to show signs of modest recovery, while some uncertainties related to global geopolitical tensions and successful completion of domestic economic stabilization program remain key determinants of the sector's overall performance.

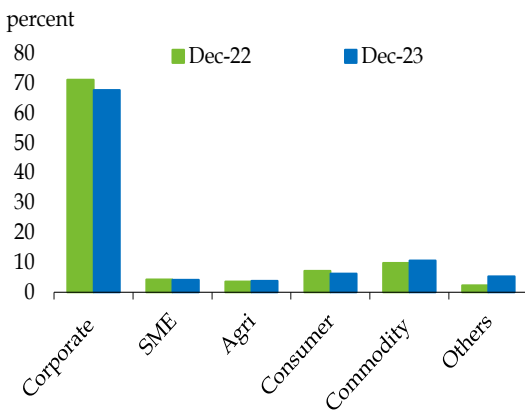


7 Corporate Sector

A sound corporate sector is imperative for financial stability

Corporate sector constitutes a significant portion (67.8 percent as of December 2023) of the banking sector's loan portfolio, indicating that the financial performance and repayment capacity of the corporate segment have a direct bearing on the overall stability of the banking and financial system (**Figure 7.1**).

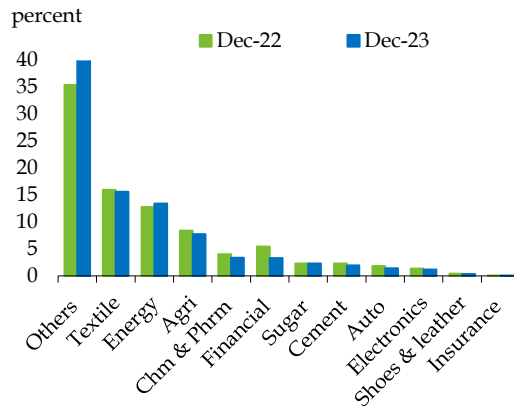
Segment-wise Share in Bank Advances Figure 7.1



Source: State Bank of Pakistan

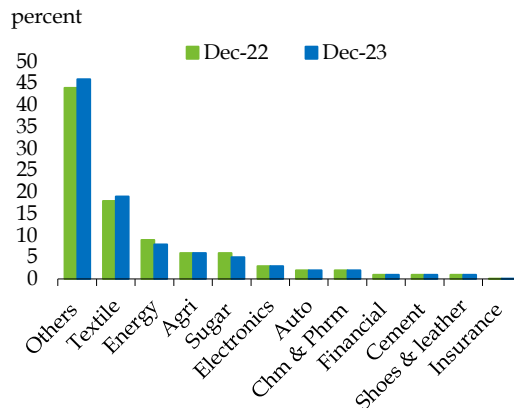
Sector-wise share in total banking exposure shows a large representation from textile and energy sectors, which are important contributors to economic growth (**Figure 7.2**). Certain sectors such as cement, sugar, auto and chemicals & pharmaceuticals, despite constituting a small part of the overall banking exposure, contribute significantly to economic growth. Any adverse changes in economic conditions may therefore impact the repayment capacity of these sectors (**Figure 7.3**) which may translate in deterioration of asset quality of banking sector.

Sector-wise Share in Bank Advances Figure 7.2



Source: State Bank of Pakistan

Sector-wise Share in NPLs Figure 7.3



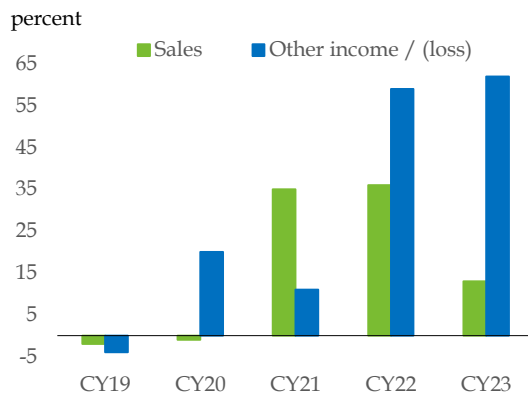
Source: State Bank of Pakistan

Amidst challenging economic environment, large corporations exhibited resilience, bolstering profitability through upward price adjustments and diversified revenue streams

Even in the face of a challenging economic environment e.g. high inflation, contractionary economic policies, depressed demand and high finance cost during CY23, the corporate sector showed resilience in its operational and financial performance as reflected by improved

profitability margins of the large companies (Table 7.1).¹ This resilience stemmed from three key factors: higher earnings due to upward price adjustments, easing of pressure on global commodity prices and diversification of revenue streams, particularly the flows of income from investment activities. The growth in other income, which contributes around 44 percent of net profits of the sector, has outpaced the growth in sales (core-earnings) in CY22 and CY23 (Figure 7.4). Detailed analysis shows that the rise in other income is primarily driven by interest earnings from investments in government securities and dividend income from equity investments and affiliated entities.

Growth of Sales and Other Income (YoY) Figure 7.4



Source: State Bank of Pakistan

7.1 Financial Assessment of Corporate Sector

The tough macroeconomic conditions and depressed demand resulted in lower growth of 19 percent in Q3CY23, as compared to 23 percent in Q3CY22 of corporate sector's assets. Both long-term and short-term borrowings witnessed subdued growth during Q3CY23 as compared to Q3CY22 owing to high finance cost. The corporate sector in Q3CY23 had sufficient cash and liquid assets (cash, near-cash instruments, short-term investments, and

inventory) to cover its short-term obligations, as reflected in healthy current ratio (Table 7.1). This was possible as stable leverage levels did not diminish these resources.

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

	Q4 CY21	Q1 CY22	Q3 CY22	Q4 CY22	Q1 CY23	Q3 CY23	YoY Growth
	billion Rupees						percent
Balance Sheet							
Non-Current Assets	3,824	3,915	4,344	4,430	4,558	5,248	20.8
Current Assets	5,007	5,401	6,146	6,178	6,663	7,103	15.6
Total Assets	8,831	9,316	10,491	10,608	11,221	12,351	17.7
Shareholders' Equity	4,131	4,304	4,593	4,679	4,866	5,454	18.7
Non-Current Liabilities	1,186	1,220	1,457	1,434	1,513	1,799	23.4
Current Liabilities	3,513	3,791	4,441	4,496	4,842	5,099	14.8
Total Equity & Liabilities	8,831	9,316	10,491	10,608	11,221	12,351	17.7
Income Statement							
Sales	2,272	2,401	2,933	2,876	2,861	3,319	13.2
Cost of sales	1,840	1,942	2,493	2,487	2,313	2,688	7.8
Gross profit / (loss)	432	459	441	389	548	630	42.9
General, admin. & other expenses	150	136	168	149	190	188	11.9
Other income / (loss)	45	74	89	81	139	125	40.4
EBIT	327	397	361	322	497	567	57.1
Financial expenses	34	41	72	73	109	104	44.4
Profit / (loss) before taxation	292	356	289	249	388	463	60.2
Tax expenses	79	96	105	84	132	177	68.6
Profit / (loss) after tax	213	260	184	165	256	286	55.4
Financial Ratios							
Gross Profit Margin (%)	19	19.1	15	13.5	19.1	19	
Net Profit Margin (%)	9.4	10.8	6.3	5.7	9	8.6	
Return on Equity (%)	20.6	24.2	16	14.1	21.1	21.0	
Return on Assets (%)	9.7	11.2	7	6.2	9.1	9.3	
Current Ratio (units)	1.4	1.4	1.4	1.4	1.4	1.4	
Asset Turnover (units)	102.9	103.1	111.8	108.4	102	107.5	
Capital to Total Assets(%)	60.2	59.3	57.7	57.6	56.9	58.7	
Debt Equity Ratio (units)	1.1	1.2	1.3	1.3	1.3	1.3	
Debt to Capital Employed (units)	0.9	0.9	0.97	0.97	1	0.95	
Interest Coverage Ratio (units)	9.5	9.7	5	4.4	4.6	5.5	
Financial Leverage (units)	2.1	2.2	2.3	2.3	2.3	2.3	
Operating cash-flow to current liabilities (%)	-1.4	4.5	-3.3	2.8	-1.4	5.4	
Operating cash-flow to total debt (%)	-1.1%	3.4%	-2.5%	2.1%	-1.0%	4.0%	
Cash flow margin (%)	-2.2%	7.0%	-5.0%	4.4%	-2.3%	8.3%	
Cash conversion cycle	78.2	58.3	99.5	135.7	95.0	78.2	

(*Data of 100 companies were used that represent 79% of total assets of all listed non-financial entities)

Source: State Bank of Pakistan

However, in first half of CY23, the ability of companies to pay their current and long-term debts solely from their core operations weakened due to deterioration in their cash flows. This impact was temporary as economic conditions improved in second half of CY23. Accordingly, the cash flow ratio significantly improved in H2CY23, thereby shoring up

¹ The analysis is conducted on a sample of 100 non-financial companies listed on the Pakistan Stock Exchange, serving as a representative subset of the larger corporate sector.

liquidity while solvency levels remained stable. This improved liquidity, especially from operations, showing that companies may be able to meet their obligations sustainably. However, taking a cautious approach due to high finance cost, companies did not excessively take on more debt for asset purchases, as evidenced by the stable debt-to-equity ratio, further easing the overall leverage burden on the sector.

The improved liquidity and stable solvency ratios were sustained by augmented profitability, as evidenced by improvement in bottom line indicators of ROE and its contributory indicators of gross, operating and net margins over the year. While strong profitability and consistent earnings growth represent healthy financial performance of firms; the indicators related to sustainability of earning and operational efficiency of firms also indicated improvement.

One leading efficiency indicator i.e. cash conversion cycle, which represents how quickly firms can convert their inventory and products into cash through sales – marked significant improvement during the year under review. Further analysis of the cycle shows that the selected firms were able to avail higher amount of supplier credit (purchase of goods and services from suppliers on credit) and lower the pending receivables from buyers, indicating these firms' relatively stronger market power and ability to fetch better terms of trade from their customers and suppliers. These factors also hold out the strong performance of the large corporate sector and contained delinquencies in the banks' corporate loan portfolio, even in the face of significantly stressed macro financial conditions.

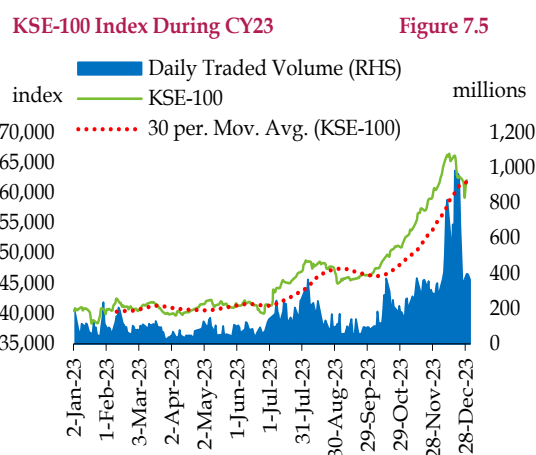
The DuPont analysis reveals encouraging signals for long-term earnings sustainability. The rise in Return on Equity (ROE) is primarily attributed to enhancements in both net profit margin and asset turnover, coupled with the consistent financial leverage ratio within the corporate sector. However, higher taxes proved to be a drag on ROE in CY23 (**Table 7.2**).

ROE - DuPont Analysis	Table 7.2			
	Ratio unless specified			
	CY20	CY21	CY22	CY23
Tax Retention Rate (A)	0.76	0.73	0.69	0.62
Interest Burden (B)	0.87	0.89	0.81	0.82
Operating Profit Margin (C)	0.16	0.14	0.12	0.17
Asset Use Efficiency (D)	0.8	1.03	1.08	1.07
Financial Leverage (E)	2.15	2.14	2.23	2.26
Return on Equity (ROE) % (A×B×C×D×E)	18.2	20.05	16.15	21.00

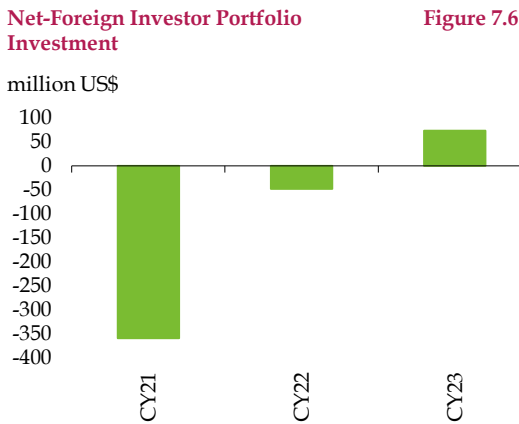
Source: State Bank of Pakistan

7.2 KSE-100 Index

The KSE-100 index experienced subdued growth due to stressed macroeconomic conditions and delay in review of IMF program (**Figure 7.5 and 7.6**). However, in the latter half of CY23, the stock market witnessed a notable resurgence. The positive momentum in key sectors i.e. banking, power, oil & gas, and cement, coupled with overall improved corporate financials and a favorable exchange rate, contributed to the remarkable turnaround in market performance.



Source: Pakistan Stock Exchange



Source: National Clearing Company of Pakistan Limited

7.3 Sectoral Analysis

Sectoral analysis revealed that six sectors² contributed a combined 80 percent to the profitability of all listed companies while only 5 sectors suffered losses. Details on performance and risk analysis of a few major sectors are given below.

Textile Sector

The textile industry faced considerable challenges in CY23 as its exports declined by 15 percent YoY, to USD 15.81 billion.

The decline in textile exports was due to lower international orders because of a slowdown in global demand while energy tariff hikes, upward revision of rate on subsidized financing facilities³ and high financing costs also adversely impacted sector's profitability. The increase in domestic cotton production, whilst favorable, was not enough to mitigate negative impact of aforementioned factors on the sector.

Due to these challenges, working capital requirements of the sector also remained lower as compared to CY22.

The sector's profitability remains vulnerable to higher costs related to energy and financial charges. However, the prospects of improved cotton supply in 2024 and the subsequent decline in local cotton prices, bodes well for the sector while the greater availability of local cotton will also help to reduce the country's import expenditure on raw cotton and will help in reducing the sector's susceptibility to fluctuations in global cotton prices.

Power Sector

As the domestic economy remained subdued in CY23, demand for electricity reduced during the year, causing overall power generation to decline by 5.3 percent on YoY basis to 130,002 GWh. This decline in power generation led to lower revenues for power generation and distribution companies as well as increased capacity charges (Rupee/kWh), causing payables of CPPA-G to rise. Accordingly, power sector circular debt also rose during the year under review to Rs 2.6 trillion by October 2023.⁴ In order to curb the growth of circular debt, the government increased power and gas sector tariff, thereby putting pressures on capacity utilization of the power sector.

As a mitigation measure, industries either reduced power requirements, increased dependence on capacity power producers or shifted towards cheaper fuel sources such as domestic coal. The share of renewables, such as wind and solar, has increased, yet it remains

² Out of total of 37 sectors, top 6 sectors include commercial banks (34 percent), oil & gas exploration companies (29 percent), fertilizer (6 percent), textile composite (5 percent), chemical (4 percent), cement (3 percent).

³ Markup rate on LTFF for plant & machinery linked with the SBP Policy Rate and with any change in the Policy rate, markup rate for LTFF is revised automatically so that the gap between policy rate and LTFF rate is maintained at 3 percent.

⁴ Circular Debt Report - October 2023, Ministry of Energy (Power Division); <https://power.gov.pk/Reports>.

relatively small in overall electricity supply in the country.⁵

Working capital requirements of power sector decreased, which can be attributed to lower power generation and payments made by the government to the sector, thus reducing the net receivables of the sector during CY23.

Recent hike in gas and electricity prices is expected to play a critical role in resolving the circular debt issue and is expected to ease liquidity constraints within the sector. While adjustments in electricity tariffs may help in curbing the buildup of circular debt, however, effective resolution of the issue requires concerted efforts for curtailing losses in power transmission and distribution.

Fertilizer Sector

The fertilizer sector witnessed substantial hike in average urea prices due to upward adjustments in gas prices by the government in CY23. Furthermore, the Federal Budget of FY24 imposed a 5 percent FED on fertilizers. Despite the increase in prices, the overall urea offtake remained consistent with the previous year, reaching 6.6 million metric tons. On the other hand, DAP offtake, which observed a dip in consumption in CY22 due to heavy floods, increased by 31 percent YoY during CY23, reflecting the normalization of demand. The industry also witnessed gas supply disruptions, affecting the overall production of urea.

The improvement in profitability of fertilizer sector was driven by higher urea prices coupled with increase in demand in CY23. Earnings of

the sector were also supported by healthy growth in other income⁶ driven by elevated interest rates. On the downside, the sector experienced rise in distribution expenses on account of higher fuel prices as well as axle load regime requirements.⁷ Fertilizer companies are characterized by sound liquidity profile and thus, working capital needs are mostly met through internally generated cash flows.

The sector made net retirement of Rs 89.6 billion in working capital loans during CY23 compared to the net borrowing of Rs 42.9 billion a year earlier.⁸ The decline in working capital loans can be attributed to improved liquidity stemming from increased sales on account of higher demand and lower inventory stocks during CY23.⁹ Moreover, the higher demand allowed companies to secure advance cash sales, particularly in DAP, thereby improving their liquidity position.

During 2024, the fertilizer consumption is anticipated to improve driven by higher farm output and enhanced support prices. However, the sector faces challenges due to gas supply shortages and ongoing gas price increases. Reductions in subsidies, that the industry receives from the government through discounted gas prices, may lead to higher fertilizer prices. This will impact the affordability of inputs for farmers as well as the sector's profitability if increased prices translate into fall in demand.

Cement Sector

The local dispatches for cement were faced with limited demand in CY23 due to decreased spending in the Public Sector Development

⁵ Pakistan's power generation (GWh) uses a fuel mix where Hydel contributes 30 percent, Nuclear 17 percent, RLNG 19 percent, Coal 17 percent, Gas 9 percent, Renewable 4 percent (Wind, Solar, Bagasse) and Furnace Oil 2 percent (CY23).

⁶ Other income contributes around 33 percent to net profit. It includes investment income on deposits, mutual funds, Government securities and dividend payout by subsidiary/associated companies.

⁷ Implemented in November 2023, Pakistan's axle load regime enforces weight limits on vehicles, aiming to bolster road safety, preserve infrastructure, and optimize transportation efficiency.

⁸ Loans by Manufacture of fertilizers and nitrogen compounds and Wholesale of fertilizers and agrochemical products (Outstanding Position at the end of December 2023 (P) Based on ISIC 4 Classifications of Private Sector Businesses

⁹ Average closing inventory stock of total fertilizer (including urea, DAP, CAN etc.) stood at 684,544 tons during CY23 vs stock of 1,134,822 tons during CY22.

Program (PSDP), higher construction costs and electricity costs, weak household demand and overall subdued economic activity, particularly in the first half of CY23. However, the adverse impacts of cement offtake on sales were mitigated through consistent price hikes by cement manufacturers.

Apart from price hikes, cement manufacturers have traditionally turned to exports when local demand weakens, so as to ensure operational viability of cement production. This trend, combined with decreasing coal costs¹⁰ due to easing global commodity prices, fueled export growth. Southern manufacturers of cement sector gained a larger advantage (197.9 percent increase YoY as compared to 39.6 percent growth for north) due to their proximity to seaports, as these locations benefit from lower coal transportation costs.

Price hikes and an increase in other income provided support to the sector's net income. Due to high interest rates and increased profitability following the expansion, companies have prioritized debt repayment. Consequently, the sector witnessed a net reduction of Rs 27 billion in its total outstanding debt during CY23.

Despite declining international coal prices, the axle-load regime and the Red-Sea disruptions may continue to exert upward pressure on imported coal prices for domestic cement manufacturers. Furthermore, cement sales may remain sluggish due to decreased government expenditure in development projects, reduced construction activity, and household budget constraints caused by inflation.

Petroleum sector

The petroleum sector comprises of firms involved in the exploration and marketing of oil and gas. The exploration companies saw uptick in their profitability due to currency

depreciation, taxation reversal on depletion allowance¹¹ and exchange rate gains made during CY23. The earnings of these companies also benefitted from rise in other-income attributable to short-term investments.

However, the oil marketing companies saw compressed margins because of subdued economic activity and ensuing inflationary pressures (price hikes for Motor Spirit & High Speed Diesel) which further contributed towards decreased domestic demand from key sectors such as auto, power (Furnace Oil requirement decreased) and also retail consumers. The price hikes supported earnings of the sector and mitigated the impact of decline in volumetric sales.

While the relatively stable parity and slightly increased auto sales in the latter half of the year, signal a potential rise in domestic petroleum demand, a more substantial boost in economic activity is needed for a significant improvement in the future outlook of these products. Moreover, pending issues of receivables arising from circular debt also need to be addressed for improved performance of the petroleum sector.

Automobile sector

CY23 presented several challenges for the auto industry. Economic activity remained subdued especially in first half of CY23, with only the agricultural sector seeing an uptick, leading to increased tractor sales. Though the appreciating rupee in the latter half of the year caused a decrease in vehicle prices, it was not enough to offset significant price hikes from previous years, causing end-consumer demand to remain subdued. Import-related restrictions implemented as part of administrative measures led to increased costs and production delays for the heavily import-dependent sector. Despite lifting of these restrictions in June 2023, the year on year increase in auto sales was mainly due to

¹⁰ Coal prices declined by around 45 percent YoY during CY23

¹¹ The Supreme Court of Pakistan (SCP)'s decision to exclude the deduction of royalties from well-head value for depletion allowance benefitted the sector as it resulted in the reversal of prior years' tax provisions, ultimately reducing the tax charge.

a low-base effect, as sales figures remained significantly below those of previous years. Furthermore, auto sales were also impacted by reduced auto financing due to macro-prudential measures¹² taken by the SBP in later part of 2021 as well as by high interest rates during the same period.

An anticipated improvement in the domestic economy in 2024 could provide an opportunity for the auto industry to revive. Moreover, recently, auto assemblers have also reduced prices of certain models which will help prop consumer demand.

Sugar sector

Sugarcane constitutes approximately 23 percent of the production of major crops¹³, 3.7 percent in agriculture's value addition and 0.9 percent in GDP. The sector witnessed improved profitability in MY22¹⁴, attributed to higher sugar prices and consumption levels. Domestic sugar consumption in Pakistan has been on the rise since MY18, due to increased consumer demand and sugar supplies. The elevated interest rates adversely affected net profit margins of the sector due to higher finance costs.

Retail prices of sugar are expected to remain high amid inflationary pressures, which is anticipated to positively impact gross margins of the sector. Nevertheless, challenges persist, particularly regarding rising selling and distribution expenses, as well as finance costs.

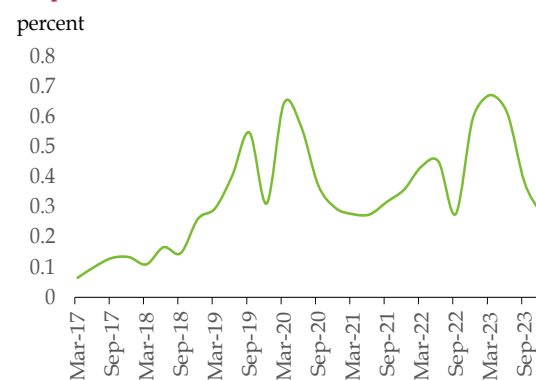
Firms' market-based resilience indicators improved over the year, mainly reflecting the

operating performance and revival in investors' sentiments towards the firms' value and potential

In line with the improvement in financial performance and revival in investors' sentiments especially in the later part of CY23, the weighted average 1-year probability of default (PD) of selected firms of the corporate sector decreased over the year (**Figure 7.7**).¹⁵ The decrease was, primarily, due to rebound in the equity market post June 2023, driven by improvements in operating performance and increased investors' confidence which was reflected in the market capitalization of the stocks listed on PSX. The enhancement of financial and operational profit metrics has strengthened the solvency buffer and contributed indirectly to the improved market capitalization of the firms.

Weighted average 1 year PD of Corporate Sector

Figure 7.7



Source: Bloomberg and State Bank of Pakistan

Further, the quantum of PDs, itself, is at the lower side and does not pose imminent default

¹² These measures included reduction in maximum tenor of auto loans from 7 to 5 years, increase in minimum down payment to 30 percent from 15 percent of the value of vehicle, and limiting total loan value up to Rs 3 million etc. The relevant circular is accessible at <https://www.sbp.org.pk/bprd/2021/CL29.htm>.

¹³ Important crops include wheat, rice, cotton, sugarcane and maize.

¹⁴ MY refers to "Marketing Year" – Brazil MY "April to March", India, China, USA & Pakistan MY "Oct-Sep".

¹⁵ 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. The model assumes that the firm provides both equity (E) as well as debt (X), such that the value of the firm (V) is E + X. According to this model, the firm will default only when the value of the firm is less than the face value of debt (X) and it will happen only at maturity period. In this chapter, the calculations are derived from 434 companies listed on the PSX, and a weighted average of the Probability of Default (PD) is computed for the sample. These weights are determined by the market capitalization at the end of December 2023.

risk (credit risk) to the lenders of corporate firms. As such, these corporate firms maintained strong financial soundness and decent operating performance despite challenging macro-financial conditions.

...banking sector's leading borrowing firms demonstrated resilient financial standing and adequate repayment capacity...

Given that banks' financial soundness is significantly influenced by the performance of their large borrowing firms and some of these firms and their business groups have systemic importance for entire banking sector, an assessment of banking sector's top 30 borrowing groups (along with their 226 identified firms) is made. These identified firms together account for around 21.4 percent of the banks and financial institutions' combined loan portfolio.

In CY23, top borrowing groups showed resilient financial performance and continued to show adequate debt repayment capacity. Further, banks in general continued to prefer lending to better rated firms (for details see **Box 7.1**).

Credit risk rating profile shows steady solvency position of corporate sector, whereas increasing numbers of large corporate firms are resorting to get themselves rated, indicating an improvement in corporate governance practices ...

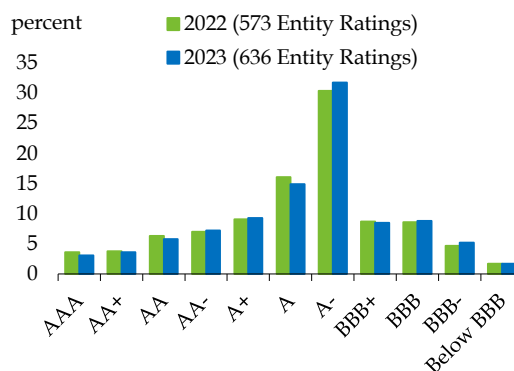
Credit rating provides an assessment of a firm's solvency and capacity to honour its financial obligation.

The number of rated companies in Pakistan increased from 573 in CY22 to 636 in CY23. Many companies in Pakistan rely on debt financing through banks or internal sources

such as retained earnings and remain less reliant on capital markets for their funding needs.¹⁶

In Pakistan, the ratings universe is shared between two domestic credit rating agencies - the Pakistan Credit Rating Agency (PACRA) and VIS Ratings. Between themselves, they have 636 public opinions (entity ratings).¹⁷ The ratings universe is concentrated mostly in high rating categories (investment grade: AAA to BBB-), representing 98.3 percent of the total (**Figure 7.8**). Higher concentration in investment grade category can be attributed to the fact that majority of the rated entities are large corporate firms having sound repayment capacity. Whereas, in terms of short-term ratings, majority of the firms (95 percent) were rated as A2 and above which represents satisfactory capacity for timely repayment (**Figure 7.9**).¹⁸

Long-term Ratings of Companies **Figure 7.8**



Source: Pakistan Credit Rating Agency and VIS Credit Rating Company Limited

This overall rating profile of the corporate sector suggests that large corporate firms in Pakistan have the potential to access long-term and short-term financing from capital markets to finance

¹⁶ In order to facilitate the growth of capital market and improve corporate governance regime, SBP aims to encourage firms to get themselves rated. 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).

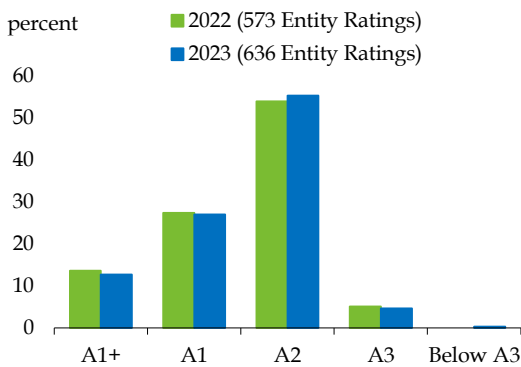
¹⁷ Only entity ratings are taken into account. The Credit Rating Agencies (CRAs) also issue other ratings, including Asset manager, IFS, Performance ranking etc.

¹⁸ PACRA & VIS rating of companies accessed on 06 February 2024.

their capital expenditures and operating activities.

Sector-wise distribution of entity ratings shows heavy concentration in textile (23 percent), followed by energy (14 percent), consumer goods (6 percent) and sugar (5 percent).

Short-term Ratings of Companies **Figure 7.9**



Source: Pakistan Credit Rating Agency and VIS Credit Rating Company Limited

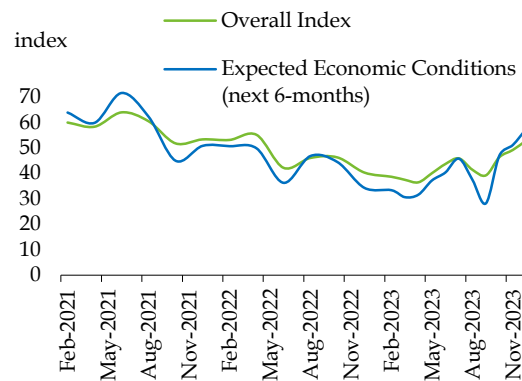
Corporate sector outlook

Going forward, a moderate economic recovery is projected in CY24, primarily driven by the agriculture sector. Recent consumer and business confidence surveys (**Figure 7.10**) also indicate a steady increase in economic activity and improvements in capacity utilization in the manufacturing sector. These developments bode well for the performance and soundness of industrial sector in the coming months.

Although, recent sizeable adjustments in administered energy prices have adversely impacted inflation outcomes and its near-term outlook, the recent data is showing a notable decline in inflationary pressures. Nonetheless, the escalated geopolitical tensions and disruptions in the Red Sea have led to increased global freight charges, posing risks to global trade and commodity prices. Looking ahead, with the expectation of moderate economic growth, the earnings growth outlook for companies seems favorable. Moreover, large firms possess sufficient liquidity and a robust

financial cushion to finance their operations and meet repayment obligations to financial institutions.

Business Confidence Index **Figure 7.10**



Source: State Bank of Pakistan

Box 7.1: Financial Performance and Soundness of Top Borrowing Groups of the Banking Sector

Corporate sector constitutes major share of banks' loan portfolio i.e. 67.8 percent as of December 2023. Many of these firms are also part of business conglomerates and multiple banks may have taken exposure on a large firm and conglomerate, thus creating credit concentration risks as well as systemic implication for banks. For this reason, SBP has set regulatory prudential limits on banks' exposure to single borrower, borrowing group, and related party exposures. Moreover, regulations define large exposure and prescribe an aggregate limit on large exposures.¹⁹ In this box, the repayment behavior and capacity as well as overall financial health of large borrowers and borrowing groups of the banking sector have been analyzed on the basis of following:

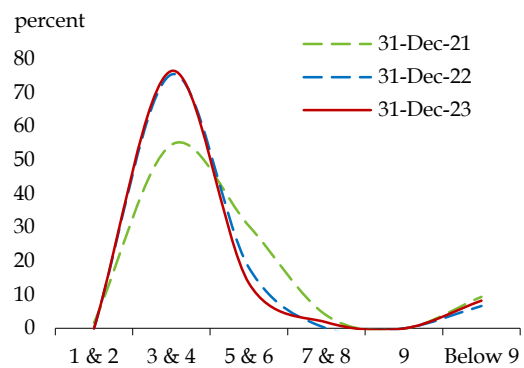
- Banks' own assessment of creditworthiness of large borrowers and borrowing groups' as captured through Obligor Risk Rating (ORR) which is assigned by banks to each corporate sector borrower.²⁰ The rating continuum goes from 1 to 12, with 1 to 9 scales for performing categories and 10 to 12 for default categories.
- Borrowers' repayment behavior in terms of any overdue payments in their loan obligations to banks.
- Latest financial indicators of leading corporate borrowers as well as market-based indicators that show how investors value these firms.

For this purpose, 30 large borrowing groups and large borrowers (comprising 226 firms) have been identified based on SBP's internal exercise, using a diversified set of sources of information on ownership of firms, including information contained in regulatory returns, financial statements of the firms, group's websites etc. Further, groups with a fund based exposure of Rs 40 billion and above are considered given their systemic risk implications.

Loans of Top 30 Borrowing Groups by their Obligor Risk Rating

The creditworthiness has been assessed for top 30 borrowing groups based on ORR assigned to them by banks. Identified firms of these business groups together hold around 31 percent (of the corporate/commercial lending portfolio of banks and DFIs at end December 2023).²¹

Based on ORRs of different entities of the borrowing groups, overall average rating (weighted by size of loans) of each group was compiled to assess the strength of these groups with risk rating of groups on X-axis and percentage of borrowings of groups on Y-axis. Assessment indicates that around three-fourths of the top 30 groups have highest to very good quality (rating: 1 to 2) or good to medium (rating: 3 to 4) quality ratings. Even though CY23 was a relatively challenging year for businesses due to stressed macroeconomic conditions, the credit portfolio of banks continued to show steady position of large 30 borrowing groups' creditworthiness and tendency on the part of banks to prefer lending to borrowers with the better creditworthiness, as significant increase in government demand for bank credit also contracted the pool of banks' loanable funds. The average internal credit rating profile of banks' loan portfolio has remained stable from CY22 to CY23, implying that the banks prefer lending to higher quality borrowers in the wake of weak macroeconomic conditions (**Figure 7.1.1**). It is important to note that around 65 percent of banks' corporate and commercial loan portfolio comprises of borrowers who have been rated by independent external rating agencies. By and large, top 30 borrowing groups exhibited strong repayment capacity except for a few groups (around 7 percent of total exposure) which fall under overdue category.

Internal Credit Rating of Top 30 Borrowing Groups**Figure 7.1.1**

Source: State Bank of Pakistan Estimates

¹⁹ Regulation R-1 of SBP Prudential Regulation for Corporate/Commercial Banking.

²⁰ BSD Circular No. 08 of 2007

²¹ This share is 29.4 percent at end December 2022

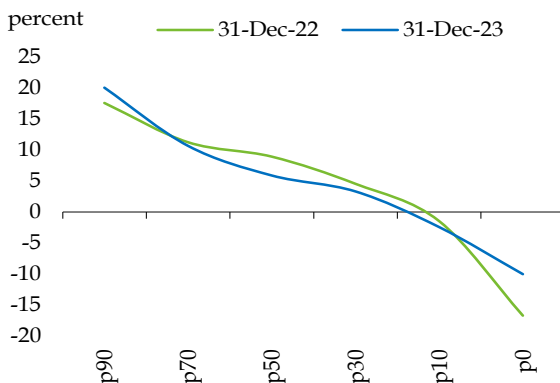
Financial Soundness and Market Performance of Listed Firms of Top 30 Borrowing Groups

Out of the 226 identified firms in top 30 borrowing groups, 71 firms were listed on PSX. To analyze the financial soundness of these firms and assess how they are valued by the market, an assessment of these 71 listed firms was made using the financial and market-based indicators on the basis of available data for the period ended December 2023 and December 2022.

Due to tough macroeconomic conditions, depressed demand, high finance cost and high taxation in CY23, earnings of the selected firms, in general, came under pressure (**Figure 7.1.2 and Figure 7.1.3**).

Percentile Standing of Companies vis-a-vis ROA

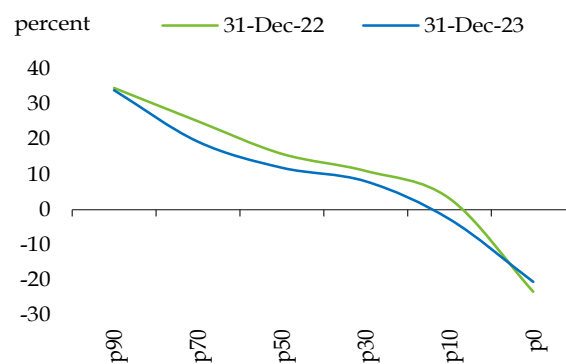
Figure 7.1.2



Source: State Bank of Pakistan and Capital Stake

Percentile Standing of Companies vis-a-vis ROE

Figure 7.1.3

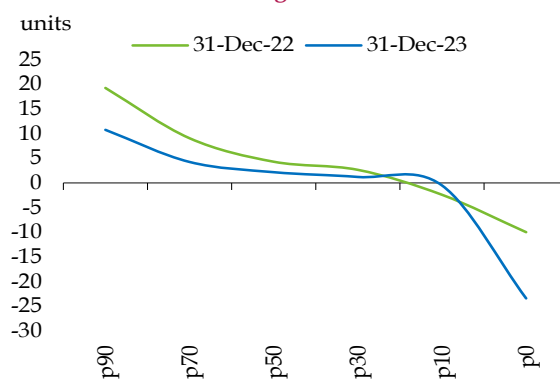


Source: State Bank of Pakistan and Capital Stake

Similarly, the financial indicators related to repayment capacity came under stress due to constrained sales and tight monetary policy environment in CY23. However, most of the firms in the sample demonstrated comfortable interest coverage ratio (**Figure 7.1.4**). Sample firms also faced slight slackness in current ratio over the year under review; however, the ratio of most of the firms remained in comfortable range showing the availability of ample liquidity cushions to honor their short-term financial obligations. Moreover, sample firms also showed stable repayment behavior as there was no significant rise in the delinquencies during the year under review (**Figure 7.1.5**).

Percentile Standing of Companies vis-a-vis Interest Coverage Ratio

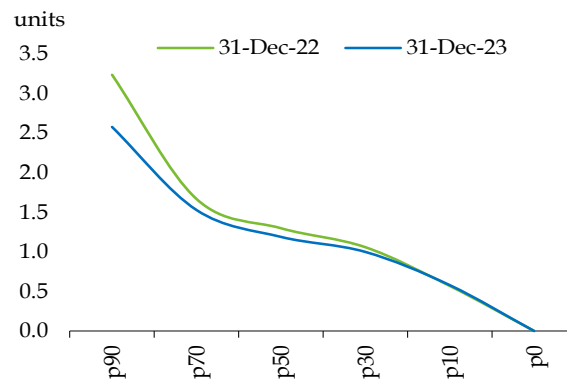
Figure 7.1.4



Source: State Bank of Pakistan and Capital Stake

Percentile Standing of Companies vis-a-vis Current Ratio

Figure 7.1.5

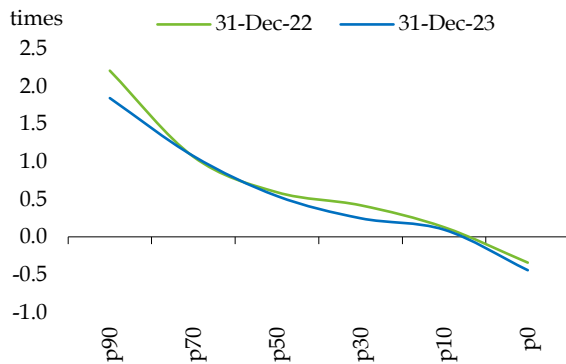


Source: State Bank of Pakistan and Capital Stake

An analysis of market-based indicators of the select firms shows that the investors in general hold steady view about the performance and potential of these firms. Relatively stable P/B and P/E ratios of these firms, even in the face of significant volatility and large movements in the market index, show that investors' perception about the value and potential of these firms remain immune from the general market conditions (**Figure 7.1.6 and Figure 7.1.7**).

Percentile Standing of Companies vis-a-vis Price/Book Ratio

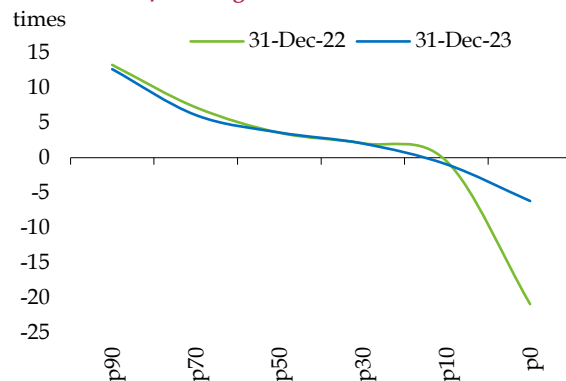
Figure 7.1.6



Source: State Bank of Pakistan and Capital Stake

Percentile Standing of Companies vis-a-vis Price/Earnings Ratio

Figure 7.1.7



Source: State Bank of Pakistan and Capital Stake

Conclusion

The comparative position of ORR and repayment behavior of the top 30 borrowing groups of the banking sector shows that these groups have generally maintained their creditworthiness. The steady internal credit ratings reflect a prudent strategy on the part of banks to have higher exposure on large, well-established firms, which have better creditworthiness. The top borrowing firms showed relatively resilient financial performance and continued to serve their financial obligations during the year under review.