

# VIS RATING METHODOLOGY

## LODGING INDUSTRY

The fundamental goal of VIS' credit analysis is to assess likelihood of the company being able to make timely payment against its obligations. Given that rating is prospective in nature, VIS integrates analysis of an entity's recent financial and operating performance with an assessment of the firm's strategic plan. The focus is on evaluating the current cash reserves and future cash flows given that obligations are expected to be met from the company's cash resources. VIS measures cash flows against four key parameters namely, strength, volatility, predictability and restrictions.

Along with gauging financial stability, VIS also evaluates the nature of the industry to see the extent of cyclicity it is impacted by; non-cyclical industries are largely unaffected by changes in the economy. On the contrary, cyclical industries have defining traits such as correlation of sales volume and price with a macroeconomic indicator like GDP or interest rate. Usually such companies are capital intensive and require regular fixed-capital expenditures. Moreover, their profitability is dependent on low unit costs and their weak pricing power (in case of largely fragmented markets). These traits lead to infer that the company operating in a cyclical industry may experience a growth in sales and earnings disproportionately higher than the expansion in economy. Conversely, the decline would be disproportionately larger than the contraction in the economy. Accordingly, in an economic upturn, the company operates at higher capacity levels to benefit from economies of scale (low fixed cost per unit and high marginal revenues). The lodging industry can be classified into business and tourism orientation or a mix of both. Location and weather seasonality are two important rating drivers for the Lodging industry, wherein the business locations are less prone to severe business cycles emerging out of economic downturns than their counterparts in tourist locations.

Strong cash flows are expected to service debt and meet capital expenditure or other obligations; it is estimated by calculating historical and projected cash flow coverage's at various operating levels to assess the ease with which the company carried out/will carry out its investment and debt repayment.

To ascertain volatility - the variability of cash flows across business cycles due to sensitivity to economic factors - we interpolate downside and upside scenarios of sales and earnings based on various phases of the cycle. Predictability refers to actual cash flows being above or below what is expected from typical business cycles due to some non-cyclical factor. We judge this by studying the dynamics of the industry and assigning weightages to various non-economic factors. For example, adverse geopolitical conditions might have a greater impact on the lodging industry than the economy.

### ANALYTICAL FRAMEWORK

This rating methodology applies to entities offering lodging and allied facilities to local and international travelers of various classes and budget as also business facilitation services like conference halls, food and beverages and out-door catering services. These include the local and international chains of hotels and their clientele includes tourists, businessmen, guests of multi-national companies and airline crews. Being a service oriented industry their distinguishing features are their franchise value established on the basis of quality of their services and facilities in comparison their prices. Any sustainable competitive advantage over other lodging companies will support the rating if it translates into a higher market share and more control over supply and prices.

### Macro Environment

- Economic Climate
- Political Climate

### Industry Specific Considerations

- Occupancy Trends
- F&B and Ancillary Services
  - Trends
- Cyclicalit y & Seasonality
- Income Source Diversification
- Geographical Diversification
- Fixed Income Revenues
- Manpower
- Quality and Location of Lodging Properties
- Capex Strategy
- Brand Equity
- Franchise and Brands

### Standard Rating Considerations

- Quality of Management
- Revenues & Costs
- Profitability and Cash Flows
- Capital Structure and Liquidity
- Budgets & Projections
- Internal Control & Audit
- Management Information Systems
- Sponsor Support

## ECONOMIC AND POLITICAL CLIMATE

The Lodging Industry (LI) is affected by Government's fiscal policies, which may be supportive or suppressive. Import restrictions, tariffs and high taxation may create hurdles in operations whereas tax holidays, cheaper interest rates and excellent infrastructure can accelerate the industry's growth. A variety of adverse political factors may also adversely impact the LI's growth. Risks like political uncertainties, civil commotion, terrorism and impact of international events can cause well-performing companies to falter, and discourage prospective investors and entrepreneurs.

## OCCUPANCY TRENDS

The foremost objective of the analysts at VIS is to ascertain the prospects for leisure and business travel in the country, the two broad client segments of the LI. Bright prospects can serve to support the ratings, as strong future demand will lead to growth of the industry and the company under review. Data and information available locally as well from international sources is gathered to access the future trends in the tourism and business segments.

The occupancy rate, which is the ratio of number of rooms occupied to the total number of rooms available, is the best indicator for demand. Highest, lowest (worst case) and average annual occupancy rates are studied and then utilized for trend analysis and estimating the market share. It is imperative to look at the company under review vis-à-vis its competitors as changes in its relative cost and market share could spell survival or bankruptcy. In a competitive environment, chances are that only companies with stable/ increasing market shares and lower-than-average industry costs will be able to stay afloat.

## FOOD & BEVERAGE (F&B) AND ANCILLARY SERVICES TRENDS

Since a significant portion of the LI's revenues are attributable to F&B and ancillary services, it is relevant to study these trends as well. These include cultural events and tourism services, wedding banquets, seminars and conferences (trade, professional, educational or political). Business related activities may be noticeably predominant in metropolitan cities, whereas tourism related activities like cultural shows and food festivals are season-related. Companies that can use restaurants and events to promote their core business of lodging are generally more successful in the LI, while others with ample lodging capacity but lacking in facilities to host large events will lose out on potential revenues and eventually, market share.

### **CYCLICALITY & SEASONALITY**

The LI is extremely sensitive to economic changes and thus ratings of lodging companies, like all cyclical companies, are generally constrained by the cyclical nature of their business. They seldom fall in higher rating bands (i.e. Double A and above). VIS reviews a company's performance through the business cycle to estimate the extent to which revenues and profits can vary, and arrive at a rating which would not ordinarily warrant a rating change as the company moves from one phase of the cycle to the other. Demonstrated ability of a company to withstand prolonged slumps in industry cycle and fuel growth once the trends reverse is an important rating criterion for VIS.

Apart from normal business cycles, LI undergoes the impact of seasonality as it depends heavily on tourist and business activity in the country. With a properly segmented client base, seasonal variations can be smoothed out successfully. VIS gauges how effectively the company manages through seasonal fluctuations by using appropriate marketing techniques.

VIS considers the absence of alternative income sources negatively, as hotels with single income sources are highly vulnerable to impacts of cyclical nature and seasonality. The company should demonstrate maintaining its cash flows through income source diversification. Examples of other income sources include rental income from ancillary tenants, social and business event management, resort management, tour operations etc.

Geographical spread within and outside the country provides the LI with risk mitigation to locational and weather cyclical nature and is an important rating rationale for VIS. VIS considers the franchise availability in LIs from international chains as it provides greater market access and internationally compatible ambience and service quality. The fixed costs of such franchise arrangements are, however, studied carefully to assess their impact on the cost effectiveness of the LIs.

### **MANPOWER**

Another characteristic of the LI is that it is labor intensive and requires trained human capital, owing to its status as a service industry. The continuous training of staff both at local and international level to sustain the ongoing trends of service quality in lodging industry are important attributes in assessment of HR status of a LI.

### **QUALITY AND LOCATION OF LODGING PROPERTIES**

The analysts at VIS give due importance to the hotel's quality and location of lodging properties, as they determine the company's earning power. Properties located in center of cities are in a better position to capture repeat business from tourist and business clientele because of the awareness and access afforded by its centrality. Similarly, properties with exclusive rights, like a strip of private beach or a golf course, attract more customers.

As the dominant form of hotel companies in Pakistan is owner/operators, an additional factor that comes into play is real estate value. In an economic boom the value of the properties goes up. Besides the obvious gain, financing can be obtained easily with prime properties used as collateral. However, given that real estate investment is essentially illiquid, it might not generate cash when required.

### **CAPEX STRATEGY**

Amongst the entry and exit barriers of the lodging business are the huge initial capital expenditure and recurring expenses that are necessitated to retain market share and fend off competition. Management's long-term plans generally earmark internal and/or borrowed funds to develop or acquire new properties (strategic capital expenditure). Furthermore, a yearly budget is allocated for renovation of the existing properties (regular capital expenditure), which is typically carried out from internally generated funds. Analysts study the amount of regular capex required and ascer-

tain whether the cash flows will meet them and still have surplus to partly finance strategic capex. VIS takes into consideration the emerging trends of segregation of owners of property from their operators who are the lodging industry experts. It is important here to determine the arrangement, cost and duration of the right to use the property to assess its impact on the operational dynamics of the LI.

Repairs and maintenance (R&M) expenses - cash spent annually on the upkeep of the properties, fixtures and equipment - are one of the critical heads of operating expenses because the standard of services provided by the hotel needs to be consistently maintained and improved. R&M, like regular and strategic capex, are discretionary in nature and management can delay repairs to preserve liquid resources or perhaps to show better profits. However, continuous deferment might result in loss in productivity and reduced asset life.

Analysts also judge management's willingness or the level of discretion exercised in deciding capex and R&M by using the ratio of sum of capital expenditure and R&M to depreciation. This ratio denotes how effectively the company is maintaining the earning capacity of its assets. A ratio greater than one indicates increasing earning assets and probable future cash inflows.

The quality of market research that a company conducts before it carries out strategic capital expenditure and the probability of success of projects in the pipeline is also analyzed. A consistent project-success record will support the company's rating.

### **BRAND EQUITY**

Brand equity, which is the company's established market reputation, is a critical rating factor as it leads to customer loyalty and recognition, repeat business, hence higher occupancy rates and rising cash flows. A company which can cash in on its established brand equity by charging higher room rates and avoid suffering a fall in occupancy at the same time is considered positively as compared to a company with little or no brand equity. A strong brand also helps to diversify geographically and compete internationally, attract attention of prospective franchisees and win favor of financiers and investors. Similarly, for independent contract operators, strong brand equity improves their chances of winning management agreements.

### **FRANCHISE AND BRANDS**

Ownership of a reputable franchise is considered positively because a franchise can serve to increase revenues, as international travelers might already be familiar with the brand name. Also, a franchisee can charge a premium on the room rate because of its conformance to international standards. The franchisee benefits from the assistance provided by the franchiser in terms of latest developments in hospitality (knowledge transfer), efficiency enhancements (training etc.), better marketing techniques and ancillary services. To gauge the value of the franchise and its resultant benefits, analysts study the number of years the franchise has been held, the level of cordiality in the relationship with the franchiser, the conformance to prescribed standards and assistance provided.

After completion of detailed study of the lodging industry and its dynamics, analysts study a host of qualitative and financial rating considerations that are standard for most industrial corporates. Qualitative factors include competence and stability of management, sponsor support, IT systems, internal controls and audit etc. For quantitative analysis, an in-depth review of the company's performance over the last few years is carried out with particular emphasis on return ratios and margins at various operating levels. The financial policies analyzed include dividend-payout and profit-retention policies, capital structure, hedging policies and contingency liquidity plans e.g. unutilized standby lines of credit, access to capital markets etc.

### **QUALITY OF MANAGEMENT**

Success of a company is directly attributable to the management's professional abilities and thus the analysts at VIS

give due weight to the quality of management by taking into account its qualification, experience, and track record. The CEO's vision and strategic direction are matched with the company's performance to determine if they are being implemented correctly. Ideally, the vision should trickle down to all department heads and especially the lower-level employees. The methodology rewards stability in management only if it is competent, otherwise, an ineffective, stable management might adversely impact the company's performance with time. Demonstrated preventive measures, contingency planning and strategies employed for damage-control after any threatening incident, are indicative of the management's competence, confidence and foresightedness. The management style is also taken into account, especially with reference to the authority and responsibility vested in the general managers of the company's properties.

The methodology checks for effective functioning of the board-level and department-head level management committees. The frequency of the meetings, depth of discussions and the quality of decisions taken by the committees are all analyzed.

### REVENUES & COSTS

The Average Daily Room Rate (ADRR) is the standard yardstick to measure the average revenue per room for each night. It is calculated by using the ratio of total room revenues to total rooms let in a year. A falling ADRR does not necessarily mean shrinking revenues as occupancy and aggregate revenue might have gone up due to the rate cut. Therefore, an alternate measure - the Revenue Per Available Room (RevPAR), which takes into account occupancy rates as well - is commonly used. A hotel with rising RevPAR is considered favorably as it indicates growth in cash flows over time.

Cost-control ability of an operator is given due weight in the methodology. Two of the largest heads of operating expenses are payroll and utility charges. Operating at optimal capacity to achieve economies of scale should be every hotel manager's objective and those who try innovative strategies to achieve this reflect sound management quality. Hotels that are able to successfully curtail their overhead and increase efficiency are viewed favorably by VIS as it enhances their ability to service debt due to the cost saving. In addition cost-cutting might also help the company to withstand downturns.

### PROFITABILITY AND CASH FLOWS

Similar to other corporates, profitability is an important aspect during the rating exercise. Trend analysis of margins at various sales levels is considered to read the direction of the company's future. Ratios like Return on Average Assets and Return on Average Equity are used to gauge the earning power of the company's assets and the return on common shareholders' funds. Equity growth, ascertained through the retained earnings ratio shows the company's internal capital generation capability.

Although profitability is important, the greatest emphasis is on cash flows. Despite robust profitability, the company may default on its obligations due to a liquidity crunch. Cash flows should be significant enough to meet the debt servicing requirements and regular capex, and still have enough surplus to make strategic capex and/or dividend payout. A sensitivity analysis of cash flows for probable future scenarios is beneficial in ascertaining impact on coverage's. VIS ascertains whether a lodging company has significant revenue concentration in any geographic region, which might weaken cash flow coverage's when faced with a downturn for that region.

### CAPITAL STRUCTURE AND LIQUIDITY

Capital structure of a lodging company is analyzed thoroughly by ascertaining the company's various sources of funds and its costs. Furthermore, nature of the source and associated burdens are also analyzed to ascertain the 'true leverage'. For example, although preference shares are equity instruments, they entail fixed payments out of profits giving them essential traits of debt. Conversely, directors' loans often carrying no interest and not having a fixed tenor may be considered to be part of the equity. Analysis involves studying level of debt that a company utilizes using the leverage

and gearing ratios. The company should have enough available room for additional debt to capitalize on new investment opportunities as they arise. The effectiveness of leverage is also tested using financial leverage index i.e. ratio of ROAE to ROAA. Any negative covenants on debt that interfere with the company's financial flexibility may constrain ratings of the company. The ability to negotiate terms on existing or new loans to suit the company is considered a credit positive by VIS.

Liquidity position is gauged by analyzing how successfully the company has matched its funds to maturing and long term liability. We often use the current ratio as a basic indicator of liquidity. Skillful working capital management is essential to meet the maturing liabilities, in order to avoid cash stress.

### **BUDGETS & PROJECTIONS**

Budgets and medium-term projections are studied for realistic assumptions and flexibility. Current performance is compared with previous budgets to see the level of variance and the reasons attributed for it. Regular comparisons with budgets highlight management's ability or inability, as the case may be, to achieve its planned targets. As the emphasis of credit analysis is more on the actual cash flows than accounting profits, downside scenarios are prepared and used to estimate the strength, variability and predictability of cash flows.

### **MANAGEMENT INFORMATION SYSTEMS**

The rating methodology gives key consideration to Management Information Systems (MIS) and technology. Yield Management Systems help optimize revenues from rooms by helping decide upon the ideal price and occupancy setting. These systems also track customers' preferences and help earn more mileage per marketing rupee. Database systems are mission-critical as all the reservations, inventory and accounting data have to be continuously recorded, consolidated and accessed. Similarly, statistical reports for executive decision-making must be meaningful and readily available. High quality reservation systems ensure client convenience and build loyalty and repeat business. Affiliation with international hotel reservation systems attracts international travelers and, hence, give the company a competitive edge.

### **INTERNAL CONTROL & AUDIT**

VIS considers the degree of internal control an important rating factor. The probability of smooth operations is high in a company where procedures and policies are documented and stringently enforced. The internal audit department and/or external consultants can formulate manuals and impose checks and balances at various critical junctions to ensure minimal errors and frauds.

### **SPONSOR SUPPORT**

Exhibited sponsor support during a liquidity crunch is a positive factor in the rating exercise. This support may be in the form of an equity injection or interest free loan. If the company is part of a larger group, intra-group synergies and assistance are considered positively as in most cases, the group's strength and financial flexibility have a direct impact on the company. It is important in sponsors support that it has a demonstrated past track record and real strength of it emanates from an equity injection to sustain the operations of a company at benchmarked performances rather than wait for consequential situations.



### **Faheem Ahmad**

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Mr. Ahmad possesses 30+ years experience in financial risk assessment with focus on Islamic finance, venture capital and general management. He has top level management experience at international level in the fields of credit ratings, Islamic and conventional financial risk assessment modeling, industrial management and construction engineering. Mr. Ahmad is an active participant at international forums on Credit Ratings. He obtained his B.S in Civil Engineering from NED University of Engineering and Technology, Karachi. He also has Masters Degrees in Engineering and Business Administration from USA. He could be contacted at faheem@vis.com.pk



### **Javed A. Callea**

*Advisor*

Mr. Callea is a professional in the financial sector with over 35 years of experience mostly in the financial institutions with certain exposure to service and infrastructure sectors in Pakistan. He has held the position of Chief Executive of a leasing company for 10 years. His core areas of expertise cover leasing, development financing, project management, investment & merchant banking, strategic investment management and real estate. Major financial institutions he worked for include Pakistan Industrial Credit and Investment Corporation, State Life Insurance Corporation, Bankers Equity, Crescent Leasing Corporation and Saudi Pak Ind. & Agri. Inv. Company. He has also served as Member Finance of Water & Power Development Authority of Pakistan and as member of the Inquiry committee on stock exchange crises in 2000 commissioned by the SECP. He earned his MBA degree from the Institute of Business Administration in 1974.



### **Muniba Abdullah, CFA**

*Senior Manager*

Muniba Khan is involved in the credit analysis of various industrial companies and financial institutions. She has been associated with VIS since 2013 and her overall experience in ratings includes insurance, microfinance banks, commercial banks and manufacturing sectors. She holds a Masters degree in Business Administration from Institute of Business Administration, Karachi (IBA). She is also currently pursuing a Masters degree in Economics from IBA.™

Jahangir Kothari Parade (Lady LLOYD Pier)

Inspired by Her Excellency, The Honorable Lady Lloyd, this promenade pier and pavillion was constructed at a cost of 3 Lakhs and donated to the public of Karachi by Jahangir Kothari to whose generosity and public spirit the gift is due. Foundation stone laid on January 5, 1920. Opened by Her Excellency, The Honorable Lady Lloyd on March 21, 1921.

*Dome: A roof or vault, usually hemispherical in form. Until the 19th century, domes were constructed of masonry, of wood, or of combinations of the two, frequently reinforced with iron chains around the base to counteract the outward thrust of the structure.*

*Origins: The dome seems to have developed as roofing for circular mud-brick huts in ancient Mesopotamia about 6000 years ago. In the 14th century B.C. the Mycenaean Greeks built tombs roofed with steep corbeled domes in the shape of pointed beehives (tholos tombs). Otherwise, the dome was not important in ancient Greek architecture. The Romans developed the masonry dome in its purest form, culminating in a temple built by the emperor Hadrian. Set on a massive circular drum the coffered dome forms a perfect hemisphere on the interior, with a large oculus (eye) in its center to admit light.*



Jahangir Kothari Parade

## National Excellence, International Reach

VIS Credit Rating Company Limited is committed to the protection of investors and offers a blend of local expertise and international experience to serve the domestic financial markets. With its international reach, VIS is positioned to aim for an international mark. In this regard, the global experience of our principal, Japan Credit Rating Agency, Ltd. has been invaluable towards adding depth to our ongoing research endeavors, enriching us in ways, that enable us to deliver our responsibilities to the satisfaction of all investors.

The edifice of the Jahangir Kothari Parade has stood proudly through the years and is a symbol of our heritage. Its 'Dome' as the most stable of building structures, exemplifies architectural perfection. Committed to excellence, VIS continues its endeavor to remain an emblem of trust.

# VIS Credit Rating Company Limited

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