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"Role of TFCs as a Financing Vehicle in Development of Capital Markets"

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EXECUTIVE SUMMARY

Economies and businesses, all over the world, are facing new trends of globalization and the free market economy. These trends have produced a compelling and comparative environment for Pakistan's public and private sector economies as well as for organizations. With the changing trends in the financial markets of Pakistan, investors are looking out for alternate ways for raising finance. TFCs have come out as an important source of alternate financing in the era of excessive liquidity and huge appetite for such instruments.

The report primarily deals with the issues faced by the Corporate Debt Market in Pakistan and how these issues can be resolved along with the in-depth analysis of issuance of TFCs by one of the leading textile mills in the country. The report gauges the topic from both the investor and issuer's perspective.

Amid the today market conditions, a lucrative opportunity exists for the issuer's for the issuance of TFCs as there is excessive liquidity in the market and with the issuance of first ever TFCs on Profit and Loss Sharing basis by Sitara Chemical Industries Ltd has opened up new avenues in the Islamic mode of financing. The final conclusion drawn from the report is past and the present of the TFCs have been impressive enough to make us keep our fingers crossed for the success of this instrument in Pakistan.

CHAPTER 1: INTRODUCTION

1.1 Research Question:

A modern and efficient capital market is the backbone of an economy. It plays a crucial role in mobilizing domestic and foreign resources, and channeling them to promote investment activities both for short and long-term periods. Over the years Pakistani economy has been growing at a steady rate. The highly underdeveloped equity market of Pakistan has registered phenomenal growth in terms of the size of the market and institutional development but the fixed income securities market has not developed as quickly and is highly undersized both in breadth and depth.

A strong corporate debt market is highly desirable for the rapid growth of any economy as it leads to the efficient mobilization of resources for long-term investment. Raising debt through capital market is a more efficient way of securing funds because the company does not have to go through the cumbersome process of obtaining funds from financial institutions or in different installments.

The aim of this paper is to highlight the **"Role of TFCs as a Financing Vehicle in Development of Capital Markets"** and to determine the factors that make TFCs an attractive investment opportunity.

With the slash of interest rates on National Saving Securities and other deposits, corporations have a window of opportunity to tap and make the most of it while providing an alternative investment option as well as reduction in the cost of capital. The paper seeks to focus on the aspects that are taken in to consideration while designing TFCs where as the research focuses on the importance of the design and structure in making the instrument a worthwhile investment for the investors as well as for itself.

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[*] Chou, Catherine. Reforming Pakistan's Capital Markets, ADB Report 1999

1.2 Background:

Issuance of Debt securities by companies is a comparatively new phenomenon in Pakistan. Till early nineties debt securities were issued by state owned organizations only. However, in mid-nineties, private sector enterprises started issuing their own securities, which are both, privately placed and listed on the stock exchanges. Debt securities or Corporate Bonds are known as Term Finance Certificates (TFCs) in Pakistan.

Listed debt issues comprised a mere PKR17.7142 billion of capital at the Karachi Stock Exchange (KSE) as on September 1, 2003 which is approximately 6% of the total listed capital. Unlike debt markets in India or Hong Kong, where listed debt issues have higher capitalizations compared to equities, the debt market in Pakistan is much smaller in size, of shorter maturity and largely dominated by the money market.

The money market that is more of an overnight and short-term debt market, and is used by the State Bank of Pakistan (SBP) for controlling monetary policy through open market operations and Treasury bill auctions. Financial institutions use it primarily for liquidity management. As such, the trading of short term debt instruments cannot be included in the domain of a debt capital market, where the emphasis is on longer-term financing for corporate and project finance.

The Corporate Debt Market in Pakistan effectively developed during the last eight years, when the first ever TFCs were launched by Sapphire Fibers Ltd through private placement. Packages Ltd launched the first ever publicly offered TFCs. This launch opened new vistas for the corporations to raise capital and provided investors with an alternative investment opportunity.

1.3 Objectives:

The aim of the paper will be to study the bond market, which in general is under-developed both in breadth and depth as compared to banking system and equity

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- Bond Track - A Review of the TFC Market – IP Securities Research
- www.kse.net.pk

market. The study seeks to highlight the reasons for underdevelopment of the debt market. Especially emphasis is on long-term debt market and the role of TFCs has played in reviving the debt market of Pakistan. The objectives of the study are to analyze:

1. Overall bond market over the years.
2. Impediments to the development of the debt market.
3. Launch of TFCs and barriers in the initial years.
4. Designing of TFCs and technicalities involved in the structuring the instruments.

1.4 Research Techniques:

The approach used for carrying out this study will be based on exploratory research. Exploratory research is used when one is seeking insights into general nature of a problem, the possible decision alternatives. The research methods are highly flexible, unstructured and qualitative. This absence of structure permits a thorough pursuit of interesting ideas and clues about the problem situation.

1.5 Data Collection Method:

For the collection of data both the primary and the secondary sources will be utilized.

1.5.1 Primary Sources:

Primary data is collected especially to address a specific research objective. To collect information from primary sources, interviews with the managers of various Brokerage Houses dealing in Fixed Income securities and investment bankers would be conducted and analysis would be carried out on the basis of the findings.

1.5.2 Secondary Sources:

For this study secondary source of journals, research reports by Brokerage Houses, websites and newspaper articles will be utilized.

CHAPTER 2: LITERATURE REVIEW

2.1 Capital Market's Role in Economic Development:

The capital market includes the portion of the financial system involved in:

1. Mobilization and intermediation of private savings.
2. Allocation of medium and long-term financial resources through a variety of debt and equity instruments both in the public and private sector investment.

Capital markets play a crucial role in mobilizing domestic resources and in channeling them efficiently to the most productive investments. The level of capital market development is thus an important determinant of a country's *level of savings, efficiency of investment* and ultimately of its *rate of economic growth.*

An efficient capital market can also provide a range of attractive opportunities to both domestic and foreign individual and institutional investors. A developed capital market usually comprises saving facilities; banking system, financial institutions for industry, agriculture and housing; primary and secondary markets where bonds and equities are traded and issued; an underwriting system; and an official regulatory authority to supervise the market and protect the investors.

An important point to be emphasized is that an efficient capital market is not an end in itself as the primary purpose of capital market development is to strengthen the economy and thereby the standard of living of the people. Therefore, efficient capital markets complement and support the productive activities of the economy.

2.2 Overview:

In recent years, the economies of the Asian region have been growing rapidly; at about twice the global average. International cash generation and commercial banks have traditionally financed most of this growth, but the equity markets have developed to a stage where these also provide significant sources of financing. In fact, several Asian markets despite the current crisis are now among the largest in the

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[*] Khan, Aftab Ahmad, Capital Market's Role in Economic Development, March 31, 2003

world. Bond market development has however lagged throughout the region. The pattern of capital market development in Pakistan has been similar.

2.3 Emergence of Bond Markets in Asia:

Since the Asia and Tequila crises of the late 1990s, a growing number of emerging market countries have focused on developing local bond markets to lock in local-currency, fixed-rate, and long-term funding, and help governments and corporations better manage their financing risks.

Both crises accentuated the severe problems borrowers can face when they rely on short-term, foreign-currency funding and take sizable interest rate, refunding, and foreign-currency risk. When the Thai baht’s downfall sparked a cascade of falling currencies throughout the Asian region, loans were defaulted on, others were not replenished, and many countries had to contend with a far more serious crisis than warranted by any economic problem in the country. The fault lay in large part with the way borrowers financed themselves. If corporations had funded with bonds, funds and rates would have been locked in, and corporations could have weathered the crisis better. The Asia crisis also showed how quickly problems can escalate and be transmitted throughout an economy and to other parts of the globe. It showed that this could happen even when countries have solid macroeconomic fundamentals.

The other benefits that local bond markets offer include:

- Diversifying financial sectors
- Allocating capital more effectively
- Increasing financial sector competition

Growing economies need to support major trends such as infrastructure development, privatization, securitization, and the rise of new institutional investors requiring long-term assets to match long-term liabilities. Bonds will play an important role in meeting those needs.

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[*] Report on the Development of Corporate Bond Markets in Emerging Market Countries, The Emerging Markets Committee of the International Organization of Securities Commissions, May 2002

2.4 Bond's Market in Pakistan:

The market for the bonds of statutory corporations and corporate entities is at an early stage of development, but its prospects appear promising. These institutions have a genuine need to issue more debt instruments, given their desire to secure term financing, the limited availability of alternative funds, and their large capital expenditure needs. Moreover, there is a ready market for these bonds, given their relatively attractive yields and a large and growing pool of investible funds. There is clearly a potential for growth.

2.5 Rationale for Issuing Bonds:

Since the Asian financial crisis of 1997-98, attention has increasingly focused on the relative roles of the banking sector and of the capital market in developing economies. The exposure constraints on the banks limit the advancement of loans beyond a certain level therefore issuing bonds is an alternative to raise capital without increasing the share capital thus avoiding the dilution effect. Following are the benefits of issuing bonds:

2.5.1 An Alternative Source of Debt Finance:

Over reliance on bank lending for debt financing exposes an economy to the risk of a failure in the banking system. Therefore the presence of an active and efficient domestic capital market, in particular, the bond market, give corporations an alternative means of raising debt capital in the event that banks were unable to do so, thus ameliorating any potential adverse effect that a bank-credit crunch may have on the economy.

It is also argued that a bond market can help accelerate the resolution of a banking crisis, by allowing the banking system to recapitalize its balance sheets through securitization (i.e. the issuance of bonds backed by non-performing loans).

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[*] Report on the Development of Corporate Bond Markets in Emerging Market Countries, The Emerging Markets Committee of the International Organization of Securities Commissions, May 2002

2.5.2 Lower Cost of Capital:

Companies can incur greater financing costs through bank loans than through bond financing. Banks charge administrative costs that arise from arranging loans, in processing information about borrowers and monitoring them. A domestic corporate bond market helps corporations reduce their financing costs in two ways. First, it allows corporations, through bond issuance, to borrow directly from investors, bypassing the major intermediary role of a commercial bank (a process known as disintermediation).

Corporate bond markets can help borrowers reduce their financing costs in two ways. First, they facilitate bank disintermediation by allowing direct access to investors, thus removing the "middleman" and related costs. Though the companies have to incur floatation costs but these costs are lower compared to the administrative costs charged by the banks. Second, by issuing corporate bonds, firms may tailor their asset and liability profiles to reduce the risk of maturity mismatch on their balance sheet, thus reducing the overall cost of capital.

2.5.3 Reduced Risks Associated With Maturity Mismatch:

Corporate borrowers that undertake long-term investment commitments may face the difficulty of matching the long-term cash inflows from their investment assets against the short-term cash outflows from bank loans in a bank-reliant financial system. This maturity mismatch may threaten corporate solvency in the event that long-term cash inflows from investment assets do not materialize simultaneously to offset the short-term cash obligations arising from bank loans. The desire to avoid this maturity mismatch may encourage firms to stay away from long-term investments or entrepreneurial ventures that have a long-term payoff. In the long run, this may result in a decline in the economy's productive capacity, since most capital investments are of a long-term nature.

Corporate bond markets allow firms to mitigate this problem. For instance, if a firm observes a lengthening of the maturity of its assets, it may issue corporate bonds with similar or longer maturities and use the issuance proceeds to retire shorter maturity debt, such as short-term bank loans.

2.5.4 Promotes Financial Stability in the Economy:

In the absence of a corporate bond market, a significant proportion of debt funding for corporations would come from the banking sector. By extending loans to corporations, however, banking institutions assume a considerable amount of risk, mainly due to the maturity mismatch between liquid short-term assets (i.e. deposits, which can be withdrawn on demand) and relatively illiquid long-term assets (i.e. loans). Banks cannot transfer credit risk to depositors and this difficulty is further compounded by the highly idiosyncratic and asymmetric information banks possess about borrowers. In addition, in emerging markets, because a few banks account for the bulk of lending activity, there is a concentration of credit risk within the banking sector, and this leads to an increased level of systemic risk in an economy that heavily relies on bank loan financing.

A bond market can promote financial stability by contributing to a more diverse financial system. With issuance of bonds by the corporations, the burden of credit risks in the economy can be spread among the various investors, thus reducing the credit risks borne by the banking sector.

2.5.5 Broadening of Capital Markets:

Without a well-functioning bond market, investors face a relatively limited array of asset choices and as a result they are likely to hold substitute assets such as bank deposits, and to a lesser extent, equity. In extreme circumstances, investors may also acquire more non-financial assets such as property that ultimately reduce the supply of savings that can be mobilized for productive investment.

An active and efficient bond market would broaden capital markets by offering savers opportunities to invest in a wider range of assets. This allows them to meet their risk profiles better and to make more optimal asset allocation decisions.

2.6 Corporate Bond Markets:

The issuing and trading of corporate debt securities started flourishing after mid nineties when Packages Ltd issued first ever publicly listed TFCs. The government is conscious of the importance of developing the term debt market and has pursued a series of initiatives since 1995 of assistance to market development. Most notably, it has introduced moderating policies on stamp duties, the taxation of investment income for individuals from investment in term finance certificates (TFCs) (income received by individuals from TFC investments is now exempt from taxation), and the withholding tax. The government also established SECP (Securities Exchange Commission of Pakistan), which has taken over the role of the Corporate Law Authority.

The corporate debt market is expected to benefit from the Capital Market Development Program (CMDP), which is funded, by the Asian Development Bank (ADB) and is being implemented under a program loan. Initial planned outputs of this program include the establishment of a national clearing and settlement system and an over-the-counter debt market. A second phase, added recently, will focus on developing the domestic bond market and includes developing a long-term yield curve in government securities by encouraging greater investment by wholesale investors in long-term government securities.

In addition, major market participants have begun a healthy dialogue on policy matters affecting the development of the corporate debt market. This interaction has been given a helping hand by the Securities Exchange Commission of Pakistan (SECP) new policy board, which includes five members from the private sector. Private sector participants are willingly sharing their knowledge with the SECP and stock exchanges. Various market participants have suggested the SECP would benefit from technical support for the development of policy on particular debt instruments.

2.7 Central Market Infrastructure

Some corporate debt is traded on-line on the stock exchanges. However, there is no publication of indicative bid/offer rates for corporate debt securities on the Reuters' pages of market participants. Transactions in listed securities, done by members of the three stock exchanges, are settled through the settlement systems of the exchanges. Other corporate debt traded over the counter is settled privately, through physical delivery in exchange for checks. Pakistan's depository, the Central Depository

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[*] Leonardo, John. Pakistan Survey: Issues in Local Bond Market Development, IFC Journal 2000

Company of Pakistan Limited, was established in 1993 to provide efficient delivery, settlement, and transfer of securities transactions through a computerized book-entry system. The company has declared all listed equity securities eligible for its depository system. About 95% of the traded values of equity securities are registered in dematerialized ("demat," that is, electronic book-entry) form. In August 1999, the Central Depository Company began offering individual accounts. The depository company has set reduced fees for TFCs to encourage registration in demat form.

Pakistan has two credit-rating agencies, the Pakistan Credit Rating Agency (PACRA) and DCR-VIS. PACRA that was established in 1994 and is the largest operator; its major shareholder is Fitch IBCA, while IFC and the Lahore Stock Exchange are minor shareholders. DCR-VIS is associated with Duff & Phelps.

2.8 Prologue to TFCs:

In Pakistan, the terms corporate bond and Term Finance Certificate are used interchangeably. TFC was the name given to the instrument that emerged from legislation ratified in 1984, consenting the issue of redeemable capital securities. As a debt instrument, TFC is to an extent different from the traditional corporate bond because it was specifically created to accord with the Sharia principle of Islamic law.

2.8.1 TFC Market in Pakistan:

Since the floating of the first ever- corporate bond issue in the form of TFC by Packages in February 1995, the bond market remained fairly placid up to Fiscal Year 2000. The number of issues was limited due to the high interest paid on government securities, especially on National Saving Schemes, which put the TFC issuers at a comparative disadvantage in raising finance through this instrument. High cost of issuance was another of the factors hampering the growth of TFCs in the beginning (currently the maximum possible expenses related to an issue is approximately 0.2% of the size of the issue).

But then in fiscal year 2001-02, the gloomy situation of the corporate bond market took a turnaround, at least from the issuers' side. Around 25 new issues totaling Rs. 15.74 billion were floated in the two consecutive fiscal years and five new issues amounting over Rs. 2.6 billion only in the first quarter of 2003.

In the second quarter of the year 2003 Government of Pakistan (GoP) approved a financial package of 19 billion as equity financing to pull Pakistan International Airline out of loss. Rs.4 billion out of these fall under long term finance arranged through local banks and syndicates mainly comprising of United Bank, Habib Bank and National Bank. Whereas a major chunk of 15 Billion of these has been arranged through TFC's. Following are a few major features for the same.

Installment payable	Semi annual (A total of 12 installments)
Repayment period	2003 – 2010
Rate of Profit	50 Basis point above the base rate* with a floor of 8 % and a cap of 12.50 % p.a.
Call Option	Early redemption option exercisable at 24 and 48 months from the date of issue with a 60 days notice period. The TFC's will be redeemed at a premium which will be calculated at a rate of .025% Flat of the outstanding amount at the time of the exercise of the call option.
Trustee and Trust Deed	United Bank Limited has been appointed by the GOP as the trustee and is will enforce the corporations outstanding obligations on a pari passu charge basis in proportion to the amount owed to them according to the trust deed.

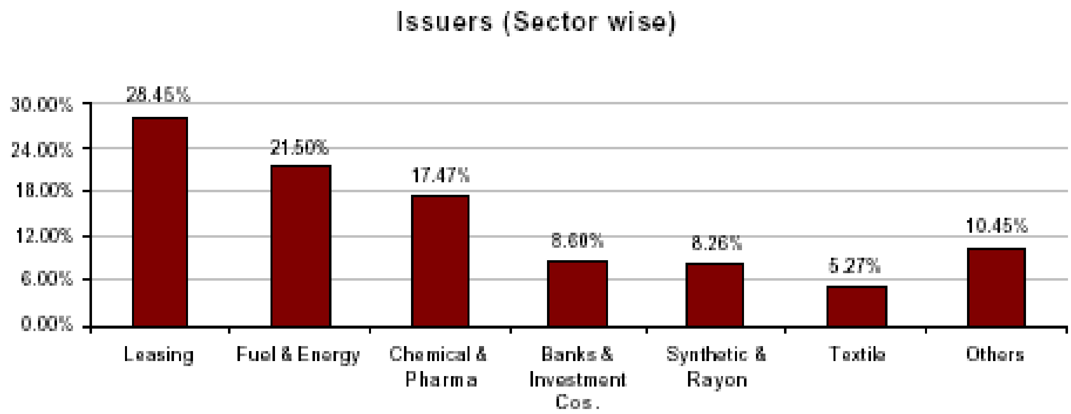
*Base rate is the state bank of Pakistan (SBP) discount rate prevailing at two working days before the commencement of the period for which the profit rate is being computed.

These TFC's have been raised through private placement.

This became possible due to the increased interest by the Government towards building up the debt market of the country, which promoted it to take steps in this direction. It worked on bringing an easing trend in the interest rates of the country, while simultaneously reducing the rates on National Saving Securities on a continual basis. The latest reduction in NSS, along with the Government decision on linkage of NSS returns with yields on government bonds and harmonization of the tax structure of two debt instruments had brought novel strength in the corporate securities market and many firms have floated or are making up their minds in raising finance through this means.

The following figure highlights the sector wise issue of TFCs:

Figure 2.1

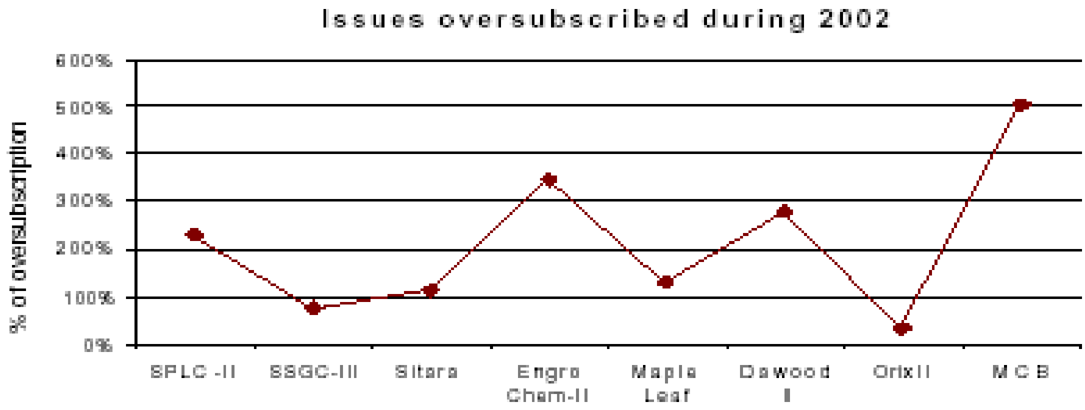


Source: IP Research

From the buyers' side, things have changed to an extent that every new issue is oversubscribed by a large amount depicting the potential appetite for this market. However the absence of liquidity has limited the growth of the secondary market. To date, the dearth of market makers in corporate securities has significantly constrained secondary market activity, as daily volumes remain relatively low but we expect that since the number of issues is increasing there will be an increased activity on secondary market front as well; (subject to the entrance of market makers) as the problem of demand and supply will be reduced up to a considerable extent.

Figure 2.2

Issues Over Subscribed in Year 2002



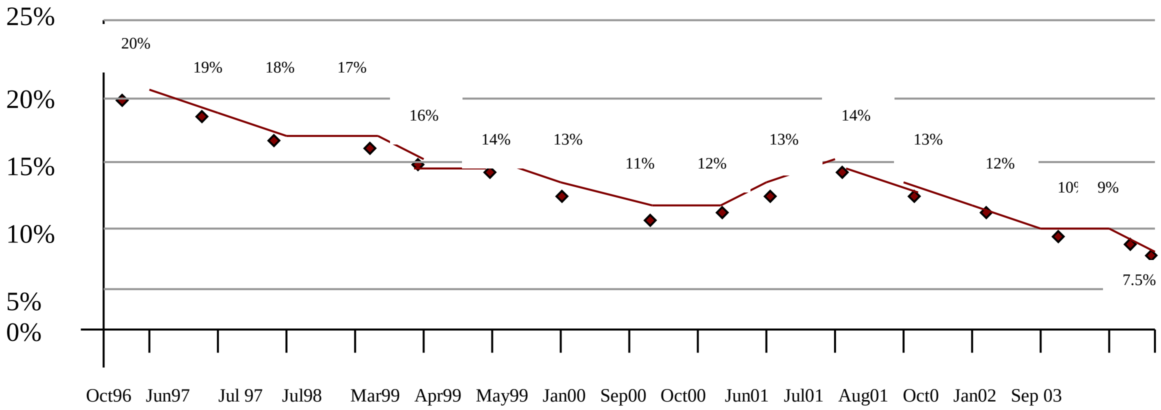
Source: IP Research

2.9 The Merits of Investing In TFCs:

TFCs typically have a predictable stream of payments and repayment of principal. Investing in these instruments would mean preserving and increasing ones capital along with the obvious motive to receive dependable interest income. The risk premium associated with investment grade (higher than A rated) securities is supposed to be extremely attractive to a Pakistani investor who has reasonably limited number of investment options on hand. An independent trustee or collateral secures ones interest and risk is assessable due to credit rating on an ongoing basis. Pension/Provident Funds, Insurance Companies and excess cash rich firms all have an opportunity to match the value of their asset and liabilities by placing their funds in the high yielding debt of top tier companies.

Moreover in the wake of falling interest rate scenario it would be prudent for the investors to review their fixed income securities portfolio and give some weight-age to this instrument in the assortment. And if one already holds any, then it is foreseen as the best time for entering the secondary capital market.

Figure 2.3
SBP Discount Rate



Source: IP Research

2.10 Key Bond Investment Considerations

There are number of key variables to look at when investing in bonds:

- Bond's Maturity
- Redemption Features
- Credit Quality
- Interest Rate
- Price
- Yield

A combined assessment of these variables would help determine the value of ones bond investment and the degree to which it matches ones financial objectives.

In Pakistan the maturity of the corporate debt instruments ranges from 3-5 years. Although some corporations did float perpetual instrument, however the average maturity of the outstanding debt market is fairly low as compared to the developed debt markets of the world.

Ones choice of maturity will depend on when one wants or need the principal repaid and the kind of investment one is seeking with in ones risk tolerance. Although at present there is not much of a choice available, but still some of the investors might choose a TFC of 3 years for the comparative constancy and security, although their investment returns will typically be lower than would be the case with a TFC of 5 years which would provide greater overall returns despite its higher exposure to interest rate fluctuations and other market risks as well as credit risks.

While the maturity is good guide, it is also worthwhile to look at the redemption features like call and put provisions, which can substantially change the expected life of the investment. Further in most of the TFC issues the principal repayment begins after the first two years of investment, though there are exceptions to this rule as well. Some of the TFC issues offer redemption in equal intervals during the life of the investment while in others it is offered along with the last interest payment.

The next consideration is the credit rating of the TFC. In Pakistan, two credit rating firms PACRA and JCR - VIS are providing the credit rating services for all TFC issues and the rating is done on an annual basis by the credit rating agencies which cover all aspects related to the firm's ability to make their interest and principal payment in time. Credit factors affecting the TFC investment might change during the course of investment. In such a case one would get to know this through the respective credit rating agency, which might put the corporate on rating watch.

The trading lot of a TFC is one unit and multiples thereof. In almost all of the new issues, the face value of one unit has been Rs 5,000, which is what one pays when one subscribes for the TFC in the primary market. However in the secondary market the price of the TFC will be based on a whole host of variables, including interest rates, supply and demand, credit quality and maturity. New issues of TFCs sell close to their face values.

Then of course as with all investments the focal point for one as investors is to look at the yield that the TFC is offering to someone. However in the case of TFCs (more specifically in the secondary market) it is advisable to consider the **yield to maturity** which would tell the total return one will receive by holding the instrument until it is matured or called.

2.11 The Current Scenario and Prospects:

Most companies are now considering raising corporate debt. Large corporations, either directly or indirectly through provident /pension funds are participating in good quality issues. Public subscription by retail investors is picking pace. Secondary market turnover is growing, albeit off a small base. The number of brokers placing and buying and selling TFC is rising. A combination of falling sovereign interest rates and rising institutional liquidity has given the TFC a firm foundation to stand on.

With falling interest rates, investors are likely to find the TFC market as an attractive avenue with a manageable risk/reward profile. Similarly with growing demand for good quality paper, more companies will enter the TFC market and attempt to establish alternate avenues of funding. Fixed income funds are likely to emerge and tap both institutional and retail money. These funds will be buying through brokers who will also come up the curve on debt instruments and push products to other institutional /retail clients. In due course a yield curve, benchmarked against the PIB rates will emerge. Eventually fixed income indexes are likely to be established which would help monitor performance.

As issuer competes to capture emerging liquidity at the best price the TFC market will witness new characteristics. Already the changes that have occurred include:

- Floating rates linked with discount rate and PIB
- Perpetual instruments
- Unsecured Instruments

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* Bond Track - A Review of the TFC Market – IP Securities Research
* Mr. Rizwan Ahmed – Muslim Commercial Bank Ltd., Staff College Karachi

CHAPTER 3: FINDINGS

BARRIERS AND IMPEDIMENTS TO THE DEVELOPMENT OF BOND MARKETS

3.1 Barriers to Growth of TFC:

Over the last decade, TFCs have witnessed tremendous growth but even then corporate debt market is dominated by bank loans. Since bonds are both a compliment and substitute to bank loans in channeling the savings of an economy to the producers of goods and services, following barriers hindered the growth of TFC market in the initial years.

Impediments to development of the government securities and corporate debt markets in Pakistan fall into three categories: those operating around the bond market, in the broader political, macro, and legal environment; those in other parts of the financial system, particularly the banking sector and government securities market; and those "inside" the market itself, arising from regulatory matters, central market infrastructure, and market participants. [*]

3.2 Around the Bond Market:

Significant impediments to market development are posed by external influences, particularly political, macroeconomic, and legal factors. Weaknesses in the broader financial system produce additional constraints.

3.2.1 Political Impediments:

Over the time Pakistan has faced several problems on the political side. First, notwithstanding the financial sector reforms implemented progressively by the government since 1991, debt market participants still consider the level of political risk high. Material variations in past economic policy suggest that recent positive initiatives may be difficult to sustain. The withholding tax on

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[*] Hayat, Usman, Barriers and Triggers to Growth of TFC, Pakistan Economist, March 11-17, 2002
Harwood, Alison, Building Local Bonds Markets – An Asian Perspective, International Finance Corporation, September 2000

TFC profit payments reintroduced in 1998, for example, had to be removed in the following year.

In addition, inconsistencies in the government's approach to economic management since 1991 frequently reflect difficulties experienced in meeting planned increased revenue requirements. Such inconsistencies create an impression of high political risk and make retail and wholesale investors hesitant about investing in long-term government securities and corporate bonds. In the past, inconsistencies in the taxation of investment income across different debt instruments have also made corporate bonds less attractive to investors. Some government economic decisions reinforce concerns about political risk, as they appear to compromise other major economic policy objectives.

Traditionally, policy implementation has been one of the government's weak suits, as can be seen in the privatization programs. Planned privatizations, including those of two banks (Allied Bank& Habib Bank) were behind schedule, which meant that recovery of the banking sector and improvements in asset management were moving slowly. Prompt and successful privatizations are urgently required to demonstrate the associated benefits to the community.

3.2.2 Macroeconomic Impediments:

Among the serious macroeconomic impediments to a corporate bond market is the crowding out caused by high government spending and low revenues. The Pakistan government has a significant fiscal deficit that creates a continuing need to borrow, and the large amount of outstanding government debt discourages private sector development by crowding out private borrowing. The excessive spending is due in part to the decision to carry and fund an extensive portfolio of poorly performing state-owned corporations and to rising government debt-servicing costs. The level of government revenue is relatively low and reflects real difficulties in generating additional revenue. Low savings rates in the country limit the resources available for investment in corporate debt securities.

Private Sector has little presence in the market as the Government Securities dominate the market. The debt market is fairly large in size but the presence of the private sector is minimal as the debt issued is almost all of public sector and outside of the selected financial institutions it is not tradable. This obviously affects liquidity and also interest in the market and leaves little opportunity for widening of the debt market.

3.2.3 Broader Legal Framework:

The low level of governance in Pakistan in both the public and the private sectors is reflected in the general inability to enforce commercial contracts. Without the rule of law, private sector development will proceed at a slow pace.

3.2.4 Market Infrastructure:

Live trading of corporate debt securities is limited to trading between members of the stock exchange. There is no separate central clearinghouse - no principal entity for the trading of corporate bonds and subsequent settlement of transactions. And market information is limited in its distribution. Details of non-broker secondary market transactions are not reported to the market.

3.2.5 Problems with Investors:

Investors are also deterred by several factors.

1. Because of the weak governance system, they lack confidence in the market. Some are concerned about whether corporate borrowers will repay loans according to agreed terms, especially after the WAPDA experience. Although not strictly related to the corporate bond market, the 1998 liquidity crisis experienced by the NIT (a government-owned mutual fund invested heavily in equities), which culminated in the waiving of redemptions, also undermined overall investor confidence in non-equity securities, including corporate debt securities.

2. The supply of issues is very limited. Major institutional investors would welcome additional investment opportunities in TFC issues,

subject to acceptable market profit (interest) rates, and could accommodate an increase in supply. But as the supply of TFCs is not up to that extent, thus, the relationship between credit quality and market pricing is often weak. Price is therefore influenced more by the short-term liquidity needs of investors rather than the financial risk of underlying securities.

3. Many investors, especially retail investors, do not fully understand debt securities. The dearth of general know-how about the concepts impedes the market to expand in real terms.

4. The per-capita income of Pakistan is very low. Due to low income, the demand for insurance and investment in pension fund is also low. After all, it is the income and wealth of the people that generates individual as well as institutional demand for corporate bonds. Low income is a long-term demand side barrier and its affects would only be mitigated by overall economic development.

Pakistanis are largely unaware of the investment opportunity provided by TFC. Even when TFC provide an attractive risk-return trade off, investors shy away from them because they are far more familiar with bank deposits and NSS. To target the small investor, TFC are being offered in denominations as small as Rs 5,000 but more needs to be done. Creating awareness among small investors is a long and slow process. In the meantime it is up to the bankers to the issue to make their depositors invest in TFC.

3.2.6 Foreign Investor Participation:

Foreign fund participation in debt instruments has been completely absent in Pakistan. This can be attributed to a number of reasons including:

a. **3.2.6.1 Increased Currency Risk:**

   The biggest risk factor for foreign investors is the foreign exchange rate risk. This is because the Pakistan rupee is subject to crawling rate adjustments, which adjust the exchange, rate by devaluing the currency by small increments. A rupee denominated bond has uncertain US dollar cash flows. Though Pakistani Rupee has been stable against the dollar since 9/11, still a risk is attached for foreign investors.

b. **3.2.6.2 High Default Risk:**

Investors might be wary of the fact that the issuer will default on his obligations.

c. **3.2.6.3 High Interest Rate and Inflation risk:**

A rise in inflation erodes the purchasing power of the PKR, leading to the scenario where more rupees would have to be invested to reap the same amount of profit. This obviously translates into a lower return on investment and makes the investment less appealing. Also there is a risk that interest rates would move against the investor's portfolio and will incur a negative return after adjusting for inflation.

d. **3.2.6.4 Liquidity Risk:**

TFC are not liquid even though they are listed. In the absence of large trading volume, a small investor is forced to hold his TFC to maturity, making it more of a debt rather than a debt security. Due to their highly risk averse nature; small investors would rather not invest in an illiquid asset. TFC are largely said to be traded by institutional investors in the telephone-based over the counter (OTC) market.

For investors who want to implement trading and portfolio strategies, liquidity is a very important factor. The risk that the debt instrument will not be marketable or readily sold without a discount has been a source of concern for investors as there is no active secondary market for such instruments.

e. **3.2.6.5 Absence of an Internationally Acceptable Rating Agency:**

Most foreign investors accept both Moody’s or S&P’s ratings and Pakistan does not have local bond ratings issued by these firms.

3.3 Across the Financial System:

Looking across the financial system, one finds obstacles to market development both in the banking system and in the government securities market.

3.3.1 The Banking System:

Despite its recent marked recovery, the Pakistani banking sector remains vulnerable to unforeseen setbacks. The state-owned development banks continue to have very weak balance sheets. With the lowering of interest rates the Banks are faced with excess liquidity and high cost of funds.

3.3.2 The Riba Debate:

Supreme Court in its judgment in Dec 1999 declared all forms of interest as "riba"- Un-Islamic - and asked the government to take necessary actions to bring the economy in line with Islamic principles. A technical evaluation of the structure of TFC would make it clear that it is but difficult to justify that TFC are not based on interest. The debate about interest or Riba and whether coupon payments of a fixed-income debt instrument is permissible or not has been one of the reasons why the medium to long-term debt market in Pakistan has not developed.

3.3.3 The Government Securities Market:

One major concern is the lack of depth in the wholesale market for longer-term government securities. To develop the market for long-term instruments, the State Bank of Pakistan (SBP) needs to introduce a new series of longer-term government securities, sold via auctions. These securities should carry coupons in line with prevailing trends in government securities markets in the West. At the same time, steps must be taken to move wholesale investors from the high-yielding "unfunded" savings certificates into a more orderly and lower-priced market for FIBs.

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[*] Harwood, Alison, Building Local Bonds Markets – An Asian Perspective, International Finance Corporation, September 2000

The government's decision in September 1999 to introduce a 10% withholding tax on income received from national savings schemes was a step in the right direction and has slightly reduced the relative attractiveness of these investments (this decision was reversed recently).

In addition, real-time infrastructure will be required in the future to support increased trading in government securities. Furthermore, the SBP should encourage the Ministry of Finance (MOF) to place a ceiling on the maximum investment that insurance companies and provident funds can make in government savings certificates to ensure that such wholesale investors participate fully in the wholesale part of the market. Although the scheduled banks generally have a sound understanding of the government securities market, the level of overall knowledge is lower in the other banks, insurance companies, and provident funds, and this need to be improved.

3.3.4 Lack of Enough Issues:

Growth in TFC is also a function of itself: the more issues are made, the more developed would be the market, thus paving the way for even more issues. To get into this virtuous circle, the number, size, and share of public offering would have to increase manifold before TFC become an established investment vehicle. The simple average of public offer component of all TFC issues to date is 31%, i.e. bulk

3.3.5 Institutional Environment:

State of development of accounting, audit and disclosure, sophistication of property rights, and the ability of the government to enforce contracts are institutional fundamentals to creating the right environment for developing a bond market. Pakistan has weak institutions and due to a number of financial scams in the past, investors are wary to put faith in the institutions to protect their investments. Improving the institutional environment is an area in which we have a long way to go.

[*] Hayat, Usman, Barriers and Triggers to Growth of TFC, Pakistan Economist, March 11-17, 2002

3.4 Steps to Overcome the Impediments and Broaden Capital Markets:

The recommendations for removing key impediments to the development of debt markets in Pakistan which apply around and across the financial system are:

3.4.1 Around the Financial System:

Given the recent change in government, political risk is clearly concern for investors. This risk will only be reduced through consistent and prudent economic management by the Pakistani government over the medium to long term. The government should make sure that it adheres to planned economic policies. Specific policy recommendations in this area have already been submitted by the multilateral agencies.

A key macroeconomic issue is the size of Pakistan's fiscal deficit and overall government indebtedness. Multilateral agencies have put forth numerous recommendations for reducing the fiscal deficit and indebtedness. Briefly, they call on the government to reduce spending, increase revenue, privatize many government-owned businesses, and reduce the size of the relatively large informal sector.

The government should also change its present approach to funding the fiscal deficit by introducing new forms of long-term government securities, preventing wholesale investors from investing in retail government securities, and reducing the interest rates on retail government securities.

In the broader legal, regulatory, and policy environment, a first step for the government would be to establish and maintain a neutral tax regime for investment income from debt instruments used in Pakistan. Second, it is important to accelerate efforts already begun to improve governance in the private and public sectors. As part of this move, the commercial law should be

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[*] Harwood, Alison, Building Local Bonds Markets – An Asian Perspective, International Finance Corporation, September 2000

reformed, and the commercial court system strengthened to ensure speedy and just resolutions of commercial disputes. A workable system of arbitration should be developed and promoted.

Implementation of these recommendations would boost investor confidence in the medium to long term. And thirdly, the Central Board of Revenue should be encouraged to remove the remaining stamp duty payable on transfers of debt securities. This would encourage additional trading in corporate debt securities.

3.4.2 Across the Financial System:

In the area of banking, the SBP should be more proactive in promoting banking sector reforms, especially since the Pakistani banking sector remains vulnerable in case there are any further unforeseen setbacks.

In the government securities markets, new forms of long-term government securities should be introduced, as the current instruments employed by SBP, which are issued at par and carry fixed rates, are unable to reflect market rates at the time of issue. Instead, the SBP should issue long-term securities through auction and adopt either carry or zero-basis coupons. In general, the SBP should try to be more consistent in policy stances affecting the government securities market. In terms of market infrastructure, the SBP should move ahead with its planned computerization, to the extent practicable, to facilitate increased secondary market trading in government securities. The SBP should also improve the distribution of information on secondary market trading. Details of trading should be distributed as soon as information capability constraints are removed.

The stock exchanges should enforce mandatory reporting of transactions in debt securities undertaken by its members.

To enhance the investor base for government securities, the MOF must be encouraged to amend the present terms of issue for government retail securities to eliminate the distortions created by present policies. The amendments should include measures to prohibit wholesale investors from investing in retail securities and further reductions in the interest rates payable on these securities. The SBP must simultaneously introduce new long-term government securities as recommended earlier. In addition, the MOF should clarify the basis for establishing profit rates for government retail securities and publicly disclose this information. Such action would promote efficiency in the government securities markets.

Methods of removing external impediments assessed on a scale of high, moderate, and low depending on the degree to which they would help increase the volume of corporate bond trading is attached as Appendix A.

3.5 Triggers to Growth of TFC:

3.5.1 An Unblemished Past:

Publicly offered TFC are always credit rated and listed, and usually secured and underwritten. This subjects the issue to multiple scrutinies and reduces risk for every one. So far there has not been any default on a TFC with a public offer. The average over-subscription of public offers is 54% and all but three issues were oversubscribed. This unblemished past is increasing the confidence of the investors. At the same time, it also means that any one default is likely to have a major adverse impact on both outstanding and new issues. This spillover of a default is a negative externality imposed by one defaulter on others but it is very difficult to internalize it, i.e. confine the overall costs of the default to the defaulter. The best move is to adopt very strict vigilance to avoid any disaster.

3.5.2 GOP Bonds:

An important factor behind lack of TFC growth had been the lack of government bonds to make a complete yield curve. The interest rate offered on the 'default-risk free' GOP securities act as a benchmark for issuing corporate bonds. They also provide the trading volume that makes the secondary bond market active. Now with different outstanding bond issues, including the new

Pakistan Investment Bonds (PIBs) issue of 3, 5, and 10 years maturity, at least the problem of not having a benchmark government bond has been largely solved.

3.5.3 Credit Rating:

Credit rating in Pakistan is being done by PACRA and JCR-VIS. The extracts from their credit rating reports are prominently displayed in every TFC prospectus and rightly so. For a common investor, it is but the credit rating that provides a sense of issuer's ability and willingness to pay. It is also a key input in determining the coupon rate. Even institutional investors rely on the credit rating to decide whether or not to invest. One can safely say that it is but difficult to exaggerate the importance of credit rating in the bond market and there is a strong need to comply with highest professional and ethical standards in this area.

3.5.4 Benefits to the Issuer:

TFC offer an alternate mode of financing to the issuers as TFCs are turning out to be significantly cheaper than bank loans; it is possible to retire debts costing as much as 18% with TFC costing 14 to 15% in initial years. TFC make it easier for the issuer to avoid maturity mismatch that is of particular relevance to financial institutions, such as leasing companies — the most active issuers in the TFC market. With the permission of the SBP, commercial banks have also joined the TFC issuers for similar reasons. Issuing TFC also brings market recognition to the issuer and it pays to be known and visible. Moreover, TFC increase the internal knowledge and skills of corporations and improve their way of going about financing. Companies should also consider TFC to diversify their financing mix.

3.5.5 Change in Institutional Parameters:

Institutional investors have been barred from investing in the NSS. With this policy change, an unfairly advantaged competitor of TFC in the institutional investment has been eliminated. The interest rates on NSS are also being brought in line with market forces, which would generate demand from small investors. Moreover, recently SBP has also allowed banks to issue TFCs.

Rated and listed TFC have become eligible for the Statutory Liquidity Reserves (SLR), which was being demanded for some time. These regulatory moves have radically increased the demand for TFC.

3.5.6 Reduction in Issuance Cost:

Over the last few years, under ADB's Capital Market Development Program (CMDP), Securities Exchange Commission of Pakistan (SECP) has devised regulations and the cost to the issuer and investor has been dramatically decreased. Following is the tax structure for Listed TFC.

Category	**Withholding Tax**	**Zakat**
Individuals	0%	2.5%
Corporations & Statutory Corporations	0%	0.0%

	On Issuance	**On Transfers**
Stamp Duty	0.15%	0.10%

To broaden the bond market of Pakistan, the Government in Year 1999-2000 waived off 10% withholding tax.

Summary of Barriers and Triggers to Growth of TFC is attached as Appendix B.

The efforts to reduce interest rates in Pakistan have started showing significant results. This is part of the overall measures to boost economic growth rate in the country. Similarly, the rates of return on NSS and T-Bills yield were lowered. Excessive liquidity of the banking system demanded some alternative avenues for investment. All these changes indicate the change in the outlook for corporate debt market. Traditionally, Pakistanis were keener to invest in gold, foreign currencies and NSS, as the perceived risk was lower. Some of these avenues are no longer attractive, but one cannot say that debt instruments offer an alternative avenue to such investors. They may still continue to invest in 'more secure' instruments despite offering lower return. However, it is important to note that companies with credible track record will

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[*] Kazmi, Shabbir, A Growing Market for TFCs, Pakistan Economist, Apr 07-13

be floating TFCs rather than increasing their capital base or depending on financial institutions for meeting their funds requirements.

During year 2001, TFC market witnessed phenomenal growth and one of the reasons for the robust grow of the TFC market was cited in Annual Report 2001 of the SBP. Companies that previously relied heavily on Development Financial Institutions (DFI) were looking at the bond markets to meet their future financial needs, as those DFIs previously received considerable funding from International Financial Institutions (IFIs), as part of their past strategy of directed development. Since this strategy has largely failed, the IFIs no longer support DFIs, particularly the leasing companies.

With discontinued support from DFIs, leasing companies are looking towards the TFCs as a way out of their financial woes. The exemption of institutional investments in TFCs from the 10 per cent withholding tax, together with the downward trend in interest rates and uncertainties in the exchange rates have made TFCs the best financing bet for leasing companies to overcome their mismatch of funds and ensure reasonable spread.

TFC are becoming sophisticated with time. In the beginning issues came with a fixed return and without any options. The new issues are using a floating rate, with a floor and a ceiling, usually set a certain percentage points above the SBP discount rate. Issuers are keeping a Green Shoe Option — a right to retain a percentage of over subscription. The tenure is usually around 5 years, though there has been one perpetual issue. Use of shelf registration implies that the issuer can split the TFC issue into tranches, which is useful for periodic financing requirements of the issuer and also allows optimal pricing of the individual tranches[1]. Some issuers are even adding a partial or a full Call option — the right of the issuer to recall some or all of the TFC outstanding (say the issuer can get cheaper debt). While some issuers made sinking funds: a reserve for paying off the bonds, most of the issues have come without one. The issue size has varied from Rs 100 million to Rs 2500 million. The new features are to the issuer's benefit but they make valuation complex because concepts like yield to call, option adjusted spread, duration, convexity etc are not well understood.

[*] 1. The shelf registration option is valid for a maximum period of twelve months for an issue amount of Rs 250 million and a maximum period of three years for an issue greater than this.

Despite the positive developments, there are still issues that need to be resolved. SECP is actively streamlining the process for issuance of TFCs by reducing costs and simplifying the procedure for approval. On similar lines, KSE in collaboration with the Central Depository Company (CDC) has reduced the annual listing fee for TFCs. The KSE has also reduced broker commission from 1.0 to 0.25 percent, and the fixed service charge of Rs 25,000 has been revoked. Additionally, the initial listing fee has been reduced from a maximum of Rs 1.0 million to Rs 0.5 million. Also, the CDC has reduced its annual registration fee for TFCs by 25 percent effective November 1, 2000. These changes would lower the issuance costs for TFCs, which should help develop this market. Furthermore, the government has continued its policy of reducing stamp duties and withholding tax on profits.

Pakistani capital markets were characterized by lack of disclosure, which was anti-investment. But things are changing with adoption of stringent regulatory policies by SECP. With the new breakthrough requirement of quarterly accounts and implementation of more international accounting standards, the hold of banks on privileged information regarding the credit worth of a company would be loosened that would pave the way for more bond issues.

Even though Pakistan does not have many large companies, the number of companies that can but have not issued TFC is large. It is up to the advisors to aggressively sell the idea of TFC to these potential clients. The knowledge and skills of the advisors to the issue are also improving with every new issue. No more a few brokerage houses or banks dominate the market. Admittedly, the new advisors and arrangers move down the learning curve at the cost of the issuers, but their increasing numbers is good news for the overall market.

3.6 Current Scenario:

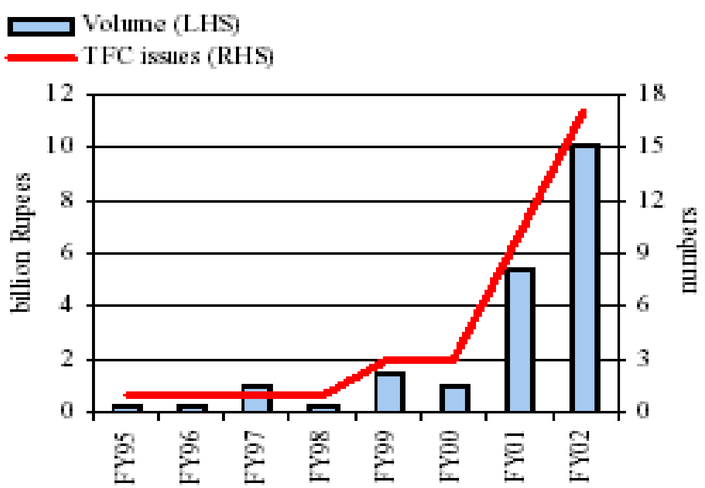
The country has already achieved a moderate level of capital mobilization through the bond at 25 percent of gross domestic product (GDP) respectively, at the end of FY02. However, the figures are deceptive as government issues dominate the bond market – with corporate bond market accounting only 0.6 percent of GDP.

While it was expected that long-term securities would be priced relative to government bonds, in reality TFCs' pricing (coupon and price) was based on the National Saving Schemes (NSS). The reason is twofold: first, secondary market for long term government papers was not in a stage where their yields were long-term benchmark rates; and second, NSS constitutes more than a quarter of all domestic government debt and is aimed mostly at the public, which the TFCs, through listing at the stock exchanges, were also targeting. This put the TFC issuers at a disadvantage in raising finance through this instrument.

However, to provide more enabling environment, the government has taken some important steps. Most prominent were changes in National Saving Schemes (rationalizing rates and banning incremental institutional investment in April 2000), and the launch of the Pakistan Investment Bonds (PIBs) with the aim of providing a benchmark for long-term securities. With the fall in interest rates, and more importantly, the cut in NSS rates since mid-1999, the effective benchmark for the pricing of corporate bonds has fallen sharply. Since then, market has picked up steeply and 32 new issues were launched in the market, of which 28 were launched since the start of the FY02 to date.

Figure 3.1

Growth in TFC Market



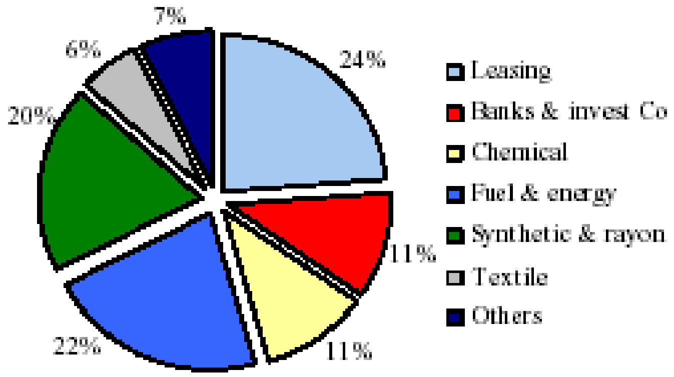
Source: Annual Report 2001-2002 State Bank of Pakistan

[*] Annual Report SBP - 2002

Figure 4.2 shows the sector wise composition of issues.

Figure 3.2

Sector Wise Issue of TFC



Source: Annual Report 2001-2002 State Bank of Pakistan

Also in the wake of falling interest rate scenario and limited quality investment options, TFCs provide an attractive opportunity for the investors. However, secondary market for these issues largely remains dormant due to lack of liquidity and absence of market makers. In order to make issues more flexible and affordable for the investors, issuers are adding different features from shelf registration to the green shoe option to TFC structure. A very interesting development is the gradual evolution in the pricing structure of the TFCs. Starting from the plain vanilla structure with fixed coupon rates; market has witnessed an increasing number of bonds with floating structures.

[*] Annual Report SBP - 2002

CHAPTER 4: ANALYSIS

This chapter will highlight the macro level analysis of the TFCs market in Pakistan along with the scrutiny of design and structure of TFC issued by a leading textile mill at the micro level.

4.1 Macro Analysis:

As early as 1985, privately placed TFCs issued by development finance institutions (DFIs) had been in existence. However, it was not until February 1995 that the first public TFCs issued by Packages Ltd. was listed on the stock exchange. The listing signaled the birth of a corporate debt market and was swiftly followed by three others, with yields of between 17.8 and 19 percent, bringing the stock of listed TFCs to a little more than Rs 2 billion.

In September 1997, additional incentives in the form of tax exemption (on the 10 percent withholding tax) were granted to TFC holders, including corporate entities such as banks, giving a boost to the investor base of TFCs. However, six months later, the withdrawal of part of the tax exemption, leaving only individuals tax exemption, dealt a heavy blow to the fixed income market.[1]

Never mind the absence of new equity listings at the stock markets, the corporate debt market in Pakistan is booming. Already in the nine months since July 2002, as many as 18 Term Finance Certificates have been floated by corporations to raise Rs9.5 billion. By contrast, 22 TFCs valued at Rs14 billion had hit the market in the preceding three years combined.

Declining interest rates and steep rise in stock prices appear to have prompted both institutions and individual investors to look around for new investment avenues. After remaining inactive during Q2-FY03 when just three new issues worth Rs2.2 billion were launched in the primary corporate bond market - as against eight issues

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* Annual Report SBP – 2002
IP Securities – Research Report

1. The rational was to prevent banks from profiting from converting their taxable loan portfolio to tax exempt TFCs.

worth Rs4.6 billion in Q1 of the year, the third quarter has again witnessed rapid growth in the new issues. Seven new TFCs of the value of Rs2.7 billion had entered the capital market during Q3-FY03. With the issuance of new instruments, the total amount of listed TFCs has reached Rs 27.4 Billion, which is only 4.7% of equity market capitalization.

As far as size of the bond market is concerned, it is far smaller than those of many developed nations. But the speed of growth in such short span of time, fuels enthusiasm about the large demand gap and depicts the hidden potential of the market. It is expected that the growth in outstanding debt market would compel augmentation in the size of the secondary market of TFCs as well.

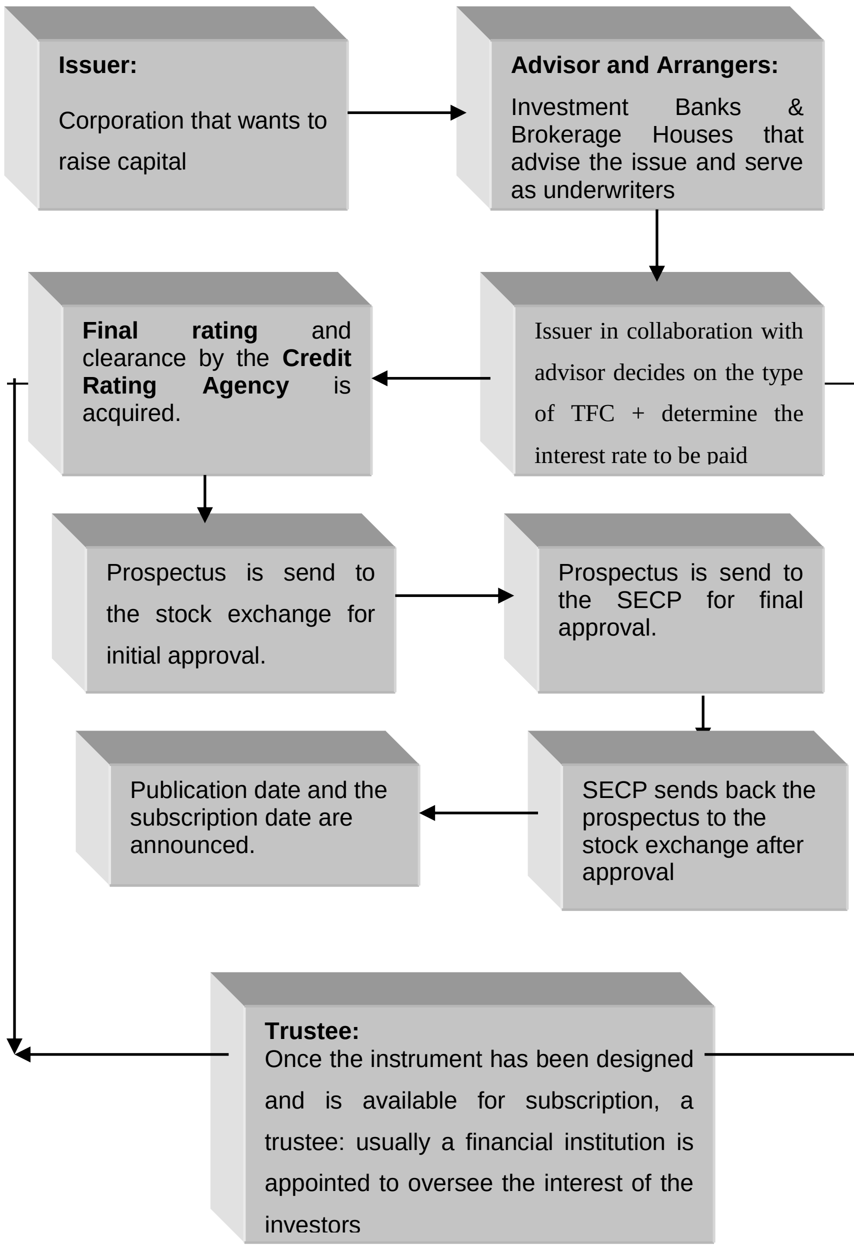
4.2 Micro Analysis:

4.3 Designing and Structuring of TFC:

The process of issuance of TFC starts from the homework of the company itself. Designing and structuring of a debt instrument involves numerous technicalities. A TFC is designed by involving the following parties:

Figure 4.1

Designing and Structuring of TFC



- Issuer
    - Corporation that wants to raise capital
- Advisor and Arrangers
    - Investment Banks and Brokerage Houses that advise the issue and serve as underwriters.
- Trustee
    - Usually a financial institution that oversees the interest of the investors.
- Credit Rating Agency
    - Agency that assigns a rating which reflects the credit risk of the TFC i.e. issuer's ability and commitment to repay the scheduled TFC payments.

4.3.1 Determination of Interest Rate for the Instrument:

The issuer in collaboration with the advisors and arrangers decide on the type of TFC to be launched and on the basis of category chosen determine the interest rate to be paid to the investors.

4.3.2 Types of TFC:

Issuers have an option either to issue fixed or floating rate instruments, although over the year's trend of the TFCs issued depicts a tendency for the floating rate variant.

- Fixed rate bond: Coupon rate is a percentage (%) of the par value.
- Floating rate bond: The coupon rate is set at a risk-free benchmark plus a risk spread to reflect the relative risk of the instrument.
    - Risk-free benchmark or base rate is typically the SBP's discount rate or the auction yield on the Pakistan Investment Bond of the same tenor.
    - Floating rate may impose caps and floor on the coupon payments.
- Some TFCs may have embedded *call* and *put* options.

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[*] Taurus Securities

The risk spread varies from organization to organization and from sector to sector in which the organization operates and is based on the following factors:

- Credit Rating
- General interest pattern in the economy
- Tenor of the instrument
- Security of the bond
- Call and refunding provisions

Apart from determining the interest rate, the issuer and advisor also works out the time period for the redemption of the principle as well as decides on the proposed security for the issue. The issuer also has to decide whether to embed *call* and *put* options and whether to evoke shelf registration or not.

Once all the basic things have been decided upon a term sheet known as the *Information Memorandum* prepared by the *advisors*, which indicates all the terms of the issue.

An information memorandum of launch of TFCs by Union Bank Limited is attached as Appendix C.

A list of outstanding issues of TFC to date is attached as Appendix D.

4.4 Analysis:

To analyze the manner in which the issue of TFC goes about, an example of launch of TFCs by Gulistan Textile Mills Ltd has been taken into consideration. The TFCs were launched in year 2001 and the analysis pertains to the time period during which the instrument was designed.

The indicative term sheet highlights the specifications of the then proposed launch.

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* Jahangir Siddiqui & Co

Indicative Term Sheet of GTML
Table 4.1

Issuer	Gulistan Textile Mills Ltd (GTML)
Advisors & Arrangers	Jahangir Siddiqui & Co. Ltd ABN AMRO Bank N.V Bank Alfalah Limited
Private Placement	Rs.200 million
Public Offer	Rs.100 million
Green Shoe Option	Up to 100% of the public offer
Rating	A- (A minus)
Expected Profit	SBP discount rate + 2.00% with a floor of 14.00% p.a. and a ceiling of 17.50% p.a.
Tenor	5 Years
Security	First pari passu hypothecation charge on the fixed assets of GTML
Redemption	Principal to be repaid in 6 equal semi-annual installments, the first such installment falling due 30th month after the issue date.
Trustee	United Bank Limited
Participation Fee	Rs.10, 000, 000-24,999,999 – 0.5% Rs.25, 000, 000– 49,999,999 – 0.10% Rs.50, 000, 000- 74,999,999 – 0.15% Rs.75, 000, 000 and above – 0.20%
Underwriting Fee	0.50%
Legal Advisor	Mohsin Tayeb Ali & Company
Listing	Karachi Stock Exchange (KSE)
Use of Proceeds	The amount raised through the TFC will be utilized for debt restructuring and other businesses permitted as per Memorandum and Articles of Association

The benchmark for coupon rate was the SBP discount rate, which was 12% at the time of issuance of TFCs.

4.4.1 Textile Industry during the Phase of Launch:

The textile industry is the largest industry in Pakistan and the most important sector of the economy. It accounted for 60% of the total export earnings, provided employment to 38% of the industrial labor force and made up 27% of the value addition in the manufacturing sector[1].

The period, during which the instrument was structured, the textile industry had an installed capacity of over 8 million spindles and approximately 146,000 rotors. In FY 99, the spinning sector produced 1,541 million kg of yarn.

Although the textile sector faced many challenges then; in the form of increased competition and deregulated global market, the textile sector in Pakistan possesses certain competitive advantages that enable it to continue being the highest foreign exchange earner in the country. The prominent advantages are:

- Availability of cotton, which is the basic raw material for the textile sector.
- The textile sector of Pakistan is labor intensive and the wage rates in Pakistan are one of the lowest in the world.

4.4.2 The Company:

Gulistan Textile Mills Ltd was incorporated on February 02, 1966 as a private limited company. It was later listed on KSE on April 11, 1966. The company is principally engaged in the manufacturing and sale of yarn. As at March 31, 2000 the total shareholders' equity stood at Rs. 926.56 million and total assets at Rs. 3.2 billion. GTML is amongst the prominent textile companies in Pakistan and is a large exporter of textile products. As at March 31, 2000 the company's total sales were Rs. 1.137 billion and exports for the half-year stood at Rs. 671.017 million.

The first unit of GTML went into commercial production at Bahawalpur in 1967 with a capacity of 12,500 spindles and with a paid-up capital of Rs. 1.0 million. Since then, it has come a long way and now the company has an installed capacity of over 75, 000 spindles and 1, 696 rotors, which produce yarn from 8/1 to32/1 Carded and Combed. It has the capability to produced

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1. * **Economic Survey of Pakistan 1999-00**
2. The share of textile in Pakistan's exports earnings is 68 percent at its present worth of exports is around $ 7 billion. The value addition in the sector account for 9 percent of GDP and it employ 38 percent of industrial workers. **Economic Survey of Pakistan 2002-03.**

100% cotton yarn as well as poly-cotton and lycra cotton yarn. Cotton waste generated is recycled to achieve maximum yield.

During year 2000, management of GTML made a strategic decision to tap the domestic debt market by offering TFCs to potential institutional investors and the general public. The proceeds from the TFC issue were to be utilized for **debt restructuring** and **other businesses permitted as per Memorandum and Articles of Association of the Company.**

4.4.3 Structuring and Designing of the Instrument:

The instrument was structured to make semi-annual payments and provide investors with a floating rate return that would be 2% higher than the SBP Discount Rate with a floor of 14.00% per annum and ceiling of 17.50% per annum. The profit rate for the semi-annual period was to be set on the first day of the subscription date. Subsequently, the profit rate was to be revised two days prior to the commencement of next semi-annual period for which mark up was to be computed.

The caps on coupon payment were incorporated to safeguard the interest of both the issuer and the investor. At the time of issue the discount rate was **12%** that has now fallen to **7.5%**. Had there been no floor rate incorporated, investor would have received a coupon payment of 9.5% today. The floor of 14% ensures that with the discount rate as low as 7.5%, the investor still earns 6.5% over and above the prevailing discount rate thus increasing the price of the instrument in the secondary market.

The redemption of principal was set to be redeemed in the last three years, in six equal installments, the first installment beginning from 30^{th} month from the issue date.

The TFC was offered in sets of Rs. 100, 000/- in private placement so as to accommodate large institutional investors. The TFC was offered in sets of Rs.5, 000/- in the public offer so as to accommodate small investors.

Table 4.2

Redemption of TFCs:

1	2	3	4	5	6
Period	**Principal Redemption**	**Expected Profit**	**Total Redemption**	**Maximum Prompt Payment Bonus**	**Principal Redemption Amount Outstanding**
-					100, 000.00
6	20.00	8, 750.00	8, 770.00	1, 750.00	99, 980.00
12	20.00	8, 748.25	8, 768.25	1, 749.65	99, 960.00
18	20.00	8, 746.50	8, 766.50	1, 749.30	99, 940.00
24	20.00	8, 744.75	8, 764.75	1, 748.95	99, 920.00
30	16653.33	8, 743.00	25, 396.33	1, 748.60	83, 266.67
36	16653.33	7, 285.83	23, 939.17	1, 457.17	66, 613.33
42	16653.33	5, 828.67	22, 482.00	1, 165.73	49, 960.00
48	16653.33	4, 731.50	21, 024.83	874.30	33, 306.67
54	16653.33	2,941.33	19, 567.67	582.87	16, 653.33
60	16653.33	1, 457.17	1, 1180.50	291.43	-
Total	100, 000.00	65, 590.00	165, 590.00	13,118.00	

In the event company redeemed a TFC on or prior to its redemption date then the company will be entitled to a Prompt Payment Bonus up to the maximum limit set forth in the column 5 of the calculations above. The TFC Redemption in respect of each TFC would be reduced by the extent of the prompt payment bonus.

Calculation of Prompt Payment Bonus is given in Appendix E.

4.4.5 Procedure to Subscribe:

For the purchase of TFCs the potential investor was required to inform the advisors through the commitment letter. GTML then at its discretion entered into a TFC agreement.

[*] Prospectus - GTML

4.4.6 The Security:

The TFC was secured through first pari passu hypothecation charge on fixed assets of the company.

4.4.7 The Trustee:

United Bank Limited was appointed as the trustee for the issue. As per the terms of the of the Trust deed, the trustee was to ensure:

- The terms and conditions of the Security Document are adhered to:
- The interests of the TFC holders are safeguarded by taking actions that it deems necessary (as prescribed by the Trust Deed) in the event of any breach of terms and conditions of the TFC instrument, the Trust Deed and the Security Document.

4.4.8 Event of Default:

The event of default was to be governed by terms and conditions of the TFC Investor Agreement. In the event that the Trustee is notified of such an event of default, the Trustee may enforce the security held by it in accordance with the terms of the Security Trust Deed.

4.4.9 Governing Laws:

The laws of Pakistan govern the issue.

4.4.10 Credit Rating:

The instrument was given a credit rating of A- (A minus) by Pakistan Credit Rating Agency.

4.5 Procedure of Credit Rating:

The procedure of the rating begins with a signing of agreement between the issuer and the rating company. Subsequent to the signing of the agreement, the credit rating company provides the company with detailed questionnaire for gathering exhaustive data on financial and qualitative aspects of the company intending to issue the TFCs.

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[*] PACRA

The factors that were taken into account for rating of GTML's proposed TFC instrument were taken into consideration:

4.5.1 History and Management of the Company:

The group has been in Textile Business since 1962, when it first started a spinning unit in former East Pakistan. In 1967 Gulistan Textile Mills Limited was established in Bahawalpur. At present the group has a capacity of 175, 000 spindles, 4,000 rotors and 179 Airjet Looms in its various companies/units.

The group has also diversified its interests into other sectors too. The group has an established power plant by the name of Gulistan Power Generations Limited with a capacity of 20.80 MW. It also has a company by the name of Pervez Industrial Corporation, which produces household items under KIWI brand. This company is joint venture with a US based company, Sara Lee Company. The company had an annual turnover of Rs. 6 billion in 1999, one third of that was contributed by GTML.

The group has a team of around 400 employees, which include professionals like Chartered Accountants, MBAs, Textile Engineers, and Cost Accountants etc. The professional team has a strong grip on the monitoring system of the group. The group believes in having a satisfied workforce and therefore has a policy to pay competitive compensation packages to its employees.

The group now has seven Public Limited Companies and one Private Limited Company. Four of these are listed on stock exchanges while the other three are unlisted. Of the seven companies, five produces yarn, one produces fabric while the seventh company is a power generation plant. The eighth company produces KIWI brand household products.

4.5.2 Human Resources:

GTML puts great emphasis on continuous training and development of its employees who are made to attend various training programs to enhance their technical capabilities in the context of textile industry.

The relation between the employees (labor) and management are very well managed which can be gauged from the production results of GTML being the highest in the spinning industry. There has never been unrest in any of the group companies. The management satisfies the labor union with good payouts and fair treatment of the employees.

4.5.3 Capital Base and Dividend Payout:

GTML went into commercial production in 1967 with a paid-up capital of Rs. 1 million and as at 1999, this stood at Rs.126.36 million. The total shareholder's equity at the end of FY 99 stood at over Rs.818 million which compares favorably with most other companies in the industry.

The dividend payout history of the company for the years 1995-99 is shown below:

Table 4.3

Years	Cash Dividend	Bonus Shares
1995	-	-
1996	5%	-
1997	15%	-
1998	-	-
1999	22.50%	-

4.5.4 Operations:

The company produces different varieties of yarn, which include coarse as well as fine counts of cotton and blended yarns, combed as well as carded yarn. The company has the capability to produce mélange as well as dyed cotton yarn.

4.5.5 Marketing Strategy:

The company's strategy has been to diversify its market in terms of its customers, territory and product range to avoid/reduce volatility. With a view to reduce the dependency on the Hong Kong market, which consisted of more than 57% of the company's total exports in 1997, the company has developed

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* Company Prospectus - GTML

customer bases in Singapore, Taiwan, Korea and Indonesia in Far Eastern region, UAE and Egypt in the Middle East Region, Bangladesh and Sri Lanka in the Asian Region, Denmark, Italy and Germany in the European Region and the USA. GTML has also developed customer in Australia.

The company has focused its efforts at reducing its dependency on a few customers and has consistently endeavored to make contacts with new customers. This effort has been successful and can be gauged by the fact that in 1997, 80% of the company's export sales went to its 20 large customers whereas by 1999 this decreased to 55%.

4.5.6 Financial Analysis:

A summary of key ratios based on historical statements is as follows**:**

Table 4.4

Key Ratios	**1997**	**1998 (%)**	**1999 (%)**	**H/Y2000 (%)**
Gross Profit Margin	15.10 %	13.39 %	13.34 %	22.04 %
Operating Profit Margin	11.71 %	11.69 %	11.76 %	19.98 %
Net Profit Margin	2.57 %	1.10 %	2.48 %	9.48 %
Return on Equity	6.27 %	2.64 %	6.10 %	11.63 %
Debt to Equity	34.85	40.99	46.74	36.68
Times Interest earned	1.36	1.19	1.34	1.96
Current Ratio	0.95	0.94	0.97	1.01
EPS (Rs.)	3.85	1.66	3.95	8.53

Following broad indications can be observed from the table above:

- Profitability seems to be going higher backed on impressive half yearly performance.
- Although debt leverage has risen, but due to better deployment of funds, the times interest earned has also improved concurrently.

As of FY 99 GTML’s standing vis-à-vis key sector companies is as follows:

Table 4.6

	Name of Company	# Of Spindles	Sales	Paid-up Capital	Total Assets	Total Equity
1.	Gulistan Textile Mills	78,752	2, 010	126	2, 720	819
2.	Dewan Textile Mills	61, 704	1, 883	84	2,	614
3.	Ibrahim Textile Mills	58, 080	785	136	812	187
4.	Saif Textile Mills	48, 000	927	189	692	458
5.	Umer Fabrics	39, 840	1, 609	240	1, 404	396
6.	A.A Textile Mills	38,400	772	103	375	191
7.	Zainab Textile Mills	38,400	782	176	616	200

Based on the detailed analysis of the issuer, PACRA came up with the rating of A- (A minus) for the instrument. This rating indicated a low expectation of credit risk and a strong capacity for timely payment of financial commitments.

GTML's rating reflected a maintained risk profile with almost stable capital structure. The rating also takes into account the stressed cash flows, though the strong standing of the Gulistan Group and its demonstrated capacity to mobilize requisite funds from external sources mitigate the concern.

Once the rating was awarded to the instrument, the issuer entered into the following agreements:

4.5.7 The TFC Underwriting Agreement:

Once the rating was finalized, GTML entered into an agreement with the underwriters to underwrite the Public Offer of face value of TFCs. The agreement was on “full guarantee” basis and the public offer less than Rs.100 million amount to the general public was to be subscribed by the underwriters in accordance with the underwriting commitments and the underwriting agreement.

* PACRA

4.5.8 The Structuring and Placement Agreement:

GTML signed a Structuring and Placement Agreement with the Advisors. The scope of the work of the advisors was to use reasonable endeavors to privately place Rs. 200 million, assist GTML with the listing process of the TFCs on the Karachi Stock Exchange, arrange underwriting for the public offering and coordinate with GTML to assist them in completing transaction.

4.5.9 The Security Trust Deed:

The Security Trust Deed between GTML and United Bank Limited specified the functions and obligations of the Trustee. The trustee had all the powers and discretion conferred upon it by Trustee Act 1982, and the Security Trust Deed.

4.5.10 The Security Document:

The Security Document defined the terms and conditions of the first pari passu hypothecation charge on the fixed assets of GTML.

Gulistan Textile Mills Limited issued the TFCs in September 5, 2001 and the issue was over subscribed by 21 %.

CHAPTER 5: CONCLUSION & RECOMMENDATIONS

There is widespread agreement among the government and private sector participants that Pakistan needs a viable bond market in order to mobilize private savings efficiently for long-term investments. Moreover, the government and the financial community have recently taken important steps to foster capital market development. While this support is important, even crucial, there are a number of areas requiring greater attention in order for a robust bond market to develop.

With a decline in local interest rates, companies are finding it cheaper than before to raise funds through debt. Most of it is for working-capital requirements. There is a dire need to create the right environment to foster growth of the long-term segment of debt financing. The "long bond" concept needs to gain acceptance. At the same time, lenders, on their part, need confidence in the system as well as the government's macro-economic policies. The Riba issue needs to be managed.

TFC market is yet at a nascent stage in terms of size in Pakistan. No doubt issues are pouring in but unless the individuals come up and show their fair share of interest in these issues, the market is going to remain slim.

One central issue that has to a certain extent stymied the progression of the TFCs in Pakistan is the investor mentality. The individual investor has to get out of the mindset which is inclined towards investing either in government saving schemes or the Stock Exchange, and to change this inclination, those at the helm i.e. the Brokerage Houses, potential issuers and other institutions which are in any way linked to this market ought to do better marketing of this instrument than they have been doing uptil now. Unless awareness is created, TFCs would keep on rolling in the corporate sector without any substantial interest from the individual investors.

A buoyant secondary market is the culminating stage in the evolution of a basic corporate debt market. For issuers, it gives a clear indication about investor appetite and firmly establishes an alternate avenue for fund raising. For investors it removes inefficiencies and develops a neat yield curve, which places each instrument in relation to one another. In most developed countries, fixed income markets are larger than the equity markets, whereas in Pakistan the capital raised via TFC makes approximately 5% of the market capitalization.

One of the major reasons for underdevelopment of the secondary market is that the bulk of TFC are placed privately. Mainly the financial institutions and large pension and retirement funds actively participate in pre-IPOs. Since the TFCs are considered less risky and also offer attractive returns, therefore these institutions hardly sell their holdings and prefer to carry them till maturity. The concept of ***realizing capital gains*** on fixed income securities is not understood by many of the investors, which leads to inactive secondary market. Secondary market also remains dormant due to lack of liquidity and absence of market makers.

Another issue that needs to be taken into consideration is the fact that although till now no issue has defaulted but any default at any point in time would prove catastrophic for the TFC market. It would have a "*domino effect*" and may create a situation from where any hope of another issue may die altogether.

The regulators are vigilantly monitoring the debt market, but for the development and phenomenal growth of the TFC market, the need for adoption of stringent policies is required to audit the Rating companies, so that the ratings issued remain un-biased and provide a clear reflection of the risk attached with the instrument.

Leasing companies can make the most out of the development of TFC market by issuing TFCs to overcome the mismatch of funds and ensure reasonable spread in period of declining interest rates.

With the permission of Government to issue 15 and 20 year Pakistan Investment Bonds, a new avenue for the issuers has opened up, as a bench mark will be available to the issuers for launch of TFCs with a longer tenor. With this permission the yield on TFCs has moved upward by 1.5 – 2.5%. This increased yield gives a hope of increased secondary market activity in days to come.

The second phase of Asian Development Bank's Capital Market Development Program will focus on the augmenting and deepening of our capital markets with emphasis on the debt markets. The efforts that have been made by SECP and government are really encouraging. Simply criticizing and pinpointing different practices and regulations would probably not solve the problems related to our corporate bond market. Thus, we can conclude that Pakistani debt markets show good promise. The commitment to reform the whole infrastructure and continuing progress in addressing impediments will be paying huge dividends in future. Encouraging capital formation and efficient allocation of capital in the development of the economy holds good promises for tomorrow.

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Prospectus – Gulistan Textile Mills Ltd

Business Recorder – October 08, 2003

Appendix A

High-Priority External Impediments

Political

- Inconsistent economic policies
- Inconsistent taxation of investment income across different debt instruments
- Slow progress in implementing planned financial sector privatizations

Macroeconomic

- Crowding out effect on the private sector arising from the large government deficit
- Higher-cost retail borrowing used to fund the government's deficit
- Institutional access to retail debt instruments
- Large informal sector diluting overall effectiveness of economic policies and influence of financial institutions in the secondary debt markets

Broader financial system

- Wholesale government securities market provides limited market signals, especially for long-dated instruments
- Weak banking system constrains secondary market bond market trading

Legal environment

- Ineffective commercial law

Moderate-Priority External Impediments

Broader financial system

- Lack of awareness of the role of corporate debt securities in private sector development

Source: Building Local Bonds Markets – An Asian Perspective – Alison Harwood

Appendix B

Barriers and Triggers to Growth of TFC

<table>
<tr><th colspan="2"></th><th>Supply Side</th><th>Demand Side</th><th>Institutional</th></tr>
<tr><td rowspan="2">BARRIERS</td><td>Short Term</td><td>•Lack of enough issues
•Expensive
•Long lead time</td><td>•Lack of Liquidity
•Competition from NSS for small investors</td><td rowspan="4">•Weak legal, audit, and accounting systems
•Poor record in preventing and handling past financial scams
•Small size of insurance and pension funds
•Established Credit Rating
•Increasing number and
•know-how of Advisors Improving Disclosure</td></tr>
<tr><td>Long Term</td><td>•Ambiguity on the issue of Riba</td><td>•Investor Ignorance
•Low Per Capita Income</td></tr>
<tr><td rowspan="2">TRIGGERS</td><td>Short Term</td><td>•Large number of potential issuers including banks</td><td>•Unblemished Past Consistent Over-subscriptions</td></tr>
<tr><td>Long Term</td><td>•Cheaper funds to issuers</td><td>•Bar on Institutional investment in NSS
•TFC eligible as SLR
•Attractive returns to investors</td></tr>
</table>

Source: Pakistan Economist March 2002

Appendix C

Indicative Term Sheet of Union Bank Limited TFCs

Appendix D

LISTED DEBT SECURITIES (TFC) - as on September 01, 2003					
S. No.	Company	Date of Listing	Amount Listed Rs. in Million	Years of maturity	Rating
1	Saudi Pak Leasing.Co. Ltd	08-03-1999	250.00	4	AA -
2	Dewan Salman Fiber Ltd	12-07-1999	863.760	5	A+
3	PILCORP	14-02-2000	287.500	5	A-
4	Paramount Leasing	15-08-2000	250.000	4	A+
5	Orix Leasing Pakistan Ltd.	21-05-2001	741.965	4	AA
6	Sui Southern Gas Co. Ltd.	16-07-2001	1,000.000	5	AA
7	Engro Asahi Polmer & Chemical	13-08-2001	500.000	5	A
8	Dewan Salman II	06-08-2001	1,816.350	4	A+
9	Pakistan PTA Limited (ICI)	01-10-2001	1,600.000	5	A
10	Engro Chemical	11-01-2002	500.000	5	AA-
11	Security Leasing	11-02-2002	200.000	4	A-
12	Crescent Leasing Corp. Ltd.	04-03-2002	261.785	5	A+
13	Reliance Weaving Mills Limited	13-05-2002	150.000	5	A-
14	Union Leasing Limited (II)	12-06-2002	357.070	3	A-
15	Shahmurad Sugar Mills Limited	24-06-2002	200.000	4	BBB
16	Saudi Pak Leasing Co.Ltd. (II)	15-07-2002	430.000	5	AA-
17	Sui Southern Gas Co. Ltd. (II)	24-07-2002	1,250.000	5	AA
18	Sitara Chemical Industries Limited	24-07-2002	360.000	5	AA-
19	Engro Chemical Limited (II)	16-08-2002	1,000.000	5	AA-
20	Maple Leaf Cement Factory Limited	16-09-2002	250.000	4	A-
21	Muslim Commercial Bank Ltd.	02-10-2002	1,600.000	5	A+
22	Orix Leasing Pakistan Ltd. II	11-09-2002	746.835	4	AA
23	Crescent Leasing Corp Ltd. II	14-10-2002	250.000	5	AA-
24	WorldCall Communication Ltd.	22-11-2002	350.000	5	AA-
25	Quetta Textile Mills Limited	27-12-2002	750.000	5	A-
26	Union Bank Limited	29-01-2003	750.000	5.5	A-
27	Security Leasing Corporation Limited (II)	19-02-2003	299.000	4	A
28	KASB Leasing Ltd.	05-03-2003	200.00	5	A -
29	Trust Leasing Corporation Ldt.	04-07-2003	250.00	5	A
30	Ittehad Chemicals Ldt.	30-07-2003	250.00	5	A

				Subscribed By		
S. No.	Company	Listing	Redeemed On	Public	Institutional Investors	Total
1	Nishat Mills	25-04-1996	January -1999	75.510	175.000	250.510
2	Packages Limited	11-04-1995	February -2000	122.370	110.000	232.370
3	Sui Southern Gas	31-12-1995	October -2000	117.375	400.000	517.375
4	ICI	10-11-1996	October	374.810	750.000	1124.810
5	Sigma Leasing Corporation Ltd.	28-02-2000	January 18, 2003	66.000	80.000	146.000
6	Gatron Industries Ltd.	27-07-1998	June 20, 2003	74.305	200.000	274.305

Source: www.kse.net.pk

Appendix E

Calculation of Prompt Payment Bonus:

Let 'R' be the SBP discount rate or, if such rate is discontinued, any successor to such rate announced by the SBP. If R is less than or equal to 12%, then the prompt payment bonus will be Maximum Prompt Payment Bonus as set forth in the column five of the redemption calculations.

Redemption of TFCs:

1	2	3	4	5	6
Period	**Principal Redemption**	**Expected Profit**	**Total Redemption**	**Maximum Prompt Payment Bonus**	**Principal Redemption Amount Outstanding**
-					100, 000.00
6	20.00	8, 750.00	8, 770.00	1, 750.00	99, 980.00
12	20.00	8, 748.25	8, 768.25	1, 749.65	99, 960.00
18	20.00	8, 746.50	8, 766.50	1, 749.30	99, 940.00
24	20.00	8, 744.75	8, 764.75	1, 748.95	99, 920.00
30	16653.33	8, 743.00	25, 396.33	1, 748.60	83, 266.67
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60	16653.33	1, 457.17	1, 1180.50	291.43	-
Total	100, 000.00	65, 590.00	165, 590.00	13,118.00	

If R is equal to or greater than 15.5% then the prompt payment bonus shall be zero. If R is greater than 12% but less than 15.5% the prompt payment bonus for a particular TFC shall be the product of:

1. The principal redemption Amount Outstanding (AO) as set forth in column 6.
2. (15.5 – R)% and
3. 0.5 (Being the semi-annual adjustment)

$$= AO \times (15.5 - R)\% \times 0.5$$