The Pakistan Credit Rating Agency Limited

Rating Report

MCB Islamic Bank Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
29-Jun-2018	A	A1	Positive	Maintain	-
16-Oct-2017	A	A1	Stable	Maintain	-
01-Feb-2017	A	A1	Stable	Maintain	-
01-Feb-2016	A	A1	Stable	Initial	-

Rating Rationale and Key Rating Drivers

MIB is a wholly owned subsidiary of MCB Bank Limited (MCB). MCB has long term rating of "AAA" reflecting its robust profile duly supplemented by its strong market position in local banking landscape, established brand equity, and sound financial profile. MIBs standalone risk profile is improving. The management’s strategy is to focus primarily on high-rated, blue chip corporate clients. Meanwhile, undertaking new business lines including Micro, SME and Consumer financing are also on the horizon. MIB has set relatively high targets for deposit growth and plans to focus on maintaining its financing book quality. The thrust of the business plan is to achieve breakeven. The bank is in the process of advancing its operational infrastructure including branch network. Technological implementation and setting governance structure were mile stones achieved by bank in the last year. The ratings incorporate inherent constraints faced by MIB, mainly limited branch network, small deposit base and high cost structure particularly in early years.

The positive outlook captures the continued improvement in the MIB's relative positioning in the growing Islamic banking industry.

Disclosure	
Name of Rated Entity	MCB Islamic Bank Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Non-Banking Finance Companies(Jan-17)
Related Research	Sector Study | Islamic Banking(Jun-18)
Rating Analysts	Jhangeer Hanif | jhangeer@pacra.com | +92-42-35869504

MCB ISLAMIC BANK LIMITED (MIB) PROFILE	
Incorporated	May, 2014
Profile	▪ MCB Islamic is a small sized bank, currently has 166 branches after the demerger of 90 MCB branches into/ within MIB.
Legal Status	Un-listed
Head Office	Lahore

INDUSTRY SNAPSHOT

The banking sector has experienced highest growth in terms of advances in 2017 over the last decade. As a consequence, there is mounting pressure on capital adequacy ratio of the banks. The challenge is exacerbated as the internal generation of capital (profits) are witnessing a dip. Some relief on income side is expected with recent uptick in interest rates.

OWNERSHIP

- MIB is a wholly owned subsidiary of MCB Bank Limited. (ref: Note 1) MCB is the country's fourth largest bank in terms of deposit and operates a branch network of 1,433 spread across Pakistan.
- Apart from MIB, MCB has four more subsidiaries namely, a) MNET Services (Pvt.) Limited, b) MCB Financial Services (Pvt.) Limited, c) MCB Leasing Closed Joint Company Limited, and d) MCB-Arif Habib Savings and Investments Limited.

GOVERNANCE

- The overall control of the bank vests with eight members of the Board of Directors (BoD) including CEO. The Board currently comprises seven members (one position is vacant).
- Mr. Raza Mansha (son of Mian Mansha) is the chairman of the Board. He accompanied ~ 2 decades of diversified experience in various business sector including Banking, Textile, Power, Cement, Insurance, Hotels, Properties, Natural Gas, Agriculture, Dairy etc.

MANAGEMENT

- Mr. Ali Muhammad Mahoon, President of MCBIBL, has over 25 years of experience with local and international financial institutions.
- The experienced top management team heads different functions of the bank.

RISK MANAGEMENT

- MIB has implemented Oracle Flexcube Universal Banking System as its core banking software.
- MIB's financing book is dominated by Diminishing Musharikah and running Musharikah (end-Dec17 60%), followed by Murabaha financing (end-Dec17: 32%) and others including Ijarah Istisna etc. (end-Dec17: 8%).
- During CY17, MIB witnessed an increase of ~95% in advances (end-Dec17: PKR 31,474mln; end- De16: PKR 16,174mln).The Bank's ADR rationalized to 96.3% (end-Dec16: 113%) more in percentage terms owing to the small book of advances.
- Top-13 private performing client's concentration remained high at 30% during CY17.
- The new management, after asset cleansing, has focused on quality lending. Currently, MIB has only one non-performing financing amounting ~PKR .729mln.
- As a result infection ratio remained at ~0% end-Dec17 (end-Dec16: ~0%); owing to expanding phase of the bank.
- In line with industry, MIB invested majorly in Government of Pakistan (GoP) Sukuks (81%), whereas rest of the book (19%) is invested in non-strategic equity investments. Going forward, MIB will invest further in GoP Sukuks.
- The management's strategy is to focus primarily on high-rated, blue chip corporate clients. Meanwhile, undertaking new business lines including Micro, SME and Consumer financing are also on the horizon.

BUSINESS RISK

- During CY17, MIB's NIMR witnessed an increase of ~11% owing to the significant rise in earning assets (82%); mark up expenses also inched up. Hence, Bank slightly increased in terms of spread to 2.7% (CY16: 2.1%).
- Non-markup income recorded an improvement of ~69% mainly emanating from increase in dividend income as well realized gain on sale of investments.
- The rise in non-markup expense (55%) stood at PKR 1,845mln which resulted to loss of PKR 263mln (CY16: Profit PKR80mln).
- During 1QCY18, MIB's interest income witnessed ~90% growth followed by 41% growth in NIMR to stand at PKR 326mln.
- However, other operating income witnessed significant decline (1QCY18: PKR 69mln, 1QCY17: PKR 175mln) primarily on account of decline in realized gain on sale of investments. Consequently, with increased non-markup expenses, the bank reported a loss for the quarter; PKR 45mln (Profit 1QCY17: 10mln).
- MIB has set relatively high targets for deposit growth and plans to focus on maintaining its financing book quality.

CAPITAL & FUNDING

- Deposit mobilization remained the key source of funding. During CY17, MIB's customer deposits increased to PKR 27bln (CY16: PKR 12bln), up 125% YoY against 9% growth achieved by the industry.
- Nevertheless, the bank's deposit share in the system is small (0.2%) owing to the evolutionary years of the bank.
- Although the deposit size is smaller, CASA proportion in total customer deposits inched up in %age terms to 83% at end-Dec17 (end-Dec16: ~67%).
- Top-20 depositors' concentration remained the same on YOY basis but still higher at 46% (end-Dec16: 46%).
- Going forward, deposit mobilization is likely to increase deposit per branch projected to be at PKR 568mln by CY18.

MCB Islamic Bank Limited

BALANCE SHEET	31-Mar-18	31-Dec-17	31-Dec-16	31-Dec-15	31-Dec-15
				(Restated after merger)	(Change of Y/E to Dec)
	1Q	CY17	CY16	CY15	CY15
Earning Assets					
Financing	38,927	31,474	16,174	12,568	973
Private Sukuks	2,352	2,088	2,035	2,052	(39)
Total Financing	41,279	33,562	18,209	14,620	933
Investments	9,904	7,098	3,734	3,962	664
Others	5,062	4,103	2,751	6,277	8,132
	56,245	**44,764**	**24,695**	**24,859**	**9,729**
Non Earning Assets					
Non-Earning Cash	3,002	3,391	1,510	769	76
Deferred Tax	299	289	-	-	9
Provision for Loan Losses - Prudential General	(1)	(0)	(1)	(113)	-
Fixed Assets & Others	3,652	3,328	2,365	1,364	294
	6,952	**7,008**	**3,874**	**2,020**	**379**
TOTAL ASSETS	**63,197**	**51,771**	**28,569**	**26,879**	**10,108**
Remunerative Liabilities					
Deposits	34,718	32,691	14,279	9,450	38
Borrowings	15,921	7,927	2,786	632	-
	50,639	40,618	17,065	10,082	38
Non-remunerative Liabilities	1,727	1,522	1,238	6,839	86
TOTAL LIABILITIES	**52,365**	**42,140**	**18,303**	**16,921**	**124**
EQUITY (including revaluation surplus)	**10,831**	**9,632**	**10,266**	**9,958**	**9,984**
Total Liabilities & Equity	**63,197**	**51,771**	**28,569**	**26,879**	**10,108**

INCOME STATEMENT	31-Mar-18	31-Dec-17	31-Dec-16	31-Dec-15	31-Dec-15
	1Q	CY17	CY16	CY15	CY15
Profit / Return Earned	725	2,061	1,527	376	155
Return Expensed	(399)	(1,006)	(577)	(101)	(0)
Net Revenue	**326**	**1,055**	**950**	**275**	**155**
Other Income	69	439	259	25	11
Total Revenue	**395**	**1,494**	**1,209**	**300**	**166**
Admin and Other Expenses	(464)	(1,845)	(1,190)	(203)	(113)
Pre-provision operating profit	(69)	(351)	20	98	53
Provisions	(0)	0	94	(40)	-
Pre-tax profit	(70)	(351)	114	58	53
Taxes	24	88	(34)	(5)	(5)
Net Income	**(45)**	**(263)**	**80**	**52**	**48**

Ratio Analysis					
Performance					
ROE	-1.7% *	-2.6%	0.8%	2.1%	1.9%
Cost-to-Total Net Revenue	118.4%	124.4%	99.3%	67.7%	68.1%
Provision Expense / Pre Provision Profit	-0.6%	0.0%	-474.6%	40.9%	0.0%
Capital Adequacy					
Equity/Total Assets	17.4%	19.0%	35.3%	37.2%	99.0%
Capital Adequacy Ratio as per SBP	19.5%	23.8%	39.7%	46.4%	182.4%
Funding & Liquidity					
Liquid Assets / Deposits and Borrowings	35.5%	37.5%	58.7%	109.0%	na
Advances / Deposits	112.1%	96.3%	113.3%	132.0%	na
CASA deposits / Total Customer Deposits	93.1%	83.0%	67.3%	55.6%	100.0%
Intermediation Efficiency					
Asset Yield	5.9% *	6.1%	6.4%	6.2%	6.8%
Cost of Funds	3.5% *	3.5%	4.2%	2.0%	0.6%
Spread	2.4% *	2.7%	2.1%	4.2%	6.2%
Outreach					
Branches	76	76	66	40	6

Annualized*

Rating Team Statements
(1) Rating is just an opinion about the creditworthiness of the entity and does not constitute recommendation to buy, hold or sell any security of the entity rated or to buy, hold or sell the security rated, as the case may be | Chapter III; 14-3-(x)

2) **Conflict of Interest**
i. The Rating Team or any of their family members have no interest in this rating | Chapter III; 12-2-(j)
ii. PACRA, the analysts involved in the rating process and members of its rating committee, and their family members, do not have any conflict of interest relating to the rating done by them | Chapter III; 12-2-(e) & (k)
iii. The analyst is not a substantial shareholder of the customer being rated by PACRA [Annexure F; d-(ii)] Explanation: for the purpose of above clause, the term "family members" shall include only those family members who are dependent on the analyst and members of the rating committee

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(4) PACRA does not disclose or discuss with outside parties or make improper use of the non-public information which has come to its knowledge during business relationship with the customer | Chapter III; 10-7-(d)
(5) PACRA does not make proposals or recommendations regarding the activities of rated entities that could impact a credit rating of entity subject to rating | Chapter III; 10-7-(k)

Conduct of Business
(6) PACRA fulfills its obligations in a fair, efficient, transparent and ethical manner and renders high standards of services in performing its functions and obligations; | Chapter III; 11-A-(a)
(7) PACRA uses due care in preparation of this Rating Report. Our information has been obtained from sources we consider to be reliable but its accuracy or completeness is not guaranteed. PACRA does not, in every instance, independently verifies or validates information received in the rating process or in preparing this Rating Report.
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(12) PACRA receives compensation from the entity being rated or any third party for the rating services it offers. The receipt of this compensation has no influence on PACRA´s opinions or other analytical processes. In all instances, PACRA is committed to preserving the objectivity, integrity and independence of its ratings. Our relationship is governed by two distinct mandates i) rating mandate - signed with the entity being rated or issuer of the debt instrument, and fee mandate - signed with the payer, which can be different from the entity
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(19) PACRA reviews all the outstanding ratings on semi-annual basis or as and when required by any creditor or upon the occurrence of such an event which requires to do so; | Chapter III | 18-(b)
(20) PACRA initiates immediate review of the outstanding rating upon becoming aware of any information that may reasonably be expected to result in downgrading of the rating; | Chapter III | 18-(c)
(21) PACRA engages with the issuer and the debt securities trustee, to remain updated on all information pertaining to the rating of the entity/instrument; | Chapter III | 18-(d)
Probability of Default
(22) PACRA´s Rating Scale reflects the expectation of credit risk. The highest rating has the lowest relative likelihood of default (i.e, probability). PACRA´s transition studies capture the historical performance behavior of a specific rating notch. Transition behavior of the assigned rating can be obtained from PACRA´s Transition Study available at our website. (www.pacra.com). However, actual transition of rating may not follow the pattern observed in the past | Chapter III | 14-(f-VII)
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Rating Scale

Credit Rating Scale & Definitions

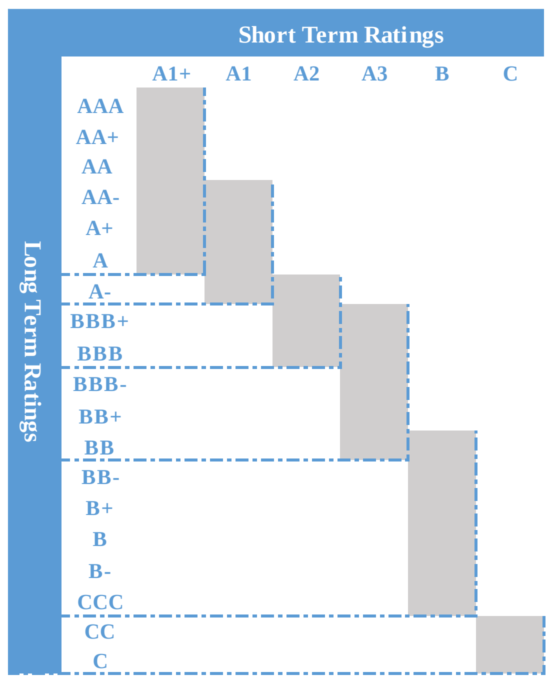
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long Term Ratings

AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Short Term Ratings

A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.
B	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.
C	An inadequate capacity to ensure timely repayment.



Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch Alerts to the possibility of a rating change subsequent to, or in anticipation of, a) some material identifiable event and/or b) deviation from expected trend. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating Watch may accompany Outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, e) the entity/issuer defaults., or/and f) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.