The Pakistan Credit Rating Agency Limited

# Rating Report

## FINCA Microfinance Bank Limited

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| Rating History | | | | | |
|---|---|---|---|---|---|
| Dissemination Date | Long Term Rating | Short Term Rating | Outlook | Action | Rating Watch |
| 06-Nov-2018 | A | A1 | Stable | Maintain | - |
| 30-Apr-2018 | A | A1 | Stable | Maintain | - |
| 30-Dec-2017 | A | A1 | Stable | Maintain | - |
| 30-Jun-2017 | A | A1 | Stable | Initial | - |

### Rating Rationale and Key Rating Drivers

The ratings reflect association of the bank with a global microfinance organization – FINCA International. This affiliation supports FINCA Microfinance Bank in terms of building a wholesome strategy and also in establishing robust systems and controls. FINCA is a mid-tier player in Pakistan’s microfinance sector (June'18: ~7% share in total gross loan portfolio and ~10% share in total microfinance deposits). The bank intends to build a stable and diverse deposit base. Given that the current deposit landscape is very competitive, building a granular (as well as low cost) deposit base is challenging. To achieve the stated objective the bank optimizes on increasing its branchless banking (BB) business. The bank is eyeing tier II capital in the form of subordinated loan to strengthen its capital base. Liquidity profile remained relatively stretched. FINCA's paramount focus remains on digitizing its operations and strengthening its technological infrastructure to expand its outreach. In this regard, the bank is upgrading its MIS and developing variant digital products to serve diversified market segments, including corporates. Digital banking mix is currently small. Asset health dwindled slightly to ~1.4%. Strong banking practices with extended branch network acclaims FINCA’s efforts to provide long term solutions to their customers.

The ratings are dependent upon the bank's ability to sustain its profitability while building up market position. Successful establishment of foothold in digital banking remains critical amidst stiff competition.

| Disclosure | |
|---|---|
| **Name of Rated Entity** | FINCA Microfinance Bank Limited |
| **Type of Relationship** | Solicited |
| **Purpose of the Rating** | Entity Rating |
| **Applicable Criteria** | Methodology \| Criteria \| Rating Modifier(Jun-18),Methodology \| Correlation Between Long-Term And Short-Term Rating Scale(Jun-18),Methodology \| MFI (Jun-18) |
| **Related Research** | Sector Study \| Microfinance Bank(Apr-18) |
| **Rating Analysts** | Nadeem Sheikh \| nadeem.sheikh@pacra.com \| +92-42-35869504 |

## Profile

**Structure** FINCA Microfinance Bank Limited ("the Bank") was incorporated as a public unlisted company in June, 2008, under section 32 of the Companies Ordinance, 1984 (now Companies Act, 2017). The Bank commenced operations in 2013. The bank operates with a nationwide network of 120 branches.

**Background** Initially, Kashf Foundation established the bank in 2008 and sold its majority stake to FINCA International in 2013.

**Operations** The bank offers a diversified range of financial products and services to low income wage earners as well as the self-employed community. Micro-lending products include (i) FINCA Karobari Karza – the premier lending product of FINCA Microfinance Bank (ii) FINCA Izafi Karza (iii) FINCA Kashtkar Kazra (only for farmers) (iv) FINCA Maweshi Karza (Livestock) & (v) FINCA Sonehri Karza (Gold-backed loans). The bank is also establishing its foothold in branchless banking operations.

## Ownership

**Ownership Structure** The bank is majorly owned by FINCA Microfinance Cooperatief U.A. (~86.4%), followed by Kashf Holding (Pvt) Ltd (~5.2%), International Finance Corporation (IFC) (~4.9%), Triodos Fair Share Fund (~2.7%) and Acumen Fund Pakistan (~0.8%).

**Stability** Simplified shareholding with one major shareholder represents a stable structure.

**Business Acumen** Based in Amsterdam – FINCA Microfinance Cooperatief U.A. operates as a subsidiary of FINCA International, Inc. FINCA International, a not-for-profit organization located in Washington D.C., is a founder of 21 microfinance institutions across the globe.

**Financial Strength** Financial muscle of the sponsors is deemed strong.

## Governance

**Board Structure** The Board comprises nine directors, including five representatives of FINCA International, one is representative of minority shareholders and three independent directors.

**Members' Profile** Most of the board members have international exposure and carry diversified expertise. They have been associated with microfinance industry since long.

**Board Effectiveness** The Board of Directors has four committees for oversight of responsibilities namely (i) HR Committee (ii) Risk Management Committee (iii) Audit Committee & (iv) Digital Financial Services (DFS) Committee – the DFS Committee is precisely formed to oversee operations and progress in the digital banking domain.

**Financial Transparency** The Audit Committee of the bank is headed by an independent director. The internal audit department directly reports to the Audit Committee ensuring independence from the rest of the organization. M/S KPMG Taseer Hadi & Co. Chartered Accountants are the External Auditors of the bank.

## Management

**Organizational Structure** FINCA Microfinance Bank has a horizontally spread organizational structure comprising of fourteen departments. A total of eight department heads, other than CFO and COO, report directly to the CEO, while performance of four departments is entirely overseen by the COO and one by the CFO.

**Management Team** Mr. Mudassar Aqil is the CEO of the bank since 2011. Mr. Aqil has ~20 years of experience in the banking and finance industry. Before joining FINCA, he was associated with a leading commercial bank in Pakistan. The CEO is assisted by an experienced management team.

**Effectiveness** Four Management Committees are in place namely i) Board Management, ii) Asset Liability Management (ALCO) iii) Risk, and iv) IT steering to ensure operational efficiency and efficient decision making.

**MIS** To support the timely decision making of management, MIS system generates detailed reports containing details regarding disbursement, repayment, recoveries, deposits and compliance.

**Risk Management Framework** The bank has in place a separate Risk Management department to oversee various risks including credit, operational, IT and market risks. Risk Management Committee meets on a regular basis to ensure that the risk profile of the bank remains within BoD's approved limit.

**Technology Infrastructure** Recently, management has taken numerous steps towards digitizing its processes. The management aims to scale up the IT infrastructure for future business growth and network expansion. All branches are expected to be migrated to the new technology of Autosoft software by March'19.

## Business Risk

**Industry Dynamics** Pakistan Microfinance Industry comprises of 44 microfinance providers including 11 Microfinance Banks (MFBs), 17 Microfinance Institutions (MFIs), 7 Rural Support Program (RSPs) and 9 others projects. Microfinance banks dominate the industry with a share in Gross Loan Portfolio of ~68%.

**Relative Position** The bank catered ~7% borrowers of MFB market as at End-June'18, grabbing a ~7% market share in terms of Gross Loan Portfolio which stood at PKR~17,083mln as at End-June'18 (End-Dec'17: PKR~15,110mln) recording a growth of ~13% period-on-period. Simultaneously, the bank secured a share of ~10% in total MFBs deposits as at End-June'18.

**Revenue** During the period under review, the bank's total operating income increased to PKR~2,475mln with a growth of ~28% YOY basis (1HCY17: PKR~1,932mln). The gain is attributed to increase in Net Interest/ Markup Revenue which hiked by ~31% on the backdrop of increased advances.

**Profitability** The bank's earning assets remained relatively stable at ~85% of total asset as at End-June-18 . Due to effective management of advances, the bank manged to sustain its spread at ~19% as at End-June'18 (~20% End-Dec'17). Bottomline clocked in at PKR~461mln, depicting good translation of the topline. The bank's branchless banking domain is currently cost exhaustive where it is gradually building up its pace.

**Sustainability** The bank aims to maintain its status as a "Premier" microfinance bank in the country by concentrating on providing best customer services. Branchless banking and digital services remain to be the key driving factors on the bank's growth. The bank's flagship product SIMSIM is growing rapidly and has reached ~282,000 individuals subscribers till now. Currently, the bank is gearing up on developing mobile-wallet platform for customers that can be retained for long term. These include as well as corporates to which customized services such as salary transfer facility are provided.

## Financial Risk

**Credit Risk** Gross Loan Portfolio (GLP) recorded at PKR~17,083mln as on End-June'18. The Bank's loan book is primarily concentrated in non-collateralized loans. Gold backed loan portfolio accounts for ~2% of the total loan book. Advances continued to be dominated by Agri Input Loan (End-June'18: ~43%), followed by Livestock Loan (End-June18: ~29%), and Enterprise Loan (End-June18: ~27%). Write-offs during the period were recorded at PKR ~177mln. Infection ratio settled at ~1.4%.

**Market Risk** The bank's investment portfolio constituted ~19% of bank's total assets at End-June'18 (End-Dec'17: ~21%). Investments solely comprise Market Treasury Bills, limiting the market risk. The shorter duration of T-Bills implies likely hedge against interest rate volatility while providing liquidity support to the bank, and to match its duration to its deposits (liabilities).

**Funding** The bank's advances to deposit ratio (ADR) stood at ~81% at End-June'18. Total deposits of the bank clocked in at PKR~21,045mln. The Bank's deposits are majorly concentrated in fixed deposits which comprise of ~67% of total deposits.

**Liquidity** Liquidity profile remained stretched as liquid-assets-to-deposits and borrowings (liquidity ratio) stood at ~35% at End-June'18 (End-Dec'17: ~37%).

**Capital Adequacy** The Capital Adequacy Ratio (CAR) of the bank remained relatively stable at ~18.3%, though depicting a downward trend at at End-June'18 (End-Dec'17: 18.58%), above the minimum requirement of State Bank of Pakistan i.e ~15%. The bank strategizes on securing a subordinated loan in CY19 to keep its CAR intact.

**FINCA MICROFINANCE BANK LIMITED**

PKR mln

| BALANCE SHEET | 30-Jun-18 | 31-Dec-17 | 31-Dec-16 | 31-Dec-15 |
|---|---|---|---|---|
| | 6M | Annual | Annual | Annual |
| **Earning Assets** | | | | |
| Total Finances | 16,846 | 14,886 | 10,094 | 5,352 |
| Investments | 5,464 | 5,209 | 1,885 | 1,039 |
| Deposits with Banks | 1,616 | 1,557 | 1,248 | 410 |
| | **23,926** | **21,652** | **13,228** | **6,802** |
| **Non Earning Assets** | | | | |
| Non-Earning Cash | 1,060 | 976 | 810 | 357 |
| Net Non-Performing Finances | (9) | (23) | (12) | 66 |
| Fixed Assets & Others | 3,204 | 2,536 | 1,592 | 1,227 |
| | **4,255** | **3,490** | **2,390** | **1,650** |
| **TOTAL ASSETS** | **28,181** | **25,142** | **15,618** | **8,452** |
| **Interest Bearing Liabilities** | | | | |
| **Deposits** | | | | |
| CASA | 6,918 | 5,717 | 3,394 | 2,136 |
| Time Deposits | 14,127 | 13,467 | 7,675 | 3,921 |
| | **21,045** | **19,184** | **11,070** | **6,057** |
| **Borrowings** | 1,902 | 1,669 | 1,350 | 115 |
| **Non Interest Bearing Liabilities** | 1,489 | 1,006 | 766 | 346 |
| **TOTAL LIABILITIES** | **24,436** | **21,859** | **13,185** | **6,518** |
| **EQUITY (including revaluation surplus)** | 3,739 | 3,275 | 2,420 | 1,915 |
| **Deferred Grants** | 6 | 8 | 13 | 18 |
| **TOTAL LIABILITIES & EQUITY** | **28,181** | **25,142** | **15,618** | **8,452** |

| INCOME STATEMENT | 30-Jun-18 | 31-Dec-17 | 31-Dec-16 | 31-Dec-15 |
|---|---|---|---|---|
| | 6M | Annual | Annual | Annual |
| Interest / Mark up Earned | 3,018 | 4,809 | 2,986 | 1,900 |
| Interest / Mark up Expensed | (831) | (1,256) | (648) | (535) |
| **Net Interest / Markup revenue** | **2,188** | **3,553** | **2,338** | **1,365** |
| Other Operating Income | 288 | 564 | 441 | 283 |
| **Total Revenue** | **2,475** | **4,117** | **2,780** | **1,648** |
| Other Income | 47 | 129 | 110 | 43 |
| Non-Interest / Non-Mark up Expensed | (1,620) | (2,461) | (1,683) | (1,340) |
| Pre-provision operating profit | 902 | 1,785 | 1,207 | 351 |
| Provisions | (176) | (407) | (219) | (106) |
| Pre-tax profit | 726 | 1,378 | 988 | 245 |
| Taxes | (265) | (523) | (357) | (79) |
| **NET INCOME** | **461** | **855** | **631** | **167** |

| Ratio Analysis | 30-Jun-18 | 31-Dec-17 | 31-Dec-16 | 31-Dec-15 |
|---|---|---|---|---|
| **Performance** | 6M | Annual | Annual | Annual |
| ROE | 26% | 30% | 29% | 10% |
| Cost-to-Total Net Revenue | 64% | 58% | 58% | 79% |
| **Capital Adequacy** | | | | |
| Equity/Total Assets | 13% | 13% | 15% | 23% |
| Capital Adequacy Ratio as per SBP | 18% | 19% | 21% | 30% |
| **Loan Loss Coverage** | | | | |
| Impaired Lending / Gross Finances | 1% | 1% | 1% | 2% |
| Loan Loss Provisions / Non-Performing Advances | 104% | 110% | 110% | 48% |
| **Funding & Liquidity** | | | | |
| Liquid Assets / Deposits and Borrowings | 35% | 37% | 32% | 29% |
| Finances / Deposits | 80% | 77% | 91% | 89% |
| CASA deposits / Total Customer Deposits | 33% | 30% | 31% | 35% |
| **Intermediation Efficiency** | | | | |
| Asset Yield | 26% | 28% | 30% | 32% |
| Cost of Funds | 8% | 8% | 7% | 10% |
| Spread | 19% | 20% | 23% | 22% |

# 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.

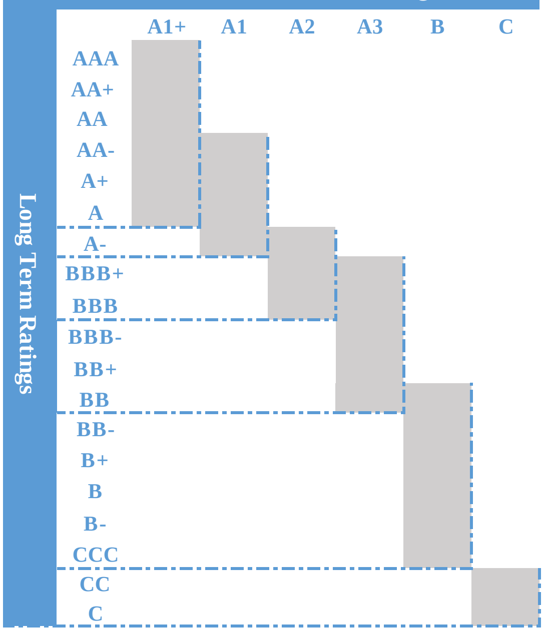
### Long Term Ratings

| | |
|---|---|
| AAA | **Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments |
| AA+<br>AA<br>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+<br>A<br>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+<br>BBB<br>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+<br>BB<br>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+<br>B<br>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<br>CC<br>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. |

### Short Term Ratings




**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.

**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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(9) PACRA ensures before commencement of the rating process that an analyst or employee has not had a recent employment or other significant business or personal relationship with the rated entity that may cause or may be perceived as causing a conflict of interest; | Chapter III; 11-A-(r)
(10) PACRA maintains principal of integrity in seeking rating business | Chapter III; 11-A-(u)
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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
(13) PACRA does not provide consultancy/advisory services or other services to any of its customers or to any of its customers’ associated companies and associated undertakings that is being rated or has been rated by it during the preceding three years unless it has adequate mechanism in place ensuring that provision of such services does not lead to a conflict of interest situation with its rating activities; | Chapter III; 12-2-(d)
(14) PACRA discloses that no shareholder directly or indirectly holding 10% or more of the share capital of PACRA also holds directly or indirectly 10% or more of the share capital of the entity which is subject to rating or the entity which issued the instrument subject to rating by PACRA; | Reference Chapter III; 12-2-(f)
(15) PACRA ensures that the rating assigned to an entity or instrument is not be affected by the existence of a business relationship between PACRA and the entity or any other party, or the non-existence of such a relationship | Chapter III; 12-2-(i)
(16) PACRA ensures that the analysts or any of their family members shall not buy or sell or engage in any transaction in any security which falls in the analyst’s area of primary analytical responsibility. This clause shall, however, not be applicable on investment in securities through collective investment schemes. | Chapter III; 12-2-(l)
(17) PACRA has established policies and procedure governing investments and trading in securities by its employees and for monitoring the same to prevent insider trading, market manipulation or any other market abuse | Chapter III; 11-B-(g)

**Monitoring and review**
(18) PACRA monitors all the outstanding ratings continuously and any potential change therein due to any event associated with the issuer, the security arrangement, the industry etc., is disseminated to the market, immediately and in effective manner, after appropriate consultation with the entity/issuer; | Chapter III | 18-(a)
(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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