The Pakistan Credit Rating Agency Limited

Rating Report

FINCA Microfinance Bank Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
	A	A1	Stable	Maintain	-
29-Apr-2019	A	A1	Stable	Maintain	-
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 (End-Jun'19: ~11% share in total gross loan portfolio (GLP) and ~10% share in total microfinance deposits). The bank intends to build a stable and diverse deposit base. However, given the current business scenario, FINCA has also availed borrowings from SBP, under the line of credit (LoC) arrangement, to underpin its funding needs. The bank's liquidity profile, net of borrowings, reflects a stretch. FINCA's current paramount focus is pivoted around boosting its Capital Adequacy, which hovers near the benchmark. Resultantly, room to grow in GLP is squeezed. Augmentation of the same is desirable to create room for sustainable growth. The bank has stepped into the digital banking domain, however, the mix is currently small. Asset health impairment has risen to ~2.3% at End-Jun'19 (End-Dec'18: 1.9%). Average loan size of the bank is on the higher side in relation to its peers, which needs to be in check amidst rising industry's infection ratio. The bank's GLP has witnessed a dip in its growth pace, owing to overall market conditions, coupled with its efforts to keep its CAR above the benchmark.

The ratings are dependent upon the bank's ability to uphold its business profile amidst the changing market environment. Maintenance of asset quality is pertinent. Meanwhile, improved net liquidity profile remains imperative.

Disclosure

Name of Rated Entity	FINCA Microfinance Bank Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | MFI (Jun-19)
Related Research	Sector Study | Microfinance(Sep-19)
Rating Analysts	Muhammad Usman | muhammad.usman@pacra.com | +92-42-35869504

Profile

Structure FINCA Microfinance Bank Limited (herein referred to as "FINCA" or "the bank") was incorporated as a public unlisted company in June, 2008, under section 32 of the Companies Ordinance, 1984 (now the Companies Act, 2017). The bank operates with a nationwide network of over 135 branches.

Background Initially, Kashf Holdings (Pvt.) Ltd. established the bank in 2008. FINCA International acquired majority stake in the bank, through dilution of Kashf Holdings' shareholding in the year 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, in which it is at an initial stage.

Ownership

Ownership Structure The bank is majorly owned by FINCA Microfinance Cooperatief U.A. (~86.4%), followed by Kashf Holdings (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 considered strong.

Governance

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

Members' Profile Most of the board members have international exposure and carry diversified expertise. They have been associated with the 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 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. Farid Ahmed Khan joined the bank as CEO in Sep'19, replacing Mr. Mudassar Aqil. He is a seasoned financial services veteran, having 25 years of global experience in financial services, including fund management, investment banking, investment research, business development and project finance. Before joining FINCA, he was associated with the asset management wing of 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 Committee, 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 have migrated to the new technology of Autosoft software.

Business Risk

Industry Dynamics Pakistan Microfinance Industry comprises 41 microfinance providers including 11 Microfinance Banks (MFBs), 15 Microfinance Institutions (MFIs), 6 Rural Support Programmes (RSPs) and 9 other projects. MFBs dominate the Industry with a share in lending portfolio of ~70%. The total Gross Loan Portfolio of MFBs amounts to PKR ~206,003mln, recording a meagre growth of ~9% during the period.

Relative Position The bank catered ~7% borrowers of MFBs market as at End-1HCY19, grabbing an ~11% market share in terms of Gross Loan Portfolio which stood at PKR~22,048mln as at End-1HCY19 (End-CY18: PKR~20,868mln) recording a biannual growth of ~6%. Simultaneously, the bank secured a share of ~10% in total deposits of MFBs, as at End-1HCY19.

Revenue Interest/Mark up income of the bank increased to PKR~4,045mln during 1HCY19 (1HCY18:PKR~3,018mln), a growth of ~34% YoY. During the period, the bank increased its portion of Livestock lending in total advances, while the ratio of Agri-Input loans declined in relation to previous periods.

Profitability Net interest mark up income increased to PKR~2,778mln during 1HCY19 (1HCY18: PKR~2,188mln), a period on period growth of ~27%. However, the net income of the bank decreased to PKR~387mln (1HCY18: PKR~461mln), owing to high administrative costs, mostly relating to the mobile money platform, SIMSIM.

Sustainability Digital services remain to be the key driving factors on the bank's growth, although the branchless banking operations are still at an infancy stage. The bank's flagship product SIMSIM is growing steadily and has reached over ~350,000 subscribers till date. The growth of the gross loan portfolio has dwindled slightly, in the recent past, as a result of the macroeconomic conditions in the country. The low Capital Adequacy Ratio of FINCA, has also had an affect on the growth of the bank.

Financial Risk

Credit Risk The Bank's loan book is primarily concentrated in non-collateralized loans while represents a fairly diversified product segmentation in agri-input loans (~37%), followed by Livestock Loan (~35%) and Micro-Enterprise loan (~26%). During the period under review, the bank's NPLs ratio rose to ~2.3% (End-CY18: ~1.9%). The bank has written off advances of PKR~371mln during 1HCY19 (CY18: PKR~394mln).

Market Risk Short term investments as at 1HCY19 increased significantly to PKR~7,845mln (End-CY18: PKR~3,827mln). The addition majorly consisted of investment in government securities, which shall prove to be beneficial with respect to the Capital Adequacy Ratio of FINCA.

Funding The bank's funding is majorly fueled through deposits (~81%) with some portion from borrowings (~19%). Deposit base primarily consisted of time deposits (~71%), out of the total amounting to PKR~24,852mln (End-CY18: PKR~23,742). The bank's advances-to-deposit ratio (ADR) stayed consistent at 87%.

Liquidity Liquidity profile increased during the period under review as the bank's liquid assets-to-deposits and borrowings ratio rose to ~34% at End-1HCY19 (End-CY18: ~29%). A rise in the investment in government securities led to a increase in liquid assets on an overall basis.

Capital Adequacy Capital Adequacy ratio (CAR) stayed consistent at ~16% as at End-1HCY19 (End-CY18:~16%). CAR, though above the SBP's defined threshold in Prudential Regulations, remained on the edge necessitating an immediate action to prevent further decline. The management is, therefore in the process of raising Tier-II capital in the form of subordinated loan to keep the CAR intact.

FINCA MICROFINANCE BANK LIMITED

PKR mln

BALANCE SHEET	30-Jun-19	31-Dec-18	31-Dec-17	31-Dec-16
	Annual	Annual	Annual	Annual
Earning Assets				
Total Finances	21,539	20,477	14,886	10,094
Investments	7,845	3,827	5,209	1,885
Deposits with Banks	413	2,489	1,557	1,248
	29,797	**26,794**	**21,652**	**13,228**
Non Earning Assets				
Non-Earning Cash	2,127	1,639	976	810
Net Non-Performing Finances	175	104	(23)	(12)
Fixed Assets & Others	6,335	3,743	2,536	1,592
	8,637	**5,486**	**3,490**	**2,390**
TOTAL ASSETS	**38,434**	**32,280**	**25,142**	**15,618**
Interest Bearning Liabilities				
Deposits				
CASA	7,167	7,052	5,717	3,394
Time Deposits	17,685	16,690	13,467	7,675
	24,852	**23,742**	**19,184**	**11,070**
Borrowings	5,908	3,319	1,669	1,350
Non Interest Bearing Liabilities	3,248	1,187	1,006	766
TOTAL LIABILITIES	**34,008**	**28,247**	**21,859**	**13,185**
EQUITY (including revaluation surplus)	4,426	4,030	3,275	2,420
Deferred Grants	1	2	8	13
TOTAL LIABILITIES & EQUITY	**38,434**	**32,280**	**25,142**	**15,618**

INCOME STATEMENT	30-Jun-19	31-Dec-18	31-Dec-17	31-Dec-16
	Annual	Annual	Annual	Annual
Interest / Mark up Earned	4,046	6,531	4,809	2,986
Interest / Mark up Expensed	(1,268)	(1,828)	(1,256)	(648)
Net Interest / Markup revenue	**2,778**	**4,703**	**3,553**	**2,338**
Other Operating Income	367	676	564	441
Total Revenue	**3,145**	**5,379**	**4,117**	**2,780**
Other Income	73	126	129	110
Non-Interest / Non-Mark up Expensed	(2,062)	(3,490)	(2,461)	(1,683)
Pre-provision operating profit	1,156	2,015	1,785	1,207
Provisions	(416)	(435)	(407)	(219)
Pre-tax profit	740	1,580	1,378	988
Taxes	(352)	(623)	(523)	(357)
NET INCOME	**387**	**956**	**855**	**631**

Ratio Analysis	30-Jun-19	31-Dec-18	31-Dec-17	31-Dec-16
Performance	Annual	Annual	Annual	Annual
ROE	20%	26%	30%	29%
Cost-to-Total Net Revenue	64%	63%	58%	58%
Capital Adequacy				
Equity/Total Assets	12%	12%	13%	15%
Capital Adequacy Ratio as per SBP	16%	16%	19%	21%
Loan Loss Coverage				
Impaired Lending / Gross Finances	2%	2%	1%	1%
Loan Loss Provisions / Non-Performing Advances	66%	74%	110%	110%
Funding & Liquidity				
Liquid Assets / Deposits and Borrowings	34%	29%	37%	32%
Finances / Deposits	87%	87%	77%	91%
CASA deposits / Total Customer Deposits	29%	30%	30%	31%
Intermediation Efficiency				
Asset Yield	31%	27%	28%	30%
Cost of Funds	10%	8%	8%	7%
Spread	21%	19%	20%	23%

Rating Scale | Corporate

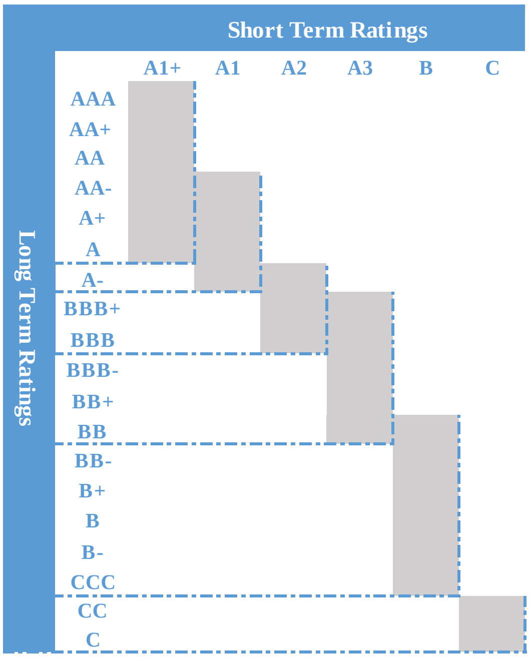
2019

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.

Regulatory and Supplementary Disclosure
(Credit Rating Companies Regulations,2016)

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

Restrictions
(3) No director, officer or employee of PACRA communicates the information, acquired by him for use for rating purposes, to any other person except where required under law to do so. | Chapter III; 10-(5)
(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.
(8) PACRA prohibits its employees and analysts from soliciting money, gifts or favors from anyone with whom PACRA conducts business | Chapter III; 11-A-(q)
(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)
(11) PACRA promptly investigates, in the event of a misconduct or a breach of the policies, procedures and controls, and takes appropriate steps to rectify any weaknesses to prevent any recurrence along with suitable punitive action against the responsible employee(s) | Chapter III; 11-B-(m)

Independence & Conflict of interest
(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)
Proprietary Information