The Pakistan Credit Rating Agency Limited

Rating Report

U Microfinance Bank Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
18-Aug-2020	A	A1	Stable	Initial	YES

Rating Rationale and Key Rating Drivers

The ratings reflect association of U Microfinance Bank (herein referred to as “U Bank” or “the bank”) with Pakistan Telecommunication Company Limited (PTCL), the country's leading Information and Communication Technology Service Provider. This affiliation supports the bank in terms of building a strategic congruence alongside establishing robust systems and controls. U Bank is a mid-tier yet fast growing player in the Microfinance Sector (End-Dec'19: 7.2% market share in total Gross Loan Portfolio (GLP) and 8.7% share in total microfinance deposits). The bank's ambitious growth strategy encompasses multi-faceted targets focused towards achieving growth in the retail banking segment, developing digital banking platform and building a wholesome treasury book. Expansion on the conventional front is pillared on geographical penetration by way of increasing the bank's branch network; though, this uplifts the operating costs of the bank, it is also paving its way to the top five Microfinance Banks of the country in terms of GLP. On the contrary, the bank's digital segment is yet to progress a long way to mark its presence in the competitive landscape; the mix is currently small. The bank's funding needs are primarily fostered through a growing deposit base, coupled with sizable borrowings. Sponsor support is reflected by way of subordinated debt intended to be convertible to Tier-I capital, in order to keep capital adequacy in check. The bank's credit quality remains aligned to the Industry, which has recently deteriorated on account of pressured macro-economic indicators, particularly on account of COVID-19 outbreak and its rippling impact on various economic sectors. Asset impairment ratio rose to 4.1% at End-Dec’19 (End-Dec'18: 1.3%), which necessitates cautious management approach. Profitability concerns may plague the bank in the short term owing to its designed business model. 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 infection ratio. The bank's product mix mainly comprises livestock (61%) and agriculture lending (26%), consisting of "bullet repayments" depicting concentration risk. As the nationwide lockdown has triggered risks of reduced recovery and disbursements in the sector, the bank is developing proactive strategies to shield its business profile from unforeseen challenges, including secured lending. While the SBP's Relief Scheme has alleviated short term credit quality concerns, the out-turn of the situation, and its relative impact on the industry players, including U MFB, is yet to unfold in the short horizon.

The ratings are dependent upon the bank’s ability to aptly combat the emerging risks under the current scenario in order to keep its business and financial risk profile intact. Meanwhile, the Ratings are also placed under “Watch” to reflect the need for overseeing the risk profile of the bank against unavoidable challenges.

Disclosure	
Name of Rated Entity	U Microfinance Bank Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | MFI (Jun-20),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-20),Criteria | Rating Modifier(Jun-20)
Related Research	Sector Study | Microfinance(Sep-19)
Rating Analysts	Jibran Cheema | jibran.cheema@pacra.com | +92-42-35869504

Profile

Structure U Microfinance Bank Limited (herein referred to as "U Bank" or "the bank") has been incorporated, under section 32 of the Companies Ordinance, 1984 (now Companies Act, 2017). In the year 2013, the bank was granted license by SBP for commencement of nationwide operations.

Background Rozgar Microfinance bank Ltd was established in 2003, as a district wide microfinance bank, operating in Karachi. In the year 2012, Pakistan Telecommunication Company Limited (PTCL) acquired 100% of its shareholding. Henceforth, its name was changed to U Microfinance Bank Limited.

Operations The bank has a network of ~212 branches, across 183 cities in Pakistan, while the head office is situated in Islamabad. The lending portfolio is dominated by livestock (61%) and agriculture (26%) lending. The bank is also establishing its foothold in BB operations via its mobile wallet, UPaisa.

Ownership

Ownership Structure The bank is a wholly owned subsidiary of PTCL, which is co-owned by the Government of Pakistan (62%) and Etisalat International Pakistan (LLC) (26%) (Etisalat), a state owned Telecom Corporation of UAE. Management control of PTCL rests with Etisalat.

Stability The ownership structure of the bank has not changed since it was acquired by PTCL, in 2012. Stable ownership and sovereign support of the Government of Pakistan, complimented by the technical and financial prowess of a global tech giant, bodes well for the future stability of the bank.

Business Acumen PTCL, the backbone for the country's telecommunication infrastructure, is the market leader in providing telephone and internet services nationwide. The Etisalat Group is one of the world's leading telecom groups, which operates in ~16 countries across the Middle East, Asia and Africa.

Financial Strength PTCL has been assigned credit ratings of AAA/A-1+ by VIS (Oct'19). The sponsor's ability to support the bank can be gauged, with substantial subordinated lending to the bank. Etisalat Group enjoys credit ratings of AA-/Stable (Jun'19) and Aa3/Stable (Jun'19) by S&P Global and Moody's, respectively.

Governance

Board Structure The Board of U Bank consists of eight directors, comprising representatives of PTCL, along with two independent directors.

Members' Profile Mr. Mohammad Nadeem Khan, the acting Chairman of the Board, has over 25 years of experience in the industry. He has been serving as the CFO of PTCL and Ufone, since the year 2003.

Board Effectiveness The Board is sub-divided into five committees for oversight of responsibilities. These comprise the (i) HR Committee (ii) Risk Management Committee (iii) Audit Committee (iv) IT Committee and (v) Finance Committee.

Financial Transparency M/S KPMG Taseer Hadi & Co. Chartered Accountants, one of the 'Big 4' audit firms, are the external auditors of the bank. An unqualified audit opinion was expressed on the financial statements for the year ended Dec'19. The internal audit department reports directly to the Audit Committee, ensuring independence.

Management

Organizational Structure U Bank has a horizontally spread organizational structure comprising nine departments. All department heads, other than in case of internal audit, report directly to the CEO.

Management Team The President and CEO, Mr. Kabeer Naqvi, has 20 years of professional experience to his name and has been with the bank, since Sep'15. Mr. Naqvi is a member of ACCA. He is a part of the Board of Directors at Pakistan Microfinance Network and also chairs its audit committee.

Effectiveness The bank has designated various management committees to manage and oversee operational efficacy. The committees in operation, comprise the following; (i) Asset Liability Committee (ii) Finance Committee (iii) IT Steering Committee (iv) Product Committee (v) IFRS 9 Implementation Committee.

MIS The bank has deployed PIBAS for handling the core banking operations which has Visual Basic at the front-end whereas the back-end is Oracle based. The other IT platform is SYBASE-365, for the BB segment. It is a financial services platform which provides an end-to-end solution for mobile commerce businesses.

Risk Management Framework The Risk Management Committee exists to ensure risk profile of the bank remains in check. A risk management manual contains guidelines to help management in improving the internal control environment. Morever, a disaster recovery site is in place in Lahore, located alongside the PTCL data center.

Technology Infrastructure The management aims to scale up the IT infrastructure for future business growth and network expansion. Building on the synergies with Ufone, the has a technological platform, to facilitate BB operations (UPaisa), utility payments, ATM service and G2P payments.

Business Risk

Industry Dynamics Pakistan's Microfinance Industry comprises 38 microfinance providers including 11 Microfinance Banks (MFBs), 17 Microfinance Institutions, 6 Rural Support Programmes and 4 other projects. As at End-Dec'19, the total Gross Loan Portfolio (GLP) of the overall industry amounted to PKR~305,753mln (End-Dec'18: PKR~274,707mln), recording a growth of 11%, on a YoY basis. A recent slump in industry growth is witnessed, amid economic uncertainty. The locust swarms in various parts of Punjab and Sindh is expected to have an impact on the credit health of entities, which have a sizable lending mix in the Agriculture segment. The outbreak of the pandemic Covid-19, has added further uncertainty in the industry, since the consumers are part of a segment, which is deemed to be highly financially vulnerable.

Relative Position The bank catered to 4.3% of the borrowers of the industry as at End-CY19, grabbing a 7.2% market share in terms of GLP, in light of substantial recent growth in the branch network and loan portfolio. Simultaneously, the bank secured a share of 8.7% of total deposits in the industry, as at End-CY19.

Revenue The gross interest income of the bank amounted to PKR~7,266mln during CY19 (CY18: PKR~4,366mln), depicting a substantial YoY growth of 66%. An exorbitant rise in interest expense during the year, limited the growth of Net Interest/Mark up Revenue (NIMR) to 27%, during CY19.

Profitability In CY19, in spite of a rise in NIMR, profitability was dented due to a sharp rise in provisioning and administrative expenses. The rise in administrative costs is a consequence of the expansion in the branch network. Consequently, the net profit during CY19 amounted to PKR~254mln (CY18: PKR~547mln).

Sustainability In light of the safety precautions taken during the global pandemic, the importance of branchless banking, has risen manifold. On the other hand, the effect of Covid-19 will put pressure on the growth prospects, liquidity and future infection of the loan book, of all industry players.

Financial Risk

Credit Risk Infection in the loan portfolio is on the rise, as depicted by impaired lending forming 4.1% of the GLP as at End-CY19 (End-CY18: 1.3%). Product and geographical diversification will bode well in mitigating the credit risk. The GLP of the bank has been part of rising trend (End-CY19: PKR~21,882mln, End-CY18: PKR~17,225mln), which has coincided with an increase in NPLs.

Market Risk The bank's earning assets comprising deposit accounts, call money lending and investments in market treasury bills made up 25% of its total assets, as at End-CY19 (End-CY18: 37%). Investments such as Market Treasury Bills, tend to provide a hedge against interest rate volatility, thus, a fall in such investments has elevated the market risk.

Funding As at End-CY19, the share of deposits in total funding stood at 67%, indicating increasing reliance on borrowing for funding purposes. The bank stands out as the most geared bank, among its peers. The total borrowing as at End-CY19, stood at PKR~11,333mln (End-CY18: PKR~10,628mln). Deposit concentration risk remains a concern, as the top 50 depositors accounted for 54% of the total deposits. Moreover, the bank's advances to deposits ratio (ADR) worryingly rose to 92% (End-CY18: 83%).

Liquidity Liquidity profile deteriorated, as evident by the bank's liquid assets to deposits and borrowings ratio falling to 33% as at End-CY19 (End-CY18: 46%). The weakened liquidity profile is majorly a result of the two-fold effect of a decrease in liquid investments and a rise in borrowings.

Capital Adequacy The CAR of 16.7% as at End-CY19 (End-CY18: 19.1%), reflects a significant stretch. In light of this, PTCL showcased its intent to support the bank, as seen by the conversion of Tier-II Subordinated Debt amounting to PKR 800mln, into equity. Such a move paved the way for a rise in the CAR to 19.6% by End-May'20, to alleviate some pressure on the capital adequacy of the bank.

U Microfinance Bank Limited

BALANCE SHEET	31-Dec-19	31-Dec-18	31-Dec-17
Earning Assets			
Advances	20,984	17,007	10,600
Investments	6,970	1,968	1,786
Deposits with Banks	3,009	11,012	2,579
	30,963	**29,988**	**14,965**
Non Earning Assets			
Non-Earning Cash	1,728	1,472	781
Net Non-Performing Finances	390	13	(46)
Fixed Assets & Others	7,010	3,319	1,931
	9,127	**4,804**	**2,666**
TOTAL ASSETS	**40,090**	**34,792**	**17,631**
Funding			
Deposits	**23,290**	**20,535**	**11,971**
Branch Banking	23,111	20,395	11,817
Branchless Banking	179	140	155
Borrowings	**11,333**	**10,628**	**3,669**
	34,623	**31,163**	**15,641**
Non Interest Bearing Liabilities	2,416	820	611
TOTAL LIABILITIES	**37,039**	**31,983**	**16,252**
EQUITY (including revaluation surplus)	3,051	2,809	1,379
Deferred Grants	-	-	-
Total Liabilities & Equity	**40,090**	**34,792**	**17,631**

INCOME STATEMENT	31-Dec-19	31-Dec-18	31-Dec-17
Interest / Mark up Earned	7,266	4,366	2,645
Interest / Mark up Expensed	(3,843)	(1,676)	(1,152)
Net Interest / Markup revenue	**3,424**	**2,690**	**1,493**
Other Operating Income	900	625	448
Total Revenue	**4,324**	**3,315**	**1,941**
Other Income	39	15	10
Non-Interest / Non-Mark up Expensed	(3,220)	(2,286)	(1,457)
Pre-provision operating profit	1,143	1,044	494
Provisions	(838)	(260)	(86)
Pre-tax profit	304	784	408
Taxes	(51)	(237)	(149)
Net Income	**254**	**547**	**259**

Ratio Analysis	31-Dec-19	31-Dec-18	31-Dec-17
Performance			
ROE	9%	26%	19%
Cost-to-Total Net Revenue	74%	69%	75%
Provision Expense / Pre Provision Profit	73%	25%	17%
Capital Adequacy			
Equity/Total Assets	8%	8%	8%
Capital Adequacy Ratio as per SBP	17%	19%	16%
Non-Performing Advances /Gross Advances	4%	1%	0%
Funding & Liquidity			
Advances / Deposits	92%	83%	88%
CASA deposits / Total Customer Deposits	36%	40%	39%
Intermediation Efficiency			
Asset Yield	24%	19%	18%
Cost of Funds	12%	7%	7%
Spread	12%	12%	10%
Outreach			
Branches	212	141	100

Credit Rating

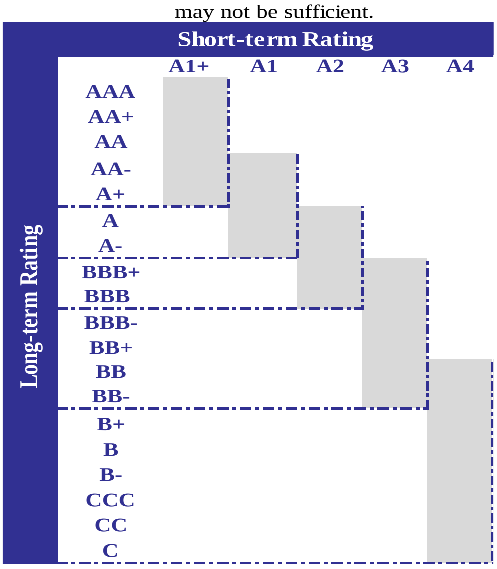
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long-term Rating

Scale	Definition
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 Rating

Scale	Definition
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
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.



The correlation shown is indicative and, in certain cases, may not hold.

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 some material identifiable event with indeterminable rating implications. 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 rating 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) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) 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.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note. This scale is applicable to the following methodology(s):

Entities

a) Broker Entity Rating
b) Corporate Rating
c) Financial Institution Rating
d) Holding Company Rating
e) Independent Power Producer Rating
f) Microfinance Institution Rating
g) Non-Banking Finance Companies (NBFCs) Rating

Instruments

a) Basel III Compliant Debt Instrument Rating
b) Debt Instrument Rating
c) Sukuk Rating

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)
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