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-2021	A	A1	Stable	Maintain	Yes
18-Aug-2020	A	A1	Stable	Initial	Yes

Rating Rationale and Key Rating Drivers

The ratings reflect association of U Microfinance Bank Limited (U 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 fast growing player in the Microfinance Sector (End-Dec'20: 9.3% market share in total Gross Loan Portfolio). The Bank's ambitious growth strategy encompasses multi-faceted targets focused towards achieving growth in the retail banking segment, developing digital banking platform. A sizeable book of GoP securities (end-Mar21: PKR 11,428mln) in the investment portfolio helped in maintaining adequate liquidity. 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. The ratings are constrained by high concentration in deposit base; increased on account of gaining. The recent conversion of PKR 1,000mln into preference shares along with the conversion of Tier-II Subordinated Debt of PKR 800mln into common equity, augmented the capital structure. As of Mar’21, overall CAR of the Bank was reported at 20.9%. The Bank's credit quality remains aligned to the Industry, which has deteriorated on account of pressured macro-economic indicators, particularly on account of COVID-19 outbreak and its rippling impact on various economic sectors. The Bank's product mix mainly comprises livestock and agriculture lending, consisting of "bullet repayments" depicting concentration risk. Almost half of the Bank’s portfolio is gold backed as on Mar'21. Moreover, the Bank has recognized a sizable subjective provision in order to add a further cushion for absorption of expected loan losses. This provides a strong mitigant against potential credit risk.
Under the current scenario, continuity of COVID-19 pandemic (penetration of third wave in Pakistan) will poise challenge to business and asset quality. Though SBP’s Relief Packages have come handy to the sector in protecting the credit quality of the players during the first wave, the out-turn of the situation, and its relative impact on the risk profiles of industry players, including U Bank, is yet to unfold in the days to come.

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-20)
Rating Analysts	Maryam Ijaz | maryam.ijaz@pacra.com | +92-42-35869504

Profile

Structure U Microfinance Bank Limited ("U Bank" or "the Bank") was incorporated, under section 32 of the Companies Ordinance, 1984 (now Companies Act, 2017). The Bank was granted license by SBP for commencement of nationwide operations in 2013.

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

Operations The Bank offers a wide range of microfinance loans, deposit products and branchless banking solutions. It has a network of ~212 branches, across 183 cities and rural areas in Pakistan, while the head office is situated in Islamabad. 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 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. The Group provides U Bank with international expertise and strategic direction through its presence on the Board.

Financial Strength PTCL has been assigned credit ratings of AAA/A-1+ by VIS (Oct'20). 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'20) and Aa3/Stable (Jun'20) by S&P Global and Moody's, respectively.

Governance

Board Structure The Board of U Bank consists of eight directors, comprising representatives of Etisalat, PTCL and Government of Pakistan.

Members' Profile All of the board members have international exposure and carry diversified expertise. Mr. Burak Sevilengul, the Chairman of the Board, has over 24 years of experience.

Board Effectiveness During CY20, four board meetings were held. Attendance of board members in these meetings remained adequate. There are five board committees in place which help the board ineffective oversight of the Bank's overall operations on relevant matters.

Transparency M/S KPMG Taseer Hadi & Co. Chartered Accountants, are the External Auditors of the Bank. An unqualified audit opinion was expressed on the financial statements for the year ended Dec'20. 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. The reporting lines and job descriptions at each level are well defined.

Management Team Mr. Kabeer Naqvi, the President & CEO, has 20 years of professional experience to his name. A team of professionals assist him.

Effectiveness The Bank has formed various committees at the management level for effective and smooth functioning of each business segment.

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 within check. A risk management manual contains guidelines to help management in improving the internal control environment. 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, 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 39 microfinance providers including 12 Microfinance Banks, 17 Microfinance Institutions (MFIs), 6 Rural Support Programmes and 4 other projects. As at end-Dec'20, the total active borrowers of the industry stood at 7.0mln (FY20: 6.9mln), which shows a marginal increase of 1.4%. However, the restrictions are being lifted only in a phased manner and the degree of relaxations vary across regions depending upon the severity of COVID-19 pandemic. The Industry Gross Loan Portfolio (GLP) clocked in at PKR 324,155mln (FY20: PKR 299,948mln). The surge in active borrowers and GLP continues contributed by the MFB peer group, which added over 170,000 clients and over PKR 115,000mln of GLP. The PAR>30 days decreased from 4.8% to 3.7% as the infection ratio for MFBs declined from 5% to 3.3% whereas it increased for the MFIs from 4.2% to 4.9%.

Relative Position The Bank catered to ~4.9% of the borrowers of the industry as at end-Dec20, grabbing a ~9.3% market share in terms of GLP, in light of substantial recent growth in the loan portfolio. Simultaneously, the Bank secured a share of 12.4% of total deposits in the industry, as at end-Dec20.

Revenue During CY20, discount rate registered a steep decrease. Based on the anticipated interest rate movement, the Bank focused on asset base with shorter maturities, resulting in 69.2% increase in net interest income over the year. Income on advances increased by 54.4% to PKR 9,066mln whereas, on investment side, gross markup increased by 62.5% to PKR 490mln. The NIMR in 3MCY21 continued on its upward trajectory, experiencing a growth of 57.5%, compared to the corresponding period.

Profitability During CY20, profit before tax of the Bank witnessed a remarkable growth and was reported at PKR 1,204mln (CY19: PKR 311mln). This is highest profit that Bank has earned since its inception. The Bank's operating expenses increased by 32.9% to PKR 4,271mln (CY19: 3,214mln). The rise in administrative costs is a consequence of expensive resource. Despite significant increase in worker welfare fund and tax expense, the benefit of healthy revenue base helped the Bank in posting healthy profits during 3MCY21.

Sustainability Going forward, U Bank's key focus would be to enhance its lending book mainly through micro credit; though it remains a challenge during the pandemic. 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 U Bank remained the largest contributor in terms of industry's GLP. During the 3MCY21, U Bank's loan portfolio registered a growth of 28.7%, mainly financed through deposits. The Bank's asset quality remained under control and is considered satisfactory; with a slight increase infection ratio stood at 1.2% as at end-Mar21 (end-Dec20: 0.1%). Moreover, borrowers, having aggregate outstanding exposure of PKR 8,500mln, have availed regulatory relief, the risk of increase in credit losses persists. The lending portfolio is dominated by the livestock (38.8%) and agriculture (17.7%) lending.

Market Risk U Bank's investment portfolio comprises 19.0% of total earning assets. At end-Mar21, investments stood at PKR 11,428mln (end-Dec20: PKR 17,954mln), registering 36.3% contraction for the period on account of maturing T-Bills. The investment portfolio remained dominated in government securities (82.5%), thus, a fall in such investments has elevated the market risk.

Funding As at end-Mar21, the share of deposits in total funding stood at 72.7%, indicating increasing reliance on deposits for funding purposes. The total borrowing as at end-Mar21, stood at PKR13,318mln (end-Dec: PKR 17,285mln). Deposit concentration risk remains a concern, as the top 50 depositors accounted for 52.0% of the total deposits. Moreover, the Bank's advances to deposits ratio (ADR) stood at 87.5%.

Liquidity U Bank regularly monitors its liquidity through its Asset and Liability Management Committee (ALCO) and aligns asset-liability mismatch accordingly. The Bank witnessed an improvement in its liquidity profile, as evident by the liquidity ratio improved to 40.0% as at end-Mar21. This is majorly driven by two-fold effect of a increase in liquid investments and a fall in borrowings. Top-20 deposits concentration of the Bank stood at 52.0% as at end-Mar21.

Capital Adequacy With the support of PTCL by conversion of Tier-II subordinated debt of PKR 800mln into equity, the equity of the Bank stood at PKR 5,969mln. During 3MCY21, the Bank achieved a CAR of 20.9% with contribution from Tier-1 capital (15.6%) and Tier-II (5.3%).

PKR mln

U Microfinance Bank Limited Un-listed Public Limited	Mar-21 3M	Dec-20 12M	Dec-19 12M	Dec-18 12M
A BALANCE SHEET				
1 Total Finances - net	39,801	31,283	20,984	17,007
2 Investments	11,428	17,954	6,970	1,968
3 Other Earning Assets	9,041	8,467	3,009	11,012
4 Non-Earning Assets	7,576	14,286	8,737	4,791
5 Non-Performing Finances-net	(1,049)	(1,277)	390	13
Total Assets	66,797	70,713	40,090	34,792
6 Deposits	46,029	46,105	23,290	20,535
7 Borrowings	13,318	17,285	12,684	10,628
8 Other Liabilities (Non-Interest Bearing)	1,478	1,648	1,065	820
Total Liabilities	60,826	65,038	37,039	31,983
Equity	5,969	5,674	3,051	2,809
B INCOME STATEMENT				
1 Mark Up Earned	2,937	10,134	7,266	4,407
2 Mark Up Expensed	(1,277)	(4,342)	(3,843)	(1,702)
3 Non Mark Up Income	262	1,263	939	599
Total Income	1,922	7,055	4,363	3,305
4 Non-Mark Up Expenses	(1,219)	(4,295)	(3,220)	(2,261)
5 Provisions/Write offs/Reversals	(157)	(1,580)	(838)	(260)
Pre-Tax Profit	546	1,180	304	784
6 Taxes	(137)	(274)	(51)	(237)
Profit After Tax	409	906	254	547
C RATIO ANALYSIS				
1 Performance				
Net Mark Up Income / Avg. Assets	9.7%	10.5%	9.1%	10.3%
Non-Mark Up Expenses / Total Income	63.4%	60.9%	73.8%	68.4%
ROE	28.1%	20.8%	8.7%	26.1%
2 Capital Adequacy				
Equity / Total Assets (D+E+F)	8.9%	8.0%	7.6%	8.1%
Capital Adequacy Ratio	20.9%	21.7%	16.7%	19.0%
3 Funding & Liquidity				
Liquid Assets / (Deposits + Borrowings Net of Repo)	40.0%	40.2%	32.5%	46.4%
(Advances + Net Non-Performing Advances) / Deposits	84.2%	65.1%	91.8%	82.9%
Demand Deposits / Deposits	5.1%	6.4%	10.2%	10.1%
SA Deposits / Deposits	40.3%	36.4%	26.1%	30.2%
4 Credit Risk				
Non-Performing Advances / Gross Advances	1.2%	0.1%	4.1%	1.3%
Non-Performing Finances-net / Equity	-17.6%	-22.5%	12.8%	0.4%

Credit Rating

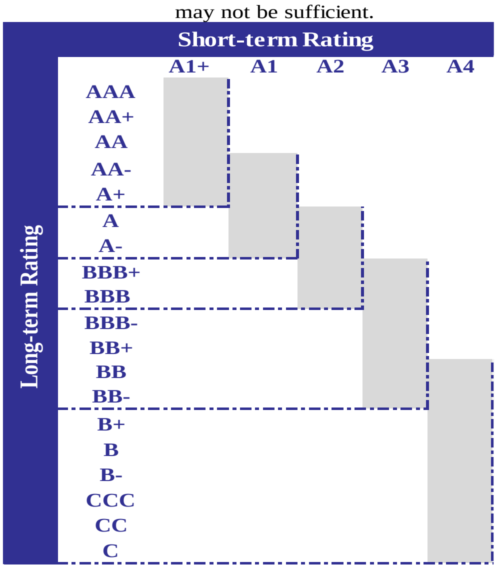
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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

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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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(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)
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(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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