The Pakistan Credit Rating Agency Limited

Rating Report

Khushhali Microfinance Bank Limited | PPTFC | TBI

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
24-May-2022	A-	-	Stable	Preliminary	-

Rating Rationale and Key Rating Drivers

The assigned rating of the instrument of Khushhali Microfinance Bank Limited (or "KMBL" or the "Bank") takes comfort of the prominent position of KMBL as the leading provider of microcredit services in the microfinance sector of Pakistan. Currently. KMBL is having a market share of ~ 18% at Dec'21 (Dec'20: 19%) in the gross loan portfolio. The rating draws comfort from the bank's association with Unite Bank Limited (UBL) - the second largest private sector Bank in Pakistan with a strong and well-diversified domestic franchise. The rating incorporates the uncertainty involving the financial risk profile of the bank as around 40% of the total performing portfolio is categorized as rescheduled in light of SBP’s directions to relax repayment terms for borrowers effected by the COVID-19. Hence, the rating will remain sensitive to the recovery of both amounts placed under deferred loan and accrued mark-up category which has also increased by 27% as at Dec'21 as compared to last year. The uncertainty in the portfolio during restructured tenure has impacted profitability. The Bank has planned to issue PPTFC-Tier I, amounting to PKR 1,500mln to strengthen capital adequacy further. While the liquid investments (majorly in Gov. securities) are 24% of total assets. Three major shareholders are considering the aggregate stake sale to a consortium of renowned strategic investors; the divestment process in underway and is expected to be completed by Jun'22.

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 bank’s propensity to protect its performance indicators amidst constrained business environment, is imperative.

Disclosure

Name of Rated Entity	Khushhali Microfinance Bank Limited | PPTFC | TBI
Type of Relationship	Solicited
Purpose of the Rating	Debt Instrument Rating
Applicable Criteria	Methodology | Debt Instrument Rating(Jun-21),Methodology | Microfinance Institution Rating(Jun-21),Criteria | Rating Modifiers(Jun-21)
Related Research	Sector Study | Microfinance(Sep-21)
Rating Analysts	Madiha Sohail | madiha.sohail@pacra.com | +92-42-35869504

Issuer Profile

Profile Khushhali Microfinance Bank Limited (or "KMBL" or the "Bank") (previously Khushhali Bank Limited) incorporated in 2000 with proclamation of Khushhali Ordinance by Government of Pakistan. Subsequently, it was transformed into a public limited company in 2008. KMBL takes pride in being the largest microfinance bank in Pakistan. In 2021, KMBL was able to expand its outreach with 240 provincial branches, 5 SME branches, 18 permanent booths and 15 post office booths, building up the largest network of microfinancing institutes in Pakistan

Ownership The Bank is owned by United Bank Limited (UBL) (30%), Rural Impulse Fund (24%), Responsibility Global MF (20%), Shore cap II Limited (14%), ASN-NOVIB (10%) and Bank AL-Habib (2%). Three major shareholders are considering the aggregate stake sale to a consortium of renowned strategic investors; the divestment process in underway and is expected to be completed by Jun'22. UBL is an "AAA" rated bank with an asset base of PKR 2.6bln and equity base of PKR 204mln as at Dec'21.

Governance The Board is chaired by Aameer Karachiwalla. Mr. Ameer with over 30 years of experience, is a Chartered Accountant from the Institute of Chartered Accountants of England & Wales. privatization. He is also the Chairman of the Board at UBL Insurers Ltd. and 1Link. Before joining UBL. Mr. Aameer held senior positions at a number of financial institutions and multinationals including American Express Bank, Citicorp Investment Bank and Artal Group of Companies.UK National, Robert Binyon graduated in Modern History from Christ Church Oxford and has a long experience of the banking industry around the globe.

Management M.Ghalib Nishtar is the founding President of Khushhali Microfinance Bank, Pakistan's largest microfinance bank. Saleem Akhtar Bhatti is a fnance expert with more than 25 years of industry experience. Amina Hassan is a well-rounded service-sector professional with profound experience in managing grassroots initiatives for socio-economically vulnerable groups.

Business Risk Pakistan Microfinance Industry (MFI) comprises of 50 microfinance providers including 30 microfinance institutions (MFIs). During CY21, active borrowers of the industry exceeded pre-COVID figure to 8.1 million borrowers after recording growth of 16% compared to CY20. Similarly, the GLP surpassed PKR 390 billion during CY21, an increase of 21% compared to CY20. The growth in active borrowers and GLP continues to be driven by the MFB peer group as they managed to add over one million clients and PKR 52 billion in GLP. NBMFC peer group also contributed to portfolio growth with an addition of PKR 16.7 billion. In case of MFBs, PAR > 30 days increased to 5.1% (CY20: 3.3%) on account of expiration of loan deferment period allowed by SBP. However, the PAR > 30 days of MFIs recovered to report at 2.9% in CY21 (CY20: 4.7%). The Bank catered to 22% of the active borrowers of the microfinance industry as at End-CY21, grabbing a 9% market share in terms of Gross Loan Portfolio. On the other hand, the bank secured a share of 13% of total deposits in the industry, as at End-CY21. During CY21, mark-up income earned by the Bank increased to PKR 11,082mln (CY20: PKR 7,059mln) with a considerable increase of 57%. Loss from branchless banking in CY21 clocked in at PKR 1088mln (CY20: PKR 643mln), indicating an increase of 69%. Markup expense for CY21 increased by 2% to PKR 1,697mln (CY20: PKR 1,656mln). The Bank witnessed an upsurge of 62% in its non-markup expense to PKR 6,977mln (CY20: PKR 4,300mln). The Bank's provisioning expense increased to PKR 988mln (CY20: PKR 202mln), indicating a surge of 4.9x. Consequently, net income increased to PKR 728mln during CY21 (CY20: PKR 530mln).

Financial Risk During the year, provision charges on classified loan portfolio increased to PKR3.960bln (2020: PKR 2.992bln), an increase of 32% YOY due to performance issues of Deferred & Reschedule Portfolios. The bank has prudently increase general provision reserve to 1.90% against the regulatory requirement of 1.0% on total loan portfolio at the end of 31 Dec'21. The Bank reported Profit Before Tax (PBT) of PKR 0.87bln (2020: PKR 2.39bln) and Profit After Tax (PAT) of PKR 0.57bln (2020: PKR 1.74bln) for the year ended 31 Dec'21, a reduction of 64% in PBT & 67% in PAT YOY. The net markup income slightly declined by 2% and closed at PKR 9.69bln (2020: PKR 9.94bln). Markup revenue on loans remains stable at PKR 18.6bln, the growth of loan portfolio of 17% helped offset the interest income losses on rescheduled portfolio. The profit margin fell due to major increase in requisite provisions, revenue suspensions against non?performing bullet deferred and rescheduled loans, and partly due to declining net interest margins attributable to monetary easing. During the year under review, Bank's total asset registered a growth of 9% and the asset base increased to PKR 116.52bln (2020: PKR 107.12bln). Net advances to total assets also increased to 61% from 57% of last year. The equity of the Bank increased byPKR. 391mln and closed at PKR 11.18bln from PKR 10.79bln of last year, growth of 4% YOY. The bank has consolidated its liquidity position and based on improvement in business conditions the liquid assets are held at 24% of total assets.

Instrument Rating Considerations

About The Instrument KMBL is in process of issuing Rated, Privately Placed Listed/ DSLR, Unsecured, Subordinated, perpetual Tier I Term Finance Certificates (TFC) of up to PKR 1,500mln (inclusive of PKR 300mln GSO) to contribute towards the bank's Tier I capital for complying with the Capital Adequacy Ratio (CAR) requirement prescribed by the SBP for Microfinance Banks. The profit will be payable semi-annually, with the rate of 6MK+4%. The instrument will be subordinated to the payment of principal and profit to all other claims except common shares. The issuer may call the TFCs, in parts or in full, after five years from the issue date on the principal redemption date, thereafter, subject to prior approval from the State Bank. The call option once announced will not be revocable. As per the lock-in clause requirement for tier I issues, neither profit nor principal would be payable (even at maturity), if such payment will result in a shortfall in Bank's minimum capital requirement, leveraged ratio or capital adequacy ratio or results in an increase in any existing shortfall in MCR, LR or CAR. The TFC will be subject to loss absorbency clause, upon the occurrence of a point of Non-Viability event, SBP may fully or permanently convert the TFCs into common shares of the Bank. The TFC will be subject to loss absorption upon the occurrence of a pre-specified trigger. According to which if KMBL's common equity Tier-I ratio falls to or below 6.625% of Risk Weighted Assets, the KMBL will have full discretion to determine the amount of TFCs to be permanently converted into common shares or written off, subject to prior approval of SBP.

Relative Seniority/Subordination Of Instrument The instrument will be subordinated as to payment of principal and profit to all other claims except common shares disbursement.

Credit Enhancement The transaction will be unsecured.

PKR mln

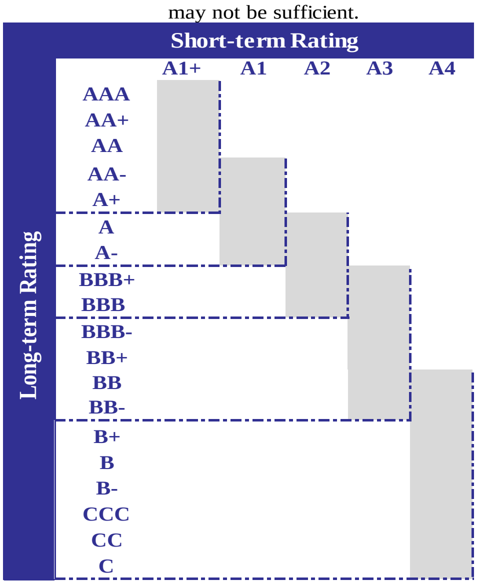
Khushhali Microfinance Bank Ltd Public Limited			Dec-21 12M	Dec-20 12M	Dec-19 12M	Dec-18 12M
A	**BALANCE SHEET**					
	1	Total Finances - net	67,767	58,755	51,064	42,833
	2	Investments	14,090	17,680	10,112	8,916
	3	Other Earning Assets	10,277	11,548	4,631	9,336
	4	Non-Earning Assets	21,273	17,234	13,209	8,720
	5	Non-Performing Finances-net	3,117	1,886	2,477	667
		Total Assets	116,524	107,103	81,493	70,472
	6	Deposits	93,162	88,650	63,882	56,018
	7	Borrowings	7,608	2,828	3,726	3,965
	8	Other Liabilities (Non-Interest Bearing)	4,569	4,831	4,486	2,290
		Total Liabilities	105,339	96,309	72,094	62,273
		Equity	11,185	10,794	9,399	8,198
B	**INCOME STATEMENT**					
	1	Mark Up Earned	18,653	18,670	15,259	11,926
	2	Mark Up Expensed	(8,961)	(8,732)	(6,799)	(4,590)
	3	Non Mark Up Income	1,995	1,543	1,973	1,639
		Total Income	11,686	11,481	10,433	8,974
	4	Non-Mark Up Expenses	(6,856)	(6,097)	(5,655)	(4,726)
	5	Provisions/Write offs/Reversals	(3,960)	(2,992)	(2,259)	(778)
		Pre-Tax Profit	870	2,392	2,519	3,470
	6	Taxes	(298)	(652)	(682)	(1,012)
		Profit After Tax	572	1,740	1,836	2,459
C	**RATIO ANALYSIS**					
	1	**Performance**				
		Portfolio Yield	27.7%	31.3%	31.1%	27.7%
		Minimum Lending Rate	29.4%	30.4%	29.7%	22.7%
		Operational Self Sufficiency (OSS)	104.7%	112.9%	115.8%	132.7%
		Return on Equity	4.9%	15.9%	17.5%	31.8%
		Cost per Borrower Rupees	8,072	6,962	6,997	6,651
	2	**Capital Adequacy**				
		Net NPL/Equity	27.9%	17.5%	26.4%	8.1%
		Equity / Total Assets (D+E+F)	9.6%	10.1%	11.5%	11.6%
		Tier I Capital / Risk Weighted Assets	13.2%	14.4%	14.2%	15.9%
		Capital Adequacy Ratio	18.3%	19.1%	19.2%	18.9%
		Capital Formation Rate [(Profit After Tax - Cash Dividend) / Equity]	5.1%	16.1%	16.8%	28.9%
	3	**Funding & Liquidity**				
		Liquid Assets as a % of Deposits & Short term Borrowings	26.8%	32.9%	19.6%	23.6%
		Demand Deposit Coverage Ratio	243.4%	349.6%	159.9%	168.1%
		Liquid Assets/Top 20 Depositors	157.0%	182.3%	140.6%	231.5%
		Funding Diversification (Deposits/(Deposits+Borrowings+Grants))	92.4%	96.9%	94.5%	93.4%
		Net Advances to Deposits Ratio	76.1%	68.4%	83.8%	77.7%
	4	**Credit Risk**				
		PAR 30 Ratio	6.5%	5.4%	6.8%	3.1%
		Write Off Ratio	5.6%	4.8%	3.5%	1.5%
		True Infection Ratio	11.2%	9.5%	9.7%	4.6%
		Risk Coverage Ratio (PAR 30)	34.3%	43.7%	33.7%	52.0%

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):

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

Proprietary Information

Regulatory and supplementary Disclosure

Nature of Instrument	Size of issue	Date of Issue	Years	Security	Quantum of security	Nature of Assets	Book value of Assets (PKR mln)	Trustee
PPTFC-TBI	1.5bln	To be Decided	Perpetual	Unsecured and subordinated as to payment of principal and profit to all other indebtedness of the bank, including deposits and will not be redeemable before maturity without prior approval of SBP.	N/A	N/A	N/A	The Bank of Punjab (BOP)

Khushhali Microfinance Bank Limited | PPTFC | TBI| Redemption Schedule

Due Date Principle	Opening Principal	Principal Repayment	Due Date Markup/ Profit	Markup/Profit Rate (6MK+ 4%)	6M Kibor	Markup/Profit Payment	Installment Payable	Principal Outstanding
	PKR in mln					PKR in mln		

Redemption Schedule not applicable since its a perpetual TFC whereby there is no fixed or final redemption date. Profit (if declared) will be payable semi-annually in arrears, on a non-cumulative basis, on the outstanding TFC amount. The first such profit payment will fall due six months from the Issue Date and subsequently every six months thereafter subject to complying with regulatory requirements. The instrument carries a call option which may be exercised after Dec-22 (5 years), subject to approval of the SBP.