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
15-Apr-2022	A	A1	Negative	Maintain	Yes
28-Apr-2021	A	A1	Stable	Maintain	Yes
28-Apr-2020	A	A1	Stable	Maintain	Yes
29-Oct-2019	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 incorporates the association of FINCA ("the Bank") with a global microfinance organization – FINCA International. This affiliation supports FINCA Microfinance Bank in terms of building a strategy and also in establishing robust systems and controls. FINCA is a mid-tier player in Pakistan's microfinance sector with ~4.3% share in total gross loan portfolio. The Bank reflects its presence across the province with 130 branches in and around 13 districts. While growth strategies for the Bank have been taken under consideration, overall performance indicators reflected a deteriorated outlook in CY21 amidst economic slowdown lately exacerbated by the aftermaths of global pandemic spread. Consequently, the Bank's GLP witnessed a substantial decline. Asset quality impaired significantly, as deferred book to total GLP was sizeable. Further challenges in recovery and markup suspension led to decreased markup earned. SBP's recent circular pertaining to further relaxation in recording provisioning expense of NPLs is expected to bring reversal. However, full recovery of principal amount will remain essential to avoid further dent in profitability. Bottom line of the Bank decreased manifold. Management's commitment to recoup the asset health and consolidate the Bank's position within the stipulated time is an acute necessity. Moreover, since the projected outlook of the Bank indicates absorbing significant cash losses, timely yet matching sponsor support through Equity injections is essential. Though SBP's Relief Packages have come handy to the sector in protecting the credit quality of the players during the previous waves, the out-turn of the situation, and its relative impact on the risk profiles of industry players, including FINCA, is yet to unfold in the days to come.

The ratings are dependent upon the out-turn of management's plans to steer the risk profile of the Bank towards improved trajectory. Timely Sponsor Support is imperative. The assigned outlook is reflective of the short-term challenges that the Bank's business and financial risk profile are facing, particularly reflecting in high infection ratio and diminution in GLP along-with constrained profitability. "Watch" reflects the need to oversee the risk profile of the Bank against unavoidable challenges, going forward.

Disclosure

Name of Rated Entity	FINCA Microfinance Bank Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Microfinance Institution Rating(Jun-21),Criteria | Correlation Between Long-term & Short-term Rating Scales(Jun-21),Criteria | Rating Modifiers(Jun-21)
Related Research	Sector Study | Microfinance(Sep-21)
Rating Analysts	Sehar Fatima | sehar.fatima@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 128 branches.

Background Originally, Kashf Holdings (Pvt.) Ltd. established the Bank in 2008 with the name of KASHF Microfinance Bank Ltd. 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 (ii) FINCA Izafi Karza (iii) FINCA Kashtkar Karza (for farmers) (iv) FINCA Maweshi Karza (Livestock) & (v) FINCA Sonehri Karza (Gold-backed loans). The bank is also establishing its foothold in branchless banking operations.

Ownership

Ownership Structure The bank is majorly owned by FINCA Microfinance Cooperatief U.A. (86.4%), followed by Kashf 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 Microfinance Cooperatief U.A. A representative of minor shareholding of Kashf Holdings (Pvt.) Ltd. and three independent directors complete the composition of the Board.

Members' Profile 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 formed to oversee operations and progress in the digital banking domain.

Transparency 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. Financial Statements for the year ended 31 December 2021 and Audit Report thereon shall be published by the Bank in due course.

Management

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

Management Team Mr. Jahanzeb Khan - CEO – possesses 24 years of experience with one of the largest financial services institutions including JPMorgan Chase & Co., Blue Chip Management Consulting firm, Deloitte Consulting, and Telenor Microfinance Bank (Easypaisa). He 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 timely decision making of management, the 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 the Board's approved limit.

Technology Infrastructure The management has taken numerous steps towards digitizing its processes. The aim is 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 (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%).

Relative Position The bank catered to 2.5% of the borrowers of the industry (including MFIs, RSPs and other projects) as at end-Dec'21, grabbing a 4.3% market share in terms of GLP.

Revenue Interest/Mark up income of the Bank depicted a decline as compared to the corresponding period. The fall was due to the decline in fresh disbursements during CY21. Challenges in recovery and markup suspension caused further diminution. Net interest income also experienced downfall.

Profitability The Bank's profitability took a major hit during CY21. Bank's performance during the period wasn't sufficient to cover the expenses including operating expenses, provision expense and taxes.

Sustainability Digital services remain to be the key driving force on the bank's growth. The bank's flagship product SimSim is growing steadily, with more than 450,000 customers. 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 has and will put pressure on the growth prospects, liquidity and future infection of the loan book, of all industry players.

Financial Risk

Credit Risk FINCA's loan book is primarily concentrated in non-collateralized loans while representing a fairly diversified product segmentation in Micro-Enterprise loans (35%), followed by Livestock loans (32%), and Agri-Input loans (32%). The bank's infection ratio increased during CY21, getting larger impact from deferred book.

Market Risk Short term investments as at end-Dec'21 increased. The addition majorly consisted of further investment in government securities.

Funding The Bank's funding is majorly fueled through deposits constituting 83% of the funding of the bank. Deposit base primarily consisted of time deposits (54%). The bank's advances-to deposit ratio (ADR) declined to 74.1% (End-Dec'20: 81.5%), driven by the decrease in advances.

Cashflows & Coverages Liquidity profile slightly improved during the year, as the bank's liquid assets-to-deposits and borrowings ratio rose to 39.9% at end-Dec'21 (End-Dec'20: 34.4%). Surge in investments led to increase in liquid assets on an overall basis.

Capital Adequacy Capital Adequacy ratio (CAR) stood at 15.2% as at End-Dec'21 (End-Dec'20: 20.9%). The Bank is in compliance with the regulatory requirement of 15% CAR. Equity base decreased, driven by decrease in unappropriated profit.

			PKR mln
FINCA Microfinance Bank Limited	**Dec-20**	**Dec-19**	**Dec-18**
Public Unlisted Company	**12M**	**12M**	**12M**
A BALANCE SHEET			
1 Total Finances - net	20,811	21,425	20,477
2 Investments	6,449	6,244	3,827
3 Other Earning Assets	2,688	1,446	2,489
4 Non-Earning Assets	9,468	7,582	5,382
5 Non-Performing Finances-net	435	614	104
Total Assets	39,851	37,312	32,280
6 Deposits	26,083	23,911	23,742
7 Borrowings	5,511	5,553	3,319
8 Other Liabilities (Non-Interest Bearing)	3,014	3,129	1,187
Total Liabilities	34,607	32,594	28,247
Equity	5,243	4,716	4,030
B INCOME STATEMENT			
1 Mark Up Earned	8,629	8,312	6,531
2 Mark Up Expensed	(3,039)	(2,998)	(1,828)
3 Non Mark Up Income	845	954	802
Total Income	6,435	6,269	5,505
4 Non-Mark Up Expenses	(3,824)	(4,168)	(3,490)
5 Provisions/Write offs/Reversals	(1,228)	(1,090)	(435)
Pre-Tax Profit	1,383	1,012	1,580
6 Taxes	(478)	(358)	(623)
Profit After Tax	905	653	956
C RATIO ANALYSIS			
1 Performance			
Net Mark Up Income / Avg. Assets	14.5%	15.3%	16.4%
Non-Mark Up Expenses / Total Income	59.4%	66.5%	63.4%
ROE	18.2%	14.9%	26.2%
2 Capital Adequacy			
Equity / Total Assets (D+E+F)	13.2%	12.6%	12.5%
Capital Adequacy Ratio	20.9%	19.8%	15.9%
3 Funding & Liquidity			
Liquid Assets / (Deposits + Borrowings Net of Repo)	34.4%	32.2%	29.4%
(Advances + Net Non-Performing Advances) / Deposits	81.5%	92.2%	86.7%
Demand Deposits / Deposits	10.6%	9.3%	8.4%
SA Deposits / Deposits	32.3%	22.0%	21.3%
4 Credit Risk			
Non-Performing Advances / Gross Advances	3.4%	4.7%	1.9%
Non-Performing Finances-net / Equity	8.3%	13.0%	2.6%

Credit Rating

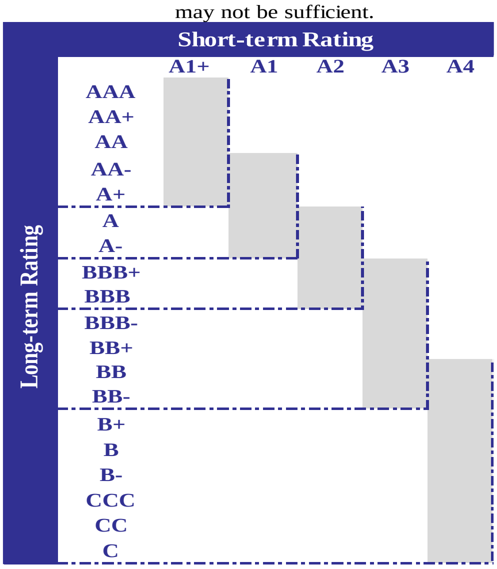
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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)
Proprietary Information